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Q2 2022 Market Commentary

Produced by our Portfolio Management Team, Affinity Investment Advisors, LLC

Capital Markets Review

Most global equity markets declined into bear market territory in the first half of the year. Fixed income indices have also produced negative returns in 2022, with some longer duration bonds slipping into a bear market. The elephant in the room remains inflation. The Federal Reserve has been forced to raise the Fed Funds Rate 150 basis points this year and is expected to continue increasing aggressively for the remainder of the year – perhaps another 200 basis points. The Federal Reserve has also ceased to expand its massive $9 trillion balance sheet, which has and will impact U.S. economic growth. The extent to which these hawkish actions are able to contain and reduce inflation will likely impact capital market returns in the near to intermediate term future. The duration of this tightening cycle is equally important as investors generally discount such interest rate trends well into the future.

Equity Market Review

The severity of the year-to-date decline in U.S. equities was due primarily to performance in the 2nd quarter. The S&P 500 Index fell -19.96% in the first half of 2022, but -16.10% of the semi-annual decline occurred in the 2nd quarter. Equity returns seemed to worsen as inflation remained persistently high, forcing the Federal Reserve's hand to raise rates more aggressively. This persistence has increased the chances of an economic recession in 2022 or 2023 – if we are not already in a recession right now.

Something that was noted in the last quarterly commentary is the wide dispersion of returns across equity styles and sectors. Growth stocks, represented by the Russell 1000 Growth Index, have declined -28.07% while value stocks, represented by the Russell 1000 Value Index, fell -12.86%. Nonetheless, growth stocks have produced significantly better results relative to value stocks over the trailing 3-, 5-, and 10-year periods.

Performance Results	Q2 2022	1 Year	3 Years	5 Years	10 Years
Russell 1000 Growth Index	-20.92%	-18.77%	12.58%	14.29%	14.80%
Russell 1000 Value Index	-12.21%	-6.82%	6.87%	7.17%	10.50%

All data as of 6-30-2022; Source: FTSE Russell

Prior to late 2021, growth stocks dominated due to outsized performance from the largest capitalization stocks in the S&P 500 (and large cap growth indices). The following table shows just how robust performance proved to be for the largest growth companies for the three-year period ending 2021 before the sell-off this year.

Largest S&P 500 Companies	3 Years (As of 12/31/2021)	Year-to-Date (As of 6/30/2022)
Apple	68.0%	-21.5%
Microsoft	51.9%	-22.1%

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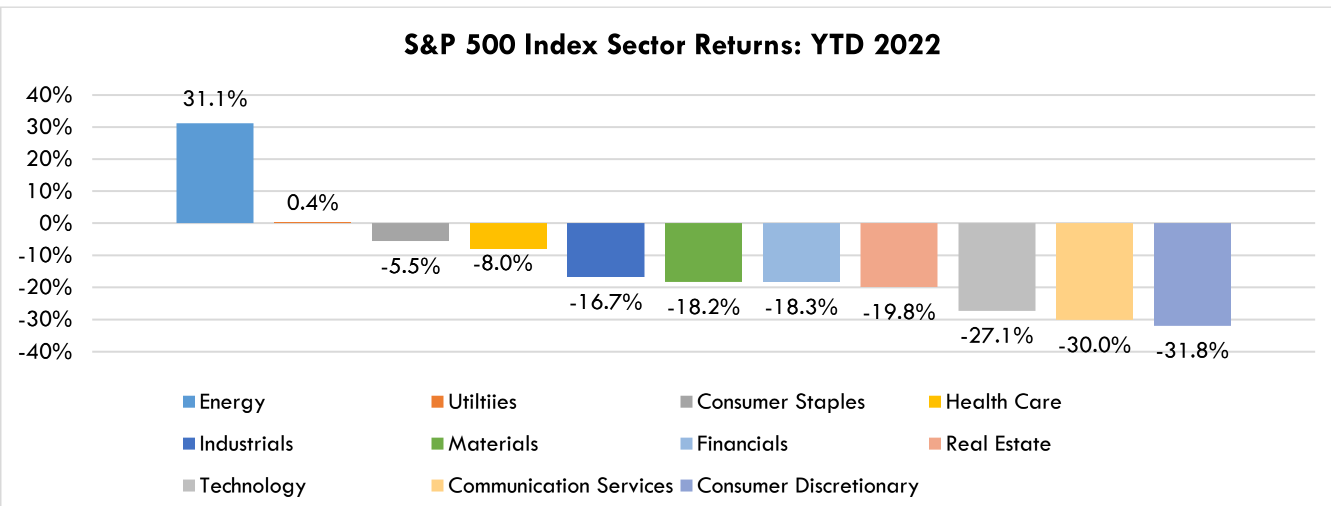
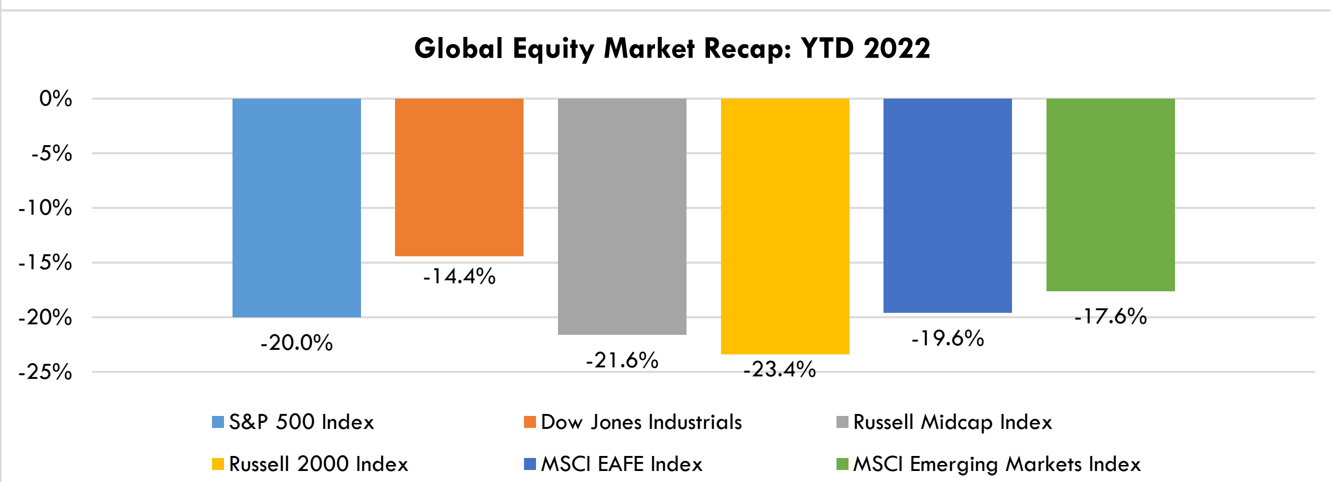
Amazon	31.6%	-35.0%
Alphabet	41.8%	-22.3%
Tesla	158.9%	-40.3%
S&P 500 Index	*26.1%*	*-20.0%*

