# Market Outlook
## Second Quarter 2022

RPA
RETIREMENT PLAN ADVISORS
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### MARKET SNAPSHOT

**It's been an extremely difficult year for investors, with equity markets falling into bear market territory (down more than 20%) and "low-risk" bond markets registering low-double-digit losses.**

**Global stocks (MSCI ACWI Index) fell 15.7% for the quarter and are down 20.2% for the year.** The S&P 500 dropped 16.1% for the quarter and is also down 20% for the year. Developed international markets (MSCI EAFE Index) were down 14.5% for the quarter and 19.6% YTD. Emerging-market stocks (MSCI Emerging Markets Index) held up a bit better, dropping 11.4% for the quarter and down 17.6% YTD. Core investment-grade bonds (Bloomberg U.S. Aggregate Bond Index) dropped 4.7% for the quarter and 10.3% YTD.

**Big picture, balancing these and many other data points, our base case shorter-term (6 months to one year) economic outlook for the U.S. and global economy is for continued and potentially sharp deceleration in economic growth driven by rapidly tightening monetary policy in response to sustained high inflation.**



It's been an extremely difficult year for investors, with equity markets falling into bear market territory (down more than 20%) and "low-risk" bond markets registering low-double-digit losses. Over the past few months, the economic backdrop has worsened with sustained high inflation and slowing growth, as the Federal Reserve and other global central banks aggressively tighten monetary policy. Exogenous shocks—the Russian war on Ukraine and China's zero-COVID lockdowns—continue to further disrupt the global economy and financial markets.

It's natural to be concerned about these developments and worry about what the future holds. It feels better when our investment portfolios are going up than when they're going down. **And when it comes to investing, doing what *feels* good in the moment isn't usually the best long-term decision.**

Here's our view in a nutshell: Near term, we think it's prudent to expect more equity market pain ahead, as an economic slowdown and potential recession likely lead to corporate earnings disappointments triggering further stock price declines. That said, with global stock markets already down over 20%, we believe *much of* the damage has already been done. Over the medium term, we view this as largely a healthy "reset" for the markets: a normal cyclical downturn setting the stage for more attractive forward-looking returns.

## Second Quarter Market Recap

After a rough first quarter, global stocks and bonds suffered further sharp markdowns in the second quarter as stagflation fears and rising interest rates pummeled all broad asset classes. Global stocks (MSCI ACWI Index) fell 15.7% for the quarter and are down 20.2% for the year. The S&P 500 dropped 16.1% for the quarter and is also down 20% for the year, after being down as much as 24% through mid-June. Developed international markets (MSCI EAFE Index) were down 14.5% for the quarter and 19.6% YTD. Emerging-market stocks (MSCI Emerging Markets Index) held up a bit better, dropping 11.4% for the quarter and down 17.6% YTD.

Core investment-grade bonds were pummeled again in the second quarter, with the benchmark Bloomberg U.S. Aggregate Bond Index (the "Agg") dropping 4.7%. This puts the "safe-haven" Agg down an incredible 10.3% for the year to date—its worst first-half ever. In other segments of the fixed-income markets, high-yield bonds (ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index) fell 9.9% and floating rate loans (S&P/LSTA Leveraged Loan index) dropped 4.5% for the quarter.

# Macro Backdrop: Recession Risk Continues to Rise as High Inflation Persists

A sharp economic growth slowdown in the U.S. and abroad is all but certain this year. The risk of a U.S. recession within the next 12 months continues to rise, to the point where we'd call it a reasonable conservative base case. Having said that, it is the *severity* of any potential downturn and its *impact on corporate earnings* across a range of reasonably probable scenarios that is relevant for our investment approach. What we are certain of is that the business cycle has not been revoked; recessions and bear markets are inevitable—as are subsequent recoveries and bull markets.

The Fed would never actually say they expect to cause a recession from tightening monetary policy—to do so would just about guarantee that outcome. But Fed Chair Powell went about as far as he could, testifying to Congress on June 22-23 that "It's not our intended outcome at all, but it's certainly a possibility."

Tightening monetary policy leads to tighter "financial conditions:" higher interest rates, higher corporate bond yields (wider "credit spreads"), lower stock prices, and a rising dollar. Tighter financial conditions in turn depress consumer and business spending, reducing aggregate demand in the economy. Lower demand (lower GDP growth) should reduce overall price pressures and hence inflation. That's the Fed's playbook and toolkit.

This simple economic cause-and-effect assumes the supply side of the economy remains steady. However, this has not been the case due to (1) the Russia/Ukraine war's impact on energy and agricultural commodities, and (2) COVID-related supply chain disruptions. We hope and expect these exogenous supply shocks will recede with time. But the Fed can't do anything about them. As Powell said to Congress, "A soft landing… is going to be very challenging. It has been made significantly more challenging by the events of the last few months—thinking there of the war and of commodities prices and further problems with supply chains."

