Rising Inflation & Interest Rates, Geopolitical Events, & Recession Fears Result in Worst First Half for Equity & Fixed Income Assets in Decades

The S&P 500 continued to decline in the second quarter, hitting the lowest level since December 2020 as still-high inflation, sharp increases in interest rates, rising recession risks, and ongoing geopolitical unrest pressured stocks and other assets.

After a rebound in March, the S&P 500 dropped sharply in April to start the second quarter. While some of the reasons for the declines were similar to the first quarter (rising rates, high inflation, geopolitical concerns) the primary catalyst for the April sell-off was something new: a massive COVID-related lockdown in China. Unlike most of the rest of the world, China continues to enforce a "Zero-COVID" policy, whereby small outbreaks are met with extremely intense city- and province-wide lockdowns. This sharp drop-in economic activity not only increased the chances of a global recession but also compounded global supply chain problems (Shanghai, the world's busiest port, operated far below capacity during the lockdowns). The severe decline in economic activity in China combined with lingering concerns about rising interest rates and high inflation hit stocks hard in April, and the S&P 500 fell 8.7%.

The selling continued in early May, as the Federal Reserve raised interest rates by 50 basis points at the May 4th meeting, the single-biggest rate hike in 22 years. Additionally, at the press conference, Fed Chair Jerome Powell clearly signaled that the Fed would continue to hike rates aggressively to tame inflation and that weighed on stocks, pressuring the S&P 500 to fall to new 2022 lows in mid-May. But towards the end of the month, markets staged a modest rebound thanks to potential improvement in multiple market headwinds. First, as COVID cases declined, the Chinese economy

started to reopen, and by the end of May, the port of Shanghai was operating at 80% capacity, a material improvement from earlier in the month. Additionally, Atlanta Fed President Raphael Bostic stated that the Fed might "pause" rate hikes in the late summer or early fall, and that gave investors some hope that the end of the Fed rate hike cycle may be closer than previously thought. Finally, some inflation metrics implied price pressures may be peaking.

Those potential positives, combined with deep, short-term oversold conditions in equity markets, prompted a solid rally in late May and the S&P 500 finished the month with a fractional gain.

But the relief didn't last long. On June 10th, the May CPI report showed inflation had not yet peaked as CPI rose 8.6% year-over-year, the highest reading since 1982. That prompted a violent reversal of the late-May gains, and the selling and market volatility was compounded when the Federal Reserve increased interest rates by 75 basis points on June 15th, the biggest rate hike since 1994. Additionally, Fed Chair Powell again warned that similar rate hikes are possible in the coming months. The high CPI reading combined with the greater-than-expected rate hike hit stocks hard, and the S&P 500 dropped sharply in mid-June to its lowest level since December 2020. During the last two weeks of the quarter, markets stabilized as commodity prices declined while U.S. economic readings showed a clear moderation in activity and that rekindled hope that a peak in inflation and an end to the rate hike cycle might come sooner than feared. Those factors, combined with the fact that markets had become near-term oversold again, resulted in a modest bounce late in the month, but the S&P 500 still finished with a solidly negative return for June.
In sum, the factors that pressured stocks in the first quarter, including high inflation, the prospect of sharply higher interest rates, geopolitical unrest, and rising recession fears, also weighed on stocks in the second quarter and until investors get relief from these headwinds, markets will remain volatile.

Third Quarter Market Outlook

The S&P 500 just realized its worst first-half performance since 1970 as initial market headwinds of high inflation and sharply rising interest rates combined with growing recession risks and extreme geopolitical uncertainty pushed stocks and bonds sharply lower through the first six months of the year.

Those declines are understandable considering inflation reached a 40-year high, the Federal Reserve raised interest rates at the fastest pace in decades, the world's second-largest economy effectively shut down and the Russia-Ukraine war raged on.

But while the volatility and market declines of the first six months of 2022 have been unsettling and painful, the S&P 500 now sits at much more historically attractive valuation levels. And at current prices, a lot of negativities have been priced into the market, opening the possibility of positive surprises as we move forward in 2022. One area that continues to improve due to high volatility is our Competitive Bid Structured Investments. High volatility leads to improved terms, primarily with higher maximum returns. We leverage our independence in a competitive bid process as these notes are created exclusively for our clients. In addition, as valuations have become more reasonable, we have focused on the Closed-End Fund markets, where we are beginning to see much more attractive valuations compared to a year ago and fairly good value when judged over a longer period.

Regarding inflation and Fed rate hikes, markets have aggressively priced in stubbornly high inflation and numerous additional rate hikes from the Federal Reserve between now and early 2023. But if we see a definitive peak in inflationary pressures in the coming months, then it's likely the Federal Reserve will hike rates less than currently feared, and that could be a materially positive catalyst for markets.

On economic growth, the Chinese economic shutdown has increased global recession concerns, but recently officials in Shanghai declared "victory" against the latest COVID outbreak and if Chinese economic activity can return to normal, that will be a positive development for global economic growth. Meanwhile, recession fears are rising in the U.S., but stocks are no longer richly valued, and as such, aren't as susceptible to an economic slowdown as they were at the start of the year.

Finally, regarding geopolitics, the human tragedy in Ukraine continues with no end in sight, but the conflict has not expanded beyond Ukraine's borders, and many analysts believe that some sort of conflict resolution can be reached in the coming months. Any sort of a truce between Russia and Ukraine will likely reduce commodity prices and global recession fears should decline as a result.

Bottom line, the markets have experienced numerous macro-and micro-economic headwinds through the first six months of the year, and they have legitimately pressured asset prices. But the sentiment is very negative now, and a lot of potential “bad news” has been at least partially priced into stocks and bonds at these levels, again creating the opportunity for potential positive surprises.

To that point, the S&P 500 has declined more than 15% through the first six months of the year five previous times since 1932. And in all those instances, the S&P 500 registered a solidly positive return for the final six months of those years.

Obviously, past performance is not necessarily indicative of future results, and we will continue to be vigilant to additional risks to portfolios, but market history provides a clear example that positive surprises can and have occurred even in difficult markets such as this. More importantly, through each of those declines, markets eventually recouped the losses and moved to considerable new highs.

At Blue Bell Wealth Management, we understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this challenging investment environment. We, like other advisors, preach to, "Stay the course," but unlike many advisors, we seek to improve our clients' position while remaining focused on the long-term goals. We can accomplish this primarily by investing in Closed-End Funds at larger than normal discounts and continue to manage downside risk with our Structured Investment ladder. While this strategy may not immediately prove beneficial, we have been through similar cycles, and we understand the long-term opportunities that markets like this present. Successful investing is a marathon, not a sprint, and even extended bouts of volatility like we've experienced over the past six months are unlikely to alter a diversified approach set up to meet your long-term investment goals and may actually prove beneficial over the longer-term.

Therefore, it's critical for you to stay invested, remain patient, and stick to the plan, as we've worked with you to establish a unique, personal allocation target based on your financial position, risk tolerance, and investment timeline.

Rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

Please do not hesitate to contact us with any questions, or comments, or to schedule a portfolio review.

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