A View from the Bevy – 2Q22

Market Review

The best thing that can be said about the first half of 2022 is that it's over. It was the worst first six months of a year for stocks since 1970, with the S&P 500 index down more than 20% from its early January peak. The stock selloff has been broad, with every sector other than energy and utilities declining. Stocks fell in 10 of the 12 weeks during the second quarter, unable to sustain any rallies.

Stock declines were not limited to the U.S, as countries around the world are being impacted by some of the same macro-economic forces. Inflation in Europe is running extremely high, and the Euro has declined by more than 8% versus the U.S. dollar as the European Central Bank has been relatively slow to increase interest rates. As seen in the table below, most major indices are down nearly 20% so far this year, with the tech-heavy NASDAQ down almost 30%. The MSCI World ex U.S. Index had its worst first half of a year on record.

Market Indices	2nd Quarter 2022	Year-to-Date
S&P 500	-16.10%	-19.96%
Bloomberg US Aggregate Bond	-4.69%	-10.35%
S&P 500 (Equal-Weight)	-14.36%	-16.68%
Dow Jones Industrial Average (DJIA)	-10.78%	-14.44%
NASDAQ Composite	-22.44%	-29.51%
Russell 2000	-17.20%	-23.43%
MSCI World	-16.19%	-20.51%
MSCI World ex U.S.	-14.66%	-18.76%
MSCI Emerging Markets	-11.45%	-17.63%

Source: AJO. Data supplied by FactSet Research Systems.

Bonds weren't spared either as the U.S. Federal Reserve (Fed) began aggressively raising interest rates to combat decades-high inflation. The 10-year Treasury note, a benchmark for mortgages, business loans and other kinds of debt, fell nearly 10%. There were no safe havens for investors, and even assets that were thought to be uncorrelated to the general market - such as cryptocurrencies and gold – fell. Bitcoin, the largest cryptocurrency, has fallen more than 50% from its peak. Gold, a commodity that should benefit in times of inflation and is typically viewed as a "safe haven" during bouts of market volatility, has fallen 1% this year and is down nearly 11% from a March peak.

While there is some reason for optimism moving forward, let's first dissect what triggered this first-half of the year malaise. One of the primary culprits has been stubbornly high inflation, which is running at its fastest pace in more than 40 years in the U.S. and has been similarly troublesome globally. Already-high food and energy prices were exacerbated by the war in Ukraine. The war has

also intensified existing global supply chain snarls caused by pandemic-related shutdowns, making it more difficult for companies to manage inventories and fill customer orders.

In an effort to battle inflation and prevent it from becoming "entrenched" in the economy as it did in the 1970's, the Fed is using interest rate increases to cool demand. They must walk a fine line, however, as too many rate increases could impact business and residential investment, and ultimately consumer spending. The uncertainty around this delicate balance is causing much of the volatility and asset repricing we are seeing in markets this year.

Economic concerns here are mirrored around the globe as other central banks, including the European Central Bank and the Bank of England, share the Fed's concerns and are weighing similar aggressive interest rate hikes.

Market Outlook

The major questions heading into the third quarter are 1) will the Fed's aggressive tightening tip the economy into recession or will we have a soft landing; and 2) will companies surprise or disappoint as they report second quarter earnings in July and August. Since earnings drive stock prices, these earnings reports will have a major impact on the direction of the market.

Despite the rough first half in markets and coincident grim media coverage, the jury is still out on whether a recession is inevitable. While the odds have certainly increased, as many market watchers feel that the Fed has waited too long to tighten, it's important to remember that both consumers and companies continue to have healthy balance sheets. Many consumers also still have excess savings, as the average debt-to-income ratio is down sharply from previous years. The job market is still very strong, and consumers are still spending despite high inflation. If we do have a recession, which is not a forgone conclusion, businesses and consumers are entering from a position of financial strength relative to past recessions.

As to the questions about earnings, expectations remain high, although there can be no denying that inflation and supply chain issues have eroded corporate profit margins. While some companies have so far been able to pass along price increases to consumers, upcoming earnings reports will be scrutinized closely.

