Market Review and Outlook—July 20, 2022

Bonds are in the News, and Not in a Good Way—In the first half of 2022, US bonds fell 10%. That is the sharpest decline in any calendar year in more than 45 years. The chart below shows that quality taxable and quality municipal bonds have provided annualized returns of less than 2% for the ten years through June 30th. There are multiple factors at play here. Low interest rates for the past decade have driven the very low ten-year results. The recent sharp increase in interest rates this year (yields for 3-year Treasury bonds tripled from 1% to 3% in the first half of 2022) drove the sharp recent results.

Inflation and the Fed Driving Bond Results—Inflation exceeded 4% last summer for the first time in 30 years. While core inflation has declined in recent months to just under 6%, headline inflation, which includes energy and food costs, has remained very high, recently exceeding 9% (the highest its seen for 40years). While late last year inflation was expected to moderate, it rose instead. The Russian invasion of Ukraine in late February made things worse, driving food and energy costs even higher, but this was only one of multiple factors.

The Federal Reserve Bank shifted from 'watchful concern' to nearly an 'alarm' stance in the first half of 2022. It shifted from purchasing bonds in 2021, to selling them in 2022, but only recently is the pace of these sales meaningful. Starting a little slowly in early 2022, but then quickly accelerating, the Fed has boosted its overnight rate to its early 2020, pre-COVID, level. The Fed is expected to continue to boost the rate through the end of the year, likely doubling it within six or so months. Bond prices fell sharply through June, not only due to the moves that the Fed made, but also based on the moves the Fed is expected to make by December 2022.

US Stocks Fell—Their 2022 decline was bad, and worse than bonds', but not that bad historically. Furthermore, their 20% decline by June felt better as it was preceded by a 24% annualized return for the prior 3 years (+90%, unannualized). The fairly surprising dynamic is that in the first six months US stock profits rose by over 6½%, but stocks fell 20½% as investors were only willing to pay 73% as much for a company's earnings on June 30th as they were willing to pay on December 31st. Thus stock investor confidence plummeted.

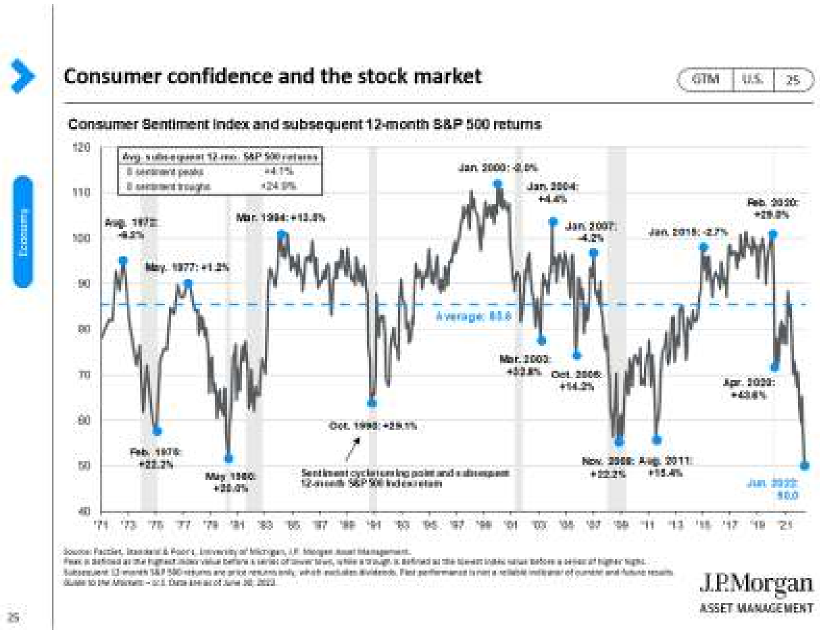
On the next page I'll present my views on what's ahead. What is right here appears to be an opportunity to be greedy while others are fearful, to pick up better bargains in both stocks and bonds than we've seen in several years. As David Kelly from JP Morgan reminds us, "the most important thing for long-term investors to remember is that they are long-term investors." To long-term investors, the red in the table below reminds us that 1) our portfolios have lost significant value in recent quarters, but 2) in the past when charts like this show red ink in the past 3– and 12-months, long-term investors have benefited handsomely by simply holding on.

