Market Commentary

Second Quarter 2022

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The second quarter of 2022 was one of heightened investor angst marked by concerns of elevated inflationary pressures and fears of slowing economic growth that could lead to a recession. US stocks, as measured by the benchmark S&P 500 Index, declined by 16.1% on a total return basis during the three-month period. This brought the YTD return on US equities to -19.96% which was the worst first half return for US stocks since 1970.

Fixed income yields continued to increase at a particularly rapid rate for most of the quarter, spiking higher across the maturity spectrum as the Fed moved far more aggressively than most had expected. When we wrote our last commentary, expectations were for the Fed to increase rates by 25 basis points at each of the seven remaining Fed meetings during 2022. Inflation and employment reports since then have shown an economy that has numerous imbalances with the coincident pressures on prices. The Fed has been changing its response on what seems like a weekly basis with a 50 basis point increase in May followed by a 75 basis point hike in June. Thus, the Fed is front-loading the interest rate hikes which will get us to the terminal rate much faster than previously anticipated. While we agree with rapid Fed action, the aggressive financial tightening significantly increases the chances of an economic recession. We wrote in our last commentary, "*While markets may react negatively in the short-term to larger than expected moves, we believe it is prudent to quickly move away from crisis-era interest rates*." The 10-year note ended the quarter at 2.97%, significantly higher than the 2.34% yield on March 31, and nearly double the 1.51% at year-end 2021. The benchmark Treasury yield reached a peak of 3.48% in mid-June before giving back some of the yield increase by quarter end. Although we expected yields at the longer-end of the yield curve to drift higher, we did not foresee the abrupt increase during the quarter that pushed rates to levels last seen in 2011. The Fed is in a tight spot, partially caused by their lack of action during 2021 when it was clear inflationary pressures were building. They can either continue raising rates methodically which will likely slow the economy further, or they can pull back on rate increases which could let inflation take hold. Neither is helpful for the short-term, although we believe equity markets have already discounted a great deal of the downside.

The price for benchmark West Texas Intermediate began April at $100.28 and increased in a jagged pattern for most of the quarter, peaking near $123 in early June before receding a bit to end the quarter at $105.76. This brings the YTD price increase to 41% for crude, although a lack of refining capacity in the US has resulted in larger increases for gasoline prices at the pump. The supply/demand curve for oil is more inelastic than for other consumer goods since it is a necessity for most, restricting the potential reduction in demand. That said, we note that gasoline sales have declined for 14 consecutive weeks when compared to 2021 levels. Although we see unambiguous evidence of demand destruction when oil crosses $100 per barrel, it is the deleterious effect on other consumer spending that is a larger concern, particularly for lower income households. We continue to estimate the fair value of oil, absent the current geopolitical tensions, to be in a range of $70-$90 per barrel. However, we expect oil to stay at or above the higher end of that range while the Ukraine invasion continues.

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Economic and Market Outlook

Following the S&P 500 decline of 20% from its January peak, US equities markets have officially entered a bear market. This has investors asking, "what comes next?" While the short-term direction of the market will be driven by the Federal Reserve, economic readings, and investor sentiment, we can give some longer-term guidance. Stocks are now on sale. We have always cynically noted that Americans want to buy everything on sale **except** stocks. People who were more than happy to buy into the market in January are now reticent to purchase equities when the market is more than 20% cheaper. Many stocks are down 50% or more from their peaks. To whet your appetite a bit more, we note that since 1945, purchasing stocks on the day that stocks entered a bear market (measured by the S&P 500) would result in an average subsequent 12-month return of almost 23%. In 10 of the 12 bear markets during that time period, stocks were higher one year after entering a bear market. We understand it is challenging to invest money in an asset class that appears to be dropping on an almost daily basis. This is one of the primary reasons it makes sense to do so. Fear and greed have always driven markets. When fear is plentiful, it is time to have the courage to stand for your convictions. Of course, markets may decline further in the short-term, but with equities down more than 20% thus far and earnings continuing to rise, stocks are much cheaper than they were six months ago when investors were gleefully investing.

One of the reasons this market decline "feels" worse than others of the same magnitude, is due to the increasingly high correlation between equity and fixed income returns over the past six months. For the previous two decades, stocks and bonds tended to move in opposite directions much of the time so declines in one asset class would be ameliorated by gains in the other. Thus far in 2022, both asset classes have traded in lockstep most of the time, removing any cushioning effects from the sell-off in stocks. We have previously addressed our belief in why it makes sense to own fixed income and we have not altered our views. In fact, just as we counsel investors to buy stocks after declines, we think fixed income has gotten much cheaper since late 2021 and is more likely to provide meaningful positive returns over the next few years. With the Fed laying out their view on where short-term interest rates will be in 12-18 months, we believe bond yields have the bulk of their increases behind them by now. As an example, two-year Treasury Notes ended 2021 yielding 0.73%. On June 30, the two-year note was yielding 2.93%. While rates may continue to drift higher, we do not expect to see the magnitude of bond price declines experienced in the first half of 2022 repeat.

