Market Overview

Nowhere to Hide

2022 has certainly been a challenging year for financial markets as nearly all asset classes have sold off in dramatic fashion with relatively high correlation. Every major asset class, including government bonds, has posted double-digit percentage losses through the end of June with the sole exception being commodities. The last time markets experienced such a broad-based downdraft was during the Great Financial Crisis of 2008-2009. **However, this time there are notable differences both within the economy and financial markets. The first being a far more stable domestic economy with strong corporate balance sheets and a fortified consumer benefiting from both strong home prices, and savings and investment balances near record highs.** As of March 31st, household net worth of $149.3 trillion was $33 trillion or 28% above pre-pandemic levels and just down from last year's annual record of $149.8 trillion. No doubt there was some erosion in this figure during Q2 however, the average American household is unquestionably better financially than they have been in decades.

It is important to note that it is typical and healthy for financial markets to correct periodically, and bear markets are normal, occurring on average once per economic cycle. In financial terms, a bear market is defined as a decline in equity prices of greater than 20%. Toward the end of Q2, equity markets breached the 20% barrier and entered bear market territory and fixed income markets have performed at levels not seen since the 18th and 19th centuries[1,2] when the United States was a fledgling nation. Considering all that has occurred since the outbreak of the COVID pandemic in March of 2020 and the unprecedented monetary and fiscal response that led to two years of extraordinary gains in nearly all asset classes, **it should be no surprise that we are experiencing a reconciliation within financial markets as they right-size and return to a more normal state.**

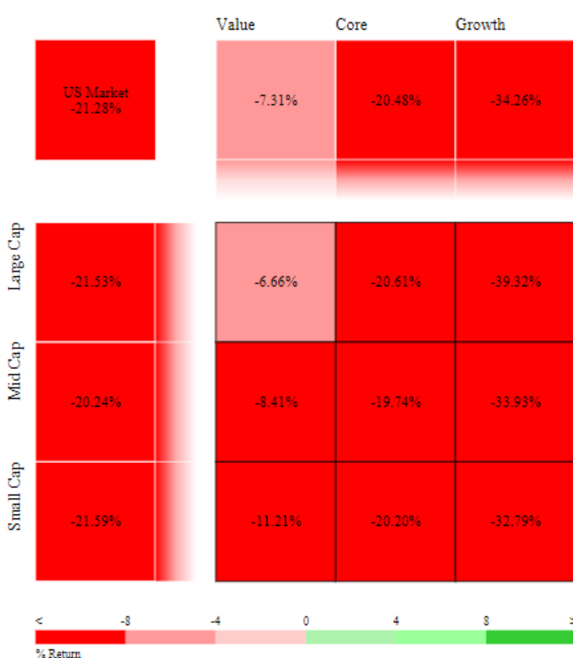
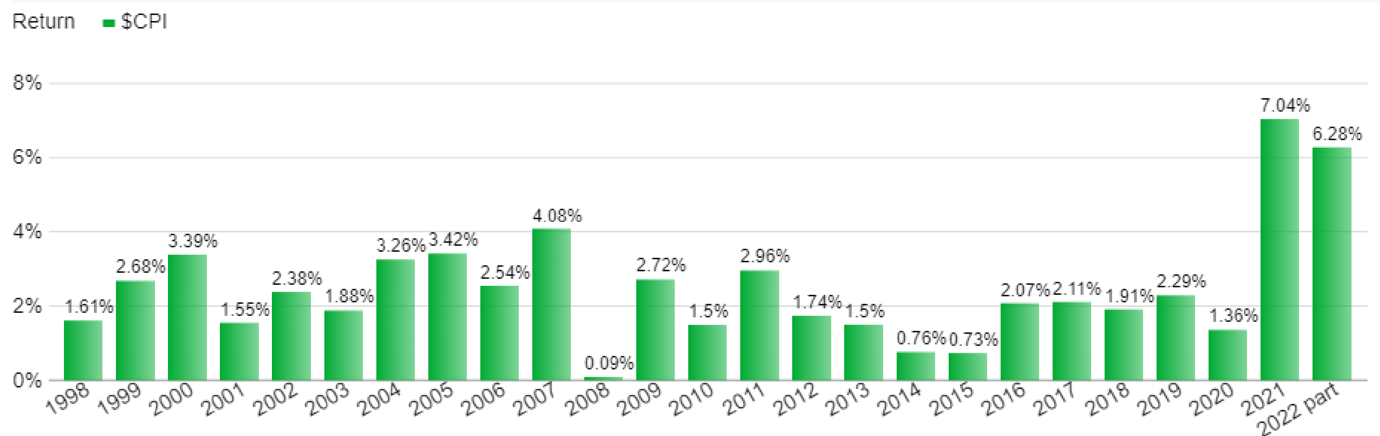


