ELEMENT POINTE
ADVISORS

2022 Mid-Year Market Update and Outlook:

July 2022

Please see page 18 for important disclosures.

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Mid-Year Recap

The first half of 2022 was monumentally bad for risk assets, with the exception of oil and some commodities. The S&P 500's total return of -19.96% was its worst first-half year's performance since 1970, and the NASDAQ's decline of -29.22% was its worst first half on record. Investment grade bonds, historically viewed as a ballast in portfolios during turbulent times, failed to provide any relief. Instead, the Bloomberg US Aggregate Index, a broad index of high quality fixed-income securities, declined -10.72%. This was the index's worst first-half year on record, dating back to 1975.[1] Not surprisingly, the traditional "60/40" portfolio is on pace for its worst year ever.

As we have discussed in previous writings, we came into this year somewhat cautious on equities. We believed valuations were elevated based on unsustainably low interest rates and excessive liquidity. We also believed that US economic growth would disappoint due to fading pandemic stimulus, and that elevated inflation would force the Fed to tighten monetary policy more than consensus expectations. We became decidedly more bearish after Russia invaded Ukraine in late-February, when it became clear several weeks into the conflict that a quick resolution was highly unlikely. The conflict sparked a renewed surge in energy and food inflation at a time when the global economy was already facing inflationary pressures from ongoing supply-chain challenges and pandemic-related stimulus measures. We believed at the time that this perfect storm of inflation catalysts would push interest rates sharply higher and force the Fed to accelerate its rate-hiking campaign. That, in turn, would pressure equity and bond valuations and would increase the odds of recession, as Fed overtightening has historically been a leading cause of recession. Essentially, this is what has transpired so far this year.

Exhibit 1: Asset Class Returns

Asset Class and Index Returns	2Q 2022 Total Return	YTD Total Return	2021 Total Return (USD)	3-Year Annualized
Cash - Bloomberg Barclays U.S. Treasury Bills 1-3 Mo.	0.13%	0.16%	0.04%	0.57%
Bloomberg Barclays U.S. Agg Index	-5.08%	-10.72%	-1.54%	-1.07%
Bloomberg Barclays Municipal Bond Index	-3.22%	-9.25%	1.52%	-0.27%
Bloomberg U.S. High Yield Index	-9.48%	-13.85%	5.28%	0.34%
Bloomberg Emerging Market Bonds (USD)	-8.64%	-17.07%	-1.65%	-3.51%
S&P Preferred Stock Total Return Index	-7.87%	-15.30%	6.64%	1.13%
MSCI All-World Index (USD)	-14.60%	-19.08%	19.05%	7.12%
Dow Jones Industrial Average	-10.78%	-14.44%	20.95%	7.23%
S&P 500	-16.09%	-19.96%	28.68%	10.57%
Nasdaq Composite	-22.27%	-29.22%	22.21%	12.23%
Russell 2000	-17.21%	-23.45%	14.78%	4.17%
Stoxx Europe 600 (USD)	-14.99%	-21.83%	16.09%	1.34%
Japan - Nikkei Index (USD)	-14.90%	-21.32%	-4.39%	1.44%
MSCI Emerging Markets Index (USD)	-10.33%	-16.57%	-2.32%	1.27%
Hedge Funds - HFRI Index	-4.80%	-3.99%	10.31%	6.34%
Wilshire Global REIT Index	-19.26%	-22.42%	34.99%	-1.72%
Bloomberg Commodity Index	-5.92%	18.03%	27.05%	13.68%
WTI Crude Oil	5.53%	40.71%	55.01%	21.87%
Gold	-6.20%	-1.02%	-3.38%	8.70%
USD Index	6.50%	9.44%	6.37%	9.44%

Source: Bloomberg, Hedgefund HFRI Index, as of 06/30/22
3-year annualized period reflects start of Q3 2019 through end of Q2 2022.
Total return numbers assume dividends reinvested in the index. Investments cannot be made directly into an index and performance reflected does not account for the fees and expenses associated with investing.
Index and Asset Class returns are currency-adjusted to the USD.

1. Jasinski, Nicholas. "Stocks Had a Nasty 6 Months. The Second Half Could Be Ugly Too." Barron's, July 2, 2022, https://www.barrons.com/articles/stock-market-dow-nasdaq-sp500-51656720367.

In the first half of 2022, the US 10-year yield rose 165 basis points to 3.17% and the Fed-sensitive 2-year yield rose 231 basis points to 3.04%. Both yields closed well off of their highs from mid-June, but the sharp move higher throughout the year has pressured both equity and bond prices. The move in yields raises the rate that investors use to discount corporate profits and puts pressure on equity multiples. After months of valuation compression, US equities entered into a bear market in June, with declines led by the NASDAQ, whose companies are considered longer duration and more sensitive to changes in interest rates. All major US equity indices suffered double-digit declines, and value stocks outperformed growth stocks. International markets were plagued by similar factors as the US, as stocks in Europe and Japan slightly underperformed the S&P 500, while emerging market equities marginally outperformed despite sluggish economic growth in China (Exhibit 1). Within fixed income, all major indices suffered double-digit losses, with the exception of the Bloomberg Municipal Bond Index, which dropped -9.25%. High-yield bonds and other credit-sensitive securities also performed poorly, as credit spreads widened considerably on growing recession fears.

Despite high inflation, gold struggled to gain any traction, declining -1.02% in the first half of the year. Other asset classes such as preferreds, convertibles, and public REITS all dropped at least -15%. The only major asset class that had positive returns was commodities. The Bloomberg Commodity Index gained 18.03% led by WTI crude oil's price rise of 40.71%. Element Pointe-managed diversified portfolios benefited from an overweight to commodities and niche exposures to direct lending and private REITs. Direct lending eked out a small gain, as the loans in the strategy are nearly all floating rate. Private REITs in our managed portfolios performed well due to their overweight to the multifamily and industrial sectors. Both sectors have favorable supply/ demand dynamics and generally perform well in inflationary periods.

While we have never recommended direct exposure to bitcoin or other tokens in client portfolios, it is worth mentioning that the entire crypto ecosystem has come under tremendous pressure over the last few months. The much feared "crypto winter" has arrived after widely-held algorithmic stablecoin, Terra, and its companion token, Luna, imploded in May. The collapse of Terra has set off a chain of events that has resulted in the bankruptcies of large crypto hedge fund Three Arrows Capital, and cryptocurrency lender Celsius, and the potential fire sale of BlockFi, another cryptocurrency lender. A series of other crypto companies have announced measures to freeze client withdrawals, and contagion fears remain prevalent throughout the ecosystem. We believe that these contagion fears are also weighing on sentiment for equities and risk assets broadly.

Notable Events of the First Half of 2022

1) Russia invaded Ukraine in late February, sparking food and energy inflation throughout the world. The conflict has exacted a heavy toll for both sides with little hopes for a negotiated settlement at this time. The ongoing conflict has created an acute energy shock for Europe that is curbing economic activity in the region and has it on the verge of recession.

2) Inflation in the US hit a 40-year high of 8.6% in May. Inflation has become the number one issue for voters and politicians. After calling inflation "transitory" last year, the Fed is now raising rates aggressively in hopes of bringing inflation back down towards its long-term target of 2%.

3) In order to combat inflation, the Fed has raised the Fed Funds rate 150 basis points so far this year, including a 75 basis point hike in June, which was its largest increase since 1994. The Fed's aggressive rate-hiking campaign, which is expected to include at least another 175 basis points of hikes in the second half of this year, has recession fears on the rise.

4) The first half of the year was historically poor for traditional "60/40" portfolios, with both the S&P 500 and the Bloomberg Aggregate fixed-income indices suffering double-digit losses.

5) Mortgage rates rose over 250 basis points causing a sharp deceleration in housing activity. However, housing prices have remained firm as there continues to be an imbalance of supply and demand.

6) China's zero-COVID policy has weighed down its economy, although economic activity has picked up recently as the government eased lockdowns and loosened restrictions on leading technology companies.