Source: Refinitiv; 3-year returns are annualized.

Value stocks outperformed growth stocks in the 1st quarter, and that trend continued during Q2. The performance of sectors explains a large part of the return differential. The chart below shows that the larger growth-oriented sectors, such as Technology, Consumer Discretionary, and Communication Services underperformed the broader market, while value-oriented sectors such as Energy and Utilities outperformed.



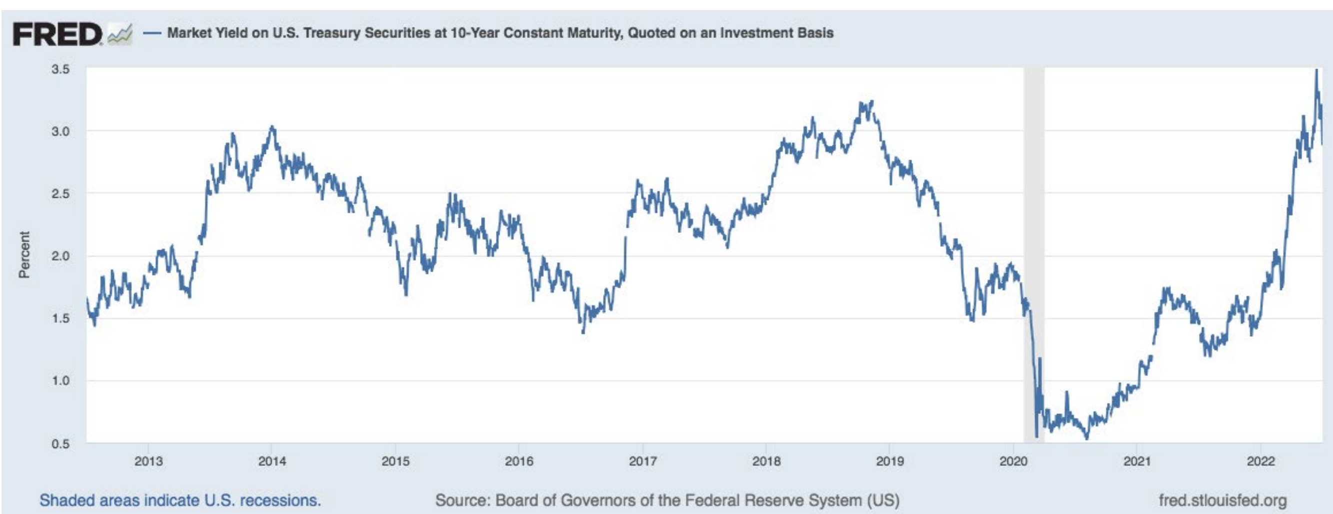


Sources: FTSE Russell; Refinitiv; MSCI; S&P Global, & Dow Jones

The “risk-off” environment accelerated in the second quarter. The chart above shows returns for a variety of global equity asset classes for the first half of the year. All equity categories have declined meaningfully in 2022. Within the U.S., small capitalization stocks underperformed mid-cap and large-cap stocks. This is not surprising given the fact that small cap stocks typically exhibit greater volatility. Non-U.S. large cap stocks in developed countries (MSCI EAFE) performed similarly to U.S. large cap stocks (S&P 500 Index). On average, stocks within emerging markets performed better than most equity asset classes. This may seem odd given the greater perceived risk of investing in companies in developing countries; however, the returns by country were broadly dispersed. For example, the MSCI Emerging Markets Latin America Index slipped a mild -0.6% in the first half of the year, primarily due to the region’s greater exposure to energy and other commodity products. Meanwhile, the MSCI Emerging Markets EMEA Index cascaded -28.4% lower.

