Worst First Half in Half a Century

Global markets closed out *the* most tumultuous first half of a year in decades driven by accelerating inflation, the war between Russia and Ukraine and a doubling of risk-free interest rates (including yields on riskier securities). The S&P 500 fell 21%, suffering its worst first half of a year since 1970. Investment-grade bonds, as measured by the iShares Core U.S. Aggregate Bond exchange-traded fund, lost 11%—posting their worst start to a year in history (or at least since 1842). Non-investment-grade (or "junk") bonds, as measured by the iShares iBoxx High Yield Bond exchange-traded fund, fell 15.4%. Also, both stocks and bonds posted a negative first and second quarter, consecutively.

This has been the result of a global phenomenon, not just a US one. Stocks and bonds in Europe, markets in EAFE, and emerging markets all tumbled, hurt by slowing growth and stickier than expected inflation.[1] And cryptocurrencies came crashing down, burdening institutional and individual investors alike with steep losses. Anecdotal evidence does show that younger generations have been hit the hardest, as sectors like Crypto, IPOs, SPACs, and super-high growth areas like EVs, AI, Robotics and Cloud Computing are down over 70% from their all-time highs back in 2021.

About the only thing that rose in the first half was commodity prices. Oil prices surged above $100 a barrel, and U.S. gas prices hit records after the Russia-Ukraine war disrupted imports from Russia, the world's third-largest oil producer. However, investors have been underweighted commodities after years of underperformance and under-investment in the sector.

Volatility has increased dramatically in all markets. For example, the VIX (an index that measures the expected volatility of the S&P 500) has more than doubled from a level of 12-15 during the QE (quantitative easing period) to around 30 today. During the first half of the year, 90% of trading days had an intraday range greater than 1% range. This is the highest level since 2009 when 99% of the trading days saw ranges greater than 1%.

We see no reason for volatility to subside in the second half. The Fed and central banks from India to Brazil to New Zealand plan to keep raising interest rates to try to rein in inflation, which has become a global issue. The moves will likely slow down

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- The S&P 500 fell 21%, suffering its worst first half of a year since 1970
- Investment-grade and high yield bonds posted their worst start to a year in history (or at least since 1842)
- Commodity and commodity-linked equities were the only positive performers in the half
- Volatility was consistently elevated, and is likely to remain elevated for the remainder of 2022
- Though the odds of a recession have increased meaningfully most street analysts are forecasting a brief and shallow recession
- Though uncertainty remains, positioning and historical data would suggest a second half with better performance

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com

[1] The EAFE index seeks exposure to a broad range of companies in Europe, Australia, Asia and the Far East.

growth, potentially tipping economies into recession and generating further tumult across markets.

The good news for investors is that markets have not always done poorly after suffering big losses in the first half of the year. In fact, history shows they have often done the opposite. There have been just five instances in history where both stocks and bonds posted negative returns for two consecutive quarters. Recessions have been associated with three of the previous four periods and the jury is still out on this latest instance. Wall Street is split between the 50% that think we are already in a recession or will have one within 2022, and those that still think that we could see a soft-landing[2]. However, no one is speaking about a deep or prolonged recession. There is an overall general agreement and consensus about a shallow and short recession.

When the S&P 500 has fallen at least 15% the first six months of the year, as it did in 1932, 1939, 1940, 1962 and 1970, it has risen an average of 24% in the second half, according to Dow Jones Market Data. Fund managers currently have larger-than-average cash positions, smaller-than-average equities positions and a markedly high degree of pessimism about the economy. All these factors should make for a better second half of the year. The below table summarizes 1H '22 performance for the major asset classes, volatility, and crypto.

Exhibit 1: YTD Asset Performance

Rates	Dec-21	Jul-22	*% Change*
UST 2 Yr	0.73%	2.80%	*283.6%*
UST 10 Yr	1.51%	2.87%	*90.1%*
UST 10 Yr - 2 Yr	0.78%	0.07%	*-91.0%*
US 30 Yr Mortgage	3.27%	5.74%	*75.5%*
US Agg Corp % YTW	1.75%	3.72%	*112.6%*
US Agg Corp % Spread	0.93%	1.55%	*66.7%*
High Yield % YTW	4.20%	8.89%	*111.7%*
High Yield % Spread	2.81%	5.69%	*102.5%*
DXY	95.67	105.24	*10.0%*

Equities	Dec-21	Jul-22	*% Change*
SPX	4,766	3,784	*-20.6%*
DJIA	36,338	31,097	*-14.4%*
Nasdaq	15,645	10,989	*-29.8%*
Russell 2000	2,245	1,710	*-23.8%*
Eurostoxx 600	488	407	*-16.6%*
Shanghai	3,632	3,388	*-6.7%*
Nikkei	29,302	25,936	*-11.5%*
MSCI ACWI	755	597	*-20.9%*
SPX Earnings Yield	4.40%	5.99%	*36.1%*

Inflation	Dec-21	Jul-22	*% Change*
CPI Y/Y	6.80%	8.60%	*26.5%*
CORE CPI Y/Y	4.90%	6.00%	*22.4%*
CORE PCE Y/Y	4.89%	4.69%	*-4.1%*
10 Yr Breakeven	2.59%	2.36%	*-8.9%*

Commodities	Dec-21	Jul-22	*% Change*
WTI Oil	$75.21	$107.87	*43.4%*
Gold	$1,795.00	$1,798.90	*0.2%*
Copper	$446.40	$361.70	*-19.0%*
FAO Food Index	135	157	*16.3%*

Volatility	Dec-21	Jul-22	*% Change*
VIX	17.22	27.73	*61.0%*
Nasdaq Vol	21.20	35.32	*66.6%*

Cryptocurrency	Dec-21	Jul-22	*% Change*
Bitcoin	$46,195	$19,247	*-58.3%*
Ether	$3,679	$1,057	*-71.3%*

[2] A soft landing is a term used to describe the goal of the U.S. central bank when it seeks to raise interest rates just enough to prevent an economy from overheating and experiencing high inflation, without causing a severe economic downturn.

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