LIVE OAK WEALTH MANAGEMENT

Quarterly Insights

– July 2022

High Inflation and Rising Interest Rates Result in the Worst S&P 500 Performance in Decades

The Rocky Road to Normal

The first half of 2022 is officially over…good riddance. This past six-month period was one for the record books, and not in a good way. Stocks officially closed out their worst six-month start to any year, going back over half a century. Many of us have never been in a market this volatile.

This has also been the only time in the last 50 years when both the S&P 500 and bonds have both been down more than 10%. That's how unusual this moment in time is. And the reality is that there has been almost no place to hide.

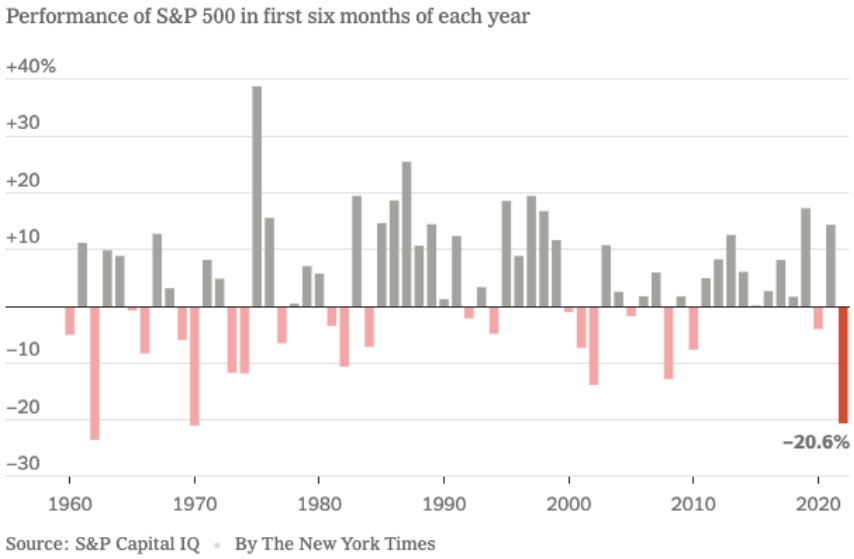
The economy is on the cusp of a recession, battered by high inflation and rising interest rates, which eat into paychecks, dent consumer confidence, and lead to corporate cutbacks. As it has teetered, markets have declined. I am sure you have seen plenty of headlines and articles such as the one below. It feels absolutely terrible for most investors. Uncertainty seems to be the new normal.

A First Half to Forget

Markets Post Worst First Half of a Year in Decades

Investors gird for more volatility; almost everything—from stocks to bonds and crypto—falls to start 2022

The S&P 500 ended the first half of the year down 20.6%, the worst start to a year since 1962.



What will happen in the back half? If history is a guide, continued volatility should be expected. As for the direction, anything is possible. The good news is that the market finished the second half of the year with a positive return when the first half was down -15% or greater.

S&P 500: Worst Performance through 124 Trading Days (1928 - 2022)

Rank	Year	Price Return: First 124 Trading Days	Price Return: Day 125 to Year-End	Price Return: Full Year
1	1932	-44.5%	53.4%	-14.8%
2	1962	-26.5%	20.0%	-11.8%
3	1940	-20.9%	7.4%	-15.1%
4	2022	-20.6%	?	?
5	1970	-20.2%	25.3%	0.0%
6	1939	-17.9%	15.5%	-5.2%
7	2002	-13.8%	-11.1%	-23.4%
8	2008	-12.9%	-30.3%	-39.3%
9	1974	-11.5%	-20.6%	-29.7%
10	1973	-11.3%	-6.8%	-17.4%
11	1937	-10.4%	-31.5%	-38.6%
12	1982	-10.1%	27.3%	14.5%
13	1953	-9.1%	2.8%	-6.6%
14	1984	-8.1%	9.6%	0.8%
15	1949	-7.9%	19.9%	10.5%

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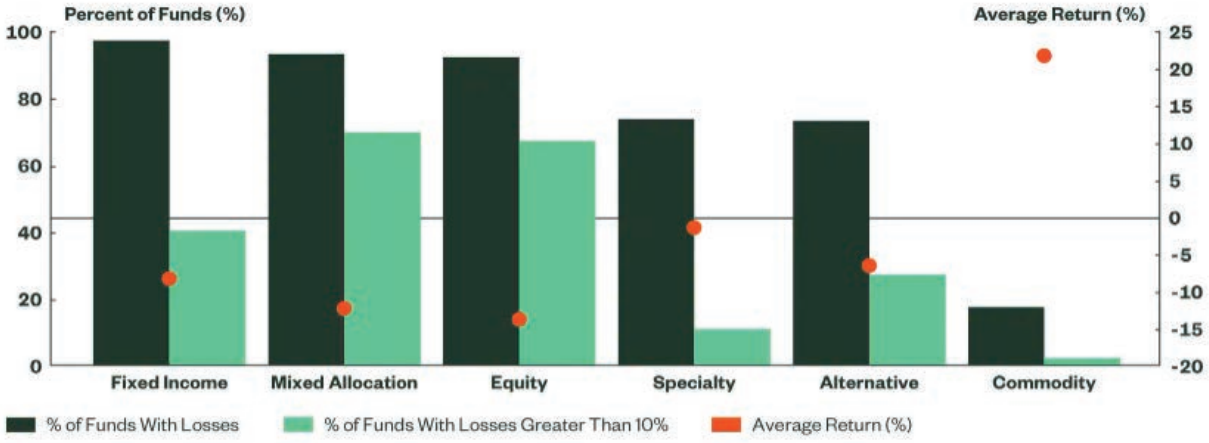
So far this year has been a very difficult one for investors, with heavy losses in both equity and fixed-income markets. On the positive side, the impact of COVID-19 on the economy continues to fade; however, in its place, investors face new challenges, with Russia's brutal invasion of Ukraine and China's zero-COVID policy both contributing to sustained high inflation. In response, the Federal Reserve raised interest rates by 0.75% in June and promised further tightening in the months ahead.

High inflation and Fed tightening have, in turn, led to fast-rising mortgage rates, which, combined with record-low consumer sentiment and stock market losses, is rapidly undermining economic momentum.

