# MARKET UPDATE

## Economic Market Update – Second Quarter, 2022

July 20, 2022

2022 has been painful for investors in nearly every asset class. Please join us as we review the first half of the year, highlighting a few areas that did work in investors favor and the many that did not.

- The first half of 2022 was one of the worst 6-month periods for stock and bond investors in history.
- Rising interest rates led to a rapid repricing in assets and created a "bear market in everything."
- Market volatility is likely to remain elevated for the foreseeable future.

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**There is no sense in sugarcoating it – the first half of 2022 was absolutely brutal for investors.** To understand just ***how*** brutal requires some historical context. Let's start with the stock market, where we have data on the S&P 500 going back to 1926[1]. Out of all the rolling 6-month periods across 96 years of history, 97% saw better returns than we just experienced in the first half of 2022. The only periods when returns were worse? The Great Depression, WWII, 1970s stagflation, the 2001 bursting of the tech bubble, and the Great Financial Crisis. Talk about some ***infamous*** company.

**What could be worse? Well, bond returns were even weaker** – at least historically speaking. The return for the Bloomberg U.S. Aggregate Bond Index in the first six months of 2022 was the worst in the history of the index – though we would be remiss without highlighting that history is slightly shorter, with data only going back to 1976. Data for U.S. Treasuries extends back slightly further, but the story there is not much prettier. Whichever way you choose to slice it, fixed income just posted one of the worst starts to a year in modern history. Stocks and bonds were both negative, two quarters in a row. "Wait," you may be thinking, "I thought that wasn't supposed to happen?" Historically speaking, you would be correct – an analysis of the historical data makes clear just how much of an outlier the first six months of the year have been for markets.

**Experiencing negative returns in both stocks and bonds during the same quarter is unusual,** but certainly not unheard of, particularly in the decade or so after the Great Financial Crisis, when rates have been at or near the zero-bound. But experiencing negative returns in both stocks and bonds two quarters in a row? Now that is historically anomalous. A review of historical return data going back to 1871 courtesy of a database maintained by Robert Shiller, the winner of the 2013 Nobel Prize in Economics, reveals only three other instances when both stocks and bonds were down concurrently over two consecutive quarters: 1974, 1969, and 1931. In the case of 1931, stocks and bonds were both down for three consecutive quarters. A possible silver lining? Stocks and bonds have never both been down four quarters in a row.

**What has driven the bear market in everything?** In short, inflation was higher and more persistent than expected, which in turn led to a more aggressive tightening path from the Fed. The result? A significant jump in interest rates that lowered bond prices and filtered through to the equity market in the form of lower multiples. Since the start of the year, the price/earnings multiple on the S&P 500 has compressed 24%, from 21x to 16x. The S&P 500 finished the first half of the year mercifully down just 20%, with earnings growth providing the 4% boost. In fact, at the same time multiples have been coming down, earnings estimates for 2022 and 2023 ***increased*** during the first half.

**The result of these seemingly mixed messages? Heightened volatility.** The S&P 500 has seen daily moves of 2% or more during 20% of the trading days in 2022 through June 30, a rate 2.5 times higher than the average over the past 20 years. This elevated level of volatility has also included several head fakes, with the S&P 500 experiencing rallies of 6% or more on four

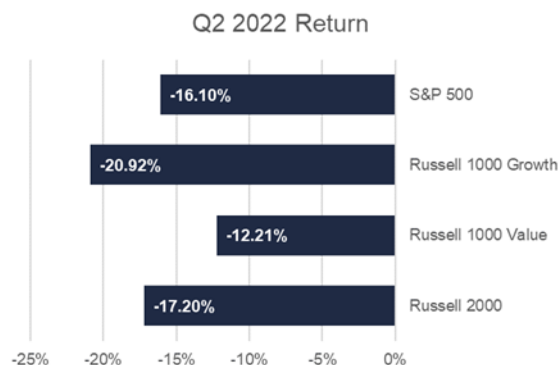
[1]Data is for the S&P 90 prior to 1957.

