

The economy and markets have begun to repair some important imbalances, which should set the stage for better returns going forward.

First, economic growth has slowed to a sustainable pace. In the year that ended in the fourth quarter of 2021, real GDP grew by 5.5%. Bank estimates of second-quarter real GDP growth at +1.4% are higher than the Atlanta Fed's. This decline is necessary, since most economists believe the potential long-run growth rate of the U.S. economy is around, or even below, 2%. We entered the year close to full employment. If growth had not slowed, persistent wage inflation could have been higher.

Second, the Federal Budget deficit has fallen very sharply. Based on numbers through the end of May, JPM expects a deficit of \$825 billion or 3.3% of GDP this fiscal year, and \$780 billion or 3.0% next year. At these levels, the federal debt will not approach the debt ceiling until 2024, and, importantly, federal debt as a share of GDP is now declining, reducing the risk of a fiscal crisis.

Third, falling business confidence and higher wages should begin to eat away at the enormous excess demand for labor. The number of job openings in the United States fell from a record 11.9 million at the end of March to 11.4 million in April and to 11.3 million in May. Openings should continue to decline over the rest of the year as businesses reassess their hiring plans, rebalancing the labor market without causing a notable increase in the unemployment rate.

Fourth, high prices are having their usual, albeit delayed, impact on supply and demand. The Bloomberg Commodity Index, having hit an all-time peak in June, has now fallen 14.8% in less than a month, reflecting declines in crude oil, gasoline, natural gas, copper and corn prices. This, in turn, reflects the impact of higher prices in both increasing production and cutting demand. Fewer manufacturers are complaining about slower deliveries, according to the Institute of Supply Management, and the prices paid index fell in June to its lowest level in four months.

Even with this, prices remain high, which should continue to increase supply and constrain demand in the months ahead. While overall CPI increased to 9.1% in June, JPM expects much milder readings in July and August.

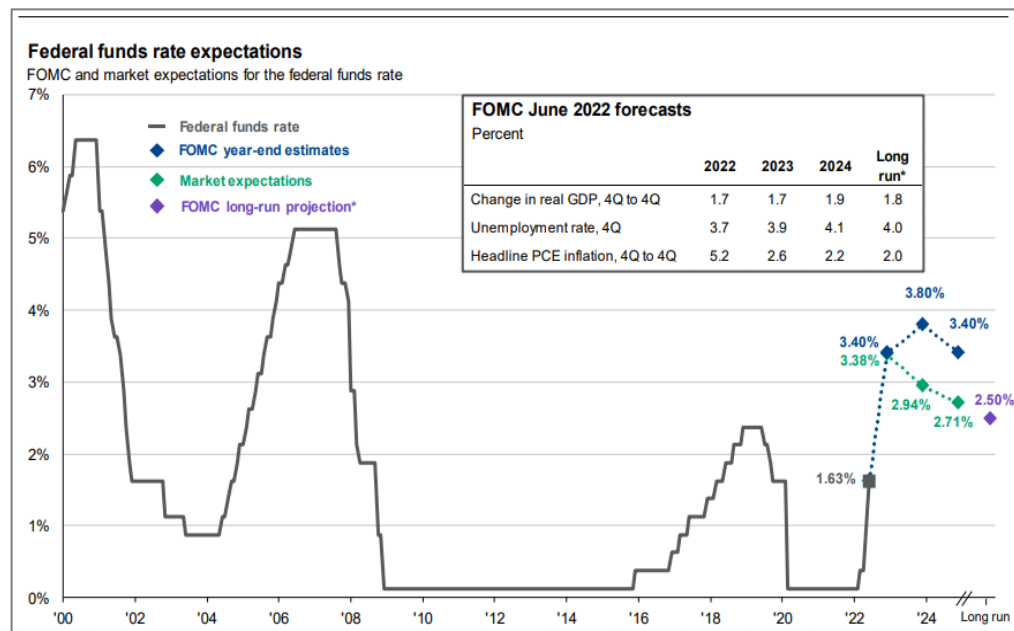
Valuations have mostly returned to more reasonable levels. It's also notable that the valuations that seemed most out of whack at the start of the year have generally fallen the most. All of this is moving in a somewhat logical direction. Still, there seems further room to go with the dollar still looking fundamentally too high, value stocks still look cheap relative to growth stocks, and international equities look cheap relative to U.S. equities. This presents opportunities for disciplined investors who are able and willing to invest today. There are many things that could still go wrong, including the U.S. economy stumbling into recession. And markets can still move lower. But there are also things that could go right, such as a decision by the Fed to tack to a less hawkish path. Even after an exceedingly difficult first half of 2022, disciplined and rational investors can take advantage of better valuations to position portfolios for better economic and market days ahead. Remember, markets are forward looking, and historically much of the market upside will already be reflected in the pricing by the time you read about the good news.

