OXFORD | HARRIMAN & COMPANY

Second Quarter 2022 Commentary

An Oxford Harriman & Company Market Commentary

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Looking Back at a Rocky First Half

Financial markets remained unsettled during the second quarter as investors continued to search for direction amid a sea of changing condition, and uncertainty. Unfortunately, the overall direction of the markets remained to the downside. The S&P 500 finished the second quarter with its worst three-month period since the first quarter of 2020 and worst first half of a calendar year since 1970. This commentary recaps the first half of 2022 and discusses the top investment themes heading into the second half of 2022.

2nd Quarter Sees a Mixture of Old & New Themes

Investors navigated a combination of old and new investment themes during the second quarter. Inflation remained a major headline as the CPI accelerated at a more than 8% year-over-year pace during both April and May. In response to this persistent inflation, the Federal Reserve continued to tighten monetary policy by raising interest rates at each of the April, May, and June meetings. Same as the first quarter, stocks traded lower as the interest rate increases caused investors to sell riskier assets.

Multiple new themes emerged during the second quarter. Several large retailers reported substantial inventory buildups as inflation pressured consumer spending on discretionary items. These retailers warned their profit margins could decline in the coming quarters as they may need to mark down items to sell the merchandise. From a monetary policy perspective, the Fed supplemented its interest rate increases by starting to reduce its balance sheet and unwind quantitative easing. The Fed is opting not to reinvest the proceeds of up to $30 billion of maturing Treasury securities and up to $17.5 billion of maturing mortgage-backed securities per month. This decision is another way for the Fed to decrease the amount of money supply & liquidity in their attempt to slow inflation.

Federal Reserve Gets Aggressive at June Meeting

The Federal Reserve adopted a more aggressive tightening stance at its mid-June meeting. The central bank raised the federal funds rate 0.75% and unveiled a 'strong commitment' to bring inflation back down to 2%. For historical context, June was the first 0.75% increase since 1994. The Fed's latest move is another indication of how 40-year high inflation readings are driving the Fed's monetary policy decisions.

We compared this current tightening cycle to the prior five cycles. Factoring in the 0.75% increase at the June meeting, the Fed has raised interest rates 1.50% since the first increase in March. Investors expect the Fed to maintain its 0.75% pace at the late-July meeting, which would make 2022 the fastest 2.25% increase compared to the last five cycles. Market consensus calls for the Fed to keep raising interest rates at its meetings later this year, although the number and size of the increases remain uncertain.

The June meeting may represent a potential turning point. Throughout the first half of 2022, investors were concerned the Fed was not being aggressive enough to combat persistent inflation. The thinking was inflation could become entrenched if the Fed raised rates too slow, which could force the Fed to raise interest rates for a longer period and to a higher endpoint. The June meeting marks a clear change in the Fed's thinking and indicates the central bank will front-load interest rate hikes if necessary to ease inflation.

The equity rally and declining Treasury yields suggest investors became slightly more confident the Fed's aggressive tightening upfront could get inflation under control sooner. The quicker inflation is under control, the sooner the Fed may be able to slow its interest rate hikes and reevaluate policy decisions.

Investors initially reacted positively to the Fed's updated guidance. The S&P 500 was down approximately 19% from the start of the second quarter through the Fed's meeting on June 16th. From June 16th through June 24th, the S&P 500 gained almost 7%, and Treasury yields declined. The equity rally and declining Treasury yields suggest investors became slightly more confident the Fed's aggressive tightening upfront could get inflation under control sooner. The quicker inflation is under control, the sooner the Fed may be able to slow its interest rate hikes and reevaluate policy decisions.

There is also a potential downside to the Fed's tightening strategy, and the market appears to be focused on this risk as we begin the third quarter. Investors continue to debate how quickly or to what extent the Fed's actions will impact the economy. There is a risk the impact from the Fed's actions is delayed and the Fed keeps raising interest rates, potentially overtightening and slowing economic activity more than expected over the next 12-18 months. This tightening cycle comes off historic lows for yields and historic highs for money printing, and the exact outcome is uncertain.

Economic Data Continues to Point to Softer Growth

The latest economic data indicates investors are justified in worrying about the Fed overtightening and tipping the U.S. economy into a recession. Data has shown slowing across a range of economic indicators including housing, consumer confidence, the labor market, and consumer spending. The data remains strong relative to historical standards, but it does indicate the U.S. economy is starting to soften.

The latest economic data indicates investors are justified in worrying about the Fed overtightening and tipping the U.S. economy into a recession. Data has shown slowing across a range of economic indicators including housing, consumer confidence, the labor market, and consumer spending. The data remains strong relative to historical standards, but it does indicate the U.S. economy is starting to soften.