The following two charts illustrate the declines in both the stock and bond markets better than any other charts I have seen this year. The chart below illustrates that more than 90% of all stock-and-bond-focused ETFs have losses, covering $4.6 trillion assets from equity and $1.1 trillion for bonds, as shown in Figure 1. And almost 70% of equity funds have a more than 10% loss, totaling $3.9 trillion in assets.

Figure 1: Percent of ETFs by Fund Category With Losses Year to Date

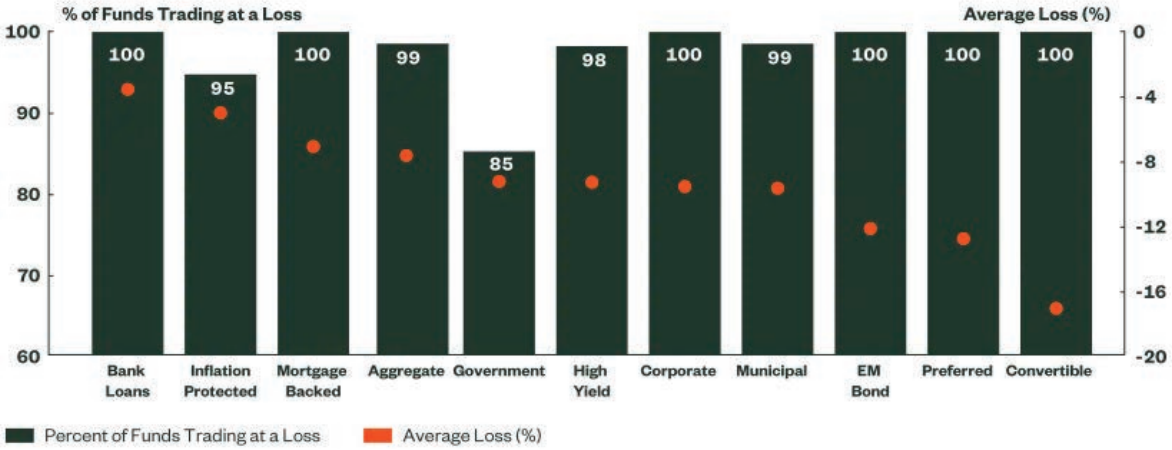


Source: Bloomberg Finance, L.P., as of May 24, 2022, per SPDR Americas Research calculations. **Past performance is not a reliable indicator of future performance.**

The chart below shows 100% of bond ETFs are trading at a loss in 6 of 11 fixed-income segments. Though average bond ETF returns are not as poor as equity returns, in 8 of 11 bond sectors returns are worse than -9%.

Bank loan funds, because of their exposure to floating-rate securities that have minimal duration risk, have fared the best amid rising rates—even though every fund is down on the year. Convertibles have the worst return of any bond sector tracked due to their equity sensitivity.

Figure 3: Losses by Bond Category



Source: Bloomberg Finance, L.P., as of May 24, 2022, per SPDR Americas Research calculations. **Past performance is not a reliable indicator of future performance.**

What should investors be thinking about as we head into the rest of 2022? We will try and answer those questions and more.

After a rebound in March, the S&P 500 dropped sharply in April to start the second quarter. While some of the reasons for the declines were similar to the first quarter (rising rates, high inflation, geopolitical concerns), 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, whereby small outbreaks are met with extremely intense city- and province-wide lockdowns. At the peak of the recent COVID outbreak and subsequent lockdowns throughout China, it was estimated that 46 separate cities and provinces, impacting 300 million people and 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 500 fell 8.7%.

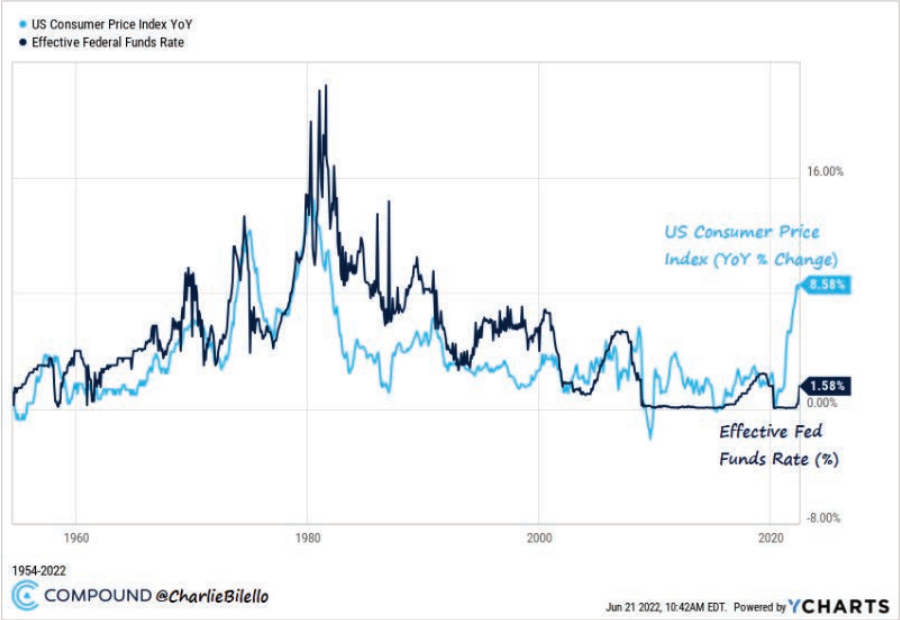
The selling continued in early May, as the Federal Reserve raised interest rates by 50 basis points at the May 4th meeting, the single biggest rate hike in 22 years. Additionally, at the press conference, Fed Chair Jerome Powell clearly signaled that the Fed would continue to hike rates aggressively to tame inflation, which weighed on stocks, pressuring the S&P 500 to fall to new 2022 lows in mid-May. But toward the end of the month, markets staged a modest rebound thanks to potential improvement in multiple market headwinds. 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 Raphael Bostic stated that the Fed might "pause" rate hikes in the late summer or early fall, and that gave investors some hope that the end of the Fed rate hike cycle may be closer than previously thought. Finally, some inflation metrics implied price pressures may be peaking. Those potential positives, combined with deep, short-term oversold conditions in equity markets, prompted a solid rally in late May, and the S&P 500 finished the month with a fractional gain.