KEY TAKEAWAYS

- It has been a particularly challenging first half for both equities and bonds. History shows bull markets have exceeded bear markets in both duration and return.
- Markets expect interest rates to continue rising and a high likelihood of a shallow and mild recession.
- Headline Consumer Price Inflation reached 9.1% year-over-year in June, the highest in 40 years. The Fed is unconditionally focused on taming inflation and will continue aggressive rate hikes to do so. The average consensus target for the Fed Funds rate at the end of 2022 is 3.25-3.5%.
- The current fixed income environment presents new challenges and important new opportunities.

RECESSION RISK

Since its founding in 1913, the Fed's goal has been to keep the U.S. economy growing, and unemployment and inflation low. Following an extended period of economic growth, and with the compounding effects of supply chain shortages, COVID-19 restrictions and diminished energy and food supplies as a result of Russia's invasion of Ukraine, inflation has rapidly increased to near historic levels. A cool-off is warranted. While initially considered transitory, high inflation has proven to be stubbornly high. The Fed's projection (blue FOMC line below) and market expectations (green line below) suggest interest rates will rise quickly to about 3.5% by some time in 2023. For more detail on interest rates, please refer to the section that follows.



Source: JP Morgan Guide to the Markets

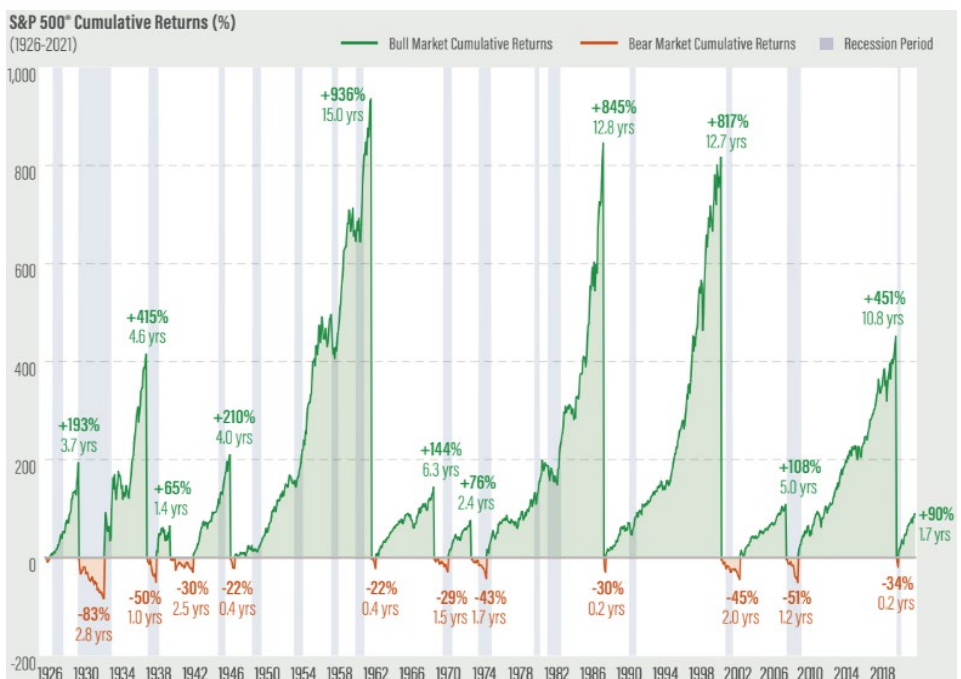


The first half of 2022 was particularly challenging for investors, with stocks down sharply and investment grade bonds returning an historic double-digit decline. Investor sentiment is nearing record lows and consumer pessimism is growing, as high inflation and Fed tightening have resulted in rapidly rising mortgage and consumer borrowing rates. The projected pace of interest rate increases has led investors and consumers to assume a U.S. economic recession is imminent.

