

Quarter-In-Review – There are very few quarters in market history when the balance between winners and losers is so heavily skewed towards the red. The financial crisis stands out for many of us as particularly bad, but even then, bonds provided some diversification benefit by zigging when stocks zagged. It was the same during the tech bust of 2000 to 2002. Even though the dotcom darlings were crushed, you actually made money in other segments of the equity market during that period. Not so during this last quarter. As you can see from the table to the right, the equity markets were a wash in red. All the major sectors were down double-digits for the quarter, and the S&P 500 fell into bear market territory for the first time since March 2020. Growth oriented stocks continued to struggle, with large-cap growth falling -20.9% for the three months. Large-cap value held up on a relative basis (-11.4%) due in large part to the commodities sector, but even here, prices corrected hard in June with raw commodity prices down -8.4% for the month and energy stocks off -15.3%. It's also worth noting that cryptocurrencies were hit hard with Bitcoin down -56.6% for the quarter!!

The fixed income markets provided no calm during the storm. As you can see from the table to the right, the Fed Funds rate, 2-year, and 10-year Treasury yields all increased in the second quarter. The yield on the 10-year actually hit a high of 3.48% in mid-June before backing off by quarter's end. The rise in rates meant intermediate-term government bonds lost -4.5%, while shorter maturity bonds were down -1.4%. Just as with stocks, there was nowhere to hide as a bond investor. Treasury Inflation Protected securities lost -6.1%, floating rate funds were down -5.2%, and both investment grade and high-yield bonds were off close to -9%.

Changing Expectations – The second quarter started much as the first quarter ended in terms of the market debate. Investors were solely focused on the trajectory of inflation and how aggressive central banks would be in trying to tame prices. The Federal Reserve (Fed) in the U.S. and the Bank of England both communicated forcefully during the quarter that aggressive rate hikes were needed to address the

Market Benchmarks			
Market Indices	2 nd Qtr	YTD	3-Yr An
S&P 500 Index	-16.1%	-20.0%	+10.4%
Russell 2000	-17.3%	-23.5%	+4.1%
Global Equities	-15.2%	-19.8%	+6.5%
Int'l Index (EAFE)	-13.2%	-18.8%	+1.3%
Emerging Mkts	-9.2%	-14.9%	+1.9%
Other Indicators			
	6/30/22	3/31/22	12/31/21
Fed Funds Rate	1.5%-1.75%	0.25%-0.5%	0%-0.25%
2-Year Treasury	2.98%	2.32%	0.73%
10-Year Treasury	3.01%	2.33%	1.51%
S&P 500 P/E Ratio*	15.9	19.5	21.2
Crude Oil	\$105.76	\$101.20	\$75.45
Core Inflation	4.7%	5.4%	4.7%

*Forward 12-month operating earnings per S&P

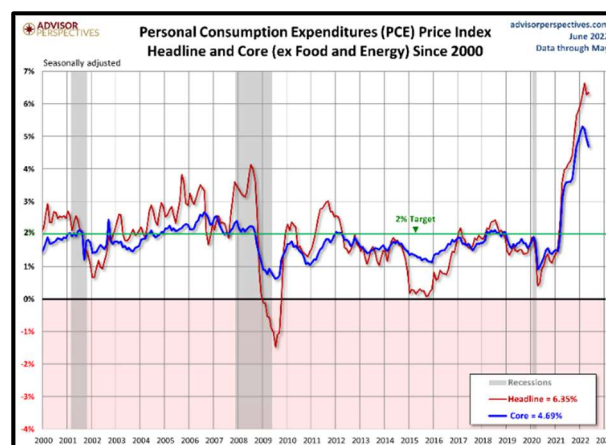
situation, and as expected, the Fed hiked rates by 0.5% on May 4th. To a lesser extent the European Central Bank echoed this theme and said they planned to *finally* move their policy rate out of negative territory in July.

But there was a subtle shift in market perceptions in mid-May as investors started to price in two seemingly contradictory scenarios. On the one hand, the consumer price inflation report released on May 11th came in above expectations and put an end to any hope that inflation was moderating. This set the stage for a 0.75% hike in June, with something similar expected in July.

But another narrative started to emerge – that of a possible recession on the horizon. Higher interest rates, tighter liquidity, and an energy price shock were all contributing factors to the growing concern. Moreover, there was a growing line of reasoning that the Fed would have to engineer a recession to bring inflation lower. After all, they have no tools to control the supply of goods. All they can do to combat inflation is pull demand down. And

the only way to do this is through lower growth or an outright recession. Investors, obviously, were torn between two conflicting paths.

