VWG WEALTH MANAGEMENT
A Hightower Company

VWG Wealth Management 2022 2nd Quarter Review

Executive Summary

- An extremely complex combination of factors weighed on prospects for the global economy in the 2nd quarter. The Ukraine war, partial COVID-19 shutdowns in China, continuing supply chain shortages, tight labor markets, spiking oil and gas prices all threatened stability and the outlook for future growth.
- As measures of inflation spiked far beyond expectations, the Federal Reserve and global central banks aggressively pivoted with immediate and projected future interest rate increases. Gloom has engulfed global financial markets, as fears over the economic damage that surging inflation could cause confronts fears over the likely central bank responses to that surge.
- U.S. bonds are on track for their worst calendar year decline since 1972. The Bloomberg Barclays Aggregate Bond Index has fallen 10.2% this year. By the middle of June, the total value of the U.S. bond market draw down was close to $3 trillion.
- U.S. and global stocks were broadly and relentlessly liquidated. The S&P 500 Index fell in 11 of the quarter's 13 weeks, dropping 16.1% for the quarter and 19.9% this year. International stocks fared no better.

- Acute attention was focused on rising energy prices which helped drive inflation higher. Tight global crude markets were further strained by partial sanctions on Russian oil. Rolling COVID-19 lockdowns reduced Chinese refinery output while global demand for refined products firmed.
- Though counterintuitive, fears of a coming recession means that a lot of bad news could be already priced in. Sentiment is extremely poor. Asset prices are becoming increasingly attractive.
- VWG urges investors to employ specific behaviors and actions to successfully navigate through the current economic and market stresses. Patience will be required. It is important to stay focused on durable long-term investment strategies and entrepreneurial operators. Attractive opportunities will be presented.

Review of the Markets

The speed and magnitude of the second quarter's U.S. bond market losses have been astounding. This year's decline in the Bloomberg Barclays Aggregate Bond Index is *almost four times* the prior worst half-year performance for U.S. bonds dating back to 1976. It fell 4.6% this quarter and has declined 10.2% this year. Per the Bespoke Investment Group, more bond market wealth has been drawn down this year than *any other period on record* *(with the proviso that dollar changes in asset values rise over time with the size of the economy).*