One question being asked is **when** a recession might occur. According to Deutsche Bank, the relationship between Fed hiking cycles and the timing of recessions is tricky. Typically, economists will declare a recession when a country's Gross Domestic Product (GDP) declines for two consecutive quarters. Other factors like employment and consumer spending are considered when calling a recession. Heading into the second half of 2022, there are mounting concerns that the U.S. economy could slip into a recession, as real GDP declined during the first quarter. However, new data suggests growth was positive in the second quarter, due in part to higher consumer spending in primary pandemic-impacted industries such as travel, restaurants, leisure and entertainment. This could negate a technical recession. Preliminary guidance does suggest weakening economic growth in the third quarter, but it is far too early to tell if a recession is imminent. Per Deutsche Bank, the amount of time between the start of Fed rate hiking cycles and a recession has historically ranged from as few as 11 months to as long as 86 months, with an average span of 37 months (more than three years!).

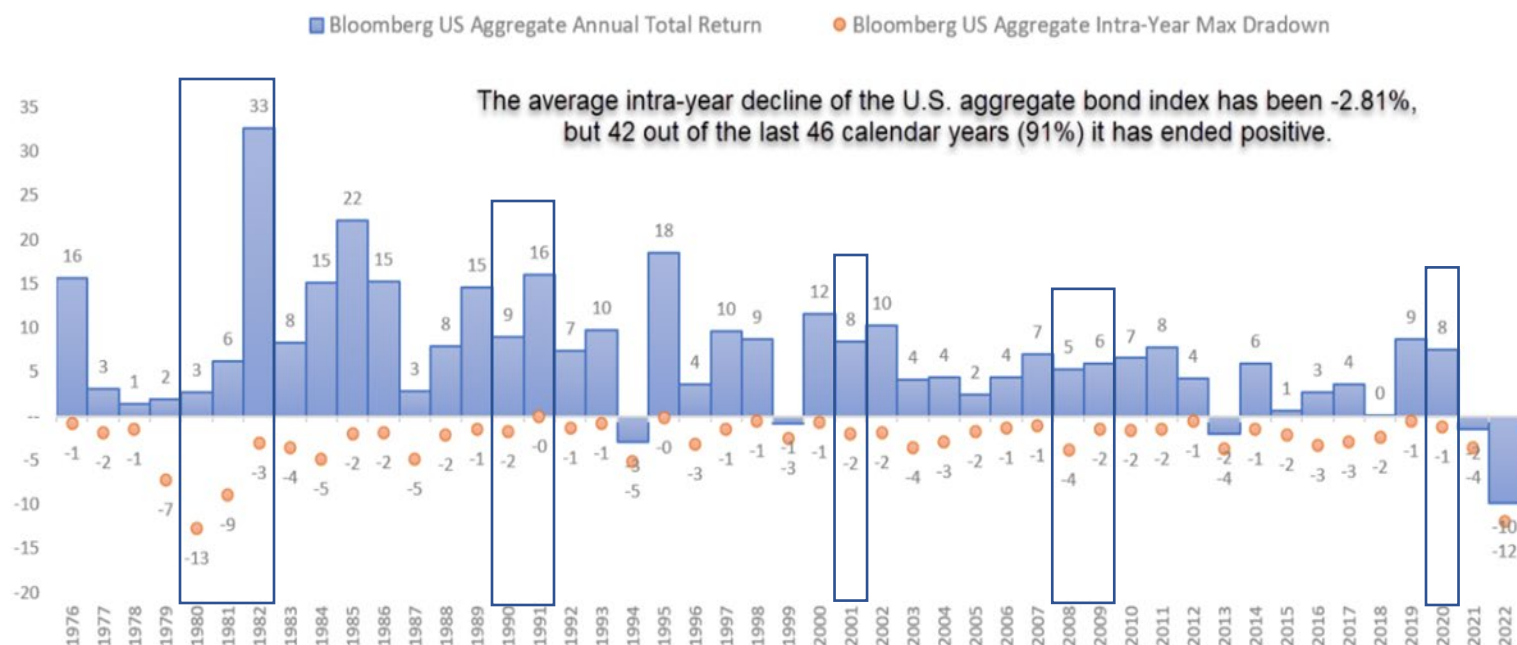
While the timing of a recession is unpredictable, we do see evidence to support one will occur over the intermediate-term. Schroders is forecasting a "high probability" of a U.S. recession in the next twelve months. When considering economic momentum, the greatest headwind is fiscal drag, with some economists predicting the federal budget deficit will likely shrink from 12.4% of GDP last fiscal year, to less than 4% of GDP this year (largest decline as a % of GDP since the end of World War II). Next, higher mortgage rates are expected to batter the housing sector, while at the same time, U.S. exports will be impeded by a more than 8% rise in the trade-weighted dollar since the beginning of the year. The takeaway is that growth momentum is slowing, and we need to see inflation moderate to avoid a moderate recession.

