
MIDYEAR MARKET OUTLOOK

CETERA® INVESTMENT MANAGEMENT

At-A-Glance

The S&P 500 went into a bear market, declining more than 20% from its peak.

The 10-year Treasury yield jumped over a percentage point this quarter, reaching as high as 3.5%. Bond returns were also negative, as prices fell when yields rise.

Headline inflation, which includes more volatile food and energy prices, surprised on the upside in May. CPI rose 8.6% year-over-year.

The Fed, which normally focuses on core inflation, started to pay more attention to the volatile headline inflation. They got aggressive in tone and action, raising rates by 0.75% in June.

Recession risks have increased as the Fed's aggressive pace could cause policy missteps if it raises interest rates too fast and slows down the economy more than needed. The Fed is late to curbing inflation, however, and is running out of options.

Bearish market sentiment is high and upside surprises are possible. The first year of a bull market tends to offer outsized returns, so investors should stick to investment objectives.

2022 MID-YEAR OUTLOOK

Fed Uncertainty Grows

Overview

Much of investors' attention this quarter has been on stock markets, as the S&P 500 went into a bear market, defined by falling over 20% from its most recent high. This is unsettling for many, but it is important to see through the noise and focus on fundamentals and the longer-term outlook. Long-term stock returns are driven by corporate earnings, which are impacted by the state of the economy. Investors currently fear persistently high inflation and the [U.S. Federal Reserve's](#) (The Fed's) response to it. So, as investors, we must ask ourselves how these factors will impact the economy, and thus corporate earnings? While complicated, the analysis might be less complex than previous years, as the U.S. government likely won't try to save the day by surprising investors with another round of stimulus.

The U.S. economy is slowing quickly, with growth being hamstrung by current Fed actions and the expectation of further Fed actions. We are currently seeing this in housing data, and there are fears we could be in a recession already. Higher food and energy prices may slow overall consumption.

The good news is that the labor market is currently very strong. If job losses and hiring freezes start to occur, we may benefit from unemployment starting from a very low point, which could make for a milder recession.

A recession may also be already priced into equity markets, as valuations have fallen from high levels back to their 15-year averages. Corporate earnings remain strong but will likely trend lower as inflation and slow economic growth eat into corporate profits.

In bonds, yields have risen dramatically, causing large price declines. The bond market is forward-looking, and the Fed is pricing in further rate hikes. We note that longer maturity bond yields have increased less than yields of shorter maturity bonds. If a recession occurs, longer maturity bond yields may fall due to a slower growth outlook. This could help drive bond returns that already offer much higher current yields than a year ago.

It has been a tough year thus far for investors as the markets price in recession risks. It is important to point out that recession data is historically based. In other words, we could be in a recession right now and not know it until after the recovery has started. And it is also possible to see positive equity returns in a recession as investors look to the recovery. On a positive note, bearish sentiment is currently high, which can be a potential contrarian indicator for a better entry point. Put another way, when too many people are pessimistic, that can be a sign of a market bottom. Additionally, there could be positive upside surprises if there is a resolution in the war in Ukraine and/or if the Chinese government further eases its restrictive zero-COVID policies.

We want to reiterate our recommendation to diversify across asset classes, sectors, and countries, while adhering to long-term risk and return objectives. Your financial professional can help you stay on track and keep focused on your personalized long-term plans, helping you navigate this market volatility.

Global Economy

Much of the current market fears are centered around the Federal Reserve. Investors fear the Fed, which is now behind the inflation curve (as we discussed in detail in our last outlook) and is now getting aggressive in raising interest rates to fight inflation. Raising interest rates too quickly, or more importantly, too high, could slow the economy too much. The financial media describes this as a “hard landing.” A “soft landing” is the desired scenario, where the Fed can raise interest rates but not cause a recession. With all these fears around a recession, it is important to define what it is that we fear so much.

What is a Recession?

Many define a recession as two consecutive quarters of negative real gross domestic product (GDP) growth, but this is not the technical definition. The National Bureau of Economic Research (NBER) gets the honor of declaring a recession based on “a significant decline in economic activity that is spread across the economy and that lasts more than a few months.” Notice both definitions are backward looking. We will not know if we are in a recession until after it begins. And it is quite possible to be out of a recession by the time we are announced to be in one. Even then, we would likely not know that we are out of the recession at that time. That may not be as complex as time travel, but it is confusing. We will discuss forward-looking markets more in the equity and bond market sections.

