Economic and Market Overview

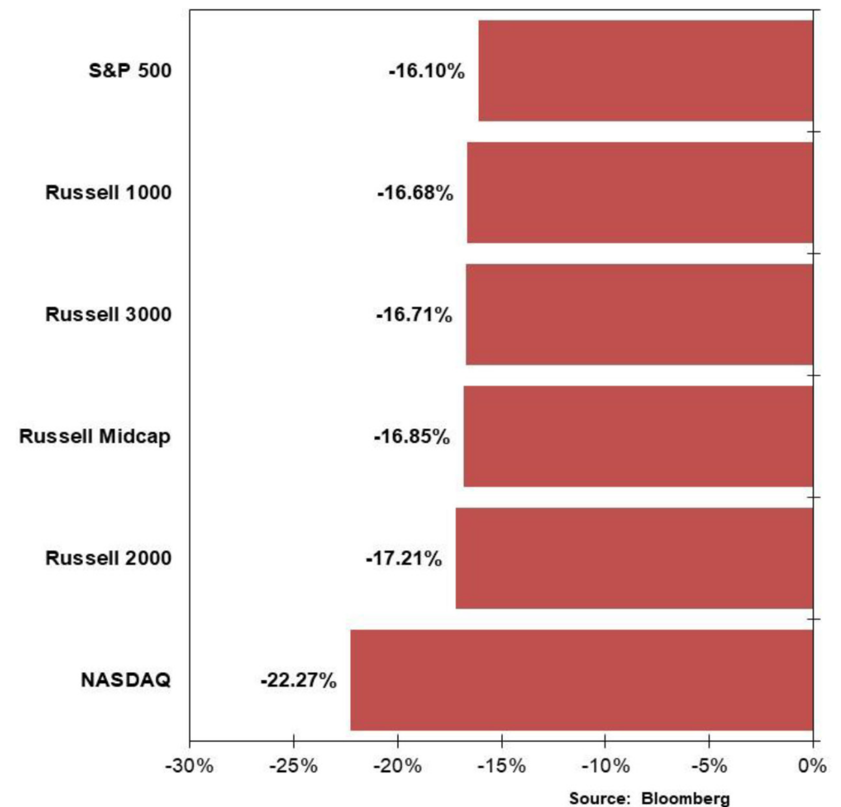
Second Quarter 2022

Building a Lifelong Partnership

OCTAVIA WEALTH ADVISORS

The Economy

The US economy slowed precipitously in the quarter, as the Russian invasion of Ukraine and significant swings in inventory accumulation put a damper on growth. Against this backdrop, the Bureau of Economic Analysis released the third estimate of the first quarter 2022 real GDP, a seasonally adjusted annualized decline of 1.6%, slightly lower than the prior estimate, but a material deterioration from the 6.9% increase in the prior quarter. The employment situation once again surprised on the upside in the quarter, as gains exceeded expectations. The May report showed that employers added 390,000 jobs in the month, and that the unemployment rate fell to 3.6%. The Federal Open Market Committee (FOMC), in an effort to aggressively battle surging inflation, twice raised its federal funds rate target range in the quarter to 1.50% to 1.75%, from a range of 0.25% to 0.50%. The 75-basis point increase on June 15th was the first since 1994, and many economists expect the FOMC to continue to aggressively raise rates until inflation is under control.



