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SECOND QUARTER 2022 ECONOMIC AND FINANCIAL MARKETS REVIEW

The stock and bond market turmoil that began in the first quarter this year intensified during the second quarter as investors became concerned about rising inflation and its negative impact on the economy. Inflation is currently high for several reasons. First, the Federal Reserve Board lowered interest rates to zero during the pandemic and left them too low for too long. They also printed too much money, particularly during the pandemic, to help support the economy. Second, the war in Europe and other geopolitical issues have led to higher energy and food prices. Third, the pandemic created supply chain issues, which has caused problems getting raw materials and finished goods to their final destinations. Finally, a very tight labor market has led to wage inflation..

The Federal Reserve Board has been raising interest rates during the second quarter and reducing the money supply in an attempt to rein in inflation. However, investors are concerned that this monetary tightening could slow corporate earnings growth and cause an economic recession. As a result, the S&P 500 Index finished the first half of this year down 20.58%, while the Dow Jones Industrial Average lost 15.31%. The Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index declined 6.77% during the first half of 2022.

Since the great recession in 2007, the Federal Reserve Board has kept interest rates extremely low. Unfortunately, this loose monetary policy, combined with unprecedented spending on fiscal stimulus, ended up fueling inflation, especially as demand for goods and services increased after the pandemic. Reversing this easy money policy has meant raising interest rates, leading to increased borrowing costs for both consumers and businesses. The Fed is now attempting to create a “soft landing” whereby they increase interest rates just enough to slow the economy and inflation without causing a recession. However, stock market investors are concerned that they will create a “hard landing,” sending the economy into recession and harming corporate earnings.

In addition to rising interest rates, increasing oil prices negatively impacts many different parts of the economy. Not only does it cost consumers more money to travel, but it also increases shipping costs for businesses. Oil is also used as a raw material in many products that have seen their prices rise. Food prices have also increased because Ukraine is one of the largest wheat producers in the world, and the war is preventing Ukraine from exporting enough of it.

Several companies warned during the second quarter that their earnings are being harmed by difficulties obtaining raw materials to make finished products. This is mainly due to supply chain disruptions that resulted from the pandemic. For example, consumer demand for products like automobiles is robust, but there are not enough semiconductors to manufacture enough autos to meet demand, leading to higher prices for cars.

Finally, due to a robust economy, labor costs have been rising. When wages increase, these costs are typically passed onto consumers in the form of higher prices for goods and services.

While investors have been concerned that inflation and higher interest rates will lead to a recession, this is not necessarily a guaranteed outcome. The U.S. economy is currently growing despite rising

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interest rates, rising energy prices, and supply chain issues. Traders and investors do not like when the Fed raises interest rates, but if they raise rates just enough to reduce inflation without creating a recession, this "soft landing" scenario could be cheered by investors later this year.

For this reason, we recommend that most clients not make any drastic changes to their portfolios at this time despite challenging market conditions. It is possible that the market decline could get worse before a new bull market begins. However, it is typically best to wait for volatility to subside and a sustainable recovery to start before attempting to change long-term investment plans.

We continue to recommend short-term bonds rather than long-term bonds because short-term bonds are less sensitive to rising inflation and interest rates. We also continue to prefer large company stocks over small company stocks because large-company stocks are typically less volatile than small ones. After several years of U.S. stocks outperforming, foreign stocks appear relatively inexpensive. Finally, gold prices should continue to benefit if inflation and geopolitical uncertainties persist.

As always, we will continue to monitor ongoing economic and financial market conditions. In the meantime, please contact us if you have any questions or concerns regarding your portfolio or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on July 1, 2022.*

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