July 2022
Market Commentary

First Affirmative FINANCIAL NETWORK
Invest for a Sustainable Future

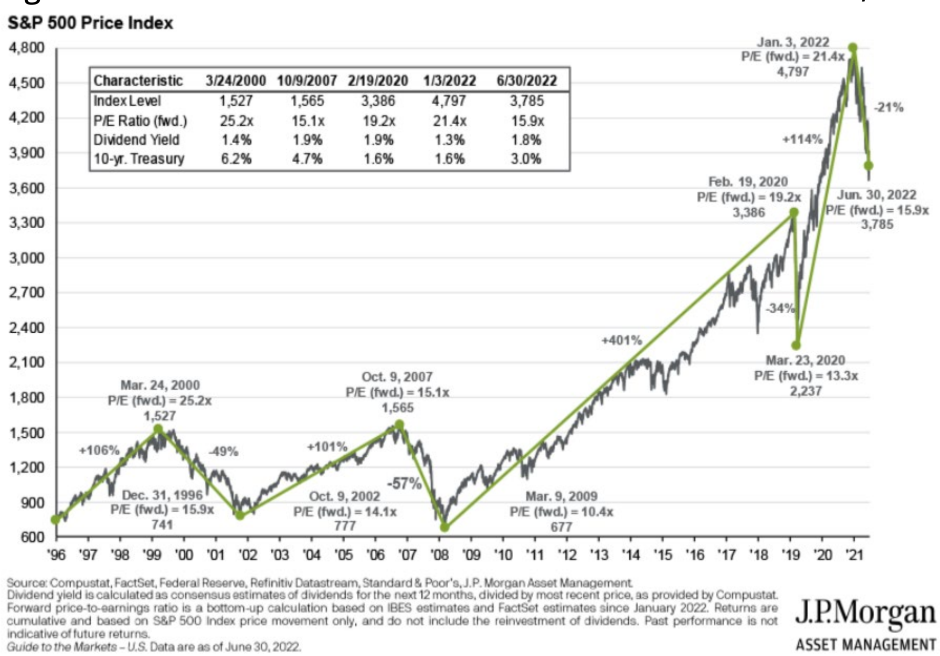
What'll it be? Soft Landing, Stagnation, Hard Landing, or Stagflation
By Theresa Gusman
July 20, 2022

"History Doesn't Repeat Itself, but it often Rhymes." - Mark Twain

Overview

Stocks recorded their worst first half in more than 50 years, with the S&P 500 plunging 20.6% (see Figure 1, below). However, equity valuations have become more attractive (see Figure 2, page 2), the Fed is now acting quickly to mitigate inflation, and following a short, possibly sharp, economic downdraft, we anticipate a return to trendline growth. This backdrop suggests stabilization followed by a choppy rebound in equity markets.

Figure 1. S&P 500 at Inflection Points – Bull and Bear Markets, 1996 to Date



Soft Landing, Stagnation, Hard Landing, or Stagflation

The last time equities fell 21% in the first half was 1970 (see Figure 3, page 2), so we looked back. In 1970, the US faced high budget deficits, low interest rates (relative to inflation), surging oil prices (oil embargo), and the collapse of managed currency rates. This combination — plus fiscal and monetary policy inaction, social and political unrest, and an un-winnable war — resulted in the **stagflation** of the 1980s.