The other question being asked is how investors should position their portfolios for a recession. While many investments will be affected during Fed tightening and a slowing economy, severe down-market periods are typically short, and are followed by longer periods of sustained positive returns. This chart shows the average bull market has lasted 7.2 years with an increase of 387%, compared to the average bear market that has lasted a mere 1.3 years with a decrease of 39%! Forecasters do not expect a severe recession nor a severe market decline.





The Bloomberg U.S. Aggregate Bond Index's drawdown this year nearly matched the worst intra-year decline since the inception of the Index in 1976. The monthly drawdown through June was 11.9%, while the largest drawdown on record was 12.7% in 1980. The magnitude of the correction in bonds this year is highly unusual. The average intra-year decline for the U.S. Aggregate Bond Index has been 2.8%, but over the last 46 years, it has ended the year positive 42 times, or 91%. To drive home the point, we have isolated each of the recessionary periods in the chart below. The takeaway is that bonds have tended to provide positive returns even when the U.S. economy is in a recession. This is attributable to income and price reversion, which have historically combined to generate positive returns over full calendar years.



When we consider:

- the pace at which the Fed has proclaimed it will raise rates;
- the unpredictability of headline inflation;
- the stickiness of core inflation; and
- the confluence of factors that are likely to result in fiscal drag;

it seems likely that economic momentum will decline, and the U.S. economy will find itself in a recession.

Several leading market participants judge the likelihood as highly unlikely that the Fed can deliver a soft landing. As we look back at prior recessionary periods, we can see that equity bear markets are typically short and followed by longer periods of sustained growth, and that bond market total returns are usually positive.