7) Higher interest rates and tightening liquidity have resulted in large losses for growth stocks and high-profile investors like Tiger Global and ARK Invest.

8) Not to be spared, the crypto ecosystem unraveled with Bitcoin down roughly -70% from its all-time high in November and many altcoins down much more. Contagion risks remain and several high-profile crypto companies have filed for bankruptcy or conducted fire sales.

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US Equities

US equities had a challenging start to the year, with the S&P down -20%, the NASDAQ down -29%, and the Russell 2000 down -23%. The performance of the indices masked larger weakness beneath the surface. For example, the average NASDAQ stock has fallen -51% this year, and the average Russell 2000 stock has fallen -47%.[2] All sectors declined except for the energy sector (Exhibit 2). The energy sector was the lone bright spot with a total return of 31.64%, as Russia's invasion of Ukraine served to tighten global energy markets and ignited big rallies in crude oil and natural gas. Consumer discretionary, communication services, and information technology led the year's first-half declines. All three sectors have a large percentage of high-multiple or unprofitable companies that were most affected by the move up in rates and tightening liquidity. Value stocks dramatically outperformed growth stocks, a trend that began with the approval of the COVID-19 vaccine in late 2020 and has continued since that time. However, starting in mid-June when calls for recession became more prevalent, bond yields collapsed and the relative performance of equity sectors began shifting.

Exhibit 2: GICS Sectors

U.S. Sector	2Q 2022 Total Return	YTD Total Return	2021 Total Return	3-Year Annualized
Information Technology	-20.24%	-26.91%	34.52%	18.68%
Financials	-17.50%	-18.73%	34.87%	6.65%
Healthcare	-5.91%	-8.33%	26.13%	13.60%
Consumer Discretionary	-26.16%	-32.82%	24.43%	5.37%
Industrials	-14.78%	-16.79%	21.10%	6.03%
Consumer Staples	-4.62%	-5.58%	18.63%	10.85%
Energy	-5.29%	31.64%	54.35%	10.02%
Utilities	-5.09%	-0.56%	17.67%	9.01%
Real Estate	-14.72%	-20.11%	46.14%	6.95%
Materials	-15.90%	-17.90%	27.28%	10.25%
Communication Services	-20.71%	-30.16%	21.57%	5.35%

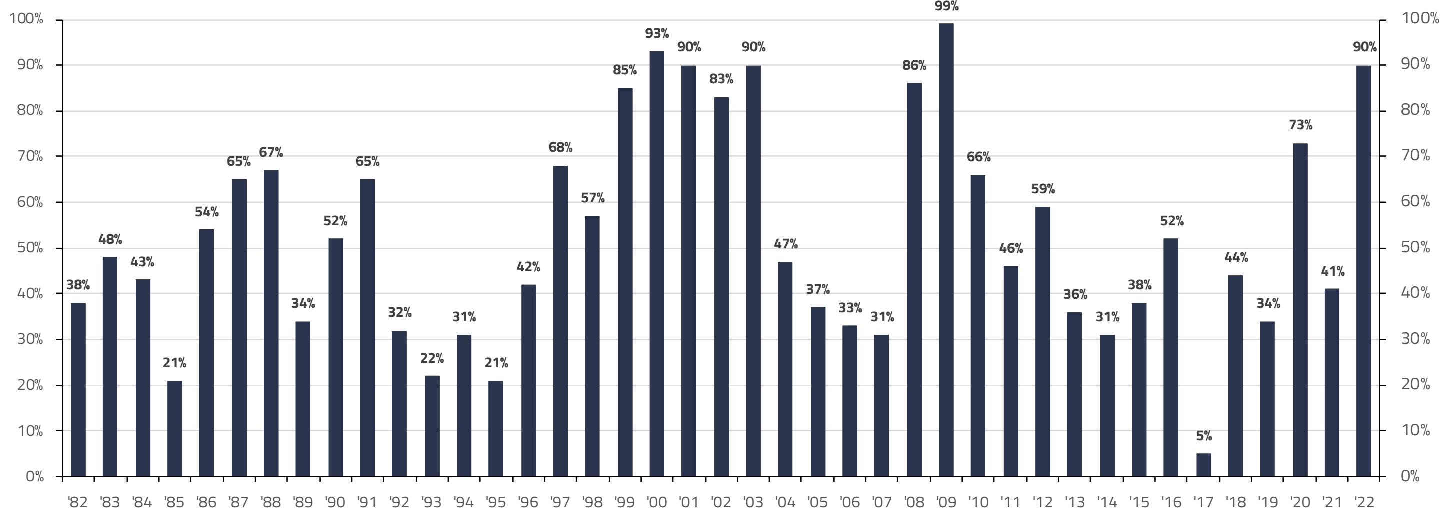
Source: Bloomberg, as of 06/30/22
3-year annualized period reflects start of Q3 2019 through end of Q2 2022.
Dividends reinvested in the index.

Defensive sectors including consumer staples and utilities continue to show leadership, but cyclical sectors including financials, materials, energy, and industrials have come under significant pressure. Many "value" companies come from these cyclical sectors, therefore this activity could potentially spark a rotation back into growth stocks. It is too early to call this a lasting change in trend; but, at a minimum, the market is pricing in significant odds of a recession.

2. Alkeon Capital Management June Monthly Letter citing JPM May 2022 data.

As we expected coming into the year, US equities have been abnormally volatile in the first half of 2022. As Exhibit 3 shows, 90% of the trading days this year have resulted in the S&P 500 having a trading range of greater than 1%. Over the last 40 years, this measure of volatility has only been higher during the periods of the Dot-Com Crash and the Great Financial Crisis (GFC). The other observation to note is that periods of high volatility tend to last several years. This is a factor in our decision to maintain cash overweights in discretionary managed portfolios, as we believe elevated volatility will persist into 2023, potentially creating favorable opportunities to deploy cash.

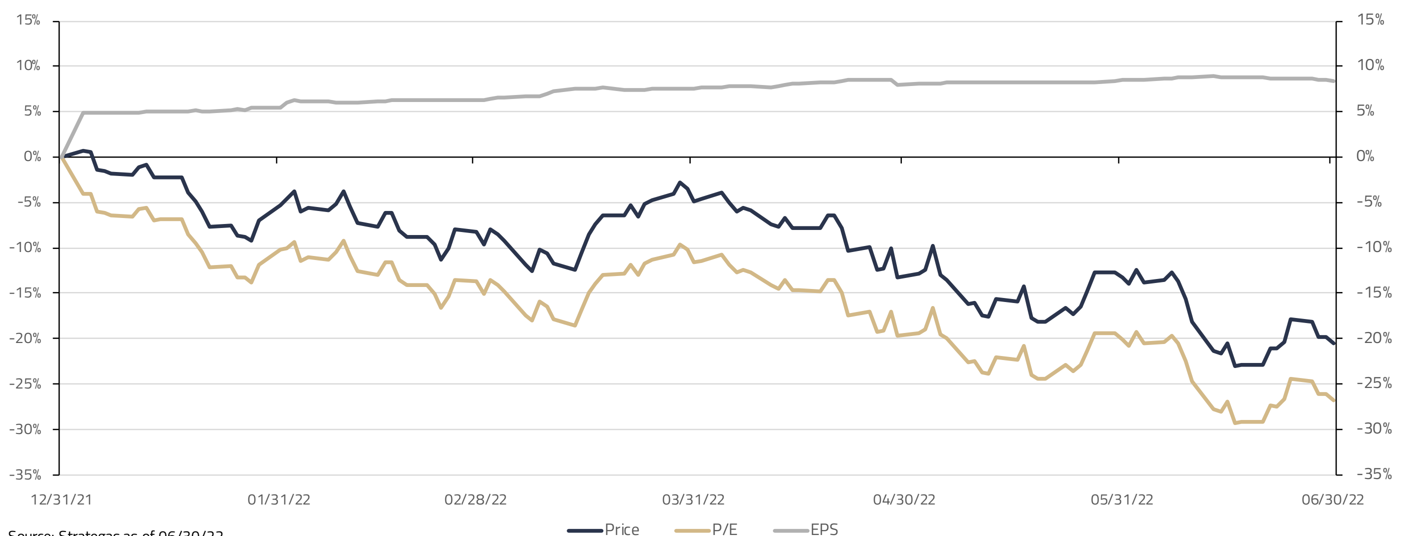
Exhibit 3: Percent of Days with S&P 500 Range >1% (First Half By Year)



