Convergence Commentary

July 2022 Market Recap

Quick Hits:

- Markets rebounded significantly in July with the S&P 500 up 9% and the Nasdaq up 12% during the month.
- The strong performance could be attributed to better-than-expected earnings across the market and potentially improving macroeconomic factors.
- 2nd Quarter GDP came in negative for the second straight quarter, triggering the technical definition of a recession, although more data is required to make it official.
- The Federal Reserve hiked rates again in July by 75 basis points, but the Fed's commentary was more optimistic than it had been previously.

Market-Moving Highlights

As expected, the Fed increased interest rates again by 75 basis points on July 27th. The market had already priced in a 75-basis point hike but rose substantially on Jerome Powell's commentary during his press conference. He indicated that the Fed could begin to slow the pace of rate hikes and that he did not think we're currently in a recession. He also stated that they would continue to monitor the inflation data to determine what actions will be necessary in the future.

The Consumer Price Index (CPI) once again came in above expectations in June, rising 9.1% compared to expectations of 8.8%. The index increased broadly, led by food and energy prices (BLS). However, the silver lining here is that commodity prices started to decline in the back half of June and continued to decline into July. Commodities are a leading indicator of inflation, and since CPI is backward-looking, the sharp declines in commodities were not reflected in the June CPI report. While the elevated inflation report for June was obviously not ideal, lower commodity prices indicate we may see lower readings over the next few months, so long as commodity prices do not begin to increase substantially again.

The advanced estimate of U.S. GDP was released on July 28th and decreased at an annualized rate of .9%. This marked the second consecutive quarterly decline in GDP, following the 1.6% decline in the first quarter. As we touched on last month, technical recessions are defined by two consecutive quarterly declines in GDP. However, this does not mean we are already in a recession. Recessions are declared by the National Bureau of Economic Research, and they consider several other factors. These other factors such as strong employment, industrial production, and consumer spending remain strong and make it unlikely that a recession will be declared in the near term.

Despite being the best performer in 2022 so far, the Energy sector has sharply declined since reaching highs in the middle of June, officially entering a bear market at the beginning of July. While this is bad news for Energy investors, this is positive news for the rest of the economy, as this reflects a broader decline across important commodity prices. Commodity prices coming down could be a sign that inflation is slowing. It also tells us that the Fed's goal of destroying demand to bring inflation down might be starting to work.

For the first time since 2002, the US Dollar and the Euro reached parity, meaning the exchange rate was 1:1. This occurred because the value of the US dollar has increased while Europe has struggled significantly with higher energy prices as a result of the war in Ukraine and inflation that's worse than what we have in the United States. A stronger US dollar compared to the Euro can cause tourism in Europe to be cheaper for Americans as well as make imports from Europe cheaper, which could help inflation moderate some. However, it hurts American multinational companies that do business in Europe because their revenue shrinks when they convert it back to US dollars while the Euro is falling. The other implication for the U.S. economy is that exports become more expensive in foreign markets, which could potentially reduce U.S. output.

Index Performance

Index	1 Month	YTD	1 Year	5 Year
S&P 500	9.11%	(12.58%)	(4.64%)	12.83%
Nasdaq 100	12.35%	(20.47%)	(14.95%)	15.37%
Russell 2000	10.38%	(15.43%)	(14.29%)	7.12%
MSCI ACWI ex US	3.38%	(15.63%)	(15.27%)	2.45%
S&P US Aggregate Bond	2.54%	(7.88%)	(9.00%)	1.25%

The major indexes had their best month so far in 2022. In fact, the S&P 500 and Dow had their best months since November of 2020. Since June 16th when markets hit their last bottom, the Dow is up 9.3%, the S&P 500 is up 11.98%, and the Nasdaq is up 15.4%. This rally comes as a major relief to investors following one of the worst first halves of a year for stocks ever recorded. There were some significant one-day rallies throughout the month as well, with July 19th seeing 98% of stocks higher on the day, the most since December 26, 2018 (LPL). The major indexes were also up substantially after the Fed held its press conference to discuss the interest rate hike on July 27th, causing the Nasdaq to be up over 4% and the S&P 500 to be up 2.62%. Broad "up" days like these are potential signs that market conditions could be improving. The rally in July could be attributed to better-than-expected earnings and more optimism surrounding the macroeconomy. Through the end of July, 72% of companies that have reported have exceeded their expectations. While we do not believe we are completely out of the woods yet due to the uncertainties that still face the market, the more time that passes, the more likely it becomes that June 16th could mark the low for the current bear market. However, inflation will need to start improving, starting with the CPI report in August and the Fed will need to steer the economy away from a potential recession by not overdoing their interest rate hikes.

S&P 500 Sector Highlights & Commentary

Best Performing Sectors		Worst Performing Sectors	
Consumer Discretionary	17.08%	Communication Services	2.16%
Information Technology	12.20%	Consumer Staples	3.57%
Industrials	9.09%	Energy	3.69%

All the major sectors were up in the month of July. The July rally was led by Consumer Discretionary and Information Technology, which also happened to be two of the worst sectors in the first half of the year. Big tech earnings were a major catalyst for the sectors, especially Amazon and Apple. Amazon and Tesla were both up about 30% in July and are the two biggest companies in the consumer discretionary sector. Meanwhile, semiconductors, which make up a significant portion of the information technology sector, also had a strong July because of the semiconductor production bill passed in Congress.