But the relief didn't last long. On June 10th, the May CPI report showed inflation had not yet peaked as CPI rose 8.6% year-over-year, the highest reading since 1982. That prompted a violent reversal of the late-May gains, and the selling and market volatility was compounded when the Federal Reserve increased interest rates by 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 stocks hard, and the S&P 500 dropped sharply in mid-June to its lowest level since December 2020. During the last two weeks of the quarter, markets stabilized as commodity prices declined, while U.S. economic readings showed a clear moderation in activity, which rekindled hope that a peak in inflation and an end to the rate hike cycle might come sooner than feared. Those factors, combined with the fact that markets had become near-term oversold again, resulted in a modest bounce late in the month, but the S&P 500 still finished with a solidly negative return for June.

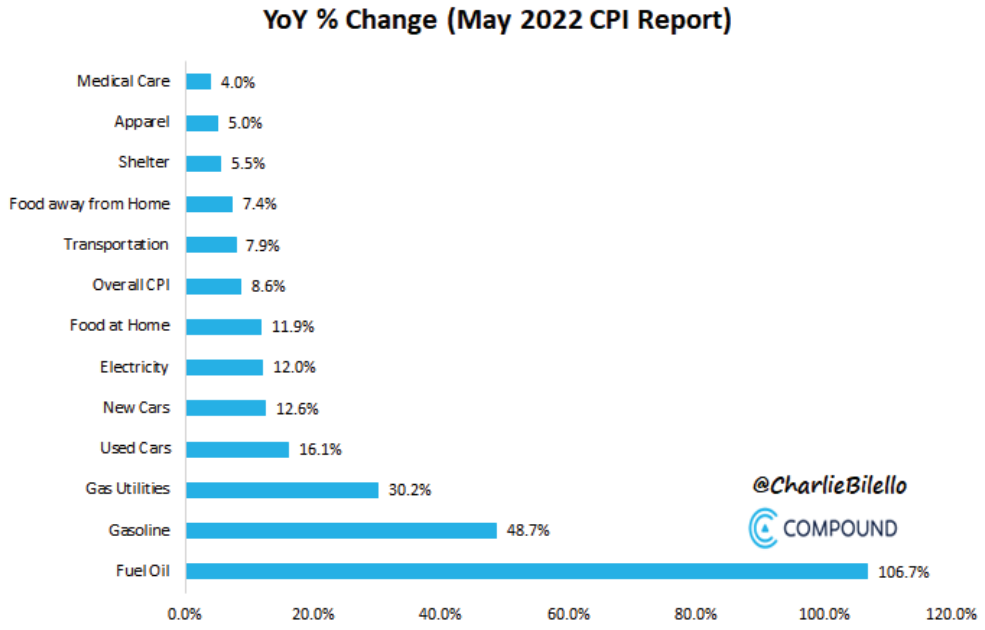
In sum, the factors that pressured stocks in the first quarter, including high inflation, the prospect of sharply higher interest rates, geopolitical unrest, and rising recession fears, also weighed on stocks in the second quarter, and until investors get relief from these headwinds, markets will remain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

Will We See Inflation Continue Higher?

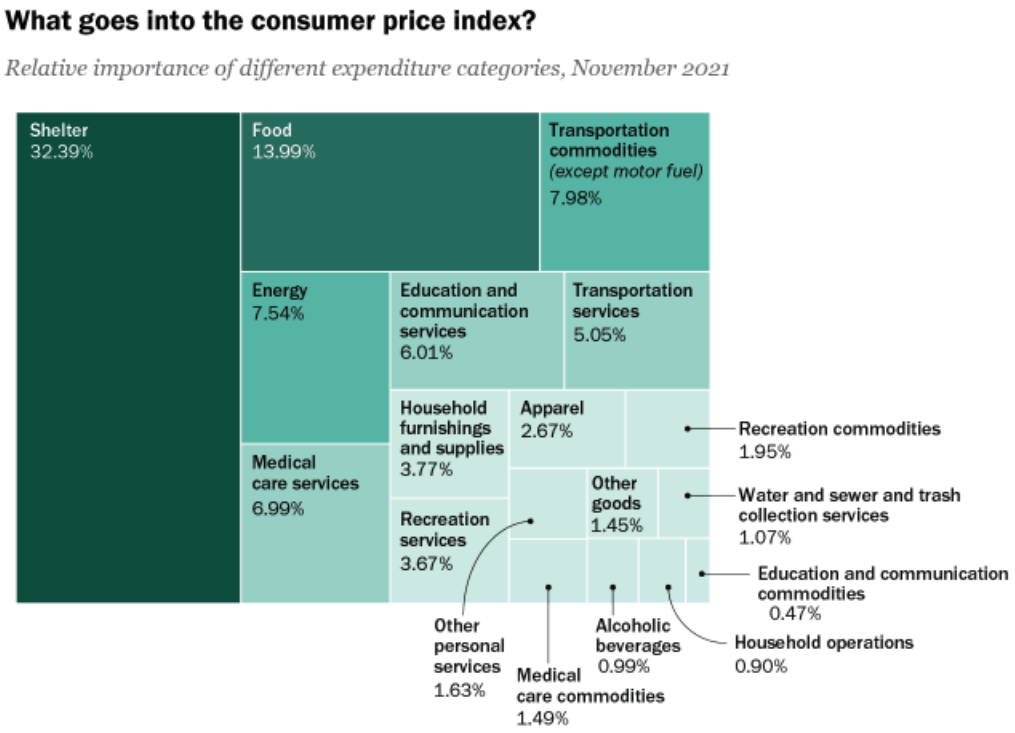
Inflation continues to run very hot, with a May headline CPI showing an 8.6% year-over-year gain, well above market expectations. Today's high inflation largely reflects the impact of surging consumer spending, fueled by fiscal stimulus, colliding with supply shortages across major sectors of the economy. More recently, this has been amplified by a general recovery in airfares, hotel rates, and rents from their pandemic lows. The Russian invasion of Ukraine and China's attempts to maintain a zero-COVID policy are extending supply-chain problems, and year-over-year CPI inflation may not have peaked yet.