In the big picture, balancing these and many other data points, our base case shorter-term (6 months to one year) economic outlook for the U.S. and global economy is for continued and potentially sharp deceleration in economic growth driven by rapidly tightening monetary policy in response to sustained high inflation. A recession is a reasonable conservative scenario but not a certainty. We are not economic forecasters (thankfully!). Much more relevant for us as portfolio managers and investment analysts is assessing the potential severity of any economic slowdown/recession and its impact on corporate earnings and interest rates, and what is being discounted in asset prices.

Our best guess at this point is that if the U.S. economy does fall into a recession, it's likely to be a more "normal" type of cyclical recession rather than like the 2008-09 financial crisis, the 2000-02 dotcom bubble bust, or the 2020 COVID recession. Given the sharp stock and bond market declines we've already experienced this year, this leads us to a relatively positive medium-term (five-year) outlook for financial markets and asset class returns.

# Financial Markets Outlook

## U.S. Stocks

As we write this in late June (with the S&P 500 around 3900), our base case five-year expected return range for the S&P 500 is 7% to 12%, annualized. This compares to the roughly 3% to 8% expected return range at the end of the first quarter.

A 7%-12% return range is in line with our long-term (10 to 20+ year) return expectations for U.S. stocks. And it offers an attractive premium above the expected returns for core bonds.

## Emerging Markets (EM) and Developed International Stocks

These markets have declined largely in line with the U.S. market this year, with EM doing a bit better.

Our base case five-year expected returns for EM and developed international stocks are in the low double digits, supported by low starting valuations and cyclically depressed earnings. This offers a margin of safety for investors, as a lot of bad news and negative sentiment is already priced into these markets, more so than for the S&P 500 in our view. Things don't have to become absolutely great for international and EM stocks to generate strong returns from here; they just need to get better from currently depressed levels. From a macro perspective, the pandemic and war have not helped these markets. But we don't view those shocks as a permanent state of affairs.

We would expect EM stocks to outperform the S&P 500, boosted not only by the tailwind of a depreciating dollar but also by those markets' generally higher sensitivity (beta) to cyclical global economic conditions compared to the U.S. market.

## Fixed Income

Coming into the year, we had been expecting interest rates to rise, putting continued pressure on core bond returns. That played out again in the second quarter, and fixed-income returns were negative across the board. The benchmark 10-year Treasury yield rose from 2.3% at the end of March, peaked at 3.5% on June 14, and ended the quarter at 2.98%. Incredibly, the June high marked the highest 10-year Treasury yield since April 2011.

The recent losses for the bond market are painful, but the good news for investors is declining prices result in higher yields and higher future expected returns. We can't rule out further shorter-term price declines, but at current yield levels the return potential for bonds has increased to attractive levels across most areas of fixed-income and appears to be pricing in some degree of negative outcomes. For example, core bonds (the Agg) at the end of the second quarter are yielding approximately 3.7%, levels not seen since the fourth quarter of 2018, and prior to that late 2009.

# Closing Thoughts

In summary, we think odds are there's more downside for the stock market yet to come over the next several months or quarters. If further declines happen, it may be a good time to add incrementally to stocks at lower prices and higher expected returns.

As always, thank you for your continued confidence and trust.

**Best regards,**

**Retirement Plan Advisors**



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# Market Indicators
## Second Quarter 2022

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### S&P Sectors

| | QTR | YTD | 1Y | 5Y |
|---|---|---|---|---|
| S&P Technology Select Sector TR USD | -19.67 | -26.51 | -13.13 | 19.96 |
| S&P Financial Select Sector TR USD | -17.50 | -18.73 | -12.68 | 7.22 |
| S&P Consumer Disc Select Sector TR USD | -25.51 | -32.47 | -22.45 | 10.22 |
| S&P Health Care Select Sector TR USD | -5.91 | -8.33 | 3.37 | 12.13 |
| S&P Industrial Select Sector TR USD | -14.78 | -16.79 | -13.42 | 7.15 |
| S&P Cons Staples Select Sector TR USD | -4.04 | -5.25 | 5.89 | 8.63 |
| S&P Energy Select Sector TR USD | -5.26 | 31.76 | 39.21 | 7.20 |
| S&P Utilities Select Sector TR USD | -5.09 | -0.55 | 14.30 | 9.79 |
| S&P Real Estate Select Sector TR USD | -14.72 | -20.02 | -5.17 | 8.51 |
| S&P Materials Select Sector TR USD | -15.90 | -17.89 | -8.69 | 8.67 |
| S&P Telecom Select Industry TR USD | -15.82 | -23.06 | -22.67 | 3.39 |

