

This month's Market Minute reflects the views of our Investment Office and was composed by [Thomas M. Seay, Senior Managing Director, Research.](#)


OVERVIEW

Since peaking near 3.5% in mid-June, the 10-year U.S. Treasury yield has declined by over 80bps to 2.65% as markets continue to digest the Federal Reserve's growth and inflation policy conundrum¹. Directionally, the trend in core CPI seems to continue favoring a moderating inflation backdrop, yet the influences of volatile food and energy prices appear to keep headline inflation and CPI, at decades' high levels. Even though payroll employment growth remains strong and consumer balance sheets, including excess savings, are healthy, elevated prices at the pump and rising grocery store bills have consumers in a sour mood. With sentiment declining, both at home and in C-suites, combined with higher interest rates, the economy has taken a hit. We'll leave it to the politicians and the media to battle over semantics (i.e., is the USA in a recession), but the fact is economic growth is slowing.

Caught in the middle of this tug-of-war, the Federal Reserve has clearly come down on the side of fighting inflation. In the Fed's press release following their July 27th FOMC meeting, the Fed clearly stated their goal, "The Committee is strongly committed to returning inflation to its 2 percent objective." In Chairman Powell's press conference following the meeting, he reiterated multiple times the Committee's desire to "restore price stability" to maintain long-term growth potential. The financial markets' response appears to be thinking we have either seen the high in interest rates, or close to, and it is time to add risk to portfolios.

DOMESTIC EQUITY *As of July, 29, 2022*

U.S. EQUITY MARKETS				
Index	1 Month	Quarter-To-Date	Year-To-Date	1 Year
DJIA	6.8%	-4.7%	-8.6%	-4.1%
S&P 500	9.2%	-8.4%	-12.6%	-4.7%
Russell 2000	10.4%	-8.6%	-15.5%	-14.3%
Russell 1000 Growth	12.0%	-11.4%	-19.4%	-11.9%
Russell 1000 Value	6.6%	-6.4%	-7.1%	-1.5%

US equity markets traded sharply up in July, particularly in the final two weeks of the month, with S&P 500 Index gaining +9.2% for the month. Markets largely began trade anticipating the Fed is nearing the end of its hiking cycle and that a slowing US economy in 2023 will precipitate rate cuts by the Fed beginning in mid-2023. As a result, growth-oriented stocks—generally with greater cash flows projected for the future—outperformed their value-oriented peers (Russell 1000 Growth Index +12.0% vs. Russell 1000 Value Index +6.6%). Meanwhile, small cap stocks generally outperformed large caps (Russell 2000 Index +10.4% vs. Russell 1000 Index +9.3%) and small cap growth stocks also outgained their small cap value peers.

INTERNATIONAL EQUITY MARKETS

Index	1 Month	Quarter-To-Date	Year-To-Date	1 Year
MSCI ACWI ex USA	3.4%	-10.8%	-15.6%	-15.3%
MSCI EAFE	5.0%	-10.3%	-15.6%	-14.3%
MSCI Emerging Markets	-0.2%	-11.7%	-17.8%	-20.1%
MSCI EAFE Small Cap	6.6%	-12.2%	-19.7%	-20.3%

International equities lagged US markets in part because the prospect of a recession in Europe has become more likely as Russia further restricts gas exports to Western Europe. At this point, it looks all but certain the large users of Russian gas such as Germany and Italy will have to ration gas supplies during the winter which is likely to curtail industrial production. Developed markets (MSCI EAFE Index +5.0%) outperformed emerging markets (MSCI EM Index -0.2%) and small caps outperformed their large cap peers in both developed and emerging markets (MSCI ACWI Index +3.4% vs MSCI ACWI ex US Small Index +5.8%). MSCI EM Index struggled in July weighed down by China equities—MSCI China were down -9.5% in July—which sold off in the month due to more COVID-19 lockdowns in additional Chinese cities, as well as the anticipation of looming defaults in its property sector.

FIXED INCOME *As of July 29, 2022*
FIXED INCOME MARKETS

Index	1 Month	Quarter-To-Date	Year-To-Date	1 Year
BarCap US Aggregate	2.4%	-2.4%	-8.2%	-9.1%
BarCap Global Aggregate	2.1%	-6.3%	-12.1%	-14.6%
BarCap US High Yield	5.9%	-4.5%	-9.1%	-8.0%
JPM Emerging Market Bond	3.2%	-7.7%	-16.2%	-17.1%
BarCap Muni	2.6%	-0.4%	-6.6%	-6.9%

Although the Fed's increase of the fed funds rate on July 27th caused short-term rates to rise, further out, the interest rate curve significantly declined as US Treasury 10-year yields declined by 36 basis points to end the month at 2.65%¹. Due to the drop in interest rates and a tightening of credit spreads, both investment grade and high yield bonds resulted in gains that essentially reversed the declines witnessed in June. The Bloomberg High Yield Index returned +5.9% - the best month since late-2011¹. Emerging market debt markets also benefited from lower rates and tighter spreads as the J.P. Morgan Emerging Markets Debt index was up +3.2%¹.

The tone in municipal markets improved, although fund flows remain negative, as muni investors see strong fundamentals at the state and local government level and value in bonds yielding over 2%. The Bloomberg Municipal Bond index returned +2.6% for the month of July¹.

CLOSING

While valuations are beginning to look interesting for long-term equity investors, we still do not believe they fully reflect the earnings deterioration that is likely to come in the second half of 2022. The potential for inflation to remain elevated due to an acceleration in rent inflation, continued supply chain disruptions, tight labor markets, and continued high energy and food prices could keep the Fed in a restrictive monetary policy mindset. The Fed now expects fed funds rate to reach 3.25%-3.5% by the end of 2022 (100 basis points of additional increases in the fed funds rate) and 3.8% by 2023, well above its longer run rate of 2.5%. In this environment, we remain disciplined in our investment strategy as markets experience significant volatility, as evidenced by July's sharp rally. Lastly, investors should be prepared for a more drawn-out process before markets find any real footing. We believe this period is likely to be littered with more 5-10% declines than usual, followed by rallies of similar magnitudes as Fed policy makes its way into the economy.

SOURCES

¹ Bloomberg 7/29/2022

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