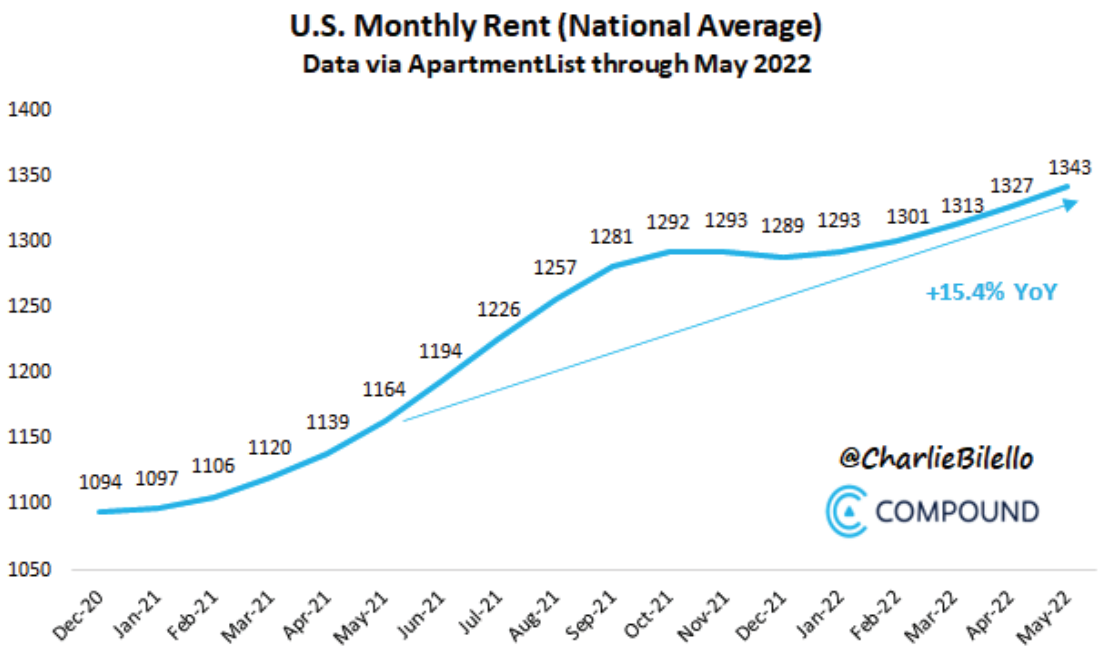
Where are prices rising? Everywhere. Here's the breakdown of price increases in the latest CPI report:



What sectors of the economy make up the Consumer Price Index? Below, you will see that shelter makes up 32.39% of the index, food makes up 14%, and energy makes up 7.54% for a total of 53.92%. Over half of inflation is made up of these three categories. Until we see a moderation and decline in these three areas, inflation is likely to continue to increase, albeit at a possibly slower rate.



Once again, shelter (the single biggest component of CPI at 33% of the Index) inflation is being wildly understated (@ +5.5% YoY increase) with rents up 15.4%, as shown in the chart below. Over the last year, home prices are up a record 20.6%. This means that the true inflation rate is much higher than 8.6% and could continue to be a contributor to potential higher inflation readings.



The First Sign of Light

What could potentially alter the Fed's rate hiking plans? Any signs of a peak in inflation. Declines are not usually something to celebrate, but this is a notable exception that hopefully will continue. In the chart below, we have started to see a broad-based decline in commodity prices, from energy and base metals to agriculture and precious metals. Over half of all commodities prices are down 20% or more. Is this a trend that will continue or a decline in a bull market resulting in higher prices in the future? We will see; however, a reason for part of the decline is factoring in a potential recession, resulting in a decline in the purchase and use of commodities. As I write this quarterly update on Monday, July 5th, oil (West Texas Intermediate) is down another 8.5%, trading below $100/barrel while gas is down another 8% as well. Oil has declined $21 dollars from a high of $121, while gasoline has declined 74 cents in the futures market.

The decline in agriculture prices, such as corn, soybeans, wheat, and cotton could also help stop the pace of food inflation we've all endured by paying higher prices at the grocery store. The coast is not clear by any means, but in what has been a long, dark inflationary tunnel, this is one of the first signs of light.

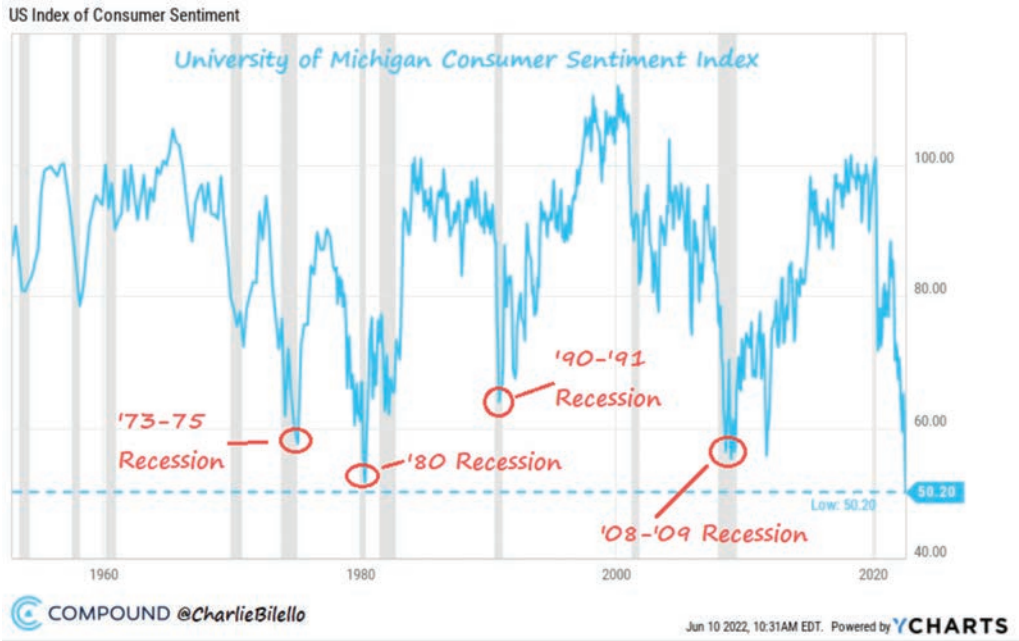
	Commodities	Percentage From 52-Week High
Energy	Crude Oil	-13.0%
	Gas-RBOB	-12.5%
	Heating Oil	-6.4%
	Natural Gas	-32.9%
	Ethanol	-10.0%
Precious Metals	Gold	-11.2%
	Silver	-21.4%
	Platinum	-22.6%
	Palladium	-37.8%
Base Metals	Copper	-24.0%
	Aluminum	-36.9%
	Nickel	-53.6%
	Steel	-42.1%
	Tin	-48.7%
	Zinc	-24.8%
	Lead	-22.4%
	Iron Ore	-47.9%