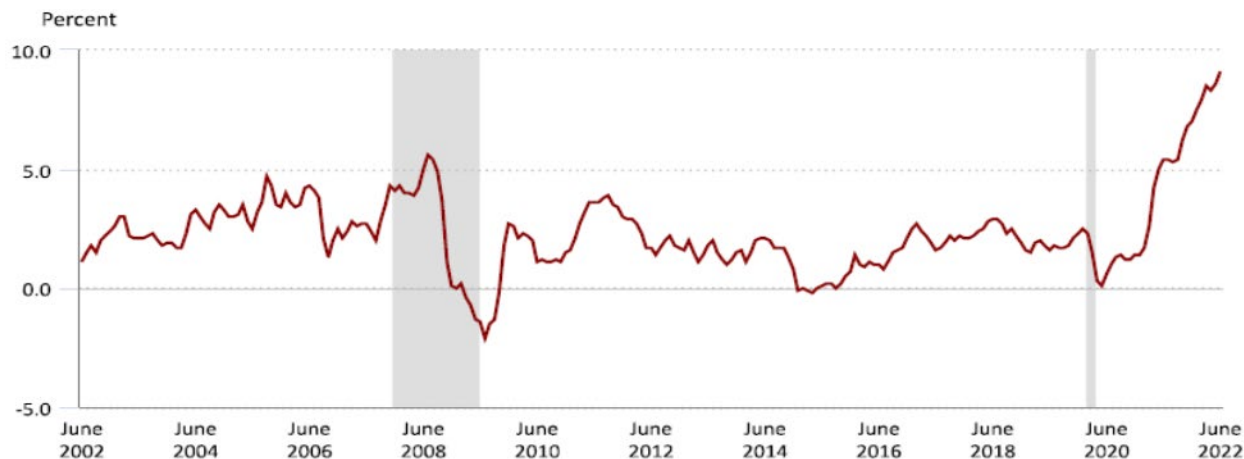
We also see that being out of the market for only a few days can significantly reduce an investor's long-term cumulative return. As we move seemingly ever closer to a recession, our guidance to clients is to stay fully invested, rely on quality, value and diversification to minimize volatility and unrealized loss, and remain focused on managing risk, as the law of market cycles rewards the steadfast investor with a long-term focus.



HIGHER RATES TO LOWER INFLATION:

At its June meeting, the Fed announced a rate hike of 75 bps (0.75%), after a key inflation gauge came in at an unrelenting 9.1% annual rate for the period ending June 30, 2022, the highest in 40 years. This was an unwelcome uptick from the previous year-over-year inflation rate of 8.6%. The current target Fed Funds rate is now 1.5-1.75%. The Fed is expected to raise rates another 75 bps at its next meeting, with two further 50 bps increases by the end of the year. This would put the Fed Funds rate in the range of 3.25-3.5% by year-end.

Exhibit 1: 12-Month Percentage Change, Consumer Price Index, All Items (20 yr History)



Hover over chart to view data.

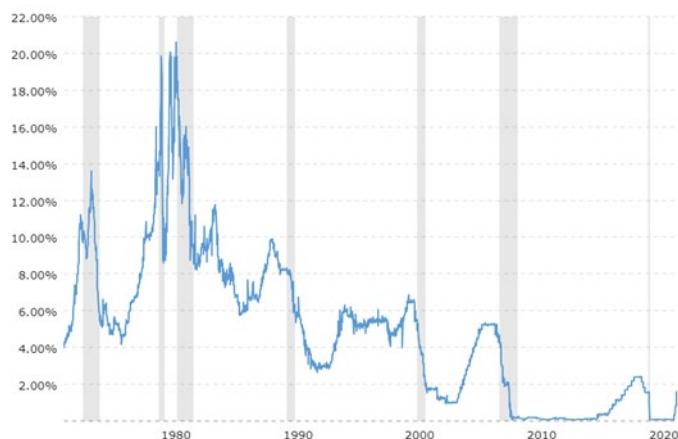
Note: Shaded area represents recession, as determined by the National Bureau of Economic Research.

Source: U.S. Bureau of Labor Statistics.

