WestStar Wealth Management | Wealth Watch

For Managed Portfolios

2022 Q2 Review & Q3 Outlook

Among a number of challenges facing the economy in 2022, the most grievous has been inflation. In an attempt to curtail the highest acceleration in prices since 1981 the Fed has hiked its key short-term interest rate three times so far with more to come. Longer-term rates have followed suit, with the 10-year treasury yield more than doubling since the end of 2021. As such, even "safer" investments have declined in value, with bonds experiencing the worst first-half-of-the-year performance in the history of the index measuring that market.

"The Name is Bond…"

We have often cautioned our clients that while bonds are generally less volatile than other types of investments they are not without risk. Indeed, the inverse relationship between bond prices and interest rates has certainly manifested this year. Remaining focused and not succumbing to fear when even bonds have declined by double-digits can be formidable. The category and environment bring to mind "Agent 007" who always maintains his composure amid the most dangerous situations. For this reason, James Bond movie titles will guide us in this edition.

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Your wealth, well managed.

What You Need To Know:

- All major investment categories were negative in the second quarter
- WestStar's tactical strategy continues to emphasize defensive areas of the portfolio
- Past instances of steep first-half market downturns have been followed by second-half rebounds
- Mid-term election years tend to be weak, particularly in the first half, but often strengthen in the third quarter
- There are positive signs that inflation may have peaked and relief may be forthcoming
- Recession risks have increased but recent market weakness is consistent with an average bear
- Adhere to your long-term strategy

Asset Class Index Performance* Year-to-Date As of June 30, 2022

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Commodities
18.44%

Money Market (Cash)
0.17%

Alternative Investments
-5.49%

US Investment-Grade Bonds
-10.35%

High Yield Bonds
-14.19%

International Bonds
-16.49%

International Emerging Market Stocks
-17.63%

International Developed Market Stocks
-19.57%

US Large Cap Stocks
-19.96%

Real Estate
-20.35%

US Small Cap Stocks
-23.43%

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Performance: *Skyfall*

The title of Bond's 2012 hit film is a fitting description of what happened in the markets in the second quarter. Every major investment category was negative—including what had been the lone positive performer in Q1, Commodities. The stock market experienced the worst first-half since 1970, with the S&P 500 down -20%, officially constituting a "bear market." As previously mentioned, there were no safe havens, with even bonds experiencing the worst first half in the 40 year history of the Barclays Aggregate Index. While International stocks outperformed US stocks, every major country fell in Q2 and only three gained in the first half.

Tactical Strategy: *The World is Not Enough*

Our proactive strategy shifts in 2022 have helped our clients in that we had reduced our exposure to stocks in Q1, maintained an underweight to Bonds, and emphasized Alternative Investments and Real Assets (Commodities, etc.). However, even opportune maneuvers may provide little solace when facing a market where everything is down. While on the surface diversification may have seemed irrelevant in the first half, it remains a cornerstone of a well-constructed portfolio over time.

Historical Bear Market Perspective: *You Only Live Twice*

Every investor has heard the proviso, "past performance is no guarantee of future results." While most definitely true, the adage, "history may not repeat itself but it often rhymes" is as well. Historical perspective on past bear markets can provide insight into what we have experienced in 2022.

Year	First Half	Second Half	Bear End	Recession End
1932	-45.44%	+55.53%	02/27/1933	03/31/1933
1940	-20.10%	+6.01%	04/28/1942	N/A
1962	-23.48%	+15.25%	06/26/1962	N/A
1970	-21.01%	+26.72%	05/26/1970	11/30/1970
2022	-20.56%	??	??	N/A

Source: Standard & Poor's, Ned Davis Research, WestStar Wealth Mgmt

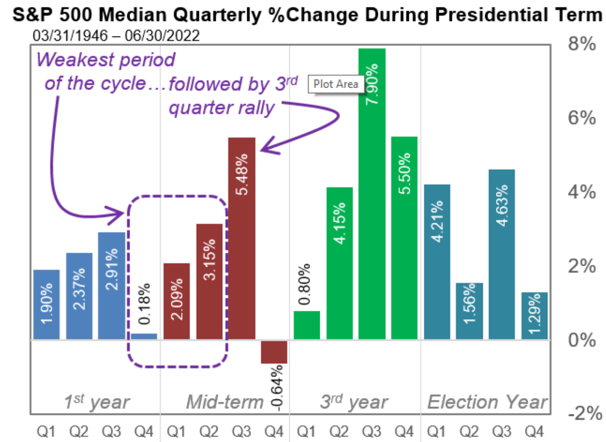
There have been four prior instances of first-half-of-the-year stock declines of at least 20%. The table at left indicates all four experienced second half rebounds, with three by double-digits. Of the two that coincided with recession we note the bear market ended before the recession did. With recession risk rising in 2022, what might happen should one occur now?