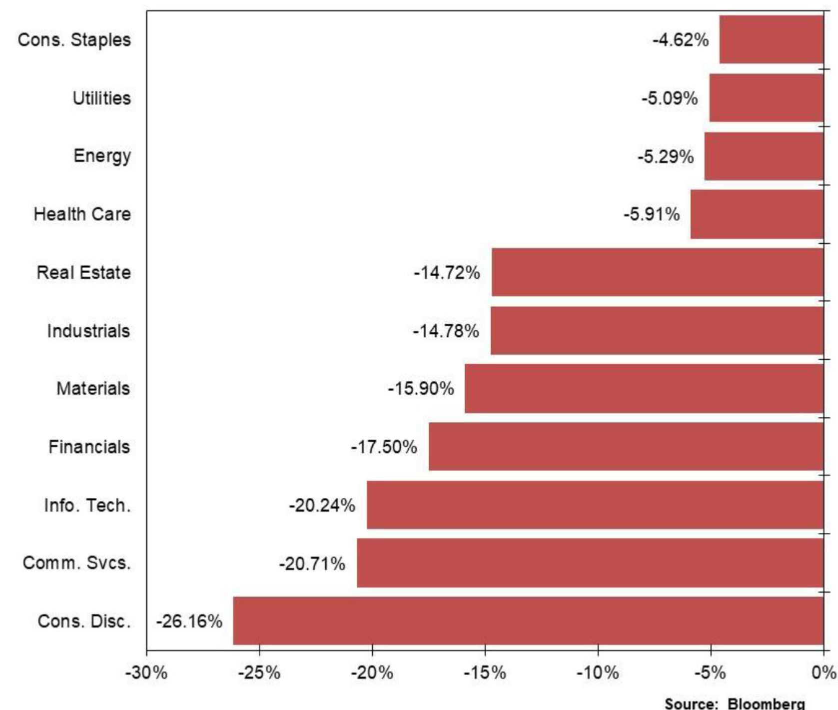
Highlights and Perspectives

GROSS DOMESTIC PRODUCT (GDP)

In the latest data available, the Bureau of Economic Analysis released the third estimate of the first quarter 2022 real GDP, a seasonally adjusted annualized decline of 1.6%, slightly lower than the prior estimate of -1.5%, and a significant deterioration from the 6.9% gain in the prior quarter. A number of factors contributed to the slowdown, including the Russian invasion of Ukraine, continued declines in real income resulting from extremely high inflation, and volatility in inventory accumulation. Supply chain disruptions continued to wreak havoc as well, as did new Covid-related lockdowns in China. Trade was a major drag on growth, as exports declined after rising sharply in the previous quarter, and imports grew. Inventories were also a detractor. Corporate profits declined by 2.3% (not annualized) during the quarter after having risen 0.7% in the prior period. Inflation expectations were in line with the prior quarter, but remain elevated.

HOUSING

The housing segment continued to suffer as a result of the rise in interest rates, which negatively impacts the level of mortgage rates. Existing-home sales for May (the latest monthly data available) dropped 3.4% to an annualized rate of 5.4 million units, down about 8.6% from year-ago levels. The inventory of existing homes continued to be somewhat tight at 2.6 months of supply, up slightly from levels of the prior year. Existing-home prices in May increased 14.8% from May 2021. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at 67, down slightly from a reading of 69 in the prior month. The decline was the sixth consecutive monthly drop, reflecting higher mortgage rates as well as rising input costs resulting from the inflationary environment. Even though confidence among homebuilders has declined, the industry is benefiting from the extremely low levels of supply, and homebuyer demand for the time being remains resilient.market remains in solid condition, even if mortgage rates were to rise from current levels.



