ECONOMIC & INVESTMENT PERSPECTIVES

MAY: STOCKS & BONDS STABILIZE FOR NOW
INFLATION, PESSIMISM, AND LOWER EQUITY VALUATIONS

Figure 1: 5/31/2022 Returns (source: Bloomberg)

Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	0.8%	-8.7%	-8.1%	-11.4%	2.0%
Investment Grade Corp Bonds	LQD	1.9%	-12.9%	-11.1%	-16.3%	3.9%
U.S. Treasury Bonds	GOVT	0.0%	-9.2%	-7.6%	-10.8%	1.4%
U.S. 20+ YR Treasuries	TLT	-2.3%	-20.9%	-14.4%	-24.9%	3.5%
Muni Bonds	MUB	1.5%	-6.5%	-5.9%	-8.4%	3.3%
High Yield	HYG	1.6%	-7.2%	-4.9%	-9.8%	4.8%
Non-US Corp Bonds	IBND	1.0%	-14.0%	-19.6%	-20.5%	3.4%
Emerging Markets Bond LC	EMLC	1.4%	-8.9%	-15.5%	-20.4%	4.9%
Global Equity						
ACWI Global Equity	ACWI	0.4%	-12.9%	-6.8%	-14.3%	7.7%
United States	VTI	-0.3%	-14.3%	-4.2%	-15.4%	8.2%
International Developed	EFA	2.0%	-11.0%	-10.5%	-14.9%	8.3%
Emerging Markets	EEM	0.6%	-12.7%	-20.8%	-24.1%	9.5%
Global Equity by Region						
United States	VTI	-0.3%	-14.3%	-4.2%	-15.4%	8.2%
Europe	IEUR	2.2%	-12.2%	-10.9%	-15.1%	9.6%
Asia ex-Japan	AAXJ	1.1%	-13.3%	-22.4%	-25.6%	9.6%
China	MCHI	2.6%	-17.5%	-36.1%	-38.5%	18.8%
Japan	BBJP	1.8%	-13.8%	-14.4%	-23.3%	5.6%
Latin America	ILF	8.9%	21.2%	0.5%	-12.6%	26.0%
US Equity						
US S&P 500	IVV	0.3%	-12.7%	-0.3%	-13.9%	8.6%
NASDAQ 100 QQQ	QQQ	-1.6%	-22.4%	-7.2%	-24.6%	10.0%
US Large Growth	IWF	-2.3%	-21.9%	-6.5%	-23.6%	9.7%
US Large Value	IWD	2.0%	-4.6%	0.7%	-6.9%	7.2%
US Eqwt S&P 500	RSP	1.0%	-8.1%	-0.1%	-9.7%	7.8%
US Mid Cap	IJH	0.8%	-11.0%	-6.6%	-14.0%	8.3%
US Small Cap	VTWO	0.1%	-16.6%	-17.0%	-24.3%	9.6%

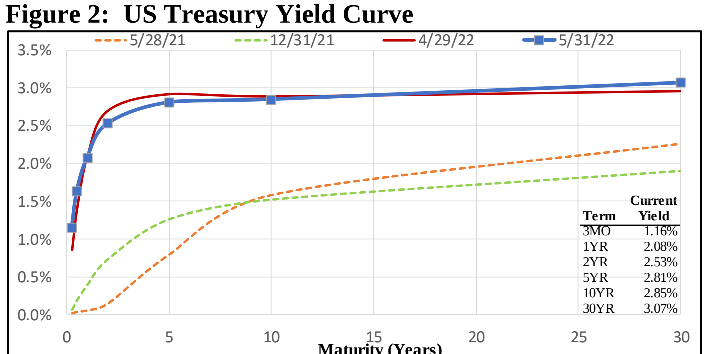
After spending most of the month in negative territory, global stock and bond markets recovered to end May higher for the most part. Long duration assets (long-term bonds and growth-oriented stocks) continued to lag amid expectations of aggressive interest rate increases as central banks combat elevated inflation. Performance highlights for the month and year-to-date (YTD) follow.

- Bonds: The U.S. Aggregate index (AGG) rose 0.8% (-8.7% YTD) as interest rates stabilized. Corporate bonds (LQD) were up 1.9% (-12.9% YTD), and high yield bonds (HYG) rose 1.6% (-7.2% YTD) despite wider credit spreads. Non-US bonds (IBND and EMLC) gained as the dollar weakened.
- Global equity (ACWI): +0.4% in April (-12.9% YTD).
- U.S. Equity: The broad market (VTI) fell 0.3% (-14.3% YTD), and the S&P 500 (IVV) rose 0.3% (-12.7% YTD). Large growth stocks (QQQ and IWF) fell roughly 2% and remain more than 20% below previous highs as rising interest rates erode the present value of future earnings. Small stocks (VTWO) rose 0.1% (-16.6% YTD) and are 24% below 52-week highs. Energy stocks rose 16.0% on average as oil prices spiked, offsetting weakness in consumer and real estate sectors.
- Non-U.S. Equity: Developed market stocks (EFA) rose 2.0% (-11.0% YTD), with small gains in Europe and Japan. Emerging markets (EEM) rose 0.6% (-12.7% YTD). Latin American stocks have led YTD (ILF +21.2%) due to heavy commodity exposure; China has lagged (+2.6% in May, -17.5% YTD) due to the negative economic impact of COVID lockdowns.

