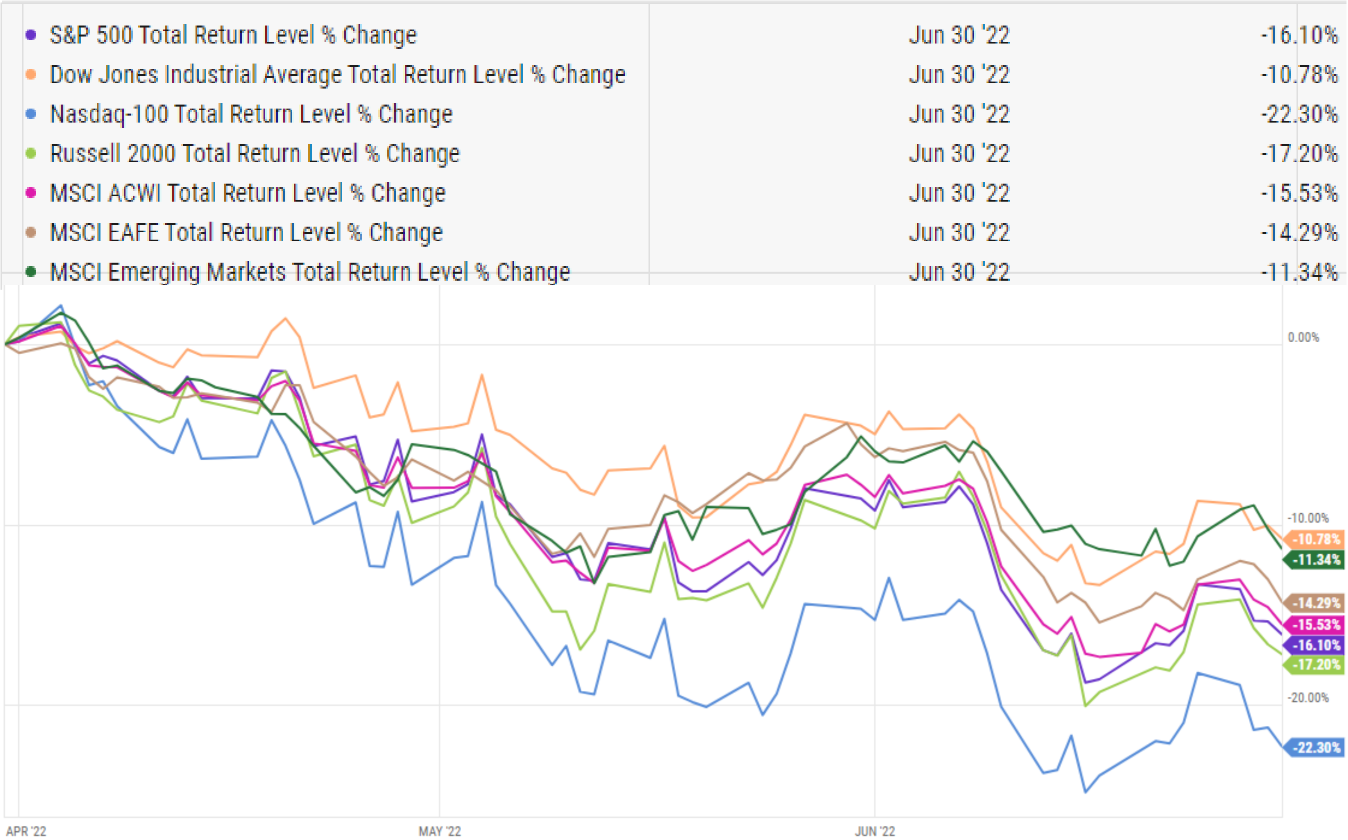
Markets

During the second quarter of 2022 equities accelerated the march into bear territory as inflation concerns, and the resulting rise in interest rates, continued to grow on the back of persisting supply chain and geopolitical issues. No equity market segments were spared from the downturn, though some areas were hit harder than others as the high-valuation, tech-heavy Nasdaq 100 took the brunt of the decline after ending the quarter down 22.30%, bringing year-to-date (YTD) losses to 29.22%. Small-caps came next as the Russell 2000 ended 2Q down 17.20% with YTD losses of 23.43%, followed by domestic large-caps as the S&P 500 ended the quarter down 16.10% with a YTD decline of 19.96%, the index's worst first-half performance since 1970. Even the more defensive companies, as represented by the Dow Jones Industrial Average, took a hit with the index ending the 3-month period down 10.78%, bringing YTD losses to 14.44%. These same themes played out on the international stage as the MSCI All Country World Index (ACWI) ended the period down 15.53% with a YTD decline of 19.97%. The market made little distinction between international developed and emerging markets, as both indices ended deep in the red with the developed MSCI EAFE TR index falling 14.29% during the quarter and ending down 19.25% YTD. The MSCI Emerging Markets index followed closely behind after ending the quarter down 11.34%, posting a YTD decline of 17.47%.