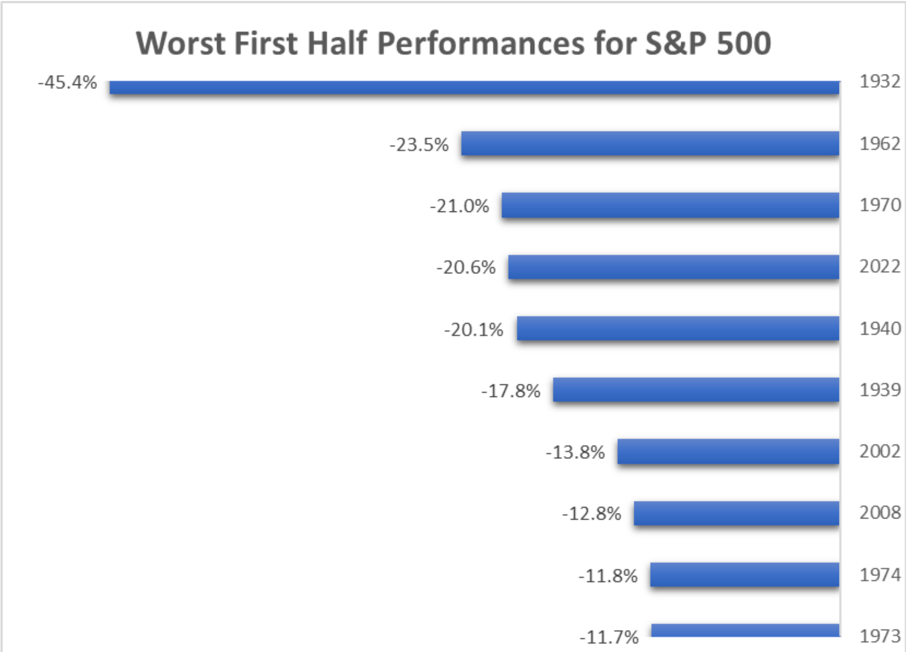
Except for the collapse in managed currency rates (although Brexit may be close), this scenario might sound familiar. However, today, equity, fixed income, and commodity markets, the economy, and now the Fed are moving rapidly. This speedy response should allow us to avoid a prolonged 1970s-80s style period of little or no growth in the economy (**stagnation**) combined with high inflation and above trend unemployment. In our view, the speed with which the Fed is raising rates, companies are slowing hiring, and prices (particularly commodity prices) are falling presage a **hard landing**. We believe a rapid shift from strong economic growth to slow-growth to a flat economy, and ultimately a (brief in this instance) recession followed by a return to trend growth as inflation subsides is the most likely scenario. This could happen over 6-12 months, which would be good news for the US equity market.

Figure 2. S&P 500 Valuation Measures, 1997 to Date

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	15.94x	16.85x	-0.27
CAPE	Shiller's P/E	28.74x	28.01x	0.11
Div. Yield	Dividend yield	1.76%	1.99%	0.70
P/B	Price to book	3.36x	3.10x	0.32
P/CF	Price to cash flow	12.14x	11.16x	0.45
EY Spread	EY minus Baa yield	0.93%	0.22%	-0.36

Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since June 1997 and by FactSet since January 2022. Current next 12-months consensus earnings estimates are $240. Average P/E and standard deviations are calculated using 25 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow availability.
Guide to the Markets – U.S. Data are as of June 30, 2022.

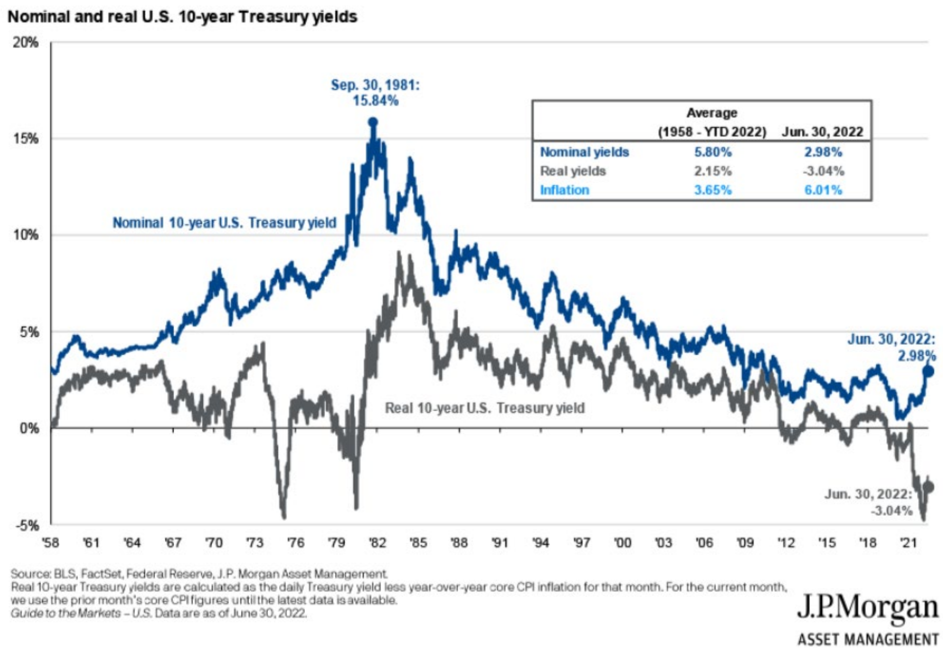
Figure 3. S&P 500 Worst First Half Performances, 1927-2022



We are heartened by the initial closure of the gap between inflation expectations and reality as evidenced by the recent decline in real interest rates (see Figure 4, below). As noted in previous Market Commentaries, either nominal rates will rise to reflect the surge in inflation, inflation will retreat, or we will see some combination of the two (as we expect). The narrowing of the gap began to play out in the second quarter as the Fed moved quickly, market sentiment shifted, and commodity prices retreated (copper prices plunged 31% from March 4th to early July). Fiscal spending (excluding outlays for the war in Ukraine) has also moderated following the flood of pandemic-induced spending over the past two years.

