2Q22 Market Commentary
Paying the Pandemic Price Tag

To say the first half of 2022 has been challenging from an economic and investment perspective would be an understatement. The global equity market as measured by the MSCI AC World Index posted its worst first half of a year on record and fell firmly into bear market territory (a drop of 20% or more). Even the bond market could not escape the chaos as the Bloomberg Barclays Global Aggregate Index also saw the worst first half on record and bond investors have been forced to accept equity like losses. Commodities benefitted from geopolitical turmoil and supply constraints. However, even the modest return on cash was outstripped by inflation that is running at a 40-year high.

What we are witnessing this year is the world trying to pay the pandemic price tag. While we enjoyed a surge in economic activity for most of 2021, the actions taken during the pandemic to avoid a global depression are proving to have longer-lasting ramifications. We are not suggesting that there was a better choice in the depths of the pandemic. The world was in unchartered territory and protecting human life took precedence. However, we must now navigate through the clean-up of years of money printing and excessive fiscal stimulus.

Matthew Andrulot

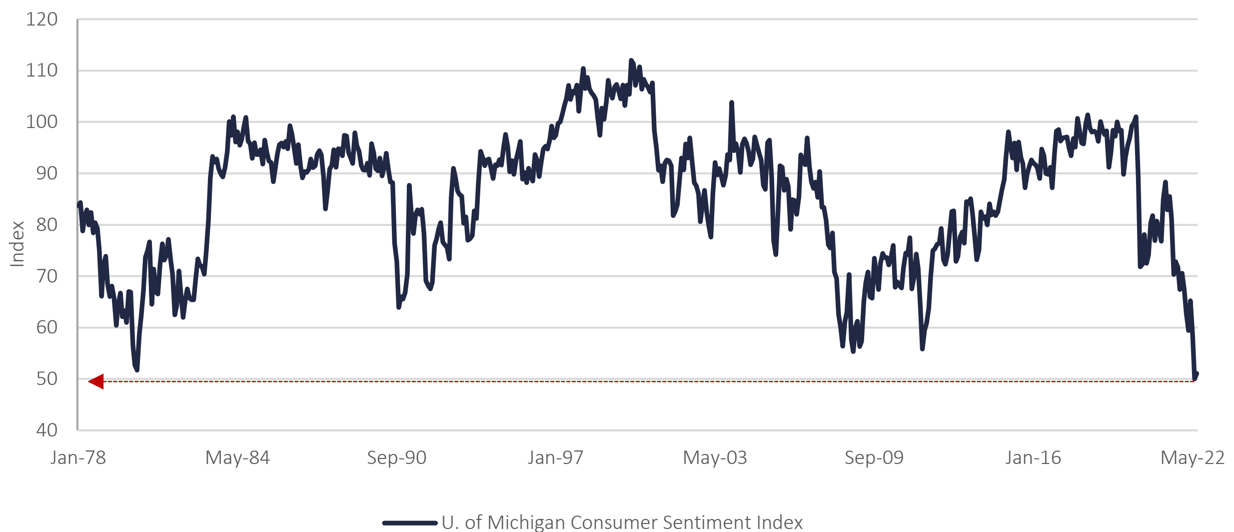
Past performance is not indicative of future returns

Inflation remains stubbornly high and global central banks have found themselves behind the curve. The decade's old regime of easy money is being flipped upside down at the expense of global equity and bond investors. In addition consumers have never felt this bad about the economy, even worse than the 1980s (Chart 1). In this quarterly commentary, we will offer insight into the economy and what we expect as we close out this challenging year. We will discuss how to be positioned, especially given that many areas of the equity market have already experienced recession like drawdowns, and we believe may present opportunity for investors with a longer-term time horizon.

