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Market Commentary

Stocks and Bonds Rally on Hope for a Soft Landing

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Key Observations

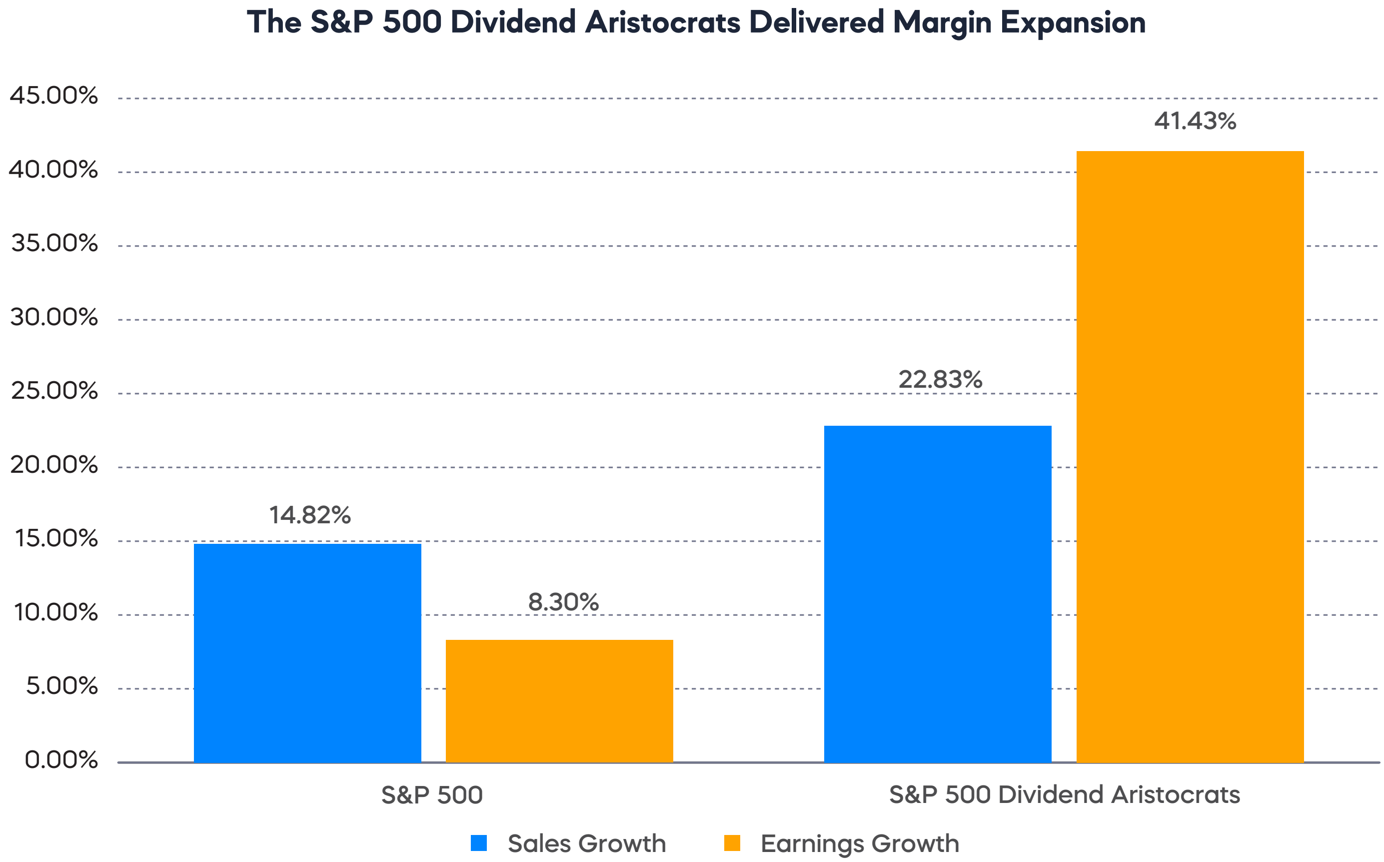
A Soft-Landing Rally

Two straight quarters of shrinking GDP drove a 9% rally in the S&P 500® during the month of July. Let's call it a soft-landing rally. Many investors are hoping that a bit of economic slowdown will convince the Federal Reserve to reign in the path of rate hikes. Among optimistic indicators was the June payroll report that tallied up an increase of 372,000 non-farm jobs.