Considering the interdependency of global economies, we believe a **soft landing** is the least likely scenario. The surge in the US dollar relative to the euro (the dollar fell below parity early this month) and Russia's stranglehold on European energy supplies suggest the inflation pain in Europe could far exceed that of the US. Also, the ECB is behind the Fed in its response to inflation. Energy price controls and supply mitigation efforts so far have softened the blow to European consumers and businesses. Ultimately, these will break and the downdraft in European economies could be severe.

Figure 4. Nominal and Real 10-Year Treasury Yields, 1958-June 30, 2022



Second Quarter Market Review

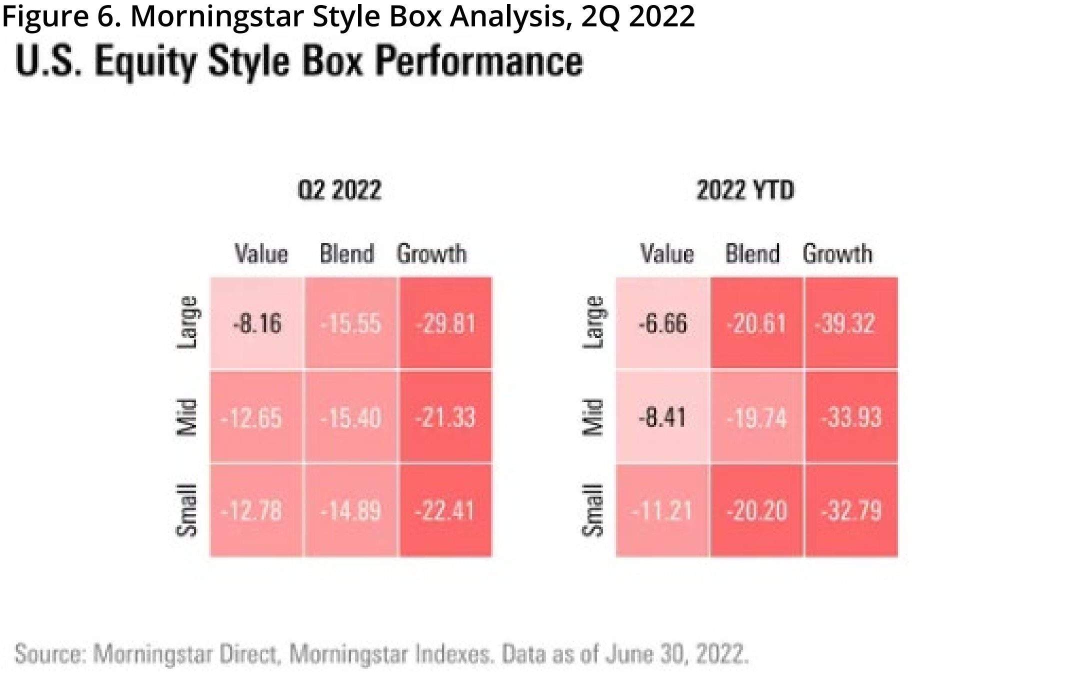
Only China Region Funds (among long-only strategies) and cash did not decline in the second quarter. Large value funds (-8.16) outperformed large growth, which's fell 29.81% in the quarter. Non-US equities outperformed US equities as global equities (MSCI ACWI) fell 15.66% and emerging markets dropped 11.45%. The US Aggregate Fixed Income index declined 4.31% (see Figures 5 and 6, page 4).

Figure 5. Global Equity, Fixed Income, and Real Assets Performance (Percentage Change), 2Q 2022

		2Q2022	2022 YTD	Last 12 Months	Last 24 Months Annualized
Equities	**Global**	-14.17	-19.96	-15.59	8.42
	US Equities	-15.87	-21.38	-14.24	11.25
	US Large Cap	-15.71	-20.98	-13.10	11.46
	US Mid Cap	-15.98	-22.20	-16.00	11.09
	US Small Cap	-15.91	-21.65	-20.75	11.36
	Non-US Equities	-12.53	-18.01	-19.21	4.65
	Non-US Developed Markets	-13.17	-19.05	-17.31	4.71
	Non-US Emerging Markets	-10.42	-17.40	-25.75	1.93
Fixed Income	**US Aggregate**	-3.55	-10.26	-10.29	-5.46
	US Treasuries (Intermediate)	-2.49	-7.67	-8.32	-5.25
	Municipals (Intermediate)	-3.45	-10.72	-10.57	-3.77
	Investment Grade Corporate	-5.82	-13.87	-13.88	-5.70
	US Corporate High Yield	-8.99	-14.11	-13.14	-0.81
	Bank Loan	-5.36	-5.82	-4.87	1.14
	Emerging Markets	-11.15	-20.23	-21.23	-8.11
Real Assets	**Commodities**	2.21	28.51	38.35	46.66
	Energy (Oil/Gas)	-5.89	28.84	40.30	56.88
	Energy Pipelines (MLPs)	-12.05	9.84	3.47	29.77
	Precious Metals	-10.24	-4.48	-5.07	-1.18
	Industrial Metals	-23.71	-11.66	-2.94	19.74
	Agriculture	-5.67	3.31	9.50	23.01
	REITs (Real Estate)	-14.48	-20.52	-8.07	11.13