separate occasions in the midst of the drawdown. Even the few assets with positive to flat returns during the “everything” bear market have sent confusing signals. The U.S. dollar was the top asset in Q2 as the flight to safety intensified globally. The Bloomberg U.S Dollar Spot Index, which measures the dollar against a broad basket of global currencies, was up 5.74% on the quarter and is now up 7.39% on the year. This matches the historical role the dollar has played as a safe haven in times of heightened market stress. Commodities also posted a positive return on the quarter, with the S&P GSCI up 2.01% in Q2 and an astounding 35.80% year to date. This is broadly out of line with historical trends, which have seen energy and industrial commodities sell off in tandem with other risk assets. Precious metals have been the historical exception in the commodities complex, with gold in particular a frequent haven in times of uncertainty, rallying in the face of large market declines. Thus far, 2022 has seen the inverse of this historical norm, with gold down -7.51% for the quarter and -1.17% for the year. Two other traditional safe havens – the Swiss Franc and the Japanese Yen – have likewise failed in this role thus far in 2022. The Bloomberg Swiss Franc Spot Index fell -10.43% over the first half of the year. The Deutsche Bank Yen Trade-Weighted Index fell even further, down -11.62%. Stocks and bonds both negative, some havens up while others fall, commodity return patterns inverted…something is rotten in the state of Denmark.

**What lies in store for the remainder of 2022 after such an unusual start to the year?** Will the final six months of the year play out like 1969, with the dual pain in stocks and bonds reversing course after two quarters? Or could a repeat of 1931 be in the offing, with another quarter of pain ahead? Our detailed outlook for the economy and markets in the back half of the year will be published shortly on the heels of this quarterly review. But to ease frayed nerves in a highly uncertain environment, an examination of the prevailing unemployment rates in 1931, 1969, and today can provide a concise preview of our forthcoming in-depth analysis. The 12 modern U.S. recessions (i.e. those for which we have robust economic data) have all featured a significant rise in the unemployment rate. The upward shift in the unemployment rate prior to and during recessions has been so consistent that it has developed into a recession indicator called Sahm’s Rule, named after former Federal Reserve economist Claudia Sahm, who first identified the relationship.[2] 1931 saw the unemployment rate rise from 8.7% to 15.9% (and to 23.6% by the end of 1932). 1969 saw the unemployment rate rise from 3.4% to 3.5%. Thus far, 2022 has seen the unemployment rate decline from 4.0% to 3.6%. **If past is prologue, the labor market is fortunately signaling that the path of market in 2022 is more likely to mirror 1969 than 1931, meaning at a minimum at least one market, stocks or bonds, is likely to be positive in Q3.**

## U.S. Equity Markets

Continuing the tumultuous ride that began in the first quarter, the S&P 500, the bellwether for U.S. stock returns, finished the quarter down -16.10%[3].

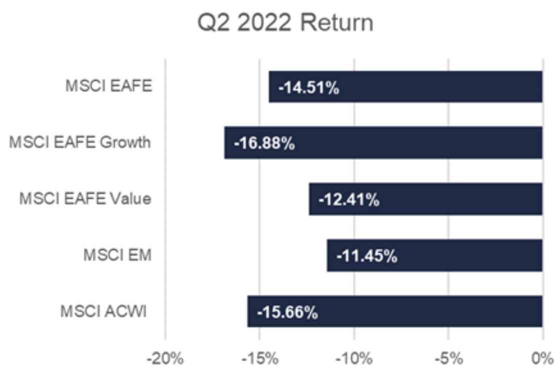



[2]The technical definition of Sahm’s Rule signals the start of a recession when the three-month moving average of the national unemployment rate rises by 0.5% or more relative to its low during the previous 12 months.

[3]All returns are total returns unless otherwise stated; international returns are net returns in USD.

