

**EQIS**

# EQIS Quarterly Commentary

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Q2 2022



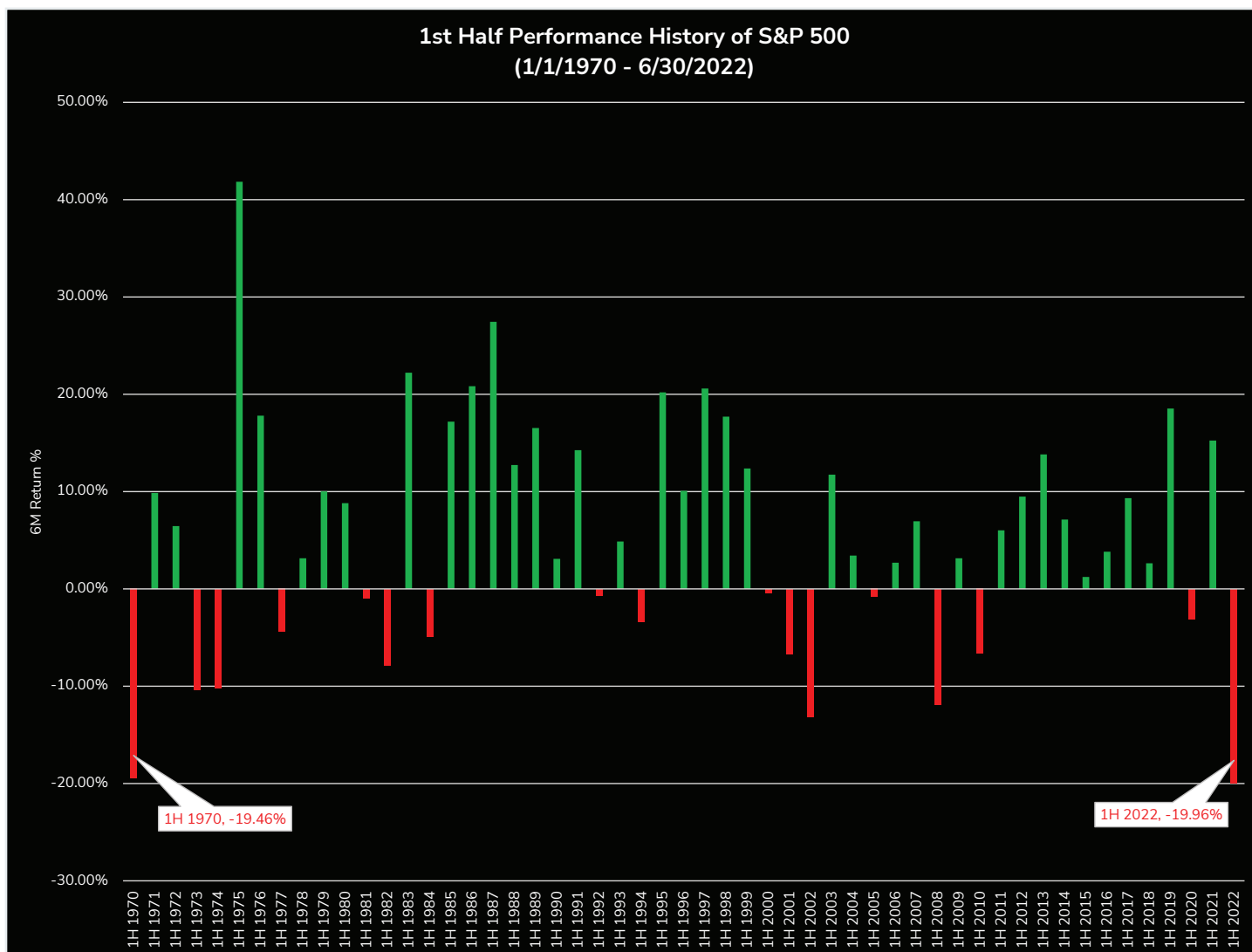
## Central Bank Tightening and Recession Fears

The first six months of 2022 marked the worst performance since 1970 for equities as the S&P 500, Dow Jones Industrial Average, Nasdaq, and Russell 3000 finished the quarter and first half down by 10% to 29%.

The combination of central bank tightening due to persistent inflation caused in part by continued supply chain issues and labor market tightness, pushed equities into bear market territory as the probability of a recession grows.

Broad Market	QTD %	YTD %
S&P 500 TR USD	-16.10	-19.96
DJ Industrial Average TR USD	-10.78	-14.44
NASDAQ Composite TR USD	-22.28	-29.23
Russell 3000 TR USD	-16.70	-21.10