The Fed has made it clear that it intends to act swiftly and decisively to tame inflation, and that the fight against inflation is unconditional and will continue regardless of faltering markets or sentiments. A steep rise in interest rates is short-term pain for long-term gain. Runaway inflation is bad for the economy, and a persistent inflationary spiral would cause a cost-of-living crisis, as wage gains have failed to keep up with prices. 2021 saw inflation of 7%, which continued and increased even further in 2022 (See Exhibit 1).

The Fed's rate increases this year have been the most rapid rate rises since 1994. If the Fed continues on its current trajectory, we will see the largest annual rate rise since the 1980's, when double-digit interest rates triggered multiple economic downturns in a prolonged fight against inflation (See Exhibit 2). While the current inflationary environment has many significant causes, including global supply chain snarls, labor shortages and the war in Europe causing comorbid energy and food crises, the Fed is only able to address one underlying cause: spending. By raising rates and slowing spending, the Fed hopes to get inflation under control. However, with many underlying supply-related causes unresponsive to this single-prong strategy to tamp down prices, the fight against inflation is shaping up to be brutish. The Fed sees a return to low levels of inflation as critical to economic stability and is resolved in combating sky-high levels with restrictive monetary policy, even if that means a slower pace of economic growth and slowing wages and employment.

Exhibit 2: The Fed Funds Rate: 30 Years





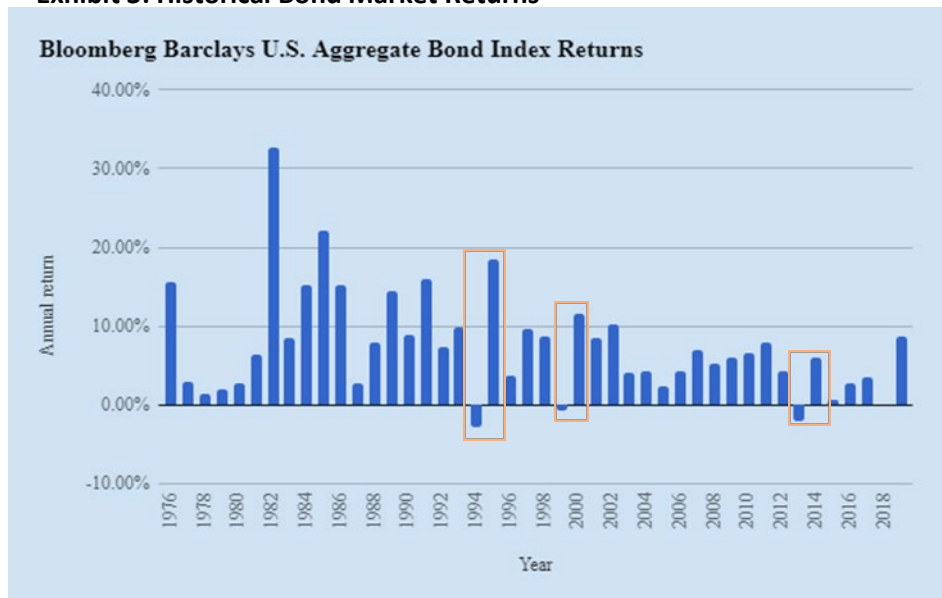
The pertinent questions on investors' minds are what kind of inflation numbers we'll see in the near future and when these numbers will begin to fall significantly. Currently, inflation is expected to remain high through the end of the year, but decline in 2023 to 3-4% and 3-3.5% thereafter.

The Fed is projected to raise rates at a continued aggressive pace through the end of the year. Rate hikes are expected to taper off in 2023, with the current consensus forecasting a terminal peak between 3.5-4%. In the longer term, though, rates are expected to moderate, coming down below 3.5% in 2024 and below 2.5% in the long-run. The market focus right now has shifted from the pace of rate hikes to how high interest rates will ultimately go. The link to economic risk is clear: the higher rates go, the more likely it is that the U.S. economy will slow significantly enough to enter a recession.

