Herbert R. Smith and Company

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	2Q	YTD
DOW	-10.77	-14.44%
S&P	-16.10	-19.97
NASDAQ	-22.27	-29.22
10-Yr Treasury		3.01%
10-Yr Municipals		2.85%
Fed Funds		1.58%
GOLD	$1807.27	
SILVER	$20.27	

Inside this issue:

Market Risks: Higher Energy Costs, Inflation, Higher Rates, and Looming Recession Push Stocks and Bonds Lower in the Second Quarter

Initial optimism following strong first quarter earnings has been derailed by all of the above, plus continuing high energy costs and the Russia/Ukraine conflict. The S&P continued to decline in the second quarter, hitting the lowest level since December 2020.

After a rebound in March, the market dropped sharply by the end of April. While some of the reasons for the declines were similar to the first quarter, the primary catalyst for the April sell-off was something new: a massive COVID-related lockdown in China. Unlike most of the rest of the world, China continues to enforce a "Zero-COVID" policy where small outbreaks are met with city and province-wide lockdowns. At the peak of the recent COVID outbreak and subsequent lockdowns it was estimated 300 million people representing nearly 80% of China's economic output were shut in and shut down; essentially halting the world's second largest economy. This sharp drop in economic activity not only increased the chances of a global recession, but also compounded global supply chain problems. Shanghai, the world's busiest port, operated far below capacity during the lockdowns. The severe decline in economic activity in China combined with lingering concerns about rising interest rates and high inflation hit stocks hard in April and the S&P fell 8.7%.

The selling continued as the Fed raised interest rates by 50 basis points at the May 4th meeting, the single biggest rate hike in 22 years. Additionally, Fed Chair Powell clearly signaled that the Fed would continue to hike rates aggressively and that weighed on stocks, pressuring the markets to fall to new 2022 lows in mid-May. Towards the end of the month, markets staged a modest rebound. First, as COVID cases declined, the Chinese economy started to reopen and by the end of May the port of Shanghai was operating at 80% capacity, a material improvement from earlier in the month. Additionally, Atlanta Fed President Bostic stated the Fed might "pause" rate hikes in the late summer or early fall and that gave investors some hope that the end of the rate cycle may be closer than previously thought. Combined with deep, short-term oversold conditions in equity markets, a solid rally in late May allowed the S&P to finish the month with a fractional gain.

But the relief didn't last long. On June 10th, May CPI rose 8.6% year-over-year, the highest reading since 1982. That prompted a reversal in the late May gains which was compounded when the Fed increased interest rates 75 basis points on June 15th, the biggest rate hike since 1994. Additionally, Fed Chair Powell again warned that similar rate hikes are possible in the coming months. The high CPI reading combined with the greater-than-expected rate hike hit the market hard, especially tech stocks, and the market dropped sharply in mid-June. During the last two weeks of the quarter markets stabilized as commodity prices declined and U.S. economic data showed a clear moderation in activity, rekindling hopes that a peak in inflation and an end to the rate hike cycle might come sooner than later. Add the fact that markets had become near-term oversold again, this resulted in a modest bounce in the month, however, the S&P still finished with a negative return for June.

In sum, the factors that pressured stocks in the first quarter, including higher energy costs, inflation, sharply higher interest rates, geopolitical unrest, and rising recession fears, also weighed on stocks in the second quarter and until investors get relief from these headwinds, markets will remain volatile.

Second Quarter Performance Review

All four major stock indices posted negative returns for the second straight quarter, and like in the first quarter, the tech-heavy Nasdaq underperformed, primarily thanks to rising interest rates, while the Dow relatively outperformed. Also, like the first quarter, rising rates and growing fears of an economic slowdown fueled the continued rotation from high valuation, growth-sensitive tech stocks to sectors of the market that are more resilient to rising rates and slowing economic growth.

By market capitalization, large-cap stocks again outperformed small-cap stocks in the second quarter, although the performance gap was small. Small-cap stocks are typically more reliant on debt financing to sustain their businesses, and therefore, more sensitive to rising interest rates than large-cap stocks. Additionally, investors moved to the relative safety of large caps amidst rising risks of a future slowing of economic growth or recession.

From an investment style standpoint, both value and growth registered losses for the second quarter, a departure from the first quarter where value posted a positive return. However, value did again handily outperform growth on a relative basis in the second quarter. Investors continued to flee growth-oriented tech stocks and rotate to more fairly valued sectors of the market, although both styles finished the quarter with negative returns.

