Capital Markets Review and Outlook

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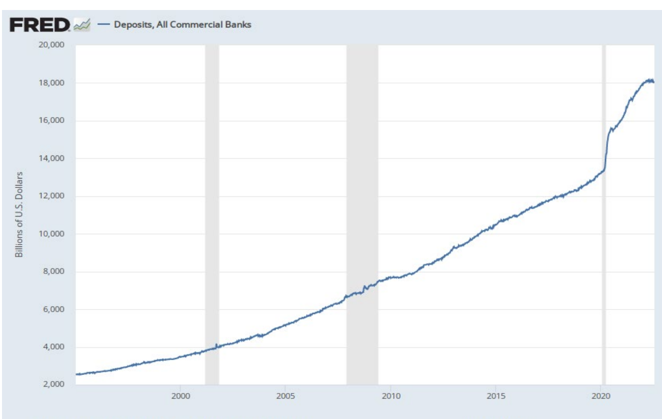
Economy and Outlook

Central banks continued to tighten monetary policies by pushing interest rates higher in July as they strived to bring surging inflation rates under control. The European Central Bank (ECB) raised its official rates by 50 bp, the first increase in 11 years. Although this was the central bank's largest rate increase in over 20 years, this only brought the ECB's' deposit rate to zero, highlighting the number of years the rate was in negative territory. Also in July, the Bank of Canada delivered a supersized hike of 100 bp, while the Federal Reserve raised its federal funds rate by 75 bp for the second consecutive month. The benchmark rate in the U.S. is now in a 2.25%-2.5% range, a steep rise from the 0%-0.25% range it had been in for almost two years. There are some signs that higher interest rates are having the intended effects of slowing the economy and bringing inflation down. In the residential real estate market, mortgage demand dropped to the lowest level in over 20 years. Sales of existing homes in June dropping by 20% from the previous year as mortgage rates soared. The U.S. economy declined 0.9% in the second quarter, the second quarterly decline in a row. While a rule of thumb suggests that two consecutive quarterly declines in GDP point to an economy in recession, that is unlikely to be the case this time because of the underlying strength in the U.S. economy including continued strong job growth and an unemployment rate that remains near the lows in half a century. The National Bureau of Economic Research is the agency that officially declares recessions and expansions and will not render its judgement (based on a number of varied economic indicators) for many months. Consumer spending remains the primary driver for the U.S. economy. In this regard, consumer cash balances are at record high levels due to the massive fiscal and monetary stimulus measures undertaken to combat the effects of the coronavirus pandemic. The graph on this page shows that the amount of money in deposit accounts at commercial banks is around $3 trillion higher than the pre-pandemic trend. This will provide a tailwind for the economy in a higher interest rate environment. The Federal Reserve may, therefore, be able to thread the needle and engineer a soft-landing for the economy without tipping it into a recession.



Equity Markets

Despite fears about recession and inflation, equity markets rebounded strongly in July as companies reported better than feared second quarter earnings and outlooks. The broad domestic equity market represented by the Russell 3000 index closed sharply higher, gaining +9.4% for the month and trimming its year-to-date decline to -13.7%. Highlighting the importance of investing with a longer-term time horizon (especially for institutional investors) is the fact that despite the steep declines in equity markets in the first half of the year, the annualized returns (thru July) for the Russell 3000 index over the past 3 and 5-years are +12.6% and +12.2% respectively, while the annualized return over 10 years is +13.5%. Gains occurred across the capitalization spectrum with Small Cap (+10.4%) and Mid Cap (+9.9%) edging ahead of Large Cap (+9.3%). However, Large Cap remains firmly ahead over the trailing 1 year by a significant margin. For a second consecutive month, Growth outperformed Value across all capitalizations, especially in Large Cap where the outperformance was +540 bp for the month. Year-to-date, however, Value continues to significantly outperform Growth across all capitalizations. Rallying markets led to a reversal in sector performance in July as Cyclicals outperformed Defensives. Consumer Discretionary (+18.9%) was the best sector performer followed by Technology which gained +13.5%. However, Consumer Discretionary was one of the worst performers this year with a loss of -20.1%. Consumer Staples and Health Care which both rose +3.3% were the laggards for the month. Although oil prices declined sharply in July with the benchmark WTI closing 9% lower for the month and ending below $100 per barrel, the Energy sector rose +9.7% in July buoyed by the strong earnings and dividend increases reported by energy companies. The Financials sector gained +7.2% for the month despite the pronounced flattening in the Treasury yield curve which resulted in an inversion of the yield curve. International equity markets also rebounded in July but to a lesser degree compared to the U.S. partly due to the continued rise in value of the U.S. dollar with the trade-weighted dollar index rising +0.7% for the month. The MSCI Developed Markets index rose +5% in July. Australia and France were the standouts with returns of +6.6% and +6.4% respectively, while Italy (+2.5%) and Germany (+2.4%) lagged. Italian markets were negatively impacted by the political turmoil that led to the resignation of Mario Draghi as prime minister and an election next month. Heightened concerns about the security of gas supplies from Russia weighed on German markets. The MSCI Emerging Markets index posted a negative return for the month (-0.2%) dragged down by the significant decline in China (-9.5%) due to problems spreading in the property market, new Covid lockdown measures and continued concerns with regulatory issues. While India (+9.3%) and Korea (+5.8%) were strong performers, China remains the largest component of the Emerging Markets index. Year-to-date, relative performance has reversed between the Developed Markets and Emerging Markets indices with the former now leading the latter by +220 bp.