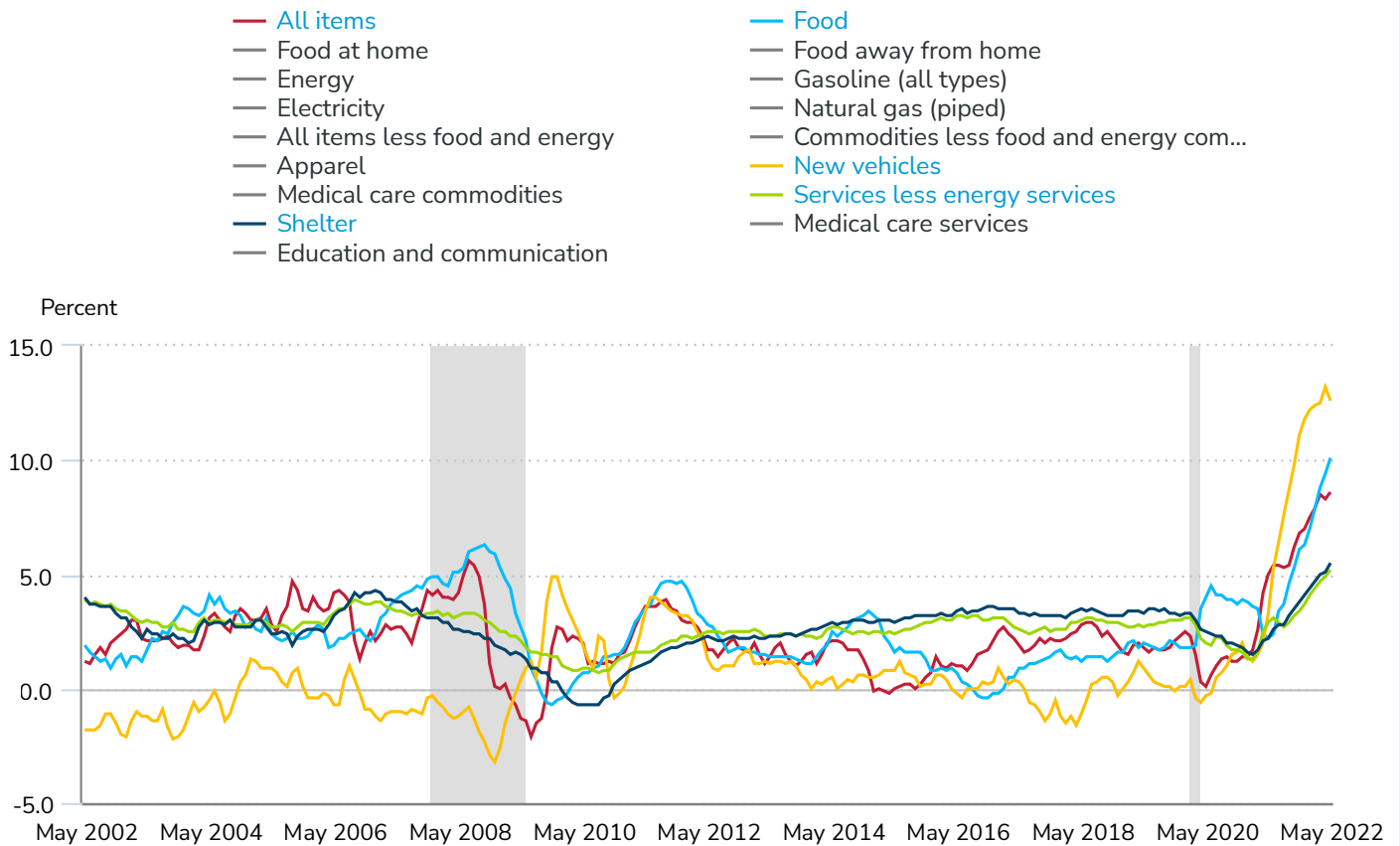
Source: Morningstar Direct



Source: Morningstar Direct

Inflation continues to be the core of the problem throughout much of the developed world. Central banks have signaled their commitment to temper persistently high inflation with rate hiking cycles. Early in the pandemic-induced recession of 2020, the increases in inflation were limited to a small set of goods such as used cars as consumer demand outstripped supply-side constraints. Now as consumers have shifted their buying habits back to services, there has been a widening of inflation pressures. Services prices excluding energy have sharply increased as consumers' spending habits shift.

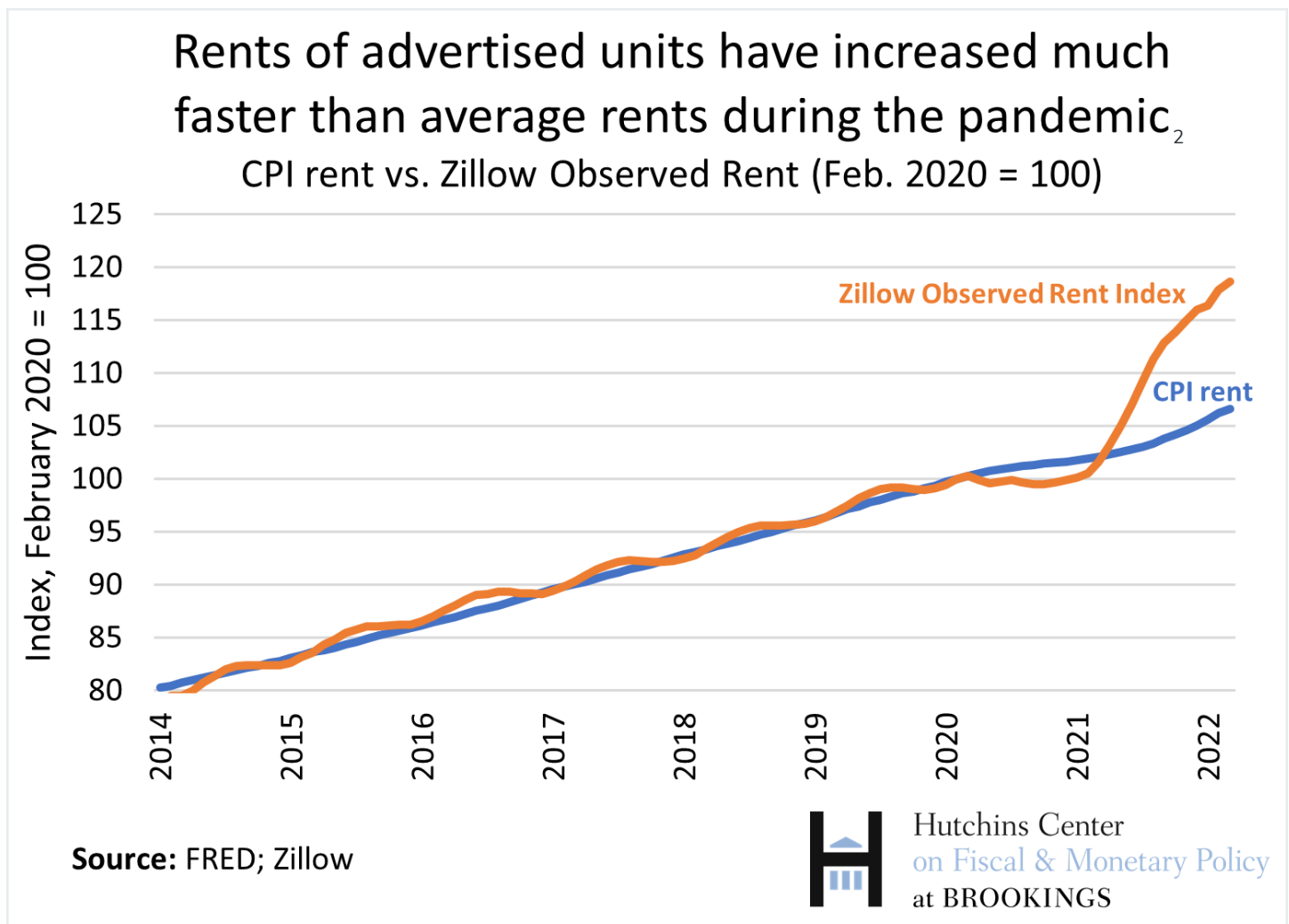
12-month percentage change, Consumer Price Index, selected categories, not seasonally adjusted



Note: Shaded area represents recession, as determined by the National Bureau of Economic Research.  
 Source: U.S. Bureau of Labor Statistics.