For example, housing demand soared during the pandemic, but both starts and permits have declined more than 10% on an annualized basis since the end of 2021. The housing market slowdown coincides with a more than 2.50% increase in the 30-year fixed mortgage rate since the end of 2021, suggesting rising mortgage rates are already pressuring housing demand.

Further, recent data shows consumers spent more at gas stations and grocery stores as gasoline and food prices rose and less on discretionary-related goods, such as autos, electronics, and home furnishings. The data offers a near-term look at how high inflation is impacting and shifting consumer spending.

Additionally, the University of Michigan's Consumer Sentiment Index made a new record low of 50 during June as consumer sentiment continued to deteriorate. Weaker consumer confidence coincides with high inflation and points to a worried U.S. consumer, which is concerning because the consumer accounts for nearly 70% of U.S. economic activity.

Finally, while initial jobless claims remain low by historical standard, the trend has reversed from 2021's steady decline as jobless claims drift higher during 2022. Data shows the U.S. continues to add new jobs each month, but the pace of those job gains has slowed significantly compared to 2021.

Finally, while initial jobless claims remain low by historical standard, the trend has reversed from 2021's steady decline as jobless claims drift higher during 2022. Data from the Bureau of Labor Statistics shows the U.S. continues to add new jobs each month, but the pace of those job gains has slowed significantly compared to 2021. The 390,000 jobs added during May 2022 were the slowest pace since April 2021. These measures indicate labor demand is softening, a notable change from the last 12 months when businesses struggled to fill open jobs.

Equity Market Recap

As mentioned earlier, the second quarter remained difficult for equities. The S&P 500 Index lost 16.1%, only slightly outperforming the Russell 2000 Index's -17.3% return. It was an especially difficult quarter for Growth stocks as rising interest rates continued to pressure valuations. The Russell 1000 Growth Index traded down 21.1% and underperformed the Russell 1000 Value Index's -12.3% return. The Nasdaq 100 Index, which investors view as a concentrated Growth index due to its overweight in technology stocks, traded down 22.5% during the second quarter.

Other riskier assets fared even worse during the first half of 2022. Crypto currencies lost more than half their value, with some falling to zero. Pandemic-favorite growth stocks were the ones that entered 2022 the most in favor and with the highest valuation multiples. Many of these stocks subsequently lost more than 40% of their value with some falling far deeper.

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International markets' lower exposure to expensive Growth stocks led to outperformance relative to U.S. markets during the second quarter. The MSCI EAFE Index of developed market stocks declined 13.1% during the quarter, while the MSCI EM Index of emerging market stocks fell 10.4%. Despite international stocks' outperformance during the second quarter, questions remain about the impact of rising energy prices in Europe and tighter financial conditions in emerging markets (i.e., higher interest rates & lower liquidity).

Bond Market Impacted by Rising Treasury Yields

Bonds traded lower during the second quarter as Treasury yields continued to rise in anticipation of tighter Fed policy. Corporate investment grade bonds produced a negative 8.4% total return, slightly outperforming the negative 9.4% total return generated by corporate high yield bonds. While investment grade bonds outperformed in aggregate during the second quarter, the group's outperformance versus high yield bonds primarily occurred during the second half of June after the Fed's new aggressive tightening stance caused investors to grow concerned about slower economic activity.

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Spreads between corporate high yield bonds and Treasury bonds widened significantly during the second quarter. The spread is a measure of credit risk, more specifically how much more yield investors demand to lend to riskier companies. Spreads widened from 3.40% at the start of the second quarter to 5.26% on June 28th. This spread widening indicates investors are concerned about borrowers' ability to make principal and interest payments as financial conditions tighten. Looking back at the past five years, the 5.26% spread is near levels last seen during late 2020, the months following the Covid outbreak, and late 2018, the last time the Fed raised interest rates.

Second Half 2022 Outlook

Entering the third quarter, the outlook remains uncertain. Some investors believe the Fed's actions will dramatically slow economic growth and push the U.S. economy into a recession. Conversely, some investors believe the U.S. economy is strong enough to withstand the Fed's actions and view the stock market as oversold. Volatility is likely to continue until more clarity is gained on some of the following most pressing issues:

While we continue to believe the market will remain volatile as these issues are debated among investors, we do recognize that, historically, the market is forward looking. At some point, the market will have discounted any potential recession and will begin to reflect future growth.

- The direction and impact of Federal Reserve policy
- Inflation's persistence
- War-related food and energy price implications
- The strength of the US Dollar and the impact on domestic earnings
- US economic slowdown and/or recession timing and severity

While we continue to believe the market will remain volatile as these issues are debated among investors, we do recognize that, historically, the market is forward looking. At some point, the market will have discounted any potential recession and will begin to reflect future growth. Our team will continue to monitor the above uncertainties, among others, in the coming months to help guide investment portfolio positioning.

Sincerely,

Dennis P. Barba, Jr.
CEO & Managing Partner

Michael P. Finkelstein, CFA
Partner