BUCKHORN INVESTMENT ADVISORS

Second Quarter Market Review and Comment
July 2022

Updated Market Performance

Returns	2nd Quarter 2022	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**-16.10%**	**-10.62%**	**10.60%**	**11.31%**	**12.96%**
DJIA	**-10.78%**	**-9.05%**	**7.24%**	**9.98%**	**11.70%**

Performance: April gave back March's gains and then some posting a return of -8.72%. April showers almost brought May flowers posting a flat return of 0.18%. June fell -8.25%, continuing the downward trend this year leaving us with a 2nd quarter 2022 total return of -16.10%. This is the worst start to the year and 2nd quarter since 1970. We are also officially in a bear market which is a decrease of 20% from the last closing high set January 3, 2022, of 4,796.56.

After the 1st quarter 2022 posted a loss of -4.60%, the 2nd quarter 2022 brought the pain with a return of -16.10%. The Dow Jones Industrial Average (DJIA) outperformed the SP500, posting -10.78% loss over the same period. For the previous twelve months the SP500 has returned -10.62%, underperforming the DJIA which returned -9.05% over the same period. The annualized three-year returns are right around average (around 10.50%) for the SP500 posting 10.60%, the DJIA three-year returns trailed the average increasing 7.24%. Over the last five years the annualized returns are running around historical norms (around 10.50%), with the SP500 returning 11.31% and the DJIA posting 9.98%. The ten-year annualized numbers are running above long-term averages (around 10.50%), with the S&P500 returning 12.96% versus the DJIA which turned in 11.70%.

Breaking down the returns for Q2 2022, we note that there were seven outperforming sectors and four underperformers. **The best sectors were Consumer Staples (-5.23%), Utilities (-5.73%) and Energy (-6.13%)**. **The underperformers during the quarter were Consumer Discretionary (-26.32%), Communication Services (-20.87%) and Information Technology (-20.44%).** The best sectors over the last twelve months were Energy (34.09%), Utilities (10.84%) and Consumer Staples (3.94%). Following behind, were Communication Services (-29.63%), Consumer Discretionary (-24.73%) and Industrials (-14.76%).

Economy: Growth in the economy has begun to decelerate and is currently below average (Historical growth is ~3.00%). Expectations are that the second half of the year should have higher growth than the first half but not by much. Inflation was supposed ease meaningfully in 2022, but the Russia-Ukraine conflict thwarted that. The Fed has been tightening monetary policy to prevent runaway inflation. The Fed started raising interest rates at the end of Q1 2022. Normally when the federal reserve begins to tighten monetary policy and raise short term rates, they usually end up hindering growth and causing the economy to go into recession. Recession risks are currently high; However, the Fed has telegraphed more aggressive monetary tightening than anticipated, we anticipate this will lead to a double dip recession. We believe we are currently in a technical

recession. We think we will come out of the recession in the second half of the year and have the real recession sometime in 2023 or 2024.

The third estimate of 1st quarter 2022 Gross Domestic Product (GDP) is -1.5% according to the report released at the end of June by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 1st quarter decreased -8.4% from the 4th quarter 2021 third estimate of 6.9%. GDP for 2021 came in at 5.7% compared to -3.5% in 2020, 2.2% in 2019, 2.9% in 2018 and 2.2% in 2017. Currently the Atlanta Fed GDPNow estimate (Forecast of U.S. GDP Growth) has forecasted 2022 Q2 GDP growth at -1.6%. By comparison, China says their GDP increased at 4.8% in the 1st quarter of 2022. Increasing from 4th quarter 2021 reading of 4.0%. China's 2021 GDP was 8.1%, 2.3% in 2020, 6.1% in 2019, 6.6% in 2018 and 6.8% in 2017. Growth rates for the European Union (EU) and the Euro Area were 5.6% and 5.4% respectively in the 1st quarter 2022. For 2021, GDP grew 5.3% for the EU and 5.3 for the Euro Area. For 2020, GDP fell -6.1% for the EU and -6.37% for the Euro Area. For 2019, GDP rose 1.5% for the EU and 1.2% for the Euro Area. This is down from the 1.9% growth achieved by the EU and the 1.8% achieved by the Euro Area in 2018. GDP Growth forecasts for the end of the 2nd QTR 2022 are 3.10% for the EU and 1.0% for the Euro Area.

Unemployment is continuing to trend below historical norms (~5.76%), but we are starting to see more layoffs in the headlines. According to the Bureau of Labor Statistics, June unemployment remained the same at 3.6% from May. Unemployment for 2021 came in at 5.36%. Unemployment was 8.11% and 3.67% in 2020 and 2019 respectively. The number of unemployed was essentially unchanged at 5.9 million in June. These are minor changes from their pre-pandemic levels in February 2020 of 3.5% and 5.7 million, respectively. The labor force participation rate was little changed in June at 62.2% but remains 1.2% lower than in February 2020.

Inflation increased 9.1% in June continuing to run hot and above average trend. After averaging 7.97% in the 1st quarter 2022, inflation as measured by the Consumer Price Index (CPI) increased to an average of 8.67% for the 2nd quarter 2022. The average rate of inflation for 2021 was 4.70% and was above average by historical standards (~2.47% over last 30 years and 3.23% from 1914-2021). The energy index rose 41.6% over the last year, the largest 12 month increase since the period ending April 1980. The food index increased 10.4% for the 12 months ending June, the largest 12 month increase since the period ending February 1981.

Consumption is an important driver of the economy as it represented 68.4% of 1st quarter 2022 nominal GDP. The U.S. Census Bureau announced in July that retail sales for June 2022 were up 1.0% from May and were up 8.4% above June 2021. Gasoline stations were up 49.1% from June 2021, while the food services and drinking places were up 13.4% over the same period.