Chart 1

Consumers Have Never Felt Worse

Data is preliminary reading for July 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



U.S. Economy – Clearing Out the Excess

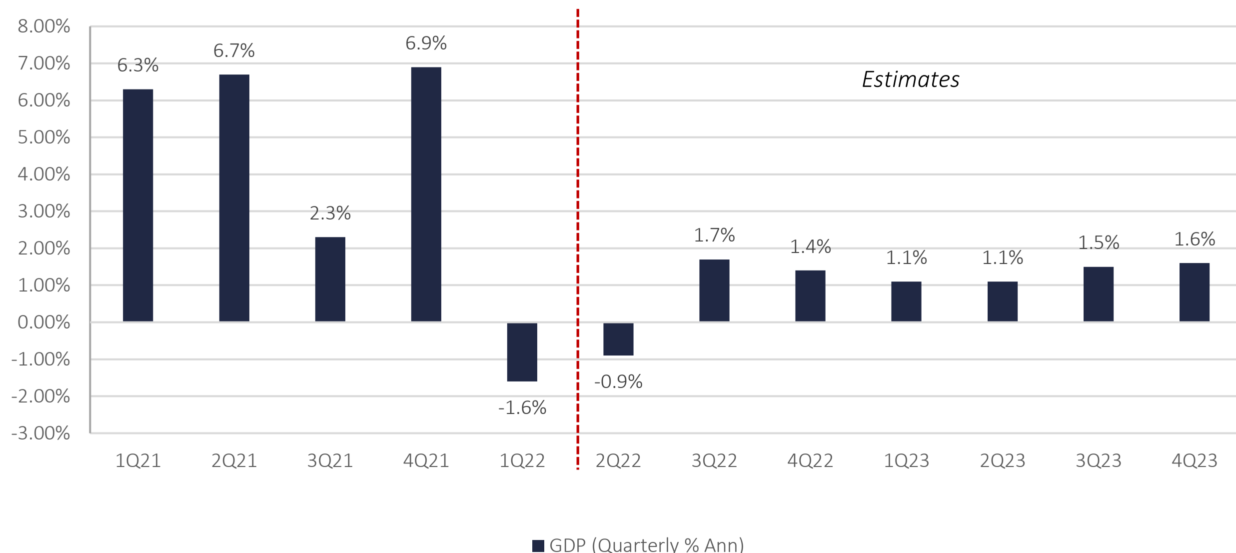
The first reading of U.S. GDP for 2Q22 tells us that we entered the technical definition of a recession with two consecutive quarters of negative GDP (Chart 2). Unfortunately, the Federal Reserve (and many other global central banks) has found itself chasing inflation and is needing to act aggressively, ultimately at the expense of economic growth. While the consumer balance sheet may be healthier than any other time leading up to a recession, surging prices on gasoline and food will continue to squeeze savings and hamper spending power. The housing market is also under immense pressure because of rising mortgage rates, limited inventory, and prices at a record high. According to the NAHB Homebuilder Sentiment Survey, prospective buyers' traffic has slowed to a seven-year low (except for the dip during the pandemic shutdown). In addition, manufacturing is cooling as businesses grow concerned over the outlook for the economy. It is important for investors to understand that recessions are part of any long-term investment cycle. In fact, prior to the long business cycles that we have been fortunate to experience since 1990, recessions occurred every three to four years. While recessions feel bad while we are in them, they are also a healthy part of an economic cycle. Clearing excesses in the economy is crucial and the actions taken during the pandemic created excesses that are not sustainable for our economy.

> The Federal Reserve has found itself chasing inflation and needing to act aggressively, ultimately **at the expense of economic growth.**

Chart 2

Technical Recession Upon Us

Data is estimates as of July 30, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