EMPLOYMENT

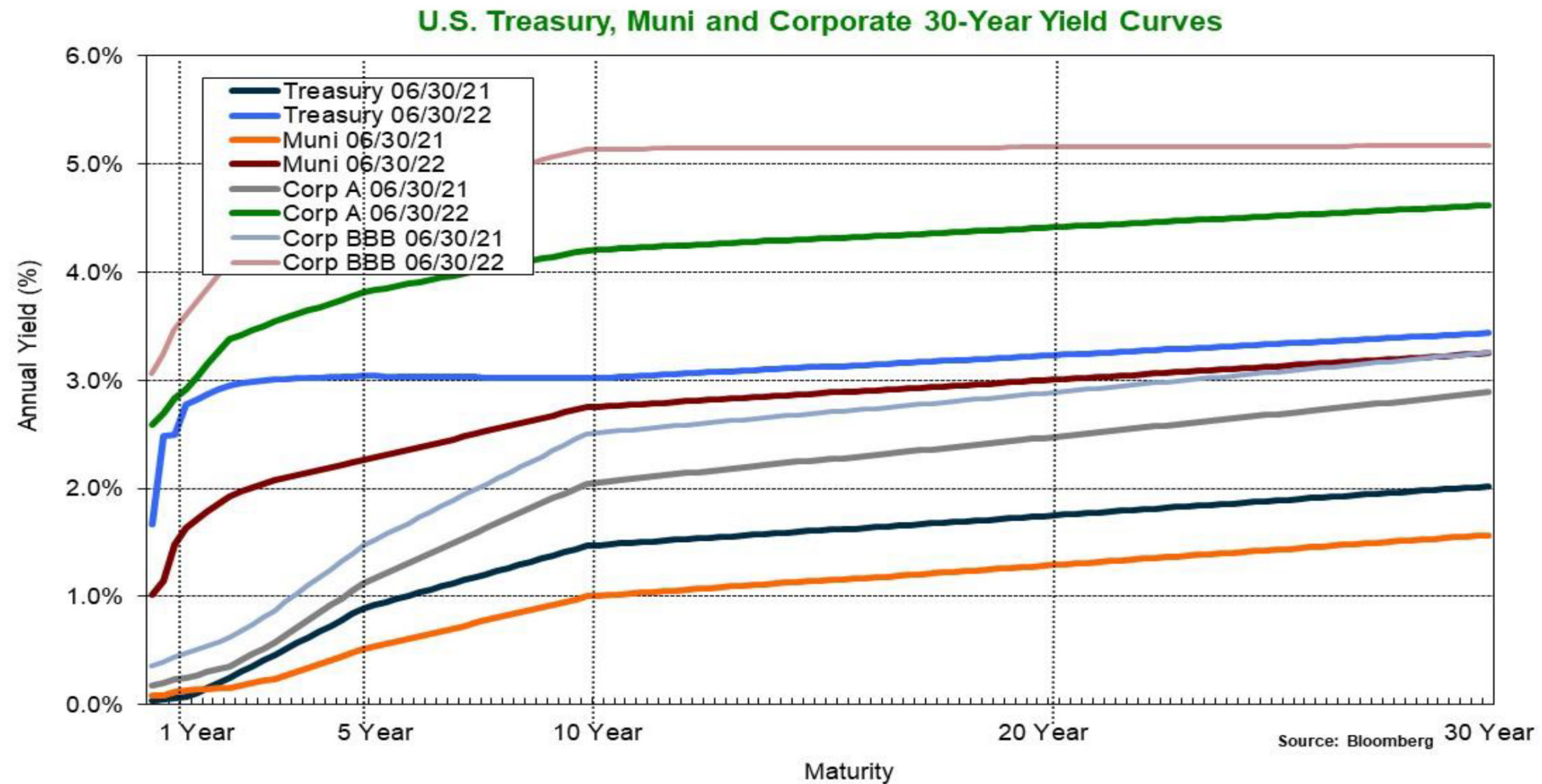
The May employment report (the latest data available) delivered good news, as gains exceeded consensus expectations. However, the results fell short of the prior month's gains. Service industries led the way, as analysts had expected, and healthcare and construction were also strong contributors. Employers added 390,000 jobs during the month, above the consensus expectations of a gain of 325,000. Another positive sign is that employers are retaining workers, as there were fewer layoffs during the month. Analysts expect job gains to slow as the economy heads to full employment. The unemployment rate in May fell to 3.6%, and the labor force participation rate remained steady at 62.3%.

FEDERAL RESERVE POLICY

In order to combat the highest inflation rate in more than 40 years, the Federal Open Market Committee (FOMC) raised its federal funds rate target range twice during the quarter to 1.50% to 1.75%, from a range of 0.25% to 0.50%. The 75-basis point increase on June 15th was the first of that size since 1994, and many economists expect the FOMC to continue to aggressively raise rates until inflation is under control. The committee's statement accompanying the most recent increase included language that the FOMC is "strongly committed" to bringing inflation to its 2% objective. In addition, the statement lacked reference to the job market also being a concern. Analysts point out that even though the FOMC has begun to raise rates aggressively, monetary policy is still very accommodative since high inflation means the real fed funds rate is negative. The FOMC's "dot plot," a forecast of future rate changes, indicates the committee now expects the fed funds rate to be at 3.375% at the end of this year and 3.8% at the end of 2023.

