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Investment Market Review
July 2022

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The S&P 500 index posted its worst first-half performance since 1970, falling 20% from January 1 through June 30. The NASDAQ and other tech-heavy indexes suffered even greater declines. Investors are grappling with persistently high inflation and a Fed that is getting more aggressive in its efforts to contain it.

Inflation accelerated to 9.1% in June, the highest reading since 1981. The June number followed an 8.6% increase in May. Prices have been rising at a troubling rate for items consumers encounter on a daily basis. Food prices were up 12% year-over-year in June and gasoline prices increased by 60% over the same period.

The Fed is attempting to bring inflation back down to its 2% target by increasing interest rates and reducing the size of its balance sheet (quantitative tightening). The higher than expected inflation reading in May prompted the Fed to increase the federal funds rate by ¾ of a point at its June meeting versus the ½ point hike it had communicated to the markets just weeks prior. The June move was the most aggressive since 1994 and marked the third consecutive meeting at which the Fed raised rates. Markets are currently anticipating additional rate hikes through the remainder of the year and a federal funds rate around 3.5% - 4% by year end.

The Fed has made it clear that containing inflation is their top priority and that they will do whatever is necessary to bring it under control. Their success in this mission is of paramount importance. Inflation is a corrosive force that erodes the future value of wealth and is a particular burden on the pocketbooks of those least able to bear higher prices. Low and stable inflation is vital to a healthy economy.

The risk of recession is rising as the Fed tries to slow overall demand in the economy. While the Fed is not explicitly trying to ignite a recession, they have acknowledged that the rate hikes necessary to reduce inflation may do just that. Most prognosticators who are forecasting a recession expect it to be mild and relatively short-term in nature. A recession is not a foregone conclusion, but the risk remains elevated.

With the exception of energy, all sectors in the S&P 500 were down over the first six months of the year. The consumer discretionary, technology, and communications services sectors were the worst performers, registering declines ranging from -27% to -33%. Energy was the only sector to post a positive result, rising 32% on higher oil and gas prices.

Corporate earnings have continued to increase while valuations on stocks have contracted over the last few quarters. The price-to-earnings ratio (P/E ratio) is a fundamental measure of stock market valuation. The P/E ratio measures the price an investor is willing to pay for one dollar of earnings. The P/E on the S&P 500 has declined from over 22x in mid-2021 to around 16x in June, bringing it more in line with the long-term average. The contraction in the P/E ratio has more than offset the rise in earnings. In other words, although corporate earnings continue to grow, investors are paying less for those earnings, resulting in a decline in the overall stock market. As we have discussed in previous letters, high and rising inflation tends to push P/E's lower, which is exactly the scenario we are seeing play out.

Near-term market projections are challenging in the best of times and nearly impossible in the current environment. The war in Ukraine, aggressive tightening by the Fed, inflationary pressures, and lingering supply chain issues are but a few of the factors that will continue to weigh on the markets, although to a large degree these items are already priced in. A deviation from current expectations (i.e., more rate hikes than investors currently expect or festering inflation) would likely rattle markets further. Volatility, with a chance of additional declines over the coming quarters, is quite possible. Even so, sticking with a well-crafted investment strategy that is aligned with your goals is generally the best approach to weather a volatile market.

As such, client portfolios with Eads & Heald Wealth Management contain several time-tested risk-mitigation strategies. Our portfolios are very well diversified across major economic sectors. Above all, client portfolios hold high quality securities, companies which are leaders in their respective industries and among the largest publicly traded companies in the United States. In periods of stock market volatility and ongoing corrections, high quality stocks rule.

These strategies can potentially offer some relative downside protection in times of turmoil, and keep you on track for long-term investment success. Over a long investment time horizon, the stock market is resilient and historically has been a great wealth-generating machine. The economy will get through these difficult times and we strive to keep our clients well-positioned to benefit over the long-term.

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