Source: Strategas as of 06/30/2022

Bear markets often come in three phases, and we believe we are early in the second phase. The first phase is characterized by multiple contraction. In this year's case, the multiple contraction was sparked by a sharp upward move in interest rates in response to elevated inflation. Given where current 2023 S&P 500 earnings estimates stand, the S&P 500 ended the second quarter at a forward price to earnings ratio (P/E) of roughly 15x. The market's current P/E ratio has declined by over 25% from where it started the year (Exhibit 4) and is below the 25-year average of 16.85x.[3] Current market prices seem attractive by this measure, but the problem is that 2023 consensus earnings estimates do not reflect the reality of a sharply decelerating US economy that is trending towards recession.

Exhibit 4: Year-to-Date Percent Change in S&P 500 Price, P/E Ratio, & EPS



Source: Strategas as of 06/30/2022

3. JP Morgan Q3 2022 Guide to the Markets, p.5.

The second phase of a bear market is usually driven by earnings cuts. Sell-side analysts are notoriously slow in updating negative projections. We believe investor consensus of 2023 estimated earnings for the S&P 500 is around $220, which means next year's earnings decline is forecasted to be modest and that the market ended the quarter at a P/E of 17.2x. However, in our view, 2023 earnings estimates of $220, while achievable, are likely to disappoint to the downside because profit margins during the last two years were unusually high and will likely revert towards their long-term average. Furthermore, the average decline in S&P earnings over the last fifteen recessions has been -31.6% (Exhibit 5). While this average is skewed by the results of the Great Depression and the GFC, we believe that a recession could result in a 2023 S&P earnings decline of -20% to -25%. However, it is also possible that the economy avoids recession and instead suffers through a prolonged period of stagflation. If this is the case, earnings would not decline as sharply, but the timeline of any earnings recovery would be pushed out several years.

Exhibit 5: S&P Earnings Declines & Recoveries During Prior Economic Cycles & Recessions

Full-Cycle Period	Recession Period	Reported Earnings Declines	Reported Earnings Recoveries
1Q'28 - 1Q'33	3Q'29 - 1Q'33	-74.5%	-
2Q'33 - 2Q'38	3Q'37 - 2Q'38	-49.2%	197.6%
3Q'38 - 4Q'45	1Q'45 - 4Q'45	-29.4%	91.9%
1Q'46 - 4Q'49	4Q'48 - 4Q'49	-3.3%	185.7%
1Q'50 - 2Q'54	2Q'53 - 2Q'54	-17.6%	22.4%
3Q'54 - 2Q'58	3Q'57 - 2Q'58	-22.0%	57.7%
3Q'58 - 1Q'61	2Q'60 - 1Q'61	-11.7%	19.1%
2Q'61 - 4Q'70	4Q'69 - 4Q'70	-12.9%	94.4%
1Q'71 - 1Q'75	4Q'73 - 1Q'75	-14.8%	77.6%
2Q'75 - 3Q'80	1Q'80 - 3Q'80	-4.6%	97.0%
4Q'80 - 4Q'82	3Q'81 - 4Q'82	-19.1%	5.3%
1Q'83 - 1Q'91	3Q'90 - 1Q'91	-36.7%	103.1%
2Q'91 - 4Q'01	1Q'01 - 4Q'01	-54.0%	236.3%
1Q'02 - 2Q'09	4Q'07 - 2Q'09	-91.9%	243.9%
3Q'09 - 2Q'20	1Q'20 - 2Q'20	-32.5%	1933.1%
	Average	**-31.6%**	**240.4%**

Source: Strategas

The last phase of a bear market occurs when indifference takes hold and no one wants to buy stocks any longer. Today, sentiment around the markets and the economy is historically dire, but investor positioning does not reflect the mood. Equities continue to receive inflows, and equity exposure in portfolios is at elevated levels when compared to prior downturns. Taken together, we doubt the ingredients are present to form a lasting bottom, and we still see further risks to the downside.

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US Fixed Income

Abnormally high volatility has also been a feature of the bond market this year. The ICE BofA MOVE Index (MOVE), which measures implied volatility across the Treasury yield curve, is at a level that has only been eclipsed once before, during the Great Financial Crisis (Exhibit 6). Not only has the move in interest rates pressured equity and bond prices, but the ongoing rate volatility is also undermining confidence in risk assets and leading to reduced liquidity across capital markets. We believe that the MOVE index needs to return to normalized levels before we see sustained gains in equities and other risk assets.

Exhibit 6: MOVE Index (Treasury Market Volatility)

Source: Bloomberg, as of 07/11/2022

The first half of this year has been challenging for US fixed income markets, as evidenced by the Barclays Aggregate Index, which experienced its largest recorded drawdown. However, now that rates have increased and spreads have widened, some areas of the fixed income markets are, in our view, starting to appear more attractive. That said, the volatility of interest rates continues to be unusually high, and we believe that interest-rate risk remains to the upside. Therefore, we are not yet ready to add to duration and close out our fixed income underweights in portfolios.

With inflation running at 8.6% as of the end of May and the 10-year yield at 2.95% at time of writing, adding duration seems like a losing proposition. While we believe that inflation is peaking and will decline over the next twelve months, we believe it will remain stubbornly above 3% for several years. In order to curb demand and keep inflation expectations anchored, the Fed will need to keep real interest rates positive, which means the Fed Funds rate will likely average greater than 3% over the next few years. For this reason, we prefer to keep portfolio duration on the short end for now, unless we see 10-year yields in the 4% range.

At the start of the third quarter, the 2-year/10-year yield curve inverted The economy has slowed significantly over the last two months and may already be in a technical recession. This would normally be a great time to add duration to fixed income portfolios, but the nature of this economic cycle keeps us on the sidelines. High inflation limits the Fed's flexibility to fight a recession. Typical Fed responses like sharp rate cuts and asset purchases are unlikely, so the likeliest outcome is a prolonged period of stagflation until inflation finally drops to the Fed's target.

US Economy

Recession is popularly defined as two consecutive quarters of negative GDP growth. By this measure, the US economy may already be in a recession. First quarter GDP declined -1.6% and second quarter GDP has a good chance of being negative when the data is released in a few weeks. Of note, the Atlanta Fed has a widely followed GDP forecast model that is now calling for -2.1% GDP growth in the second quarter. Given the quarter has ended and most of the inputs are known already, it is unlikely that second quarter GDP will be positive. However, the official arbiter of US recessions is the National Bureau of Economic Research (NBER). This committee looks at the data and makes a judgment call. In their words, "A recession is a significant decline in economic activity spread across the economy, normally visible in production, employment, and other indicators."[4] By this definition, it is unlikely they will determine that we are currently in a recession. Big increases in net imports and inventory drawdowns have weighed on GDP growth in the first half of the year. Those measures can distort GDP calculations but are not a great representation of economic activity. More importantly, the economy created over 2.4 million jobs this year through May, and the US has never experienced a recession where the unemployment rate did not increase by at least 1.9 percentage points.[5] Other data points like industrial production, personal income and spending, and the ISM and PMI surveys reinforce this view.

