Graves Light Lenhart
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Graves Light Lenhart July '22 Market Commentary

Markets Rally as Economic Slowdown Continues

Market Overview:

July provided relief across many asset classes as a sizable late month bounce, in large part triggered by the market's view for *potential* slowing in the pace of future rate hikes by the Federal Reserve (Fed). This occurred on the tails of a tumultuous first half of the year in which the S&P 500 experienced its worst first half performance since 1962. Leading into the month, investor sentiment had drifted to very low levels, which was being reflected across a broad spectrum of polls and metrics gauging the market's mood. For example, Ned Davis Research (NDR) aggregates a number of commonly followed sentiment indicators into its Crowd Sentiment Poll, covering both attitudinal and behavioral measures of sentiment. Leading into July, the NDR Crowd Sentiment poll had descended into bearish depths of extreme pessimism that have seldomly been breached since the Great Financial Crisis of 2008-2009. This specific metric improved over the course of July, yet it remains in very gloomy territory, an indication that "bad news" remains priced-in across many market assets. This coincided with a late-month US gross domestic product (GDP) release which revealed a second consecutive quarterly decline at an annualized pace of -0.9%. These two data points alone act as a reminder that equity markets are always forward looking.

At the end of the month, the Fed hiked the highly followed Fed Funds Rate by 0.75% to a range of 2.25%-2.50%, which was expected. Stocks responded positively. What specifically provided solace (rightly or wrongly) was the market's interpretation that in addition to discounting peak inflation, the Fed could soon be rounding-the-corner of "peak hawkishness", which in essence means that before long the aggressive pace of rate hikes could either moderate *or* evolve into interest rate cuts in 2023. Notably, in unscripted remarks Fed Chair Jerome Powell suggested that the current Fed Fund's rate is on the borderline of economically restrictive territory and therefore the Fed could be closer to being done tightening. We are not convinced. It's worth emphasizing that the combination of a *strong* dollar as well as the runoff of the Fed's massive balance sheet has an additional tightening effect on financial conditions. According to Yardeni Research, the combined effect of these two elements may be the equivalent to a hike in the Fed Funds Rate of at least 1%. This is a point that should not be overlooked!

Asset Performance:

In July, the US equity market rebounded from its decline in the first half of the year. The S&P 500, which had fallen by -20.0% between January and June, rose by 9.2%. In many ways, July's market performance was a mirror image to the first six months of the year in that many of the worst first half performers were the strongest *out*performers in July. This would include some of the most speculative corners of the market, including cryptocurrencies, which have typically benefitted from more accommodative monetary policy. Additionally providing buoyancy for the markets was the ongoing second quarter earnings season, which through month-end wasn't as despondent as many investors had anticipated. Month-end earnings data from Factset suggested management teams across Corporate America were shaving expectations for forward earnings, as opposed to slashing them in recessionary form. We note that the read-through on earnings is still evolving, as 56% of S&P 500 companies had reported their 2Q22 earnings at month-end. As is often the case, when extreme levels of pessimism are priced-in, corporate releases which are "better than feared" can indeed provide for a relief rally.

Key US Index Returns	YTD '22	July '22
S&P 500	-12.6%	+9.2%
Nasdaq	-20.5%	+12.4%
Dow Jones Industrial Average	-8.6%	+6.8%

Relevant Fixed Income Yields	YE 2021	July '22
US 10-Year Treasury Note	1.51%	2.64%
Investment Grade Corp. (C0A0)	2.4%	4.4%
High Yield Corp. (H0A0)	4.3%	7.7%

Source: Factset as of 08/01/22

Fixed Income performance was broadly strong for the month, with interest rates declining across the US Treasury curve. Much like stocks, most subcomponents of the bond market experienced a historically poor first half to the year. Not since 1788 - the year before the founding of the Treasury - had US government bonds fallen so much over a first half period, according to data tabulated by Deutsche Bank's strategy team. With interest rates dropping over the course of July on slowing growth concerns, bonds generally rallied. For example, the Bloomberg Aggregate Bond Index rallied by 2.4%, its strongest single month return since August, 2019. While interest rates can often overreact in both directions, we recently posited that better entry yields were finally making many components of the bond market more interesting (3Q22 Client Newsletter). We maintain this view.

Closing Thoughts:

The July rebound was welcome. Historically, an equity retracement of such proportion following a period of poor performance doesn't occur very often. The key question remains. Have we just witnessed a bear market rally, or is the market bottom now in the rearview mirror? Unfortunately, history shows that such a determination will not be made for at least a few months. While current signals provide mixed messages, we highlight that the recent rally started before stocks were broadly viewed as cheap, and many of the strongest performers have below-average fundamentals. Therefore, we remain cautious in approach, while recognizing that the recent selloff has provided many compelling opportunities for our clients' portfolios.

Warm regards,

Ash Heatwole, CFA
Portfolio Manager, Associate Director of Wealth Management

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