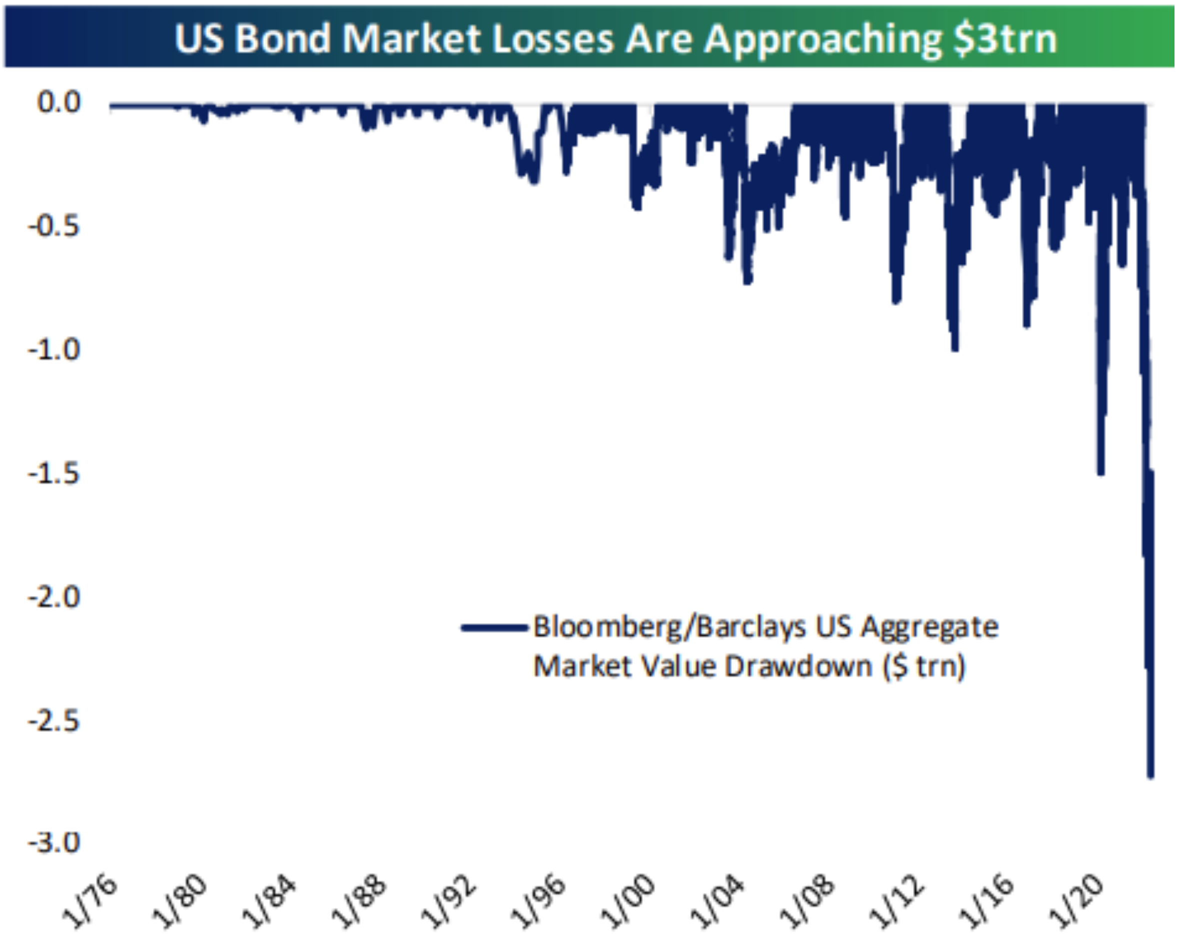
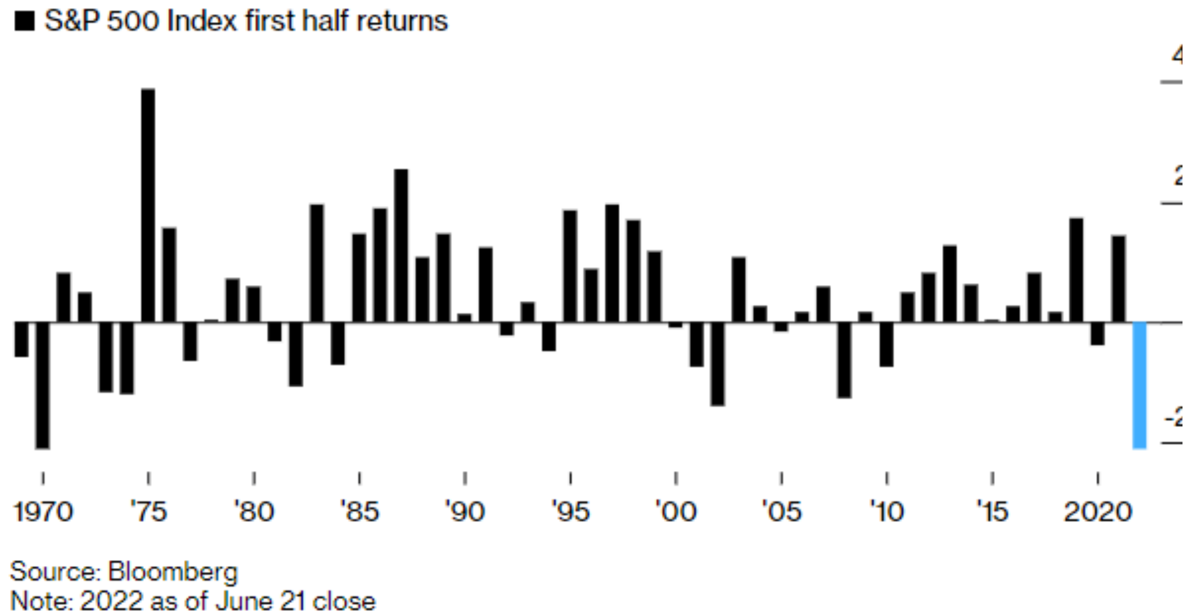


Chart courtesy of Bespoke Investment Group, data as of June 15, 2022

Reacting to rising yields and quickly tightening financial conditions, high yield bond spreads *(the difference between the yield of a computed high yield bond index and the spot Treasury yield)* widened to above 5.0%. This level has historically illustrated elevated recession risk. The Bloomberg Barclays High Yield Bond index fell 10.4% in the quarter and has declined 14.8% year-to-date. Municipal bonds also suffered. The S&P National Municipal Bond Index dropped 2.5% and has fallen 7.8% this year.

Against this backdrop, stocks and almost all liquid assets (including cryptocurrencies) were relentlessly liquidated. The S&P 500 Index fell in 11 of the 13 weeks in the quarter. The average stock in the index is now down about 30% from its 52-week high. The S&P 500 lost 16.1% for the quarter and is down 19.9% for the year. This marks the worst start to a year for the U.S. large stock benchmark since 1970. Small U.S. stocks as measured by the Russell 2000 index dropped 17.3% and is down 23.5% this year.



