TFC FINANCIAL
The Financial Counselors

COMMENTARY | Q2 2022
July 2022

OUR VIEW

The S&P 500 Index lost 16.1% during the quarter, for a half-year loss just under 20%.

Second Quarter Review

A poor first half of the year ended with major equity indexes in bear market territory and bond prices falling at the fastest pace in decades. Concerns about inflation and the implications for monetary policy were at the top of the investor "Wall of Worries." With no end in sight for the war in Ukraine and doubts about the outlook for Chinese growth, there was not much good news during the second quarter. The risk of recession is higher than was the case to start the year, with considerable debate about the potential timing and severity of a recession in the U.S.

Global equities, as represented by the MSCI All Country World Index, fell 15.7% during the second quarter, bringing the half-year loss to more than 20%. The S&P 500 Index lost 16.1% during the quarter, for a half-year loss just under 20%. U.S. small company stocks lost 17.2%, bringing the half-year loss to more than 23%. Developed international stocks, as measured by the MSCI EAFE Index, were relative outperformers during the quarter, falling by 14.5% but in line with the U.S. in bear market territory for the half-year. To the surprise of many investors, emerging markets stocks fell "only" 11.4% during the quarter and have fallen less than U.S. and developed international stocks for the half-year period.

Value stocks were relative outperformers during the quarter. The Russell 1000 value index fell by approximately 12%, in stark contrast to the loss of nearly 21% for the Russell 1000 Growth Index. The gap between growth and value indexes was more than 15% for the first half of the year, a major reversal of fortune after several years of growth outperformance. Although we welcome a return to an environment in which fundamentals such as cash flow and balance sheet strength matter to investors, many growth companies with promising long-term business prospects have fallen as steeply as more speculative, lower quality growth stocks.

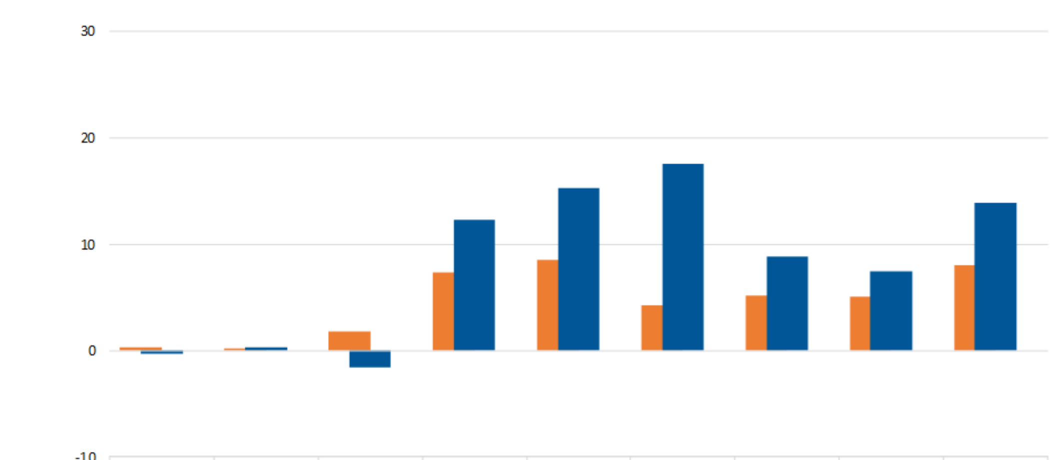
Energy stocks were the only sector in the S&P 500 Index that gained ground in the half-year. The more defensive utilities and consumer staples sectors lost less than the market during the second quarter and for the half-year. Communications services, consumer discretionary and technology sectors were the worst performers during the quarter and the half-year.

The bond market was equally challenging during the quarter, with interest rates rising in response to more restrictive Fed policy. The Bloomberg Barclays Aggregate Index lost 4.7%, bringing half-year losses to more than 10%. The Bloomberg Municipal Index fell by 2.9% during the quarter, with half-year losses of nearly 9%. The shorter-duration Bloomberg 1-5 year Government/ Credit Index fell 1.1% for the quarter and 4.6% for the half-year period.

Energy and agriculture commodity prices continue to be elevated in response to supply constraints exacerbated by Russia's invasion of Ukraine.

TFC client portfolios declined in absolute terms along with market indexes and were slightly ahead of client benchmarks during the quarter. TFC's value fund holdings were bright spots, as were insurance-linked securities and private real estate holdings (in most client portfolios). The U.S. and developed international growth holdings that were big gainers during the height of the pandemic gave back prior profits in the half-year period. Intermediate-term bond holdings also detracted from performance.

Quarter To Date Returns 6/30/2021



	Short Term Bonds	Short Term Muni Bonds	Barclays Agg.	Global Equities	S&P 500	U.S. Small	Intl. Large Core	EM	Global Real Estate
QTD	0.3	0.3	1.8	7.4	8.5	4.3	5.2	5.0	8.1
YTD	-0.3	0.3	-1.6	12.3	15.3	17.5	8.8	7.4	13.9
Full Cycle*	2.6	1.8	2.8	19.3	21.6	27.6	12.3	20.1	3.0

* Full Cycle is the annualized return from February 12th 2020 peak to present.