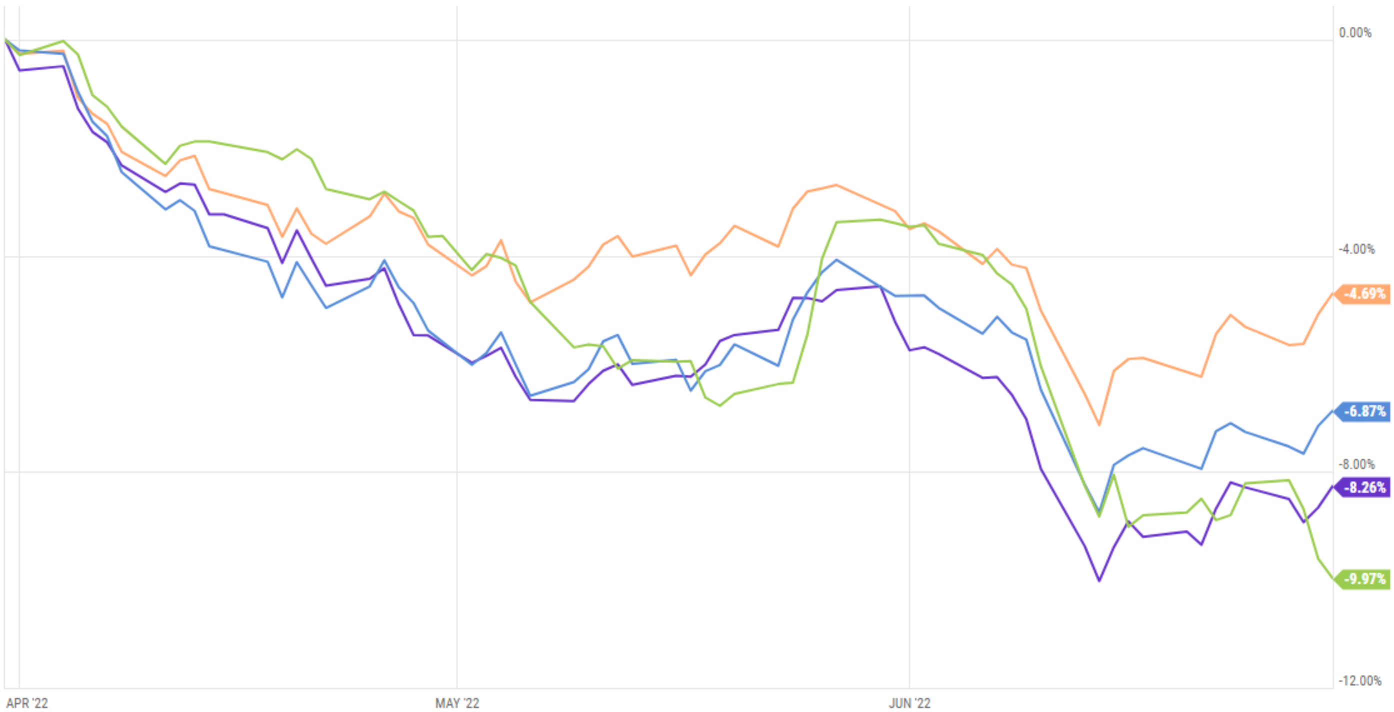


Source: YCharts

Turning to the fixed income market, the Treasury curve, as measured by the 2s-10s spread, steepened marginally as yields on both ends rose, with the 10-year yield rising slightly more than the 2-year. Interestingly, the 2s-10s curve began the quarter inverted, with the 2-yr yielding 2.44% and the 10-yr yielding 2.39%, but ended the period in a largely flat position with the 2-yr yielding 2.92% and the 10-yr yielding 2.98%. Both instruments experienced significant yield and price fluctuation as the 2-yr ranged between 2.37% and 3.45% while the 10-yr ranged between 2.39% and 3.49%, a stunning range of 108bps and 110bps, respectively.