Sometimes we learn more from informal definitions. The 33rd President of the United States, Harry Truman, described a recession as when your neighbor loses their job, and expanded that it is a depression when you lose *your* job. While this was used as a funny quip at the time, he has a point. When people are employed, or do not fear losing their jobs, they tend to spend money and the U.S. economy, which is roughly 70% based on consumer spending, grows. Every recession is different. The cause, the magnitude, the length, and the strength of the economy before the recession are all very important factors. How each of these impacts the labor market is also different. We will dive deeper into these individual factors below.

Current Economy

So, where do we stand now? In 2021, the U.S. economy grew to a record \$23 trillion, a 5.7% increase from the year prior. This represents the total market value of all the finished goods and services produced in the United States. We do not discount that GDP contracted by 3.4% in 2020, so this high growth number may be coming off low numbers, but the growth rate from last year is not sustainable. Perhaps the U.S. economy grew a bit too fast, propelled higher by two massive stimulus bills early in the year.

Labor Market

Last quarter, we wrote about the strength of the labor market. There are currently more than 5 million job openings than unemployed individuals. This is an unprecedented record, since in a typical economy, there are more unemployed individuals than job openings. The current unemployment rate is a low 3.6%, making for a tight labor market. If there were a recession and the labor market softened, the good news would be that we are starting from a very good place of low unemployment. We reiterate, when people are employed and do not fear losing their jobs, they tend to spend money.

Fed Funds Rate

An economic slowdown may come, due to increased borrowing costs caused by the Fed raising interest rates. The Fed has been raising short-term interest rates from zero, and they currently sit at 1.50% to 1.75% after the most recent hike of 0.75% in June. Notably, this large of a hike has not been implemented since 1994 when the Fed raised rates by the same amount, and it was also one of the few times monetary policy tightening did not lead to a recession. The Fed’s current dot plot shows future interest rate projections from its voting

members. The current median projection for the Fed Funds rate at the end of this year is 3.4%, and 3.8% in 2023. While that seems high coming from a starting point of zero, we forget that the Fed Funds rate was 2.4% in 2019, and over 5% in 2007 and during much of the 1990s. A 3% Fed Funds rate is not that high relative to history. We became accustomed to a zero Fed Funds rate after the Great Financial Crisis when the Fed implemented ZIRP (Zero Interest Rate Policy). It is possible for the economy to do well in this higher-rate environment.

