**Mid-Year Capital Markets Update**

**Reassessing the Evolving Market Landscape**

***Key Observations***

* *We anticipated a challenging investment environment with heightened levels of volatility.*
* *The broad themes outlined at the beginning of the year – the evolving nature of the pandemic, central bankers’ balancing act and historically high inflation remain the prevailing themes. Along with the rising probability of recession, these themes will likely drive capital markets volatility throughout the second half of the year.*
* *As of June 13, 2022, the S&P 500 officially entered bear market territory, which is more than 20 percent below its all-time high set in January of 2022. In addition to a challenging global stock market rout, the 10-Year U.S. Treasury yield is up about 2 percent year-to-date (through June 14), making the first half of 2022 one the worst periods for the bond markets on record.*

**The State of the Broader Economy**

With the economic fallout including the exacerbation of inflationary forces from the war in Ukraine, CPI at 40-year highs, a flattening yield curve bordering on inversion and a bear market in the S&P 500 index (as of June 13), recession expectations have been steadily rising during early 2022. Near-term economic and inflation data is likely to underwhelm if not disappoint, particularly on the heels of the strong economic advances in the aftermath of massive fiscal and monetary stimulus throughout the pandemic. In the current environment, even in the face of slowing economic growth and forward-looking growth expectations, the Fed has little wiggle room to focus on anything other than reining in inflation. Given the Fed’s failure to raise rates in 2021 in the face of what it called ‘transitory’ inflation at the time, it has no choice now but to play catch up to try to rein in inflation even if means causing a recession. As a result, global stock and bond markets have been grappling with increasing stagflation concerns, which have necessitated the broad repricing of financial assets that we have seen.

**Our 2022 Themes – Revisited**

1. **From Pandemic to Endemic**

Despite the general trend toward less virulent subsequent variants, we expect COVID-19 to continue to exacerbate supply chain bottlenecks particularly in China where a zero COVID-19 policy is still leading to unpredictable production stoppages and global economic growth headwinds. It is another factor leading to supply shortages and inflationary pressures.

1. **Policy Maker Tightrope**

Central bankers across the globe continue to implement an array of policy responses, crafted to answer to their own unique economic circumstances. While central banks in many advanced markets are raising rates to dampen inflation, conditions elsewhere have required more nuanced approaches – ranging from the European Central Banks’s near-term emphasis on quantitative tightening and higher rates to the People’s Bank of China’s efforts that lean into more stimulus to stabilize an economy recently maligned by widespread lockdowns in response to a COVID-19 outbreak.

1. **Inflation: Coming or Going?**

Inflation continues to run at 40-year highs, which is untenable to the Fed. As shown by the Fed’s nearly unanimous approval of its 75 basis point hike on June 15, there will be a more accelerated and emphatic path to higher rates than expected as recently as last week or last month. Among Fed officials, the weighted-average expectation for the Fed Funds rate at year-end currently stands at 3.6 percent according to the CME FedWatch Tool as of June 17, 2022. One week ago on June 10, it stood at 3.3 percent and one month ago on May 17, it stood at 2.9 percent. The current Fed Funds Rate is 1.5-1.75 percent[[1]](#footnote-1).

1. **Volatility Ahead: Be comfortable with your risk posture**

Equity markets no longer enjoy accommodative monetary policy and find their relative appeal more directly challenged by meaningfully higher bond yields. As investors find they can earn higher rates of return investing in bonds on a go forward basis, stocks reprice (down) until a new equilibrium is achieved. Interest rate volatility remains higher than normal as investors labor to gauge the Fed’s further policy intentions, which will be driven by inflation data. So far in 2022, the number of days where the U.S. Treasury has moved 10 basis points (0.10 percent) or more is well above the pace of previous years.

1. Federal Reserve. As of June 17, 2022 [↑](#footnote-ref-1)