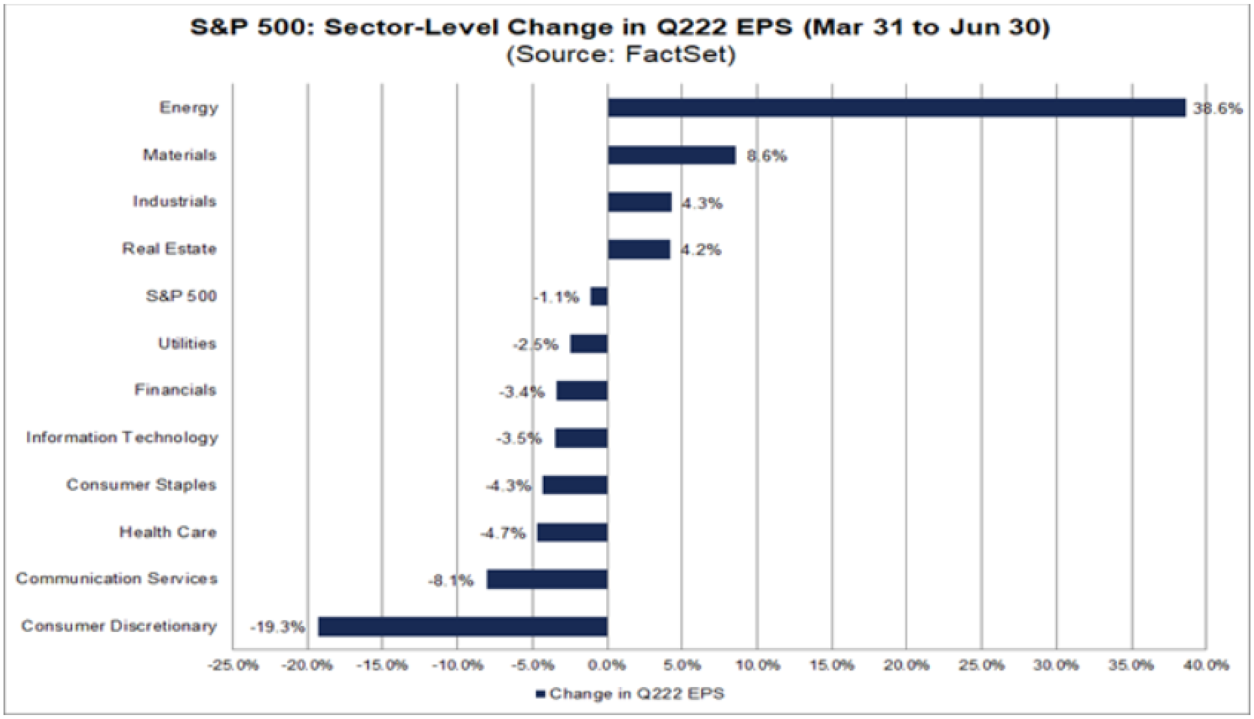
As the same factors which fueled the equity sell-off extended into the fixed income universe, all observed indices ended down, though there were some interesting distinctions in the return distributions. For example, domestic fixed income markets "outperformed" global markets as the Bloomberg US Agg TR ended the second quarter down 4.69% as compared to the Bloomberg Global Agg TR which ended the period down nearly double at 8.26%. On a YTD basis, the distinction becomes more blurred as the indices have lost 10.35% and 13.91% respectively. Turning to asset quality, the lower-quality, higher-yielding instruments as represented by the US High Yield Master II TR Index ended the quarter down 9.97% as the higher-quality S&P 500 Investment Grade Corporate Bond TR Index ended down 6.87%. YTD the two indices have behaved relatively in-line as they ended the first half of the year down 14.04% and 13.52%, respectively.

Bloomberg Global Aggregate Level % Change	Jun 30 '22	-8.26%
Bloomberg US Aggregate Level % Change	Jun 30 '22	-4.69%
S&P 500 Investment Grade Corporate Bond Index Level % Change	Jun 30 '22	-6.87%
US High Yield Master II Total Return Index Value % Change	Jun 30 '22	-9.97%



Source: YCharts

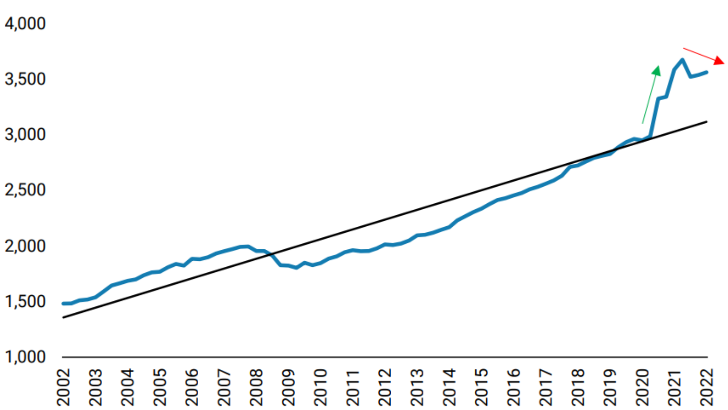
Despite the declining markets and rising recession fears, S&P 500 market analysts appear unphased as CY 2022 bottom-up EPS estimates increased by 0.8% during the quarter to an estimated annual growth rate of 10.2%. While the index's annual growth rate was revised up, analysts are anticipating a hit to Q2 earnings as they decreased their estimated growth rate for the quarter by 1.1%. Importantly, however, such a decrease in expected quarterly earnings is smaller than historical averages such as the 5-year average downward revision of 2.4% and 10-year average downgrade of 3.3%. At the sector level, 7 of the 11 sectors saw a decrease in their bottom-up EPS estimates for the second quarter, led by the Consumer Discretionary (-19.3%) and Communication Services sectors (-8.1%). Of the 4 sectors that saw an increase in their bottom-up EPS estimates, Energy led the way by a huge margin at +38.6% while Materials followed far behind at +8.6%. Regarding guidance from the companies themselves, unsurprisingly the amount of negative guidance being issued is higher than recent historical averages though still significantly lower than the peak levels seen in 1Q2016.