Inflation

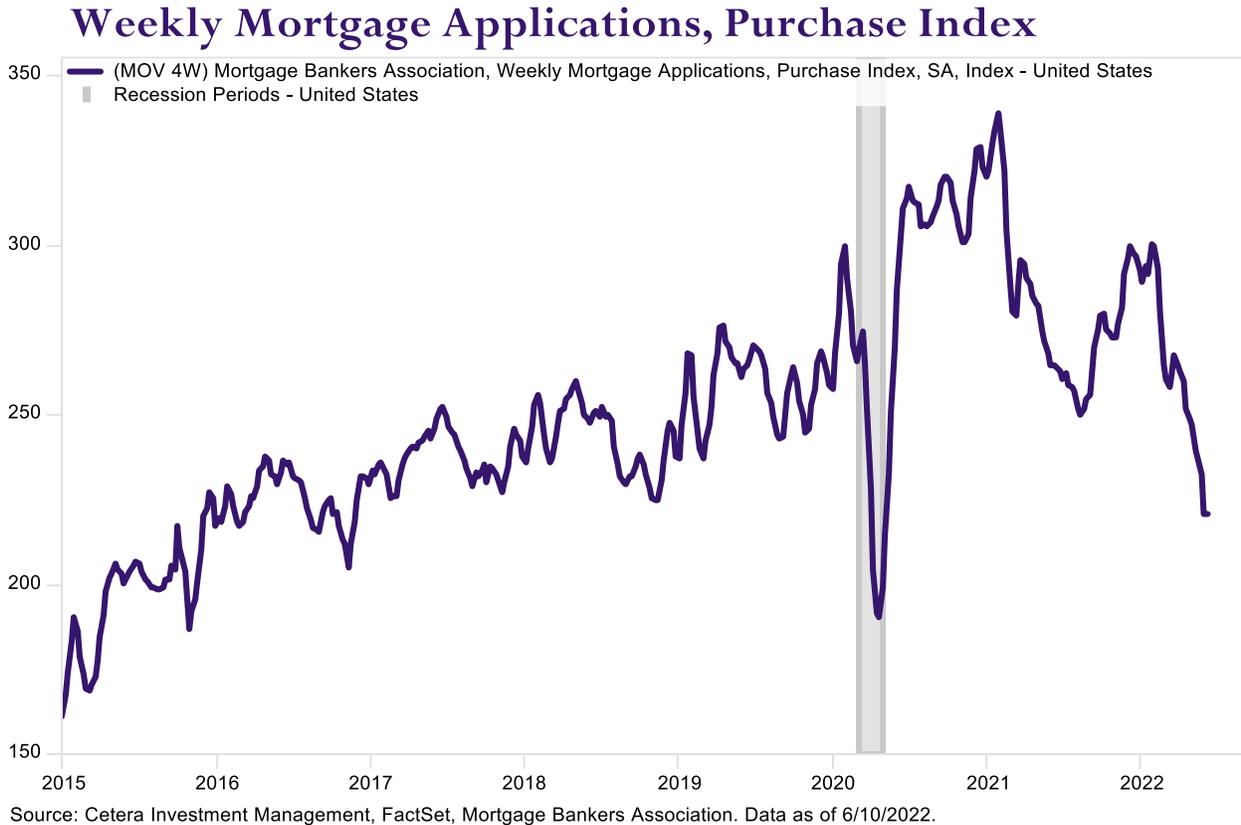
The key question comes down to what level of the Fed Fund rate will squash inflation. May's inflation data surprised many, including us, rising 8.6% year-over-year. Like many, we thought we could have seen peak inflation in March when it hit 8.5% and eased in April to 8.3%. Again, these are year-over-year numbers, so the monthly inflation for March, April, and May were 1.2%, 0.3% and 1.0%, respectively, which are high levels of monthly inflation. Food and energy prices soared, pushing headline inflation up. However, core inflation which strips out these volatile elements was up 6% year-over-year in May, slowing from 6.5% in March and 6.2% in April (year-over-year). A possible Fed policy mistake could be in these details though, as a focus on headline inflation may cause the Fed to overtighten even though core inflation is slowing.

The Fed had long targeted core inflation, but in his latest press conference, Fed Chairman Jerome Powell seemed to shift away from focusing on core inflation, placing an emphasis on headline inflation. He admittedly acknowledged the Fed has less control over the global factors driving food and energy price increases but would try to fight them by squashing their demand. In other words, he is willing to sacrifice the labor market and economy to lessen demand, and hopefully slow the pace of inflation in food and energy. Surprisingly, the market rallied the day of his press conference, but reversed course and fell sharply the following day. This could potentially be a [huge policy mistake](#) and we will continue to monitor this new emphasis on headline inflation.

Digging further into the May's CPI report, a more persistent inflation driver was revealed. Shelter costs make up 32% of overall CPI and 41% of Core CPI. These costs rose 0.6% in May, the fastest pace since March 2004. Housing activity increased during the pandemic, accelerating price growth and driving inventory to the lowest level on record earlier this year. Housing inventory has been trending lower since the fallout of the Great Financial Crisis. After 2008, there was an excess supply of housing, so builders and developers slowed the pace of construction. Though activity picked up toward the end of the prior expansion, there was a shortage in housing relative to demand, driven by favorable demographics. The COVID-19 pandemic made matters worse when builders halted production, and then lumber prices and supply chain shortages prevented them from completing homes.

The housing market is likely to look a lot different in the second half of the year. Home construction activity is now at historically elevated levels, and more completed inventory will come to market in the months ahead. The pace of rapid home price appreciation is likely to slow because borrowing costs have surged since the end of last year, impacting affordability for new entrants into the housing market. Inventory of new and existing homes is likely to increase in the coming months, but we are unlikely to see inventory climb to normal levels this year, by historical standards. Rising rates have already dented activity, as seen in mortgage purchase applications in **Figure 1**. Many potential buyers have reached affordability ceilings, and we are likely to see home price appreciation slow rapidly through year-end.

Figure 1: Weekly Mortgage Applications (Moving Four Week Average)



Other inflation drivers should continue to abate. Supply chain disruptions are now less frequent, and we also see a decline in freight costs. The labor market is strong but could weaken as companies fear a recession. Evidence of this can be seen as some companies have made news with hiring freezes and talk of layoffs. This demonstrates that the Fed's interest rate increases and telegraphed future actions are already influencing companies and their future decisions.