Agricultural	Lumber	-57.7%
	Corn	-17.3%
	Cotton	-36.8%
	Coffee	-13.7%
	Cocoa	-13.4%
	Sugar	-10.7%
	Wheat	-27.2%
	Soybeans	-19.5%
	Soybean Oil	-25.1%
	Soybean Meal	-19.6%
	Orange Juice-Frozen	-15.3%
	Oats	-24.9%
	Rice(Rough)	-10.1%
	Cattle-Feeder	-2.5%
	Cattle-Live	-9.8%
	Hogs-Lean	-15.3%
	Down 10% or more	**88%**
	Down 20% or more	**52%**
	Down 30% or more	**27%**

The U.S. Consumer Has Never Felt Worse

The U.S. Consumer Sentiment Index from the University of Michigan, going back to 1952, has never been lower, hitting an all-time low in June, demonstrating that the consumer is growing increasingly pessimistic about economic conditions. Unrelentingly high inflation was the most frequently cited concern among Americans surveyed. As Federal Reserve Chairman Jerome Powell has repeatedly reminded us, consumer spending accounts for roughly 70% of economic output, so it's important to pay attention to consumers' mindsets. If individuals and households are worried about the direction of the domestic economy, they'll likely be inclined to spend less and hang on to more of their hard-earned pay.

In the University of Michigan Consumer Sentiment Index shown below, you'll also notice that declines in consumer sentiment also correlates to previous recessions (as shown in the gray bars in the chart and labeled in red). Will this time be any different? Probably not, based on the current Gross Domestic Product (GDP) numbers, which show the second quarter may have ended with a negative growth rate.



However, entering the third quarter of 2022, there are gathering forces slowing economic momentum. After two years of record stimulus, the economy is facing an economic situation where inflation and earnings grow and force consumers to have less purchasing power and money to spend. This decline reflects an end to stimulus checks, enhanced unemployment benefits, enhanced child tax credits, and a host of other programs that were supporting lower-income and middle-income households during the pandemic. In addition, a surge in 30-year mortgage rates is weighing on the housing sector and an 8%+ rise in the trade-weighted dollar year-to-date is impeding U.S. exports. All of this, combined with collapsing consumer confidence, has raised the risk that the U.S. economy falls into recession in the near term.

We have also seen the economy slow down at a very rapid pace, the number of data points showing a slowing in the economy growing substantially. Manufacturing in the United States has slowed in conjunction with slowing new orders, building inventories, and supplier bottlenecks are starting to ease along with the prices being paid for goods (as illustrated in the commodity price chart above). Regional economic reports from Dallas and Richmond have also pointed to a slowing economy.

We'll be watching the economy very closely, because at this point it's clear the economy is slowing. The key questions now are, one, how quickly it happens, and, two, how deep the drop in activity will be, because if inflation doesn't start to come down quickly and soon (like starting in the next month or two), then we will be staring at stagflation—an economic event in which the inflation rate is high, economic growth rate slows, and unemployment remains steadily high.

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 Jones Industrial Average relatively outperformed.

By market capitalization, large-cap stocks again outperformed small-cap stocks in the second quarter, although the performance gap was small. Large-cap outperformance continued to be driven by the rise in interest rates as well as growing recession fears. 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. Rising interest rates, still-high inflation, and increasing recession concerns caused investors to continue to flee growth-oriented tech stocks and rotate to more fairly valued sectors of the market, although again both styles finished the quarter with negative returns. Following is a chart with returns through Friday, July 1, 2022:

Stock Index Performance

Index	Week	YTD	12-mo.	2021	5-yr.
Dow Jones Industrial Avg. (31,097)	-1.27%	-13.54%	-8.46%	20.95%	10.20%
S&P 500 (3,825)	-2.18%	-19.12%	-10.17%	28.68%	11.51%
NASDAQ 100 (11,586)	-4.29%	-28.72%	-19.84%	27.51%	16.52%
S&P 500 Growth	-3.73%	-27.02%	-16.05%	32.00%	13.62%
S&P 500 Value	-0.72%	-10.30%	-4.34%	24.86%	8.43%
S&P MidCap 400 Growth	-2.16%	-24.07%	-20.12%	18.89%	6.74%
S&P MidCap 400 Value	-1.08%	-12.99%	-8.41%	30.61%	7.31%
S&P SmallCap 600 Growth	-1.58%	-23.16%	-19.48%	22.56%	7.48%
S&P SmallCap 600 Value	-0.73%	-13.17%	-13.73%	30.85%	6.93%
Russell 2000	-2.09%	-22.55%	-24.98%	14.78%	5.38%
MSCI EAFE	-2.19%	-20.18%	-18.55%	11.26%	2.05%
MSCI World (ex US)	-1.91%	-19.00%	-19.97%	7.82%	2.35%
MSCI World	-2.24%	-20.08%	-14.19%	21.82%	7.78%
MSCI Emerging Markets	-1.58%	-18.27%	-25.52%	-2.54%	2.02%
S&P GSCI	-2.06%	37.80%	45.95%	40.35%	12.00%

Source: Bloomberg. Returns are total returns. *5-yr. return is an average annual.* One-week, YTD, 12-mo. and 5-yr. performance returns calculated through 7/1/22. An index cannot be purchased directly by investors. Past performance is no guarantee of future results.

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.