Source: <https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category-line-chart.htm>

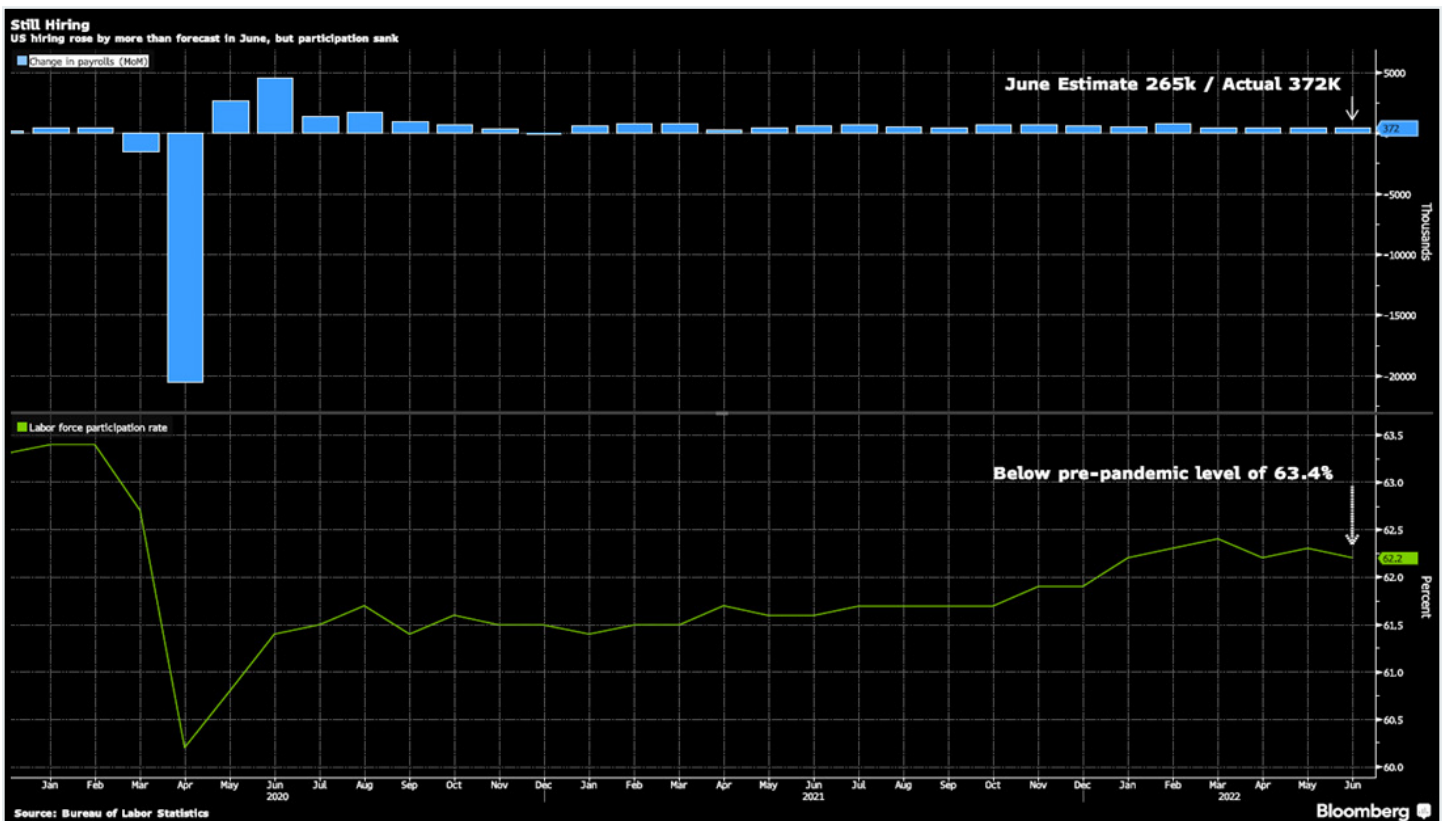
Inflation readings have also been increasing for stickier prices like shelter. The Zillow Rent Index has shown a substantial increase in the last year and a half and is a leading indicator for future rent Consumer Price Inflation. Researchers from the San Francisco Fed project that if recent trends in rents and housing prices hold, then “rent inflation will increase by about 7% in 2022 and 2023, almost twice the pre-pandemic five-year average. These findings imply that housing will boost headline CPI inflation about 1.1 percentage points above historical average by the end of 2022.<sup>1</sup>” Further increases in mortgage rates have sidelined many would-be homeowners as they get priced out of the market. Rents have seen rapid growth as potential owners have stopped looking for homes in a hot real estate market.



1. <https://www.frbsf.org/economic-research/publications/economic-letter/2022/february/will-rising-rents-push-up-future-inflation/>  
 2. <https://www.brookings.edu/blog/up-front/2022/05/18/how-does-the-consumer-price-index-account-for-the-cost-of-housing/>

The labor market remains very tight with continued near record-high job openings in the Job Openings and Labor Turnover Survey (JOLTS). The most recent report indicated approximately 11.3 million openings as of May 2022, roughly double the number of unemployed individuals. Economists anticipated only a slight decline in the number of job openings and highlights the robust labor market. While wage growth has continued to rise month-over-month, the pace at which it has been increasing is beginning to cool off. The latest month-over-month change in average hourly earnings reports from April and May show a slowing down to 0.3% vs. the prior year's average of 0.4-0.5%.