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Market Outlook

June's Federal Reserve rate increase of 0.75% was the largest single hike since 1994, a response to inflation that reached a 4-decade high in which headline inflation reached 8.6%. The Fed acknowledged that tighter policy will likely lead to higher unemployment and lower economic growth, a necessary consequence to keep inflation expectations from becoming "un-anchored."

The Fed is justifiably being held accountable for being "behind the curve" on raising interest rates and shrinking the size of their balance sheet. However, the Fed is not the only culprit for painfully high inflation. The Fed has limited influence over the rising food and energy costs that create strains for consumer budgets. Rate hikes may reduce energy demand, but tight supplies will continue to be the dominant factor driving energy prices. The tightness in labor markets may be partially attributable to government assistance that may have undermined incentives to return to work, as well as the understandable fear of contracting the Covid-19 virus that is still unfortunately rampant.

The positive outlook for inflation to decline this year is partially offset by our expectation that the "new normal" for inflation will be higher than the Fed's target rate of 2%.

We do expect inflation to ease later in the year. We are seeing early signs of an easing of wage pressures, a shifting of spending from goods to services, and gradually recovering supply chains. We expect the Fed to slow the pace of tightening if inflationary pressures recede or a growth slowdown turns into recession. The positive outlook for inflation to decline this year is partially offset by our expectation that the "new normal" for inflation will be higher than the Fed's target rate of 2%.

There has been rapid adjustment in financial conditions, in contrast to past Fed tightening cycles. 2-year Treasuries yielded approximately 0.25% last June, yields were nearly 3% at quarter-end. 10-year Treasuries yielded 1.45% last June and have more than doubled in the past year. Although more rate hikes are coming, the tightening of financial conditions that has happened already may have reduced the typical lag between Fed policy changes and economic activity.

Consumers remain in good shape despite a lot of negative news. The job market remains strong. Wage growth is strong but is slowing from the elevated levels of the post-Covid economic reopening. There is still a significant gap between the number of jobs available and the number of job seekers. Households have amassed more than $2 trillion in excess savings since the pandemic started in 2020, which is now a cushion against rising food and energy costs. Debt servicing costs are near multi-decade lows, in stark contrast to the conditions leading up to the Global Financial Crisis (GFC) in 2008-2009. Consumer sentiment has declined dramatically, but there so far is a disconnect between what people are saying and what they are doing.

Mortgage rates have surged, creating concerns about the outlook for housing. In our opinion, housing is heading for a slowdown rather than a meltdown. New and existing home sales have further to fall. The 30-year mortgage rate has increased in the past 6 months by the largest amount in decades, while housing affordability is at a 15-year low. A slowdown in housing will have a major impact on headline inflation. However, this is not a repeat of the conditions in the mid-2000s that led to the crash in the housing market and systemic risks for the world financial system. The subprime home loan market and home equity lines of credit are currently a fraction of their size during the 2000s housing bubble. The U.S. has been underbuilding housing stock for more than a decade, housing demand continues to rise, and most mortgages are fixed rate, so homeowners will not face the interest rate shock that collapsed the market during the GFC.

The risk of recession is undeniably higher than was the case at the start of the year, with the Fed facing the daunting challenge of trying to tighten policy enough to slow demand while avoiding tipping the economy into a severe recession.

Portfolio Positioning

Continued market volatility is likely, with tightening Fed policy, war raging in Ukraine and Covid posing an on-going threat to Chinese growth and global supply chains. The risk of recession is undeniably higher than was the case at the start of the year, with the Fed facing the daunting challenge of trying to tighten policy enough to slow demand while avoiding tipping the economy into a severe recession. Alpine Macro's Chen Zhao recently wrote that "controlling an economy is like taming a wild animal," which is a vivid description of the challenge the Fed faces. It is understandable to react with a full range of emotions to the market downturn and to a steady stream of unsettling headlines.

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However, it is important to remember that equity markets typically bottom while the economy is still getting worse.

We recommend being patient in this challenging environment but are taking actions that we think are appropriate. We continue to “harvest” losses in taxable accounts, creating tax losses that can offset current or future capital gains. We are finding more value and less risk in short-term bonds than in intermediate and long-term bonds and have made changes in fixed income holdings to reflect that outlook. Given the expectation that inflation will remain a long-term economic challenge, we will be making portfolio changes this summer designed to provide more stable income and inflation protection. More details will be forthcoming later this month.

We are also looking for opportunities to rebalance capital into the segments of the market that we think have overreacted to recent events, with a focus on holdings that may “bend but not break” during times of elevated economic stress. Cash flow, strong balance sheets and pricing power will be valued highly in an uncertain environment. Among struggling growth investments, companies with a clear path to positive cash flows that don’t need to tap capital markets are likely to be better positioned for this investment environment than more speculative growth names.

As always, we welcome your comments and questions.

Sincerely,

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