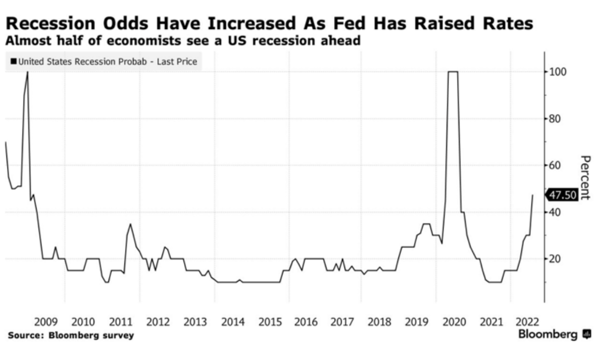
August 4, 2022

## Overview

July was a decidedly good month in an otherwise dismal year. The S&P's 500 erased its losses from June with a **9.22%** performance. The Nasdaq Composite did even better, clocking a **12.39%** jump while the Russell 2000 (Small Cap Index) added **10.44%.**
Internationally, performances were generally positive, if more muted, due to a relentlessly rising USD. The EPAC BM Index of developed economies rose **5.23%** but emerging markets declined with the MSCI (EM) down **.25%**.

The bond market turned positive too, but to a lesser degree. US Corporate bonds went up **3.24%** overall. The long-US bond rose **2.67%** while the high yield sector benefitted even more thanks to an increase in risk appetite pushing the sector up **5.90%** (Bloomberg US High Yield Index).

All of this was the result of a reversal in investors' risk perceptions driven in good part by monetary policy decisions in Europe and here as well as by mixed economic news that investors decided to interpret as positive after all. The narrative that developed was as follows:
1) The US economy is slowing faster than the FED expects, consequently, 2) The FED will have to reduce the speed and intensity of its rate hikes sooner than originally anticipated,
3) if that is the case, equity valuations may have corrected too much and a recalibration is warranted.
Whether this rally has any chance of sustaining itself remains to be seen. I doubt it. Some economic indicators are worrisome, as shown below:




In July, our median portfolio gained **3.20%.** Over the same period, a portfolio consisting of 50% ACWI (All Country World Index) and 50% AGG (US Bond Aggregate) rose **4.81%**. On a YTD basis, our median portfolio has lost **15.30%** vs. **11.08%** for our index. As a reminder, the equity allocation in our clients' portfolios varies currently from 35% to 70%, depending on risk profile.

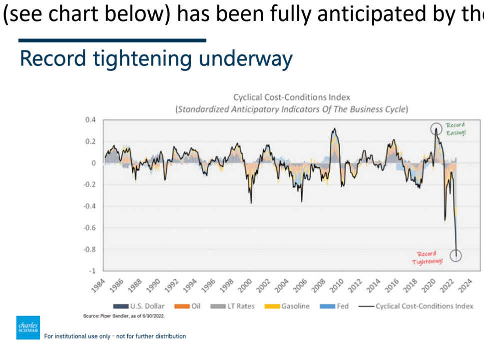
## Market developments

There are two major events that explain about 80% of the performance of equity markets in the US and around the globe in July: 1) The European Central Bank (ECB) surprise .50% interest rate hike, on July 19, 2) The relatively dovish comments of the FED's Chairman in the conference call that followed the last FOMC (Federal Open Market Committee) meeting, on July 27.

Prior to those dates, the S&P's 500 was up about 1% for the month. On July 19, the ECB surprised the market with a robust .50% interest rate hike. This was a higher rate hike than what was expected. That caused the USD to reverse itself and lose value against major currencies. In a year where the USD has gone up 10% against its major partners' currencies, the reversal was welcome and caused investors to cheer (the USD is a haven currency and tends to rise when the global economic environment deteriorates. Conversely, a loss of its value is generally viewed as good for equity risk appetite in general). The S&P's and European markets jumped close to 4% on the day and shortly thereafter. Building on this positive mood came the FOMC meeting and the relatively dovish comments by FED Chair Jerome Powell. Investors chose to interpret his words as indicative of a flexible monetary approach that might cause the US Central bank to reverse its forceful tightening stance sooner than expected.

Investors' sentiment ebbs and flows. Overreaction, in one direction or another, is part of market life. In the long run though, monetary policy rules and dictates. The market performance in July is a clear example of that. The ECB and the FED were behind the stellar equity performance that month, nothing much else.

With that in mind, I am doubtful that the significant monetary tightening that is currently taking place in the US (see chart below) has been fully anticipated by the market.

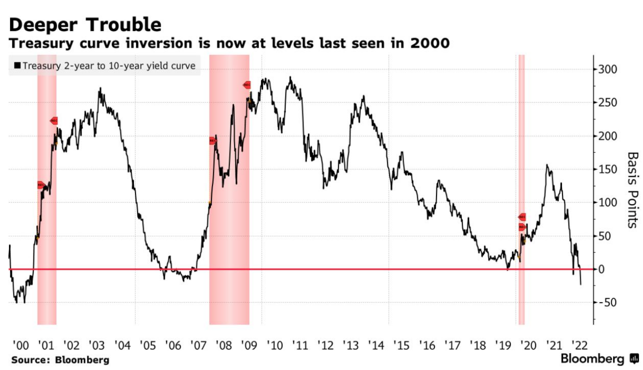


**Tilts and Allocations**

In the early part of July, I sold some of our US equity positions (SPY) to further reduce our risk exposure. Later in the month, I substituted value stocks (VTV) to US large caps (SPY). This sectorial switch reduced further our risk level while keeping us reasonably invested in the market.

Overall, our equity allocation continued to drop towards the lower end of our usual range (35% to 75%). That under-allocation to equities explains our underperformance in July. We were able to participate in the rally but not fully. While this is painful to endure, I do not believe that this rally is sustainable and prefer to be under invested in the current environment. Unless inflation drops significantly between now and late September or the economy weakens so much that the FED sends signals to investors that it will reverse its tightening stance, this rally is not likely to endure.

Meanwhile, the US Treasury yield curve continues to signal a coming recession (see chart below, as July 14):




Should a recession ensue, corporate earnings will drop. With that drop will come a market re-pricing of all risk assets. Equity will decline from current levels. I can't predict whether this will come to pass but I can't ignore the signals. Risk is rising and, in that context, a lower allocation to equities is warranted, however unpleasant this stance may be when markets rally, as they did in July.

**Conclusion**

Thus far in the second quarter earnings season, corporate earnings have been slightly better than expected and while many large corporations have indicated that they suffered from rising cost pressures and/or inventory build-ups, investors have decided to ignore these issues. The market appears to be stabilized for now.

In addition to the continued release of corporate earnings between now and the end of August, market moving economic data such as the employment number this coming Friday and inflation by the middle of August, may be fodder for some market turbulences in an environment of limited market liquidity due to depleted trading desks on Wall Street. Stay alert.

Thank you for your continued trust.

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