# THE PORTFOLIO STRATEGY GROUP, LLC

50 MAIN STREET
SUITE 1280
WHITE PLAINS, NEW YORK 10606

TEL: (914) 328-6660
(800) 535-5110

FAX: (914) 328-6670


## Second Quarter Commentary

**July 6, 2022**

Equity markets had another volatile quarter. Weeks of declines were interrupted by sharp and short-lived rallies. The S&P 500 was down 16.1% in the quarter, and all major indices were down double digits. Value outperformed growth for the second straight quarter. Large cap value performed best, down 12%, while Mid cap growth was the worst performing index, down 21%. Developed international equity was down 14.5%, while emerging markets declined only 12.4%. Gold declined 6.5%, while Bitcoin fell 59%. Hedge funds also declined, though most were down much less than the market.[1]

Year to date, the S&P 500 was down 20%, the worst first half of any year since 1970. All growth indices were down more than 28%, while value indices were down 12-15%. High quality value stocks with strong growth and growing dividends were some of the best performers after being ignored by the market the last few years. Developed international was down 20% and emerging markets declined 19%. Gold was down 1%, while Bitcoin was down 61%. Long/short equity hedge funds were generally down less than equity markets, and distressed and credit funds were down less than bond indices.[1]

Treasury yields continued to rise in the quarter. Inflation accelerated, the Federal Reserve (the Fed) raised the overnight lending rate twice by a total of 1.25%, and markets adjusted for additional rate increases. Corporate bond indices were down ~4%. High quality bonds outperformed junk bonds and spreads versus Treasuries widened. Municipal bonds declined considerably less than corporate bonds. While bond values are down significantly year to date, investors who hold individual bonds to maturity earn positive returns over the life of the investment.[2] The following are Treasury yields for various maturities:

| Maturity* | 12/31/2021 | 3/31/2022 | 6/30/2022 |
|---|---|---|---|
| 3 Month | 0.05% | 0.52% | 0.64% |
| 2 Year | 0.73% | 2.29% | 2.96% |
| 5 Year | 1.26% | 2.42% | 3.04% |
| 10 Year | 1.51% | 2.32% | 3.01% |
| 30 Year | 1.90% | 2.45% | 3.18% |

*FactSet

Inflation was the catalyst for the sharp equity declines and higher yields in the quarter. The Fed's stated inflation target is 2%. The Fed had tolerated higher inflation over the last year because pandemic induced price increases had been seen as "transitory." On June 10, the Consumer Price Index (CPI) report showed headline inflation at 8.6%, higher than expected, and indicated inflationary pressures had broadened out to most consumer categories. The 2-year Treasury yield rose 0.61% and the 10-year Treasury yield rose 0.39% from June 10 to June 15, and the S&P 500 fell 10.7% from June 9 to June 16.

---

[1] Large Cap Value is Russell 1000 Value; Mid Cap Growth is Russell Mid Cap Growth; Developed international is MSCI EAFE NR USD; Emerging markets is MSCI Emerging Markets; Value indices include the Russell 1000 Value, Russell Mid Cap Value and Russell 2000 Value, Growth indices include Russell 1000 Growth, Russell Mid Cap Growth and Russell 2000 Growth

[2] Bonds offer relatively attractive returns for the first time in years.

The Fed, which had until this point been expected to raise the overnight rate 0.50% on June 15, instead raised it 0.75% and expressed a willingness to do whatever is required to bring inflation down.

High inflation coupled with rising interest rates resulted in lower asset prices, at least in the near term. Using mortgage rates as an example: at the end of 2021, the average 30-year fixed rate mortgage rate was 3.33%. A $1,000,000 mortgage would cost the borrower $4,400 per month[3]. Six months later, the rate had risen to 6%, which would cost the borrower $6,000/month[3]. For a borrower who could not afford the higher monthly amount, a $4,400/month payment at 6% equates to a $733,230 mortgage, buying 26.7% less house. We are confident the change in mortgage rates in the table below will cool a hot housing market.

| **Effect Of Rising Rates on Mortgage Payments** | | | | **Effect Of Rising Rates on Affordability** | | | |
|---|---|---|---|---|---|---|---|
| Mortgage | Interest Rate | **Monthly Payment[3]** | **Change In Payment** | Monthly Payment[3] | Interest Rate | **Mortgage Amount** | **Change In Affordability** |
| $1,000,000 | 3.33% | **$4,400** | | $4,400 | 3.33% | **$1,000,000** | |
| $1,000,000 | 6.00% | **$6,000** | **+36%** | $4,400 | 6.00% | **$733,231** | **-27%** |

We believe the Fed will continue to tighten until there is evidence inflation is returning to more manageable levels or the financial system is threatened (like 1998 or 2008). The Fed Funds rate, now at 1.5%, is expected to reach at least 3% by year end. In addition, as of June 15, the Fed stopped buying Treasuries and mortgages as "quantitative easing" transitioned to "quantitative tightening."[4] We do not know what impact this will have on interest rates.

Energy prices have a material impact on inflation and economic growth. Oil and natural gas prices were rising before the Russian invasion due to post-pandemic demand increases. Sanctions on Russian energy have interrupted supply to western countries. Since the beginning of the year, gasoline is up 60% and diesel is up 66%[5]. Higher energy prices seep into the prices of goods and services and cut into profit margins. Since the invasion, the percentage of items in CPI report with price increases of 5% or more excluding food and energy increased from 33% of items before the invasion to 67% in May.[6] Walmart and Target, bellwethers for the American consumer, reported slowing demand and higher costs. Higher food and energy prices lower the quality of life for most Americans. There are fewer dollars to spend on other goods and services. It is difficult to envision significantly lower energy prices until sanctions on Russian exports are removed or the global economy goes into recession. Time will tell if sanctions can be sustained as winter approaches and Western Europe's dependence on Russian natural gas is fully recognized.

On the bright side, US unemployment is still very low, and wages have grown at rates not seen in years. US consumers' and businesses' balance sheets do not appear stressed. Equity valuations are at much more reasonable levels, with many being "on sale" after 30-50% declines. A peace deal between Russia and Ukraine and/or normalization of energy trade would be welcome news. Signs of slowing inflation

[3] Rounded to nearest $10; does not include property taxes or insurance
[4] The Fed will not reinvest Treasury and mortgage interest and principal payments, shrinking its balance sheet.
[5] Source: FactSet; NYMEX RBOB Gasoline and NYMEX NY Harbor ULSD prices, respectively
[6] Source: BLS CPI data from January 2022 and May 2022 (released June 10) and PSG

and/or growth in the US may be treated as “good news” by equity markets (see our intra-quarter update here).

Despite significant declines to start the year, most stock indices are still above pre-COVID highs. Experience dictates avoiding the temptation to time the market or even moving into “obvious” trades. (One example - energy stocks[7] fell 22% from 6/8 – 6/24.) Discerning the difference between a bear market rally and the start of a new bull market is only apparent in hindsight. We expect volatility to continue until inflation expectations settle down. Lower portfolio values can be unsettling. Many high-quality companies are currently down 30-50% and may be great investment opportunities for the long term. In the meantime, bond portfolios provide income, stability, and liquidity, while alternative investments can provide diversification and returns which are less correlated to the stock market.

We want to thank everyone who attended the event we held recently with Professor Timothy Frye, Marshall Schulman Professor of Post-Soviet Foreign Policy at Columbia University. Prof. Frye spoke informatively about the Ukrainian Russian war and took numerous questions from the in person and virtual audiences. The replay is available here.

[7] Source: FactSet: Energy Select Sector Fund ETF (“XLE”), which represents the energy components of the S&P 500.