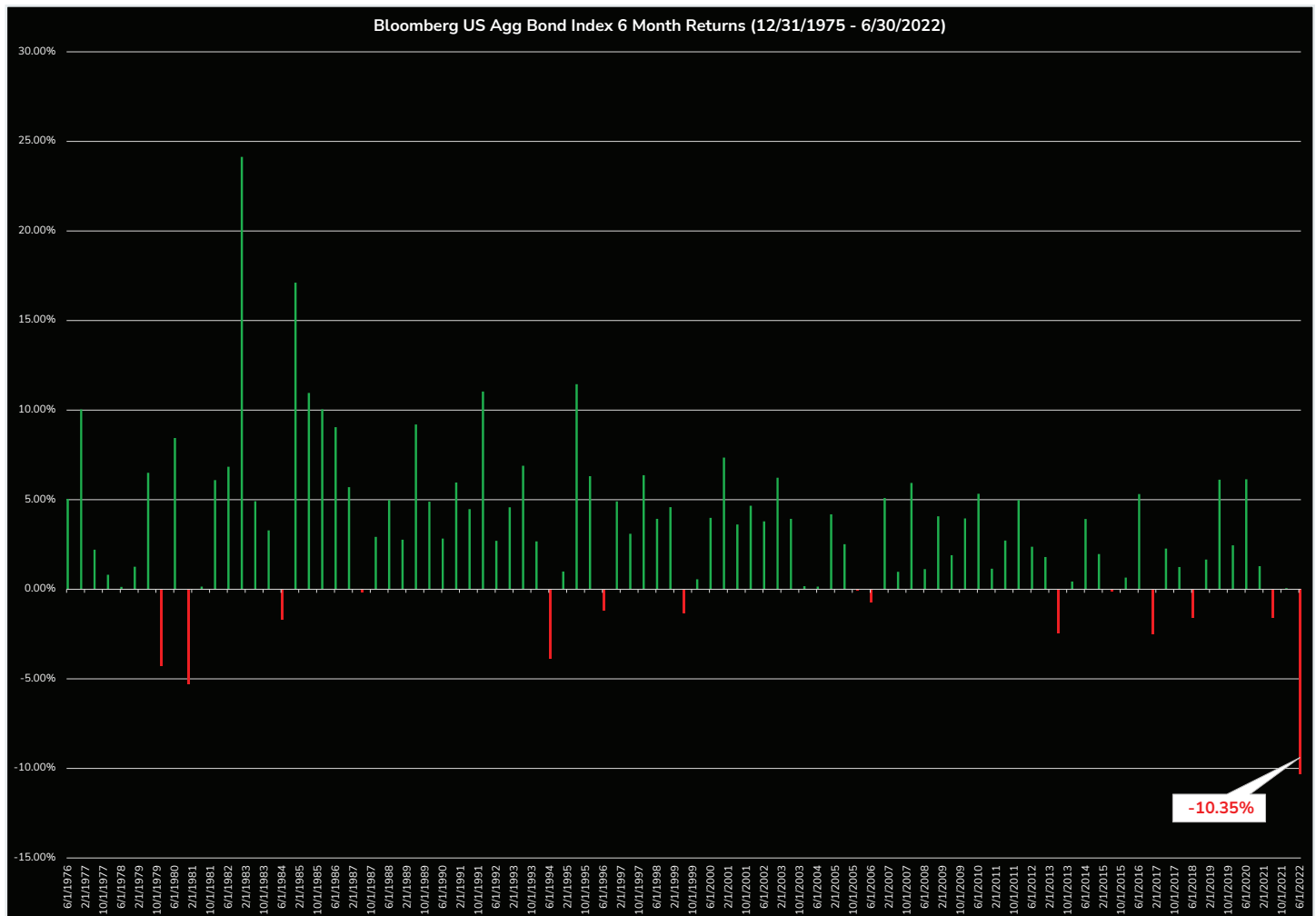
Inflation has impacted most developed and emerging market economies as commodity price increases and the rolling back of pandemic era restrictions have led to central bank tightening around the globe. As a result of restrictive monetary policy from central banks, the global economy looks set to experience a slowdown in growth.



Source: Bloomberg

## Fixed Income Markets

Fixed-income markets shared a similar fate as equity markets. The six-month return on the US Aggregate Bond Index posted a loss of 10.35%. The June inflation reading showed a nearly four decade-high and a broadening of inflationary components, defying economist expectations that inflation pressures would begin to ease. Following the disappointing inflation measure, the 10-year US Treasury closed at 3.482% on June 14th, the highest close since April 2011. The move up in yields and higher-than-expected inflation played into the Fed’s decision to increase the policy rate by 75 basis points (bps), a move they had previously taken off the table. This rate hike was the largest single increase in the Fed Funds Rate since 1994 and signaled that the Fed has an arduous task in orchestrating a soft landing.

