ECONOMIC & INVESTMENT PERSPECTIVES

JULY: STRONG RALLY FOR STOCKS & BONDS
NEGATIVE REAL GDP GROWTH - AGAIN

Figure 1: 7/31/2022 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	2.5%	-7.9%	-9.0%	-10.9%	5.3%
Investment Grade Corp Bonds	LQD	4.4%	-12.3%	-13.6%	-16.2%	7.0%
U.S. Treasury Bonds	GOVT	1.6%	-8.5%	-8.8%	-10.3%	4.3%
U.S. 20+ YR Treasuries	TLT	2.4%	-20.0%	-20.1%	-24.3%	8.6%
Muni Bonds	MUB	2.3%	-5.8%	-6.0%	-7.8%	4.2%
High Yield	HYG	6.7%	-8.0%	-7.1%	-11.3%	7.3%
Non-US Corp Bonds	IBND	2.5%	-16.8%	-21.4%	-22.1%	6.1%
Emerging Markets Bond LC	EMLC	-0.1%	-12.7%	-17.7%	-22.2%	5.1%
Global Equity						
ACWI Global Equity	ACWI	7.1%	-14.3%	-10.3%	-16.4%	10.5%
United States	VTI	9.3%	-14.0%	-7.8%	-15.5%	13.5%
International Developed	EFA	5.2%	-14.6%	-13.8%	-20.1%	10.4%
Emerging Markets	EEM	-0.3%	-17.5%	-20.7%	-25.4%	5.0%
Global Equity by Region						
United States	VTI	9.3%	-14.0%	-7.8%	-15.5%	13.5%
Europe	IEUR	5.2%	-16.8%	-15.8%	-21.3%	11.6%
Asia ex-Japan	AAXJ	-1.7%	-17.4%	-20.7%	-25.1%	4.1%
China	MCHI	-11.0%	-20.4%	-29.4%	-32.8%	14.4%
Japan	BBJP	6.3%	-15.0%	-14.3%	-24.3%	8.9%
Latin America	ILF	4.6%	4.8%	-11.5%	-24.6%	13.6%
US Equity						
US S&P 500	IVV	9.3%	-12.6%	-4.7%	-14.1%	13.8%
NASDAQ 100 QQQ	QQQ	12.6%	-20.5%	-13.0%	-22.8%	17.1%
US Large Growth	IWF	12.1%	-19.5%	-12.1%	-21.4%	17.9%
US Large Value	IWD	6.6%	-7.2%	-1.7%	-9.9%	10.4%
US Eqwt S&P 500	RSP	8.6%	-9.5%	-2.9%	-11.6%	12.6%
US Mid Cap	IJH	10.9%	-10.8%	-5.7%	-14.1%	15.1%
US Small Cap	VTWO	10.5%	-15.5%	-14.3%	-23.5%	14.7%

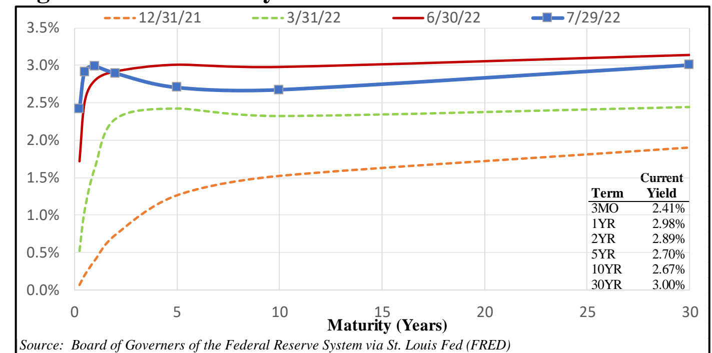
Global markets rebounded strongly in July, especially in the U.S., despite (or perhaps because of) clear signs of that the economy is slowing while inflation remains high. Bonds gained as long-term yields fell, and stocks rocketed higher on expectations that the Fed may be nearing the end of the rate hike cycle. Performance highlights for the month and year-to-date (YTD) are below.

- Bonds: The U.S. Aggregate index (AGG) rose 2.5% (-7.9% YTD). Corporate bonds (LQD) were up 4.4% (-12.3% YTD), and high yield bonds (HYG) gained 6.7% (-8.0% YTD) as credit spreads narrowed. Non-U.S. corporate bonds (IBND) were up, but emerging markets credit (EMLC) was flat; both have under-performed YTD due to U.S. dollar strength.
- Global equity (ACWI): +7.1% in July (-14.3% YTD).
- U.S. Equity: The broad market (VTI) rose 9.3% (-14.0% YTD); the S&P 500 (IVV) also gained 9.3% (-12.6% YTD). Large growth stocks (QQQ and IWF) were up more than 12% in July but remain down roughly 20% YTD. Small stocks (VTWO) rose 10.5% (-15.5% YTD) and are 23.5% below 52-week highs. All sectors posted gains for the month, led by tech and economically-sensitive stocks and industries.
- Non-U.S. Equity: Developed market stocks (EFA) rose 5.2% (-14.6% YTD), with gains in Europe and Japan. Emerging markets (EEM) lost 0.3% (-17.5% YTD); Latin American stocks (ILF) logged solid gains, but China (MCHI) fell 11.0% (-20.4% YTD) amid local and global economic concerns.

