RDM CAPITAL ASSOCIATES
WEALTH MANAGEMENT

Second Quarter 2022 Market Commentary:

Bull to Bear Transition
June/July 2022

With the second quarter drawing to a close, we're reaching out prior to quarter-end to proactively address the recent market downturn and equity markets entering bear market territory. Bear markets are defined by a 20% or more drop in the S&P 500 during any time period. From the market highs of January, the S&P has fallen more than 20% and is now down ~ 18% in the second quarter alone. However, given current market dynamics, even traditional "safe haven" investments have depreciated year-to-date, with U.S. treasuries also down over 10%. Below, we highlight some of the major market considerations that have led to this precipitous drop and the economic outlook going forward.

Inflation Data Remains Elevated and Stagflation Looms

Any market observer has surely followed the persistently high inflation in the U.S. and abroad that has roiled financial markets. Most recently, the May CPI data reflected a 8.6% year-over-year increase in prices, primarily led by oil and food prices, which was slightly higher than the consensus estimate of economists. As we noted in our mid-quarter market update and prior commentaries, inflation remains persistently high due to a confluence of several inflationary trends: supply chain shortages at home and abroad related to COVID restrictions and imbalances, monetary and fiscal policy intended to stimulate the economy out of the pandemic that has been overdone and mismanaged, the Russia-Ukraine war that has crimped global supply of oil and wheat, among other things, and a tight U.S. labor market that has led to higher wage expectations.

Economic data recently has reflected a slowing economy that should naturally lead to slower inflation. For example, surveys of both consumer and business confidence have recently reflected lower confidence in economic conditions due to rising costs and recession fears. Additionally, mortgage rates have risen significantly this year, with the average 30-year fixed mortgage rate reaching 5.78%, which is the highest rate since 2008 and compares to the 3.11% average rate at the end of 2021. This rate move will slow the housing market in the near-term as prices have also skyrocketed since the pandemic and home affordability has been hit by both factors.

Nonetheless, the Federal Reserve last week announced an increase in the fed funds rate by 0.75%, bringing the rate to 1.5-1.75% with a more hawkish tone towards future rate hikes anticipated over the next year. We view this as a necessary move by the central bank as inflation expectations are beginning to filter into several other areas of the economy in a negative manner. It is imperative that the Fed act aggressively to stifle inflation and, equally as important, inflation expectations, which can often take on a life of their own. The Fed has adopted a more aggressively hawkish stance overall and is prioritizing reducing inflation even if the measures taken increase the risks of a recession in the near term.

However, the current inflation problem is not going to be exclusively solved by the Fed. Historically the Fed's ammunition has been effective in a traditional cyclically over-heating economy. Yet, economic conditions currently are not reflecting an economy that has grown too strong for too long. Rather, the economy is recovering from a once in a generation pandemic that has been over-stimulated monetarily as well as fiscally. Had COVID never come about, the Fed would have likely been gradually raising interest rates over the past couple of years. This would have been unpalatable during an extraordinary pandemic and now the Fed is forced to play catch up and reverse some of the demand side stimulus provided during the pandemic. Unfortunately, this is unlikely to impact the supply-side forces that are increasing inflation. Therefore, a true turn in inflation may not occur until pandemic-related supply chain issues have also been resolved and fiscal policy stimulates fundamental business growth, rather than infusing cash stimulus intended to stimulate the demand side of the economy.

Our current base case scenario for the U.S. economy is a potential period of stagflation that will last an indeterminate amount of time, depending on policymakers' response. Stagflation is an economic condition that has not been felt in the U.S. since the 1970s and is a combination of persistent inflation and economic stagnation or low growth. As noted above, it appears inflation is persisting and it's starting to impact business activity as consumers cut back and businesses feel the pain of higher input costs. This naturally would lead to lower economic growth than in recent years. In a worse-case scenario, the U.S. economy would fall into recession, although we don't feel that is currently the most likely result. Unemployment is still very low, business and consumer balance sheets are very strong and there is an uptick in economic activity with more room to run from pandemic re-openings, particularly in Asia. Alternatively, in a best-case scenario, it seems that a return to robust economic growth is also not imminent given the restrictive monetary policies needed to tame inflation. In a stagflation environment, exposure to commodity and materials sensitive equities can buffer some of the negative effects. Typically, economic stagnation will provide a headwind to overall equity returns while at the same time higher inflation and higher interest rates are a headwind for bond returns. Thus, we intend to emphasize our equity portfolio towards hard asset sensitive equities and maintain exposure to high quality equities of stable businesses with pricing power.