While we can take comfort that the US is not currently in a recession, as defined by the NBER, it is highly likely that this will not be the case over the next twelve months. Many forward-looking indicators have deteriorated sharply over the past two months as higher interest rates and tightening liquidity conditions take their toll on economic activity. Not surprisingly, the most rate-sensitive areas of the economy, including housing, autos, and other durable goods, have responded first. In housing, the MBA Purchase Index, a leading indicator of housing activity, is down over -15%, pointing to a sharp slowdown in the housing sector. New vehicle sales are tracking at an annualized rate of 13.7 million through June. That number is below both 2020 (14.5 million) and 2021 (14.9 million) and well below pre-COVID sales of 17 million in 2019. Although supply chain challenges, which have held back production and sales, have plagued the industry, new vehicle sales data combined with sagging used-car sales and price data, suggests that demand is waning.

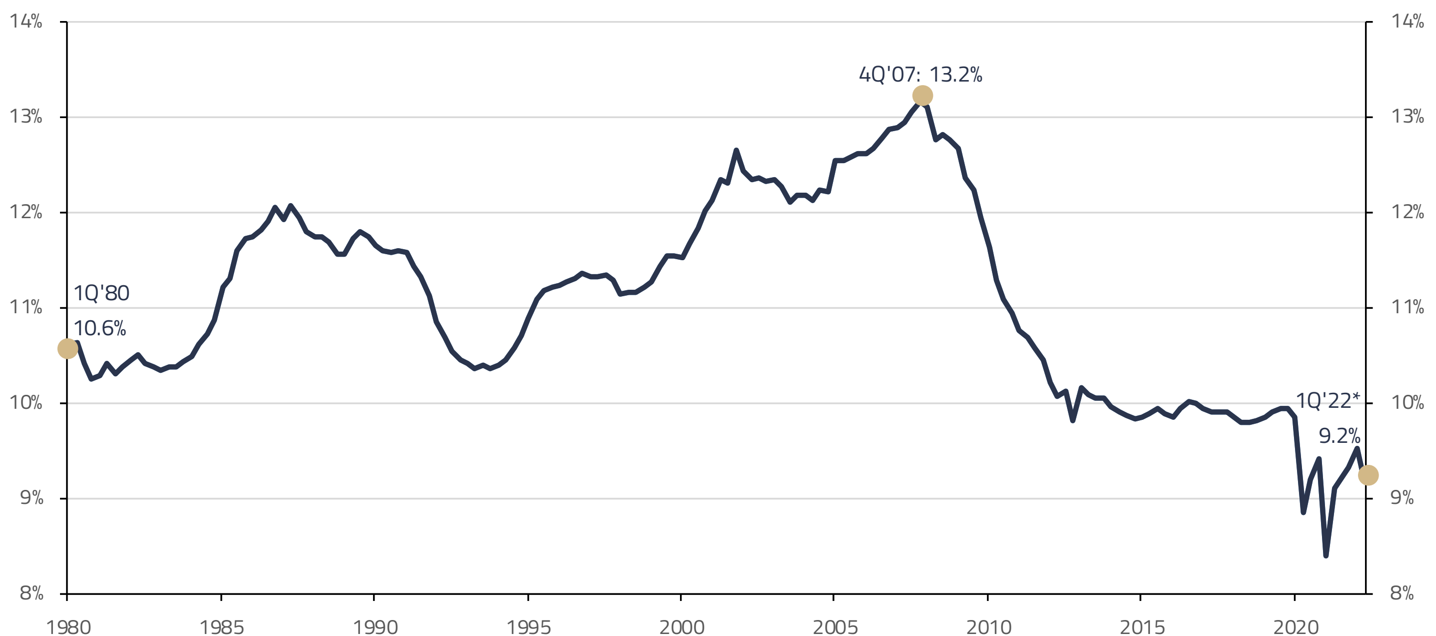
Exhibit 7: University of Michigan Consumer Sentiment

Source: Bloomberg, as of 6/30/2022

4. Hilsenrath, Jon. "If the U.S. is in a Recession, It's a Very Strange One," Wall Street Journal, July 5, 2022.
5. Ibid.

It is clear that abnormally high inflation and rising rates are having a negative impact on the consumer. Consumer confidence, as measured by the University of Michigan, is at an all-time low, worse than during the GFC (Exhibit 7). Wage gains are not keeping up with inflation, such that real incomes are negative. Consumers have begun to respond to this challenging environment by changing buying behaviors and reducing spending. This abrupt change caught many large retailers off-guard, and many now have excess inventories that will weigh on profitability. The good news is that households began the year with healthy balance sheets and low debt-service ratios (Exhibit 8). Federal Reserve data shows that households in the first quarter 2022 had 30% more cash and cash equivalents than two years ago.[6] According to Moody's Analytics, Americans accumulated extra savings of $2.7 trillion during the pandemic and have only drawn down $114 billion of those extra savings so far.[7] While some troubling signs have recently emerged, like a sharp jump in outstanding credit card debt and an increase in subprime delinquencies, we believe consumer spending will hold up relatively well if inflation starts to subside considerably. Of note, we are becoming increasingly cautious on luxury spending. We estimate that the wealth destruction in US equities (~-$14 trillion) and crypto markets (~-$2 trillion) is bound to have an impact on high-end goods and services.

Exhibit 8: Household Debt Service Ratio (Debt Payments as % of Disposable Income, Seasonally-Adjusted)

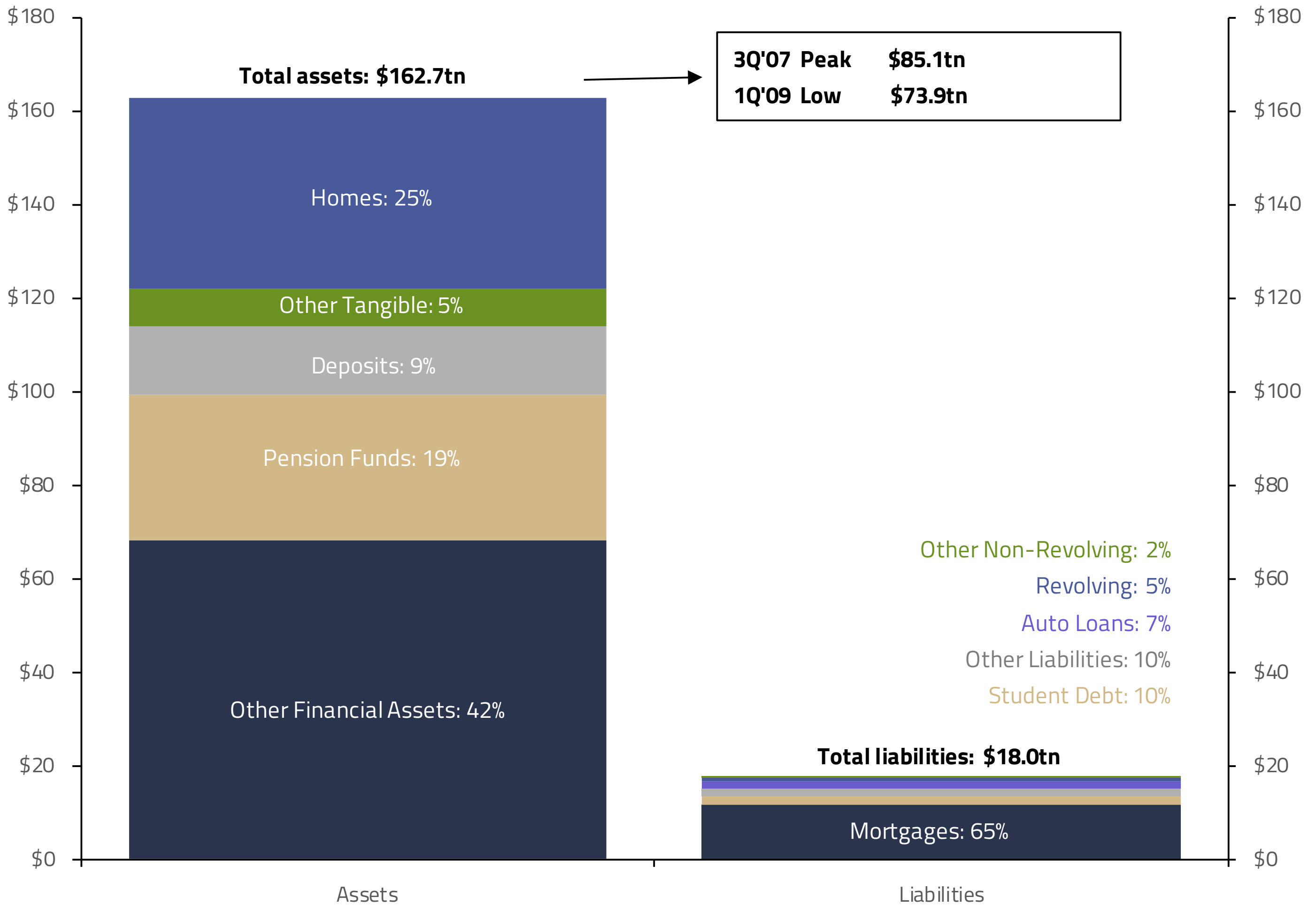


Source: J.P. Morgan Asset Management, St. Louis FED as 12/31/2021
*1Q22 figures are J.P. Morgan estimates