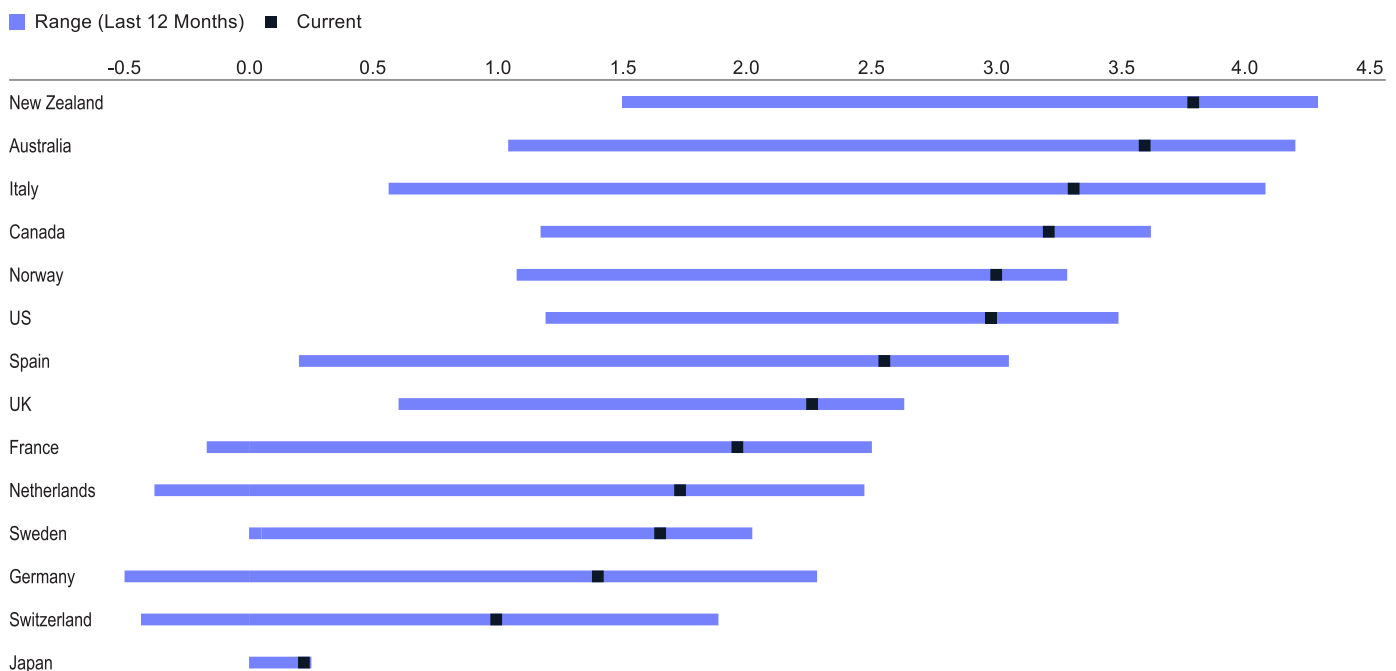


Source: Morningstar Direct

The Fed acknowledged that several more hikes are planned to combat the highest inflation in 42 years, and the terminal rate will likely be above the neutral rate. It is also possible that the neutral rate, which is the interest rate that neither stimulates nor slows the economy, may be higher in this inflationary environment than it was in recent decades. The effects of the rate hikes were immediately felt in the 30-year fixed mortgage rate as it climbed above 5% for the first time in 10 years. The Fed appears to be behind the inflation curve and will likely need to stunt growth to tame inflation. An increased pace of tightening has pushed recession probability models from 30% to roughly 60%, pointing to the potential for aggressive rate hikes to tip the economy into a recession.

Currently, policy rates have increased by 150 bps in the US, 115 bps in the UK, 125 bps in Canada, and 75 bps in Australia. In addition, the European Central Bank signaled an initial rate hike of 25 bps in July, followed by further tightening in September with increases to the policy rate in 50 bp increments. The actions and commentary from Central Banks point toward restrictive monetary policy in the future with an emphasis on reining in inflation even with weakening GDP readings.

## 10-YEAR SOVEREIGN BOND YIELDS (%)



Source: Macrobond, Goldman Sachs Asset Management. As of July 1, 2022.

Source: <https://www.gsam.com/content/gsam/us/en/advisors/market-insights/gsam-insights/fixed-income-macro-views/global-fixed-income-weekly.html>

Longer-dated Treasuries continue to be the worst performers as long duration magnifies the impact of interest rate hikes. The entire yield curve has reset significantly higher than this time in 2021, and there does not appear to be an end in sight. The 10-year US Treasury closed at 3.482% on June 14th, the highest close since April 2011. The yield on the 10-year US Treasury fell in the latter half of June as traders focused on the increased recession risks. On June 30th the Atlanta Fed lowered its estimate for second quarter GDP to -2.1% from -1%.

Rates	QTD %	YTD %
USTREAS T-Bill Cnst Mat Rate 1 Mon	0.10	0.12
USTREAS T-Bill Cnst Mat Rate 3 Mon	0.01	-0.02
USTREAS T-Bill Cnst Mat Rate 6 Mon	-0.26	-0.51
USTREAS T-Bill Cnst Mat Rate 1 Yr	-0.58	-1.52
USTREAS T-Bill Cnst Mat Rate 2 Yr	-0.57	-3.17
USTREAS T-Bill Cnst Mat Rate 3 Yr	-0.84	-4.61
USTREAS T-Bill Cnst Mat Rate 5 Yr	-2.02	-6.87
USTREAS T-Bill Cnst Mat Rate 7 Yr	-3.30	-8.76
USTREAS T-Bill Cnst Mat Rate 10 Yr	-4.98	-11.24
USTREAS T-Bill Cnst Mat Rate 20 Yr	-10.58	-19.03
USTREAS T-Bill Cnst Mat Rate 30 Yr	-12.75	-22.17
<b>Benchmark: Bloomberg US Treasury Bills TR USD</b>	<b>0.06</b>	<b>0.02</b>

Source: Morningstar Direct



Source: Bloomberg

## US Equity Markets

The first half of 2022 saw equities reach bear market territory as the S&P 500 fell -21.08% from its January 3rd high of 4,796.56 to 3,785.38 on June 30th. All 11 S&P sectors finished in negative territory, with 7 of 11 sectors ending down double digits. The equity size and style indices also experienced painful losses, with the Russell index series down double digits for the second quarter.

Within the S&P 500 sectors, when comparing valuations (EV/EBITDA), we can see that Financials, Materials, Health Care, and Energy look relatively attractive when compared with the historical averages of EV/EBITDA. Evaluating profitability based on EBITDA helps to remove distortions to bottom line earnings from earnings management and gives a clearer picture of a company's performance.

US Equity Size	QTD %	YTD %
Russell 1000 Growth TR USD	-20.92	-28.07
Russell 1000 TR USD	-16.67	-20.94
Russell 1000 Value TR USD	-12.21	-12.86
Russell Mid Cap Growth TR USD	-21.07	-31.00
Russell Mid Cap TR USD	-16.85	-21.57
Russell Mid Cap Value TR USD	-14.68	-16.23
Russell 2000 Growth TR USD	-19.25	-29.45
Russell 2000 TR USD	-17.20	-23.43
Russell 2000 Value TR USD	-15.28	-17.31
<b>Benchmark: Russell 3000 TR USD</b>	<b>-16.70</b>	<b>-21.10</b>

