Making Sense of Finance

Karagosian Financial Services | 7/22/2022 | Volume 25, Issue 3

Second Quarter 2022 Review

STOCK MARKET

The downturn in the stock market earlier this year accelerated in the second quarter. After a rocky start to 2022, the S&P 500 index continued on the path of a price/earnings (P/E) multiple contraction, meaning earnings grew in general but the value given to the reported earnings shrunk. The S& P 500 index P/E multiple started the year at 21x and had dropped to less than 16x by the end of June. All major stock market indices decreased by double digit percentages last quarter. The S&P 500, Dow Jones Industrial Average and Nasdaq Composite declined 16%, 11% and 22% respectively in the second quarter. On a year-to-date basis, the S&P 500 index loss of 20% was the worst first half performance since 1970. Current high inflation is prompting the Federal Reserve to act aggressively on the raising of interest rates which is a huge driver of the negative market sentiment. A large worry is that the Fed will overshoot on raising rates and cause the economy to slip into a recession. The Fed would like to slow down demand growth but not have it turn negative. Typically, the stock market acts as a leading indicator for the economy and will decline (and rise) before the economy does.

No stock sector was left unscathed last quarter. All categories had negative returns, the better performing groups (not as much of a decrease in price) were the "defensive" sectors – consumer staples and utilities. Also, energy stocks, after posting huge gains in the first quarter of 2022, realized small losses in the second quarter as oil prices came off their peak at the end of June but were still over 40% higher than a year ago. However, energy stocks were still positive on a year-to-date basis. Losses in the technology sector continued and it was among the worst performing sectors last quarter as well as consumer discretionary and communication services. Even gold did not provide much of a hedge against the market's decline with a decrease of 7% in the second quarter.

Foreign stock markets did not fare any better than U.S. markets last quarter. The MSCI EAFE index of developed country markets dropped 15% in U.S. dollar terms. The U.S. dollar

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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continued to strengthen which was detrimental to foreign market returns when translated to U.S. currency. (The U.S. dollar recently traded at parity with the Euro which hasn't happened since 2002 when the Euro was a relatively new currency). High inflation and rising interest rates are not just unique to the U.S. economy. European countries, in particular the United Kingdom and Germany, are experiencing inflation rates at multi-decade highs, in turn leading to the raising of rates by their respective central banks. Emerging markets also turned in poor second quarter stock market performances. In stark contrast, after a dismal first quarter, the Chinese stock market was the only emerging market to post a positive return last quarter as Covid lockdown measures in the country relaxed somewhat.

BOND MARKET

The Federal Reserve continued to raise the Fed Fund rate target in the spring as expected, with an increase of 50 basis points in May and another 75 basis points in June. The current Fed Fund rate target now stands at 1.50%-1.75%. More hikes are in the forecast. As such, the bond market reacted negatively to these actions with more losses on bond prices, but not to the same extent as was the case in the first quarter. The Bloomberg Aggregate Bond Index, an index of domestic investment grade bonds, decreased over 4% in the second quarter. This brought its total loss for the first half of 2022 to 10%, more than what might be expected for bonds that are often considered a more conservative investment. This is only the second time in 40 years that stocks and bonds both posted losses for two consecutive quarters (last time was in 2008).

Yields on Treasuries rose across the board for all maturities (bond prices decline when yields rise). A One-Year Treasury ended the second quarter with a yield of 2.80% and a Ten-Year Treasury yield finished at 2.98%. Corporate bonds declined more than Treasuries and municipal bonds last quarter, with lower quality corporates performing worse than investment grade as spreads versus comparable maturity Treasuries widened. As yields on all types of bonds rose, so did mortgage rates, with a typical 30-year mortgage rate increasing to the 5.50-6.0% range. Mortgage applications fell to a 22-year low last week. The Federal Reserve interest rate hikes may be weakening demand as intended.

OUTLOOK

We expect interest rates to continue increasing. It's a bit ironic that the Fed is hoping for a slow down or recession in order to combat runaway inflation. As of July 21, oil was below $100 ($120 in June) a barrel with little change with the Ukraine invasion. This tells us that much of the peak oil prices were artificial and propped up by speculators. We suspect prices will remain elevated though, given the general negativity toward the Oil and Gas industry due to environmental concerns and the Biden administrations push towards more environmentally friendly energy sources.

If you want to combat inflation you want to invest in stocks, in our opinion. It's the only asset class that consistently outpaces inflation over time. That doesn't mean stock prices won't be volatile in the short term. Companies can pass costs through to customers or find greater efficiencies within their organization. Hard assets are also usually a good hedge, specifically against inflation. We're not big proponents of commodities though, due to more limited upside potential.

Real estate prices will probably lose their luster for the next year or so. A doubling of mortgage rates in just a few short weeks has definitely dampened demand, but demand still seems robust. That, plus the attractiveness of physical assets may well keep prices from any steep decline.

With the yields between one and 30 year Treasury bonds nearly identical, the choice is obvious for us. The shorter-term bond pays the same with 29 years less of risk. At about 3%, this at first, seems more attractive than the sub 2% rates from just a few months ago, but with inflation at nearly 9%, you're really losing 6% per year in buying power. For our clients, we use short term bonds as a higher yielding place holder than cash.

Finally, if you are a client, you know we do not participate in any crypto related investments. Bitcoin has fallen by more than 67%, as of this newsletter and many crypto banks/exchanges/lenders are either bankrupt or in serious financial distress. Besides being a "new" thing, "crypto" has not delivered on any of its selling points; its highly correlated to the stock market, its not used as a currency, in general, and many of the exchanges and lenders that were created for the asset class centralized much of the risk.