With inflation weighing on the economy, it is imperative that the Fed takes firm action to bring inflation down to the central bank's target. The good news is that inflation likely peaked in June as oil and commodity prices are well off recent highs. We are also seeing solid improvements in supply-chain bottlenecks and delivery times, and freight rates are declining sharply. One issue, however, is that inflation needs to be much lower for the Fed to pivot to a less aggressive monetary policy stance. We do not see this happening over the next three months, and likely not before the end of the year. Although it is starting to slow, the current labor market is still tight, driving above-average wage gains. One of the Fed's main goals is to bring the labor market into better balance by reducing demand, which unfortunately means that unemployment needs to rise. We are starting to see early evidence that this may soon happen. The forward-looking employment components of the ISM surveys recently dropped into contraction territory, initial jobless claims have been trending higher over the past three months, and the job openings data has posted two successive monthly declines, including a large decline in May of -427,000 jobs. While the employment market remains a source of strength for the US economy, early signs of softening are welcome news for the inflation outlook.

6. Lahart, Justin. "Americans' Cash Hoard Could Cushion a Downturn," Wall Street Journal, June 24, 2022.
7. Ensign, Rachel Louise and McCaffrey, Orla. "Americans Begin to Draw Down Pandemic-Era Savings," Wall Street Journal, July 6, 2022.

Exhibit 9: Consumer Balance Sheet (4Q'21, Trillions of Dollars Outstanding, Not Seasonally-Adjusted)



Source: J.P. Morgan Asset Management, Federal Reserve, FactSet
* Values may not add to 100% due to rounding

The economy is already slowing considerably, and yet, the Fed is only about halfway through its rate-hiking cycle. This is why it is highly likely that the US will experience a recession (according to NBER) over the next twelve months. Monetary policy predominantly works with a lag, so the effects of this tightening campaign largely remain in front of us. This nuance is the reason why the Fed does not have a good record of achieving an economic soft landing when hiking rates. So the big question for investors is "what type of recession awaits?" The pandemic has created so many unique economic distortions, it is unlikely that history is a good guide. There are important reasons to believe that it will be a shallow recession. Consumer balance sheets and the banking system are healthy, debt-service costs are low, homeowners' equity is at a record high, and the jobs market is starting from a position of extreme strength. On the other hand, inflation is at a 40-year high and history suggests it will take time to fully correct. Interest rates need to push higher, perhaps significantly more than the market expects, to curb demand and keep inflation expectations from coming unanchored. The path ahead is highly uncertain, but we will continue to analyze the data as it comes in and remain open-minded about any possible eventuality.

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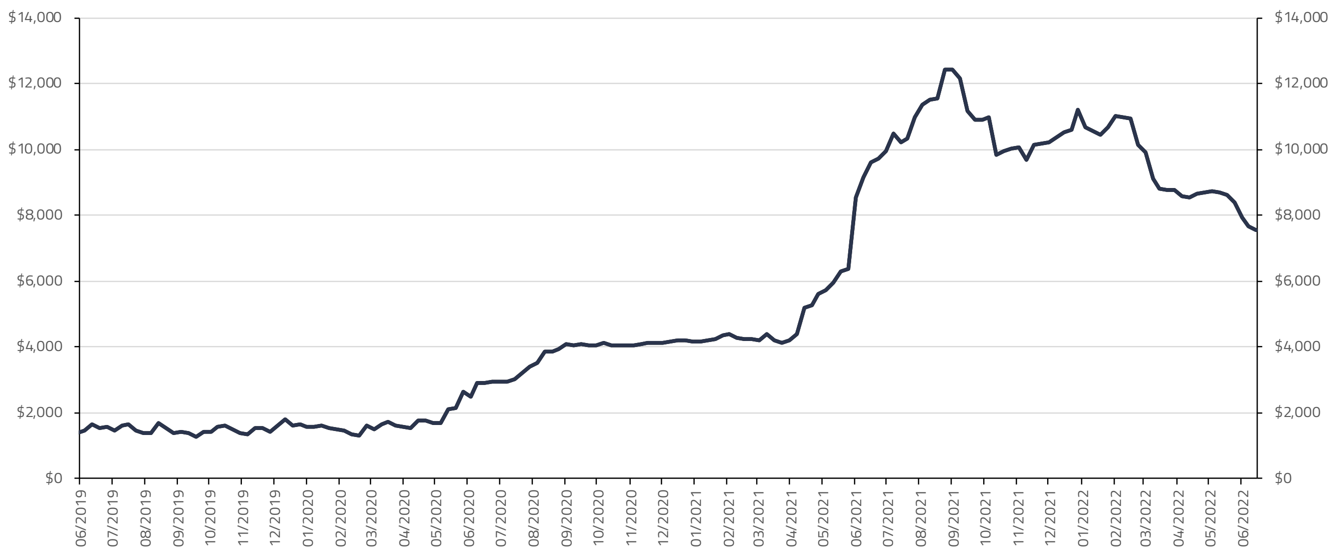
Monetary Policy

Calendar year 2022 has been mired by a period of global price instability, as a combination of surging commodity prices, supply chain disruptions, and rebounding demand have pushed inflation measurements to levels unseen in decades. The Consumer Price Index posted a 12-month percentage change of 8.6% in May, driven by outsized increases in food and energy of 10.1% and 34.6% respectively. The core measurement, which excludes changes in food and energy prices, increased by 6% year-over-year, well ahead of the Fed's 2% target. Amid this period of price instability, the US labor market has achieved historical tightness, with the June Jobs Report implying an unemployment rate of 3.6% and the number of job openings exceeding the number of unemployed workers by a factor of 2x. The strength of the employment market has led the Federal Reserve to prioritize achieving price stability, an initiative reflected by the relatively draconian actions of the central bank over the past few months.

On June 15, the Federal Reserve raised interest rates by 75 basis points, marking the largest increase since 1994 and lifting the benchmark rate to a range of between 1.50% and 1.75%, a rapid escalation from the range of 0.00% to 0.25% at the beginning of the year. History suggests that periods of stubbornly high inflation require an extended period of monetary restriction to erode demand, which should curb inflation pressures. The Fed aspires to restore price stability through a "soft landing" where growth is moderate but positive, and unemployment rises modestly, if at all. This belief is reflected in leadership's median projection that inflation will fall to 2.6% in 2023, while unemployment will remain below 4%. Soft landings are infrequent; however, they have occurred in the past, as Fed Chairman Powell argued that soft landings occurred after monetary tightening in 1965, 1984, and 1994.[8] However, inflation was low in 1965 and 1994, and below 5% in 1984, implying a much different economic environment than today. While the restrictive level of interest rates is conducive to tempering price pressures, the resulting erosion of demand most often harms overall economic growth. As a result, we are skeptical that the Fed will be able to achieve a soft landing through this rate-hiking cycle, given our belief that current inflation levels will require extensive monetary tightening before mean reversion is experienced. While not empirically causal, every recession since the 1950s has been preceded by an extended period of rising rates prompting us to hold the view that there is a higher likelihood that the Fed puts the US economy into recession rather than a soft landing.[9]