S&P Sector Performance					
Index	Week	YTD	12-mo.	2021	5-yr.
Communication Services	-4.54%	-29.69%	-29.20%	21.57%	6.28%
Consumer Discretionary	-4.69%	-31.50%	-23.04%	24.43%	10.17%
Consumer Staples	0.41%	-4.23%	8.47%	18.63%	9.08%
Energy	1.29%	33.53%	39.17%	54.39%	7.23%
Financials	-1.42%	-17.56%	-12.16%	34.87%	7.46%
Health Care	0.42%	-7.22%	3.64%	26.13%	12.41%
Industrials	-0.79%	-16.04%	-13.19%	21.10%	6.93%
Information Technology	-4.47%	-26.72%	-13.44%	34.52%	20.24%
Materials	-3.07%	-17.35%	-8.63%	27.28%	8.87%
Real Estate	-0.43%	-18.63%	-3.90%	46.14%	8.85%
Utilities	4.14%	1.94%	15.85%	17.67%	10.32%

Source: Bloomberg. Returns are total returns. *5-yr. return is an average annual.* One-week, YTD, 12-mo. and 5-yr. performance returns calculated through 7/1/22. An index cannot be purchased directly by investors. Past performance is no guarantee of future results. On 9/28/18, the Global Industry Classification Standard (GICS) was reconstituted and the Telecommunications Services sector was renamed Communication Services. GICS sector information for periods prior to 9/28/18 may not necessarily be comparable to the reconstituted sectors.

The S&P 500 is now down over 24% from its peak in early January, the largest decline since February-March 2020 and the longest since 2015-2016.

@CharlieBilello	S&P 500 Corrections >5% since March 2009 Low				
Correction Period	# Days	S&P High	S&P Low	% Decline	"Stocks Fall On..."
2022: Jan 4 - June 17	164	4819	3637	-24.5%	Inflation, Rising Rates/Fed Tighening, Russia/Ukraine War, Recession Fears
2021: Nov 22 - Dec 3	11	4744	4495	-5.2%	Covid Omicron Variant, Fed Taper Fears
2021: Sep 2 - Oct 4	32	4546	4279	-5.9%	China Contagion Fears, Fed Taper Fears, Covid Delta Variant
2021: Feb 16 - Mar 4	16	3950	3723	-5.7%	Inflation Fears, Rising Rates
2020: Sep 2 - Sep 24	22	3588	3209	-10.6%	Coronavirus, No New Stimulus Deal, Election Fears
2020: Feb 19 - Mar 23	33	3394	2192	-35.4%	Coronavirus, Global Depression Fears
2019: Jul 26 - Aug 5	10	3028	2822	-6.8%	Trade War, Tariffs, Yuan Devaluation, Recession Fears
2019: May 1 - Jun 3	33	2954	2729	-7.6%	Trade War, Tariffs, Inverted Yield Curve, Global Slowdown/Recession Fears
2018: Sep 21 - Dec 26	96	2941	2347	-20.2%	Rising Rates, China Slowdown, Trade War/Tariffs, Housing Slowdown
2018: Jan 26 - Feb 9	14	2873	2533	-11.8%	Inflation Fears, Rising Rates
2016: Aug 15 - Nov 4	81	2194	2084	-5.0%	Election Fears/Concerns/Jitters
2015/16: May 20 - Feb 11	267	2135	1810	-15.2%	Greece Default, China Stock Crash, EM Currencies, Falling Oil, North Korea
2014/15: Dec 29 - Feb 2	35	2094	1981	-5.4%	Falling Oil, Strong Dollar, Weak Earnings
2014: Dec 5 - Dec 16	11	2079	1973	-5.1%	Falling Oil, Strong Dollar
2014: Sep 19 - Oct 15	26	2019	1821	-9.8%	Ebola, Global Growth Fears, Falling Oil
2014: Jan 15 - Feb 5	21	1851	1738	-6.1%	Fed Taper, European Deflation Fears, EM Currency Turmoil
2013: May 22 - Jun 24	33	1687	1560	-7.5%	Fed Taper Fears
2012: Sep 14 - Nov 16	63	1475	1343	-8.9%	Fiscal Cliff Concerns, Obama's Re-Election
2012: Apr 2 - Jun 4	63	1422	1267	-10.9%	Europe's Debt Crisis
2011: May 2 - Oct 4	155	1371	1075	-21.6%	Europe's Debt Crisis, Double-Dip Recession Fears, US Debt Downgrade
2011: Feb 18 - Mar 16	26	1344	1249	-7.1%	Libyan Civil War, Japan Earthquake/Nuclear Disaster
2010: Apr 26 - Jul 1	66	1220	1011	-17.1%	Europe's Debt Crisis, Flash Crash, Growth Concerns
2010: Jan 19 - Feb 5	17	1150	1045	-9.2%	China's Lending Curbs, Obama Bank Regulation Plan
2009: Oct 21 - Nov 2	12	1101	1029	-6.5%	Worries About The Recovery
2009: Sep 23 - Oct 2	9	1080	1020	-5.6%	Worries About The Recovery
2009: Jun 11 - Jul 7	26	956	869	-9.1%	World Bank Neg Growth Forecast; Fears Market Is Ahead Of Recovery
2009: May 8 - 15	7	930	879	-5.5%	Worries That Market Has Gotten Ahead Of Itself
Median	**26**			**-7.6%**	COMPOUND

The Federal Reserve and Interest Rates

At the June Federal Reserve meeting, the Fed approved the largest interest-rate increase of .75% since 1994 and signaled it would continue lifting rates this year at the most rapid pace in decades. New projections showed all 18 officials who participated in the meeting expect the Fed to raise rates to at least 3% this year, with at least half of all officials indicating the fed funds rate might need to rise to around 3.375% this year. Powell said it was becoming more difficult to achieve what is known as a soft landing, where the economy slows enough to bring down inflation while avoiding a recession.

The goal is to raise the cost of borrowing in order to slow consumption of everything, which will allow inventories to build and bring prices back down. In other words, the Fed is tackling inflation's rapid growth.

Policymakers also guided for interest rates of 3.4% by the end of this year. So, by getting to neutral, the central bank has achieved its first objective in the fight against inflation. From there, it can afford to slow the pace of rate hikes and see what happens to the economy.

Powell explained that supply-chain problems have been more far-reaching and longer-lasting than the central bank anticipated. In addition, overall demand has been strong, further constraining supply. The dynamics have led to broad-based price increases.