On a sector level, all 11 S&P 500 sectors finished the second quarter with negative returns. Relative outperformers included traditionally defensive sectors such as utilities, consumer staples, and healthcare, which are historically less sensitive to a potential economic slowdown, and the quarterly losses for these sectors were modest. Energy was also a relative outperformer thanks to high oil and gas prices for much of the second quarter, although a late-June drop in energy commodities caused the energy sector to finish the quarter with a small loss.

Sector laggards in the second quarter were similar to those in the first quarter, with communication services, tech, and consumer discretionary sectors seeing material declines due to broad rotation away from the more highly valued corners of the market. Specifically, internet stocks weighed on the communications sector, while traditional retail stocks were a drag on the consumer discretionary sector following unexpectedly bad earnings from several major national retail chains. Financials also lagged in the second quarter thanks to rising fears of a future recession combined with a flattening yield curve, which can compress bank profit margins.

Internationally, foreign markets declined in the second quarter as the Russia-Ukraine war continued with no signs of a ceasefire in sight. However, foreign markets relatively outperformed U.S. markets as foreign central banks are expected to be less aggressive with future rate increases compared to the Fed. Emerging markets outperformed developed markets thanks to high commodity prices for most of the quarter and despite rising global recession fears.

Fears of a global recession hit most commodities at the end of the quarter and erased what was, up to that point, a positive performance for broader commodities. Oil finished the quarter with a small loss. Prior to late June, oil prices were sharply higher, but rising fears of reduced future demand and increased supply weighed on the oil market into the end of the quarter. Gold, meanwhile, turned negative despite the increase in market volatility and multi-decade highs in inflation as the strong dollar and rising real interest rates weighed on the yellow metal.

Switching to fixed-income markets, most bond indices again suffered negative returns as inflation and the prospect of faster-than-expected rate increases from the Fed are anticipated. Shorter-term Treasury Bills outperformed and came in with a slightly positive return.

Corporate bonds underperformed in the second quarter as rising recession fears paired with already-high inflation weighed considerably on corporate debt. For much of the quarter, high-quality investment-grade bonds and lower-quality high yield corporate bonds had similar negative returns, implying investor concerns about a future recession were general in nature. However, disappointing economic data hit high-yield corporate bonds at the end of the quarter and they underperformed their higher-quality counterparts.

Third Quarter Market Outlook

The S&P 500 just realized its worst first-half performance since 1970, inflation is at 40-year highs, the Fed raised interest rates at the fastest pace in decades, while the world's second-largest economy effectively shut down and the Russia-Ukraine war rages on.

But while the volatility and market declines of the first six months of 2022 have been unsettling and painful, we believe the markets have aggressively priced in higher inflation and additional rate hikes and now sits at a much more historically attractive valuation level, opening the possibility of positive surprises as we move forward in 2022. If we see a definitive peak in inflationary pressures in the coming months, then it's likely the Federal Reserve will hike rates less than currently feared, and that could be a materially positive catalyst for markets and the economy.

On economic growth, the Chinese economic shutdown has increased global recession concerns, but recently officials in Shanghai declared "victory" against the latest COVID outbreak. If Chinese economic activity can return to normal, that will be a positive development for the supply chain and global economic growth. Meanwhile, recession fears are rising in the U.S., but stocks are no longer richly valued, and as a result aren't as susceptible to an economic slowdown as they were at the start of the year.

Opportunity & Potential Returns

Finally, regarding geopolitics, the human tragedy in Ukraine continues with no end in sight, but the conflict has not expanded beyond Ukraine's borders. NATO expanding to include Finland and Sweden will certainly weigh in favor of Ukraine, and any resolution will likely reduce commodity prices (including food) and global recession fears should decline as well.

With a lot of potential "bad news" already priced into stocks and bonds at these levels, there is an opportunity for potential positive surprises. To that point, the S&P 500 has declined more than 15% through the first six months of the year five previous times since 1932. And in all those instances, the S&P 500 registered positive return for the final six months of those years. More importantly, through each of those declines, markets eventually recouped the losses and moved to considerable new highs.

We understand the risks facing both the markets and the economy, and are committed to effectively navigating this challenging investment environment. With a diversified approach to meet long-term goals targeted on your financial position, risk tolerance and time horizon, it is critical to stay invested, remain patient, and stick to the plan.

Herbert R. Smith & Company has been providing investment advice to institutional and wealth-management clients for almost 50 years. Our expertise in managing assets has assisted our clients in meeting their financial goals without moving beyond reasonable risk guidelines. Our mission statement is:

To provide professional investment advisory services helping clients accumulate and maintain financial wealth through conservative long-term investment strategies.

Please call us if you have any questions or concerns:

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