US Economy

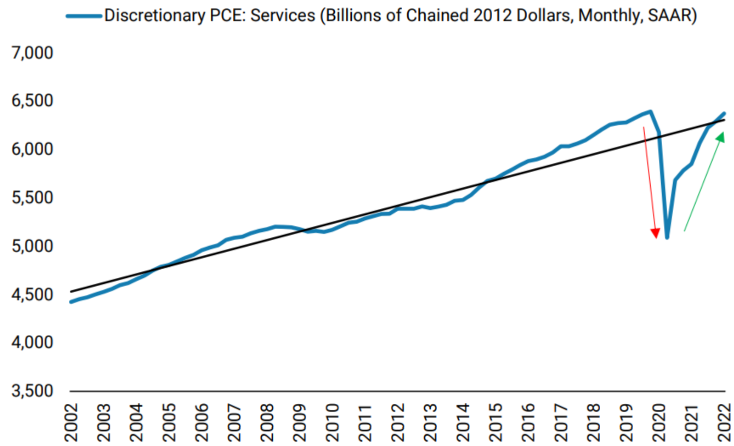
Beginning the domestic economy recap with the most crucial factor to the US economy, the consumer, we look to 2 reports which reveal an important shift in spending composition and outlook. A recent Morgan Stanley research report highlights how consumer goods spending is coming off a 2-year period of over-consumption as the Bureau of Economic Analysis (BEA) revised previous spending data down significantly (April personal spending revised from +0.7% MoM to +0.3% MoM) while the newly released personal spending report for May posted an outright contraction of -0.4% (vs. the -0.3% expected). As predicted by most relevant industry analysts, the bulk of the hit to personal spending in May came from spending on durable goods which fell 3.5% as compared to spending on non-durable goods which fell 0.6%. Interestingly, this dip in spending on goods comes at the same time as discretionary spending on services continues to recover back to trend-line, though the 0.3% MoM gain in services spending was not enough to counter the dip in goods spending.

Exhibit 3: Discretionary goods PCE has begun to moderate after accelerating during the COVID pandemic...



Source: FRED, Morgan Stanley Research. Durable + non-durable goods PCE ex-energy, clothing and food.

Exhibit 4: ...while at the same time, discretionary services spend is recovering back to trend-line after a period of under-consumption.



Source: FRED, Morgan Stanley Research. Services PCE ex-housing & utilities services.

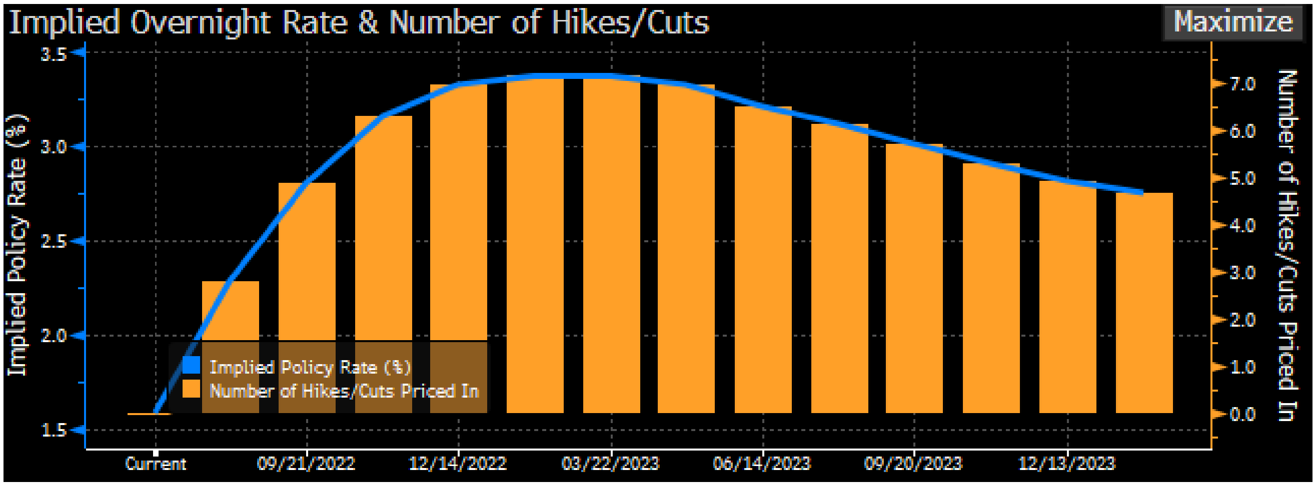
Such detrimental changes to US consumer spending habits occurring concurrently with the strongest US inflation rate in 40 years, equities entering bear-market territory, and interest rates rising alongside central bank tightening are affecting consumer and economic outlook alike. Recent AlphaWise US consumer data shows most income brackets plan to cut back on spending in the next 6-months, with these cuts concentrated in non-essential expenses. Taking all of this into account, Morgan Stanley's most recent macro models highlighted the probability of a recession has increased significantly in recent weeks, up from 15% to 35%.

This change in outlook is further shown by the most recent consumer confidence measures from the Conference Board (CB) and the University of Michigan, both of which have fallen sharply from their recent highs. The more relevant CB indicator fell more than expected in June from 103.2 to 98.7, as the forward-looking expectations component declined steeply from 73.7 to 66.4, the lowest level since 2013. This forward-looking component continues to fall as respondents become increasingly more pessimistic on business conditions, employment, and their own income outlook. The Michigan measure of confidence, because it is known to pick up more on cost of living and financial positions as opposed to the CB measure which places more emphasis on the labor market, fell to the lowest level on record during June amid equity market weakness and surging inflation. Evidently, with both measures deteriorating significantly, and with no help expected from the US Federal Reserve's rising rate regime, risks are firmly centered on weaker performance from consumer spending during the second half of the year.

