July Investment Outlook 2022

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Current Market Conditions

Rocky first half of 2022 draws to a close

The first half of 2022 will be remembered for its confluence of historic, but negative social, economic, and investment milestones. The list of disturbing low points includes war in Europe for the first time in 75 years; inflation at a 40-year peak; the highest ever U.S. peacetime debt-to-GDP ratio; the ongoing struggle to fully contain COVID-19; and the woeful -20.0% year-to-date performance of the S&P 500. The decline in the Bellwether index represents the worst first six months in fifty years.

The investment environment proved challenging across the spectrum of risk assets and geographies, with international equity markets and small capitalization stocks down 19% and 23%, respectively. Fixed income assets were not immune, with a broad performance measure down 10% due to increasing fears over the credit worthiness of bond issuers in a slowing economy and rising interest rates, which cause bond prices to move in the opposite direction. Hedge funds saw declines, but losses were muted as short positions provided some offset to a downward market. As discussed below, the exception to market declines were commodities, which posted over 18% YTD gains, in large part due to supply disruptions caused by the Russia-Ukraine war.

Commodity prices retreating a bit

Commodity prices began 2022 significantly higher than in 2021, which supported increased inflation expectations fueled by a variety of factors, including a post Covid-19 demand surge, restrained capital investment, supply chain challenges, and the war in Ukraine. Over the last few weeks, commodity prices have retreated somewhat. Oil has traded below $100 a barrel after reaching $130, and other commodity prices have declined from their peaks as well. Industrial metals, lumber, and many agricultural commodities have all retreated from recent high prices. The housing

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market is showing signs of slowing demand due to sharply higher mortgage rates. Previous areas of supply chain tightness, such as the semiconductor market, have loosened, resulting in increased product availability and lower prices. Inflation may have plateaued, but the old adage that the cure for high prices is itself high prices is feeling more and more relevant. We will further explore the implications of this below.

Investment Approach and Strategy

Market timing challenging to execute effectively

When the ship is getting tossed about, it is tempting to rush to a safe port and wait out the storm. While that is certainly solid advice on the high seas, in capital markets, it is often riskier to execute an analogous strategy. In the equity markets, the best and worst days are frequently tightly intertwined, making it difficult to miss out on one and not the other. Timing the market correctly requires two correct decisions: when to sell and when to buy. Getting either one of those wrong can lead to worse performance than doing nothing at all.

To better illustrate this, we conducted an analysis that looks back over approximately 35 years since 1988. Over that period, the return on the S&P 500 has increased 10.5% per year on average. Importantly, a sizable portion of that return has occurred over a just a handful of days. Missing just the twenty best days (on average less than one day a year over that period), the annualized performance drops to just 6.4%. The chart below shows the dramatic long-term negative impact of market timing on total wealth.

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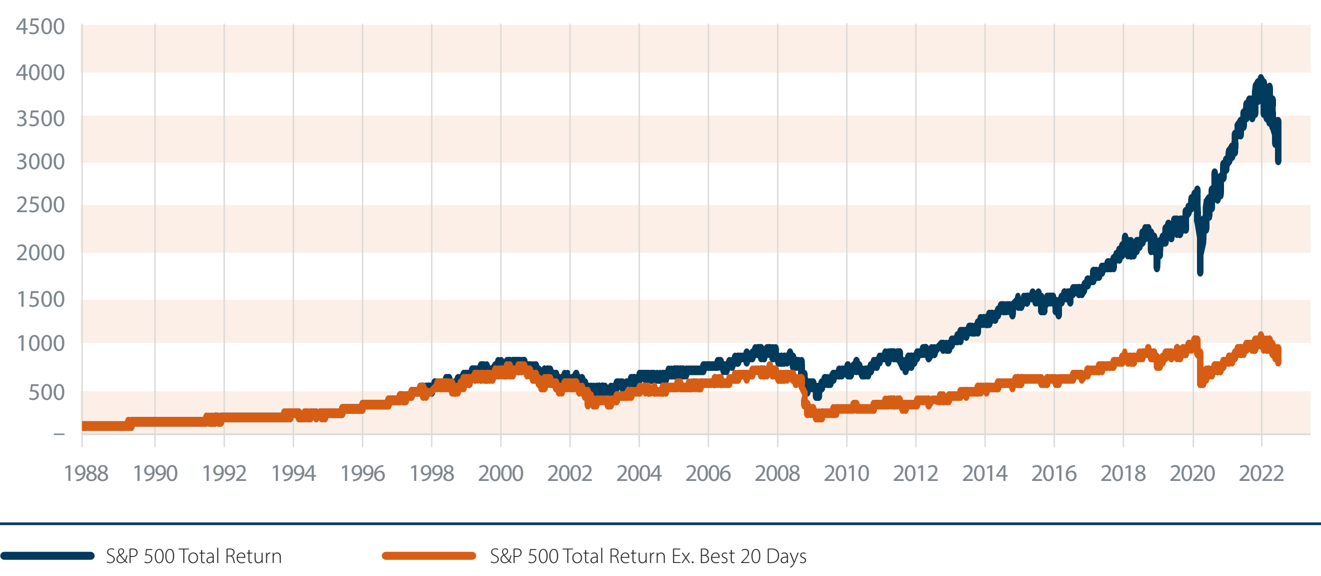
S&P 500 Growth of $100 - With and Without the 20 Best Days