Real GDP growth declined slightly in the first quarter of 2022, falling by 1.5%. A deceleration in private inventories weighed on growth after helping propel GDP in the second half of 2021. Declines in government spending and a surging trade deficit outweighed the increase in consumer spending which rose a healthy 2.7% during the quarter. That said, it **was** a decline in real GDP meaning another negative print in the second quarter would meet the textbook definition of a recession. However, the type of recession investors fear is one with sharp declines in consumer spending and rapid increases in unemployment. We see the Fed's actions and believe consumer activity will likely slow from the headwinds of rising interest rates and inflationary pressures. If supply chain pressures continue to moderate, it could help alleviate some inflationary stresses by boosting supply. This would contrast with normal economic slowdowns where inventories rise from decreasing demand, which tends to precede recessions. We do not foresee that happening in 2022, despite the potential for negative GDP reports. Fed Chair Powell told the Senate Banking Committee in late June, "I am trying to lower demand growth, we don't know that demand actually has to go down, which would be a recession." At its June meeting, the Federal Reserve released its updates for economic growth. They expect real US GDP to rise by 1.7% in both 2022 and 2023. These estimates are lower than the March estimates of 2.8% and 2.2% for 2022

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and 2023, respectively, but still in positive territory. We believe the Fed remains too optimistic regarding its growth and unemployment forecasts. The rapid increases in interest rates are purposely meant to reduce consumer demand and job openings in an effort to bring the inflation rate down meaningfully. The Fed is trying to engineer a "soft landing" which is defined as a large reduction in inflation while not tipping the economy into a recession. This is a challenging task in normal times and is made much more difficult by the huge amounts of money put into people's hands over the past two years due to the pandemic.

Thus far, companies are producing consistent revenue and earnings gains. Over the longer-term, earnings will always drive stock prices and consequently as long as earnings continue to grow, we do not believe a deep or long-lasting recession is imminent. Balance sheets of individuals, corporations, and most states are very strong which will help cushion any short-term hiccup in growth.

Portfolio Positioning

Tandem has continued to use volatility to trim fixed income positions and add to equities selectively. While bonds have declined in price during 2022, equities have declined much more, causing portfolio asset allocations to stray from desired levels. Our conservative, risk-conscious investment strategy has always favored aggressively protecting against downside risks at the expense of potentially foregoing some potential upside in rising markets.

Investors have just suffered through the worst six-month period for bonds since 1842. You read that correctly, 180 years ago. This explains why even balanced portfolios have seen meaningful declines YTD. With that behind us, it makes sense to believe we will face a more normalized fixed income environment in the coming months. With bond yields looking as if they are stabilizing, we continue to seek opportunities to increase overall portfolio yield without significantly increasing the risk to principal. Last quarter we wrote that we would not look to invest in maturities much beyond three years. After the two larger than expected Fed rate hikes in the past quarter, we see opportunities in maturities out to approximately five years and are wary of extending maturities much beyond that because there is little to no increase in yield beyond that duration.

The sharp sell-off in equities thus far in 2022, combined with modest increases in earnings has resulted in a much cheaper market than we saw six months ago. In fact, aside from a couple of weeks at the depths of the COVID-related panic in March 2020, US equities are selling at the lowest multiple on forward earnings estimates in several years. Many stocks look quite cheap when looking out 24-36 months. The unknown is the path the economy and earnings will take to get us there. Earnings estimates for the S&P 500 have remained steady for 2022, with current expectations for an increase in the high single digits versus 2021. While we expect to see modest reductions in earnings estimates going forward, we believe a great deal of this is already factored into stock prices. The June 30 valuation of the S&P 500 is approximately 15.9x forward earnings estimates, which is below the 25-year average of 16.85x and significantly below the 20-22x forward estimates during 2021. In fact, even though the S&P 500 is 12% above its pre-COVID peak in February 2020, the forward multiple has contracted from 19.2x to 15.9x due to the growth in corporate earnings.

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Conclusion

In summary, both equity and fixed income markets are cheaper than they have been in quite some time. Because investors are so focused on the immediate short-term, they tend to lose perspective. We have many times counseled longer-term views, particularly during volatile times. Most people would be stunned to learn that since the beginning of 2020 – a period that includes the entirety of the COVID pandemic and the bear market it delivered, along with the sharp declines in equities thus far in 2022, the S&P 500 has returned 22%, or 8.3% on an annualized basis. If two and a half years ago we told you the world would face a global pandemic which would bring the sharpest economic contraction in US history, and equities would face not one, but two bear markets in the ensuing 30 months, would you have expected a positive return of 22%? This is what looking at the longer-term means. It means putting your emotions in check and looking at your portfolio through a multi-year time horizon, rather than simply the last few weeks or months of returns. Volatility brings emotional responses which can negatively affect portfolio decisions.

We believe the chances of a recession in the next 18 months have increased but also believe that much of this is priced into stocks at current levels. Investors are quite anxious now and this manifests itself through the significantly increased daily volatility. We counsel that looking out three to five years, the current environment will have been a desirable entry point for investments. We also understand the current volatility makes investing in these markets challenging as the compulsion to watch daily price movements can hamstring investors. Investing in down markets takes conviction, a well-considered investment plan, and a risk-aware strategy. We seek to make investments that are compelling on a risk-reward basis while acknowledging it is still time to play defense by protecting the downside.

Please let us know if you have any specific questions or concerns about your investments. As always, we request that you inform us of any significant changes in your financial situation.

June 30, 2022

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