Exhibit 10: Cost of Freight, Shanghai to Los Angeles (USD Cost per 40-Foot Container)

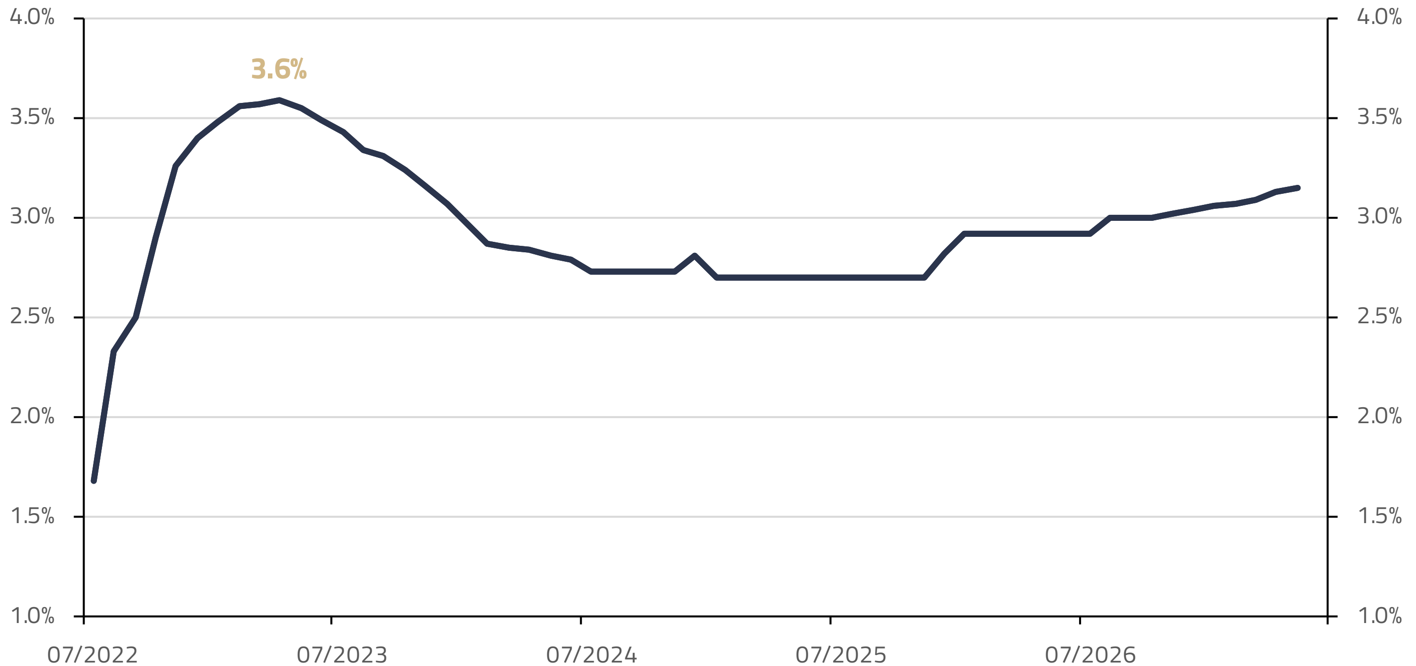


Source: Bloomberg as of 07/07/22

8. Labonte, Marc, and Lida Weinstock. Where Is the U.S. Economy Headed: Soft Landing, Hard Landing, or ... Congressional Research Service, June 28, 2022, https://crsreports.congress.gov/product/pdf/IN/IN11963.
9. Ibid.

Supply chain disruptions have put pressure on many sectors, such as the automotive sector, that have experienced drastic price increases over the past few months. Supply chain issues appear to be subsiding, as seen through decreasing freight costs between China and the US (Exhibit 10). This leads us to believe that these price increases should continue to normalize throughout the remainder of this year. The inflation components that we deem transitory contribute to approximately half of the twelve-month price increases measured by the headline CPI number.[10] On the other hand, elements of inflation tied to shelter and wages tend to be sticky but are also more reactive to changes in monetary policy. With these components contributing to half of the overall inflation measure, we believe there is still room for the Fed to tighten before reaching restrictive policy.

Exhibit 11: Fed Fund Futures Implied Yields



Source: Strategas as of 07/08/22

The June Federal Open Market Committee (FOMC) minutes suggested that the Committee would be "well positioned to determine the appropriate pace of further policy firming" after the policy rate was "near or above estimates of its longer-run level later this year."[11] The Fed should be aggressive in raising rates towards its projected end-of-year rate of 3.4%, implying at least a 75 basis point hike in July as the most probable scenario. Beyond the end of this year, the actions of the Fed become more challenging to forecast, especially as the market's expectations of the Fed Funds rate have begun to deviate from the projections of the FOMC over the past few weeks. In Exhibit 11, Fed Fund futures implied yields indicate that the Fed will bring rates to 3.6% by year-end before cutting them in 2023. The market appears to believe that the Fed put, the idea that the Fed will provide accommodative policy to support markets during times of turmoil, still exists. Since the beginning of the quantitative easing (QE) era, the Fed has shown a willingness to help markets by cutting interest rates and engaging in open market operations to provide support to asset prices. However, never before has the Fed provided stimulus in a hyper-inflationary environment. If the Fed were to end its tightening cycle with a rate between 3.25% - 3.50%, it would be the first time since 1970 that the Fed Funds rate is maintained at a level below the inflation rate.[12] Thus, we believe it is unlikely that the Fed will cut rates in the near future, and rather, rates will likely remain elevated until there is substantial evidence of normalized inflation.

10. "2022 CPI Weight Update Information." U.S. Bureau of Labor Statistics, U.S. Bureau of Labor Statistics, Feb. 25, 2022, https://www.bls.gov/cpi/tables/relative-importance/weight-update-information-2022.htm.
11. Hatzius, Jan. USA: June FOMC Minutes Stress Data Dependence and a Willingness to Adjust Pace of Tightening. Goldman Sachs, 6 July 2022, https://marquee.gs.com/content/research/en/reports/2022/07/06/fb6f29e2-8ad6-4765-9e29-8898e31847fd.html.
12. Grabinski, Ryan. Daily Macro Brief. Strategas, 8 July 2022, https://www.strategasrp.com/Document?strResearchProductID=NoQqTWKRKy%2FHWHho2pSSjA%3D%3D&FullScreen=True.