US consumer confidence measures

Source: Macrobond, ING

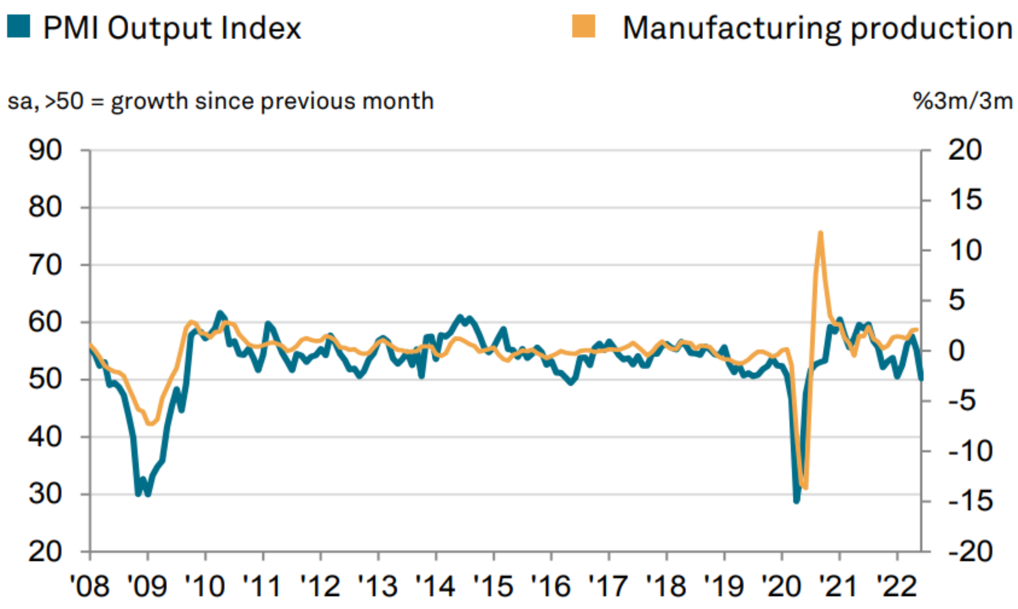
Regarding the Fed, the central bank has been busy as of late with a 75bps rate hike in June, the most since 1994. In June meeting minutes released in early July, the Fed gave no indication of slowing the pace of hikes as Fed officials backed raising rates at their next July meeting by either 50 or 75bps, even as fears of tipping the economy into a recession grew as the organization views "maintaining the central bank's credibility to control inflation as crucial." As of early July, the implied number of rate hikes remained relatively steady from last month, with futures markets continuing to price in 7 more 25bps rate hikes by YE 2022. If accurate, this would place the Fed's benchmark rate to a target range of 3.25 – 3.50% by the end of the year, with a reversal in course and rate cuts expected around the second quarter of 2023.



Source: Bloomberg

Undoubtedly giving the Fed more concern, job gains maintained the strong pace as seen in previous quarters. In all, the second quarter saw job gains of around 1.12mn jobs as compared with the 1.58mn job gains recorded in the first quarter of the year. Importantly, job gains remained strong even in June as the economy was marred with impending recession headlines as seen by the labor market gaining 372k during the month vs. the 270k expected. Also of note, however, is that this hotter-than-expected print will no-doubt add further fuel to the inflation fire the Federal Reserve has all-but-guaranteed to extinguish as a strong labor market will work to keep inflationary pressure on wage gains and other consumer-centric inflation metrics. As one Bloomberg analyst put it, "It's a payroll report that solidifies 75bps for a July Fed hike." The latest gains mean the domestic labor market has now recouped 21.5 million of the 22 million jobs lost during the pandemic, a recovery rate of 97.6%. Looking forward, however, Moody's estimates job gains to slow modestly as the economy inches towards potential, with average monthly job gains moderating to just over 100k a month by YE 2022.

Turning our focus to the business side of the economy, the latest June ISM Manufacturing report provides some conflicting conclusions. On one hand, the report showed new orders and employment contracting with order backlogs growing at a much slower rate, suggesting production numbers will weaken in 2H 2022. In all, the manufacturing index dropped from 56.1 to 53 (vs. 54.5 expected) while new orders headed into contraction territory after dropping from 55.1 to 49.2. While the decrease in client demand—the first such occurrence in over two years—was only marginal overall, it shows a marked contrast to the sharp upturn in activity seen in May. On the other hand, this area of the economy is continuing to see some relief in price pressures and general supply chain issues as the prices paid by suppliers slowed for the third consecutive month with supplier delivery times also moderating. While this suggests production bottlenecks are easing, company outlook provided a cautionary tone as they attributed the decline in activity to "inflationary pressures, weak client confidence in the outlook and supply-chain disruption."



Sources: S&P Global, US Federal Reserve.

As firms and consumers alike digest the change in direction experienced by some of these previously mentioned indicators, it is fair to say that there is a general lack of consensus on where we go from here and just how "soft" this landing will turn out to be. For example, the Conference Board is now forecasting that US economic growth will slow over the rest of this year and enter a shallow recession in late 2022 and early 2023. Such a downgrade comes as worldwide inflation readings continue to clock in multidecade highs, placing the Federal Reserve in a defiantly hawkish position to raise the Fed Funds rate into restrictive territory, potentially rising to 3.75 – 4.00% by 2023. In all, the organization projects inflation to peak in the current quarter, though remaining well above the Fed's 2% target through the end of 2023. Concurrently, they see domestic real GDP growth growing 1.9% in 2Q2022 and ending the year with a 2022 growth rate of 2.0%.