INTEREST RATES

Fixed income securities' prices were sharply lower (and yields higher) in the quarter as inflation continued unabated, and the FOMC moved to take action by raising the federal funds rate. Economic growth remained strong during the quarter, and inflation hovered near 40-year highs due to a jump in energy prices and ongoing supply chain issues, among other causes. As mentioned above, the FOMC raised the target range on the fed funds rate to 1.50%-1.75%, from the prior range of 0.25%-0.50%. The committee indicated that it will remain vigilant in bringing down inflation, even if it means additional increases of 50 basis points or higher. Analysts expect several more increases in 2022, with additional hikes likely in 2023, and for the fed funds rate to end the year at 3.375%.



The shape of the Treasury yield curve rose materially and remained relatively flat as compared to that at the end of the first quarter. Yields on shorter-term maturities of between one and five years rose up to 150 basis points, while yields in the intermediate- and long-term segments of the curve rose between 70 and 100 basis points. By the end of the quarter, the yield on the benchmark 10-year US Treasury note was markedly higher, ending at 3.02%, compared to 2.34% on March 31.

The yield on the 10-year Treasury began the quarter trending higher, and retreated for a three-week period in May before resuming an upward path through the end of the quarter. The yield reached a high of 3.48% in the latter part of June as the FOMC implemented a 75-basis point fed funds rate increase. Against this backdrop, the yield on the 3-month Treasury Bill settled at 1.67% at the end of the quarter, higher by 117 basis points from the previous quarter. The yield on the 5-year Treasury Note ended the quarter at 3.04%, compared to 2.46% on March 31, and as mentioned above, the yield on the 10-year Treasury Note jumped to 3.02%, compared to 2.34% over the same period. The yield on the 30-year Treasury Bond was also higher, ending the period at 3.19%, compared to its beginning level of 2.45%. Inflation expectations were in line with the prior quarter, with the Fed's gauge of five-year forward inflation expectations at about the level of 2.37% on March 31.

Total returns on fixed income securities were once again sharply negative during the quarter. The Bloomberg Treasury 5-7 Yr. Index declined by 2.8% for the quarter. The Bloomberg US Credit Corporate 5-10 Yr. Index sank by 6.4% during the three months. High yield securities, which often follow the performance of equities, were also lower, posting a return of -9.8%. Municipals posted similar results in the quarter, as the Bloomberg Municipal Bond Index shed 2.9%. Prices of non-US fixed income securities were also extremely hard hit in the quarter, as the Bloomberg Global Aggregate ex-US Index dropped 11.0%. Emerging markets bonds plunged, with the JPM EMBI Global Index giving up 10.6%.