Base effects will also continue to slow the pace of inflation on a year-over-year basis. When looking at prior years, if prices were already high last year, it makes it more challenging to outpace by an outsized level of growth. This is what the Fed has been referring to as "transitory", to some degree. The Fed initially thought much of the inflation would be one-time blips on the chart and not sustained. While they may have been wrong about this, there are areas in the economy where they may be right. We are seeing used car prices falling already and as it relates to supply-side disruptions, these impacts may well be transitory.

Global Inflation

High inflation is not unique to the United States. Eurozone inflation hit a record 8.1% year-over-year in May. Economists were surprised, as they were anticipating lower inflationary growth closer to April's 7.4% inflation figure. This is demanding a response from the European Central Bank (ECB), which is expected to raise rates by 0.25% in July and be out of negative rate territory by September. Currently their deposit facility remains at -0.50%. London based Research Firm Capital Economics forecasts Eurozone GDP to be 2.3% in 2022 and

1.8% in 2023. Meanwhile, they forecast U.S. GDP growth of 2.8% in 2022 and 1.5% in 2023. So, growth is expected to be lower this year for Europe but greater than the United States next year. Remember, Europe is more impacted by the war in Ukraine and the food and energy disruptions that are resulting from it.

Capital Economics also forecasts China's growth to be 2% this year and 6% next year. This forecast is not based on official Chinese data, as they attempt to get a more accurate reading. CPI was only 2.1%, year-over-year in May. This is partly attributed to China's zero Covid policy that forced many cities into lockdowns and halted economic growth. It does appear that China is willing to loosen this policy, which could open supply chains and help the Chinese economy.

Equity Markets

Fears of a recession and inflation have many worried about corporate profits, which drive long-term stock returns. However, recessions are a normal part of an economic cycle. Coming off the longest expansion in U.S. history from 2009 to early 2020, we've grown used to expansions being long. While we often try to understand if and when a recession could be coming, timing a current recession is difficult. Keep in mind financial markets are forward-looking and expectations can often overshoot reality. This is explained in behavioral finance.

Behavioral finance studies the effects of psychology on investors and financial markets. Fears and hopes are often overblown, and even when fears come true, they are often not as bad as was expected. Likewise, when our hopes come true, they are usually not as good as we anticipated. That is one reason Friday is many people's favorite day of the week. The anticipation of the weekend is better than the weekend itself. Likewise, Sunday ranks higher on people's least favorite day of the week, as many do not look forward to the work week (No surprise: Mondays are still the worst!).

Last quarter, we wrote about the importance of the Fed, how they got so far behind inflation, and why they will have to be more aggressive going forward. Markets have now caught up to this idea and could be already pricing in the expected slowdown. Stock markets tend to fall when leading into a recession because of the anticipation. Stock markets can even be positive in the recession period itself as investors are already anticipating a recovery. This makes timing very difficult, and markets often overshoot to the downside and upside. As mentioned, many times we do not even know if we are in an economic recession or recovery until after we are out of it and can measure past economic data. It is important to remember that the best long-term returns can follow large market declines. As seen in **Figure 2**, returns were large a year after the last six bear markets ended.

Figure 2: Returns at the Beginning of a Bull Market

1-Year Return (%)				
Bull Market Start Date	Large Cap Growth	Large Cap Value	Small Cap Growth	Small Cap Value
Aug-1982	62.2	61.1	99.3	89.6
Dec-1987	18.1	28.5	26.7	33.1
Oct-1990	36.4	27.0	50.8	40.0
Oct-2002	35.5	40.2	67.3	55.1
Mar-2009	68.1	78.3	88.3	98.8
Mar-2020	85.3	78.9	117.2	121.8
Average	50.9	52.3	74.9	73.1

Source: Cetera Investment Management, Morningstar, Russell Investments. Returns shown are total return, which includes dividends. Large cap stocks are represented by the Russell 1000 index. Small cap stocks are represented by the Russell 2000 index.

Corporations have been largely passing inflation on to consumers and maintaining their profit margins, but there comes a point where they can no longer continue to do so. That is happening now, and input costs, including labor costs, are taking a bite out of profits. If we look at earnings growth projections, 2021 was a great year for corporations. Obviously, it was not sustainable, and earnings growth is projected to slow to 10.3% in 2022. Like GDP growth, perhaps earnings grew too fast last year. In **Figure 3 you can see** that this projection is still higher than most years from 2010-2020.