To ease demand, the Fed will focus on the housing and labor markets, where the supply-versus-demand equation is out of balance. So, the central bank's rate hikes will cool each by bringing down prices. Powell reiterated it can't control the changes in the energy markets related to Russia's invasion of Ukraine or the supply chain due to China's COVID lockdowns.

Based on these statements, the Fed appears headed for another 0.75% rate hike in July…

We're already hearing about slowing demand from retailers. Discount giants Walmart (WMT) and Target (TGT) have said consumer spending habits are changing. They're no longer buying items like electronics and patio furniture as they had during the pandemic. The change has meant retailers are stuck with inventory, forcing them to slash prices and get rid of unwanted supplies.

It's unlikely they're the only retailers facing these issues. Transportation-data analytics firm FreightWaves has noted import demand "dropping off a cliff," so signs of slowing consumption are already showing up. All of this means the pace of forward rate hikes can start to slow after July.

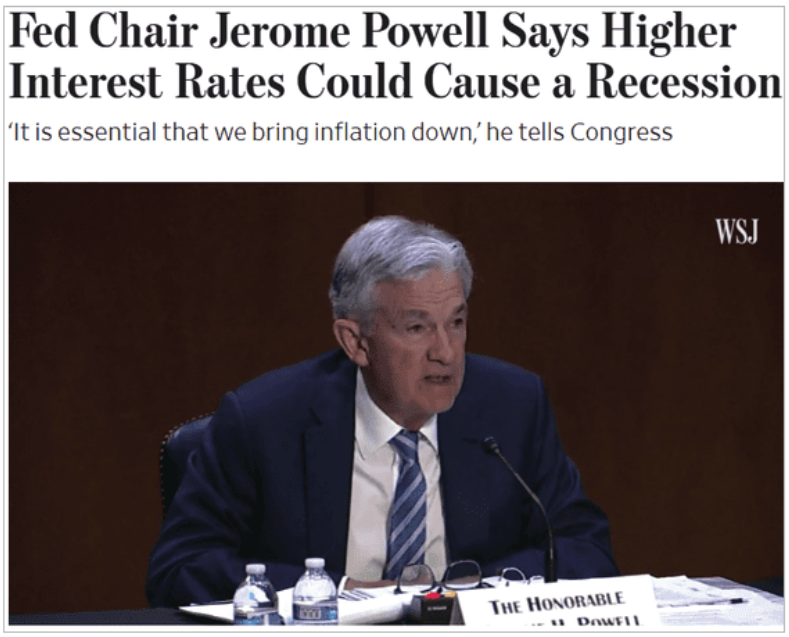
After this month's FOMC meeting on July 28, there will be three more meetings in September, November, and December to decide how it wants to act. Based on the 3.4% target for 2022, the central bank would only need to raise interest rates by another 1% to get there. And if it sees growth slow too much, it can always back down.

Federal Reserve Chairman Jerome Powell said the central bank's battle against inflation could lead it to raise interest rates high enough to cause an economic downturn.

Will the Federal Reserve Lead the U.S. Economy Into a Recession?

"It's certainly a possibility," Mr. Powell said during the first of two days of congressional hearings. "We are not trying to provoke and do not think we will need to provoke a recession, but we do think it's absolutely essential" to bring down inflation, which is running at a 40-year high.

"The events of the last few months around the world have made it more difficult for us to achieve what we want," Mr. Powell told the Senate Banking Committee on Wednesday. He also said that achieving the Fed's 2% inflation goal with a strong labor market would be very challenging; "We've never said it was going to be easy or straightforward."



There are three supply issues driving inflation that the Fed's interest-rate ammunition can do nothing about:

1) The reset of **wages** at the low end of the scale. Thanks to pandemic unemployment subsidies, the government established a new (higher) living wage, which is being passed on to consumers through higher prices.
2) The global **supply-chain disruptions** from the lockdown period have been exacerbated by war in Eastern Europe and zero-COVID policies in China.
3) High **energy prices**, sustained by a self-inflicted supply shortage, by the design of global anti-fossil fuel policies.

The good news is that we have started to see a moderation in the supply-chain disruptions along with a decline in energy prices. This will help to ease inflation concerns and lead to the possibility of slowing interest-rate increases this year.

Third Quarter Market Outlook

The S&P 500 just realized its worst first-half performance since 1970 as initial market headwinds of high inflation and sharply rising interest rates combined with growing recession risks and extreme geopolitical uncertainty pushed stocks and bonds sharply lower through the first six months of the year.

Those declines are understandable considering inflation reached a 40-year high, the Federal Reserve raised interest rates at the fastest pace in decades, the world's second largest economy effectively shut down, and the Russia-Ukraine war raged on.

But while the volatility and market declines of the first six months of 2022 have been unsettling and painful, the S&P 500 now sits at much more historically attractive valuation levels. And at current prices, a lot of negativities have been priced into the market, opening the possibility of positive surprises as we move forward in 2022.

Regarding inflation and Fed rate hikes, markets have aggressively priced in stubbornly high inflation and numerous additional rate hikes from the Federal Reserve between now and early 2023. But if we see a definitive peak in inflationary pressures in the coming months, it's likely the Federal Reserve will hike rates less than currently feared—which could be a materially positive catalyst for markets.

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

Finally, regarding geopolitics, the human tragedy in Ukraine continues with no end in sight, but the conflict has not expanded beyond Ukraine's borders, and many analysts believe that some sort of conflict resolution can be reached in the coming months. Any sort of a truce between Russia and Ukraine will likely reduce commodity prices, and global recession fears should decline as a result.

Bottom line, the markets have experienced numerous headwinds through the first six months of the year, and they have legitimately pressured asset prices. But the sentiment is very negative at the moment, and a lot of potential "bad news" has been at least partially priced into stocks and bonds at these levels, again creating the 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 a solidly positive return for the final six months of those years.