Manufacturing economy grew in June. Economic activity in the manufacturing sector expanded for the month of June, with the overall economy notching its 25th consecutive month of growth. The Purchasing Managers Index (PMI®) registered 53.0; a decrease of 3.1 from May's reading of 56.1. The Manufacturing PMI® continued to indicate sector expansion and U.S. economic growth in June. Three of the five subindexes that directly factor into the Manufacturing PMI® were in growth territory. The six biggest manufacturing industries registered moderate-to-strong growth in June, in this order: Computer & Electronic Products, Machinery, Transportation Equipment, Petroleum & Coal Products, Food, Beverage & Tobacco Products, and Chemical Products. The Production Index increased at a slightly faster rate. The Supplier Deliveries Index slowed at a slower rate while the Inventories Index increased slightly, indicating somewhat easing supply chain congestion. Eight of the 10 subindices were positive for the period; a reading of ‘too low’ for the Customers’ Inventories Index is considered a positive for future production. A reading above 50 indicates that the manufacturing economy is generally expanding; below 50 indicates that it is generally contracting. The overall economy grew for the 25th consecutive month, according to the nation's supply executives in the latest Manufacturing ISM® *Report on Business*®. Based on historical relationships between PMI and GDP, a PMI of 53.0 corresponds to a 1.5% increase in real gross domestic profit (GDP) on an annualized basis.

Home prices continued to increase in April but increasing mortgage rates will start to slow home price growth. According to the S&P Case-Shiller Home Price Indices home prices in April rose 20.4% over the last 12 months which is down 0.20% from the previous month’s 20.6%. Tampa, Miami, and Phoenix had the largest year over year increases with 35.8% for Tampa followed by 33.3% for Miami and 31.3% for Phoenix. According to the National Association of Realtors, the year-over-year change in existing home sales was -2.6% in May for Single family homes between $250,000-$500,000 and housing supply continued to remain tight in May with 2.4 months of supply.

Markets: The markets have been retreating after hitting an all-time high on the S&P 500 January 3rd, 2022, at 4,796.5. We went from being in a Bull market to being in a Bear market. At this time, the market is being driven by hawkish monetary policy, inflation, recession fears, decreasing corporate earnings growth, and the conflict between Russia-Ukraine.

What will move the markets moving forward:

- **Earnings: Earnings growth for the SP500 is expected to increase 4.2% for the 2nd quarter 2022 which is the lowest growth rate since 4th quarter 2020 (4.0%).** According to FACTSET, of the SP500 companies that have reported earnings as of July 15th (approximately 7), 60% reported earnings above the mean estimate, and 60% have reported sales above the mean estimate. Looking at future quarters, analysts project earnings growth for the 3rd QTR 2022 to be 10.1% and 9.2% for the 4th QTR 2022.
- **Valuations: Valuations have come down meaningfully this year.** The current 12-month forward Price to Earnings is 15.9 (21.4 on January 3rd, 2022). The 20 Year average P/E is 15.5, which is .4 below our current levels. There is some room for more contraction without meaningful growth. Lower interest rates have historically allowed for higher multiples, which would allow for some P/E expansion or cushion if we don’t see growth.
- **Monetary Policy/Interest Rates: Short Term Interest Rates remain low by historical averages. The average effective Fed Funds rate since July 1954 is 4.61%. The average over the last 10 years is 0.64%.** The Federal Reserve raised the federal funds rate by.75% to a range between 1.50%-1.75% in its latest meeting in June and is expected to raise rates by another .75% in July. The Fed projections suggest a fast cycle of rate hikes over the next year, with the median projection indicating a rate of 3.375% by the end of 2022. The Fed began to reduce its balance sheet holdings (quantitative tightening) in June, and the pace at which maturing bonds will roll off the balance sheet will increase in September. Shrinking the balance sheet is another form of tightening policy. The spread between the 2-year and 10-year Treasury yields has narrowed sharply as short-term rates have risen faster than long-term rates amid expectations for Fed monetary policy tightening. The yield curve typically inverts (2-year yield is higher than the 10-year yield) and financial conditions tighten significantly prior to recessions. **Ten of the last Twelve recessions have occurred during a rising interest rate environment when short term rates were higher than long term rates (Inverted Yield Curve), which leads to our ongoing concern of the Fed raising rates too fast. It is not if, but when.**

- **Inflation: Inflation increased 9.1% for the twelve months ending in June marking the largest increase since November 1981.** The only silver lining is that energy accounted for approximately half of the increase. Inflation currently does not seem to be going anywhere. We had thought inflation would cool off the second half of the year, but the Russia-Ukraine conflict has increased oil and gas prices as well as other commodities. Currently the Fed has committed to increasing interest rates and decreasing their balance sheet to try to fight inflation. This comes at a time when growth is about to slow. If growth slows too much and inflation stays elevated/high, we may end up with stagflation.
- **Russia-Ukraine Conflict: The current conflict is expected to weaken the European economy, with some speculation of a recession in some countries (especially Germany).** We are currently feeling the impact through higher oil and commodity prices. At this time, it is hard to determine the total impact this conflict will have on the US.

Forecast:

We think the biggest threats to the stock market are interest rates continuing to increase accompanied by runaway inflation, the Fed tightening monetary policy, and the Russia-Ukraine conflict. We think the SP500 will end the Q3 2022 between 3900 and 4000. At this juncture, we venture a guess that stocks will end the year somewhere between -5% and -7% for the year.

For the next six to twelve months, the Federal Funds rate will most likely increase from its current range of 1.50%-1.75% to 3.00-3.25%. **The 10-year Treasury which is currently priced at ~3.019% should remain in a range between 2.80%-3.10% through the end of the 3rd quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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