Inflation – Be Careful With Extrapolation – There is no denying that inflation has been accelerating over the last few months. The chart to the left shows the Fed's preferred inflation gauge, and as you can see, both headline and core



inflation (minus food and energy) are at multi-year, if not multi-decade highs. We see this every day driving past the gas station or in the grocery store. Inflation was percolating before the war in Ukraine, but the conflict has only exacerbated the problem, particularly in the food and energy markets. But should we extrapolate high inflation far into the future?

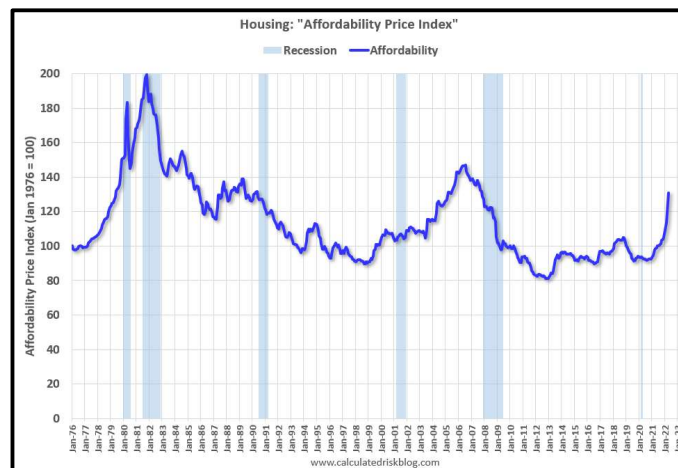


The chart to the right is interesting. It shows what are called 10-year inflation breakeven rates. Basically, it's the market's expectation of inflation over the next decade. Expectations are down to just 2.3%. What is the market telling us? Do they think supply chains are fixing themselves or the war in Ukraine is likely to end? Certainly, the supply chain story is improving. But critically, the market is starting to price in increased odds of a recession over the next year.

A Growth Slowdown or Recession? – Last quarter we'd have placed the odds of recession in the coming year at 1 in 3. But today we'd say the odds are skewed in favor a shallow recession sometime in the next year. What changed?

First, higher rates are starting to bite more than we thought. For example, mortgage rates have taken off, and while today's absolute level isn't excessive compared to the average of the last twenty years, there are a couple problems. The rate of change has been extraordinary with rates moving from 2.7% to 5.7% in a little less than twelve months. Additionally, housing affordability at these new rates is poor. The chart below from Calculated Risk shows a measure of affordability that factors in historic housing prices and interest rates. Housing is now the least affordable it's been since the housing crisis, or before that, 1989. Housing is likely to be a drag on growth in the second half.

Second is the wealth effect from lower asset prices. The lost wealth from falling stocks, bonds, and crypto prices in the last year is on track to be the largest hit to net-worth in modern history. Now granted, the run-up over the last few years is also unprecedented, especially for growth stocks and crypto. But over \$2 trillion has been wiped off the crypto market



globally alone in the last year. This will have an impact on spending trends.

Finally, the other major surprise factor has been energy costs. The chart at the top of the next page shows national gasoline prices. Additionally, electricity prices are up roughly +15% year-over-year while natural

gas prices are up +25% over the same period. Now, we should not forget that consumers in general remain in solid shape. They built up their savings balances during the COVID crisis and paid down debt. Furthermore, most consumer debt is at fixed rates, so the recent spike in yields doesn't impact many people. But increased energy costs are still troublesome.

What will differentiate between a recession and a growth slowdown is what happens to the labor market. Job growth through May has been strong and the unemployment rate remains at a low 3.6%. There are still a large number of unfilled jobs nationwide, but we have started to see hints of a slowdown. Weekly unemployment claims have ticked higher the last few weeks, not in a big way, but it is a change from the trend of the last two years. The \$64 trillion question is how will corporations react to a slower growth environment or even a recession? Will they slim down their workforce to try and maintain profitability, or will they be loath to give up the workers they fought so hard to find and train? There's no clear answer here. Clearly the crypto industry and parts of the tech sector are shedding workers, but so far the absolute number is small. The next few months are going to be key in assessing labor market trends.