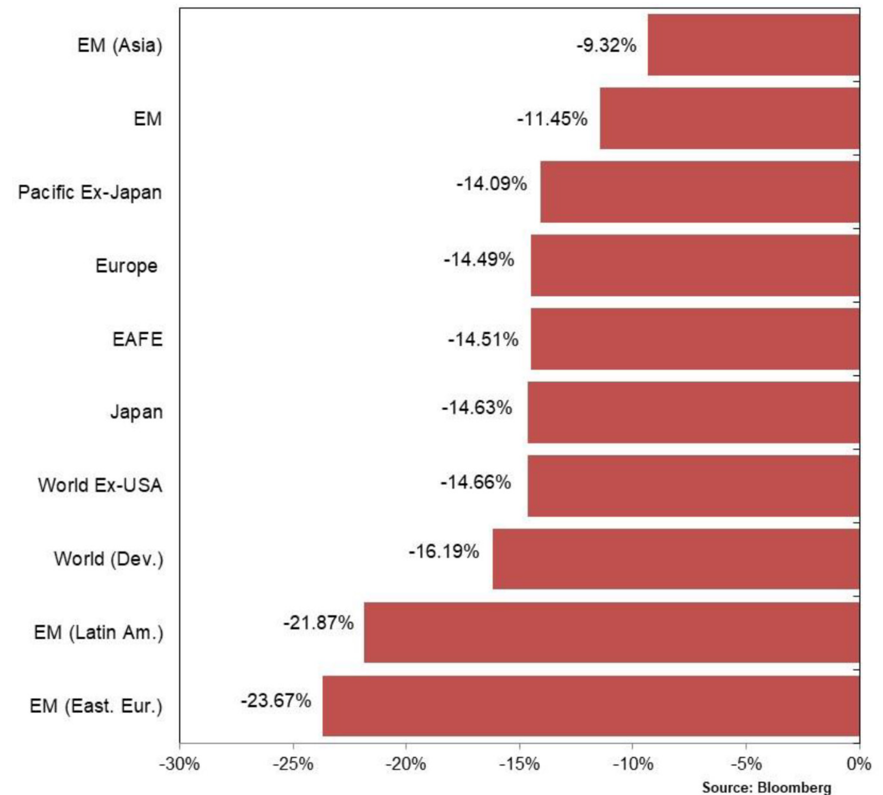
EQUITIES

The decline in stock prices accelerated in the second quarter as the FOMC moved to aggressively raise interest rates to combat historically high inflation. Investors are becoming increasingly concerned about the potential for a recession, and consequently have adopted a pessimistic outlook on stocks. In addition, supply chain bottlenecks continued to cause good shortages, and the ongoing war in Ukraine has created issues in the energy and agriculture segments of the global economy. Similar to the previous quarter, the S&P 500 peaked on the second trading day of the quarter, declined steadily into the middle of May, and then stabilized somewhat before heading lower again. Many major stock indices entered bear market territory (a decline of at least 20%) in June. When the quarter ended, the S&P 500 Index had declined 16.1%, and is down 20% year-to-date. Performance of all 11 of the primary economic sectors was negative during the quarter. Consumer Staples, Utilities and Energy were the strongest performers on a relative basis, generating returns of -4.6%, -5.1%, and -5.3%, respectively. The Consumer Discretionary, Communications Services, and Information Technology sectors were the poorest relative performers, posting returns of -26.2%, -20.7%, and -20.2%, respectively.

The Russell 1000 Index of large capitalization stocks generated a -16.7% total return. Within the large cap segment, value stocks significantly outperformed growth stocks. Small cap stocks, as represented by the Russell 2000 Index, slightly underperformed large caps, and finished the quarter with a total return of -17.2%. Small cap value outperformed small cap growth. The NASDAQ Composite, dominated by information technology stocks, finished the quarter with a loss of 22.3%. The Dow Jones Industrial Average of 30 large industrial companies declined by 10.8%.

Real Estate Investment Trusts (REITs) were lower during the quarter, with the DJ US Select REIT Index down 18.1%. Commodities were not spared in the quarter, with the Bloomberg Commodity Index declining by 5.7%.

International stocks also generated very poor results during the quarter, and generally performed in line with US equities. The MSCI ACWI Ex-USA Index, which measures performance of world markets outside the US, fell by 13.7%. The MSCI EAFE Index of developed markets stocks was lower by 14.5%. Regional performance was mostly negative for the quarter. China was the strongest performer on a relative basis, with a return of 3.4%. Eastern Europe was the poorest relative performer, declining 23.7%. Emerging markets stocks were lower, as the MSCI Emerging Markets Index fell by 11.5%.



Outlook

US consumers and investors have become increasingly pessimistic this year as a result of historically high inflation, the FOMC's aggressive interest rate increases, and the war in Ukraine, among other things. High inflation continues to be the biggest challenge confronting the world's policymakers. Analysts believe the volatility in global commodity markets – including both energy and food products - likely means that above-target inflation will remain throughout 2022. As a result, world central banks have begun to tighten monetary policy after more than a decade of quantitative easing. Restrictive monetary policy is not always an effective tool to dampen inflation resulting from supply-side pressures, and a primary concern with rising interest rates and tighter monetary policy is recession. The consensus among economists is that the US economy has only about a 50% chance of a recession in the next two years due to strong economic fundamentals, but nervous consumers and investors waylaid by the combination of rising interest rates and high inflation could see additional asset valuation erosion. There are a number of potential downside risks outlined by economists, including a continuation of the negative supply shock resulting in part from the war in Ukraine; the potential for spread of future Covid variants; the global semiconductor shortage; and property market weakness in countries where real estate valuations have been surging.