### Market Returns

| | QTR | YTD | 1Y | 5Y | 10Y |
|---|---|---|---|---|---|
| S&P 500 | -16.10 | -19.96 | -10.62 | 11.31 | 12.96 |
| Russell Mid Cap | -16.85 | -21.57 | -17.30 | 7.97 | 11.29 |
| Russell 2000 | -17.20 | -23.43 | -25.20 | 5.17 | 9.35 |
| MSCI EAFE | -14.51 | -19.57 | -17.77 | 2.20 | 5.40 |
| MSCI Emerging Markets | -11.45 | -17.63 | -25.28 | 2.18 | 3.06 |
| BBgBarc U.S. Agg Bond | -4.69 | -10.35 | -10.29 | 0.88 | 1.54 |
| High Yield | -9.83 | -14.19 | -12.81 | 2.10 | 4.47 |

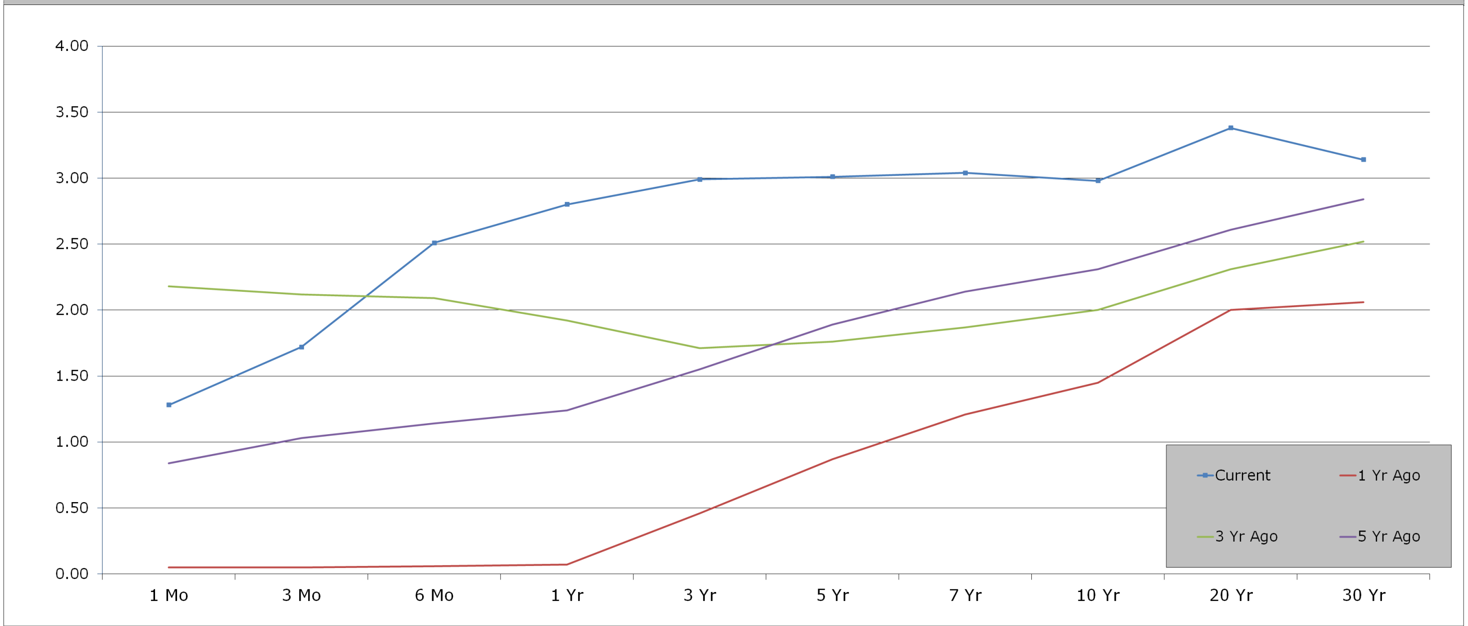
### Value / Growth Returns

| | YTD | | | Previous Calendar Year | | |
|---|---|---|---|---|---|---|
| | Large | Mid | Small | Large | Mid | Small |
| Value | -11.41 | -14.01 | -14.89 | 24.90 | 30.65 | 28.77 |
| Growth | -27.62 | -24.93 | -23.65 | 32.01 | 18.90 | 22.62 |

### Index Characteristics

| | LTM P/E | NTM P/E | Div Yld | Earn Yld |
|---|---|---|---|---|
| S&P 500 | 18.44 | 16.37 | 1.59 | 6.11% |
| Russell Mid Cap | 15.70 | 14.09 | 1.46 | 7.10% |
| Russell 2000 | 11.79 | 11.19 | 1.32 | 8.94% |
| MSCI EAFE | 12.65 | 11.66 | 4.83 | 8.58% |
| MSCI Emerging Markets | 10.92 | 10.71 | 2.73 | 9.34% |

### Long-Term Outlook on Treasury Yield Curve




Source: Morningstar

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