Investment Update

July, 2022

2022 Second Quarter Update

Review: Returns for most major asset classes were negative for the second quarter in a row. Higher than expected inflation has led to more aggressive rate hikes by the Federal Reserve, which have been negative for both equities and fixed income. International equities fared slightly better than the S&P 500 but were still down double digits. Bond yields continued to march higher, with the 10-year Treasury ending the quarter at 2.98%. However, it is worth noting that the increase in yields in Q2 was driven by higher real (inflation-adjusted) yields rather than higher embedded inflation expectations, which had been the case in Q1.

Period	2Q22	1Q22	2021
S&P 500	-16.1%	-4.6%	28.7%
MSCI EAFE[1,2]	-14.3%	-5.8%	11.8%
MSCI Emerging Markets[2]	-11.3%	-6.9%	-2.2%
Barclays U.S. Aggregate Bond	-4.7%	-5.9%	-1.5%
Barclays Municipal Bond	-2.9%	-6.2%	1.5%

[1] Europe, Australasia, Far East

[2] MSCI returns are in U.S. Dollars

Inflation Continues to Drive the Federal Reserve

Heading into this year, the market expected that the Federal Reserve might raise rates three times before year end to about 1%, but those expectations changed as inflation has persisted. The current market-implied Fed Funds Rate estimate for year end is now 3.4%, with rate hikes assumed for all remaining Fed meetings. The most recent Fed meeting in June resulted in a 75bp increase, higher than the original 50bp estimate because of a higher than expected CPI (Consumer Price Index) report and an increase in consumer inflation expectations in a New York Fed survey.

Keeping longer-term inflation expectations anchored is critical, as expectations can influence consumer behavior. To date, longer-term consumer and market expectations remain in line with historical levels, but consumer expectations for the next year are at levels not seen since the early 1980s. The University of Michigan Survey of Consumers for May showed a median of 5.3%, and the New York Fed survey median was 6.6%. Additionally, the dispersion among individual estimates is very high, illustrating both the uncertainty around inflation expectations and the likely differences in how various segments of society are being affected by current inflation.

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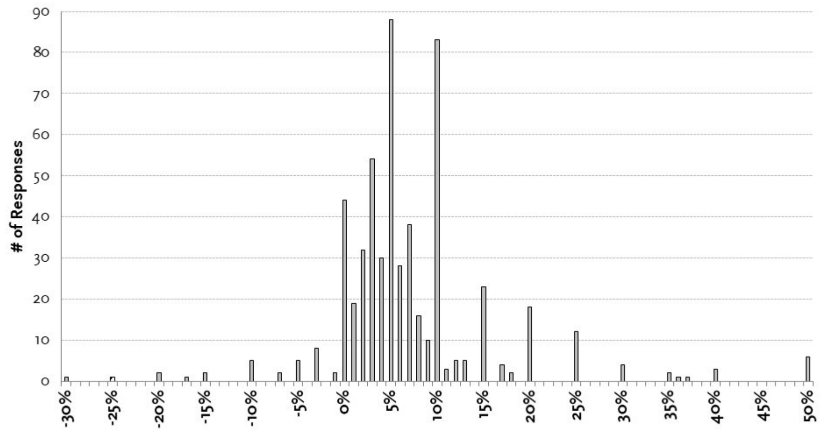
The chart below shows a breakdown of responses to the University of Michigan May survey question on 1-year inflation expectations. Though the median is 5.3%, 15% of respondents expect inflation of 10% or higher. Survey results like these led Fed Chairman Powell to state that the "bigger mistake to make… would be to fail to restore price stability."

Breakdown of May 2022 Univ. of Michigan Survey Responses – Consumer Inflation Expectations for the Next Year



Source: Wall Street Journal 06/24/2022 (University of Michigan Survey of Consumers cited as original source)

Outlook: The current consensus estimate for US GDP growth this year is 2.4%, similar to the 2010-19 average of 2.3%. After a negative Q1 GDP reading, there is an increased focus on whether Q2 GDP also declined on a quarter-over-quarter basis, potentially signaling a recession. However, it should be noted that there has never been a recession declared without rising unemployment, and thus far, the US job market remains healthy.

We would also note that the S&P 500 fell into bear market territory during the 2nd quarter, with a peak-to-trough decline of 23.6% as of June 16. This has been driven solely by P/E multiple contraction, as earnings estimates have actually increased year-to-date. If the Fed is able to engineer a soft landing for the economy—i.e., no recession—this decline would be close to the post-World War II median of 26.6% in bear markets occurring in non-recessionary periods (versus the recession bear market median decline of 33.9%). That said, we expect continued volatility until inflation reports improve.

We continue to be cautious on international growth given the numerous headwinds, including the impact of the war in Ukraine, strengthening US dollar, and China's zero COVID strategy.

Strategy: The next several months will yield critical information on inflation, jobs, economic growth, and corporate earnings. Given increased uncertainty, we continue to prefer higher quality companies within equities. Over the long term, we also continue to prefer the risk-reward in equities rather than fixed income. However, we do recognize that shorter term, tactical asset allocation shifts may be appropriate given that the recent market volatility could continue in the near term, occasionally presenting opportunities to add fixed income exposure at relatively attractive levels. This volatility may also present opportunities to make changes at the individual stock level to upgrade portfolios.