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Q3 2022 Newsletter | Jeff Griggs, CFA

Due to the wide range of risk tolerances of our clients, some topics or asset classes may have more, less, or no importance to your portfolio. For a detailed analysis, give us a call, or request a detailed performance review.

Big Picture

The S&P 500 just posted the worst first half of a year since Nixon, falling 20.6%, but that is only half the story as bonds have been crushed year-to-date as well. If the year ended now, it would be the 7th worst for the stock market, somewhere between the dot-com crash of 2002 and 1973. Combine that with a 14% retreat in the bond market and a 60/40 portfolio has lost about 16% in the first half of the year. That makes it the third worst year for a diversified, moderate risk, portfolio since 1928. The only years worse were 1931 during the Great Depression and the crash of 1937. The good news is, if we look longer term, a 60/40 portfolio has not posted a 5 year loss since WWII, with the worst 5 year period (post 1941) returning 8.9% in 1974.

While this may illustrate the power of time in the market, it does little to quell the fears investors are facing right now as recency bias and loss aversion take over. Somewhat hidden amongst the carnage, although it is beyond obvious to us at this point, is the lopsided beating growth stocks have taken during the downturn. In fact, the first half of the year represents the worst first six months for the Nasdaq and Russell 2000 ever. The 10.7% retreat in the Bloomberg U.S. Agg is also its worst start ever based on data going back to 1975. Usually, when things are this bad for stocks, bonds are there to cushion the blow, that is not the case this year and that makes this year especially painful for risk-averse investors. The data cited above was provided by Ben Carlson on his blog A Wealth of Common Sense, with more details available here.

On the Fridge

Floating Rate Bonds

For the second quarter in a row, floating rate bonds were the only sub-asset class (that we track) that posted a positive return in the quarter, rising 0.3%.

Consumer Staples

While it may be a bittersweet victory, consumer staples outperformed all other sectors losing only 4.6% in the quarter, with utilities taking second places down 5.1% in the quarter.

In the Dog House

US Stocks

US stocks performed the worst in the second quarter by a decent margin, falling 16.8%, while Developed Market stocks were the second worse losing 14.4%.

Consumer Discretionary

Straight out of the recession playbook, staples performed the best, while the consumer discretionary sector performed the worst losing 26.2% in the quarter, a full 5.5% more than the next sector communication services which fell 20.7% in the second quarter.

Looking Ahead

It is rare for the market to have such a unanimous consensus on what the near-term future will bring. As of now, nearly everyone is expecting the Fed to push us into a recession in their quest to rein inflation in by dampening demand through continuing to aggressively raise rates.

I don't necessarily disagree with the narrative. But the market is forward looking, every trade is a zero-sum game. For every seller there must be a buyer, so bottoms are hit when consensus is made. The question is not whether a recession will occur, but to what extent that possibility has already been priced in. Even if a recession is inevitable, the timing and severity are hard to predict, but a broad consensus being made early could cause capital markets to bottom well ahead of the real economy. We saw something similar in 2020, when the COVID-19 pandemic had just caused a global shut-down, you could not have written a worse scenario for the global economy and everyone agreed, yet the market bounced hard off the bottom and rocketed higher for the next 18 months. The turnaround happened well before we had viable vaccines, herd immunity, or lifted restrictions.

With lessons like that in mind, I think the prescient thing to do now is to be greedy when others are fearful and scoop up great companies with attractive long-term prospects at discount prices.

Links and Articles

The Worst Years Ever for a 60/40
As cited above, this Ben Carlson blog post highlights some of the worst years for a diversified portfolio.

The New Inflation Regime
Blackrock explores how investors can prepare for a prolonged period of structurally higher inflation.

BofA Survey Shows Full Investor Capitulation
This Bloomberg article highlights the unusual level of negativity we're currently seeing in the market.

I Haven't Seen Bargains this Good in 20 Years
Thompson Clark of Mauldin Economics highlights some of the opportunity he is seeing in the market.

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Performance

The data mostly speaks for itself, and I've already highlighted some of the carnage we've faced this year, so I won't spend too much time here. But I do think it is worth pointing out a couple of things. First, international bonds have been the worst performing sub-asset class in the fixed income space in the face of a strong dollar (ICE US Dollar index is up 9% YTD). Meanwhile, Emerging Market stocks have been the strongest performer both in Q2 and YTD, despite the disruption caused by Russia's invasion of Ukraine (Russia is the third largest economy in emerging markets). As you will see from the sector returns, Energy has been the only winning trade all year, up 32% year-to-date, while the next best sector is utilities which is down 0.6%. While it is hard to do, it is important to remember the sunk-cost fallacy when viewing these past returns. While we all wish we could have been positioned in Energy, high-dividend, and value plays at the start of the year, at a certain point margin compression is like coiling a spring and high growth companies will hit a valuation bottom with far more upside potential than their slower growing peers. This may be especially true for small-caps after the Russell 2000 just suffered it's worst first half since inception in 1978, by a large margin. It is now down 23.4% while the second worst start to the year was only a 13% decline at the start of the COVID-19 pandemic in 2020.