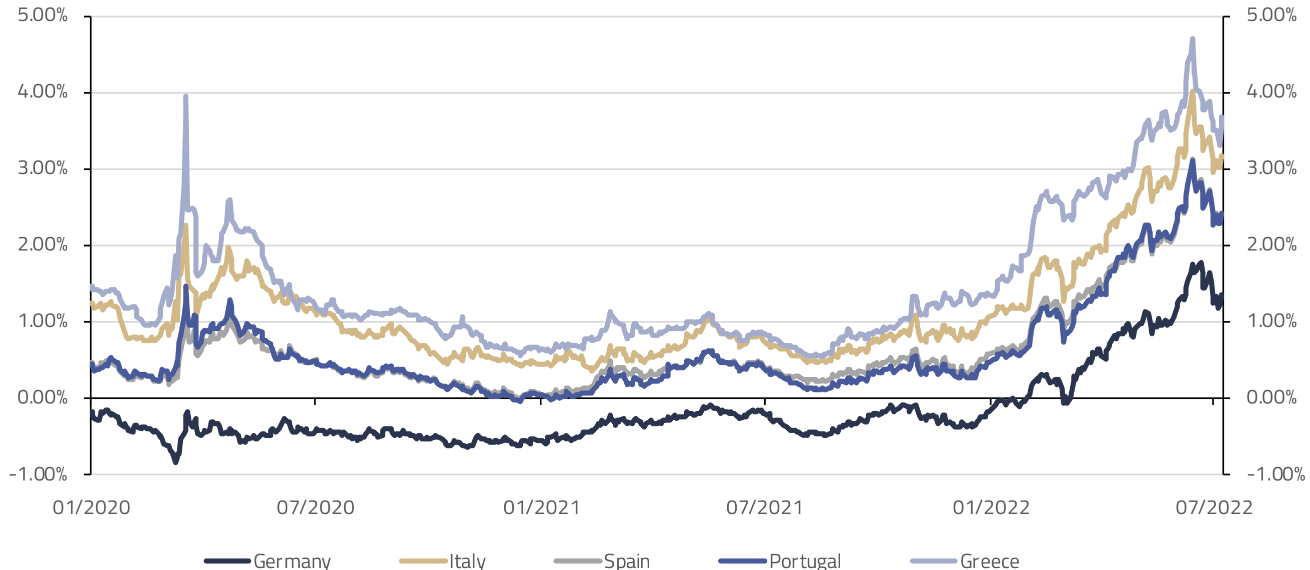
We believe it is likely that the Fed will rapidly raise interest rates towards its end-of-year target, with the July meeting resulting in a 100 basis point hike. The Powell-era Fed has shown to be cognizant of its effect on capital markets and the economy. Therefore, we believe that the Fed will be willing to adjust the course of policy change if inflation begins to meaningfully trend downwards. However, with real interest rates still in negative territory, the Fed will be more inclined to pause its hiking cycle if economic conditions worsen, rather than be compelled to once again cut rates in 2023 as the Fed Funds futures market is currently implying. The key factors that will influence the Fed's actions are 1) the trend of inflation, and 2) the risk that, if inflation does not meaningfully trend lower, the Fed will be forced to raise policy rates past their current projections. Further tightening would not bode well for US risk assets and, given the unlikelihood of rate cuts in the next 18 months, we remain cautious towards both US equity and fixed income markets in client portfolios.

International Markets

The Russian invasion of Ukraine was met by a rapid international response, with unprecedented unity from the 27-member European Union in coordination with the United States. The EU and US have imposed several rounds of sanctions to cripple Russia's ability to finance its war against Ukraine, while simultaneously creating internal pressure within Putin's inner circle by imposing immense costs on Russia's elites. These sanctions have included asset freezes, travel bans, stringent trade restrictions, and the disconnecting of several Russian financial institutions from the SWIFT network.[13] The increasingly punitive sanctions from the western allies have come at a great cost to EU nations, whose reliance on Russian energy imports has pushed them into an energy crisis that we believe will lead to a European recession before year-end.[14]

Consumer prices in the European Union were up 8.6% in June from a year earlier, the highest recording since records began in 1997. High inflation has been primarily driven by energy and food prices, which have surged since the beginning of the Ukrainian conflict, with household energy expenses up 41.9% and food prices up 8.9% from a year earlier. Core inflation, which excludes food and energy prices, was up only 3.7% from the prior year. Rising prices have prompted the European Central Bank to pull forward its rate-hiking plans, indicating it would raise its key interest rate by 25 basis points later this month to -0.25% and a 50 basis point hike likely to come at the September meeting. We believe that rising borrowing costs increase the risk of recession significantly, considering that European households are already suffering from an erosion of spending power amid rising energy costs. Moreover, rising interest rates should substantially impede the growth of economies of EU countries with higher levels of debt, such as Italy and Spain. These concerns are reflected in fixed income markets where the prospect of rate rises has already led to differing levels of increase across sovereign yields (Exhibit 12). This phenomenon, known as fragmentation, provides a further challenge for the European Central Bank, which will have to remain cognizant of how policy changes effect the economies of different member nations while simultaneously tempering inflation across the bloc without inducing a recession.

Exhibit 12: Ten Year Government Yields



Source: Bloomberg, as of 07/08/22

13. Archick, Kristin. "Russia's Invasion of Ukraine: European Union Responses and ... - Congress." Congressional Research Service, Apr. 12, 2022, https://crsreports.congress.gov/product/pdf/IN/IN11897.
14. Ostroff, Caitlin, and Tom Fairless. "Strong Dollar Sends Euro to Lowest in More than Decade." The Wall Street Journal, Dow Jones & Company, July 6, 2022, https://www.wsj.com/articles/euro-nears-20-year-low-against-dollar-on-recession-fears-11657020135?mod=Searchresults_pos14&page=1.

European recession fears are apparent in currency markets, with the Euro experiencing strong declines against the US Dollar this year to trade at its lowest levels since late December 2002. The US Dollar has strengthened broadly against foreign currencies with the ICE US Dollar index returning over 10% year-to-date, as currency markets reflect the US economy's stronger long-term growth prospects, as well as, the Federal Reserve's heightened willingness to hike rates compared to the European Central Bank and Bank of Japan. The combination of inflation woes and impending recession has led many economists to predict that the Euro will reach parity with the US Dollar, with many believing the currency could weaken further. A weakening Euro will likely exacerbate the energy crisis as energy commodities are often invoiced in dollars, increasing costs for European consumers. For US investors, this has led to poor returns in unhedged European assets that we believe are likely to continue throughout the remainder of the year.

Exhibit 13: Euro to USD Spot Rate

Source: Bloomberg, as of 07/08/22

The outlook for Europe remains bleak, as declining gas flows from Russia to the rest of Europe puts the continent in danger of running out of natural gas by the winter. Russia's state-owned gas giant Gazprom PJSC throttled deliveries via the Nord Stream pipeline to Germany in mid-June, blaming missing parts that suppliers were unable to deliver due to sanctions. European leadership denounced these claims, stating that Russia is weaponizing resources for its own political purposes. However, Europe's energy alternatives are limited even after striking deals with the US, Egypt, and Israel while securing higher volumes from producers like Azerbaijan and Norway. Subject-matter experts have forecasted that Europe could run out of natural gas by January 2023 if Gazprom were to stop pumping through Nord Stream.[15] On July 11, the Nord Stream pipeline was scheduled to begin undergoing maintenance for ten days; effectively shutting down the pipeline and pushing the Euro to parity with the Dollar.

The challenges facing Europe continue to mount as we proceed into the third quarter with major economies like Germany developing energy rationing plans as the winter looms. As the economic impacts of the Russia-Ukraine conflict take a further toll, we question whether the EU members will maintain their united stance against Russia or whether economic hardships will lead to dissention among its members. The second half of 2022 will likely be challenging for European risk assets, especially for US investors. We have limited exposure towards Europe within client portfolios in accordance with our belief that European capital markets will experience continued growth impediments as the year draws on.

15. Wallace, Joe, and Georgi Kantchev. "Russia Slashes Gas Flows, Aiming Economic Weapon at Europe." The Wall Street Journal, Dow Jones & Company, June 16, 2022, https://www.wsj.com/articles/russia-slashes-gas-flows-aiming-economic-weapon-at-europe-11655393254?mod=article_inline.

