In this Q2 recap: Stocks and bonds were rattled by rising interest rates as the Fed took aggressive monetary tightening steps to combat accelerating inflation. Higher rates and continuing supply chain bottlenecks sparked recession fears.

Quarterly Economic Update

A review of Q2 2022, Presented by Frank DeMaio

THE QUARTER IN BRIEF

Stocks dropped in the second quarter, with the pressure beginning in April, as the Standard & Poor's 500 index (-8.8%) and the NASDAQ Composite (-13.3%) experienced monthly losses to start the quarter.[1]

Investors were unnerved by comments from Fed officials about the pace and magnitude of potential rate hikes and by inflation, which showed little sign of abating. For instance, March's Consumer Price Index rose 8.5%--the fastest pace since December 1981, while the Producer Price Index–an indicator of potential future costs–climbed 11.2% year-over-year, a new all-time high.[2]

Tightening monetary policy and rising inflation sent bond yields sharply higher, with the 10-year Treasury Note yield rallying from 2.32% at March-end to 2.89% by the end of April.[3]

Markets extended their losses into May as recession fears overtook inflation as the leading worry for investors. With two rate hikes in place and at least two more signaled by the Fed, the concern turned to whether the Fed could raise rates to fight inflation without sending the economy into a recession.

It wasn't only higher rates that fed recession fears, however. China's lockdowns to arrest the spread of Omicron and continuing hostilities in Ukraine contributed to a pessimistic outlook for global economic growth.

With May looking like a repeat of April's dismal performance, stocks gained as the month came to a close after releasing the Federal Open Market Committee's (FOMC) early May meeting minutes. The market interpreted these minutes as suggesting a less aggressive Fed than the market had anticipated. The rally triggered in the final week of May–the S&P 500 and NASDAQ Composite jumped 6.5% and 6.8%, respectively–saved investors from another month of deep losses.[4]

Stocks continued their slide in June as a red-hot May inflation read heightened fears of a more aggressive Fed, while worries of an economic slowdown grew. Like May, stocks staged a powerful rebound toward month-end, as falling energy prices and declining bond yields triggered hopes that the Fed may not need to be as aggressive with rate hikes. Prices stabilized as the quarter came to a close–a welcome development–but it was not enough to take the edge off a difficult second quarter and the first half of performance.

While stock prices were coming down, first-quarter corporate earnings were notably strong, especially in light of the contraction in 1Q GDP. With 99% of companies comprising the S&P 500 index reporting, 77% reported positive earnings surprises and a blended earnings growth rate of 9.2%. However, earnings for the second quarter may be more mixed, with 70 S&P 500 companies issuing negative earnings guidance and just 31 companies issuing positive guidance.[5]

THE U.S. ECONOMY

After shrinking 1.5% in the first quarter, signs point to continued weakness in the second quarter.[6]

The official estimate of second-quarter GDP growth won't publish until the end of July, but The Federal Reserve Bank of Atlanta, which attempts to track GDP growth in real-time, reported that its "GDP Now" forecasting model is estimating an annualized 2Q growth rate of -2.1%, as of July 1, 2022.[7]

This economic weakness reflects several headwinds, including elevated inflation, rising interest rates, continuing supply chain issues, and slowing global growth.

Food, energy, and housing have been at the epicenter of inflation pressures. For the 12 months ended May 2022, food prices increased 10.1%, energy costs soared 34.6%, and the median price of existing homes jumped 14.8% year-over-year.[8,9]

To rein in inflation, the Fed has begun taking steps to facilitate what economists refer to as "demand destruction," or reducing demand sufficiently to alleviate upward price pressures. This demand destruction can be accomplished in two primary ways: by raising rates so that borrowing is more expensive and deflating asset values to reduce the wealth effect that spurs consumer spending.

A rise in recession worries has followed. In a recent survey of economists conducted by The Wall Street Journal, the probability of recession in the next 12 months has risen to 44%, typically seen only when the economy is on the brink of or during a recession.[10]

Despite the deteriorating economic data, some elements of the economy remain positive.