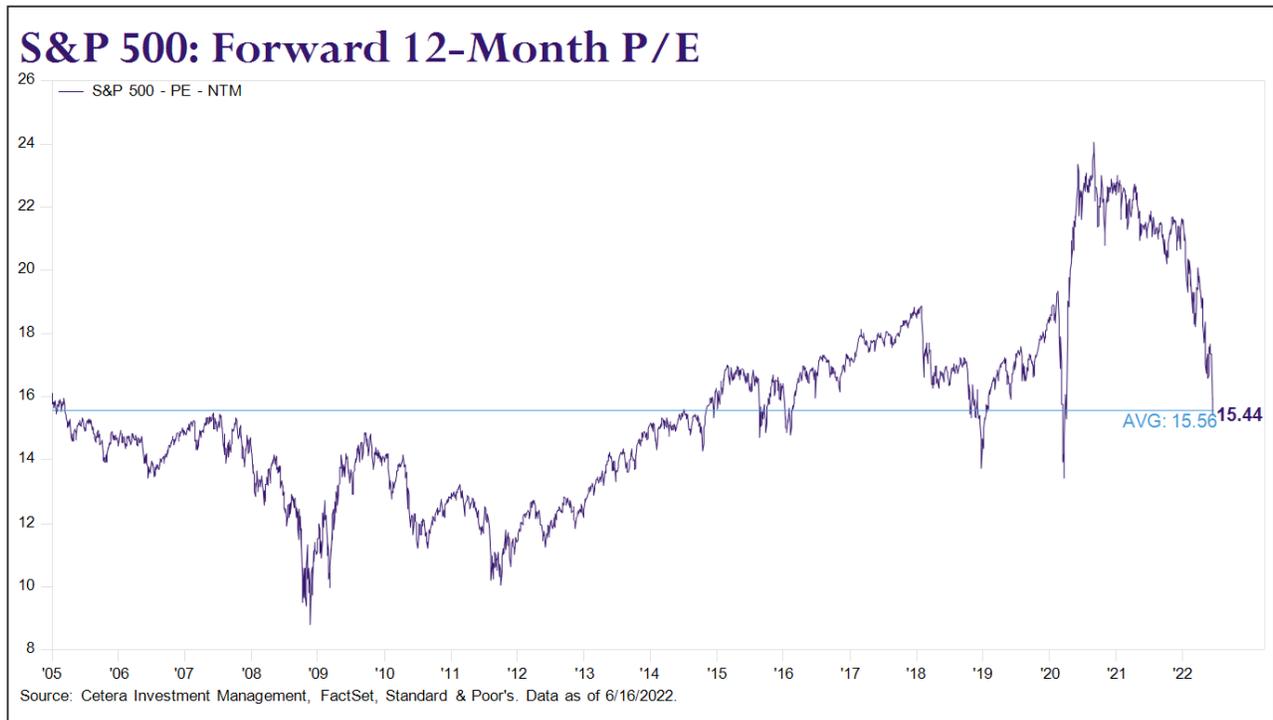
Figure 3: Corporate Earnings



Source: Cetera Investment Management, FactSet, Standard & Poor's. Earnings growth is represented by the year-over-year change in S&P 500 EPS. Data as of 6/15/2022.

While stock prices are falling and earnings have been holding steady, valuations are also falling. Stock prices relative to earnings or price-to-earnings (P/E) ratios have fallen below their 15-year averages for the S&P 500. Coming into this year, they were near 15-year highs. Valuations can remain dislocated for long periods of time, so investing based solely on valuations is a tough endeavor, however, valuations can be a determinant for long-term returns. Like other things in life, not overpaying can be important. **Figure 4** shows the S&P 500 forward 12-month P/E over time. Forward P/E just means it is looking at the projected 12-month P/Es rather than the last 12-months. Keep in mind that earnings projections can fall, making forward-looking guidance inflated in hindsight, which happens when growth slows faster than expected.

Figure 4: Stock Valuations



As we move along in this Fed rate hike cycle, we continue to expect more rate volatility. The Fed tried to engineer a soft landing that will not cause a recession. It tried to telegraph a slow pace of interest rate hikes so it would not overshoot and unnecessarily hurt the economy more than required. The recent CPI data changed this plan. The Fed can no longer take the slow path and instead must take more aggressive actions and risk overshooting and hurting the economy more than necessary. Investors reacted to this new plan and will continue to react to the Fed as it pivots through this rate-hike cycle.