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INDEX OVERVIEW

The **Dow or DJIA** (Dow Jones Industrial Average) is an unmanaged index of 30 common stocks comprising 30 actively traded blue chip stocks, primarily industrials, and assumes reinvestment of dividends. The **NASDAQ Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **S&P 500 Index** is an unmanaged index comprising 500 widely held securities considered to be representative of the stock market in general. The **DJ US Select REIT Index** is a subset of the Dow Jones Americas Select RESI and includes only REITs and REIT-like securities (The Dow Jones US Select Real Estate Securities Index (RESI) represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the US). The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks prices of futures contracts on physical commodities on the commodity market, and is designed to minimize concentration in any one commodity or sector. The **MSCI EAFE Index** is recognized as the preeminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia, and the Far East. The **MSCI Emerging Markets Index** is a free float-adjusted market-capitalization index that is designed to measure equity market performance in the global emerging markets. The **MSCI ACWI Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indices comprising 23 developed and 23 emerging markets country indices. The **MSCI Emerging Markets (EM) Eastern Europe Index** captures large and mid cap representation across four emerging markets (the Czech Republic, Hungary, Poland, and Russia) countries in Eastern Europe. With 52 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in each country. The **MSCI EM (Emerging Markets) Latin America Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The **MSCI ACWI Ex-US Index** is a market-capitalization-weighted index maintained by Morgan Stanley Capital International (MSCI) and designed to provide a broad measure of stock performance throughout the world, with the exception of US-based companies. The **MSCI China Index** captures large and mid cap representation across China H shares, B shares, Red chips, and P chips covering about 85% of this China equity universe. The **Bloomberg Barclays Municipal Bond Index** is an unmanaged index comprising investment-grade, fixed-rate municipal securities representative of the tax-exempt bond market in general. The **Bloomberg Barclays Global Aggregate ex-US Index** is a market-capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most US-traded investment-grade bonds are

represented. Municipal bonds and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The Index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in the US. The **Bloomberg Barclays US 5-10 Year Corporate Bond Index** measures the investment return of US dollar-denominated, investment-grade, fixed-rate, taxable securities issued by industrial, utility, and financial companies, with maturities between 5 and 10 years. Treasury securities, mortgage-backed securities (MBS), foreign bonds, government agency bonds, and corporate bonds are some of the categories included in the Index. The **Bloomberg Barclays Capital US 5-7 Year Treasury Bond Index** is a market-capitalization-weighted index, and includes Treasury bonds issued by the US with a time to maturity of at least 5 years, but no more than 7 years. The **Russell 1000 Index** is a market-capitalization-weighted benchmark index made up of the 1000 largest US companies in the Russell 3000 Index (which comprises the 3000 largest US companies). The **Russell 2000 Index** is an unmanaged index considered representative of small cap stocks. The **Russell 3000 Index** is an unmanaged index considered to be representative of the US stock market, and measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market. The **Russell Midcap Index** is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The **Housing Market Index** (HMI) is based on a monthly survey of **NAHB** members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months, as well as the traffic of prospective buyers of new homes. The **JPMorgan Emerging Market Bond Index** (EMBI Global) tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. The **CBOE Volatility Index** (VIX) is an up-to-the-minute market estimate of expected volatility that is calculated by using real-time S&P 500 Index option bid/ask quotes. The Index uses nearby and second nearby options with at least 8 days left to expiration and then weights them to yield a constant, 30-day measure of the expected volatility of the S&P 500 Index.

DEFINITIONS

The **Federal Open Market Committee** (FOMC) is the monetary policymaking body of the Federal Reserve System. The **federal funds rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **European Central Bank** (ECB) is the central bank for Europe's single currency, the euro. The ECB's main task is to maintain the euro's purchasing power, and thus price stability, in the euro area. The euro area comprises the 19 European Union countries that have introduced the euro since 1999. The **Gross Domestic Product** (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. The **Bureau of Labor Statistics** (BLS) is a unit of the United States Department of Labor. It is the principal fact-finding agency for the US government in the broad field of labor economics and statistics, and serves as a principal agency of the US Federal Statistical System. The **Bureau of Economic Analysis** (BEA) is an agency in the US Department of Commerce that provides important economic statistics, including the gross domestic product of the US. It is a governmental statistical agency that collects, processes, analyzes, and disseminates essential statistical data to the American public, the US Congress, other Federal agencies, state and local governments, business, and labor representatives. The **PCE (Personal Consumption Expenditure) Index of Prices** is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data, including US Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures, and is essentially a measure of goods and services targeted towards and consumed by individuals. Sector performance is represented by the **Global Industry Classification Standard** (GICS) sectors, developed by Standard & Poor's and MSCI Barra.

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