The worst performing sector, Communication Services, was only up 2.16% because of some social media companies like Snapchat and Facebook reporting slowing growth. Facebook posted its first revenue drop in the company's public history. Meanwhile, Snapchat reported slowing growth and did not provide 3rd quarter guidance, falling about 25% after reporting and causing a ripple effect across the rest of the sector. Energy rebounded some despite falling prices for the consumer. Energy companies predictably posted very strong 2nd quarter results, which helped propel the sector out of negative territory. Even though the Energy sector was positive, it still is down 15% from its highs in June.

What to Watch in August

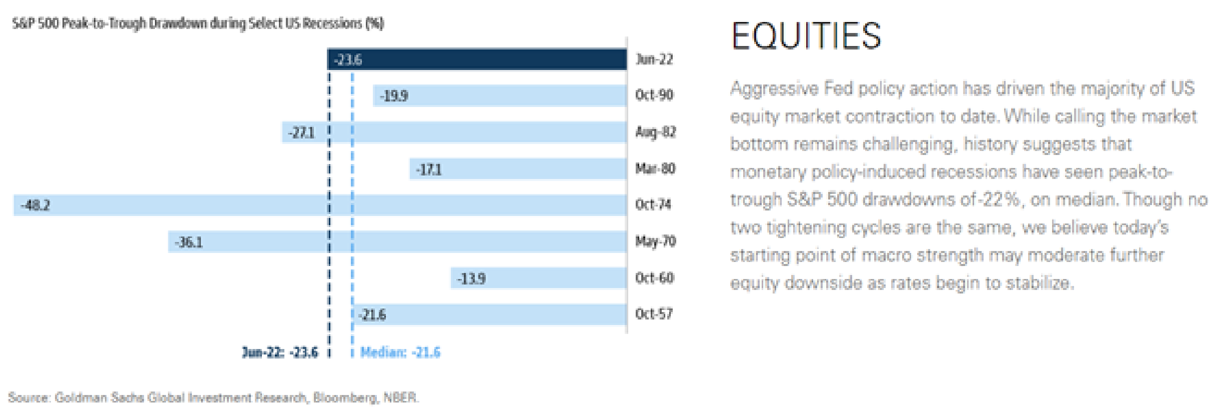
While most major companies reported their second-quarter earnings in July, about half of the companies in the United States are scheduled to report their earnings in August, including Nvidia, Disney, Berkshire Hathaway, and Starbucks. Up to this point, earnings reports have been generally positive.
CPI will be reported on August 10th for August. We expect to see some improvement in the report based on the falling commodity prices and continued demand destruction induced by the Federal Reserve's interest rate hikes. However, the degree of deceleration is still up for debate. A significant decline in prices would give a big boost to equity markets. A slight decline would likely be looked at as the expected result, while an increase would certainly be a negative surprise to the market.

At the end of the month, the Kansas City Fed will host numerous central bankers, policymakers, and economists at Jackson Hole, Wyoming to discuss economic issues. At the event, we will hear from Jerome Powell again, which could give us some indication of what the Fed is thinking about the direction of the economy.

Market Wrap

July was the best month of the year in financial markets in 2022 and there were positive signs throughout the market that could indicate stocks could start heading up again. There were also some signs that inflation finally has peaked. Gasoline has fallen from its all-time high on June 14th of $5.02 per gallon down to $4.22 per gallon (AAA.com), representing a decline of 15.9% and representing its longest consecutive decline since the start of the pandemic. It is also relevant that this decline occurred in July, which is one of the busier months of travel throughout the year. Copper, another important commodity for the economy fell about 6% in July and is now almost 28% off its all-time high in March. Commodity prices declining can be a double-edged sword. On one hand, it will almost certainly help improve inflation, but at the cost of potentially slowing the economy. Falling commodity prices can be a leading indicator that a recession is upcoming. Second, some companies, like Walmart and Target have warned of increasing supply by too much in response to the excess demand. This is caused by a shift in expectations across the supply chain, leading to overproduction. When this happens, it is known as the bullwhip effect, and causes excess inventory, which can lead to decreasing prices for the consumer.

The S&P 500 has rebounded significantly from its low in June. On June 16, it was down nearly 24% from its all-time high. At the end of July, it was down only about 12.5%, a remarkable rally for the index. The chart below from Goldman Sachs tells us that the low seen in June would fall in line with the median drawdown during a U.S. recession. Although recession still does not appear to be the base case, what we've already experienced would be a typical recession drawdown and should be viewed with optimism. While the past month has provided us with ample reason to start becoming more optimistic, it is important that we do not get ahead of ourselves, since there are still many risks still in play in the market. It certainly is possible that the current rally is just another bear market rally like the ones we already have seen throughout the beginning of the year. Only time will tell us how sustainable the current rally is. However, if the Fed begins to moderate rate hikes to try to avoid sending the economy into a recession, we could start to see moderation in the volatility we have seen so far in 2022.



Sources

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AAA Gas Prices
Historical Bottoms (gsam.com)

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