PACIFIC LIFE

MARKET insights

RETIREMENT SOLUTIONS DIVISION

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MARKET REVIEW AND OUTLOOK

Second Quarter 2022

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Equity markets continued to fall in the second quarter of 2022 with the S&P 500® index down 16.1%. Growth stocks experienced the largest quarterly loss, while large-cap value held up moderately better. Rising rates continued to hurt growth, as investors shunned overvalued companies.

Within fixed income, emerging-market bonds faced large losses, as Russian exposures detracted from performance. Short-duration bonds held up much better than their longer-duration counterparts. Credit exposures were also headwinds during the quarter.

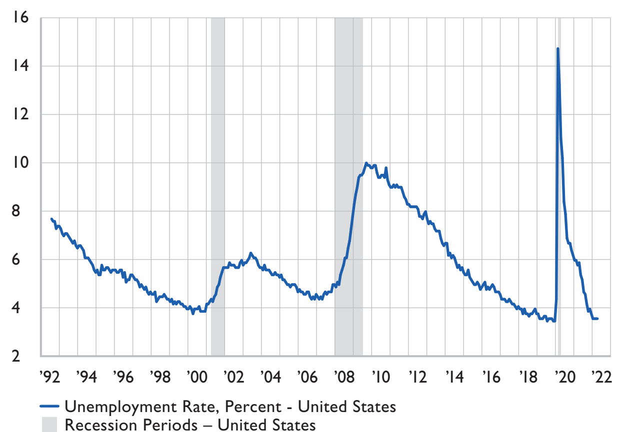
Outlook

Inflation fears, geopolitical uncertainty, tighter monetary policy, and earnings concerns will continue to weigh on market sentiment as investors gauge recession risks. This likely will mean that market volatility will linger as investors seek a market bottom.

Debates about recession risk have taken precedence as the market turmoil continues to rattle investors. Every recession is different, but whether or not the U.S. is technically in a recession (two consecutive quarters of negative gross domestic product (GDP)) will depend on how the economy held up in the second quarter. In the first quarter of 2022, U.S. GDP fell 1.6%. Although that was a sharp reversal from the 6.9% increase in the fourth quarter of 2021, the downshift came as federal stimulus programs ended and rising inflation pared back consumer sentiment and corporate profits. Furthermore, trade detracted more than 3% from the first quarter GDP.

Despite the fact that unemployment remains low, we could be in a technical recession if there is enough softness in consumer and business spending, as well as investment and trade flows. However, it should be noted that recessions typically follow periods when the unemployment rate begins to rise. So far, the unemployment rate continues to fall, even though it's at historic lows.

Figure 1: Unemployment Rate, Percent - United States



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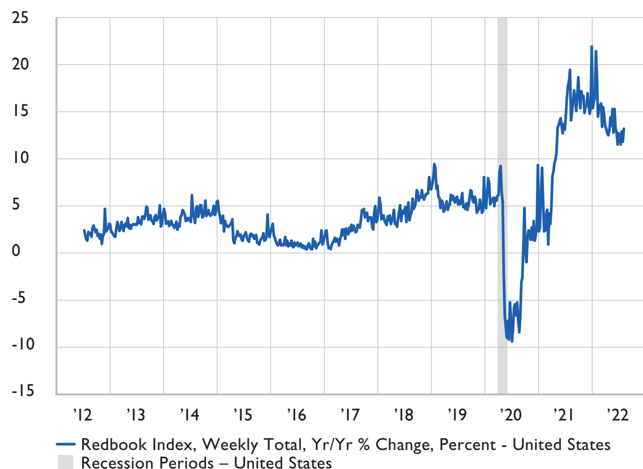
The strong employment condition also allows consumers to continue to shop at a strong pace.

Figure 2: Redbook Index, Weekly Total, Yr/Yr % Change, Percent - United States



U.S. consumers still have savings from the federal stimulus payouts, which has helped buffer some of the effects from higher prices. Furthermore, the combination of tight employment and higher inflation is reflected by the rise in wages in recent quarters. In the past two recessions, wage growth peaked around 4%. However, wage growth has surged far past that level in recent quarters.

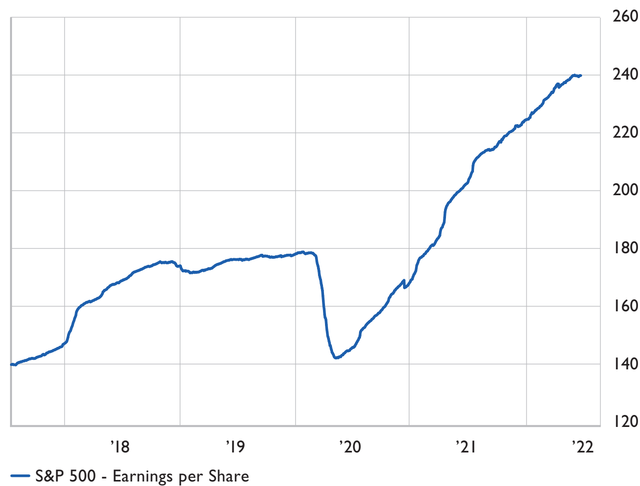
Figure 3: Average Hourly Earnings, YoY % Change - United States

Thus far, U.S. consumers seem able enough to handle higher prices. However, inflation has been more persistent than many had foreseen only a few quarters ago. This has caused the Federal Reserve (Fed) to react aggressively to tame inflation. The risk is that the Fed could slow the economy more than needed to control inflation.

The supply-chain congestion is not the only culprit to contribute to higher inflation. The Russia-Ukraine war also has continued to contribute to the elevated inflation around the globe. Commodity prices, especially crude oil, had been elevated. Inflation is expected to remain high if commodity prices remain elevated. Nonetheless, we should see some relief as commodity prices normalize to the downside.

Figure 4: Commodity Index Price - United States

Figure 5: S&P 500 - Earnings per Share



The Biden administration is also considering removing tariffs to provide relief from inflation. However, a Peterson Institute study found that the direct impact of removing all additional tariffs on Chinese imports would only lower the U.S. Consumer Price Index (CPI) by approximately 25 basis points. Given that inflation is currently running above 8%, removing tariffs on Chinese goods likely will have only a minor impact.

Despite the elevated level of inflation, the S&P 500 index earnings-per-share forecasts look relatively healthy, and companies appear to have been able to absorb higher wages and interest rates. However, there are concerns about their ability to take on even higher wages and interest rates. This has caused angst surrounding the upcoming earnings season. Nonetheless, strong corporate balance sheets should help absorb rising interest rates—for now.

Much rests on the Fed's shoulders as it attempts the elusive soft landing. The Fed cannot allow inflation to run rampant, since it would crush consumers. Since consumption represents two-thirds of U.S. GDP, overly thrifty consumers may only hurt the economy. Therefore, the Fed needs to raise rates aggressively now for being late to fight this inflation. On the other hand, raising rates too high could choke the economy as well. Although higher rates are needed to fight inflation, they will be restrictive on profit margins. Since smaller companies are more exposed to floating-rate loans on their balance sheets, we've reduced our small-cap exposures. Nevertheless, it's very important to remain diversified during these wild market swings.

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