Exhibit 1

With the extraordinary volume of monetary and fiscal stimulus, it is not surprising that inflation elevated and has remained persistent. Inflation in the United States has been very low by historical standards for an exceptional period of time and was likely to increase given the volume of COVID stimulus even without the Russo-Ukrainian conflict. Although inflation is likely to abate in the coming months (and possibly

quite dramatically), it is likely to remain elevated relative to pre-2021 historical norms. **These higher levels should be manageable and leave the economy in a healthier place than the stubbornly low inflation that persisted for over half of the prior 25 years.**



Wage growth is likely to be a persistent driver of inflation in the new paradigm, awaking from a decade of listlessness. With the uptick in wages, we can expect to see an increase in automation and new technologies in the workplace to temper cost increases while increasing productivity. The broad economy should be able to absorb the higher inflation data, and allow for modestly above-trend GDP in coming years.

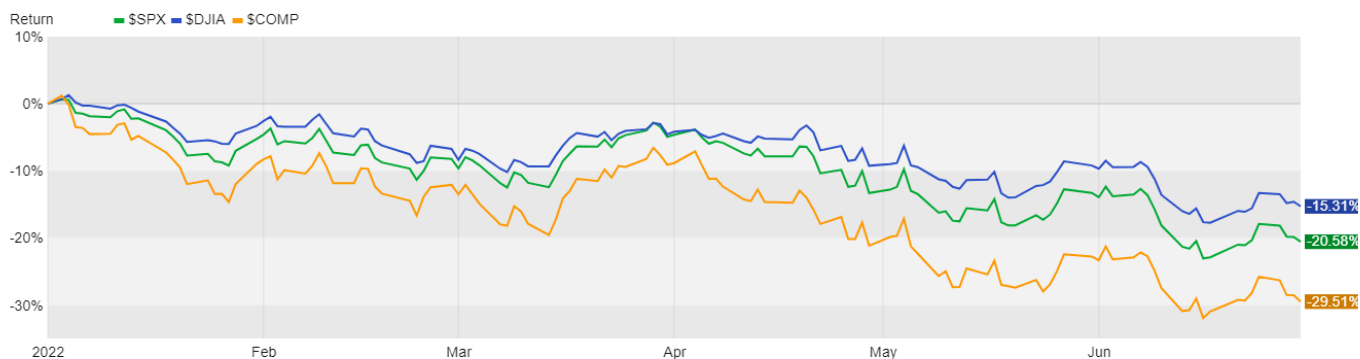
Federal Reserve Bank of the United States (Fed) has responded to the increase rate of inflation by increasing interest rates as they slowly changed their opinion from transient to persistent. Their newly hawkish tone is a clear message that the Fed is serious about and focused on taming inflation. Their challenge will be accomplishing this mission without overshooting and tempering the economy too much. **Our belief is that inflation crests and begins to moderate in the relative near term, settling at modestly higher levels than what has been common over the past two decades. Further, we believe the Fed is likely to reassess as economic data softens, leading to an accelerated return to neutral as they attempt a "soft landing."**

Our predisposition remains neutral with respect to our allocation to equities and fixed income as we believe risk/reward has become more favorable across both asset classes. Equity markets recorded a transition from a strong growth bias to a predisposition for value stocks, which we believe will likely persist on a relative basis amidst elevated volatility. Although markets have shifted preference toward value stocks, we believe there are areas with strong long-term secular growth opportunity that have become substantially more attractive after the recent pullback as compared to their prices just six months ago. Similarly, the repricing within fixed income has revealed opportunities across the spectrum and within medium-term treasuries, municipals, investment grade corporates and high yield bonds.