Matthew Andrulot

Past performance is not indicative of future returns

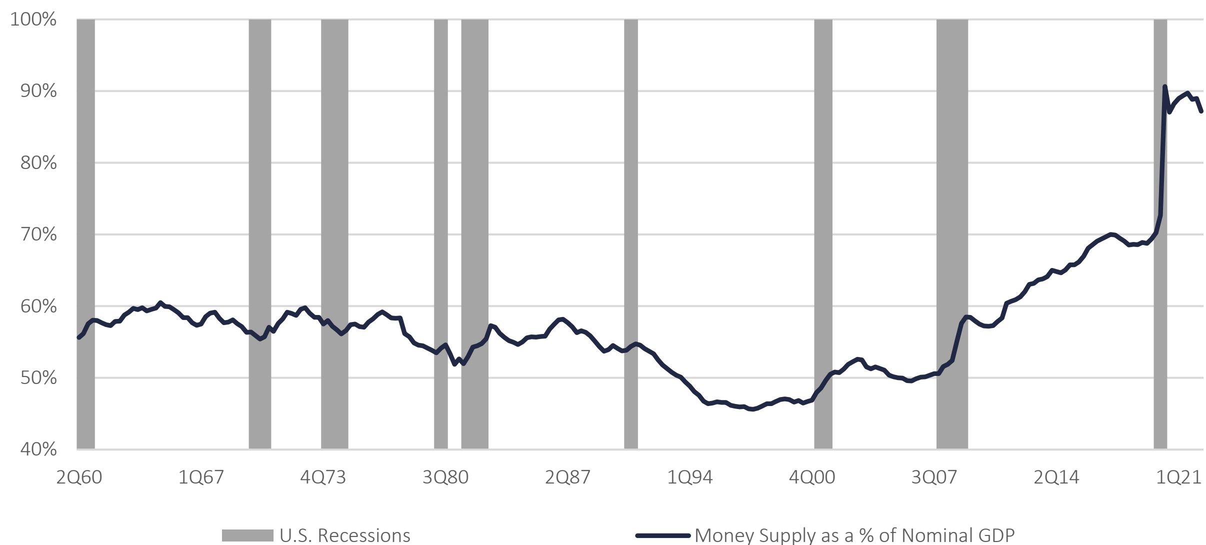
Money supply, although finally contracting, is nearly 90% of nominal GDP. That is an eye-popping amount of liquidity that needs to be drained out of the system (Chart 3). Unfortunately, it will take not only rate hikes but other extraordinary measures by the Federal Reserve to tighten policy (e.g., selling assets on their balance sheet). In addition, the pent-up demand from consumers on goods during the pandemic and now on services as the world has reopened has proven too strenuous on the supply chain and labor force.

The pent-up demand from consumers on goods and services as the world has reopened **has proven too strenuous on the supply chain and labor force.**

Chart 3

Excesses Need to be Drained

Data is as of 2Q22. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



A slowdown in spending is needed so select areas of the economy can catch up. With consumers feeling the pain from high prices, we expect consumer spending to slow as discretionary income declines. In addition, history tells us that there is a strong correlation between consumer confidence and personal consumption. In (Chart 4), when confidence has dipped to current levels, the annual growth in personal consumption has declined. While we have may have reached the technical definition of a recession, we do not expect it to be as deep and long lasting as prior recessions for several reasons:

Consumer is healthier than prior recessions: While excess savings created during the pandemic have evaporated due to higher costs of everyday necessities (e.g., food, gas), the overall consumer balance sheet remains strong. Household net worth, including home values, checking and savings accounts and investments, as a percent of a household's disposable income is over 800%! This compares to ~650% leading into the 2008 recession and ~615% leading up to the 2000 recession (Chart 5). In addition, the household debt service ratio is hovering near a record low.

Chart 4

As Confidence Goes… So Should Spending

Data is as of 2Q22, monthly confidence numbers are average for each quarter. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