Abroad, valuations are better than the S&P 500. International developed markets have a trailing P/E ratio in the 33rd percentile over the past 15 years (as of May 31). This means they have only been lower 33% of the time. Emerging market equities have even lower valuations and are in the 22nd percentile over the last 15 years. That being said, both markets have perhaps more challenges than the United States. As mentioned, Europe will be more impacted by the Ukraine war, and China's zero COVID policy is limiting its own economic growth. China makes up a third of the emerging market equity index and the Eurozone makes up roughly 50% of the developed international index weight.

We currently favor U.S. equities over other international equities. However, it is good to diversify as there could be upside surprises around the war in Ukraine and Chinese policies around COVID. We believe that the service area of the economy will continue to recover and outpace the goods-driven sector that did so well at the start of the recovery. We expect volatility to continue, so being well diversified is important.

Fixed Income

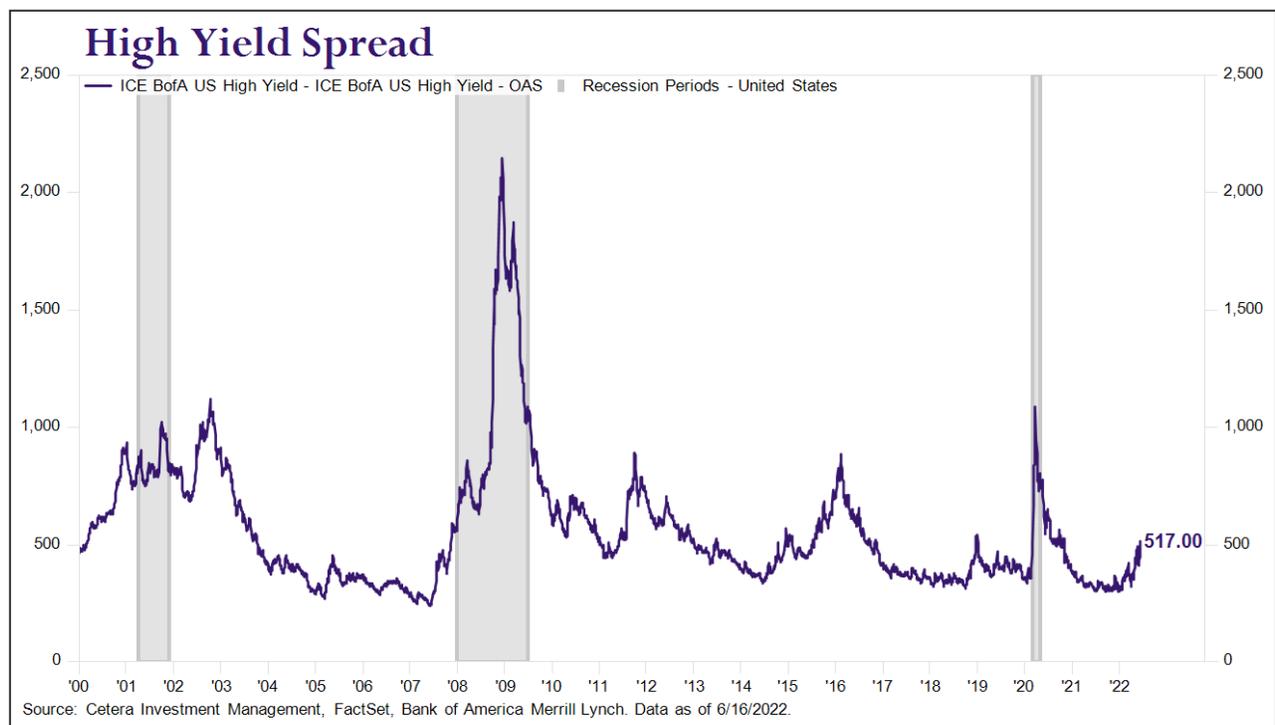
Overall, the aggregate bond index is down over 10% this year. Bond prices continued their decline in the second quarter as yields rose higher. The 10-year Treasury yield started the quarter at 2.32% and went up

over a full percentage point to 3.43% the day before the Fed meeting, which took place on June 15. The 10-year Treasury yield is important because it correlates well with 30-year mortgages. As such, the average national 30-year fixed mortgage rate went from around 3.25% to start this year to over 6%. We already see the impact on the housing market as housing starts plummeted by 14.4% in May.