	Benchmark Index	2022 Q2	YTD	LTM	3yr	5yr	10yr
Cash	**Bloomberg US Treasury Bill 1-3 M TR USD**	0.1%	0.2%	0.2%	0.2%	1.1%	0.6%
Fixed Income	**Bloomberg Global Aggregate TR USD**	-8.3%	-13.9%	-15.3%	-3.2%	-0.6%	0.1%
Fixed Income Blend	Bloomberg Global Aggregate TR USD	-8.3%	-13.9%	-15.3%	-3.2%	-0.6%	0.1%
Government	Bloomberg US Government TR USD	-3.7%	-9.0%	-8.8%	-0.8%	0.8%	1.0%
Inflation Protected	Bloomberg US Treasury US TIPS TR USD	-6.1%	-8.9%	-5.1%	3.0%	3.2%	1.7%
Municipal	Bloomberg Municipal TR USD	-2.9%	-9.0%	-8.6%	-0.2%	1.5%	2.4%
Floating Rate	Bloomberg US Trsy Floating Rate TR USD	0.3%	0.4%	0.5%	0.7%	1.2%	0.0%
Corporate	Bloomberg US Corp Bond TR USD	-7.3%	-14.4%	-14.2%	-1.0%	1.3%	2.6%
High Yield	Bloomberg US Corporate High Yield TR USD	-9.8%	-14.2%	-12.8%	0.2%	2.1%	4.5%
International Bond	Bloomberg Gbl Agg Ex USD TR USD	-11.0%	-16.5%	-18.8%	-5.1%	-1.8%	-1.1%
Equity	**MSCI ACWI GR USD**	-15.5%	-20.0%	-15.4%	6.7%	7.5%	9.3%
Equity Blend	MSCI ACWI GR USD	-15.5%	-20.0%	-15.4%	6.7%	7.5%	9.3%
US Equity	MSCI USA GR USD	-16.8%	-21.1%	-12.8%	10.4%	11.2%	12.9%
Developed Markets	MSCI World ex USA GR USD	-14.4%	-18.4%	-16.3%	2.2%	3.2%	5.9%
Emerging/Frontier	MSCI EM GR USD	-11.3%	-17.5%	-25.0%	0.9%	2.5%	3.4%
Alternatives	**Wilshire Liquid Alternative TR USD**	-3.7%	-5.5%	-5.3%	1.4%	1.4%	1.7%
Alternatives Blend	Wilshire Liquid Alternative TR USD	-3.7%	-5.5%	-5.3%	1.4%	1.4%	1.7%

Sector	2022 Q2	6mo	YTD	1yr	3yr	5yr	10yr
Information Technology	-20.2%	-26.9%	-26.9%	-13.6%	18.7%	20.2%	18.7%
Financials	-17.5%	-18.7%	-18.7%	-12.7%	6.7%	7.2%	12.5%
Health Care	-5.9%	-8.3%	-8.3%	3.4%	13.6%	12.2%	15.0%
Consumer Discretionary	-26.2%	-32.8%	-32.8%	-24.2%	5.4%	9.8%	13.5%
Consumer Staples	-4.6%	-5.6%	-5.6%	6.7%	10.9%	8.8%	10.7%
Industrials	-14.8%	-16.8%	-16.8%	-13.4%	6.1%	6.8%	11.3%
Energy	-5.2%	31.8%	31.8%	40.0%	10.1%	7.0%	4.3%
Utilities	-5.1%	-0.6%	-0.6%	14.3%	9.0%	9.8%	10.5%
Materials	-15.9%	-17.9%	-17.9%	-8.7%	10.3%	8.7%	9.9%
Communication Services	-20.7%	-30.2%	-30.2%	-29.1%	5.4%	6.1%	6.0%
Real Estate	-14.7%	-20.0%	-20.0%	-5.2%	7.0%	8.5%	9.1%

Source: Morningstar; The 1,3,5, and 10 year performance is annualized.

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Asset Class	Benchmark	Description
Cash	Bloomberg US Treasury Bill 1-3 M TR USD	Measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.
Fixed Income	Bloomberg Global Aggregate TR USD	The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers.
Government Bonds	Bloomberg US Government TR USD	The Bloomberg US Government Bond Index comprises the US Treasury and US Agency indices. The index includes US Dollar-denominated, fixed-rate, nominal US Treasuries and US agency debentures (securities issued by US government owned or government sponsored entities, and debt explicitly guaranteed by the US government).
Inflation Protected	Bloomberg US Treasury US TIPS TR USD	The Bloomberg US Treasury Inflation-Linked Bond Index (Series-L) measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.
Municipal	Bloomberg Municipal TR USD	The Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.
Floating Rate	Bloomberg US Trsy Floating Rate TR USD	The Bloomberg US Treasury Floating Rate Index measures the performance of floating rate bonds issued by the US Treasury.
Corporate Bonds	Bloomberg US Corp Bond TR USD	The Bloomberg US Corporate Bond index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.
High Yield Bonds	Bloomberg US Corporate High Yield TR USD	The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.
International Bonds	Bloomberg Gbl Agg Ex USD TR USD	The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers. This version excludes USD-denominated debt.
Equity	MSCI ACWI GR USD	The MSCI ACWI captures large and mid cap representation across 23 Developed Markets and 23 Emerging Markets countries. With 2,477 constituents, the index covers approximately 85% of the global investable equity opportunity set.
US Equity	MSCI USA GR USD	Captures broad US equity coverage. The index includes 3,108 constituents across large, mid, small, and micro capitalizations, representing about 99% of the US equity universe.
Developed Market Equity	MSCI World ex USA GR USD	Captures large and mid cap representation across 22 of 23 Developed Market countries, excluding the United States. With 1,023 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Emerging Market Equity	MSCI EM GR USD	The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 829 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Alternatives	Wilshire Liquid Alternatives TR USD	Measures the collective performance of the five Wilshire Liquid Alternative strategies that make up the Wilshire Liquid Alternative Universe, including the Wilshire Liquid Alternative Equity Hedge, Global Macro, Relative Value, Multi-Strategy, and Event Driven indices. This index is meant to provide a representative baseline for how the liquid alternative investment category performed as a whole. Constituents comprised of '40 Act mutual funds.
US Large Cap Equity	S&P 500	Widely regarded as the best gauge of large-cap US Equities. The S&P 500 is a market-weighted index that includes 500 leading companies and captures approximately 80% coverage of available market capitalization.