Horrible Quarters Often Followed By Smiling Bulls

S&P 500 Index >15% Quarterly Declines (1950 - Current)

Date	Quarterly Return	S&P 500 Index Returns		
		1 Quarter	2 Quarters	4 Quarters
6/29/1962	-21.3%	2.8%	15.3%	26.7%
6/30/1970	-18.9%	15.8%	26.5%	37.1%
9/30/1974	-26.1%	7.9%	31.2%	32.0%
12/31/1987	-23.2%	4.8%	10.7%	12.4%
9/30/2002	-17.6%	7.9%	4.0%	22.2%
12/31/2008	-22.6%	-11.7%	1.8%	23.5%
3/31/2020	-20.0%	20.0%	30.1%	53.7%
6/21/2022*	-16.9%	?	?	?
Average		6.8%	17.1%	29.6%
Median		7.9%	15.3%	26.7%
Higher		6	7	7
Count		7	7	7
% Higher		85.7%	100.0%	100.0%

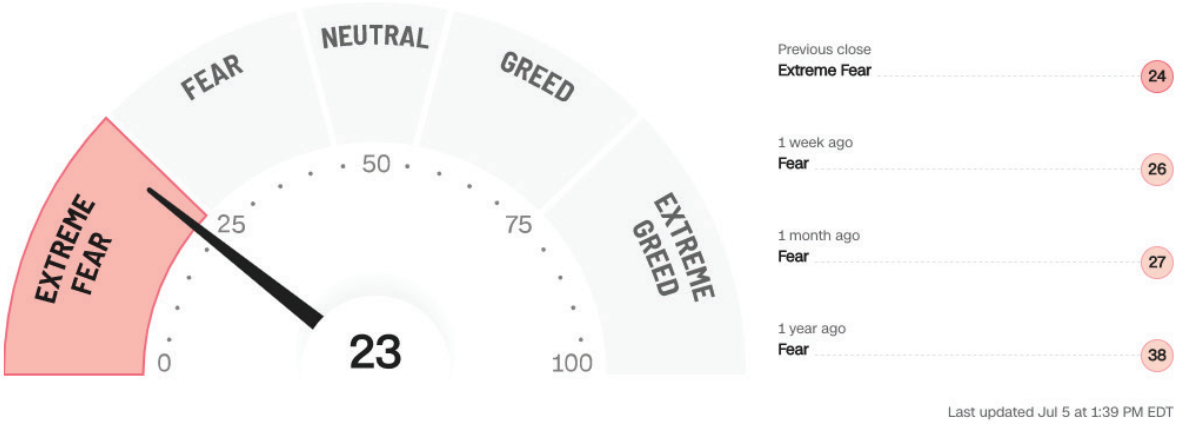
Source: LPL Research, FactSet 06/21/2022 * The current quarter isn't over yet
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.
Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

Market Sentiment

One of our favorite indicators is the Fear & Greed Index (found at https://money.cnn.com/data/fear-and-greed/). Investors are driven by two emotions: fear and greed. Too much fear can sink stocks well below where they should be; when investors get greedy, they can bid up stock prices way too far.

The answers tell us whether investors are mostly bullish, bearish, or neutral. And taking the pulse of investors this way is important…

When the bullish reading is between 50-75, it's usually a bad sign for stocks as investors are getting bullish for higher stock prices. A reading between 75-100 marks a reading of extreme greed, showing investors are very bullish. But a low reading between 0-25 means investors are scared, and a rally is possible. In fact, CNN's Fear & Greed Index shows that we recently hit "extreme fear" levels again this year. Take a look:



Game Plan for Second Half of 2022

High inflation, falling unemployment, and the Fed's much more hawkish stance led to a sharp increase in bond yields in the first half of 2022, resulting in negative returns across fixed-income markets. However, while the likely persistence of stubbornly high inflation suggests continued tightening from the Federal Reserve through the end of the year, increased recession risks could limit further increases in long-term Treasury yields.

Fixed income offers some of the most attractive opportunities. We have seen interest rates increase at some of the fastest rates in the shortest amount of time in history. Following is a chart of the 10-year Treasury rate rising to the highest rate in 11 years at 3.48%. Since then, we have seen the 10-year interest rate decline to 2.80% on recession fears.

We believe that over the next 12 to 18 months, we will continue to see interest rates decline, which could also force the Federal Reserve to lower interest rates in 2023/2024. We are currently looking at opportunities in corporate bonds, high-yield bonds, preferred stocks and 25-plus-year zero coupon bonds.

While we correctly warned that "in early 2022, we will see the largest pullback in the market that we have seen since the bottom struck in March of 2020," we clearly did not expect the market to drop this deeply. It will likely take us several more weeks/months before the market makes it clear how we will be setting up to strike new all-time highs. In the near term, 3620-60SPX is supported in the market per our calculations. A breakdown below that level will point us to the 3450/3500SPX region, from which a major bottom should develop. But for now, as long as we hold the 3620SPX support, we are looking for a rally to develop over the coming weeks to take us north of 4200SPX. But I will warn you that such a rally will be quite volatile.

The challenge this market has provided is that every time we have seen the market rally, we have seen it turn around and give up the gains and go on to make new lows. Until we can see the market sustain a move higher and achieve higher levels while holding support on pullbacks, we have to guard against the market potentially making another low, as described above.

This market reminds me of the 2016-2018 time frame. As some of you may remember, many thought the world was coming to an end during the 2015 market correction. Yet many different segments of the financial markets were setting up for a major rally that we were expecting in various risk assets across the world. At the time, we were expecting a "global-melt-up." Currently, we are again seeing the potential for many markets to align for a rally for the coming year or so. This includes the potential for the bond market to strike a bottom over the coming months and begin a 12-to-18-month rally, along with the metals market and various world equity markets. It is not often you see this type of alignment, but this is what these various charts seem to be suggesting.

We will continue to vigilantly watch for additional risks to portfolios, but market history provides a clear example that positive surprises can and have occurred even in difficult markets such as this. 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 we are committed to helping you effectively navigate this challenging investment environment. Successful investing is a marathon, not a sprint, and even extended bouts of volatility like we've experienced over the past six months are unlikely to alter a diversified approach set up to meet your long-term investment goals.

Therefore, it's critical that we have your financial plan up to date as we've worked with you to establish a unique, personal allocation target based on your financial position, risk tolerance, and investment timeline.

Rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

Please do not hesitate to contact us with any questions or comments, or to schedule a portfolio review.

Sincerely,

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Disclosure