Equity

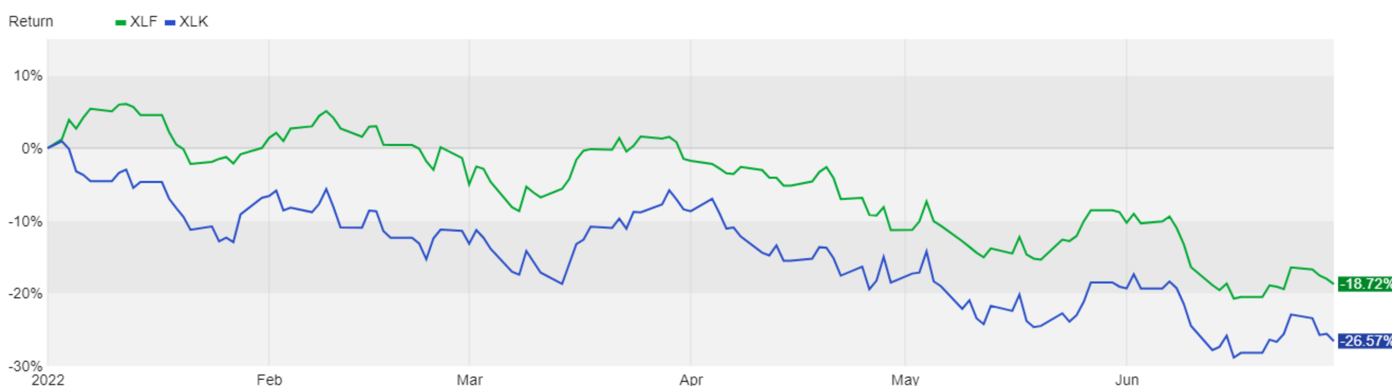
Equities struggled during the first half of the year as the entire complex was hit by a perfect storm of higher inflation, coordinated global central bank tightening, and slowing economic growth. In the aggregate, these pressures simply proved to be too much for markets to withstand. Equities started the year at elevated valuations, built on a period of economic expansion that was amplified by an avalanche of fiscal and monetary stimulus to offset the economic impacts of shutdowns during the COVID-19 pandemic. These extended valuations made prices more vulnerable to inflation, increasing interest rates, economic contraction, and slower earnings growth. The world and the financial media have now turned to the question of recession. A recession is defined as two consecutive quarters of negative GDP or said differently – contracting economic activity. **Although there is some debate in the financial press, we believe the economy is currently and has been in a recession that has yet to be confirmed by the backward-looking definition. We believe that is good news as the worst is likely behind us and we are ever closer to a return to economic expansion.** With most companies far better positioned heading into this recession and valuations have become more sensible, there is reason to be sanguine.

The average broad domestic equity index declined approximately 21% during the first half of the year with the technology heavy NASDAQ falling 29.51%, the S&P 500 sliding 20.58% and the Dow Jones Industrial Average losing 15.31%.



Value stocks outperformed growth stocks by a significant margin (over 15%) as a flight to higher quality stocks with lower valuations and less economic-sensitive earnings took hold. The best performing sectors for the year at the end of Q2 included energy, utilities, consumer staples and health care while lagging sectors were consumer discretionary, communication services and technology. Energy at one point in early June was up over 65% year-to-date before reverting marginally over the final three weeks of the month and ending the first half up 31.4%, still the only sector to end in positive territory.

Financials, historically a beneficiary from higher interest rates, modestly outperformed the broader market during the first half declining 18.7%, overwhelmed by heightened credit concerns and prospects of a slowing economy. Technology, with highly extended values, was poised for a contraction as the environment shifted. Many constituents fell on worries of slowed investment spending and higher rates stunting growth prospects, posting a first half decline of 26.6%.