The labor market is still healthy. Hiring continues to be strong, if somewhat off the pace of earlier post-pandemic quarters, unemployment is steady and near historic lows, and wages are rising, though below the rate at which prices are rising.

Consumer spending remains stable, which, in the second quarter, was on track to increase four percent annually. Consumers remain flush with about $2.3 trillion in savings (not counting asset markets holdings), so spending could remain an engine for continued economic growth as the year wears on.[11,12]

Still, having savings is not the same as spending them. Consumer confidence, critical support for consumer spending, has been eroding, which may lead to lower consumption. The University of Michigan's monthly measure of consumer sentiment has tracked this eroding confidence level; its Index of Consumer Sentiment showed a decline from 58.4.2 in May to 50.0 in June (a drop of 14.4%) and a year-over-year slide of 41.5%.[13]

GLOBAL ECONOMIC HEALTH

Global economies struggled in the second quarter as economic lockdowns in China added to existing spillovers from Russia's invasion of Ukraine. These lockdowns reduced overall consumer demand from China and exacerbated global supply chain issues, as manufacturing output slowed and exports delayed.

Consequently, many economists have reduced their estimates for Chinese growth. The International Monetary Fund (IMF) projects that China's economy will slow to a 4.4% increase in 2022, down from last year's 8.1% GDP growth rate. This growth projection mirrors Wall Street analysts' consensus estimate of a 4.4% expansion in 2022.[14,15]

How China's economy performs in the future may turn on whether China's zero-COVID policy remains in place, how it manages its deteriorating housing market, and how it balances the dynamism of private enterprise with state controls.

European economies are also stressed, weighed down by hostilities in Ukraine, rising inflation, and monetary tightening. These headwinds have led the IMF to lower its projection of 2022 GDP expansion from 3.9% to 2.8%. Its estimate of 2023 GDP growth sliced down to 2.3%.[16]

One fallout of Europe's dependence on Russian energy is that higher energy prices and businesses burden European consumers with higher input costs, which have them reevaluating hiring and investment plans. Any improvement in Europe's economic prospects may rest on how quickly the war in Ukraine resolves.

The United Kingdom's inflation rose to 7% during the second quarter. The Bank of England estimates that inflation will likely increase to 10% by year-end even as the U.K. economy falls into contraction by the fourth quarter.[17]

Japan's 2022 economic growth rate has been pared by global conditions, though the IMF increased its estimate of Japan's 2023 economic growth rate to 2.3%, up by 0.5%.[18]

The World Bank is similarly cautious, revising its estimate of global economic growth to 2.9% in 2022, down from its January forecast of 4.1%. They expect global growth to average 3% between 2023 and 2024.[19]

The MSCI-EAFE Index, which tracks developed overseas markets, slid 15.37% in Q2, while emerging markets, as measured by the MSCI-EM (Emerging Markets) Index, fell 12.36%.[20]

TIP OF THE QUARTER

If marriage gives you a new last name, be sure to notify Social Security, your bank, and the investment and insurance companies with whom you have accounts and policies about the name change.

LOOKING BACK, LOOKING FORWARD

After a difficult start to the year, stock losses continued in the second quarter as accelerating inflation, Fed interest rate hikes, supply chain bottlenecks, the war in Ukraine, and broad lockdowns in China weighed on investors.

The second quarter appears to have also brought the curtain down on a major advantage enjoyed by U.S. stocks for over a decade, the TINA trade (There is No Alternative). The TINA trade resulted from historically low-interest rates that left other asset classes at a return disadvantage to stocks. Low-interest rates contributed to a multi-year bull market by elevating the value of future earnings and forcing many income-searching investors into equities simply because bond yields were so small.

A new regime of higher rates and less liquidity has created an acute level of uncertainty in the stock market. That uncertainty may continue through the second half of the year. The Fed hiked interest rates by 75 basis points in June, with Fed Chair Powell promising that the Fed will continue to raise rates until inflation comes down to its 2% target.[21]

It's uncertain when high inflation may get resolved, especially since price pressures remain and monetary policy takes time to work through the system. May's higher-than-expected inflation report undermined earlier hopes that inflation may have plateaued.

