

# Stapp Financial Investment Letter

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Stapp Wealth Management, PLLC

Second Quarter 2022

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## Market Recap

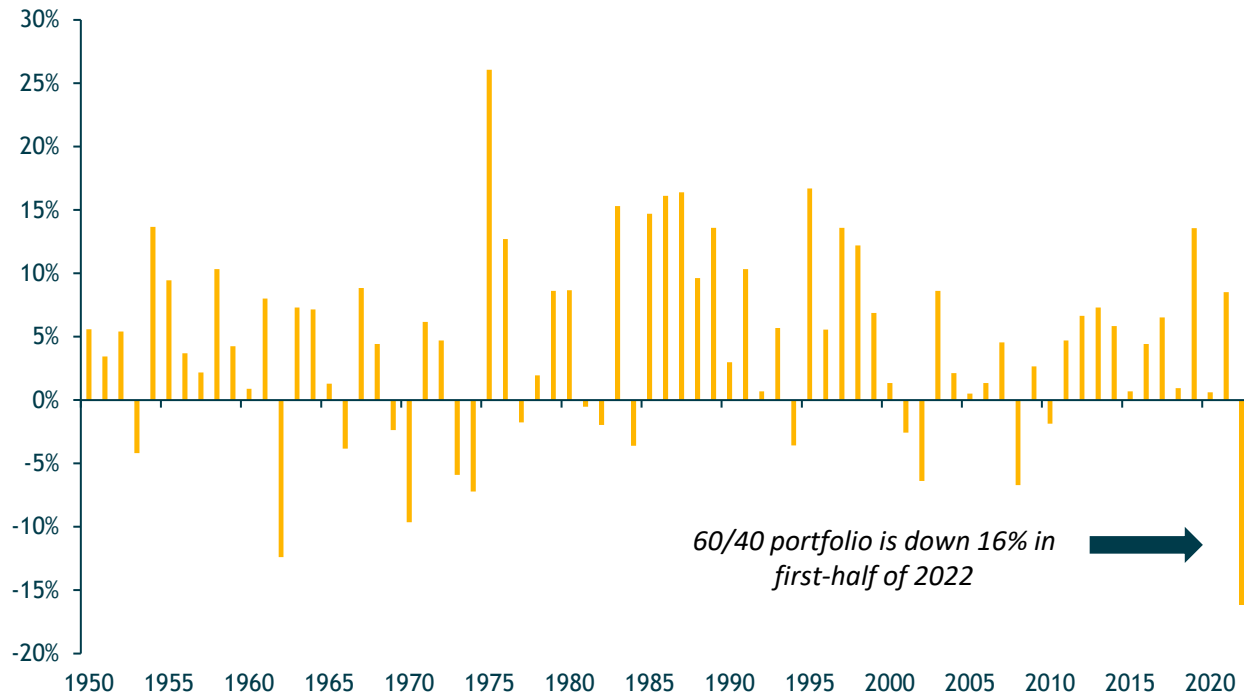
It's been a rough year, equity markets officially entered bear market territory in June, down more than 20%. US treasuries, considered the lowest risk bond, had their worst start to the year since 1788, a year when there was uncertainty over whether the states would become the United States. Other risk assets didn't fare much better. Over the past few months, inflation has run rampant globally. Inflation is a pernicious force. In times when inflation has run out of control, it has resulted in social unrest and in many cases even led to the downfall of nations. Fearing this, central banks around the world have shifted to much more aggressive policy stances with the goal of tempering inflation. The impact of these policies tightening financial conditions has brought fears of recession to the forefront. Exogenous shocks – the Russian war in Ukraine and China's zero-COVID lockdowns – continue to further disrupt the global economy and financial markets, adding a layer of complexity that may limit the efficacy of central bank policy in influencing inflation.

The S&P 500 dropped 16.1% for the quarter and is also down 20% for the year, after being down as much as 24% through mid-June. For non-U.S. stocks, the sharp appreciation of the U.S. dollar became a headwind for US investors, pushing returns that were less severe for local currency investors more negative for US dollar-based investors. Developed international markets (MSCI EAFE Index) were down 14.5% for the quarter and 19.6% YTD. Emerging Market (MSCI Emerging Markets Index) stocks held up a bit better, dropping 11.4% for the quarter, and down 17.6% YTD.

Core investment-grade bonds were pummeled again in the second quarter, with the benchmark Bloomberg U.S. Aggregate Bond Index (the "Agg") dropping 4.7%. This puts the "safe-haven" Agg down an incredible 10.3% for the year to date -- its worst first-half ever. In other segments of the fixed-income markets, high-yield bonds (ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index) fell 9.9% and floating rate loans (S&P/LSTA Leveraged Loan index) dropped 4.5% for the quarter.

As we have long been pointing out, core bonds are not low-risk or defensive assets in an inflationary (rising interest rate) environment. Taken together with the equity bear market, this is by far the worst first-half performance for a traditional "60/40" balanced portfolio (60% S&P 500/40% Aggregate Bond Index) in modern history, down 16.1%. The previous worst first half was 1962, down 12%.