International equities outperformed slightly versus domestic markets at the halfway mark. Developed markets (ex-US) declined 19.6% and emerging markets lost 17.6% as a slowing global growth outlook brought on by higher inflation and a less accommodative monetary situation pressured valuations.

While international equites sported more favorable valuations relative to domestic equities, this contributed only marginally to performance as changing macro conditions dominated. The best performing countries were Brazil, Hong Kong, Mexico and the U.K. while laggards included Germany, Italy, France and Japan. Valuation and the potential weakening in the U.S. dollar after an historic increase through the end of Q2 translates to a significant opportunity for emerging market equities as the global supply chain normalizes and a more favorable global economic backdrop is revealed. In the near term we favor developed markets over emerging markets with consideration for reversing this view over the longer term.

As we look ahead to the back half of the year, we see a combination of positives and negatives with market valuations at far more attractive levels that more accurately reflect slowing global growth. With domestic equities trading below historic levels on a 5-, 10-, and 25-year basis and earnings growth albeit slowing, but still positive, we see an increasing opportunity to rebound. The velocity and shape of the rebound remains the question. Will we recover all that was shed during the first half of 2022 in the back half, or will it take longer? In either case, the first burst has historically been significant, important not to miss and occurs without meaningful confirmation data. Absent the black swan of a deep and protracted recession, it will be extremely important to stay disciplined and stay invested to benefit from the recovery.

S&P 500 PERFORMANCE POST-RECESSION

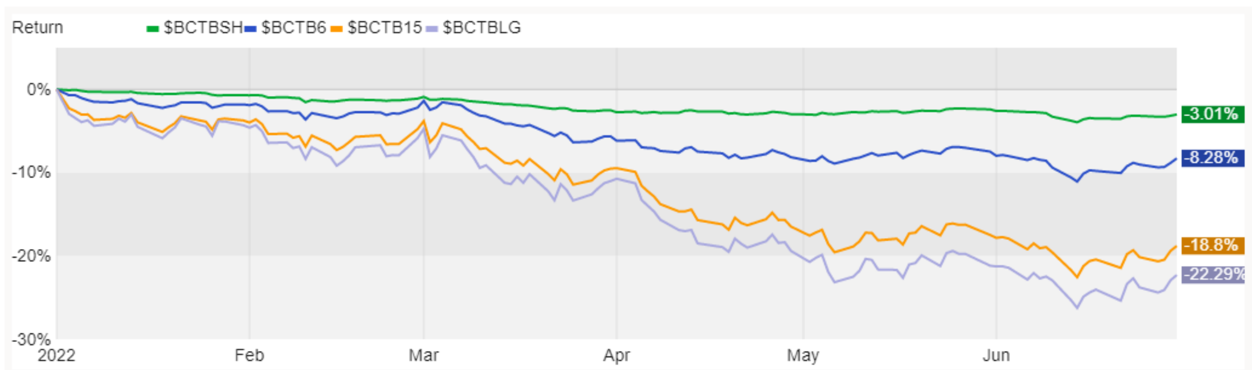
Recession	Duration	GDP	Plus 1 Year	Plus 3	Plus 5
Feb 1945 - Oct 1945	8 Months	-12.70%	-7.30%	15.29%	57.82%
Nov 1948 - Oct 1949	11 Months	-1.70%	31.50%	88.00%	171.30%
Jul 1953 - May 1954	10 Months	-2.60%	35.92%	83.74%	502.67%
Aug 1957 - Apr 1958	8 Months	-3.70%	37.30%	66.30%	89.70%
Apr 1960 - Feb 1961	10 Months	-1.60%	13.61%	35.06%	68.41%
Dec 1969 - Nov 1970	11 Months	-0.60%	11.20%	20.60%	25.20%
Nov 1973 - Mar 1975	1 Year, 4 Months	-3.20%	14.37%	21.89%	55.16%
Jan 1980 - Jul 1980	6 Months	-2.20%	12.90%	55.90%	100.90%
Jul 1981 - Nov 1982	1 Year, 4 Months	-2.70%	25.40%	67.24%	103.23%
Jul 1990 - Mar 1991	8 Months	-1.40%	11.00%	29.80%	98.20%
Mar 2001 - Nov 2001	8 Months	-0.30%	-16.51%	8.44%	34.33%
Dec 2007 - Jun 2009	1 Year, 6 Months	-5.10%	14.40%	57.70%	137.00%
AVERAGES	**11 Months**	**-2.40%**	**15.33%**	**45.84%**	**120.33%**

