The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets July 2022

From: *Philadelphia* Investment Management Group

OVERVIEW

- ***The Direction of the Securities Markets for Stocks and Bonds has Never had Such Varied Opinions From the Major Economists in the U.S.*** *About anything you would like to hear regarding inflation and recession, you would find explained in detail by these forecasters.*

- ***The U.S. Economy Hangs in a Delicate Balance as the Federal Reserve Tries to Bring Inflation Under Control.*** *The fastest pace of consumer price growth in four decades has upended financial markets this year by pushing the Fed to raise interest rates at a rapid clip.*

- ***The Russia/Ukraine War has had an Enormous Impact on Global Economies and Markets.*** *The same issues that have troubled equity markets in the U.S., namely, inflation, interest rates and concerns about economic growth, have dealt a severe blow to other economies and markets.*

THE ECONOMY

The perplexity of the economic and business crossroads, at which we seem to be, can be traced to the first days of the pandemic and the ensuing difficulty that it has placed on any accurate assessment of our current state of affairs. Concerns over inflation, on one hand, coupled with confusion as to how aggressive the Federal Reserve should go in its attack on the inflation numbers, have the securities markets extremely volatile in their attempt to sort out what the true facts are with the economy and how they should be addressed. This is a period unlike those we have had in the past. One school of thought, and it is our contention, is that too aggressive a move to rein in inflation when there are indications that some of the unbalanced demand/supply issues are improving, should influence the Fed to go easy on rate hikes.

New orders for U.S.-made capital goods and shipments increased solidly in the last couple of months, pointing to sustained strength in business spending. Even with deteriorating consumer sentiment as well as other heightened fears of a recession, there is, nevertheless, continued strength in the economy. Businesses would not order new equipment if they thought consumers and other companies were looking to pull back their purchases.

There is strong support for the camp predicting that most of the sources of high inflation will abate over the next couple of years. This includes energy, autos, and other durables. Worries about inflation broadening out into the rest of the economy look overblown.

These are difficult and different times, and policy cannot be set based on previous periods. No period has been like the one we are presently going through.

FINANCIAL MARKETS

EQUITIES

Global markets closed out their most bruising first half of a year in decades. In the U.S., equity markets, in the past quarter, fell in double-digits, while recording for the first half negative performance not seen in decades, as shown in the chart below. The S&P 500 lost 16.10% for the quarter, and for the year to date through June 30, the Index fell close to 20%. It is not surprising that the NASDAQ lost twice that of the Dow Jones due to its heavy weight in Information Technology companies. As a general statement, these companies sell at higher prices to their fundamentals, so with rising interest rates and inflation, they will tend to retreat at a faster rate. The small cap Russell 2000 fell 17.20% for the quarter and 23.43% for the year to date, which was the worst first half for the index in more than 40 years.

	Equity Returns*		
Index	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	-16.10%	-4.60%	-19.96%
Dow	-10.78%	-4.10%	-14.44%
NASDAQ	-22.44%	-9.10%	-29.51%
Russell 2000	-17.20%	-7.53%	-23.43%

*Total: price change + reinvested dividends

In addition to the Information Technology area mentioned in the previous paragraph, and as we look into the second quarter performance of the various other sectors of the S&P 500, as reflected in the chart below, Consumer Discretionary stands out as the worst performing sector. But in this case, it is not so much that the underlying companies were so expensive fundamentally as it was the anticipated slowdown in their revenues as recession fears were widely being discussed. Energy remained the best performing sector with the only positive year-to-date performance, but this area has also pulled back in the second quarter due to the high cost of energy.

Sector	Weight	Returns* 2nd Qtr	1st Qtr	YTD
• Energy	4.4%	-5.17%	39.03%	31.84%
• Materials	2.6%	-15.90%	-2.37%	-17.89%
• Industrials	7.8%	-14.78%	-2.36%	-16.79%
• Cons. Discretionary	10.5%	-26.16%	-9.03%	-32.82%
• Consumer Staples	7.0%	-4.62%	-1.01%	-5.58%
• Health Care	15.1%	-5.91%	-2.58%	-8.33%
• Financials	10.8%	-17.50%	-1.48%	-18.73%
• Info Technology	26.8%	-20.24%	-8.36%	-26.91%
• Communication Svcs	8.9%	-20.71%	-11.92%	-30.16%
• Utilities	3.1%	-5.09%	4.77%	-0.55%
• Real Estate	2.9%	-14.72%	-6.22%	-20.02%

S&P 500

06/30/22
*Price + income
Source: S&P Dow Jones

Across the board, concern about persistent high inflation will lead central banks to aggressively tighten in order to undermine consumer spending. In the second half of 2022, we don't expect sustained improvement in market sentiment until investors see more convincing evidence that inflation can be brought back under control. Of recent, however, we have been seeing signs that business is finally straightening out with demand/supply ratios improving, as evidenced by the appearance of some weakness in manufacturing. Perhaps, economic patterns are beginning to gradually return to normal.

To attempt to compare our situation today with any other period of the past is risky. And to base investment decisions on patterns of the past is likewise a serious mistake. Our best bet is to remain invested and well diversified in this current period of turmoil and not attempt to model anything after past events.

FIXED INCOME

The hawkish twist in Central Bank policy, along with high inflation, was also negative for fixed income investors who faced one of the worst starts to a year on record. All major segments lost ground in the quarter and year to date. As shown in the following table, losses in the first half ranged from a negative 22.30% for long corporate bonds to -5.15% for intermediate municipal bonds. In all cases, for both the second quarter and year to date, the intermediate area significantly outperformed the longer bond area.

Fixed Income Returns

Index	2nd Qtr	1st Qtr	YTD
Corp/Govt	-4.84%	-6.43%	-10.96%
Int. Corp/Govt	-2.28%	-4.58%	-6.75%
Long Corp/Govt	-11.48%	-10.92%	-21.15%
U.S. Government	-3.85%	-5.56%	-9.19%
- Intermediate	-1.59%	-4.02%	-5.55%
- Long	-10.93%	-10.14%	-19.97%
Corporate	-6.71%	-7.74%	-13.93%
- Intermediate	-3.75%	-5.53%	-9.08%
- Long	-12.19%	-11.51%	-22.30%
- **Quality**			
- AAA	-7.35%	-8.49%	-15.22%
- AA	-6.36%	-7.50%	-13.38%
- A	-6.01%	-7.18%	-12.76%
- BBB	-7.32%	-8.21%	-14.92%
Municipal	-3.30%	-6.18%	-9.28%
- Intermediate	-0.75%	-4.44%	-5.15%
- Long	-5.16%	-7.45%	-12.22%

Source: ICE BofA

In the second half of the year, we expect the fixed income markets will sense that these expected rate hikes will help to reduce the inflation numbers. There should be improvement in the bond markets throughout the maturity and quality ranges of fixed securities. Since we do expect further interest rate hikes this year, our fixed income policy continues to stress quality and shorter maturity and duration structures.

Within the municipal market, again, quality and short maturities are the recommended investments. In addition, general obligation bonds and carefully selected revenue bonds should be preferred in building a tax-free portfolio of investments.

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In summary, the decline and volatility in the financial markets reflect the uncertainty of the risks of high inflation and the tightening monetary policy setting the Federal Reserve has embarked on. What a real threat is to a recession occurring is an overly-aggressive policy that raises rates beyond that which is needed. Because of the confusing numbers coming out regarding the economy, mainly the result of post-pandemic conditions, our recommendation is to maintain a well-diversified portfolio of high quality equities and fixed income securities with shorter-term maturities.

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