DANN ASSET ADVISORS, LLC

Second Quarter 2022 Update

July 12, 2022

2Q22 Highlights

- Stocks fall and enter a bear market, with first-half 2022 the worst start to a year since 1970
- Bonds also fall as interest rates rise and the Fed strongly commits to reducing inflation
- Recession becomes more likely the longer inflation runs hot and the Fed continues tightening
- Inflation may be showing signs of peaking

The table below summarizes the performance of some key indices during the second quarter and year to date:

Market Performance		
Index	% Ch. 2Q22	% Ch. YTD
S&P 500	(16.1)	(20.0)
S&P Mid Cap 400	(15.4)	(19.5)
Russell 2000 (small cap)	(17.2)	(23.4)
MSCI All Country World ex US	(13.7)	(18.4)
US Aggregate Bond	(4.7)	(10.4)
Liquid High Yield	(9.9)	(13.8)

Source: Morningstar, iShares

<u>Equities</u>. After a brief respite in March, the market continued the decline that followed the early January peak. The second quarter's -16.1% return was the worst since the nearly 20% negative return in the March 2020 quarter when the pandemic was leading to lockdowns. We believe two factors contributed to the second quarter's decline.

First, inflation continued higher and more persistent than expected, causing the Fed to raise interest rates faster and potentially more significantly than investors anticipated. Higher interest rates typically reduce the multiple of earnings investors are willing to pay for stocks, with the result that the market fell as prices adjusted. And second, the Fed's tightening without inflation yet falling has likely increased the odds of a recession. Company earnings often fall during a recession, and we believe the prospect of recession and lower earnings led to a second leg down for stocks during the month of June.

As in the first quarter, growth stocks substantially underperformed value, with the Russell 1000 Growth index of large company stocks returning -20.9% compared with "only" -12.2% for the corresponding value index. Smaller company stocks modestly trailed the S&P 500 but international stocks fell less than the U.S., the first time international has outperformed since the fourth quarter of 2020. Given Europe's being more negatively impacted by high energy prices, international's outperformance seems surprising. However, digging below the surface, the international stocks benchmark has a much lower technology weight than the S&P 500's. With tech one of the quarter's worst sectors, its lower weight in the international index was a relative positive.

<u>Fixed income</u>. The 10-year treasury yield began the quarter at 2.33% and rose as high as 3.48% on June 14 in anticipation of the Fed's raising rates 75 basis points (a basis point is 1/100th of a percent) on June 15. But, from there, the 10-year yield fell to 2.97% at quarter end as investors

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began considering that higher rates could help lead to recession. The two-year treasury yield mirrored that of the 10-year, rising from 2.28% on March 31 to as high as 3.44% before retreating to 2.93% on June 30. For perspective on how higher rates can impact consumers and the economy, it's worth noting that mortgage rates have risen to levels not seen since late 2008.

The higher rates led to another exceptionally poor quarter for bonds, bringing the first half return for the Bloomberg US Aggregate Bond index (benchmark for U.S. investment grade bonds) to -10.4%. High yield bonds had outperformed the Bloomberg index during the first quarter but trailed in the second, doing especially poorly during the second half of June. As recession odds increased, investors became more focused on the potential for defaults in higher yielding, riskier bonds, leading to sales and falling prices.

Market sectors(1). All sectors fell during the quarter, with consumer staples, utilities, and energy registering the smallest declines at only 5% to 6% each. Consumer staples and utilities represent the least economically sensitive of the market's eleven main sectors, and they're likely to see the smallest drop-offs in demand from inflation and a slowing economy. The energy sector had been up 66% for the year through mid-June but from there fell 23% into quarter end as investors began focusing on the possibility of recession. For the first half, energy was the only up sector (+30%), with utilities and consumer staples stocks registering the smallest declines at only 1% and 6%, respectively.