Source: [Everything You Need to Know About Recessions (awealthofcommonsense.com)]

From an allocation perspective we are neutral with a slight bias to overweight equities given the severity of the selloff during the first half of the year, and more attractive equity valuations balanced against the improved risk/reward framework across most of the fixed income complex. We see compelling opportunities in cyclical sectors such as energy and financials along with defensive areas in health care. Relative valuation within international equities is constructive and encouraging. At current, we prefer developed markets over emerging market equities with an eye to elevate exposure to emerging markets as the global macro picture improves.

Fixed Income

The broader fixed income market experienced one of the worst performing first halves in history – according to Deutsche Bank, it is the worst on record since 1788[3]. That's right – 1788. Worries of rising inflation, a slowing macroeconomic backdrop and global central banks that were slow to react and raise interest rates all contributed to a difficult environment for fixed income performance. The performance for US Treasuries ranged from down 3.0% at the short-end of the curve to down 22.3% at the longer-end of the curve. In between sits a plethora of bond categories scarred from the whiplash of the past six months including the Barclays U.S. Aggregate index losing 10.4%, Barclays US Corporate Investment Grade Index declining 14.4%, Barclays US Corporate High Yield falling 14.2%, and the Barclays Municipal Bond Index shedding 9.0%. The municipal complex performed better than the broader asset class on improved fundamentals from fortifying stimulus funds realized during the COVID-19 pandemic and strong tax receipts. This category and especially the High Yield Municipal subcategory appear poised to deliver strong risk-adjusted returns going forward as the volatility from rising rates abates and the attractive tax-free yields take center stage.



Corporate debt in total dollars is slightly elevated versus historical levels when viewed in relation to GDP however, when viewed against operating earnings is very manageable, with carrying costs in aggregate sitting near historic lows. We continually monitor spreads as widening spreads often portend troubled waters. Currently we see little risk from this metric as credit spreads have widened over the past month, but they remain well below levels seen at the onset of COVID-19 and well below those experienced during the Great Financial Crisis or the Dot-Com crash.

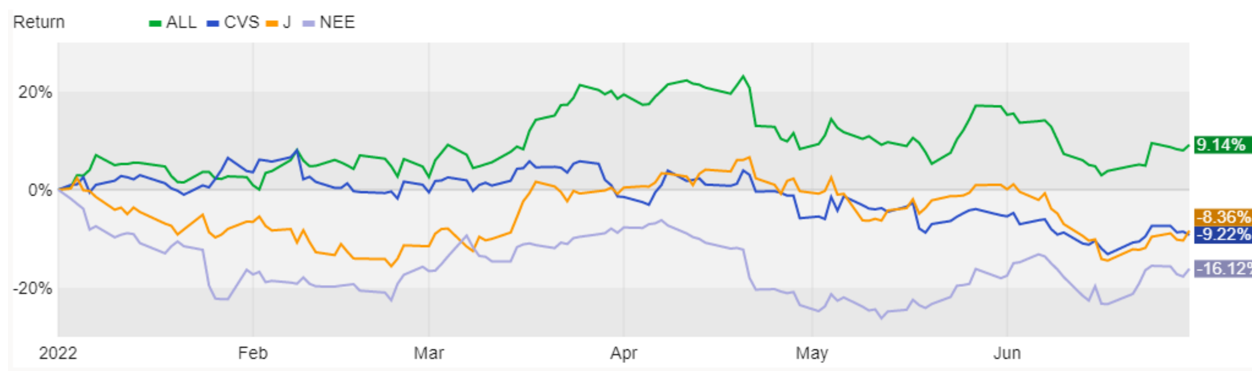
Our outlook for fixed income is increasingly favorable with a risk-reward improving across the complex over the past several months. We continue to favor exposure to high yield and senior loan categories while balancing interest in emerging opportunities such as US Treasuries, convertible securities, and emerging market debt. The actions by global central bankers and higher interest rates have pressured the US Treasury complex enough to make them investable for the first time in years. While we are intrigued by the prospects of owning US government debt, we are cognizant of the risk presented by a flat yield curve and do not believe long dated maturities offer sufficient yield for the risks inherent. For now, the medium part of the curve, maturities between 3- and 7-years looks most constructive and is likely a starting point for re -entry.

