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Fed Wrecks Markets in First Half 2022—What's Next?

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Financial markets were slammed by multiple factors during the first half of 2022. The S&P 500 registered its worst half year since 1970, the Dow Jones Industrial Average had its largest first half drop since 1972 and the Nasdaq saw its biggest decline ever. The S&P 500 has lost $8.2 trillion in total dollars since the beginning of the year.

Since January, the U.S. economy and stock market have been hit by the perfect storm. Russia's invasion of Ukraine began a bloody and disruptive war in Europe, China's COVID lockdowns added to supply chain disruption woes and hawkish central bank policies all conspired to destroy asset values. Faced with 40-year high inflation, enflamed by record money printing since the beginning of 2020, America's Federal Reserve embarked on a highly aggressive monetary policy tightening program which has led to plunging securities prices.

Russia's war in Ukraine magnified the slowdown in the global economy and has compounded the damage from the COVID-19 pandemic. Global growth is expected to slump from 5.7 percent in 2021 to 2.9 percent in 2022, significantly lower than 4.1 percent that was anticipated in January, according to a recent World Bank report.

Growth is expected to hover around the three percent pace over the next two years as the war in Ukraine disrupts activity, investment, and trade in the near term, pent-up demand fades, and fiscal and monetary policy accommodation is withdrawn. As a result of the damage from the pandemic and the war, the level of per capita income in developing economies this year will be nearly five percent below its pre-pandemic trend.

Ostensibly, Fed Chairman Jerome Powell so far cares more about the perception of being behind the curve on inflation than restoring investor confidence. For the first half of 2022, the S&P 500 index and MSCI World stock indices were down by 19.97% and 20.28%, respectively. While we did see some countertrend rallies through first six months of the year, the overall direction has been lower.

Historically, bonds have been a safe place to hide during market downturns but not this time around. Over the first half of 2022, the Bloomberg U.S. Aggregate Bond Index fell 10.35% as interest rates rose.

The Treasury yield curve had a parallel upward shift during the second quarter in response to an increasingly hawkish central bank. Credit spreads widened further amid concerns of persistently high inflation and higher probability of a recession. The spread between US BBB Corporate and the 10-year Treasury ended last quarter at 2.13%, the highest in the past two years.

In May, the FOMC committee had their third 0.25% rate hike this year. After the May CPI surprisingly reached a 40-year high, policymakers decided to act more aggressively by raising the Fed Fund Target Rate by 0.75% at the June meeting, the largest increase since 1994. Fed Chair, Powell once again reiterated their focus to bring inflation back to the target of two percent. Markets widely interpreted the Fed's message as a signal that more 0.5% rate hikes will take place at future meetings.

Looking ahead, financial markets remain highly dependent upon central bank policy. On the good news front, many commodities, including copper, oil, lumber and wheat have been falling and are well off their highs for the year. Any indications of lower inflation may help the Fed to relax its hawkish stance.

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Meanwhile, evidence of a slowing economy abounds. In fact, the U.S. may already be in a shallow recession of sorts. First quarter real gross domestic product (GDP) came in a -1.6% and we may be looking at another negative print for Q2. A recession is commonly defined as two back-to-back negative GDP numbers. Further signs of an economic contraction or even a meaningful backslide may also help the Fed to pivot back to a less restrictive monetary policy stance.

Fed policy is important for equity prices, but corporate earnings matter too. While estimates for Q2 have been coming down lately, we may see some upside surprises from those companies with market leadership positions which can pass higher costs on to their customers. Importantly, earnings are reported in nominal (rather than inflation-adjusted) terms and thus higher prices could be a positive for some.

Over the next few weeks, many of the largest bell weather companies will be reporting. Investors will be focusing not just on last quarter's earnings, but also revenue and earnings guidance for the balance of the year.

In this environment, we continue to lean into the more defensive areas of the market such as healthcare, utilities, consumer staples and energy. In fixed income, we are finding abundant opportunities to earn historically high current yields, where previously this had not been possible.

Stock Market Performance

	07/1/2022	W-o-W	M-o-M	Y-o-Y
DJIA	31,097	-1.3%	-5.2%	-10.2%
S&P 500	3,825	-2.2%	-6.7%	-11.4%
MSCI World	2,560	-2.3%	-7.6%	-15.5%
S&P/TSX	18,861	-1.1%	-8.9%	-6.5%
BSX	2,242	2.0%	1.1%	-12.4%
FTSE100	7,169	-0.6%	-4.8%	0.6%
DAX	12,813	-2.3%	-10.7%	-17.9%
CAC	5,931	-2.3%	-7.6%	-9.5%
Nikkei	25,936	-2.1%	-5.5%	-9.7%
Hang Seng	21,860	0.6%	2.7%	-24.2%
Shanghai	3,388	1.1%	6.5%	-5.6%

Key Rates and Prices

Currencies	07/1/2022	Month ago	Year ago
EUR	$1.04	$1.07	$1.19
GBP	£1.21	£1.25	£1.38
JPY	¥135.21	¥130.13	¥111.53
CAD	C$0.78	C$0.79	C$0.80
CHF	CHf1.04	CHf1.04	CHf$1.08
AUD	A$0.68	A$0.72	A$0.75
Fixed Income			
3M LIBOR	2.29	1.63	0.14
3M Treasury Bill	1.66	1.13	0.05
2Yr Treasury Note	2.84	2.65	0.26
10Yr Treasury Note	2.88	2.91	1.46
Fed Funds Rate	1.75	1.00	0.25
Commodities			
Gold/oz.	1,811.43	1,846.60	1,776.84
Silver/oz.	19.88	21.83	26.03
Copper/lb.	3.65	4.31	4.23
Oil	108.43	115.26	75.23

Global Economic Calendar (Jul 4—8)

Mon: S&P Global Canada Manufacturing PMI (CA)
Tue: Industrial Production MoM (FR); Durable Goods Orders (US)
Wed: MBA Mortgage Applications (US);
Thu: Initial Jobless Claims (US); IBGE Inflation IPCA MoM (BZ)
Fri: Change in Nonfarm Payrolls (US); Unemployment Rate (CA); CPI YoY (CH)

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