The rally in stocks was not just driven by reduced fear of the Fed (and lower interest rates across the yield curve), but also surprisingly decent corporate earnings. With second quarter results for nearly two-thirds of the S&P 500 reported, companies have in aggregate exceeded earnings estimates by over 4%. That's not a big number, but for a market that was arguably priced for companies to miss expectations, it was enough.

The coast may not be entirely clear for stocks, however. Many companies seem unable to raise prices enough to overcome their rising costs—so far this earnings season, S&P 500 earnings growth has been less than half of sales growth. Not all stocks suffered from margin compression though. Again, with about two-thirds of companies reporting, the S&P 500® Dividend Aristocrats® have delivered both robust sales growth and earnings growth that was nearly double sales growth.

Chart of the Month

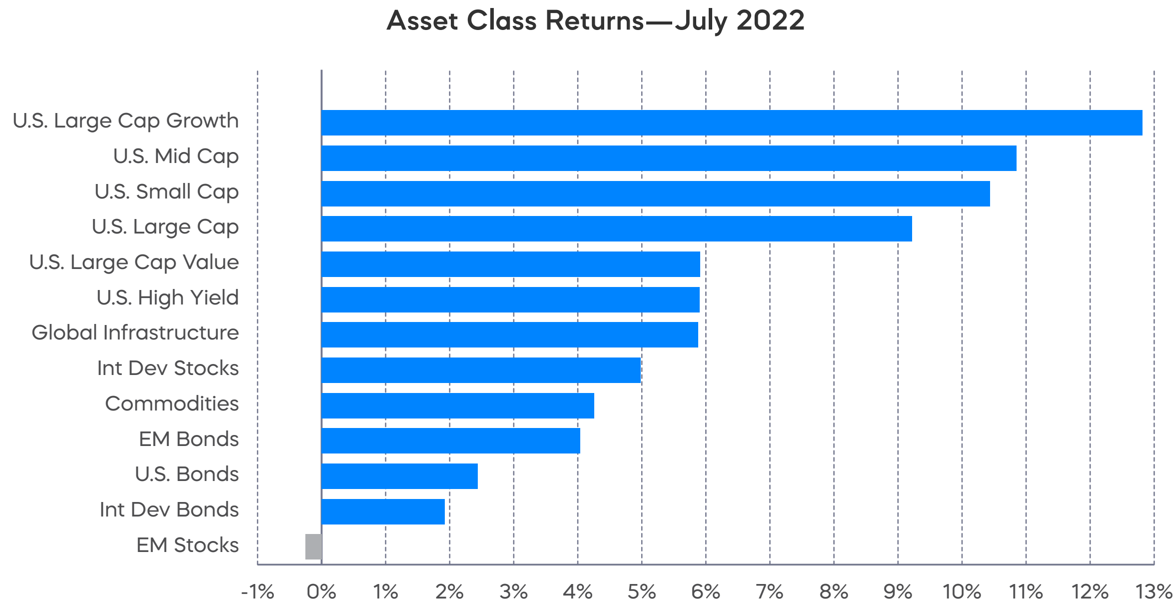


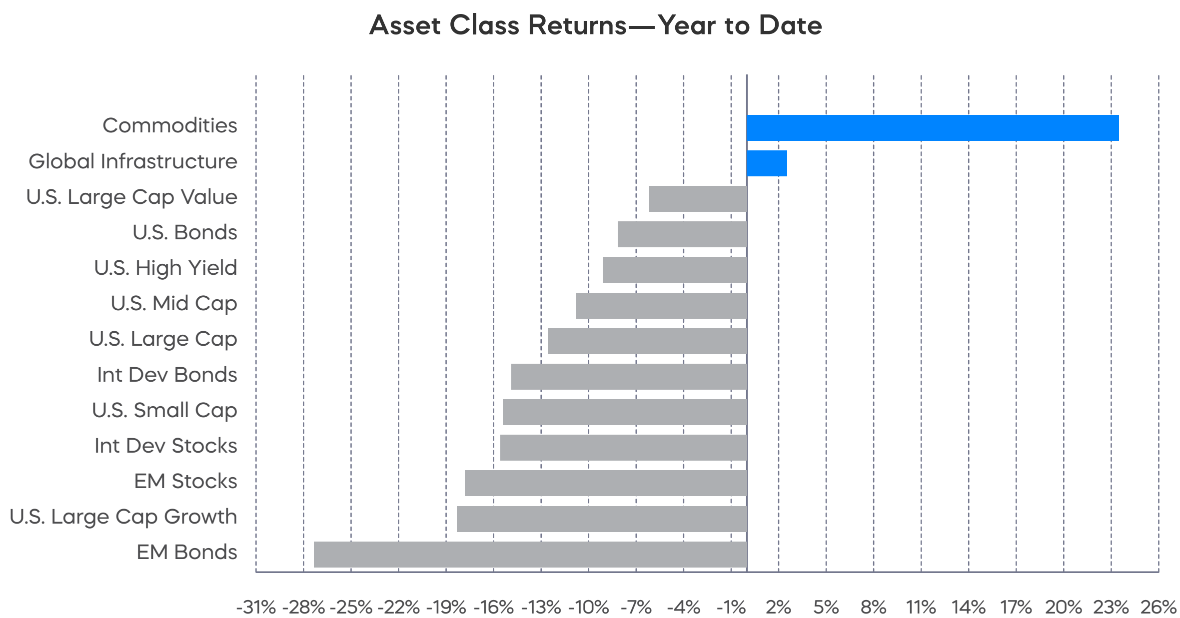
Source: Bloomberg, based on a second quarter earnings analysis that includes all companies that have announced earnings as of 8/2/22 for an earnings period ending between 5/16/2022–8/15/2022. Performance quoted represents past performance and does not guarantee future results. Indexes are unmanaged, and one cannot invest directly in an index.

The coast may not be entirely clear for bonds either. After several months of declines, the 10-year breakeven inflation rate rose roughly 20 bps in July. Wages rose as well. The Bureau of Labor Statistics Employment Cost Index rose 5.1% in June. While that didn't keep up with inflation, it's still a big number. Congratulations to those bond bulls who have gotten the call right since mid-June, but with 10-year U.S. Treasury real yields close to zero again and the pace of Quantitative Tightening accelerating, complacency might not be warranted.