Tech/Growth Trade Has Lost Steam Leading Market Downturn

Hardest hit in the market downturn are the technology stocks that previously led the pandemic market returns, with value stocks outperforming growth stocks by ~17%, the largest outperformance in over twenty years. During 2020 and 2021, as Covid lockdowns led to an increase in e-commerce and remote experiences, technology shares led the robust market returns. However, as economies re-open from the pandemic at the same time that interest rates continue to rise in response to elevated inflation, these same technology shares have lagged considerably as their more speculative future earnings become less and less attractive. To this end, the technology sector is down ~ 30% in 2022 and the consumer discretionary sector is down ~35%, reflecting the growth to value rotation and the impact of higher interest rates on growth stock valuations.

Relatedly, the cryptocurrency markets saw significant declines in 2022, with Bitcoin down nearly 70% since its November high with nearly $2 trillion in market capitalization wiped out. This is another example of a reversal of the frothiness created by stimulus policy during the pandemic (similar to the Gamestop and AMC irrational trading). While we have not allocated client funds to crypto, it is important to watch as these drawdowns impact the market overall and cause volatility from traders that have exposures across disparate markets.

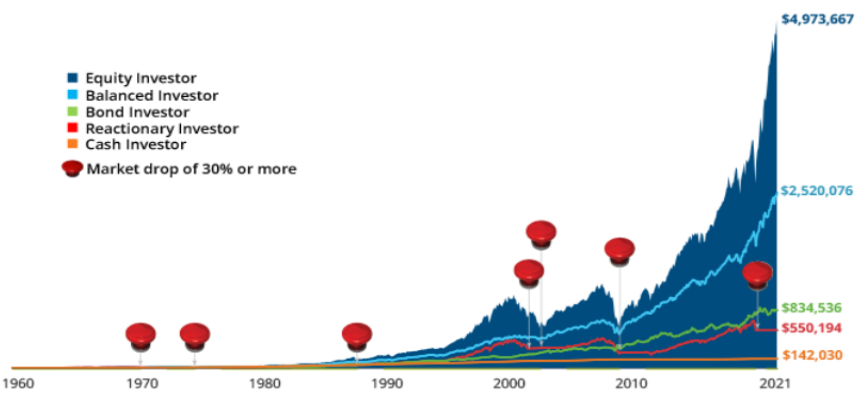
Avoiding Panic Decisions in Bear Markets

Bear markets, like economic recessions, are normal cyclical occurrences in the investment world and can be expected once every three to four years on average. Even so, the experience is not pleasant and can often lead to investors making poor investment decisions due to the stress of watching investment assets depreciate. Without doubt, the worst decision that can be made is to capitulate and sell assets that are in decline just for the temporary relief from a sense of panic. This type of decision-making will lead to lower overall wealth accumulation over time than simply riding the market waves and waiting out any temporary pause in the long-run growth of the equity markets. This is particularly true for investors with many years before their investment goal time horizon. Historically, the median S&P 500 return six months after entering a bear market is 5.5% and one year after entering a bear market is 23.9%. This was most recently illustrated during 2020, when the S&P entered a bear market on March 12, 2020 yet rebounded 59% in the year that followed.

The illustration below shows the difference in historical terms between a panic-decision making strategy of a “reactionary investor” during market downturns and an equity or balanced investor that sticks with an investment plan throughout market cycles.

The Price Of Panic

$10,000 Invested S&P 500 Index 12/31/59–12/31/21



The combination of market volatility and the constant drumbeat of negative news can make it difficult to stay calm—even for experienced investors. But giving in to panic by making abrupt changes to your portfolio could be detrimental to your long-term investment returns.

Past performance does not guarantee future results. **Equity** returns are represented by the S&P 500 Index. **Bond** returns are represented by the Bloomberg Long-Term US Treasury Total Return Index. **Reactionary** returns indicate the results of an investor who invested in S&P 500 Index, moved 100% into 90-Day T-Bills each time the market dropped 30% and then moved 100% back into S&P 500 Index two years later. **Balanced** returns are represented by 50% S&P 500 Index and 50% Bloomberg Long-Term US Treasury Total Return Index. **Cash** returns are represented by 90-Day T-Bills.

Data Source: Ned Davis Research, 12/21. For illustrative purposes only. Indices are unmanaged and not available for direct investment.

***1**. Source: Hartford Funds*

As usual, all comments are welcome and appreciated.