Source: Morningstar Direct

EV/EBITDA	Current	Historical Avg	Over/Under Valued*
S&P 500	100%	100.0%	100.0%
Energy	82%	86.9%	94.8%
Materials	78%	91.3%	85.3%
Industrials	105%	98.5%	106.2%
Consumer Discretionary	115%	100.2%	114.2%
Consumer Staples	118%	110.0%	106.9%
Health Care	111%	120.8%	91.6%
Financials	53%	91.8%	57.4%
Information Technology	163%	117.6%	138.3%
Telecommunication	78%	69.8%	111.6%
Utilities	114%	82.3%	138.2%
Real Estate	196%	166.2%	118.1%
<b>*Current/Historical Avg</b>	<b>Lower = Undervalued</b>		

Source: Bloomberg

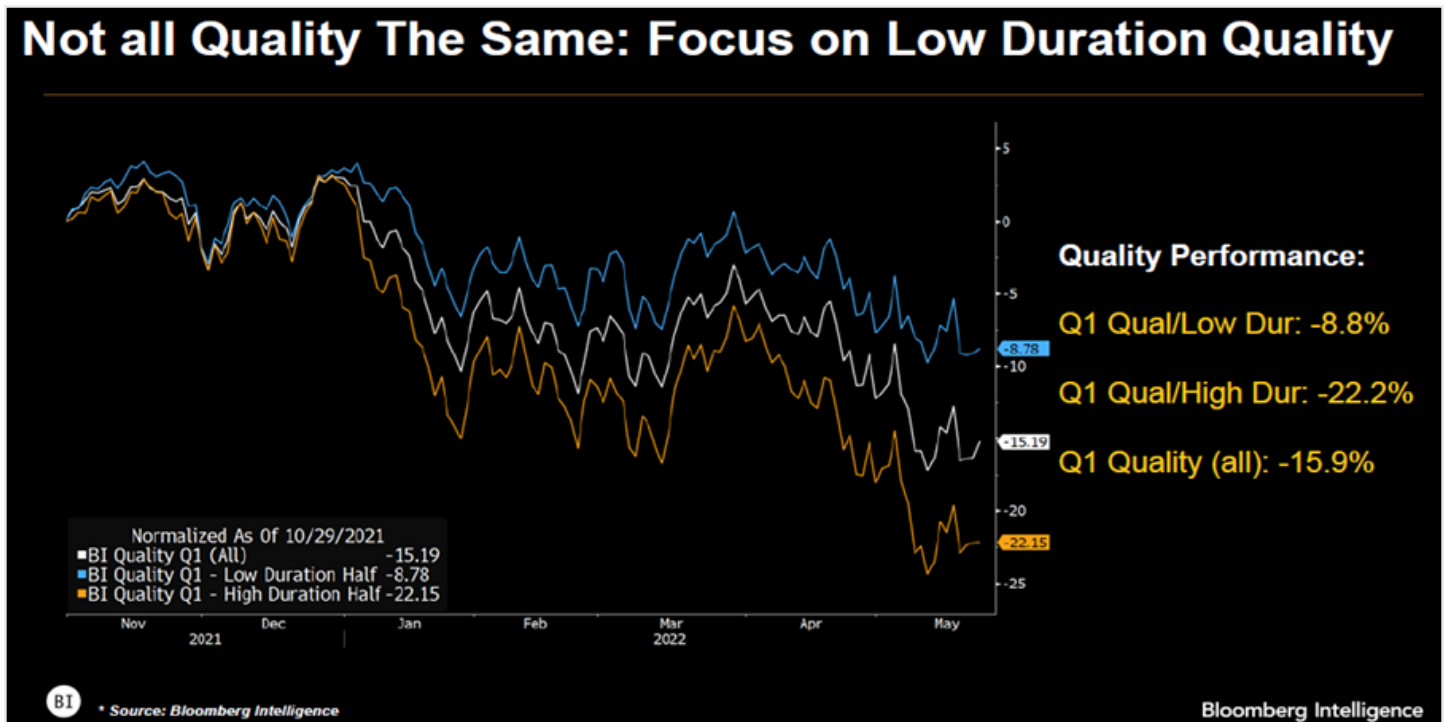
Within equities, we can also see divergence within factor groups, with quality stocks showing large dispersion when separated into low duration and high duration bins. A low duration preference would support allocations to value stocks as rates continue to rise.



US Sector	QTD %	YTD %
S&P Cons Staples Select Sector TR USD	-4.04	-5.25
S&P Consumer Disc Select Sector TR USD	-25.51	-32.47
S&P Energy Select Sector TR USD	-5.26	31.76
S&P Financial Select Sector TR USD	-17.50	-18.73
S&P Health Care Select Sector TR USD	-5.91	-8.33
S&P Industrial Select Sector TR USD	-14.78	-16.79
S&P Materials Select Sector TR USD	-15.90	-17.89
S&P Real Estate Select Sector TR USD	-14.72	-20.02
S&P Technology Select Sector TR USD	-19.67	-26.51
S&P Telecom Select Industry TR USD	-15.82	-23.06

Source: Morningstar Direct

## Not all Quality The Same: Focus on Low Duration Quality



Source: Bloomberg



The most speculative risk assets experienced some of their worst losses in the first half of 2022 as Bitcoin (BTC) and Ethereum (ETH), the two most significant digital tokens by market cap, lost -58.8% and -70.95%, respectively. The Crypto world was a major beneficiary of the excessive risk-taking in 2020-2021 due in part to cheap liquidity and leverage. That environment also fueled meteoric rises in meme stocks like GameStop (GME), AMC Entertainment (AMC), and Blackberry Limited (BB). While cryptocurrencies, NFTs, and Defi continue to attract investors, the high correlation to traditional equity indices and significant volatility point to holding a low to no allocation until the crypto winter seems to be in a later stage.



Source: Bloomberg

## International Markets

Europe continues to be highly exposed to downside risk from energy disruptions, slowing growth and cooling demand for goods. The euro area has so far absorbed the energy shocks and growth slowdown but rising interest rates and further deterioration from inflation diminish the attractiveness of European equities. Eurozone Inflation reached 8.6% in June and marked the highest reading since the Euro's inception in 1999. Energy prices have driven much of the inflation as many countries are dependent on Russian gas and oil. Since the invasion of Ukraine, Russian imports of natural gas to European countries have been reduced by more than half and have left government officials scrambling to find alternative sources.