Performance Recap

Returns of Various Market Segments: Is the coast clear?





Source: Bloomberg. July returns 7/1/22–7/31/22; YTD year returns 1/1/22–7/31/22. Performance quoted represents past performance and does not guarantee future results. Indexes are unmanaged, and one cannot invest directly in an index.

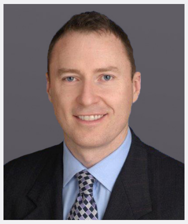
Economic Calendar

Here's a list of upcoming key economic releases, which can serve as a guide to potential market indicators.

Date Time	Event	Prior
08/10/2022 08:30	CPI MoM	1.30%
08/10/2022 08:30	CPI Ex Food and Energy MoM	0.70%
08/10/2022 08:30	CPI YoY	9.10%
08/10/2022 08:30	CPI Ex Food and Energy YoY	5.90%
08/11/2022 08:30	PPI Ex Food and Energy YoY	8.20%
08/11/2022 08:30	PPI Ex Food and Energy MoM	0.40%
08/12/2022 10:00	U. of Mich. Sentiment	51.5
08/12/2022 10:00	U. of Mich. 1 Yr Inflation	5.20%
08/12/2022 10:00	U. of Mich. 5-10 Yr Inflation	2.90%
08/16/2022 08:30	Housing Starts	1559k
08/16/2022 08:30	Housing Starts MoM	-2.00%
08/16/2022 09:15	Capacity Utilization	80.00%
08/17/2022 08:30	Retail Sales Advance MoM	1.00%
08/18/2022 10:00	Existing Home Sales	5.12m
08/23/2022 10:00	New Home Sales	590k
08/25/2022 08:30	GDP Annualized QoQ	-0.90%
08/26/2022 08:30	PCE Deflater MoM	1.00%
08/26/2022 08:30	PCE Deflater YoY	6.80%
08/26/2022 08:30	PCE Core Deflater MoM	0.60%
08/26/2022 08:30	PCE Core Deflater YoY	4.80%
08/30/2022 10:00	Conf. Board Consumer Confidence	95.7
09/01/2022 10:00	ISM Manufacturing	52.8
09/02/2022 08:30	Change in Nonfarm Payrolls	—
09/02/2022 08:30	Labor Force Participation Rate	—

Source: Bloomberg, as of 8/1/2022.