Interest Rates and the Economy

The US yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of U.S. Treasuries. Yields vacillated in May but ended the month roughly unchanged versus April. The Fed increased short-term rates by 0.5% and is likely to announce similar increases in the next two meetings (June, July) before pausing to reassess economic data and conditions. The curve remains flat at longer maturities, signaling tepid growth expectations and recession concerns. The 10-year Treasury bond now yields 2.85%.

Figure 2: US Treasury Yield Curve

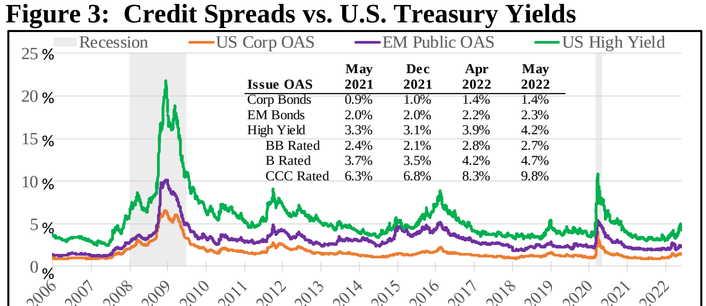


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

For bonds other than U.S. Treasuries, we track the option-adjusted yield spread (OAS) versus Treasuries of comparable maturities. Low or narrowing spreads signal optimism while high or rising spreads signal fear. Spreads widened in May and YTD, confirming the "risk-off" tone of global markets.

- Investment grade corporate bond spreads were stable at +1.4% this month but remain higher than +1.0% spreads at year-end.
- High yield (non-investment grade) spreads widened to +4.2% but are nowhere near panic levels. The riskiest bonds (rated CCC & below) spiked to +9.8% over Treasuries and are well above 2021 year-end and year-ago levels.
- Emerging market bond spreads rose slightly to +2.3% after spiking to +2.6% in February with geopolitical tensions; these spreads had been stable, but emerging market debt has underperformed due to the strength of the U.S. dollar YTD.

Figure 3: Credit Spreads vs. U.S. Treasury Yields



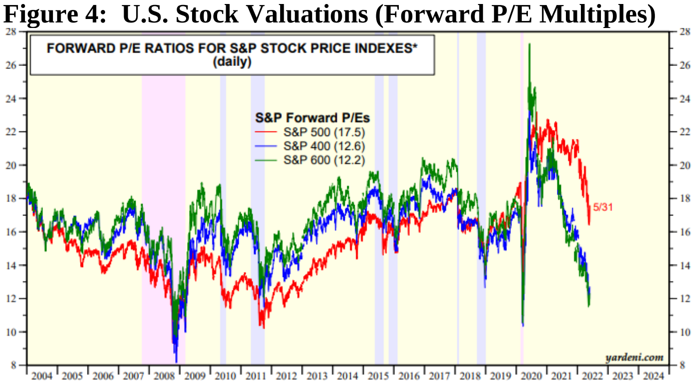
Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Inflation, Pessimism & Valuations

The U.S. and global markets are facing significant headwinds. The perfect storm of pandemic-related supply chain disruptions, spiking commodity prices in the wake of Russia's invasion of Ukraine, a tight labor market and strong demand for goods and services (boosted by aggressive monetary and fiscal stimulus) has resulted in the highest inflation in decades. To combat inflation, the Fed and global central banks have begun to reverse accommodative policies by raising interest rates and right-sizing their balance sheets by ending bond purchase programs and, eventually, reducing those holdings. Investors fear that rapidly rising interest rates will impact future economic growth and possibly push the U.S. and global economies into recession; these fears have sparked a dramatic selloff from market highs in January.