Accounting titan Deloitte, with their finger on the pulse of corporate America which is by many measures in good shape with healthy balance sheets, sees a much more gradual economic slowdown, placing only a 15% probability of an outright recession hitting the US. In fact, the only scenario they attach a smaller probability of occurrence is the 5% chance of a "relapse" resulting from a new COVID-19 variant once again causing massive economic reconfiguration such as that seen in March of 2020. They attach a 25% chance of a "Back to the '70s" scenario in which elevated inflationary expectations work with existing supply-demand-imbalances to create an inflationary spiral. This spiral and foreseeable high interest rate environment leads to a "growth recession" in which unemployment begins to rise in 2023. Their baseline scenario, assigned a 55% chance, paints an outlook more in-line with what we were seeing several months ago. Growth continues with some slowing as the economy reaches full employment, monetary policy tightens, and the Russian invasion of Ukraine continues to impact food and energy markets. While durable goods spending stalls as consumers switch back to pre-pandemic patterns, business investment continues to grow rapidly, and the infrastructure spending bill raises the level of government spending. All these factors elevate demand above pre-pandemic levels for several years, with inflation remaining above the Fed's target in 2022 but gradually settling back to the 2% range by mid-2023.

FIGURE 1

Real GDP, US$ trillion

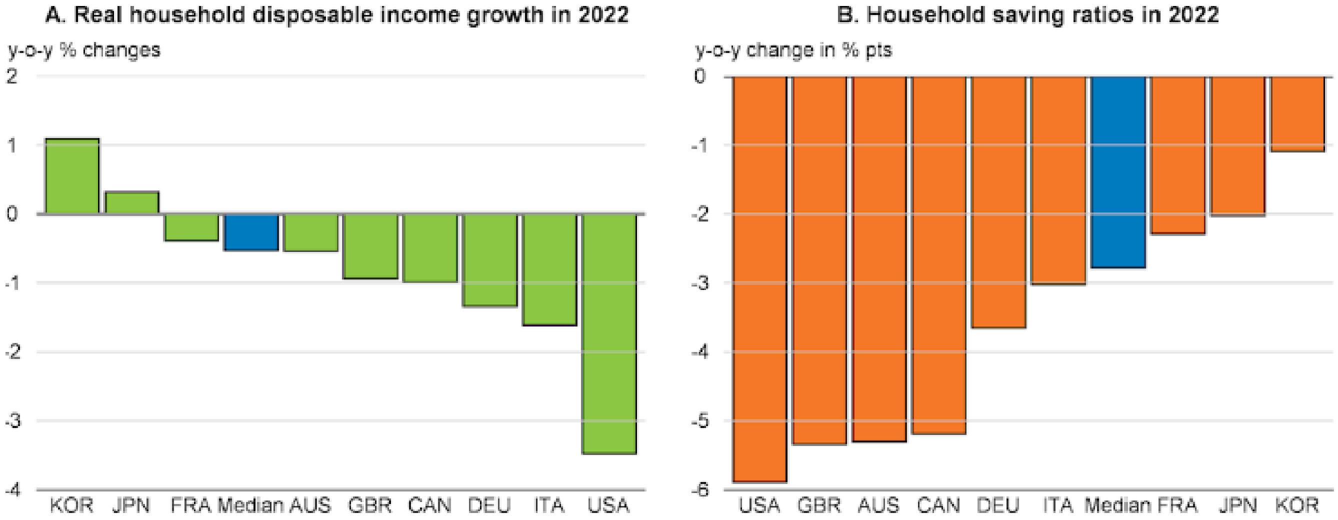
Source: Deloitte analysis.

Deloitte Insights | deloitte.com/insights

International Economy

Many of the factors explored domestically hold true in international markets as well, with median GDP forecasts being revised down and inflation forecasts being revised up as shown in the most recent OECD Economic Outlook. Importantly, the single greatest change to the international outlook is the economic impact of the war in Ukraine. Specifically, the war has quashed the hopes that the inflationary surge experienced globally in 2021 and 2022 subsides quickly. The war's acute impact on food and energy and its further aggravation of supply-chain issues, imply consumer price inflation will peak later and at higher levels than previously anticipated. Furthermore, because this negative supply shock was not expected, household incomes are rising slower than prices, worsening the deterioration in real household disposable incomes that was already underway in many OECD economies. Such developments highlight the importance of household savings ratios, which in many countries surged during the first phase of the pandemic. However, after nearly 2 years of consumers de-saving, such ratios have fallen significantly, a pattern which is assumed to continue going forward as consumers use their savings to offset the drag on real disposable incomes.

Figure 1.20. **Lower household saving ratios will be needed to support consumption given weak income growth**



Note: In Panels A and B, median denotes the median OECD economy.

Source: OECD Economic Outlook 111 database; and OECD calculations.

Considering this, and assuming a peak in global energy prices occurs in early 2023, the OECD projects that the eventual moderation in demand growth and waning supply-chain constraints should see CPI in the G20 economies peaking at 7.6% in 2022, with it moderating to 6.25% in 2023. Nonetheless, headline and core inflation are still projected to remain higher in 2023 than previously foreseen and, with inflation now seen as being higher for longer, many central banks are expected to raise rates more quickly. Global GDP growth is then projected to slow to 3% in 2022 and moderate to 1.6% in 2023 for OECD economies, around 2% weaker than previously anticipated. Specifically, the OECD revised down business investment and private consumption growth. On a regional basis, they note that European economies, particularly those bordering Russia or Ukraine, are expected to be the hardest hit. Advanced economies in the Asia-Pacific region and Americas, who have weaker trade and investment links with Russia, are still expected to be hit by weaker global demand and the impact of higher energy prices on household incomes and spending.