Category	**3 Months**	**12 Months**	**3-Yr Avg**	**5-Yr Avg**	**10-Yr Avg**
Fidelity Cash Reserves	+0.10%	+0.10%	+0.41%	+0.83%	+0.45%
Intermediate Core Bond	-4.93%	-10.74%	-1.00%	+0.72%	+1.47%
Intermediate Muni Bond	-2.96%	-8.28%	-0.31%	+1.17%	+1.84%
Multisector Bond	-6.12%	-9.60%	-0.31%	+1.33%	+2.77%
Large-Cap Stock	-14.88%	-11.58%	+9.14%	+9.77%	+11.63%
Small-Cap Stock	-14.72%	-17.27%	+5.65%	+5.58%	+9.40%
Foreign Large-Cap Stock	-13.15%	-18.69%	+1.31%	+2.08%	+5.11%
Diversified Emerging Market Stocks	-12.20%	-25.71%	+0.38%	+1.71%	+2.84%
Real Estate	-15.81%	-8.01%	+4.05%	+5.04%	+6.93%
Technology	-24.39%	-32.14%	+8.89%	+12.49%	+15.13%
Moderate Allocation (60% stocks)	-10.58%	-11.07%	+4.54%	+5.29%	+6.69%

The data in this table comes from Morningstar and is as of June 30, 2022.
Information herein should not be construed by any consumer and/or prospective client as a solicitation to effect, or attempt to effect, transactions in securities, or the rendering of personalized investment advice for compensation.

Markets Fall for a Reason—When stocks have fallen a lot, say 20%, simply holding onto your stocks, let alone rebalancing and adding to stocks, is not disregarding the reason for the stock market decline. It acknowledges the economic challenges. Furthermore, it recognizes that much, if not all, of the bad news is priced into the markets. The question for long-term investors isn't "are there reasons to worry?", but rather "are the reasons already priced in?"

The graph illustrates the University of Michigan Consumer Sentiment Index over the past half-century. You can see that it has never been lower than its June level of 50. The little box at the top left shows that, for the 12 months after the 8 past low points over the past fifty years, the S&P 500 has gained 24.9%. Are we at the trough now? We have no idea. We do know that investors are fearful, and in the past, fearful investors consistently coincide with a great time to add to stocks. Most often, the bad news is priced in already.



The 2022 stock losses have been pretty broad, although there have been some notable variations. Growth stocks have fallen much more than value stocks (large growth fell 28% in the first six months of 2022, versus a 13% decline for large value stocks). Every US stock sector fell in the first half except Energy, which jumped almost 32%. While US stocks fell 20%, foreign stocks, in their local currencies fell only 11½%. When converted to US dollars, however, foreign stocks fell just over 18%. This is tied to the US dollar, which leapt this year, partially due to the Fed's sharp increases to the overnight interest rate. The US dollar should level off, and may even decline. When that happens, foreign stocks will lose the stiff headwind that they have faced for two years.

We are using a broad brush on stock allocations, with few 'leans.' Our major lean at this time is toward value stocks, a lean we have maintained for awhile. The broad decline should mean that a rebound is similarly broad-based.

Big Changes for Bonds—This year's bond losses have presented a very different environment than we had in early January 2022. We have a sharply weaker economy—there is even a chance that we are in a recession right now! This drives us to sharply decrease our usage of opportunity bonds. We find that, with the weaker economy now and expected for a few years, opportunity bonds' risks have increased, and thus we have reduced our opportunity bond level.

The losses in quality bonds were logical, short-term bonds fell a little, intermediate bonds a bit more, and long-term bonds even more. As with stocks, the critical question is whether the future is already "priced in." The answer relies significantly on whether inflation rises, steadies, or declines. The direction of headline inflation, which is core inflation plus food and energy, should be driven by the direction of the Russian invasion. I don't pretend to have any special insight into the timeline for a negotiated end of that war. We expect that the dramatic actions this year by the Fed will lead to a steady decline in core inflation.

If that comes to pass, if core inflation continues its decline from just under 6% currently, we should see bond rates stabilize. That would lead to bonds providing returns close to their interest rates. The red ink on the first page is good news here, for bond interest rates rose earlier this year, and thus future quality bond returns could be higher in the next few years than we've seen for a decade.

These are anxiety-ridden times for long-term investors. We see substantial opportunities in today's stock markets, and believe that bonds should provide steadier returns in the coming quarters, with stronger overall annualized returns than we've seen for the decade through June 30th.