Equity Perspectives



By Kieran Kirwan, CAIA
Senior Investment Strategist

Is Bad News Really Good News?

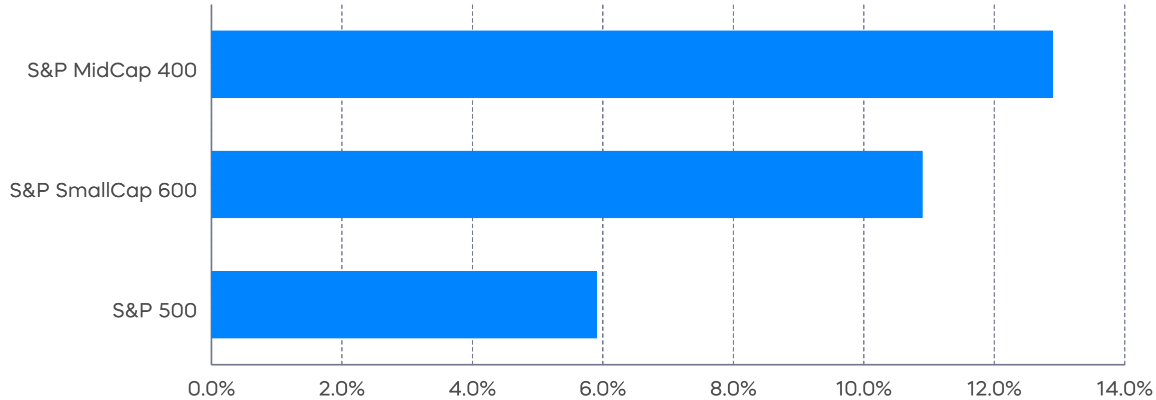
After a first half of the year that was one of the worst six-month performances for equities on record, July brought a welcome rally. The large-cap S&P 500 rose over 9% for the month led by growth stocks, which were among the market's worst performers during the drawdown. Mid- and small-cap stocks performed slightly better. Notably, stocks rallied sharply after the Fed's latest meeting that brought with it the third hike in the Federal Funds Rate. The Fed's statement after the meeting noted a slowing of economic growth and hinted at the potential for a slower pace of rate hikes going forward.

Investors seem to have taken the statement as a potentially dovish pivot in the Fed's outlook on monetary policy. It's also a reminder of the "bad news (slowing growth and consumer spending) is really good news (more accommodative conditions)" scenario from a few years ago. Such a dynamic may be supportive of risk assets in the near term, but not likely over the longer term. Caution remains warranted. Even if we are on the downside of peak inflation, we're still likely to see higher readings for the next several quarters, and therefore, a vigilant Fed.

Mid-Cap Stocks Are Delivering

Good news is coming from corporate America in terms of its latest earnings results. With earnings season for the second quarter about two-thirds complete, results have been better than was feared. S&P 500 earnings thus far are expected to grow in the low to mid single-digit range over the prior year. No apparent earnings recession thus far, but keep your eye on margins. As referenced in the opening section, higher-quality companies with pricing power are likely to continue to outpace the broad market. The other pattern of note is the strength of mid-cap earnings, which are again running well ahead of their large-cap peers. Mid-cap stocks have thus far delivered better earnings numbers than large-cap stocks and maintained their margins, potentially signaling more strength ahead.

Mid-Cap Stocks Are Leading the Way in Second Quarter Earnings Growth



Source: FactSet. Data as of 7/29/2022. Performance quoted represents past performance and does not guarantee future results. Indexes are unmanaged, and one cannot invest directly in an index.

Is it Time for Mid-Cap Stocks to Shine?

Despite outperforming their large-cap peers over the long-term, mid-cap stocks have been chronic underperformers over the past several years. Given the large cap dominance over the last few years, many investors are likely under-allocated to smaller-capitalization stocks. Market drawdowns like we've witnessed this year are never pleasant, but they can be an opportunity to reset portfolio asset allocations.

