Capital Markets Review and Outlook

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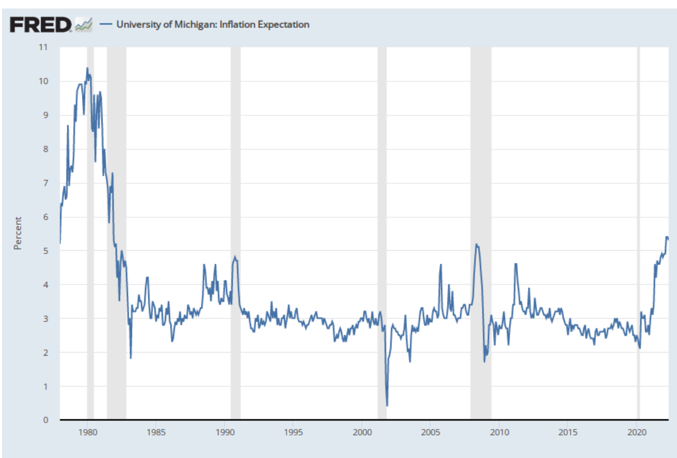
Economy and Outlook

The ongoing war in Ukraine, now in its fifth month, has contributed to the sharp rise in commodity prices which has led to the persistence of high inflation globally. In response, central banks around the world are raising interest rates aggressively. In the United States, the Federal Reserve raised its benchmark federal funds rate by 75 bp in June bringing the total increase over the past three months to 150 bp. While this is a large increase, it is important to note that this increase is from a zero level for the funds rate. The Fed chairman, Jerome Powell, has repeatedly emphasized that the central bank wants to prevent high inflation expectations from becoming entrenched in the economy. The graph on the left shows that the University of Michigan's closely watched survey of consumer inflation expectations over the next year has now been over 5% since March. The last time inflation expectations were at these levels was 14 years ago, just before the Great Financial Crisis when it was briefly (for 2 months) at 5.1%. Prior to that time, the survey results registered over 5% more than 40 years ago. The Federal Reserve is, thus, unequivocally committed to using all the tools at its disposal to prevent inflation from getting out of hand. While there are concerns that the higher borrowing costs resulting from the tightening in financial conditions could lead to a recession, it is important to note that both households and business balance sheets are strong. Consumer savings are at record high levels with $2.5 trillion saved during the pandemic from the federal government's pandemic-relief payments and reduced consumer spending. Similarly, corporate cash balances and profit margins are at near record high levels as well. As a result, households and companies have the ability (to some degree) to withstand the negative effects from higher borrowing costs. Since late last year, we have been writing that the re-normalization of central banks monetary policies will lead to a sharp increase in volatility across risk assets. This has been unfolding over the past several months and is likely to continue until the inflation backdrop provides central banks with increasing confidence that their 2% long-term inflation targets are likely to be achieved.



Equity Markets

Recession and valuation fears together with higher interest rates weighed on equity markets in June. The broad domestic equity market represented by the Russell 3000 index closed sharply lower, losing -8.4% for the month and -21.1% for the first half of the year. Declines occurred across the capitalization range with Mid Cap (-10%) the most impacted. After a prolonged period of relative underperformance, Growth outperformed Value across capitalizations in June despite the rise in yields. The outperformance of Growth ranged from +80 bp for Large Cap to +370 bp for Small Cap. For the year, however, Value continued to significantly dominate Growth by an average of +14 percentage points. As is typically seen in market downturns, Defensives outperformed Cyclicals in June. The best sector performers were Consumer Staples (-2.5%) and Health Care (-2.7%). Energy was the worst sector performer with a loss of -16.8% as oil prices declined -6% for the month and natural gas prices plunged -34%. For the year, Energy remains the best performing sector with a gain of +32%. Materials was the second worst performing sector with a loss of -13.8%. The Financials sector declined almost -11% as investors worried that the pronounced flattening in the Treasury yield curve would adversely impact banks' net interest margins. International equity markets also slumped in June on concerns about recession, inflation, and higher interest rates. Additionally, the resumption of the broad-based strength in the U.S. dollar weighed on international equity market returns as the dollar index rose +2.6% for the month. The MSCI Developed Markets (ex-US) index lost -9.3% in June. Italy (-14.4%) and Germany (-13.5%) were the worst performers as economic activity in the Eurozone fell to a 16-month low. Declining commodity prices weighed on Australia (-12.1%) and Canada (-10.4%). Japan was the best performer among developed markets with a decline of -7.9%. The MSCI Emerging Markets index (-6.6%) held up much better due to the +6.6% gain in China. Equity markets in China rebounded strongly as the government eased Covid-related restrictions, cut quarantine times by half and eased previously imposed regulatory restrictions on technology companies. Brazil was the worst performer among emerging markets with a loss of -19.2% due to the sharp declines in both commodity prices as well as the value of the Brazilian Real versus the U.S. dollar. For the first half of the year, however, the Brazilian equity market was the best performer with a gain of +2.8%. Year-to-date, the Emerging Markets index (-17.6%) is +200 bp ahead of its Developed Markets counterpart.