Combined with the loss from the first quarter, the index is now down -19.96% on the year. As typically occurs in down markets, small-cap stocks underperformed their large-cap peers again in Q2, with the Russell 2000 Index losing -17.20% for the quarter. U.S. equity performance continued to vary widely by style, but the margins were much tighter than in Q1. The Russell 1000 Value Index, which is comprised of both large- and mid-cap firms, fell just -12.21% for the quarter vs. the -20.92% return of the Russell 1000 Growth Index. The value style led in small-cap as well, with the Russell 2000 Value Index returning -15.28% vs. the Russell 2000 Growth Index's return of -19.25% on the quarter. As expected when the divergence between growth and value is so wide, performance varied widely across sectors and industries in the second quarter as well. A mix of cyclical and defensive value stocks continued to lead, but all 11 GICS sectors of the S&P 500 were negative in Q2. Consumer Staples stocks were the best performers, followed closely by Utilities, losing -5.23% and -5.73% respectively. Each sector benefited from healthy dividend yields that helped to offset stock price declines. Energy and Health Care were close behind, losing -6.13% and -6.30% on the quarter. Cyclical growth names continued to bear the brunt of the pain, with Communication Services, Consumer Discretionary, and Information Technology all laggards on the quarter, each finishing down at least -20% as concerns over the future trajectory of economic growth rose over the course of the quarter. For the first half of the year as a whole, only the Energy sector ended June 30 in positive territory.

## International Equity Markets

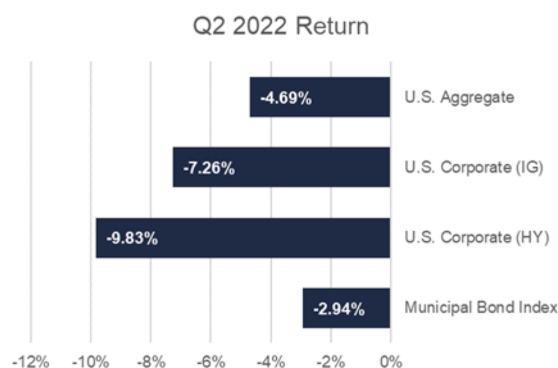



International equities outperformed U.S. stocks in Q2, exhibiting substantial outperformance in local currencies terms that was narrowed significantly for U.S. investors due to the strength of the dollar on the quarter. The MSCI EAFE Index of major developed international equity markets lost -7.83% for the quarter as a whole in local currency terms, but that loss widened to -14.51% for U.S.-based investors. The growth/value trend was present internationally as well, with the MSCI EAFE Growth Index falling -16.88% vs. a decline of -12.41% for the MSCI EAFE Value Index. Norway, a significant exporter of energy resources, was a source of strength on the quarter, but broadly speaking equity returns were weak across developed Europe after accounting for the strength of the U.S. dollar. In emerging markets, countries most dependent on Russia for energy supplies, such as

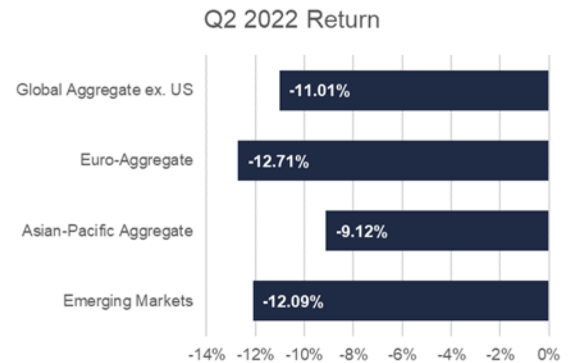
Hungary, were the hardest hit. Commodity exporters like Chile and Indonesia and nations like Turkey that were well positioned geopolitically outperformed on the quarter. Continuing the trend from the first quarter, major oil producers, like the United Arab Emirates and Qatar, held up the best, as did South Africa, a major producer of both agricultural commodities and minerals. On the other side of the equation, big importers of natural resources continued to experience significant declines. China, the biggest country in the MSCI EM Index at about 32.5%, fell -11.05% in Q2. The next two largest countries in the index, Taiwan and South Korea, suffered significant declines as well, down -20.66% and -22.47% respectively. **Summing up equity markets globally for the quarter, the MSCI ACWI Index, a proxy for the global stock market, lost -15.66% in Q2 and is now down -20.18 year to date.**