### Worst First-Half Performance for the 60/40 Portfolio Going Back to 1950

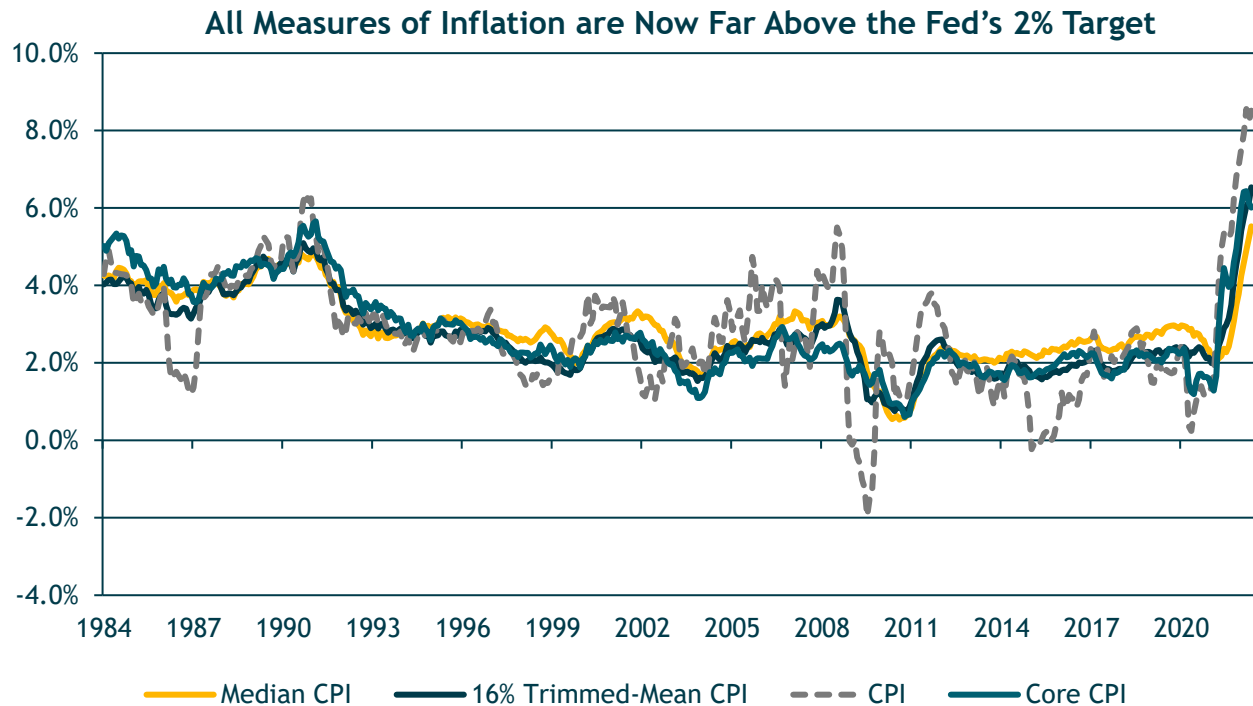


Data as of 6/30/2022. Source: Morningstar Direct. From 1950 through 1975, 60/40 portfolio is represented by 60% S&P 500 Index and 40% Ibbotson SBBI US Intermediate-Term Government Bond Index. From 1976 onward, portfolio is represented by 60% S&P 500 Index and 40% Bloomberg US Aggregate Bond Index. Portfolio rebalanced annually.

## Investment Outlook and Portfolio Positioning

In response to the accelerating inflation data that released in May, the Fed turned even more hawkish, hiking the federal funds rate a larger-than-expected 75 basis points. Tighter financial conditions in turn depress consumer and business spending, reducing aggregate demand in the economy. Lower demand (lower GDP growth) should reduce overall price pressures and hence inflation. That's the Fed's playbook and toolkit.





*Source: Federal Reserve Bank of Cleveland and U.S. Bureau of Labor Statistics. Data as of 6/27/2022.*

The ideal outcome would be the elusive “soft landing,” in which inflation is subdued without causing a recession. But the simple economic cause-and-effect influenced by the Fed’s toolkit assumes the supply side of the economy remains steady. However, this has not been the case due to (1) the Russia/Ukraine war’s impact on energy and agricultural commodities, and (2) COVID-related supply chain disruptions. We expect (hope) these shocks will recede with time, but the Fed can’t do anything about them. BCA’s U.S. investment strategist, Doug Peta put it well: “Soft landings are extremely elusive. It is fiendishly difficult to fine-tune a complex multi-faceted economy with central bankers’ blunt tools.”

Balancing these and many other data points, we expect continued and potentially sharp deceleration in economic growth driven by rapidly tightening monetary policy in response to sustained high inflation. A recession is a reasonable conservative assumption but not a certainty.