KbC Equity and Allocation Strategy Model Portfolios

We are pleased to report that relative performance across all but one of the KbC investment strategies outpaced their respective benchmarks during the first half of the year. This is especially noteworthy given the significant difficulties presented in the macroenvironment during the front half of 2022.

KbC's Dividend strategies generated alpha through the midpoint of the year, benefiting from its barbell approach of holding constant dividend payers and outsized dividend growers, demonstrating its defense nature in a declining market. Exposure to healthcare (AbbVie (ABBV), CVS Health (CVS) and UnitedHealth Group (UNH)) and defense (Lockheed Martin (LMT) and Raytheon Technologies (RTX)) drove a significant amount of the relative performance against the broader market. **Looking forward to the back half of 2022, we believe this strategy remains well positioned given its offensive and defensive core positioning along with a strong track record of stock selection.**

KbC's Market strategies outperformed its benchmark, the Vanguard Total Stock Market ETF (VTI) modestly during the first half as a slight underweight to Technology and a modest overweight to Utilities proved meaningful in driving alpha. Allstate (ALL), CVS Health (CVS), Jacobs Engineering (J), NextEra Energy (NEE), Raytheon Technologies (RTX), Constellation Brands (STZ), UnitedHealth Group (UNH) and Exxon Mobil (XOM) all contributed positively to performance during the first half.



The Alpha Leaders strategy experienced a challenging front half of the year as its modest growth tilt was impacted negatively by the general market conditions and significant underperformance relative to value stocks. Stock selection impacted performance with a handful of positions logging relative underperformance. Two semiconductor stocks, Applied Materials (AMAT) and NVIDIA (NVDA), which have provided significant positive alpha in the past, underperformed year-to-date. We view this underperformance as temporary, and we remain confident in each company's business and future prospects. Conversely, Exxon Mobil (XOM), UnitedHealth Group (UNH), Johnson & Johnson (JNJ) and Constellation Brands (STZ) were positive alpha contributors during the first half.

KbC's Alpha Tax/Qualified strategies benefited from value outperforming growth during the front of 2022 as the strategy's equal-weight approach facilitated the underweighting of technology (growth) stocks that became relatively expensive in favor of less expensive value stocks. In total, the strategy logged absolute performance that was in-line with the S&P 100 equal weight index while it significantly outperformed the S&P 100 market capitalization index.

KbC's Strategic Asset Allocation strategies slightly outperformed versus the respective blended benchmarks during the first half of the year. Despite a challenging fixed income environment, the strategy benefited from exposure to inflation-protected and senior loan categories in addition to modest outperformance in international equities. As we move into the back half of the year, these strategies are slightly tilted towards favoring equities at the margin based on the prospects for reversion in equity markets supported by the more favorable risk/reward backdrop. Finally, with respect to the fixed income side of the ledger, we are actively working to opportunistically reduce exposure to inflation-protected securities and floating rate/senior loans into 3- and 7-years US Treasuries and ultimately into the aggregate bond category as higher rates provide better entry opportunities throughout the credit spectrum.

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Exhibit 1: Morningstar Market Barometer provides a visualization of the performance of Morningstar Indexes. ©2022 Morningstar
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