In a similar move to the Fed's response to rising inflation, the European Central Bank (ECB) has made a hawkish pivot with a commitment to tackling inflation. The ECB has signaled that they are likely to announce interest rate hikes at the July meeting and likely again in September when they reconvene. The increase in policy interest rates will be the first such move in 11 years. The combination of a faster rate hiking cycle and continued economic pressures from energy and food security concerns could push the region into a recession.

Economists are expecting a pickup in wage growth as workers demand higher wages and put continued upward pressure on prices and interest rate increases. While Europe may look attractive from a current P/E valuation standpoint, the impact of rising rates and energy costs on many of the Stoxx 600 members will limit upside in the near term.

The UK is facing an all-time high inflation rate as the most recent print came in at 9.1%. The Bank of England (BoE) expects a sharp slowdown in GDP growth in the next 12 months. The BoE faces potential stagflation concerns as it projects a contracting economy in the fourth quarter of 2022 due to weakening retail sales and multi-decade lows in consumer confidence. UK consumers feel squeezed as the cost of living rises as the BoE accelerates policy tightening. The BoE's Monetary Policy Committee anticipates that total real incomes will contract by the second-largest amount since records began in 1964.

Europe Developed Equity	QTD %	YTD %
S&P Austria BMI NR USD	-17.48	-30.33
S&P Belgium BMI NR USD	-16.91	-20.51
S&P Denmark BMI NR USD	-12.43	-18.70
S&P Finland BMI NR USD	-13.02	-24.47
S&P France BMI NR USD	-14.87	-22.45
S&P Germany BMI NR USD	-18.72	-29.21
S&P Ireland BMI NR USD	-17.66	-31.91
S&P Italy BMI NR USD	-17.82	-26.58
S&P Luxembourg BMI NR USD	-27.45	-30.98
S&P Netherlands BMI NR USD	-18.70	-31.57
S&P Norway BMI NR USD	-18.38	-13.27
S&P Portugal BMI NR USD	-4.93	-2.75
S&P Spain BMI NR USD	-8.66	-12.24
S&P Sweden BMI NR USD	-23.86	-36.82
S&P Switzerland BMI NR USD	-14.73	-20.61
S&P United Kingdom BMI NR USD	-11.99	-13.09
<b>Benchmark: MSCI Europe NR USD</b>	<b>-14.49</b>	<b>-20.79</b>

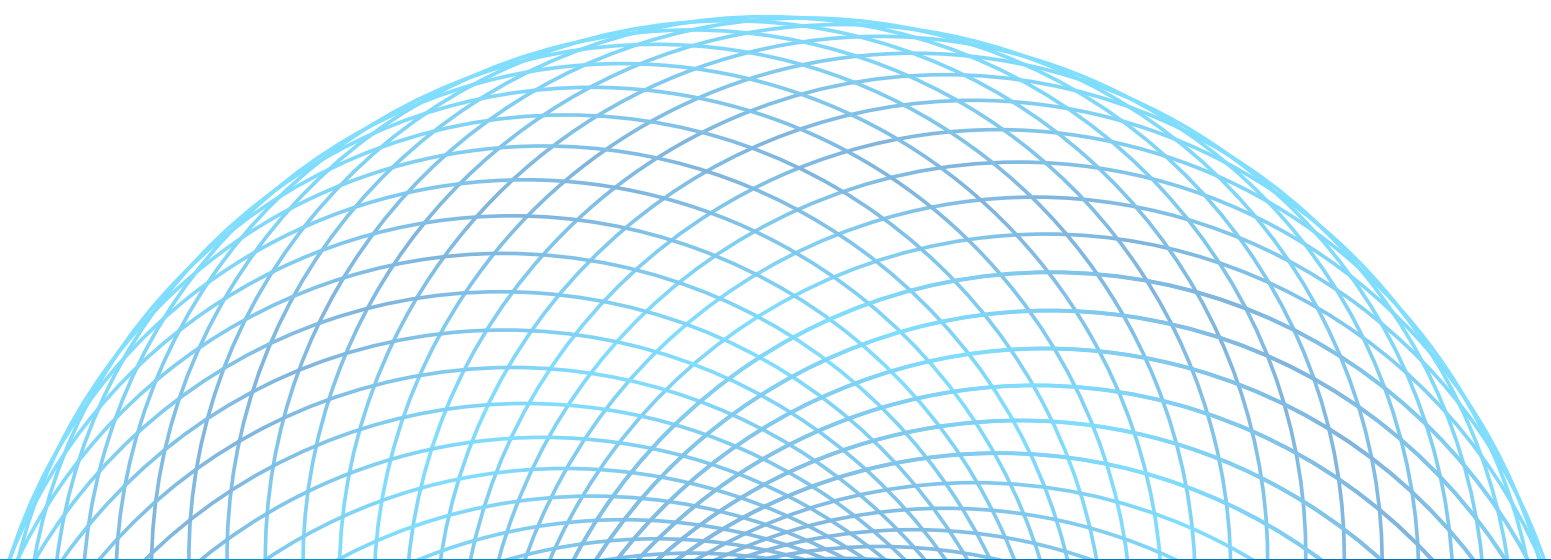
Source: Morningstar Direct

The Chinese economy has worked to ease COVID restrictions as case counts fall in manufacturing hubs. The country's growth may have bottomed with the loosening of restrictions and can be expected to rebound sharply in the second half of 2022. Fiscal policy support from Beijing has historically been focused on infrastructure spending and acts as an essential stabilizer of the economy. As a result, China is likely to have a more gradual recovery in 2022 compared to 2020. The continued weakness in real estate and shifting away from consumer demand for goods will not provide the same tailwind as 2020. An important factor in China's recovery will be the ongoing zero-COVID policy. A transition from the strict lockdowns that have rolled through significant cities may be needed for a full recovery. Analysts anticipate a potential policy loosening if COVID-19 booster shots have been administered to roughly 80% of the over-60 population. J.P. Morgan currently places the run rate of shots for this cohort at an 80% rate in October.