Fixed Income Markets Review

Interest rates bottomed in early 2020 with the onset of Covid-19. Since that time, rates have precipitously climbed higher and recently set a 10-year high (see the graph below). That said, since the top in mid-June, the yield on the 10-Year U.S. Treasury has drifted slightly lower. From a longer-term perspective, interest rates still remain relatively low. During the decade of the 1990s, the yield on the 10-Year U.S. Treasury never fell below 5% with the exception of a very brief period during 1998 when Russia defaulted on its debt and Long-Term Capital Management’s highly leveraged hedge fund collapsed.



Interest rate increases in the most recent quarter continued to pressure most fixed income asset classes. Longer duration assets were especially punished. The broad Bloomberg U.S. Aggregate Index declined -4.69% during the 2nd quarter and -10.35% for the first half of 2022. While this performance was

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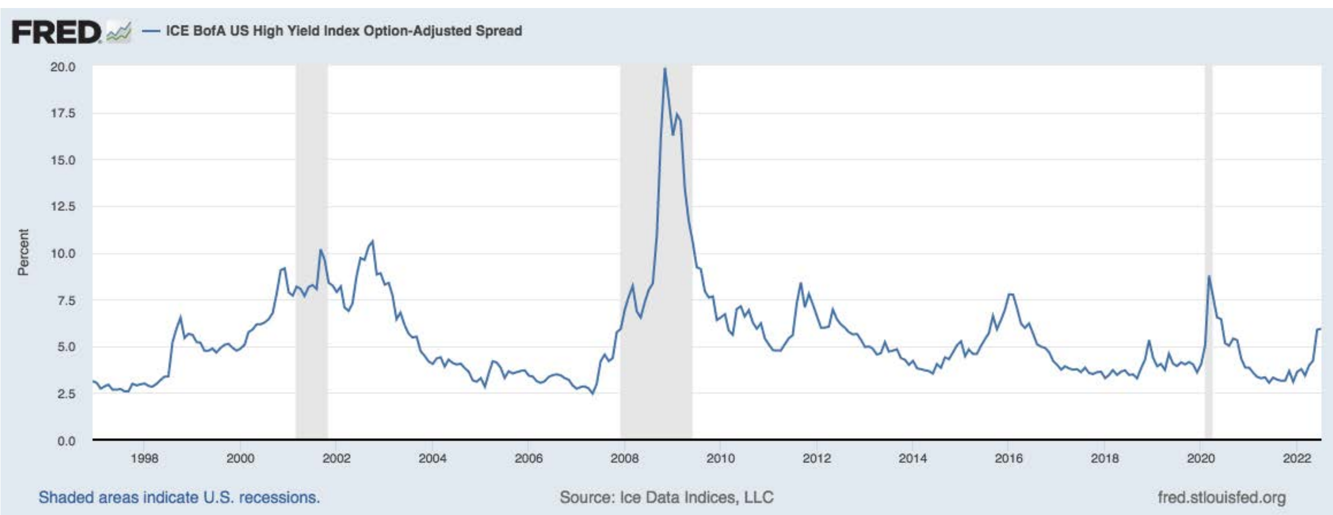
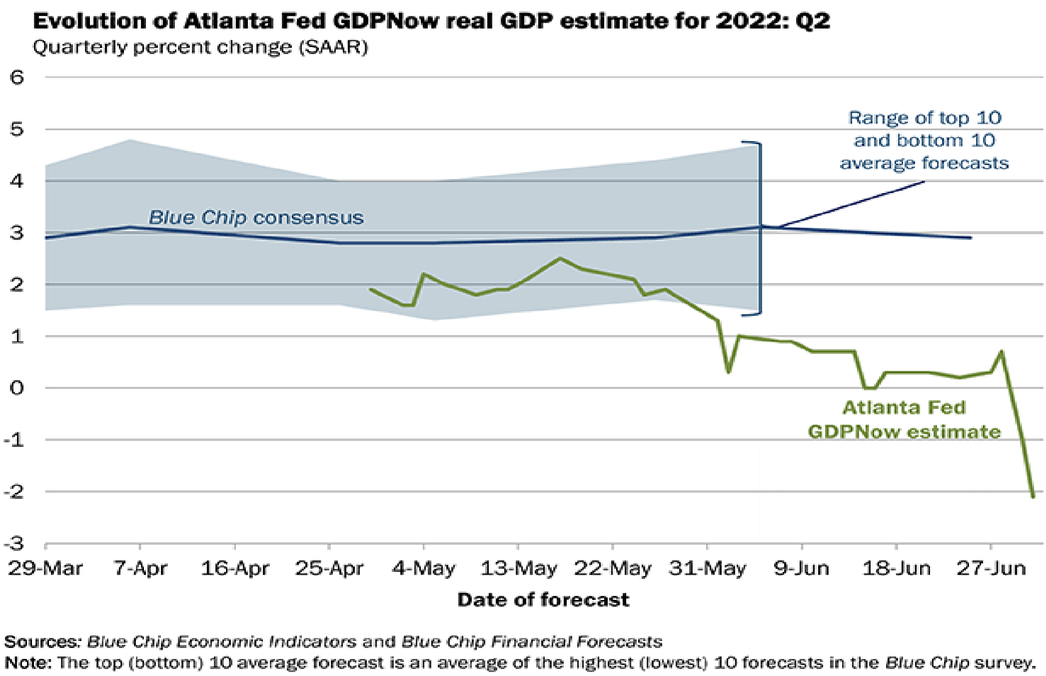
disappointing, it was nonetheless significantly better than the Bloomberg U.S. Agg Credit-Long Index which plummeted -12.59% for the quarter and -22.40% for the year-to-date period.