The Fed has a direct impact on short-term bond yields as they are tied closely with the Fed Funds rate. This has sent the 2-year Treasury yield shooting up. It started the year around 0.75% and is now 3.2%. Even though longer bond yields have also risen, the impact from the Fed Funds rate becomes less as the bond maturity rises in years. As mentioned, the 10-year Treasury yield rose about a percent to 3.43%. We mention this again, because the spread between the 2-year Treasury yield and 10-year Treasury yield can be an indicator for a future recession. If short-term yields become higher than long-term yields it could mean that longer-term growth prospects are lower.

The bond market can be a good prognosticator of the stock market. But if we look to another area of the bond market for clues, it is currently giving us mixed results. Credit spreads, and specifically high-yield credit spreads, can blow out ahead of a recession. Going into a recession, high-yield investors anticipate defaults and/or downgrades and demand additional yield on top of Treasuries, which are backed by the U.S. government. During much of the stock market volatility, high-yield spreads have increased, but haven't shot up as much as high-volatility environments in the past. They have been ticking higher (slightly above 5% spreads) but not close to levels seen prior to other recessions as seen in Figure 5 (2001: 10%, 2008: 19% and 2020: 8%).

Figure 5: High Yield Spreads



The big question for bond investors is how to adjust to this environment, as one is not compensated much more for holding long maturity bonds, which have a higher interest-rate risk. They go down more when their

yields rise. Additionally, bonds with more credit risk, such as high-yield bonds, are paying a higher yield, but there is potential for further spread widening, which would cause these bonds' prices to fall.

We currently recommend being underweight duration, which means investing less in longer-term bonds and more in shorter-term bonds. However, we are adding duration as yields go higher. Having duration and bonds in a portfolio can protect against stock market volatility. This has not been the case most recently, as higher bond yields (bond prices move the opposite direction) have been partly to blame for falling stock prices. Higher borrowing costs are not good for corporate profits. We do like corporate fundamentals, so a small percentage of high-yield bonds add to a portfolio's yield. We are overweight investment grade corporate bonds, which offer less yield than high-yield bonds but more than Treasuries. When constructing a bond portfolio, your financial professional can help you build a portfolio that suits your specific goals and objectives.

The Bottom Line

We are now in the middle of a Fed rate hike cycle and uncertainty is high. The Fed seemingly targeting headline inflation only adds to uncertainty as the Fed has little control over this more volatile metric that includes food and energy inflation. The chance of a Fed misstep has also increased, as the pace of hikes has sped up. Investors have reacted to this new information, and stocks and bonds have fallen. There is an opportunity for upside surprises if there is resolution in Ukraine and if Chinese COVID policies are eased. Additionally, the Fed is already influencing the economy as corporations announce hiring freezes and layoffs. We also see this in surveys of business leaders in both the manufacturing and servicing sectors. The Fed could already be influencing inflation by its strong messaging, even if its influence on food and energy prices may be somewhat limited.

Stock prices relative to their earnings have fallen below the 15-year average, which improves valuations. In bonds, yields have risen, and are now offering much more attractive yields. Also, as yields rise, the risk of them rising further lessens. During this simultaneous pullback in both stocks and bonds, many arguably overpriced parts of the market are now more attractive. Currently, bearish market sentiment is very high, which can ultimately be a bullish predictor. No one has a crystal ball on what direction markets will go next, but investors should not lose sight of their investment goals and objectives. And remember, market volatility is normal.

When investing it is important to ask yourself, what has changed? Have your goals and objectives or risk tolerance shifted? Allocating a portfolio based on market volatility alone is usually not a good idea. It is easy to get lost in the noise of the markets. The human element of investing is very important and often overlooked in this era of automation. Your Cetera financial professional can help you through these volatile times to keep you focused on your personal goals and objectives.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Dow Jones Industrial Average is a price-weighted average of 30 U.S. blue-chip stocks traded on the New York Stock Exchange and NASDAQ. The index covers all industries except transportation, real estate and utilities.

The NASDAQ Composite Index includes all domestic and international based common type stocks listed on The NASDAQ Stock Market. The NASDAQ Composite Index includes over 2,500 companies, spanning all 11 sector groups.

The ICE BofA US Corporate Index tracks the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market. Securities must have an investment grade rating and an investment grade rated country of risk. Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of \$250 million.

The ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. To qualify for inclusion in the index, securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch) and an investment grade rated country of risk. Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of \$100 million.