So where does this leave us on the recession question? The rule of thumb for recession is two consecutive quarters of negative growth. First quarter growth was — 1.6%, and early indicators for second quarter growth are pointing towards another contraction. But to officially call a recession we will need to see unemployment up

materially combined with a contraction in manufacturing. We aren't there yet, but the odds of both happening in the second half are increasing. But it is worth stressing that any recession later this year will probably be shallow, barring any outside shock. Consumers are well positioned to weather a slowdown, so spending may not slump even if layoffs do pick up in the second half. The chart at the bottom of the next

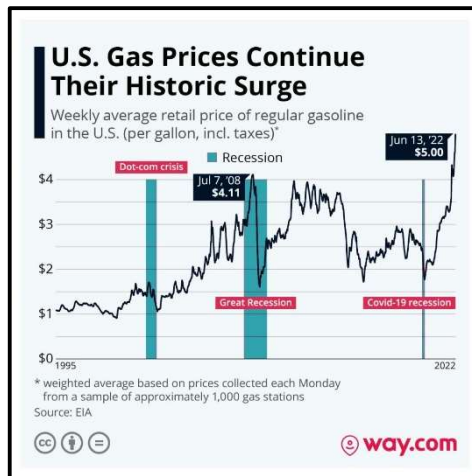
page shows that consumers have built up over \$2 trillion of excess savings. This should help cushion the blow from slower growth.

A Look Back at '73-'74 – Central banks are facing a challenge they haven't seen in decades, and how they deal with the issue will set the path for asset prices for some time to come. Consider the following. The current surge in inflation has been caused mainly by blowout spending coupled with supply chain disruptions. While some of the supply issues are likely temporary - Covid lockdowns, the Russia-Ukraine war, and people working from home - more money is being spent on less goods and services. Which of these can the Fed influence? If you said none of them then you are right. All central bankers can do is hike rates to decrease demand, which is what we are seeing now. Will this translate into moderating inflationary pressures? Historically it has.

Let's highlight two potential scenarios going forward. Let's call the first the bumpy-landing scenario. The markets continue to gyrate over the summer and into the fall as investors grapple with slowing growth, sticky prices, and central banks that remain committed to rate hikes. However, signs ultimately emerge in the fall or winter that price pressures are easing as growth slows. We are seeing early hints of this in the commodities market now. The table at the top of the next page shows how much some key commodities have fallen from their recent highs. If sustained, this is a big deal for the inflation outlook as it will feed through into much lower price pressures in the second half of the year. Slowing growth and less inflationary forces will give central banks the ability to pause.

Many will say, "so what – this won't help the markets." But we'd take the other side of that bet. To illustrate this, look at the chart at the bottom of the next page. It shows both the trend in GDP and the S&P 500 from the middle of 1973 to the end of 1976. The bear market of 1973-1974 bottomed months before growth turned higher. Why? The Fed stopped hiking rates in July 1974 and were soon cutting rates as growth faltered. The key for the markets was Fed policy, not the next retail sales report.

We wouldn't be shocked at all that such a scenario plays out this cycle. Equities remain volatile within a downtrend as growth falters and the Fed stays

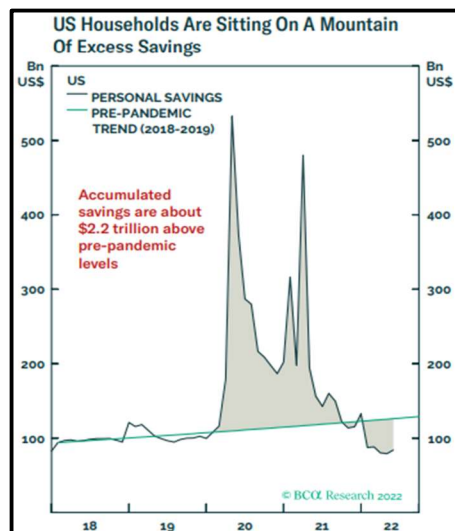


committed to tighter policy. We'd also expect earnings expectations to start to soften from today's optimistic levels as analysts are still penciling in high single to low double-digit growth rates in the third and fourth quarters of this year. However, sometime later this year the Fed goes from worrying about inflation to worrying about growth and puts any rate hikes on pause. Such a move would mirror the mid-70s cycle. Over the short-term we might see more downside for stocks in this scenario. But the challenge for investors is that selling now after the equity declines

that have already taken place with the goal of buying back at lower levels might require close to perfect timing, something few have.

What Would Cause a Hard Landing? – Where could things go wrong? We don't think it comes from the banking system like in 2008. There simply aren't large financial imbalances like there were then - consumers aren't overleveraged, corporations are generally in sound shape, and the banking system isn't overly exposed to volatile asset prices. But deep recessions can also be triggered by outside factors. The most obvious so-called 'exogenous' shock would be that energy prices spike higher in the coming months. Even a resilient global economy would likely fall into a deep recession if faced with yet another significant energy shock. We are starting to see just that in Europe. Emboldened by surging foreign revenues, Russia is cutting back the flow of piped gas to the EU, which is now receiving 53% less gas from Russia than it averaged before the start of the war. Withholding gas volumes to Europe concentrates pain while limiting revenue loss. Natural gas accounts for roughly 20% of budget revenues for Russia, less than half the income flow from oil.