Figure 1.21. **Inflation projections have been revised up in most countries**

Inflation rate for 2023

A. Headline inflation

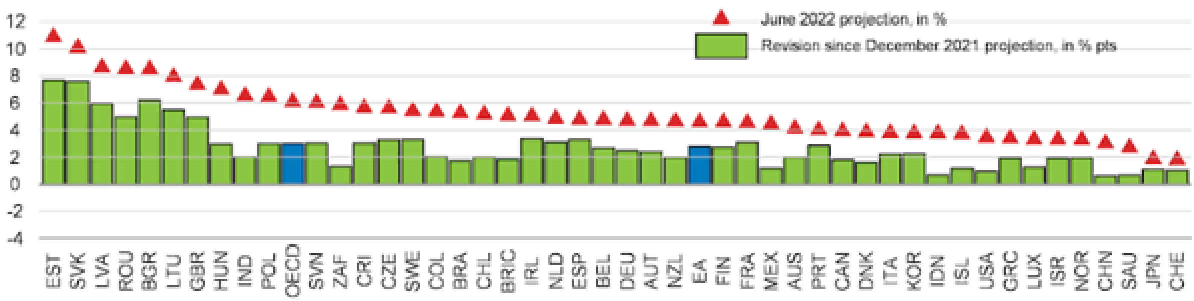
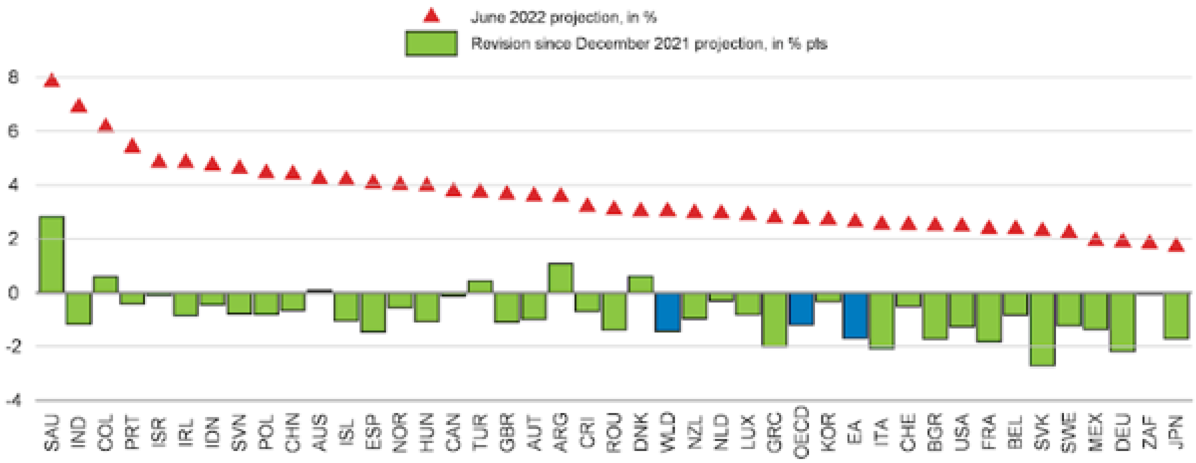


