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2022 MID-YEAR OUTLOOK

Fed Uncertainty Grows

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 fall 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.

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. Read our full Outlook here.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter. Don't forget to check out new clips discussing what may move in the markets in *The Week Ahead*.

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Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

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.