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of U.S. Treasuries. The Fed raised interest rates by another 0.75% in July, pushing short-term yields higher. Longer-term yields moved lower after the Fed indicated that rates are now in the "neutral range"; further policy action will be driven by incoming inflation and economic data. The curve is inverted (short-term rates > long-term yields), which has historically been a recession warning. The 10-year Treasury now yields 2.67%.

Figure 2: US Treasury Yield Curve

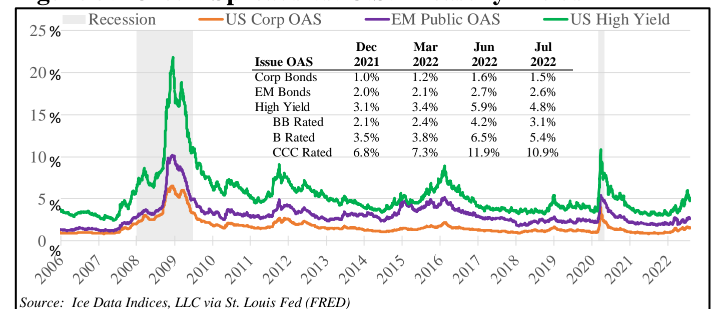


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

The bond market provides other risk metrics, including the option-adjusted spread (OAS) between various bond yields and Treasuries of comparable maturities. Low or narrowing spreads signal optimism while high or rising spreads signal fear. Spreads have widened materially this year but narrowed in July.

- Investment grade corporate bond spreads narrowed to +1.5% this month but remain higher than +1.0% spreads at year-end.
- High yield (non-investment grade) spreads decreased to +4.8%, still elevated but not at panic levels. The riskiest bonds (rated CCC & below) narrowed to +10.9% over Treasuries but are significantly above 2021 year-end spreads of +6.8%.
- Emerging market bond spreads narrowed to +2.6%; despite relatively stable credit spreads, emerging market debt has under-performed due to the strength of the U.S. dollar YTD.

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

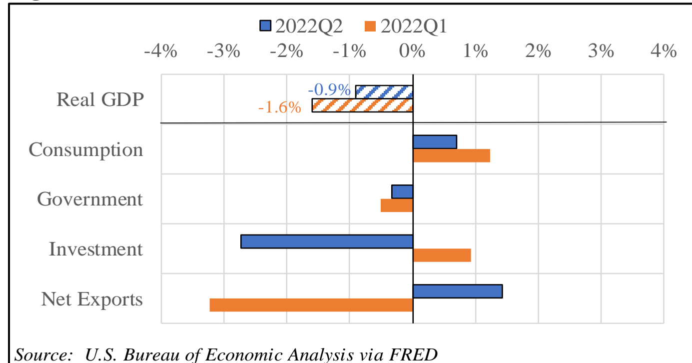


Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Growth & Inflation

The Bureau of Economic Analysis (BEA) reported that U.S. real GDP grew at an annualized rate of -0.9% in Q2, a second consecutive quarterly contraction. (Note: Real GDP stands for Gross Domestic Product, the value of all final goods and services produced in the U.S., adjusted for inflation.) The global economy is clearly slowing in the wake of on-going supply chain disruptions due to COVID and the Russia-Ukraine conflict, as well as tighter monetary policy as the Fed and global central banks seek to tame inflation. Figure 4 illustrates the real growth contributions of the four primary sub-components of GDP in the last two quarters.

Figure 4: U.S. Real GDP Growth Contribution



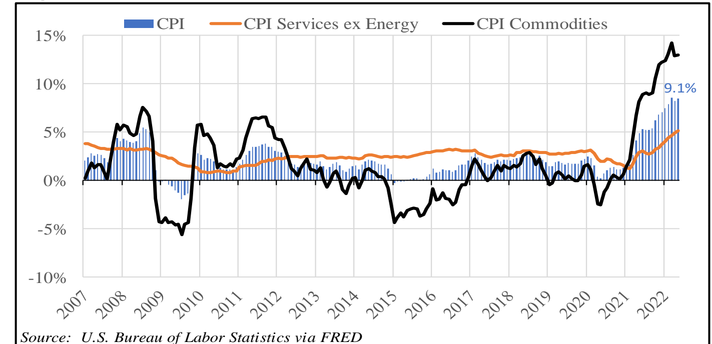
Source: U.S. Bureau of Economic Analysis via FRED

Analyzing the contributions to growth in this manner highlights two key differences between the quarters: The contribution of business investment flipped from positive in Q1 (orange bars) to negative in Q2, and net exports shifted from a negative Q1 contribution to positive in Q2. Further discussion is instructive.