International stocks fared no better in the quarter. The MSCI EAFE Index, the benchmark for large companies domiciled in developed countries, lost 13.2% for the quarter. It has fallen 18.8% this year. The MSCI Emerging Markets Index is down 17.2% this year, losing 10.4% in the quarter. Equity valuations in some countries have become very compressed as high inflation, fears of sharply rising rates, and a stronger U.S. dollar are pressuring earnings expectations. Brazil, Hong Kong, and Korea stock markets are now trading at less than 10 times trailing earnings.

All attention was on energy in the second quarter. Already tight global supplies of crude oil were further strained by partial sanctions on Russian oil. Global demand for refined products continued to firm, and Chinese refinery utilization tumbled with rolling COVID-19 lockdowns. China has the second largest refining capacity in the world. The European Union scrambled to find alternate sources of natural gas, fearing disruptions of Russian exports. The NYMEX West Texas Intermediate Crude Oil continuous contract added 5.5% in the quarter. It has increased 40.6% this year. Despite the NYMEX Henry Hub Natural Gas continuous futures contract slipping 4.4% in the quarter, it has risen 51.4% this year. The AAA national average mid-grade gasoline price hit $5.28/gallon, up from $3.45 a year ago.

High grain prices softened in the second quarter as optimism grew that 2022's global crop harvests would be able to compensate for any losses from Russia and Ukraine. Despite the Chicago SRW Wheat continuous futures contract falling 5.5% in the quarter, it has still increased 14.7% this year. Industrial metals fell at the end of the second quarter as tightening monetary and liquidity conditions fanned fears over softening future demand. The NYMEX High Grade Copper continuous futures contract dropped 21.9%.

Central Banks Struggling Behind the Curve, Confidence Slipping

2021's robust global economy and financial markets have stunningly downshifted in 2022. A confluence of major shocks has come from multiple directions. Culprits include tightness of supplies and labor, Inflation, the war in the Ukraine, constrained crude oil supplies and refinery capacity, and lockdowns in China.

The bond market first sniffed out increasing inflation stress as the yield of the 10-year U.S. Treasury bill cleared 2.0% in March, and the yield of the 2-year U.S. Treasury rising to pre-COVID levels. This began applying pressure to long-duration assets, as shown by the Nasdaq 100 Index's 9.1% drop in the first quarter. The bond rout accelerated in the 2nd quarter as inflation jumped higher. The COVID-recovery 'transitory' inflation narrative, held by the Federal Reserve and many other observers, was lost. The 12-month change in the U.S. consumer price index soared to 8.6% in May, a level not seen for over 40 years. The 10-year Treasury yield hit 3.0%.

12-month Percentage Change, U.S. Consumer Price Index all items

Shaded areas represent recession, as determined by the National Bureau of Economic Research

Chart courtesy of U.S. Bureau of Labor Statistics

In response, the March, May, and June Federal Open Market Committee (FOMC) meetings increasingly focused on inflation and severe measures that might be required to cool a red-hot labor market. During the quarter fed funds rates were raised three times to 1.50%. The forecasted year-end rate was raised to a range of 3.25%-3.50%. This abrupt change in policy led to fears that excessive rate increases could hurt the U.S. economy, possibly pushing it into recession. Bond credit spreads widened, and bonds, stocks and even crypto assets were persistently liquidated. The Bank of International Settlements (BIS) remarked, “the combination of inflationary and recessionary forces we are currently facing are historically unprecedented.”

Beyond supply shocks, tight labor markets, the war and spiking food and energy prices, some of the blame lies on lax fiscal and monetary policies, and the slow responsiveness to a strong economy. Congress passed a massive $1.9 trillion COVID aid stimulus package in March 2021, after passing a $900 billion package four months earlier. This despite vaccinations ramping up, unemployment falling swiftly, and the economy re-opening. The Federal Reserve continued to push a near zero-rate interest policy until this March. By June’s FOMC meeting when the Fed funds rate was increased 0.75%, inflation was clearly out of control. Bank of America's Head of North America Economics Ethan Harris responded, stating that "our worst fears around the Fed have been confirmed: they fell way behind the curve and are now playing a dangerous game of catch up. His reduced forward expectations are for "a long soft patch, with GDP growth to slow to almost zero, and inflation to settle at around 3%."

The U.S. is not alone. In May, Eurozone inflation hit its highest annual level since the creation of the euro currency in 1999. A record run-up in energy and food prices were stoked by Russia's war in Ukraine. Eurozone inflation is expected to average 6.8% for the entire year, leading a growing number of economists to warn Europe may tip into an outright recession. Dangerous double-digit inflation levels have broken out in Poland and many eastern European countries.