As powerful as this thinking can be, it is not always easy to follow. In the short-term, periods of meaningful market dislocation can test this discipline. We believe in the power of long-term investing, but it does require persevering through difficult periods to provide rewarding results.

Despite the challenges in the near-term, history has shown that it is important to stay invested and not miss out on the most impactful periods when it comes to returns, as they are few and far between.

What the data are telling us

Recent economic datapoints have remained positive in general but continue to show incremental weakness. Recent economists' surveys show consensus expectations for 2022 GDP growth of 2.4%, down from 3.9% at the start of the year. Corporate profit growth rates have slowed, although they remain positive. Inflation remains elevated, and the Federal Reserve Board's (Fed) response of raising interest rates and removing liquidity from the markets is squarely aimed at providing price stability. Personal consumption expenditures dipped by 0.4% from April to May, as consumers felt the effects of higher prices. Encouraging employment data shows an abundance of available jobs, and the unemployment rate remains low relative to history.

The economy is exiting an extended environment of historically low interest rates, supported by an accommodative monetary policy by the Fed. This stimulative stance was accompanied by favorable fiscal policies that brought excess liquidity into the markets. This backdrop had been supporting asset returns that were significantly above long-term historical averages.

The increasing risk of a recession, stubbornly high inflation, and geopolitical instability are pressuring returns in capital markets. With the markets off 20% since the start of the year, a good deal of downside risk is likely already priced into the capital markets, even given a recessionary environment. To gain some perspective on this, consider the chart below (published in *Forbes*) which shows how markets perform in recessionary periods.

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Stock Market Returns During Recession Years

Markets typically bottom out and rebound months before the end of a recession.

Recession Year	1945	1949	1953	1957	1960	1970	1974	1980	1982	1990	2001	2008	2020
Recession Year Returns (S&P 500)	30.3%	10.3%	-6.6%	-14.3%	-3.0%	0.1%	-29.7%	25.8%	14.8%	-6.6%	-13.0%	-38.5%	16.3%
Following Year Returns (S&P 500)	-11.9%	21.8%	45.0%	38.1%	23.1%	10.8%	31.5%	-9.7%	17.3%	26.3%	-23.4%	23.5%	26.9%

Source: CFRA Research, NBER, S&P Global

The data show that correctly timing the market is challenging and that over the long-term, remaining invested even through difficult downturns is crucial to building wealth. Coupling this with recent investment performance, how markets typically perform around economic recessions, and the latest economic data, we believe additional significant market declines are somewhat mitigated. We continue to evaluate managers and individual stocks, as we believe that the recent volatility has left opportunities to find quality long-term investments at better valuations than just six months ago.

Things We are Watching

Threading the economic needle

While a recession would clearly be undesirable, the severity and duration of a recession is crucial to focus on in terms of understanding the impact on market returns. To help gauge where this is going, there are many datapoints we evaluate. We think the key items remain inflation, the Fed's actions with respect to interest rates, GDP growth, corporate earnings, and geopolitical events.

The risks of a potential recession have risen but have also impacted views on how aggressively the Fed may need to raise interest rates in the future. Should the economy slow further, the Fed will not need to be as aggressive with its monetary policies, which could provide some relief to capital markets, presuming, of course, we avoid a severe recession. The Fed must balance the imperative to guide the economy through an uncertain period while pursuing its dual mandate of price stability and full employment.

We encourage you to contact us with any questions you may have at (212) 492-7000 or info@klingenstein.com.