## U.S. Fixed Income Markets

**While fixed income returns were slightly better in Q2 than in Q1, that is little consolation in one of the worst starts to a year for bond investors in history.** Broadly speaking, fixed income suffered the worst start to a year on record in the first six months of 2022. The yield on the 10-year U.S. Treasury, which began the quarter at 2.34%, finished the quarter at 3.01%. The yield on the 2-year U.S. Treasury experienced a similar rise, starting the quarter at 2.33% and finishing the quarter at 2.95%, just six basis points under the 10-year. The broad increase in rates across the various tenors of the yield curve, which began in Q1, continued apace in Q2, again weighing heavily on bonds prices. There was no shelter from the storm, with all major areas of the fixed income market in the red at the end of first half of the year. The Bloomberg U.S. Aggregate Bond Index, a broad measure of the performance of investment-grade fixed income markets in the U.S., experienced the worst first half performance in the history of the index, falling -4.69% in the second quarter, leaving the index down -10.35% for the year thus far. Investment-grade corporate bonds were down even more on the quarter as credits spreads continued to widen as fears over economic growth emerged, finishing the quarter down -6.90% and -13.81% for the year through June. The impact of widening credit spreads hit high yield corporate bonds even harder, with the riskier part of the corporate bond market finishing the quarter down -9.83% and -14.19% year to date. Despite generationally high inflation prints, TIPS lost ground during the quarter as well, with the Bloomberg US Treasury Inflation Protection Notes Index down -6.08% in Q2 and -8.92% for the first half. Municipal bonds suffered less, with the Bloomberg Municipal Bond Index falling -2.94% on the quarter to leave tax-free bonds down -8.98% year to date. Floating rate bonds, which have interest payments that adjust to the prevailing interest rate environment, were not immune to the sell-off in credit, with the Credit Suisse Leverage Loan Index retreating -4.35% for Q2, though a relative strong Q1 contributed to leave the sector down only -4.45% year to date.



## International Fixed Income Markets




**International fixed income performance broadly lagged the U.S. on the quarter.** The Bloomberg Global Aggregate ex. U.S. Bond Index, a proxy for the global investment-grade credit universe outside of the United States, lost -11.01% in Q1 and -16.49 for the first half of 2022. Asia-Pacific was a lone bright spot, up 1.72% for the quarter and 3.19% year to date. Europe was the laggard, down -7.36% for the quarter and -13.15% for the half. Emerging market bonds, which are predominantly issued in U.S. dollars, were hit the hardest as the dollar strengthened during the first half of the year. The JPMorgan Global Core Emerging Market Bond Index declined -12.09% on the quarter and is now down -20.82% for the year thus far. Performance was significantly better for bonds issued in local currencies, but still down -6.71% for Q2 and -8.88% year to date.

**Cross-asset returns were historically poor in the first half of 2022, leaving investors with few places to hide.** Depending on the choice of measurement for the bond market, the proverbial 60/40 portfolio could be said to have experienced the worst 6-month period in history over the first two quarters of 2022. Volatility will likely remain high in the near-term as the Fed has signaled an intention to continue aggressive hiking rates to combat inflationary pressure not seen since the 1980s. The Russian invasion of Ukraine has developed into what could be a protracted stalemate, and geopolitical uncertainty remains elevated at a level not seen for decades. The geopolitical, market, and economic environment continues to rapidly evolve, creating a level of uncertainty for market participants not seen in a decade or more. Our detailed assessment of the current environment, outlook for the back half of the year, and road map for navigating the path forward will follow in the days ahead.

**We remain committed to focusing on your long-term financial goals and priorities by constructing portfolios designed to reach those goals while minimizing risk. As always, our clients' interests always come first, and our goal is to continue to separate the signal from the noise and focus on what truly matters in the economy and markets to help you achieve your investment goals. Should you wish to have a more in-depth conversation about the current environment and its impact on your portfolio and long-term financial plan, please reach out to your Fulton team.**

**Matthew T. Brennan, CFA®**
**Senior Investment Strategist & Portfolio Manager**

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Matthew is a portfolio manager and leads the investment strategy group for Fulton Private Bank and Fulton Financial Advisors. He was a National Merit Scholar at the University of Chicago, where he graduated with a B.A. in Political Science. He is a Chartered Financial Analyst (CFA®) charterholder and is a member of the CFA® Institute and the CFA® Society of Philadelphia.


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