Chart courtesy of Eurostat / New York Times

Against this backdrop, the ECB only just announced the end of quantitative easing and their first 25bps rate increase effective July 21. In response, noted economist Charles Goodhart stated that "virtually all the central banks including the ECB are an awful long way behind the curve." Other global central banks announced strong, unexpected rate increases in June. The Swiss National Bank made their first-rate hike since 2007. The Royal Bank of Australia made their largest hike since 2000.

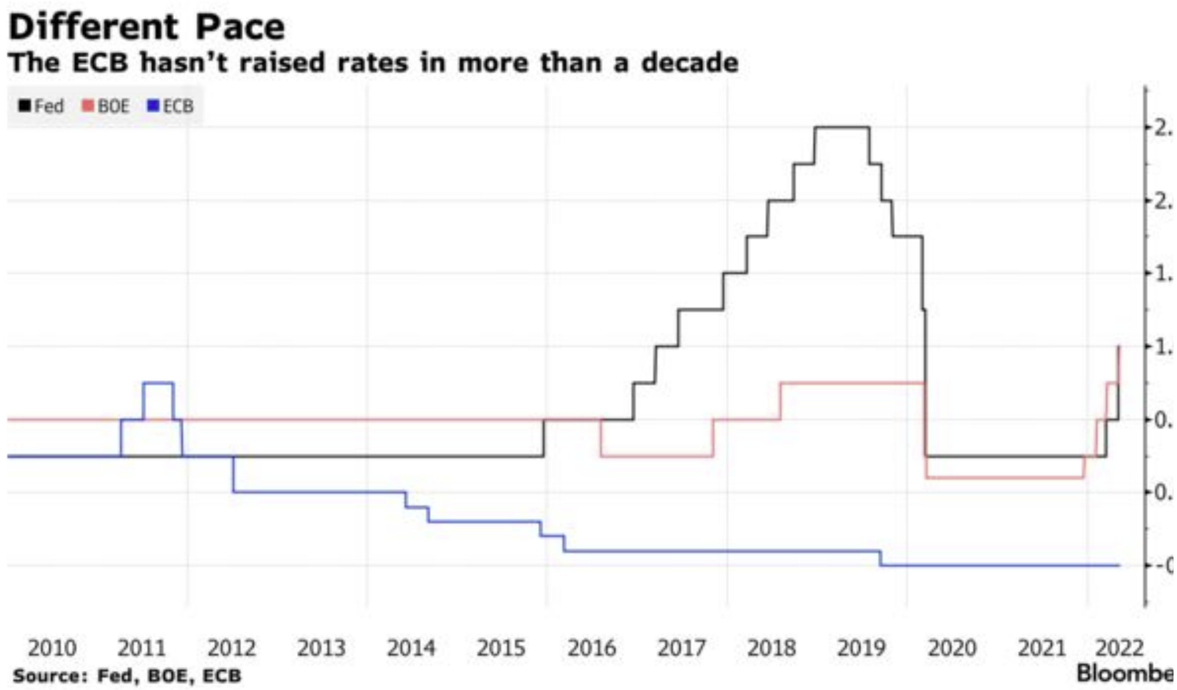


Chart courtesy of Bloomberg

It is quite possible that the persistently accommodative policies of global central banks following the 2008-09 financial crisis laid some of the groundwork to today's sticky predicament. With the aims of stabilizing prices and stimulating growth, quantitative easing (QE), zero interest rate policies (ZIRP), and yield-curve control policies were enacted widely across developed markets. This led to approximately $11 trillion in negative-yielding global debt by the end of 2019. Despite this massive stimulus, targeted levels of growth and 2% levels of inflation were not achieved. It is undeniable that large stimulative monetary and fiscal actions were required to combat the global pandemic. But the behavioral programming of the preceding decade may have helped lead to the late and incorrect diagnosis of a problem that now will not easily be controlled. The unintended consequences of late and rash central bank actions could be damaging to small and highly indebted businesses and countries, and to corporate earnings. Despite slowly emerging from the global pandemic crisis, we could still be in unknown territory.