- **Personal Consumption:** 68% of the U.S. economy is powered by the aggregate expenditures of individual consumers. Personal consumption continues to be a positive contribution to growth, though decreasing slightly from Q1 to Q2.
- **Government expenditures:** 17% of GDP is driven by direct consumption of goods and services by federal, state and local governments. Decreasing direct government spending continues to have a small, negative impact on overall GDP growth.
- **Private Investment:** 18% of the economic output comes from the expenditures and investment activity of businesses, including construction, equipment, manufacturing and inventories. A build in inventories has been a primary driver of growth in recent quarters, but the contribution to real growth was significantly negative in Q2 as the inventory build slowed.
- **Net Exports:** A trade deficit (the net value of U.S. exports minus imports) subtracts from economic growth, currently -4% of GDP. The contribution to real growth was actually positive in Q2 as the U.S. trade deficit shrank modestly.

While negative real growth is concerning, it is worth noting that nominal GDP growth (not adjusted for inflation) in Q2 was actually +7.8% annualized. Real GDP growth of -0.9% implies an inflation impact of roughly -9%, in-line with the latest Consumer Price Index (CPI) reading of +9.1% for June versus a year ago. High inflation was initially due to spiking food and energy prices and supply chain disruptions caused by the pandemic and exacerbated by the Russia-Ukraine conflict, but price increases have broadened. Figure 5 breaks CPI down into two major sub-components: commodities (raw materials: oil, gas, materials, agriculture, etc.) and non-energy services (housing, medical, transportation excluding gas, education, travel, leisure, etc.). Commodity prices have been the primary driver of high inflation, but the sustained rise in the services component is concerning. This component comprises more than half of the CPI calculation, and services inflation tends to be sticky, while commodity prices are volatile.

Figure 5: U.S. Inflation Year/Year



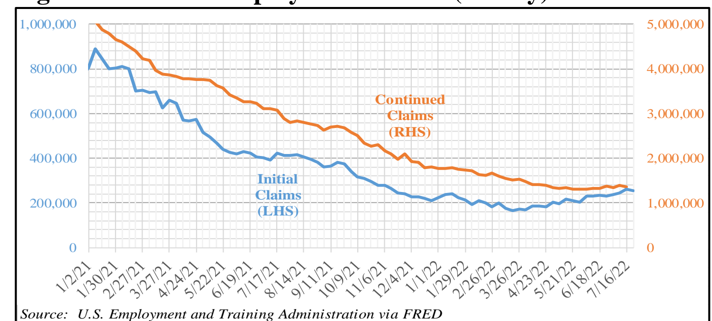
Source: U.S. Bureau of Labor Statistics via FRED

Bottom Line

Markets rallied strongly in July on hopes that the twin peaks of inflation and Fed hawkishness are behind us. Inflation data for July due out next week is expected to remain high; some moderation would not be surprising given the recent drop in oil and gas prices, but the Fed's job is far from done. What will success look like? Inflation is a supply-demand imbalance: When demand exceeds supply, prices rise. The Fed and its global counterparts are powerless to solve the supply problems in this environment, but they can reduce demand by slowing the economy. That means the medicine (tighter monetary policy) is likely to make the patient (economy) sicker before curing the disease (inflation).

The inverted yield curve suggests that the Fed will hike short term interest rates to 3% or more, but falling long-term yields signal lower growth and expectations that the Fed will have to cut interest rates as early as next year. The economy is slowing, evidenced by two consecutive quarters of negative real U.S. GDP growth, but the labor market is still very strong. The unfortunate reality is that unemployment must rise in order to reduce wage and price pressures. While employment data due out this week is expected to show another month of job gains, future employment data will likely need to be materially negative to tame inflation. Watch weekly jobless data (Figure 6) for signs of weakness; unemployment claims have risen recently, but a significant loosening of the job market will require much higher job losses. Recession remains likely; diversification and a lower risk profile (global equity, bonds and alternatives) make sense in this environment.

Figure 6: U.S. Unemployment Claims (weekly)



Source: U.S. Employment and Training Administration via FRED

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