On the (very) negative side, consumer discretionary (retailers, homebuilders, and Amazon among the key stocks in the sector) telecommunications (Meta, Alphabet, Disney, and others), and technology (semiconductors, Apple, Microsoft, and others) were the worst performers, with quarterly declines of 20% to 25%. The decline in consumer discretionary stocks likely reflects increasing pressure on consumers, with inflation restraining more discretionary spending. Communications and technology also are cyclical sectors exposed to potentially slowing consumer spending. These two sectors also tend to include higher multiple stocks, and high multiples/valuations compressed as interest rates rose. These same three sectors were the worst performers for the first six months, with consumer discretionary declining the most, at -33%.

Portfolio Positioning

Most clients' fixed income portfolios are 90% or more in investment grade mutual funds and 75% to 80% in short duration (which we define as three years or less) funds. For a handful of clients, we sold part of an intermediate term tax exempt bond fund with proceeds into a similar but much smaller fund that had recently reopened to new investors. We believe the managers of the smaller fund may be better able to take advantage of market inefficiencies to deliver good returns. On equities, we sold two actively managed U.S. focused mutual funds, with proceeds put into existing positions with some retained in cash.

Analysis and near-term outlook. In our April 11, first-quarter update we stated that "[i]nflation – its level, duration, and the Fed's reaction to it – is the key issue for the economy and market over the remainder of 2022 in our opinion." Since then, inflation has come in stronger than anticipated, with the consumer price index increasing 8.6% in May. As a result, the Fed raised its key lending rate 75 basis points at its June meeting and indicated that the next several meetings could see increases in the 50 to 75 basis point range.

In April, our base case was that the Fed would deliver a soft landing for the economy, but that recession was much more likely than continued strong growth and moderating inflation. We now view recession as significantly more likely, with the severity of a downturn depending, still, on the

level and duration of inflation (which will determine the Fed's interest rate policies). In essence, the longer high inflation persists the higher interest rates are likely to go and, potentially, the deeper the ensuing downturn.

We are not experts on the economy but note that the pandemic has led to unusual extremes. The economic downturn in the second quarter of 2020 as Covid hit was one of the sharpest and shortest on record. This was followed by the one of the strongest recoveries, as monetary and fiscal stimulus, vaccines, reopening, and pent-up demand led to a surge in consumer spending. Finally, this surge in spending combined with supply chain issues, labor shortages, underinvestment in energy, and, finally, the war in Ukraine, caused inflation to spike to levels not seen since the early 1980s. And all of this occurred in a roughly two-year period.

Our guess is that current inflation and higher interest rates combined with a Fed that continues to tighten monetary conditions will lead to the economy slowing more quickly and significantly than investors have been expecting. In essence, we believe the pandemic-induced trend of shortened cycles will continue. In this environment, the market should see a turn away from the sectors that have worked for most of 2022, and toward sectors and businesses that can generate growth and maintain strong profitability during a downturn. While one month doesn't make a trend, we may have seen the beginning of this during June with the downturn in energy stocks.

As of early July, the S&P 500 was trading at 16.0x the average of 2022 and 2023 consensus earnings estimates[3]. This compares to 16.5x over the past 25 years[4]. Unfortunately, we expect earnings estimates to come down (as often occurs as the economy is slowing) and anticipate that company managements will begin highlighting this as second quarter earnings are reported beginning later this month. In our opinion, if stocks don't make another significant move down as managements present more pessimistic outlooks as we expect, it may mean the market is close to a bottom.

We believe there are two risks to our outlook, both of which could lead to more prolonged trouble for the economy and stocks. The first is that the Fed is not aggressive enough in reigning in inflation, with the result that it gets ingrained in consumer expectations and persists for longer than we expect. The second relates to energy and other key commodities (wheat and aluminum, for example). If the war in Ukraine expands, many commodities likely will make another move higher, further exacerbating inflation and restraining consumers' discretionary spending and the economy.

(1) Market sector performance numbers based on Vanguard sector ETFs' performance.
(2) The Bespoke Report, July 1, 2022.
(3) Yardeni Research, Inc. July 5, 2022, S&P 500 Earnings Forecast.
(4) FactSet, May 9, 2022, S&P 500 Forward P/E Ratio Dips Below 18.0x For The First Time Since Q2 2020.

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