FIXED INCOME IN A RISING RATE ENVIRONMENT: A NEW FRAMEWORK FOR BONDS

The U.S., along with other developed nations, is in a race to tame inflation before it spirals into a persistent wage/price spiral. The upshot of rapidly rising interest rates is something investors haven't experienced in decades. After the 2008/2009 Great Recession, the Fed Funds rate remained near 0% for an exceptionally long period (see again Exhibit 2), as the country took time to rebuild to full employment and stoke growth. Even as rates began to rise in 2016, the pace of rate increases was slow and steady, only reaching 2.25-2.5% at the end of 2018. As the economy recovered and spreads compressed over the second half of the decade, the persistent low interest rate environment left investors searching far and wide for yield. Compare this to current times, when the Fed is projected to take rates from near 0% to ~3.5% in just nine months. The contrast is stark. This has caused bond prices to decline steeply. Spreads have also widened to their highest margins since 2016 (excluding the Covid recession in 2020) compensating investors more for taking risk.

Exhibit 3: Historical Bond Market Returns



U.S. Aggregate: -10% YTD, Yielding 3.6%, 56bps spread

U.S. Investment Grade: -13% YTD, Yielding 4.5%, 158bps spread

U.S. High Yield: -14% YTD, Yielding 8.5%, 552bps spread

With overall bond performance looking dismal and equities in a bear market, the traditional investment universe may look like a lose-lose situation. Don't let price performance discourage you. Fixed income returns have two main components: price and yield. When prices fall, yields rise, and vice versa. The yield on a bond is the interest payment, or coupon, that it pays divided by its price. As old bonds with lower yields are re-priced to compensate investors for higher interest rates, unrealized market losses can weigh on portfolios. However, taken together, the price and yield components have a counter-weighting effect.

As mentioned in the previous section, the average intra-year decline for the Aggregate Index shown above is -2.8%, with positive annual returns 91% of the time. The U.S. Aggregate drawdown through June was 11.9%, compared to the largest drawdown of 12.7% in 1980. However, even when interest rates had risen rapidly and saw new highs in 1980 and the bond market experienced this record drawdown, the Index had a +3% annual total return. Three out of 46 years saw negative total return (See Exhibit 3). All of these negative years were in the midst of rising rates and/or tapering, and all of these bond meltdowns showed marked recoveries the following year.

The upside of the current environment is that investors have an opportunity for the first time in decades to invest in bonds in a normal (albeit rising) interest rate environment and lock in higher yields. Higher rates and widened spreads may even offer the opportunity for investors to earn a positive real return in high inflation conditions. With current spreads, high yield bonds of high quality offer a chance to keep up with inflationary conditions. Credit risk, or the risk of default due to the borrower's insolvency, can be minimized by working with the highest quality managers who have a history of working through multiple market cycles.

Bonds held to maturity, the end of their term, are always redeemed at face value, or par. Because of this, the "pull-to-par" phenomenon causes bonds that previously traded at a discount to have their prices "pulled" towards their face value. This convergence represents the value of the bond that will be received when it matures. While bond prices may fall while interest rates continue to rise, barring the event of default, investors with a buy-and-hold strategy will always receive the bond's face value (par) and their coupon payments. Moreover, when investing or reinvesting interest after a drawdown, the investor is made whole. The following simplified scenarios illustrate this:

Scenario 1: An investor buys a 10-year bond with 9 years remaining at par value of \$1,000 with a 5% annual coupon. She receives \$50 each year for eight years and a total of \$1,050 in the last year when the bond matures and the principal is repaid along with the final coupon. If interest rates change over the period, the investor receives the same 5% annualized return. In total dollars, the investor has turned \$1,000 into \$1,450 over the 9-year period, earning \$450. If interest rates are unchanged and she reinvests the \$50 coupon payments, she will earn \$530 total.