Asia Equity	QTD %	YTD %
S&P Australia BMI NR USD	-20.10	-16.17
S&P China BMI NR USD	2.90	-11.73
S&P Hong Kong BMI NR USD	-1.12	-4.71
S&P India BMI NR USD	-13.66	-15.98
S&P Korea BMI NR USD	-21.50	-28.80
S&P New Zealand BMI NR USD	-20.88	-28.15
S&P Singapore BMI NR USD	-14.88	-18.17
S&P Taiwan BMI NR USD	-18.79	-24.00
<b>Benchmark: MSCI AC Asia NR USD</b>	<b>-11.02</b>	<b>-17.69</b>

Source: Morningstar Direct

In emerging markets, inflation will continue to dampen growth and impact local economies as higher food and energy prices eat into margins. In addition, policy rates have appeared to peak in Latin American and emerging European, Middle Eastern, and African regions as central banks there were early to begin rate hiking cycles.



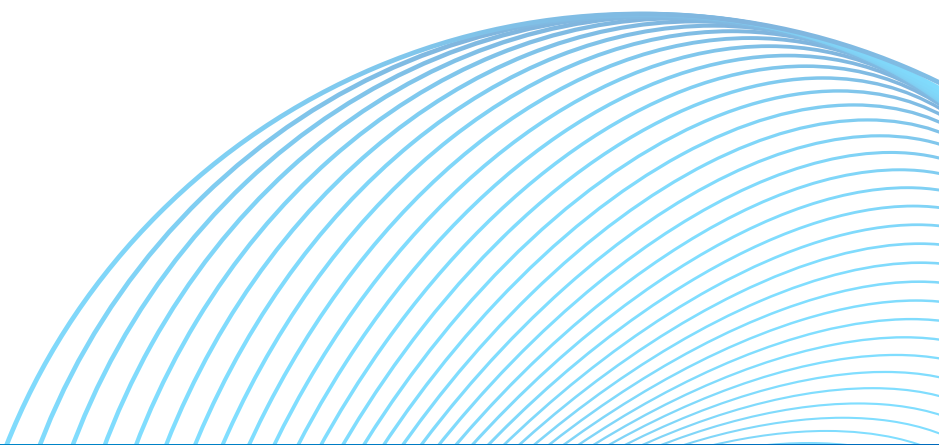
## Investment Strategy and Outlook

The first quarter was expected to see a peak rate of inflation as economists predicted we would start to see easing supply chains and a Federal Reserve targeting a soft landing with incremental 0.25% rate hikes. While the Consumer Price Index (CPI) hit a recent high of 7.9%, the Russian invasion of Ukraine added another layer of complexity to inflation. The sanctions on Russian energy are likely to continue to provide upward pressure on gas prices and inflation. Commodities recently surged due to production disruptions in agriculture products and metals, providing a rare spot for positive returns though volatility remains high. Latin American countries that are commodity exporters have benefited from the recent disruptions in eastern Europe.



Source: Bloomberg

An unintended outcome of cooling demand is the potential for a recession from declining margins, earnings, capital expenditures, and consumer spending. These fundamental drivers of equity returns will continue to put downward pressure on risk assets as the Fed works to find a neutral interest rate. Initially, our outlook for 2022 was more optimistic, given a gradual rate hiking cycle and moderating transitory inflation. However, the subsequent Russian invasion of Ukraine, unexpectedly high and persistent inflation, and a significant increase in the pace of rate hikes has altered the macro environment for the worse.

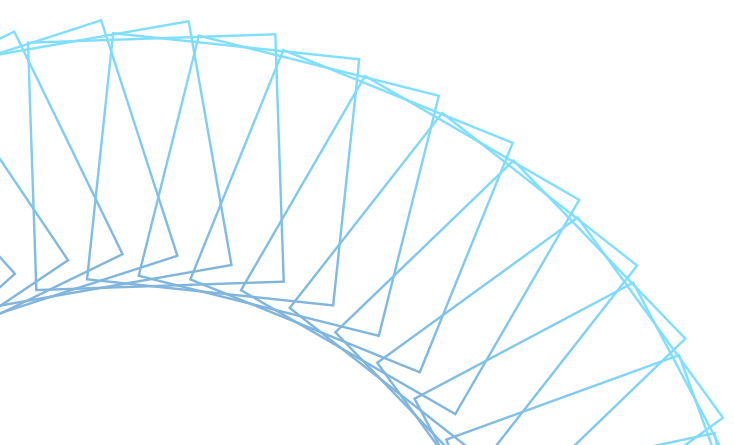


Within our broader asset allocations, we continue to remain neutral on equities. Even as current valuations are near or within historically normal averages, there remains further uncertainty and risks, but markets may be nearing an inflection point. Equities tend to overshoot both to the upside and downside and further deterioration is a potential outcome for the second half of 2022. We expect a similar environment of weakening margins and earnings in international markets to impact valuations. This will leave little room for valuation multiple expansions given policy rate hikes in the near term. As such we continue to maintain our preference for US equities over developed non-US equities, although valuations and growth abroad could shift that weighting in the coming quarters.

In our fixed income exposures, we maintain an underweight to Treasuries, especially on the longer end of the curve, and favor short duration. While duration is an explicit underweight, we see the potential for re-allocating once the Fed's policy rate hikes meaningfully impact inflation readings. Our outlook remains unchanged for investment grade and high yield for now.

The current environment is well suited to maintaining highly diverse portfolios as market risks remain higher now than at any point during the pandemic. Although stocks may experience short rebounds, we do not anticipate a meaningful recovery until at least one of several issues are resolved, including the Fed tightening, Ukraine conflict, or dissipated inflation readings. We will continue to include alternatives and non-standard asset classes to further diversify our models and seek uncorrelated alpha.

Asset Class Views 2022 (6/30/2022)			
Asset Class	Concern	Neutral	Constructive
Equities		0	
Bonds	-1		
<b>Equity</b>			
<b>Size</b>			
Large			1
Mid		0	
Small	-1		
<b>Style</b>			
Growth	-1		
Value			1
<b>Geographic Exposure</b>			
US			1
Intl Developed		0	
EM	-1		
<b>Fixed Income</b>			
<b>Geographic Exposure</b>			
US	-1		
Intl Developed	-1		
EM	-1		
<b>Credit Exposure</b>			
Treasuries	-2		
IG Corporates			1
High Yield			1
<b>Interest Rate Exposure</b>			
Duration	-2		
<b>Alternatives</b>			
Liquid Alts (F)			1
Commodities			2
Real Estate			1



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Except as otherwise specifically stated, all information and portfolio manager commentary are as of June 30, 2022.