Our best guess at this point is that if the U.S. economy does fall into a recession, it is likely to be a more “normal” type of cyclical recession rather than like the 2008-09 financial crisis, the 2000-2002 dotcom bubble bust, or the 2020 COVID recession.

Given the sharp stock and bond market declines we’ve already experienced this year, this leads us to a relatively positive medium-term (five-year) outlook for financial markets and asset class returns. And if U.S. stocks drop further this year - for example, due to increasing recession fears - we will start adding incrementally more to our portfolio allocations.



Bear Markets				
Peak	Trough	% Loss	Months	Recession?
5/29/1946	5/19/1947	-28.5%	11.7	No
6/15/1948	6/13/1949	-20.6%	11.9	Yes
8/2/1956	10/22/1957	-21.6%	14.7	Yes
12/12/1961	6/26/1962	-28.0%	6.5	No
2/9/1966	10/7/1966	-22.2%	7.9	No
11/29/1968	5/26/1970	-36.1%	17.9	Yes
1/11/1973	10/3/1974	-48.2%	20.7	Yes
9/21/1976	3/6/1978	-19.4%	17.5	No
11/28/1980	8/12/1982	-27.1%	20.5	Yes
8/25/1987	12/4/1987	-33.5%	3.3	No
7/16/1990	10/11/1990	-19.9%	2.8	Yes
7/17/1998	8/31/1998	-19.3%	1.5	No
3/24/2000	10/9/2002	-49.1%	30.5	Yes
10/9/2007	3/9/2009	-56.8%	17.0	Yes
4/29/2011	10/3/2011	-19.4%	5.1	No
9/20/2018	12/24/2018	-19.8%	3.1	No
2/19/2020	3/23/2020	-33.9%	1.1	Yes
1/3/2022	???	-23.6%	???	???
Average		-29.3%	11.4	
Median		-25.3%	11.7	

Source: Morningstar Direct. Data as of 06/29/2022.

Meanwhile, our tactical views and positioning on emerging market (EM) stocks have not changed. Our view of developed international stocks is also still positive, but we view the risks in developed international markets as being elevated and have thus trimmed this allocation. Our base case five-year expected returns for EM and developed international stocks are in the low double digits, supported by low starting valuations and cyclically depressed earnings. This offers a margin of safety for investors, as a lot of bad news and negative sentiment is already priced into these markets - more so than for the S&P 500 in our view. Things don't have to be great to generate strong returns from here; they just need to get better from currently depressed levels (and we don't expect a pandemic and war to be permanent).



In terms of our fixed-income positioning in our balanced portfolios, we have maintained our underweight to traditional core bonds, reflecting our concerns about rising interest-rates and very low starting yields.

Though our fixed-income exposure has had better relative performance as interest rates have shot higher, they have not been immune to the recent broad fixed-income price declines. They also carry more credit risk than the Agg. As such, in our more conservative portfolios we still retain meaningful core bond exposure for their traditional role as recession/dis-inflation protection.

A key part of our fixed-income diversification has been our allocation to alternatives. We believe well-managed alternative strategies with reasonable fees can add beneficial diversification and improve risk-adjusted returns as part of traditional stock/bond balanced portfolios. Alternative investments have different risk and return drivers than traditional stock and bond investments. Given the current macro risks and market backdrop, we think they are especially valuable.

Portfolio diversification into these non-traditional asset classes can be particularly valuable in an inflationary environment as we've seen this year. Trend-following managed futures strategies again led the way posting double-digit positive returns. It's also worth noting the active managed futures funds we own have now outperformed both global stocks (MSCI ACWI) and bonds (the Agg) by wide margins over the past three and five years. Our allocation to gold also helped portfolios as its return was slightly positive for the first half of the year.

## Closing Thoughts

We aren't in the business of making short-term predictions, but nonetheless believe it is prudent to be prepared for more downside for the stock market over the next several months or quarters. Declines thus far have been driven by valuations coming down even as earnings have risen slightly. But we expect to see earnings impacted at some point and this could drive further shorter-term market declines. If further declines happen and reach our target, we will add incrementally to U.S. stocks at lower prices and higher expected returns.

On the other hand, if the economy avoids recession (for now) and the markets rebound, we are well-positioned to benefit with our allocation to equities and large allocation to actively managed credit-oriented fixed income relative to core bonds.

Our balanced portfolios remain positioned with (1) an underweight to equities overall; (2) a small overweight to global equities, coming from our tactical overweight to EM stocks; (2) Positions in flexible, actively managed, credit-oriented fixed-income and floating-rate funds; (3) core positions in alternatives and alternative strategies; and (4) an underweight to core bonds (relative to a traditional 60/40 stock/bond benchmark).

While tilting towards our highest-conviction tactical views, our portfolios remain strategically balanced and well-diversified across multiple global asset classes, investment strategies, equity styles and risk-factor exposures.

As always, we thank you for your trust and welcome questions you may have.