Source Morningstar Direct as of 03/31/2022
Note: Coloring is relative. Deeper green indicates higher relative return, deeper red indicates lower relative return.

Figure 6. Morningstar Style Box Analysis, 2Q 2022



Outlook – Question: How quickly will growth slow? Answer: Very Quickly

In our last Market Commentary, we posed the question, "how quickly will economic and earnings growth slow and what impact will it have on the equity market?". It has become apparent that rapid Fed action will slow the economy and earnings growth significantly – and it has had *a big* impact on the equity market.

Barring faltering Fed resolve or an unnecessary attempt by the federal government to “fix” the economy (i.e., a stimulus package or even worse price controls), we believe the economic downdraft will be short lived. Against this backdrop, the equity market could recover as 2022 progresses.

Figure 7 below shows the historical impact of Fed rate hikes on equity market returns. Although equity market returns are unlikely to come close to the extraordinary increases we have seen in recent years, we take comfort in the fact that the average S&P 500 return in the past six rate hiking cycles was +5.8%.

Figure 7. Historical Impact of Fed Tightening, 1977 to March 2022

Federal funds rate

Target rate*, shaded areas denote periods of rate hikes

Market reaction during previous rate hiking cycles

	May 1983 – Jul. 1984	Mar. 1988 – Feb. 1989	Feb. 1994 – Feb. 1995	Jun. 1999 – May 2000	Jun. 2004 – Jun. 2006	Dec. 2015 – Dec. 2018	Mar. 2022 – Present	Avg. of past 6 rate hiking cycles
Yield change (bps)								
Federal funds rate	313	325	300	175	425	200	25	290
2-year Treasury	311	227	305	121	238	165	43	228
10-year Treasury	274	91	185	50	52	49	17	117
S&P 500 return	-9.6%	6.8%	-2.1%	8.5%	12.0%	19.0%	6.3%	5.8%
U.S. dollar	10.4%	1.7%	-4.7%	3.4%	-5.8%	-1.4%	-0.6%	0.6%

Source: FactSet, Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management.
S&P 500 returns are price returns and do not include reinvestment of dividends. Averages do not include the current cycle. Current cycle begins on March 16, 2022. *Between 1979 and 1982, the FOMC changed its approach to monetary policy, focusing on the money supply, rather than the federal funds rate. In the fall of 1982, however, the Federal Reserve shifted back to its approach of targeting the "price" rather than the "quantity" of money. Thus, because the federal funds rate was not the FOMC's key policy tool, we exclude increases in the federal funds rate between 1979 to 1982 in our analysis of rate hike cycles.
Guide to the Markets – U.S. Data are as of March 31, 2022.

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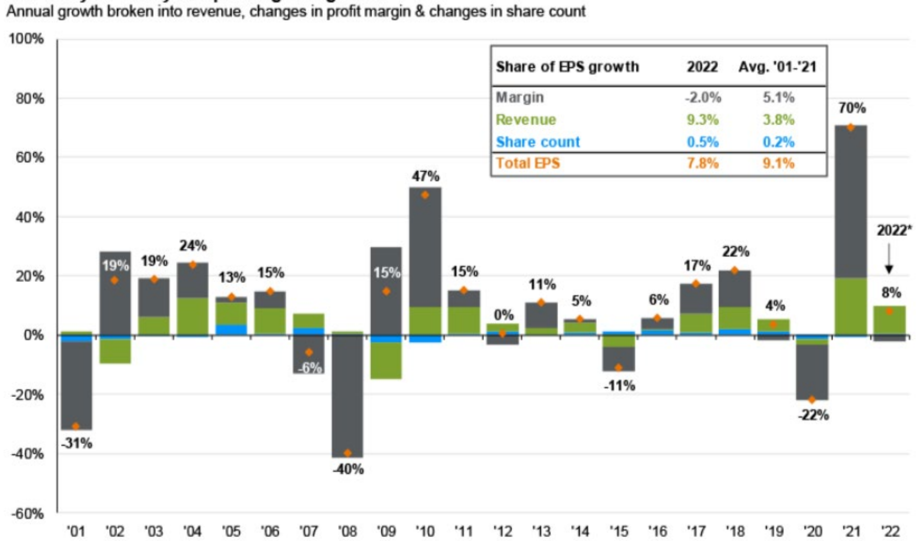
Figure 8. S&P 500 Earnings Growth, 2001-2Q 2022