Regardless of the direction of earnings, and even though supply chain issues have shown some signs of easing, expect the summer to continue to be volatile. Many market participants will be on vacation, and low volume should be expected – which certainly adds to the volatility.

Time frames are key – and short-term dislocations, as painful as they are, should be viewed as long-term opportunities. For you as clients, it's important to continue to focus on your long-term financial plans and to let us know if at any point "life" changes mean that the plan you have in place no longer represents your proper risk tolerance and long-term investment objectives.

For us, we continue to remain focused on finding high quality companies that have strong free cash flow. It is a market of stocks more than it is a stock market. Corporate profits and business cycles are the engine that underly the U.S. stock markets, and we focus on these concepts more than the short-term noise that drives day-to-day market moves.

Enjoy your summer, and please do not hesitate to contact us with any questions or concerns.

Of Interest: Is it Time to Sell Stocks? (No)

After reaching record highs in early January 2022, U.S. stocks have slumped, and volatility has increased. Headlines abound about persistent and climbing inflation, rising interest rates, and increasing global tensions. Some investors have been asking themselves whether it is time to alter the allocations within their portfolios – in other words, to sell stocks.

We don't believe so. Invariably, adjusting your portfolio based on short-term events rather than a long-term investment strategy is just another version of the age-old market timing question. Historically, researchers have examined a wide range of timing strategies and have concluded that investors are better off avoiding short-term shifts among asset classes.

Let's examine some new evidence. Today's investment management industry is highly competitive, with more stock mutual funds and Exchange Traded Funds (ETFs) available in the U.S. than listed stocks. If someone could develop a profitable timing strategy, we would expect to see some funds employing it with successful results.

But a recent Morningstar report suggests investors should be wary of those claiming to be able to successfully time the market. The report examined the results of two types of funds, each holding a mix of stocks and bonds:

- Balanced Funds: Minimal change in allocation to stocks
- Tactical Asset Allocation Funds: Makes Periodic shifts in allocation to stocks

As shown in the chart, funds that sought to enhance results by opportunistically shifting assets between stocks and bonds, underperformed funds that simply held a relatively static mix. If the performance of tactical funds that have closed had been included, the numbers supporting market timing would have been even worse.

Morningstar's conclusion: "The failure of tactical asset allocation funds suggests investors should not only stay away from funds that follow tactical strategies, but they should also avoid making short-term shifts between asset classes in their own portfolios."

% Annualized Return through August 31, 2021	3 Year	5 Year	10 Year
Tactical Asset Allocation	8.36	8.38	6.18
Balanced	10.49	9.89	8.93
Tactical Underperformance	–2.13	–1.51	–2.75

Past performance, including hypothetical performance, is no guarantee of future results. Performance may increase or decrease because of currency fluctuations. Source: Morningstar. Amy C. Arnott, "Tactical Asset Allocation: Don't Try This at Home," Morningstar, September 20, 2021.

Successful market timing requires two correct decisions: when to reduce the allocation to stocks and when to increase it again. While watching a portfolio shrink in value can be very discomforting, investors seeking to avoid the pain by temporarily shifting away from their long-term strategy may wind up trading one source of anguish for another. For example, the initial upsurge in prices from their lows often takes many investors by surprise, and many find it extraordinarily difficult to buy stocks that were available at sharply lower prices just a few weeks earlier.

Research by Dimensional Fund Advisors (Dimensional) shows that the opportunity cost of trying to time the market can be substantial: Over the 25-year period ending in 2021, a hypothetical $100,000 invested in the stocks that make up the Russell 3000 Index would have grown to $1,036,694. However, during this quarter-century, missing just the best consecutive 90-trading-day period (which ended June 22, 2020) reduced the ending wealth figure by an alarming 33%.

Add to this the likelihood of increased transaction costs and the potential tax consequences of a short-term trading strategy, and the odds of adding value through market timing grows even slimmer. Maintaining a long-term time horizon and having an investment portfolio tailored to your individual wealth management goals and objectives has historically proven to be a prudent strategy.

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