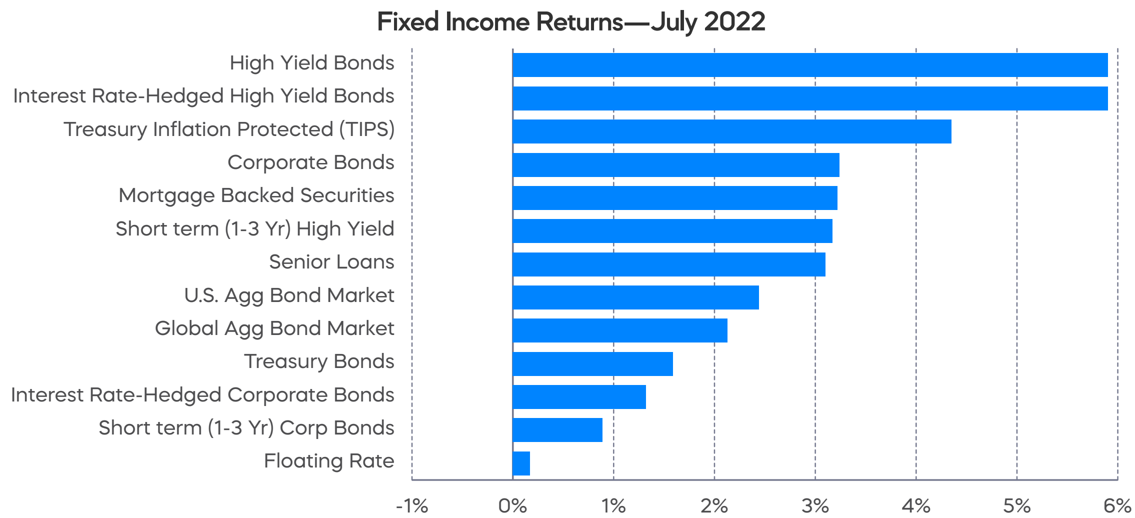
In addition to stronger earnings growth, there are a few other reasons why mid-cap stocks may be well positioned in the current environment. Relative valuations remain compelling, with the S&P MidCap 400® trading at roughly half of the value of the S&P 500. In addition, more domestic-based revenue should continue to insulate the middle market in the event the U.S. dollar continues to maintain its strength.

Investors should be selective with their mid-cap allocations in what remains a difficult equity environment. One potential solution worth consideration are strategies that have weathered market turbulence in the past, such as investing in dividend growth stocks. Akin to their large-cap peers, the S&P MidCap 400® Dividend Aristocrats® are high-quality stocks that have grown their distributions for a minimum of 15 consecutive years. They have also delivered an attractive combination of upside and downside capture that may be right for the times.

Fixed Income Perspectives

Prices Higher Across Treasurys and Corporate Bonds

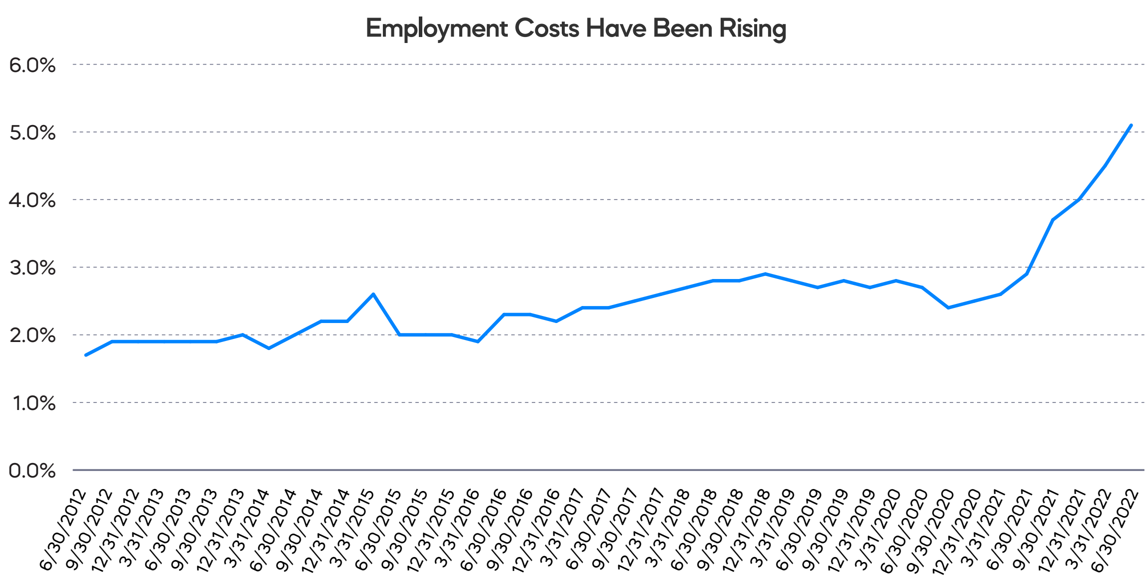
It was green across the screen in July, as a rally in U.S. Treasurys and tightening credit spreads drove prices higher across both government and corporate bond segments.