S&P 500 year-over-year operating EPS growth

Annual growth broken into revenue, changes in profit margin & changes in share count



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.
EPS levels are based on annual operating earnings per share. *2022 earnings figures are based on weekly operating earnings estimates from Standard & Poor's. Percentages may not sum due to rounding. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of June 30, 2022.

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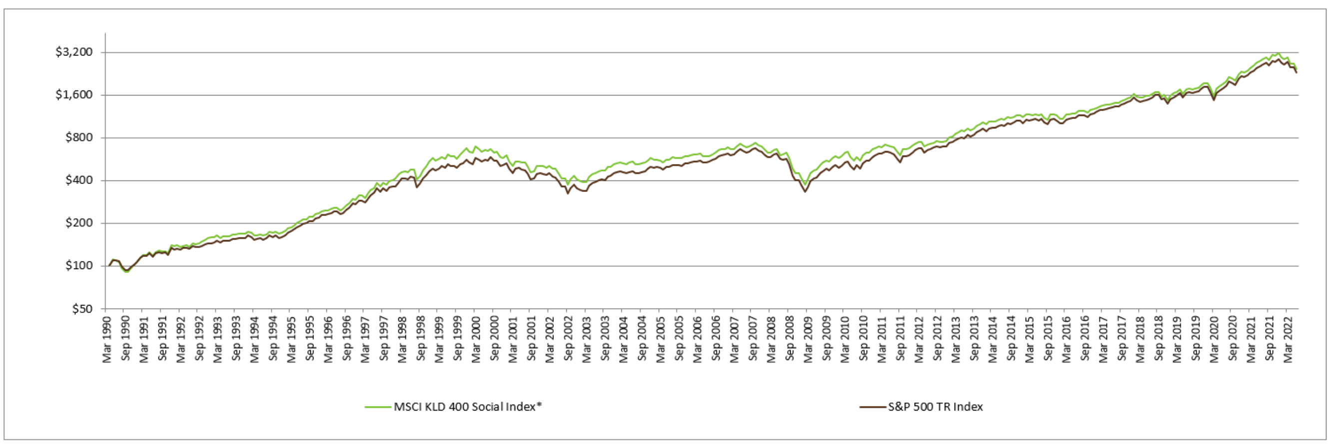
Achieving Long-Term Investment and Impact Objectives

The shift into sustainable, responsible, and impact (SRI) investments continues – albeit at a slower pace. Following years of excess performance, as shown in Figure 9, below, the MSCI KLD 400 index underperformed the S&P 500 index in the second quarter amid surging prices for fossil fuels and other commodities. This setback notwithstanding, the sustained, consistent performance of this standard SRI/ESG benchmark over time supports our view that strategies incorporating environmental, social and governance (ESG) factors – with an eye toward making the world a better place – and mainstream financial returns can be achieved simultaneously.

As always, everything we do at First Affirmative is driven by our dedication to enabling advisors to deliver financial results to clients and belief in the power of capital to bring about lasting environmental and social change. Our new, innovative Values-Aligned Direct Index Solution (VADIS) and Sustainable Managed Mutual Fund and Multi-Manager Investment Solutions are built to enable clients to achieve their financial goals over the long term, along with their individual environmental, social, governance, ethical, and values-based objectives. Each portfolio is carefully constructed to be well diversified across assets, sectors, geographies, securities, and management styles –– and designed to weather periods of uncertainty and volatility.

Figure 9. MSCI KLD 400 vs S&P 500 Indices, June 30, 2022



	MSCI KLD 400 Social Index*	S&P 500 TR Index
Annualized Return Since 5/1/90:	11.16%	10.13%

Source: Morningstar. *Data prior to 9/1/2010 is that of the MSCI KLD 400 Social Index GR, while data since 9/1/2010 is that of the MSCI KLD 400 Social Index NR. Indexes are unmanaged groups of securities. Index performance does not include the impact of cash, fees, or transaction costs. Investors cannot invest directly in indexes but may purchase mutual funds or other investment products designed to track the performance of various indices.

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