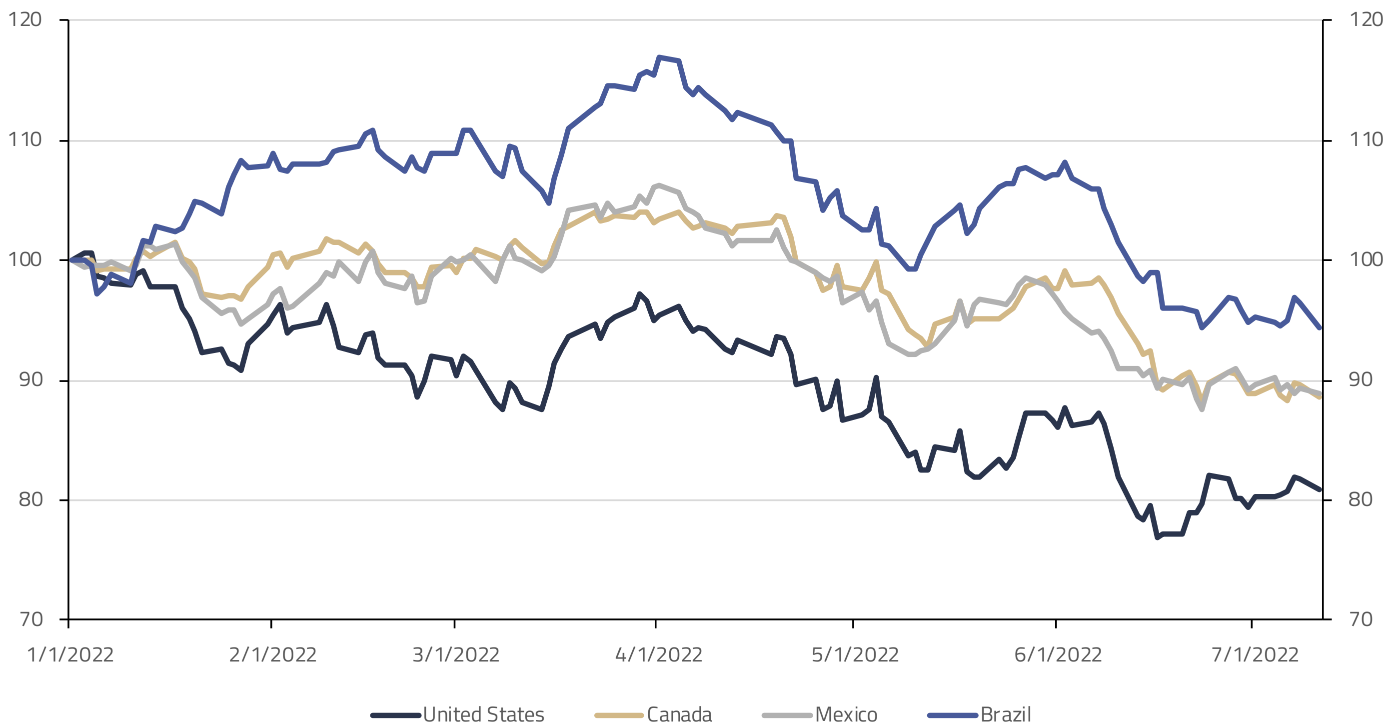
Chinese stocks experienced a 32% peak-to-trough drawdown in the first quarter of the year as Chinese Communist Party imposed COVID-19 lockdowns impaired growth.[16] However, the second quarter saw the MSCI China post its most robust relative performance against the S&P 500 in the past decade.[17] Chinese economic indicators have been strong after the recent reopening, with the Caixin Services PMI jumping to 54.5 in June from the prior month's reading of 41.4. China is one of the few regions in the world not experiencing the combination of monetary tightening and inflation, which has served Chinese equities well as of late. Chinese top health officials' June 28 announcement of the 9th edition of the COVID control guideline caused investors' optimism towards the unwinding of China's Zero Tolerance policy thereby bolstering Chinese equities on the day. Nevertheless, we remain cautious towards investing in Chinese risk assets.

While health policy seems to be becoming less restrictive, we believe that Chinese leader Xi Jinping will continue to take extreme action if future outbreaks occur, which will be detrimental to Chinese risk assets. Despite rebounds in the prices of assets linked to the property and tech sector, we still believe that those areas of Chinese markets carry an oversized amount of regulatory risk that could hamper performance at any given time. The Chinese government's inclination to tame the spread of the virus and challenge industries unaligned with party initiatives could be seen in full force recently as COVID-19 lockdowns in Macau caused Chinese gaming stocks to plummet.[18]

In addition, US-China relations remain strained, especially as the Russia-Ukraine conflict leads to further deglobalization and increased geopolitical tensions. Press reports indicate that it is likely that the Biden Administration will cut Trump-imposed tariffs on $10 billion of goods; however, with $360 billion of goods effected by tariffs, it is unlikely the scope of this relief will develop any goodwill between the superpowers.[19] The geopolitical risks, domestic crackdowns on growth industries, and China's stringent COVID-19 policies make it difficult for us to get comfortable with owning Chinese risk assets from a risk-return standpoint. Thus, we continue to retain an underweight towards China in client portfolios.

16. Lau, Kinger. "2H22 Equity Outlook: China Is No Longer on Sale, but the Outperformance Case Stays Intact." Goldman Sachs, July 8, 2022, https://marquee.gs.com/content/research/en/reports/2022/07/07/ee5e792a-f0ac-4588-9ea7-3278b3a3b4a0.html.
17. Ibid.
18. Zhao, Shirley. "Macau Casino Stocks Tumble as City Shuts Down to Tame Virus." Bloomberg.com, Bloomberg, July 10, 2022, https://www.bloomberg.com/news/articles/2022-07-11/macau-casino-stocks-tumble-as-city-shuts-down-to-curb-outbreak.
19. Clifton, Dan. "Tariff Cut Unlikely to Dent Inflation, But Could Move the Needle for Consumer Companies." Strategas, July 6, 2022, https://www.strategasrp.com/Document/Index?strResearchProductID=s96ypkHY%2FtB9X5DK1d%2F0Sw%3D%3D.

Exhibit 14: International Market Returns (Normalized to 100 on 12/31/2021)



Source: Bloomberg, as of 07/11/22

United States represented by S&P 500 Index, Canada represented by TSX Index, Mexico represented by BOLSA index, Brazil represented by BOVESPA index

With Europe on the brink of recession and China burdened by a litany of exogenous risks, a challenge we have faced in the year is how to diversify client portfolios from a geographic standpoint. Over the past few years, much of our international exposure has been levered towards markets with strong exposures to growth sectors, such as technology. The pressures of inflation and subsequent prospects of central bank tightening have been a headwind for growth stocks on a global stage. As we have tactically adjusted away from growth exposures in domestic markets, we have also done so accordingly within our international exposure. Over the past few quarters, we have been shifting international exposures towards net-export countries whose equity markets are levered towards sectors such as energy, natural resources, and materials, our thesis being that these industries should experience mitigated price-losses due to global inflationary pressures positively impacting the revenues of these industries. In Exhibit 14, we can see that the returns of stock market indices in countries such as Brazil, Mexico, and Canada have endured shallower losses compared to US, European, and Asian markets, although no equity market has been spared by this year's hardships. Unsurprisingly, the return profiles of these markets are strongly influenced by industries tied to hard assets and commodities. In accordance with our view that commodity prices are positioned to remain elevated for the near future, we plan to retain equity exposure to companies in these regions. Ultimately, we retain a domestic bias within equity portfolios, but until we see sufficient evidence that global inflationary pressures abate, we will complement our US equity exposure with international equities whose return profiles are correlated with elevated commodity prices.

2022 Mid-Year Market Update and Outlook

CONCLUSION

The first half of 2022 has been historically bad for asset prices and the outlook for the second half of the year remains challenging. Despite continued strength in the US jobs market, consumer spending, and industrial production, the US economy is decelerating quickly as historically high inflation, geopolitical tension, and an aggressive Fed rate-hiking campaign weigh on the economy. Although we see strong evidence that inflation is peaking, it remains well above acceptable levels and may take several years to reach the Fed's long-term target. Having made a policy error last year, the Fed has little choice but to keep raising rates, at least through the end of this year, to stem the inflation surge. Given this view, we believe the US economy will enter recession sometime late this year or early next year.

The length and depth of the recession that awaits remains a big question mark and is somewhat dependent on the path of inflation and the level of interest rates. The ingredients are present for a shallow recession, but if the Fed needs to tighten much more than the Fed Funds futures market now reflects, then the probability of a deep recession rises significantly. With the risks of higher rates asymmetrically skewed to the upside, we remain cautious on risk assets for the balance of the year. That said, markets have already corrected significantly and current asset prices reflect some of the challenges that await. If we continue to see weakness in asset prices, or if the fundamental backdrop improves, we would be likely to substantially close our underweights to equities and fixed income in client portfolios.

As always, we continue to monitor global economic and market conditions, and we remain available to further discuss any of these topics. Thank you for your trust and confidence in the Element Pointe team.

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