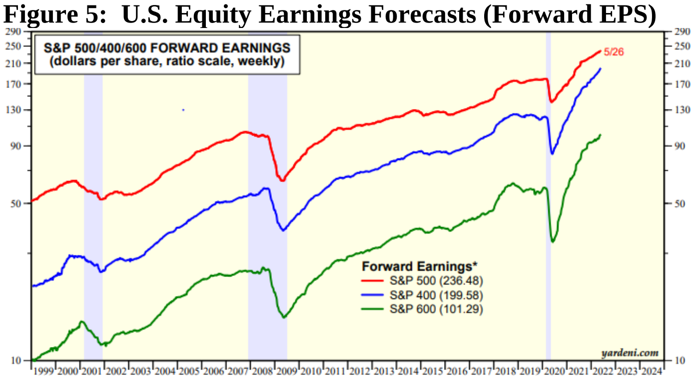
The big questions are: How much bad news is priced into markets? Is there more downside risk? While no one can answer these questions with any certainty, it is instructive to analyze two separate components of the U.S. market downdraft: change in valuation and the change in earnings expectations. Figure 4 (from Yardeni Research, Inc.) plots the forward P/E (price-to-earnings multiple) for the S&P 500, S&P 400 midcap and S&P 600 small cap indices over time. (Note: "Forward P/E" is calculated by dividing the index price by the consensus estimate for earnings per share over the next 52-weeks from any given point in time.) In this graph, the shaded vertical bars denote stock market declines of more than 20% (pink) or declines of 10-20% (gray).

Figure 4: U.S. Stock Valuations (Forward P/E Multiples)



Valuations have come down dramatically. This makes sense given that equity valuations, interest rates and inflation are highly correlated; when inflation is high, interest rates rise and stock valuations decline. Meanwhile, Figure 5 (from Yardeni Research, Inc.) illustrates that earnings forecasts have not come down. Note that the vertical gray bars in this figure mark U.S. recessions.

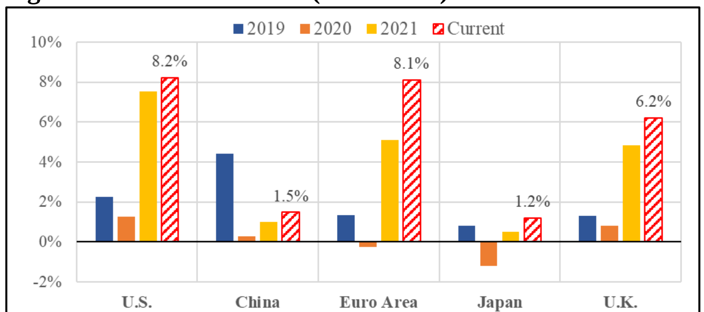
Figure 5: U.S. Equity Earnings Forecasts (Forward EPS)



In other words, the stock market declines so far reflect a reasonable valuation adjustment in response to higher inflation and interest rates, but the potential for a recessionary decline in corporate earnings does not appear to be priced in at current levels. The U.S. economy is strong (low unemployment, high demand for goods and services, strong economic and earnings growth), but investors will be on high alert for signs of weakness, and more downside could be ahead if the probability of recession rises.

This is not just a U.S. issue. Figure 6 plots inflation rates in the five largest economies. About 70% of the world's GDP (Gross Domestic Product) comes from the U.S. (26%), China (18%), Eurozone (15% across 19 countries), Japan (6%) and the U.K. (3%). Inflation is very high in Europe and the U.S. but less so in Asia.

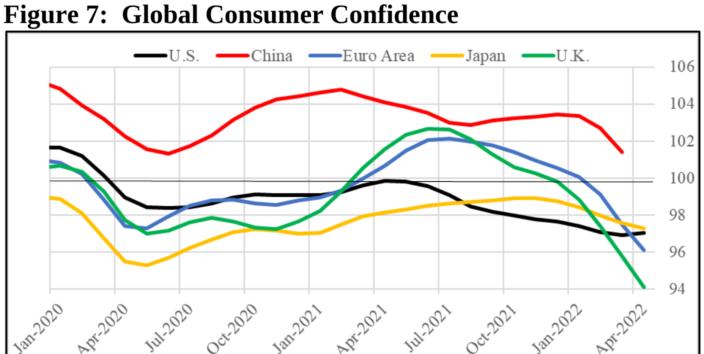
Figure 6: Global Inflation (Year/Year)



Source: Organization for Economic Co-operation and Development (OECD) via St. Louis Fed (FRED)

Elevated inflation has led to a marked decline in consumer confidence, especially in developed western economies, as illustrated in Figure 7. Readings below 100 indicate consumer pessimism.

Figure 7: Global Consumer Confidence



Source: Organization for Economic Co-operation and Development (OECD) via St. Louis Fed (FRED)

Bottom Line

Global economies and markets continue to face significant headwinds. To date, the declines in the equity markets can be attributed to a valuation shift lower due to high inflation and rising interest rates, but corporate earnings forecasts remain strong. Rising recession risks could force estimates downward. Markets are likely to remain volatile given lingering uncertainties around economic growth, which depends heavily on the spending of increasingly pessimistic consumers. On the positive side, business confidence continues to be good, and analyses of recent trades by corporate insiders (officers and directors) indicate optimism with strong, broad-based buying as stocks declined. China's emergence from virus-related lockdowns should eventually improve supply chain disruptions and global economic activity. Portfolio diversification and a balanced risk profile (global equity, bonds and alternative investments) make sense in this environment.

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