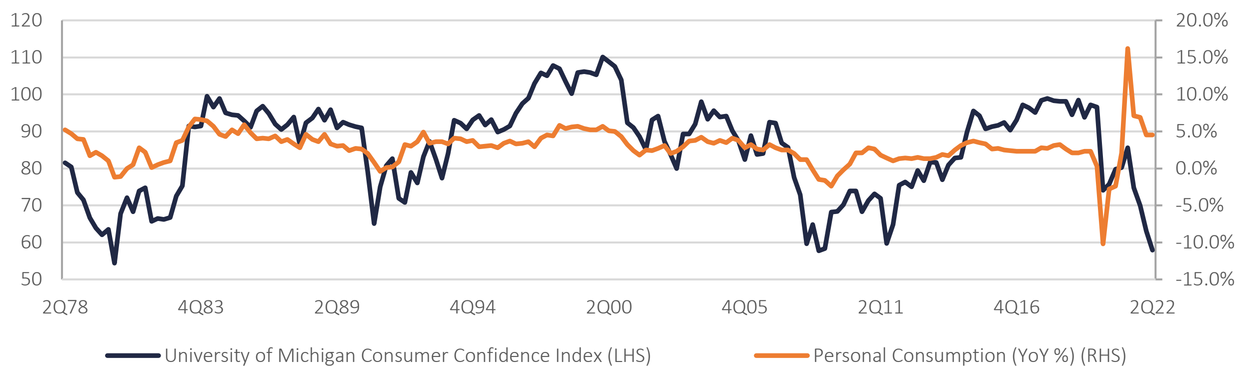


Chart 5

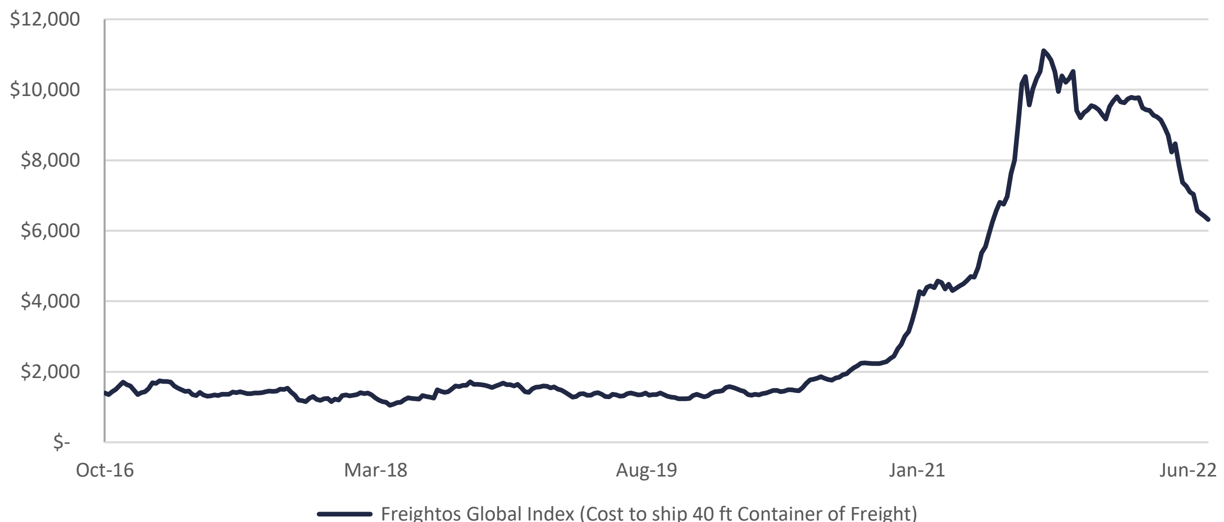
Consumers Look Stronger Than Past Recessions

Data is as of 1Q22. Data Source: Bloomberg Finance LP, Verdence Capital Advisors

- **Job growth slowing but strong labor market dynamics remain:** We are hearing some companies expect hiring freezes or layoffs as the economy slows. However, with more than one job posting for every one unemployed American, this labor market remains extraordinarily strong. In addition, it is rare to see a recession with the unemployment rate below 4.0%. Going back to 1950 (and aside from the current environment), there have only been three recessions that occurred when the unemployment rate was below 4.0% and one was the self-inflicted pandemic recession (i.e., 1953, 1969 and 2020).

- **Corporate balance sheets healthy:** Corporations have enjoyed a multi-decade period of historically low interest rates. They have shored up balance sheets and restructured expensive debt. This should help alleviate concerns of a massive increase in defaults in the economic slowdown. In addition, companies are still buying back stock (proving their fiscal health) and making capital expenditures.

Aside from the recession being at the forefront of investors' minds, the other challenge continues to be finding a peak in inflation. We admit that inflation has remained problematic for longer than we had originally anticipated. However, we believe that the annual growth rate of inflation is likely to peak in the coming months and move lower. We do not anticipate a return to the low levels of inflation that we were accustomed to prior to the pandemic, there is simply too much liquidity that needs to be drained from the system that will take years to correct. However, the combination of a slowdown (and recession) in economic growth and improvement in the supply chain, should alleviate some of the inflationary pressures. We have already seen a significant pullback in commodity prices (e.g., bear markets in many cases) which should help food prices, manufacturing prices are dropping, goods prices are moving lower with lesser demand and shipping costs are down ~40% from their 2021 peak system (Chart 6). If this continues, we should see the growth rate of inflation begin to move lower.