Fixed Income Markets

Interest rates at the front end of the Treasury yield curve rose sharply as the Federal Reserve reiterated its commitment to combat high inflation. Two-year and five-year Treasury yields rose +39 bp and +20 bp respectively to end the month at 2.9% and 3%. Further out the yield curve, the 30-year Treasury bond's yield increased by 7 bp to 3.14%, while the 13 bp increase in the yield of the 10-year Treasury note raised it to just under 3% (2.98%). Intra-month, the 10-year Treasury yield almost reached 3.5% before closing the month below 3%. For the month, the Treasury yield curve flattened significantly with the 2-year/30-year Treasury yield spread differential narrowing by 32 bp to end the month at +22 bp. At the beginning of the year, this spread was five times wider at +117 bp. Mirroring the weakness in equity markets, the investment grade credit sector also underperformed in June as option-adjusted spreads (OAS) widened resulting in an underperformance over duration-matched Treasuries. The investment grade credit curve steepened as the Bloomberg Long Credit index lost -4.2% for the month compared to the Long Treasury index which lost -1.5%, while in the intermediate space, the Intermediate Credit index and Intermediate Treasury index declined -1.8% and -0.7% respectively. The investment grade quality curve also steepened with the BBB-rated sector underperforming the Single-A sector for the month. The Bloomberg Investment Grade Credit sector lost -2.6% in June and -6.9% for the first half of the year. Declines in the high yield sector were steeper with the Bloomberg High Yield index losing -6.7% in June. The quality curve in high yield steepened as the Ba index declined -6.4% while the Caa index lost -7% for the month. For the first half of the year, the high yield index with a loss of -9.8% has underperformed the investment grade sector by almost -300 bp. A stronger U.S. dollar and a narrowing in yield spread differentials led to an underperformance for the international developed government bond market in June. The trade-weighted dollar index rose +2.6% for the month to its highest level in 20 years. As a result, the FTSE non-US government bond index lost -4.9% compared to a loss of -0.9% for the U.S. government bond market. For the first half of the year, the U.S. government bond index with a loss of -9% is significantly ahead of the international government bond index which has lost -18.7%, half of it due to the +9.7% rise in the U.S. dollar (DXY).

			Returns as of 6/30/22 (In %)				
		Month	Q2	YTD	1 Year	3 Years	5 Years
Russell 3000®	US AllCap Equity	-8.4	-16.7	-21.1	-13.9	9.8	10.6
Russell 1000®	US Large Cap Equity	-8.4	-16.7	-20.9	-13.0	10.2	11.0
Russell 1000® Growth	US Large Cap Growth	-7.9	-20.9	-28.1	-18.8	12.6	14.3
Russell 1000® Value	US Large Cap Value	-8.7	-12.2	-12.9	-6.8	6.9	7.2
Russell Midcap®	US Mid Cap Equity	-10.0	-16.8	-21.6	-17.3	6.6	8.0
Russell Midcap® Growth	US Mid Cap Growth	-7.5	-21.1	-31.0	-29.6	4.3	8.9
Russell Midcap® Value	US Mid Cap Value	-11.0	-14.7	-16.2	-10.0	6.7	6.3
Russell 2000®	US Small Cap Equity	-8.2	-17.2	-23.4	-25.2	4.2	5.2
Russell 2000® Growth	US Small Cap Growth	-6.2	-19.3	-29.5	-33.4	1.4	4.8
Russell 2000® Value	US Small Cap Value	-9.9	-15.3	-17.3	-16.3	6.2	4.9
MSCI ACWI ex-US	Global Equity ex-US	-8.6	-13.7	-18.4	-19.4	1.4	2.5
MSCI EAFE	Global Developed Mkts Equity	-9.3	-14.5	-19.6	-17.8	1.1	2.2
MSCI EM	Emerging Mkts Equity	-6.6	-11.4	-17.6	-25.3	0.6	2.2
Bloomberg/Barclays US Agg	US Core Fixed Income	-1.6	-4.7	-10.3	-10.3	-0.9	0.9
Bloomberg/Barclays US Interm. Agg	US Intermediate Fixed Income	-1.3	-2.9	-7.5	-7.9	-0.6	0.9
Bloomberg/Barclays US Credit	US Corporate Bonds	-2.6	-6.9	-13.8	-13.6	-1.0	1.2
Bloomberg/Barclays US MBS	US Mortgage Backed Securities	-1.6	-4.0	-8.8	-9.0	-1.4	0.4
Bloomberg/Barclays US Corp HY	US High Yield	-6.7	-9.8	-14.2	-12.8	0.2	2.1
FTSE Non-US WGBI	Global Fixed Income ex-US	-4.9	-12.5	-18.7	-21.9	-6.7	-2.6

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