Portfolio Strategy and Asset Positioning

VWG's primary investment focus is on evaluating and monitoring managers and entrepreneurs who intently focus their indivdual disciplines on growing and protecting our client's capital. When we do consider softening economic conditions, we generally counterbalance strongly voiced concerns with a dose of skepticism, as the tenor of these fears become the loudest after markets have already declined. Two of our favorite quotes comes to mind – *"The stock market has predicted nine out of the last five economic recessions" – Paul Samuelsson. "Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future" – Warren Buffet.*

We also pay attention to respected, experienced thought leaders. Morgan Stanley's Wealth Management CIO Lisa Shalett explained in a recent podcast, "we've always said it's foolish for our clients to guess. Even most of the folks that get paid to do this (including The Fed) have never gotten recession forecasts correct, ever. The fact of the matter is that the best we can do is to try to ascertain direction and relative order of magnitude. Other than that, I don't think we should try to hand wring about where the bottom is and how far will it go and what will be affected until we're in it."

VWG believes that specific behaviors and actions are required to navigate through market stress:

Stay calm and maintain focus on your long-term plan.

Investors who can keep their heads when others around them are losing theirs can better protect capital and be better positioned when difficulties subside. Techniques to hold proper focus include:

- update your financial planning model to ensure you are on track toward meeting your intermediate and long-term goals.
- maintain proper portfolio diversification.
- to increase staying power, certain investors should look for spots to increase portfolio cash and opportunistic ‘dry powder’ by 5% to 10%.
- limit the time you spend with popular media and financial news

Consider that asset prices and investor sentiment are already pricing in a lot of bad news.

Renaissance Macro’s Head of U.S. Economics Neil Dutta was recently quoted saying that “markets have gone a long way to pricing in a recession. Our signs show that if a recession were to occur there are no reasons to believe it would be severe or long-lasting. The market multiple of stocks is reasonable. After this year’s losses, there is no reason to be selling stocks now.” Credit Suisse’s Jonathan Golub adds that “credit spreads have blown out but there’s not a credit problem. Corporations are paying their debts, balance sheets are in excellent shape, there’s no stress. There has not been a downgrade in earnings, although some degradation should be expected. There has been a downgrade in what an investor is willing to pay for these earnings.” Several managers that VWG regularly employ are becoming increasingly excited about public equity valuations.

Consider that ‘bottoms’ most often are not specific points in time and are not a uniform process. The entire U.S. economy, all its industries and businesses, and all stocks do not ‘bottom’ simultaneously. Some stocks may already have been sold out and may have already reached what will ultimately prove to be their ‘bottoms.’ Certain businesses and industries will be able to take advantage of changing economic conditions, re-shoring of critical manufacturing, changing supply chains, and fortifying secure sources of food and energy. Specific idiosyncratic private managers and strategies may be particularly well suited to capitalizing on adversity and volatility. There are always investment opportunities somewhere. In the long-term, visionary entrepreneurs developing and employing transformative techniques and technologies, and the managers that prudently allocate capital to them, will be rewarded. High-quality, competitively advantaged, durable businesses will find ways to prosper.

Harvest tax losses.

The swift decline in bond and stock prices has left many assets and funds trading below their purchase prices. Selling these will record taxable losses (in taxable accounts) that can be used to offset future realized gains, or to prune or reallocate positions in the portfolio. The extensive availability of exchange-traded funds (ETFs) allows maintaining similar net exposure to the sold asset until the 31-day wash sale rule expires, should we recommend that it be repurchased for long-term investment. Please discuss tax loss harvesting and our recommended "tax swaps" with your VWG advisor.

Average into investments seeking long-term appreciation.

Investors under-allocated to stocks and other assets offering long-term growth should set a plan to methodically add to them. Asset prices have fallen significantly, and pessimism is rampant. As Warren Buffet famously stated, *"be greedy when others are fearful."* Economic data and market prices will likely be volatile over the coming months, so the size of positions being added should be small and diversified.

Expect that patience will be required.

The complex set of obstacles facing the global economy, and bruised asset prices, are expected to take time to heal. High levels of inflation may not quickly or smoothly dissipate. Energy and commodity shortages will not be easily cured, even if demand softens.   Very sadly, the Russia-Ukraine conflict could be in for a long slog. But investor patience does not mean "sitting it out." VWG is cautious, and we don't believe that it is time to be aggressively adding to downtrodden assets. However, the current climate is certainly more tilted to fear than to greed. This has our attention, and we are on alert for attractive opportunities. We will contact you if anything needs your urgent attention.

Best wishes for a happy and healthy summer. We look forward to speaking with you soon!

Regards,

VWG Wealth Management

Suzanne, Ashley, Rashmi, Kay, Brandi, Lynette, Ona, Michelle, Ryan, Ryan, Ryan, Susan, Marnie, Justin, Elana, Patricia, John, Rick and Jeff

Who we are

** Index Data and Charts Sourced from FactSet Research, Morningstar, Bloomberg, Strategas Research Partners, U.S. Bureau of Labor Statistics*

Please reach out to us if you have any questions or comments.

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