Fixed Income Markets

The fixed income markets were buffeted by conflicting concerns in July. In the U.S. Treasury market, a significant reshaping took place in the Treasury yield curve with the belly of the curve experiencing a significant decline in yields as 5-year and 10-year yields plunged by 31 bp to 2.7% and 2.67% respectively, while 2-year and 30-year yields declined by only 3 bp and 14 bp respectively to 2.89% and 3%. The reshaping resulted in an inversion in the yield curve with 2-year Treasury yields higher than 10-year yields. By the end of the month, the 2-year/10-year Treasury yield spread had turned negative to -22 bp. At the beginning of the year, this spread was +79 bp. An inverted yield curve is typically a sign that investors are concerned that the magnitude and rapid pace of central bank rate hikes are likely to push the economy into a recession. On the other hand, the investment grade and high yield sectors performed strongly indicating less concerns about a recession. Investment grade option-adjusted spreads (OAS) tightened in July resulting in an outperformance over duration-matched Treasuries. The investment grade credit curve flattened as the Bloomberg Long Credit index gained +4.6% for the month compared to the Long Treasury index which rose +2.7%, while in the intermediate space, the Intermediate Credit index and Intermediate Treasury index gained +2.2% and +1.3% respectively. The investment grade quality curve also steepened with the BBB-rated sector underperforming the Single-A and AA-rated sectors for the month. Sector outperformers in July include Transportation and Healthcare/Pharma while Basic Industries and Insurance were the laggards. The Bloomberg Investment Grade Credit sector rose +3% in July which helped trim its year-to-date decline to -11.2%. Gains in the high yield sector in July were even greater with the Bloomberg High Yield index rising +5.9%, almost double the performance of the Investment Grade sector. The quality curve in high yield steepened as the Ba index rose +6.1% compared to the gain of +4.9% for the Caa index. Cable/Satellite and Housing were the top two performing sectors in high yield with total returns of over 7% in July, while Metals & Mining with a return of +3.4% was an underperformer. Year-to-date, the relative performance differential between the high yield and investment grade sectors has reversed with the high yield sector's return of -9.1% outperforming the investment grade sector by +210 bp. Despite rate hikes by central banks, global bond yields declined in July on growth fears. In several regions of the world, the interest rate declines were greater than in the U.S. Ten-year government bond yields in Canada declined 60 bp while the corresponding declines in Spain, Germany and Australia ranged from 40 to over 50 bp. In addition, although the U.S. dollar rose against most currencies in July, including +2.3% versus the euro, it declined -1.4% against the Japanese yen. As a result, the FTSE non-US government bond index gained +2.1%, outperforming the U.S. government bond market which rose +1.6%. However, year-to-date, the U.S. government bond index with a loss of -7.6% is significantly ahead of the international government bond index which lost -17% over the same period.

			Returns as of 7/31/22 (In %)				
		Month	YTD	1 Year	3 Years	5 Years
Russell 3000®	US AllCap Equity	9.4	-13.7	-7.4	12.6	12.2
Russell 1000®	US Large Cap Equity	9.3	-13.6	-6.9	12.9	12.6
Russell 1000® Growth	US Large Cap Growth	12.0	-19.4	-11.9	16.1	16.3
Russell 1000® Value	US Large Cap Value	6.6	-7.1	-1.4	8.9	8.3
Russell Midcap®	US Mid Cap Equity	9.9	-13.8	-9.8	9.5	9.7
Russell Midcap® Growth	US Mid Cap Growth	12.2	-22.6	-21.8	7.5	11.1
Russell Midcap® Value	US Mid Cap Value	8.6	-9.0	-2.9	9.4	7.8
Russell 2000®	US Small Cap Equity	10.4	-15.4	-14.3	7.5	7.1
Russell 2000® Growth	US Small Cap Growth	11.2	-21.6	-23.2	4.7	6.9
Russell 2000® Value	US Small Cap Value	9.7	-9.3	-4.8	9.4	6.7
MSCI ACWI ex-US	Global Equity ex-US	3.4	-15.6	-15.3	2.9	2.4
MSCI EAFE	Global Developed Mkts Equity	5.0	-15.6	-14.3	3.2	2.6
MSCI EM	Emerging Mkts Equity	-0.2	-17.8	-20.1	0.9	1.0
Bloomberg/Barclays US Agg	US Core Fixed Income	2.4	-8.2	-9.1	-0.2	1.3
Bloomberg/Barclays US Interm. Agg	US Intermediate Fixed Income	2.2	-5.5	-6.6	0.1	1.2
Bloomberg/Barclays US Credit	US Corporate Bonds	3.0	-11.2	-12.2	-0.2	1.7
Bloomberg/Barclays US MBS	US Mortgage Backed Securities	3.2	-5.8	-6.7	-0.5	0.9
Bloomberg/Barclays US Corp HY	US High Yield	5.9	-9.1	-8.0	1.9	3.1
FTSE Non-US WGBI	Global Fixed Income ex-US	2.1	-17.0	-21.7	-5.8	-2.7