Global Equities – Recessions are Part of a Cycle; Focus on Areas Pricing in Downside Risk

An impending recession, rising interest rates and investor loss of credibility that central banks can get ahead of inflation contributed to the ongoing valuation correction and corresponding bear market in 1H22. Those areas of the global equity market (e.g., U.S. mega cap technology) that have enjoyed the decades old regime of easy money policy and low inflation experienced the worst of the equity sell off. For example, the NASDAQ 100 fell 34% from its November 2021 peak. This compares to 24% for the broad S&P 500. We expect some areas of the global equity market will continue to search for the appropriate valuation multiple that reflects the risk associated with less easy money policy and a recession in economic growth (e.g., U.S. large mega cap technology). However, the sharp move lower in many sectors and regions may be reflecting the bulk of the downside risk to the economy and earnings. Keep in mind, equity investors are typically looking six to nine months ahead and often the equity market troughs before we even know we are out of a recession. In fact, as can be seen in (Table 1), historically speaking, if an investor were to have invested in a bear market when it hit the 20% decline mark, they would have experienced attractive returns in the years that followed. Some areas that we believe may be unfairly beaten down and pose decent upside potential include:

Table 1

Historical Look at Past Bear Markets

Time period includes bear markets from 1945 to present. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

Historical Bear Markets					S&P 500 Return if Purchased when S&P 500 Dropped into Bear Market Territory			
Peak	**Hit Bear Market**	**Trough**	**Length of Bear Market (in months)**	**Peak to Trough Drop**	**1YR**	**3YR**	**5YR**	**10YR**
5/29/1946	9/9/1946	6/13/1949	37	-29.6%	-0.8%	2.6%	57.4%	216.9%
8/2/1956	10/21/1957	10/22/1957	15	-21.6%	31.0%	36.2%	40.4%	142.6%
12/12/1961	5/28/1962	6/26/1962	7	-28.0%	26.1%	59.3%	63.0%	98.8%
2/9/1966	8/29/1966	10/7/1966	8	-22.2%	24.6%	28.1%	33.5%	37.0%
11/29/1968	1/29/1970	5/26/1970	18	-36.1%	11.9%	35.4%	-9.8%	33.1%
1/11/1973	11/27/1973	10/3/1974	21	-48.2%	-26.9%	7.0%	0.3%	74.0%
11/28/1980	2/22/1982	8/12/1982	21	-27.1%	30.4%	60.7%	153.1%	269.5%
8/25/1987	10/19/1987	12/4/1987	3	-33.5%	23.2%	39.0%	84.6%	325.0%
7/16/1990	10/11/1990	10/11/1990	3	-19.9%	29.1%	56.0%	96.1%	361.9%
7/17/1998	8/31/1998	8/31/1998	2	-19.3%	37.9%	18.4%	7.2%	33.5%
3/24/2000	3/12/2001	10/9/2002	31	-49.1%	-1.2%	-5.0%	8.8%	9.8%
10/9/2007	7/9/2008	3/9/2009	17	-56.8%	-29.1%	6.0%	32.7%	123.7%
5/2/2011	10/3/2011	10/3/2011	5	-19.2%	32.0%	79.0%	96.6%	291.2%
9/20/2018	12/24/2018	12/24/2018	3	-19.8%	37.1%	103.8%		
2/19/2020	3/12/2020	3/23/2020	1	-33.9%	59.0%			
1/3/2022	6/14/2022	?						
		Average	**13**	**-31.0%**	**18.9%**	**37.6%**	**51.1%**	**155.1%**
		Median	**8**	**-28.0%**	**26.1%**	**35.8%**	**40.4%**	**123.7%**
				% Time Positive	**73.3%**	**92.9%**	**92.3%**	**100.0%**

- **U.S. small and midcap – Finding value in the undervalued:** The underperformance of small and midcap stocks over the past year (compared to large cap) may be pricing in too pessimistic of an outlook for the economy. While small and midcap stocks outperformed coming out of the pandemic, they are significantly underperforming large cap stocks over the past year and year to date. However, earnings estimates have been slashed along with the uncertain economic outlook which may be too pessimistic. In addition, historically small cap stocks have outperformed large cap stocks in the 12 and 18 months after the Fed started a tightening cycle.