Figure 1.22. **GDP growth in most countries has been revised down in 2022**

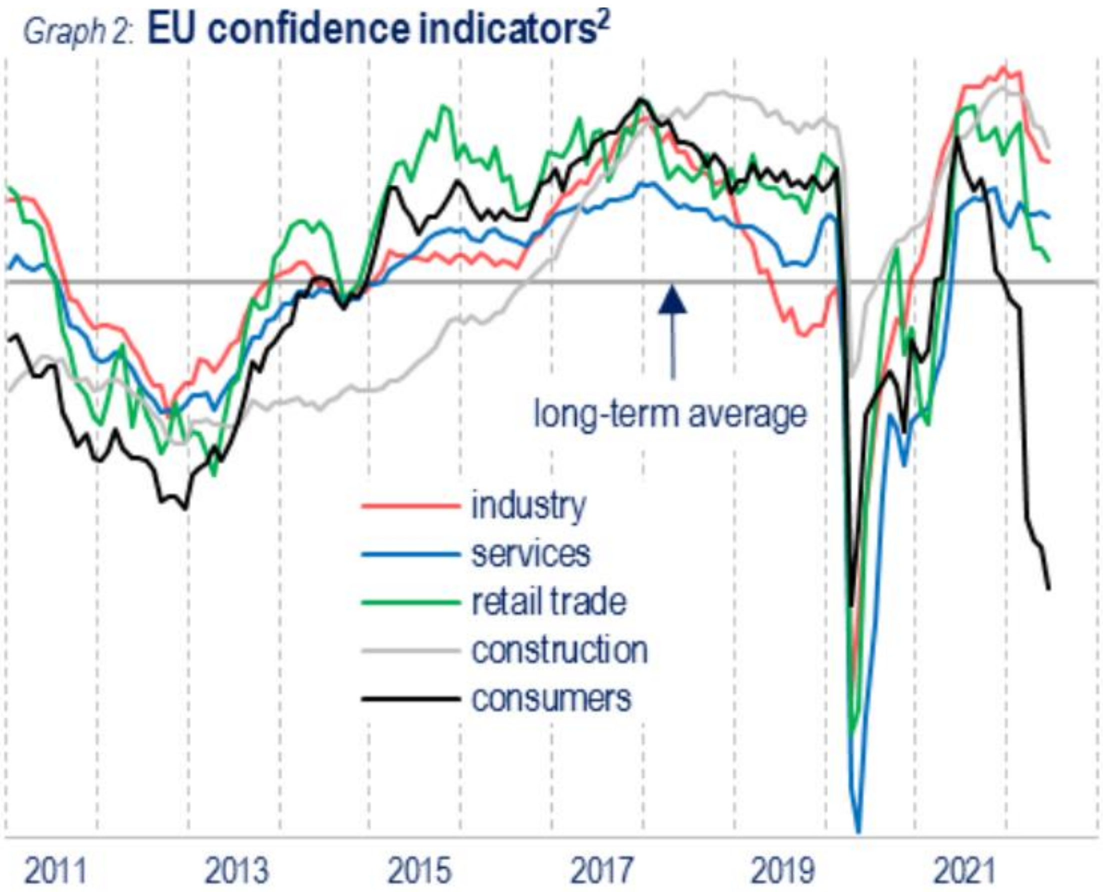
Real GDP growth rate for 2022



Note: Fiscal year for India.

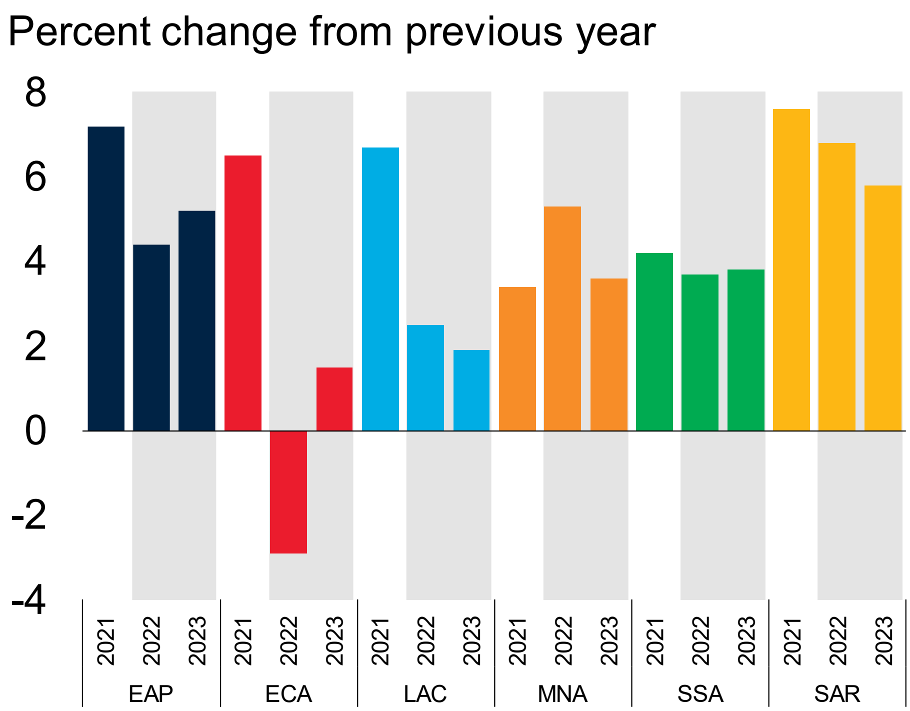
Source: OECD Economic Outlook 111 database; OECD Economic Outlook 110 database; and OECD calculations.

The economic environment outlined above is beginning to alter the mindsets of European economy participants, specifically taking a toll on the average European consumer. The European Commission's business and consumer survey results for June showed a continual decline in the Economic Sentiment Indicator (ESI) due to weaker confidence among construction managers, consumers, and to a lesser extent, retail trade managers. In terms of the ESI's underlying components, the further drop in consumer confidence resulted from marked deterioration in all 4 components, with household's outlook on their future financial situation hitting a record low and their assessment of their past financial situation dropping to a 9-year low. Concurrently, their intentions to make major purchases and their expectations about their general economic situation fell to levels last seen during the recovery of the COVID crisis.



Source: European Commission

Touching briefly on the developing side of the globe, we look to the recently released World Bank's Global Economic Prospects report. This report highlights how the economic recovery in emerging market and developing economies (EMDEs) resulting from the pandemic was already fading prior to Russia's invasion of Ukraine. Specifically, the adverse spillovers from the invasion will be most severe for Europe and Central Asia (ECA), where output is forecasted to fall sharply in 2022. Overall, output growth is now projected to slow this year in all other regions outside of the Middle East and North Africa (MNA), where the benefits of higher energy prices for energy exporters are expected to outweigh those prices' negative impacts for other economies in the region. In general, the ultimate impact of the war combined with inflation and supply issues are anticipated to weigh particularly heavy on regions with a large number of commodity importers, as well as in those with countries especially vulnerable to increases in global inflation and investor risk aversion.



Source: World Bank; EAP = East Asian and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SSA = Sub-Saharan Africa, SAR = South Asia

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