Although Russia does not appear inclined to disrupt its oil exports, the decision this week by the G7 to consider oil price caps could generate the unintended consequence of a retaliatory cutback in Russia that ultimately raises the price of global oil. The added challenge is that OPEC appears to have little excess capacity to offset any supply reductions. Just as oil overshot on the downside during the COVID crisis (remember negative prices?), oil could overshoot on the upside if there are more supply problems. The global economy couldn't handle \$200 oil, and a deep recession would unfold. This isn't our base case, but it is a clear risk.



Strategy In Uncertain Times – What should investors do given the uncertain outlook? There’s no one-size-fits-all answer to this question given that everyone’s financial and emotional situation is different. But there are certain timeless recommendations that are worth reiterating:

- Markets are volatile. We all know that, but the volatility is why stocks beat bonds and cash over long periods of time. It’s a feature, not a bug, so to speak
- Your time horizon matters. It’s easy to forget, but a long time horizon means you can almost ignore the quarter-to quarter noise.
- Your spending rate also matters. If you are drawing down your portfolio by 2% or 3% a year you are going to be fine under almost any scenario. But if you are spending 7%, 8%, or more, there’s a problem regardless of the market scenario.
- Wealth is generally created through long, slow compounding, not market timing. We are all inclined to be ‘buy and hold’ during bull markets but traders during bear markets. However, success comes from avoiding the siren song of market timing.

What are we doing with our portfolio allocations? At the margins we are doing three things:

- 1) We remain more worried about Europe than any other region. There are no easy solutions for their Russian energy dependence and they would be hit particularly hard by a surge in crude oil prices. In our mind this justifies staying underweight European assets until the energy situation stabilizes.
- 2) Secondly, to hedge against the deeper recession scenario, we have cut our exposure to lower quality corporate bonds. So called high-yield bonds have actually performed in-line

Commodities	Percentage From 52-Week High
Lumber	-57.7%
Nickel	-53.6%
Tin	-48.7%
Iron Ore	-47.9%
Steel	-42.1%
Cotton	-36.8%
Natural Gas	-32.9%
Soybean Oil	-25.1%
Oats	-24.9%
Corn	-17.3%
Crude Oil	-13.0%
Gasoline	-12.5%
Sugar	-10.7%

As of 6/30/22 Source: Bloomberg

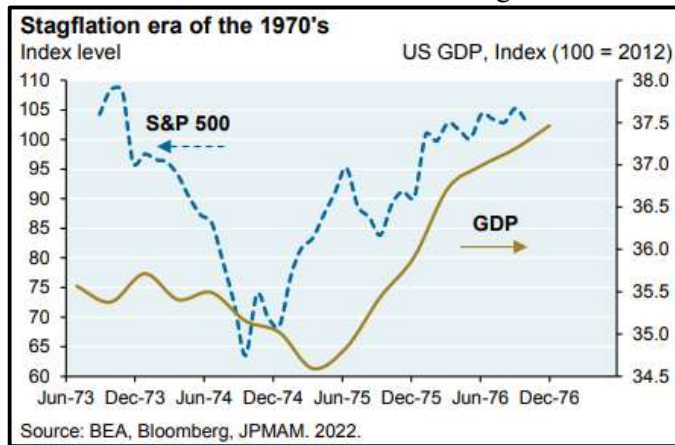
with government bonds this year despite the deterioration in the economic outlook. The spreads these bonds pay over Treasury bonds has widened modestly, but by nowhere near the amount you typically see during a contraction in growth. We think spreads could go higher (prices lower) under the wrong scenario so we cut our high-yield holdings and reinvested in high quality short maturity bonds where yields are quickly reaching 3%.

3) Finally, we think we are still in the early innings of the value stock resurgence. As we mentioned earlier, value has outperformed growth this year by a noticeable margin (large-cap value is down -11.5% versus -27.6% for large-cap growth). We think this can persist over the medium-term. The valuation discrepancy between the two remains historically wide. Large-cap value currently trades at roughly 15X estimated earnings while large-cap growth is at 25X. And we suspect many large-cap growth companies are much more at risk of earnings deterioration in the months to come than your typical value stock.

A last word on fixed income. This year has been particularly bad for bond investors as we noted at the beginning of this piece. However, yields have backed off recently and bonds have rallied in value. We think there is room for lower bond yields over the next few months if recession risks grow. We doubt yields plummet like they did during the COVID recession, but we don’t think the

second half of 2022 will prove to be a repeat of the first half. Higher yields have restored some value to the bond market, and everything from money market yields to CD rates are looking more attractive. For investors looking to park cash reserves somewhere, there are finally some good options.

Charles Blankley, CIO



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