- **International equities – Looking for a rebound:** Despite the heightened uncertainty about economic growth due to the Russia/Ukraine war and ensuing energy uncertainty we believe the underperformance of developed international equities is reflecting the likely slowdown, aggressive European Central Bank, and high recession probability for many European economies. Valuations compared to U.S. equities were cheap even before the crisis and remain near the cheapest on record. (Chart 7).

Chart 7

International Valuations Historically Cheap Compared to U.S.

Data is as of July 22, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

Despite our less than optimistic view of the economy in the next 12 months, we would not recommend reducing equity exposure at this time. Instead, remember that recessions are healthy and warranted for long term sustainable growth. This recession is no different. However, the speed at which the market priced in the upcoming economic weakness may be overdone. While we expect volatility to continue as we navigate through this bear market and economic uncertainty, we will continue to look at weakness as opportunity. Primarily because we still favor equities for the long-term over bonds. Corporate balance sheets are strong, inflation is likely to gradually fall from these heightened levels, margins have held up well as companies have passed on higher costs (Chart 8) and there remains a significant amount of money on the sidelines waiting to invest.

Chart 8

Margins Have Been Resilient

Data is as of July 22, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

Remember that **recessions are healthy and warranted** for long term sustainable growth.

Matthew Andrulot

Past performance is not indicative of future returns

Fixed Income – Little Reward for Risk but Yields Better Than Seen in a Decade

Unfortunately, the Fed's abrupt pivot from a gradual rate tightening cycle to the most aggressive pace of rate hikes since the mid-1990s has delivered bond investors with equity like losses this year. While in recent weeks, yields have retreated from the highest level seen in 11 years and the yield curve (10YR – 2YR Treasury yield) has inverted in anticipation of a recession in economic growth, we still do not see much reward for the risk in fixed income at these levels (Chart 9). The Fed is still delivering aggressive interest rate hikes and we are anxiously awaiting the peak in inflation. Therefore, we do not think we have seen the top in interest rates (or bottom in prices) in this cycle. However, over the long run, fixed income should serve its purpose as a source of portfolio diversification. Therefore, we would not abandon fixed income, especially with the economic outlook so uncertain but we would consider the following regarding fixed income allocation:

- **Short term bonds are the best house in a bad neighborhood:** Not only do short term bonds typically exhibit less interest rate sensitivity in a rising rate environment but now they are yielding higher than long term bonds. Therefore, we would focus on short-term maturing bonds and floating rate notes that can pay higher interest as rates increase. While the losses in fixed income have been difficult to stomach, investors are finally getting yield in their portfolios.
- **Credit getting more attractive but be patient:** While we do not see the credit environment deteriorating because of healthy corporate balance sheets, typically an economic recession does lead to some increase in defaults. We do not think the extra yield investors are being paid to own credit (either investment grade or high yield) is correctly reflecting the risk associated as the economy slows. We will continue to monitor further weakness and assess the credit environment to see if there is opportunity to add yield to our fixed income portfolios. However, we expect ongoing volatility as we navigate through the Fed tightening cycle and economic weakness.

Chart 9

Yield Curve Inverts the Most since 2001

Data is as of July 22, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

Matthew Andrulot

Past performance is not indicative of future returns

Alternatives – Traditional 60% Equity/40% Bond Portfolio Still has Headwinds

Until we see a peak in inflation and interest rate hikes, investors focused on a strict 60% equity/40% fixed income portfolio will likely not receive attractive risk adjusted returns. We do not believe we have seen the cyclical peak in yields which means more downside in bond prices is ahead. In addition, while the bear market in equities has likely priced in the bulk of the downside for the economy, volatility will continue as we navigate through the Fed tightening cycle and economic slowdown. While commodities were one of the sole areas to deliver positive returns in 1H22, we expect commodity returns to be challenged by demand weakness as global economic growth slows. Instead, we would prefer looking at other alternative investments, especially in the private space where we believe valuations are more attractive, investments are less correlated to traditional asset classes and are not subject to the daily volatility seen in the public markets. Sectors in the private alternative space that we favor include:

- **Real estate** remains in short supply and significant investments will need to be made to keep up with demand.
- **Infrastructure** investment has proven to be a necessity during the supply chain crisis and search for energy independence.
- **Credit** in the public space continues to look expensive with spreads near historically low levels. However, private credit appears to offer better yield potential.
- **Hedge Funds**, especially low volatility hedge funds, can offer another layer of diversification, add return potential, and serve as a hedge for investors public market equity exposure.

