ICR® 2nd Quarter Newsletter – July 2022

Stocks pulled back sharply in the second quarter with the S&P 500 losing 16.4% amid concerns of potential economic contraction both in the U.S. and globally. That pullback brought the total first half loss for the S&P 500 to 20.6%, its worst first half since 1970. The tech-heavy NASDAQ fared even worse, losing 22.4% for the second quarter alone, bringing its year-to-date loss to 29.5%. Unlike in the first quarter where there were a few bright spots like energy and utilities, there was nowhere to hide in the second quarter as every sector posted a negative return.

In their local currencies, foreign markets held up much better than the U.S., losing only about 8.8%, but because the dollar strengthened during the quarter, foreign markets lost about 15.4% when converted to U.S. dollars. This has been a major headwind for foreign investments this year, as the dollar index has gained 9.4%. Recently, the Euro and the dollar briefly reached parity for the first time since 1999. Dollar strength is a reminder that even as inflation and potential recession dominate the headlines, the dollar is still viewed as a safe haven asset by most of the world. It is also a product of the Federal Reserve raising interest rates to higher levels than the rest of the developed world, since money tends to flow into higher-yielding currencies.

The Federal Reserve's commitment to raising interest rates to fight inflation hurt the bond market in the second quarter. The ten-year Treasury yield increased from 2.33% to 2.97%, causing the value of bonds to fall. The U.S. aggregate bond index lost 4.7%, bringing its year-to-date loss to 10.4%. Traditionally, bonds have been used in portfolios as a counterbalance to stocks. That is, when the stock market is falling, bonds will often provide some stability. That has not been the case this year. In fact, the classic 60/40 portfolio (60% in stocks and 40% in bonds) is down 16.5% which, if it holds, would be the third-worst year ever for the strategy – only better than two years during the Great Depression (1931 and 1937). The last time stocks and bonds were both negative in the same calendar year was 1969. It would take a very strong second half rally in one of these assets to avoid that this year.

Did You Know There Has Been High Inflation?

It's all anyone can talk about and for good reason. It's painful, and it affects us all. Thankfully, there are some glimmers of hope that inflation may ease. The prices of most commodities have fallen substantially from their peaks earlier in the year. Cotton, lumber, aluminum, and wheat are all more than 30% below where they were just a few months ago. If that trend continues, the lower costs of input materials could help stabilize, or even lower, prices of consumer products. Second, while shortages frustrated retailers during the pandemic, many are now looking at inventory gluts because they stockpiled merchandise once it became available. Now, they must find a way to reduce those inventories, and lowering prices is the best way to do that. Finally, the market's inflation expectations have fallen significantly in recent months with the 5-year breakeven rate (implied inflation rate over the next five years) down to around 2.5%.

That all seems like good news, but the downside is that those disinflationary factors also correlate with economic slowdown. For example, copper prices – which are almost 30% below their highs – are generally

seen as a barometer of economic activity. The sharp decrease in prices may indicate weakening demand for products which require these basic materials. This weakening demand is coming at the same time the Federal Reserve is reiterating its commitment to a very aggressive interest rate policy to combat inflation. And while Fed Chair Jerome Powell has said that the goal is a "soft landing" in which inflation is tamed without substantial harm to the economy or labor market, he admitted it will be difficult, and a recession is possible.

Hopes have grown for a soft landing as second-quarter earnings reports and government data have suggested US consumers are bending but not breaking under the weight of rising interest rates and higher prices for food, energy, and housing. Fed policymakers — and investors — also draw confidence from the state of the job market, as the pace of job creation has defied expectations. But the signs of resilience are being taken with a grain of salt amid evidence of growing strain on lower-income households and expectations that rising prices will eventually erode the finances of even more households.

Recessions are certainly a cure for high inflation, but they come at a substantial cost to the economy and the workforce. So, the Fed must slow the economy enough to get inflation under control without causing unnecessary economic pain. Investors will be focused on whether the Fed continues with rate hikes and quantitative tightening or if it pivots to a more dovish stance in the face of weakening economic data. The possibility of a policy error by the Fed and its impact on corporate profits looms large for markets.

The potential impact on portfolios will largely depend on whether we do slide into a recession and, if so, the depth and length of that recession. It is our opinion that recession is imminent and the questions remaining are of severity and duration. The important question, for investors and the Fed itself, is how the bank will respond when they cannot simultaneously achieve their inflation and growth targets, forcing them to choose between the two. We believe the inflation battle will be more difficult and take longer than the market currently assumes, as policy makers might give in before they have achieved their inflation goal. This could result in prolonged stagflation, which would be a very different environment from the one that has buoyed most portfolios in recent decades. Therefore, we are evaluating various assets to determine their biases to growth versus inflation. Understanding these biases will help us prepare for the possibility of stagflation.

As always, we want to thank you for the privilege of managing your wealth and we hope you will reach out with any questions or thoughts you may have.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 6/30/22)

Index	**2022 YTD (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	-20.6	8.8	9.3
Dow Jones Industrial Average	-15.3	5.0	7.6
U.S. Aggregate Bond Index	-10.4	-0.9	0.9
MSCI EAFE (Foreign Index)	-21.0	-1.3	-0.4

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