Source: Bloomberg, data from 7/1/22–7/31/22. Performance quoted represents past performance and does not guarantee future results. Indexes are unmanaged, and one cannot invest directly in an index.

A tightening of credit spreads goes hand-in-hand with a rally in stocks. Generally, if companies are generating decent earnings growth, then they are improving their ability to pay back their debts. Credit spreads for both high-yield and investment-grade credit are in the neighborhoods of their long-term averages, but corporate-debt levels are very low. If decent corporate earnings results continue over the next several quarters, those spreads may narrow even further. The rally in U.S. Treasurys, however, may have gone too far.

Rising Wages Could be a Concern



Source: Bureau of Labor Statistics and Bloomberg data from 6/30/12–6/30/22.

Falling prices at the gas pump is a hopeful sign that inflation may be receding, but rising wages are a potentially bigger concern. Last month's 5.1% increase in the Bureau of Labor Statistics Employment Cost Index is nearly twice the average of this century. The historical stickiness of wages suggest that it may take a little while for inflation to come back down to the Fed's target of 2%. It might not take very long at all for U.S. Treasury yields to rise after what has—admittedly—been quite an impressive rally.

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Important Information

Sources for data and statistics: Bloomberg, FactSet, Morningstar, and ProShares.

The different market segments represented in the performance recap charts use the following indexes: U.S. Large Cap: S&P 500 TR; U.S. Large Cap Growth: S&P 500 Growth TR; U.S. Large Cap Value: S&P 500 Value TR; U.S. Mid Cap: S&P Mid Cap TR; U.S. Small Cap: Russell 2000 TR; International Developed Stocks: MSCI Daily TR NET EAFE; Emerging Markets Stocks: MSCI Daily TR Net Emerging Markets; Global Infrastructure: Dow Jones Brookfield Global Infrastructure Composite; Commodities: Bloomberg Commodity TR; U.S. Bonds: Bloomberg U.S. Aggregate; U.S. High Yield: Bloomberg Corporate High Yield; International Developed Bonds: Bloomberg Global Agg ex-USD; Emerging Market Bonds: DBIQ Emerging Markets USD Liquid Balanced.

The S&P 500 is a benchmark index published by Standard & Poor's (S&P) representing 500 companies with large-cap market capitalizations. The S&P MidCap 400 is a benchmark index published by Standard & Poor's (S&P) representing 400 companies with midrange market capitalizations. The S&P SmallCap 600 is a benchmark index published by Standard & Poor's (S&P) representing 600 companies in the small cap range of market capitalizations. The S&P 500 Dividend Aristocrats and S&P MidCap Dividend Aristocrats target companies that are currently members of the S&P 500 and S&P MidCap 400 that have increased dividend payments each year for at least 25 and 15 consecutive years, respectively.

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Investments in smaller companies typically exhibit higher volatility. Small- and mid-cap companies may have limited product lines or resources, may be dependent upon a particular market niche and may have greater fluctuations in price than the stocks of larger companies. Small- and mid-cap companies may lack the financial and personnel resources to handle economic or industry-wide setbacks and, as a result, such setbacks could have a greater effect on small- and mid-cap security prices. Bonds will decrease in value as interest rates rise.

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