Matthew Andrulot

Past performance is not indicative of future returns

Bottom Line:

The first half of 2022 has been challenging from an economic and investment perspective. The highest level of inflation seen since the 1980s has caused consumer confidence to collapse while soaring interest rates have stalled the euphoria in the housing market and turned a decade's worth of easy money upside down in a matter of months. We understand that acknowledging we are in a recession may be unnerving for many Americans. As difficult as it has been to digest the losses this year it is important to focus on long term investment objectives and understand that bear markets typically occur every four to five years. Being flexible, patient and having dry powder to put to work has historically been beneficial for those investors that focus on the long term and not sell into the emotion of a bear market. At times of heightened volatility and uncertainty, it is important to assess whether investments are properly balancing the risks versus the reward. Evaluating whether the pendulum of pessimism has swung too far to the negative side and may already be reflecting the complete downside risk to an investment is important. We are seeing this overwhelming level of pessimism in select areas of the global equity market and will continue to assess pullbacks as potential long-term opportunities. We are confident that active management is the best way to benefit in this highly abnormal and volatile time to take advantage of opportunities as they arise.

As always, if you have any questions about our perspective, please do not hesitate to reach out to your advisor.

Disclaimer:

Verdence relies heavily on unaudited third-party data. Data sources include public data, such as mutual fund data, and non-public data, such as information provided by other investment advisors and managers of limited partnership pooled accounts. Data and/or statistics included on this Portal, including references to performance, opinions, ratings, rankings, manager statistics and demographic information, product or strategy descriptions, either quantitative or qualitative, are based upon information reasonably available to us as of the applicable date(s) then-published. Information has been obtained from sources that we believe to be reliable, but these sources cannot be guaranteed as to their accuracy or completeness. All data and information produced by a third party has the potential to be incorrect, incomplete or otherwise misleading. No implication shall be created that the information contained on the Site is correct, including as of any time subsequent to the publish date, and Verdence does not undertake an obligation to update such information at any time after such date. Verdence makes not warranty or representation of the veracity of the data and information and its use of the information should not be implied as an endorsement of any material or statements made. Data, particularly non-public data, is subject to error and where the information is not audited, the potential for error is greater. Where shown, performance information presented is that which has been calculated and presented by an unaffiliated third-party manager. We have no insight into the performance of the advisor/product/account or fund shown and do not attempt to determine whether the performance presented is accurate. Therefore, the performance could be incorrect, overstated or not reflective of actual trading of client funds. There is the potential that the performance shown is a back test and not the result of real investment advice and trading. As such, it could not be relied upon as indicative of future returns of a particular strategy. Where performance shown is that of a pooled account, limited partnership or private equity fund, you should be aware that there is a significant lack of transparency into the operations and investment process and investment vehicles invested in. As a result pricing and valuation of the underlying holdings which produced the stated performance could be incorrect, stale, or overstated and therefore the performance figures presented cannot be relied upon. Before investing, we encourage you to request additional information, particularly performance information, of any product that you are considering for your client. You should read, as applicable, the Prospectus, SAI, Composite Disclosure and/or performance disclosure associated with any product that you are considering for investment for your or your client's. Certain products shown may have account minimums or minimum investment sizes that are unattainable for your clients and therefore they may not be eligible to invest in these products. Reference to registration with the Securities and Exchange Commission ("SEC") does not imply that the SEC has endorsed or approved the qualifications of Verdence or its respective representatives to provide any advisory services described on the Site.

© 2022 Verdence Capital Advisors, LLC.

This content is the intellectual property of Verdence Capital. Any copying, republication or redistribution of this content beyond the agreed upon terms between you and Verdence Capital, including by caching, framing or similar means, is expressly prohibited without the prior written consent of Verdence Capital. Verdence Capital is not liable for any errors or delays in content, or for any actions taken in reliance on any content.