Scenario 2: Investor A buys a 10-year bond at par for \$1,000 with a 5% coupon. The market interest rate rises from 5% to 6% immediately after purchase. The investor sells the bond at the end of year 1 for \$930 after receiving her \$50 coupon payment, earning a return of -2%. Investor B, who buys the bond at \$930, receives the same \$50 coupon but has a yield of 6% to match current rates. If she holds the bond to maturity, she will receive the full principal payment of \$1,000 at the end of her 9-year holding period and will have locked in a return of 6%. In total dollars, Investor B has turned \$930 into \$1,450, earning \$520. If she reinvests her \$50 coupon payments at the current rate, she will earn \$640 total.

Scenario 3: The same Investor B buys the same bond at \$930 after year 1. Afterwards, rates rise again from 6% to 7%. She now has an unrealized loss- her bond is worth only \$880. As long as the investor continues to hold the bond, her return will remain at 6%. If she continues to reinvest her \$50 coupon payments at the new 7% rate, she will earn more value over her 9-year investment period. In total dollars, Investor B will receive \$1,600 back, earning \$670.

If an investor has a long term buy-and-hold strategy, total return is buoyed by the yield component of a bond even when prices decline in the interim. Where just a few years ago investors were giving up on traditional fixed income due to low yields, the asset class has the potential to begin to earn its keep. Investors have a similar opportunity as in Scenario 3, with some caveats. In order to lock in returns over the long run, investors need to have the wherewithal to avoid liquidating holdings if and when prices are unfavorable. Moreover, the most favorable yields come at the highest risk, and only highly skilled managers with experience over market cycles should be trusted to assess these risks and find quality high yield issues. Fixed income within this framework presents a new opportunity in the current market environment.

KEY TERMS

Maturity: The expiration of a bond, specified by its maturity date, when the bond issuer (the borrower) pays the owner of a bond their principal, the face value of the bond, also known as "par".

Coupon: The interest payment paid by the issuer to an investor. This can be paid in annual, semiannual, or more frequent increments.

Yield-to-Maturity: The return a bondholder receives on their investment given the price paid for the bond and the coupon payments received over the life of the bond, assuming it is redeemed at par value at its stated redemption date.

Current Yield: The bond's annualized coupon payments divided by its price. If a bond's price declines, the denominator shrinks and current yield increases.

Spread: The difference in yield between two bonds with the same time to maturity, rating, perceived risk, taxability, or another feature. Generally, it refers to the difference in yield between a riskier bond and a Treasury bond of similar maturity.

Duration: A measure of how sensitive the price of a given bond is to changes in interest rates. A bond with a duration of 3 will see a price decline of 3% for every 1% rise in rates. The higher a bond's duration, the higher the interest rate risk.

Discount/Premium: The price below or above face value (referred to as par value) paid for a bond, which makes a bond's yield converge with market rates.

The U.S. Federal Reserve, “the Fed”, is one of the most powerful economic institutions in the United States, and its key duty is to manage monetary policy and to regulate the U.S. banking system.

While it is a powerful institution, there are limits to what it can control.

The Fed’s primary responsibilities include:

- (1) Setting interest rates;
- (2) Managing market liquidity through open market operations by buying/selling securities;
- (3) During periods of economic crisis, it may also serve as a “lender of last resort” to supply liquidity to banks when cash reserves are depleted.

During periods of high inflation, the Fed can increase the interest rate at which it lends money to the banking system, or it can adjust the supply of liquidity through the sale of government securities. By adjusting the rate that banks charge each other for overnight loans, the Fed establishes the basis on which all other short-term lending rates are set.

The Fed cannot control longer-term bond yields as set by the market through the purchase and sale of bonds.

The Fed can moderate the business cycle, but it cannot eliminate it. It cannot fine-tune U.S. economic growth. But the Fed can mitigate harm caused by shocks to the market such as the 9/11 attacks or the 2020 pandemic recession.

The Fed’s role is undeniably critical to the U.S. economy, but it is important to remember that it has little power to control the economy’s long-term growth.

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