High yield bonds performed well relative to other fixed income categories during the first part of the year, but declined in the 2nd quarter along with other asset classes. The Bloomberg U.S. Agg Corporate High Yield Index dropped -9.83% in Q2, bringing the year-to-date return to -14.19%. After showing great resiliency during the first part of 2022, credit spreads widened during the most recent quarter. The ICE BofA U.S. High Yield Spread, which measures the difference in yields between below investment grade corporate bonds (S&P BB or lower) and U.S. Treasury securities, jumped higher during Q2. The chart below shows the widening spread. It is worth noting that while credit spreads have widened, in our view the spread has not yet reached an alarming level (see 2001, 2009, and 2020 within the chart).



Capital Markets Outlook

As we now know, U.S. GDP declined a modest -1.6% in the 1st quarter of the year. Investors and economists are now wondering if we are the midst of a recession. If U.S GDP is negative in the 2nd quarter, then the answer is yes. As the chart below from the Federal Reserve of Atlanta demonstrates, very recently their estimates have turned negative for Q2, suggesting that it is probable – at least in their analysis – that a recession is underway. Note that this differs from many other estimates.



The more important questions perhaps are how long will growth suffer and what is the impact on the capital markets? Daunting questions to say the least. In April of this year, the yield curve (based on the U.S. 10-Year yield minus the U.S. 2-Year yield) turned negative. Since that time, it has hovered just above zero. Below is a chart showing the yield curve since 1976. Typically, inversions precede an economic recession. While the inversion in April of this year was slight (-0.05), it is perhaps an indicator.

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While the world currently faces a myriad of challenges, including inflation, an ongoing pandemic, war in Ukraine, and central bank tightening, some curious factors remain which do not suggest an impending major decline in economic growth and asset prices. For example, unemployment is below 4% in the U.S., the 5-year breakeven inflation rate in the U.S. is below 3%, and as of yet there does not appear to be a "profits recession". Expected profits for U.S. companies as well as for companies in most developed nations remain positive for 2022 and 2023. It is also noteworthy to mention that corporate balance sheets are quite strong.

The confluence of these factors will determine the future path of equity and fixed income prices. So far, the S&P 500 Index has declined -23.6% from peak to current trough (as of 6/30/2022). Since 1928 the average bear market decline has been approximately -35.6%. This suggests that additional negative returns are possible. But it also suggests that perhaps a majority of the decline has already occurred (about two-thirds of the decline based on past history). It seems prudent to remain cautious in this time of uncertainty and market volatility, but also to begin to seek to invest in undervalued parts of the market that offer attractive long-term opportunities.

Sources: Federal Reserve Bank of St. Louis; Federal Reserve Bank of Atlanta; FTSE Russell; MSCI; S&P Global; Dow Jones; Bureau of Labor Statistics; and Refinitiv.

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