Perhaps the biggest market overhang is whether the Fed can engineer a soft landing, i.e., manage inflation without sending the economy into a recession. It will take many months, possibly a year or more, to determine whether the Fed successfully threaded that needle. Nevertheless, there might be signs along the way that may help bring greater clarity. If the economic data continues to paint a mixed picture, market volatility may extend into the year's second half.

In addition to inflation and other economic data, investors will be watching corporate earnings. The outlook for profits has dimmed in recent months amid a slowing economy. To the extent that earnings results can exceed the market's lowered expectations, corporate earnings may prove to be a positive catalyst in the months ahead.

The Fed's pivot to higher rates impacted stock investors, and bond investors suffered (bond prices fall as yields rise). Nonetheless, bond yields are now higher than they were a year ago, making bonds, for many income investors, more attractive than they have been in a while.

MARKET INDEX	Y-T-D % CHANGE	Q2 % CHANGE	Q1 % CHANGE
DJIA	-15.31%	-11.25%	-4.57%
NASDAQ	-29.51%	-22.44%	-9.10%
S&P 500	-20.58%	-16.45%	-4.95%

BOND YIELD	6/30 RATE	1 MO AGO	1 YR AGO
10 YR TREASURY	2.98%	2.84%	1.44%

Sources: Wall Street Journal, June 30, 2022, Treasury.gov (Bond Yield)

The market indexes discussed are unmanaged and generally considered representative of their respective markets. Individuals cannot directly invest in unmanaged indexes. Past performance does not guarantee future results. U.S. Treasury Notes are guaranteed by the federal government as to the timely payment of principal and interest. However, if you sell a Treasury Note prior to maturity, it may be worth more or less than the original price paid.

QUOTE OF THE QUARTER

"My father said there were two kinds of people in the world: givers and takers. The takers may eat better, but the givers sleep better."

MARLO THOMAS

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Know someone who could use information like this?
Please feel free to send us their contact information via phone or email. (Don't worry – we'll request their permission before adding them to our mailing list.)

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conducted through two divisions – the NYMEX Division, home to the energy, platinum, and palladium markets, and the COMEX Division, on which all other metals trade. The CAC-40 Index is a narrow-based, modified capitalization-weighted index of 40 companies listed on the Paris Bourse. The DAX 30 is a Blue Chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange. The FTSE 100 Index is a share index of the 100 most highly capitalized companies listed on the London Stock Exchange. BSE Sensex or Bombay Stock Exchange Sensitivity Index is a value-weighted index composed of 30 stocks that started January 1, 1986. Nikkei 225 (Ticker: ^N225) is a stock market index for the Tokyo Stock Exchange (TSE). The Nikkei average is the most watched index of Asian stocks. The Hang Seng Index is a free float-adjusted market capitalization-weighted stock market index that is the main indicator of the overall market performance in Hong Kong. The All Ordinaries (XAO) is considered a total market barometer for the Australian stock market and contains the 500 largest ASX-listed companies by way of market capitalization. The SSE Composite Index is an index of all stocks (A shares and B shares) that are traded at the Shanghai Stock Exchange. The S&P/TSX Composite Index is an index of the stock (equity) prices of the largest companies on the Toronto Stock Exchange (TSX) as measured by market capitalization. The MSCI Emerging Markets Index is a float-adjusted market capitalization index consisting of indices in more than 25 emerging economies. The MSCI World Index is a free-float weighted equity index that includes developed world markets and does not include emerging markets. The CBOE Volatility Index® is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. The S&P SmallCap 600® measures the small-cap segment of the U.S. equity market. The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index. Additional risks are associated with international investing, such as currency fluctuations, political and economic instability and differences in accounting standards. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. MarketingPro, Inc. is not affiliated with any person or firm that may be providing this information to you. The publisher is not engaged in rendering legal, accounting or other professional services. If assistance is needed, the reader is advised to engage the services of a competent professional.

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