We look back through time for a year with similarities to current conditions: a quickly-slowing economy amid early expansion, supply chain constraints, and a first-term Democratic president facing a mid-term election year while struggling with spending limits. The chart at right shows that 2022's first half market action has tracked closely with that of the year 1962. The economy began slowing in the first half of that year but fears of recession proved unfounded, leading to a short, cyclical bear. In 2022 the Fed is aiming to sufficiently slow the economy to curtail inflation without igniting a recession. Should they prove successful and recession is avoided, history would suggest a second-half stock market rebound may be in store.

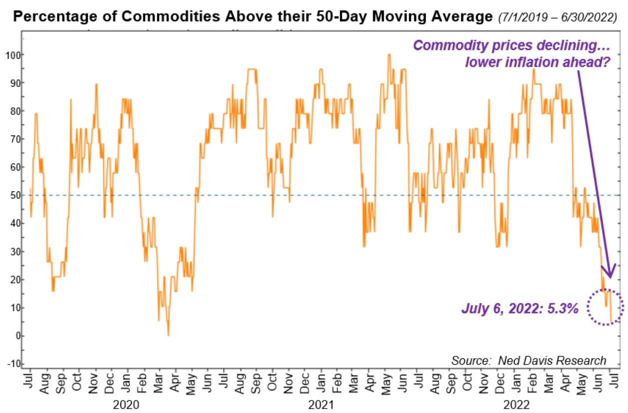
S&P 500: 1962 vs. 2022

*Large Cap: S&P 500 Index; Small Cap: Russell 2000 Index; Int'l Devel: MSCI EAFE Index; Int'l Emerg: MSCI Emerging Markets Index; Core Bond: Bloomberg Aggregate Index; Int'l Bond: Bloomberg Global Aggregate ex-USD Index; High Yield: Bloomberg US Corporate High Yield Index; Cash: BofA Merrill Lynch 3-Month US Treasury Index; Real Estate: FTSE EPRA/NAREIT Developed Index; Commodity: Bloomberg Commodity Index; Alternatives: Wilshire Liquid Alternatives Index

Finally, given that 2022 is a mid-term election year, no discussion of historical market perspective would be complete without examining past mid-term election year data. Regular readers of the Wealth Watch may recall that the mid-term election year is historically the weakest of the four during a presidential term on average, and that said weakness tends to come in the first half of that year. If we parse the cycle down further into the 16 quarters of a presidential term we find confirmation amid the more granular view. The chart at right shows that the three quarter period through Q2 of the mid-term year is the weakest such period of the four year cycle. This coincides with what we have experienced in the first half of 2022. We also note that mid-term Q3 is the third-best quarter of the 16 total, also suggesting a near-term rally. We would be remiss, however, if we did not recognize that mid-term Q4 tends to rank worst of the 16 quarters in the presidential cycle. This year's market outcome will hinge on inflation and recession.



Inflation: *From Russia With Love*



As previously mentioned, inflation has been the single largest factor in recent market and economic weakness and has been exacerbated by the Russia/Ukraine war. While May's 8.6% headline CPI inflation rate took the world by surprise and spurred the Fed's recent 0.75% rate hike, there are signs of relief on the horizon. In the chart at left we see that, whereas 95% of the 19 commodities tracked were rising in price in February, only 5% are now. Negative commodity price momentum is a signal that inflation should begin to decline. Perhaps improvements in inflation allow the Fed to be a bit less aggressive in future rate hikes, thereby reducing the risk of near-term recession. But should recession occur, how might the market react?

Recession: *Never Say Never Again*

Earlier this year economic data suggested recession was unlikely in the near future. However, a confluence of factors—not the least of which is the Fed's aggressive posture—has caused growth to slow more than expected. While not assured, the likelihood of a late 2022/early 2023 recession has increased. We can again look to history for market perspective amid recession.

Historically, the average bear market drops -25% over 9 months when not in a recession and by -35% over 15 months when in a recession. If the soft-landing scenario is achieved, the 2022 bear market would be congruent with an average one in terms of both price and time, suggesting the recent market decline is close to being over. Should a recession occur, however, further market declines might be expected. Given that scenario, reviewing every recession in the post-WWII era we find that the stock market bottoms four months before the recession ends on average. While not attractive prospects, the silver lining may be that an earlier start to a recession could mean a sooner end to it and a potentially shorter-than-average recessionary bear market.

Investment Strategy: *Tomorrow Never Dies*

It is important to remember that a prudently-designed, forward-looking investment strategy considers and incorporates both market and economic volatility over time. While short-term corrections can be quite unsettling, we cannot allow them to derail our long-term strategy. It is with this in mind that we may slightly modify one of James Bond's most famous quotes: volatility should leave us "stirred, not shaken." Whether we enjoy a second-half rebound or an early recession leads to more volatility, rest assured that we are actively monitoring developments and will remain proactive in our strategy as market conditions warrant.

The team you can trust.

As true fiduciaries, our focus isn't on selling products to our clients. Instead, we focus on providing personalized service and real financial solutions.

Our team of wealth management professionals has the valuable depth of expertise you need to navigate life's events.

From retirement planning and investment management to trust services and estate settlement, we can help you devise the most effective plan to meet your financial goals.

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