AMI Quarterly Commentary

Growth Through Stability

Q2 ▪ 2022

Capital Market Outlook

The second quarter saw the beginning of a Fed tightening cycle, historic inflation, and ongoing supply chain issues, all of which contributed to the S&P 500 index falling a little more than 16%. While the economy appears headed for a second consecutive quarter of contraction and the risk of a recession has increased, we do see some reasons for optimism looking into the second half of the year and into 2023. Key positives include, stock valuations have fallen to more normal levels and appear to incorporate some economic slowing, we are more than halfway through the average downturn that accompanies a recession, and some key commodities have declined as of late, which should ease inflation pressures.

Inflation continued to move higher in the U.S. during the quarter and the most recent Consumer Price Index (CPI) reading from June was a 40-year high of 9.1% y/y, with shelter, food and gasoline the largest contributors. Excess money supply, government spending, Russia's ongoing war in Ukraine, and COVID related supply chain issues continue to drive inflation higher. Energy is a key factor as oil & gas are used in most products either directly or indirectly. Gasoline prices exceeded $5 nationwide in June, up more than 60% y/y, weighing on both consumers and businesses. Home prices surged even as mortgage rates climbed near 6%, a dynamic that is unlikely to persist and could lead to weakness in the housing market. The increased cost of food and energy weighed on consumer confidence, which presents a risk to economic growth in the second half of the year.

In response to this historic inflation, the Fed finally took action and increased interest rates by 50bps in May. In addition, the Fed increased rates by an additional 75bps in June following a higher-than-expected CPI report for May and another two 75 bps hikes are expected following the 9.1% reported for June. Federal Reserve Chair Jerome Powell reiterated that reducing inflation is the Fed's highest priority, which further stoked concern that aggressive monetary tightening could tip the U.S. economy into a recession. Despite these concerns, the labor market has remained very strong, further clouding the economic picture from the Fed's perspective. The economy added 372k jobs in June, ahead of the 265k estimate, and the unemployment rate remained unchanged at a historically low 3.6%. The U.S. has now largely recouped the lost jobs from the COVID lockdowns of 2020.

Corporate profitability has remained largely resilient, driven by the ability of companies to pass along higher input costs to consumers. While only a few companies have spoken about a decline in demand as well as pressured margins in Q1, Q2 earnings will be a key gauge of business activity and management sentiment. While we expect corporate earnings to remain good, we would not be surprised to see companies present a more conservative outlook for the balance of the year.

Capital Market Outlook (cont'd.)

In looking at past bear markets, the depth and length really depends on whether the bear market coincides with a recession. The average bear market was a 28% decline (peak to trough) without a recession and close to 35% with a recession (see figure below). This means that the current market decline could be more than halfway through the average recessionary downturn.

S&P 500 Index Bear Markets (Post WWII)

Start Date	End Date	S&P 500 Change	Months	Recession?	1 yr return following market bottom
6/15/1948	6/13/1949	-20.6%	11.9	Yes	30.2%
8/2/1956	10/22/1957	-21.6%	14.7	Yes	31.0%
12/12/1961	6/27/1962	-28.0%	6.5	No	31.3%
2/9/1966	10/7/1966	-22.2%	7.9	No	32.9%
11/29/1968	5/26/1970	-36.1%	17.9	Yes	43.7%
1/11/1973	10/3/1974	-48.2%	20.7	Yes	38.0%
11/28/1980	8/12/1982	-27.1%	20.5	Yes	65.6%
8/25/1987	12/4/1987	-33.5%	3.3	No	21.4%
7/16/1990	10/11/1990	-19.9%	2.8	Yes	29.1%
3/24/2000	10/9/2002	-49.1%	30.5	Yes	33.7%
10/9/2007	3/9/2009	-56.8%	17.0	Yes	68.6%
2/19/2020	3/23/2020	-33.9%	1.1	Yes	74.8%
1/3/2022	7/11/2022	-20.4%	6.3	?	?
	Average with recession	**-34.8%**	**15.2**		**46.1%**
	Average without recession	**-27.9%**	**5.9**		**28.5%**

Source: Bloomberg, S&P Dow Jones Indices

As we look out to the second half of the year, there are some early indications that inflation could ease. Some key commodities are off their highs, namely oil, wheat, corn, and copper. We continue to see the possibility of a relatively modest economic contraction in late 2022 or early 2023, however, official recessions are often called after the market has bottomed. While impossible to know when the market will bottom, it is important to remember a few key points: bear markets are normal and a long-term investor will encounter many through their life, and the stock market has recovered from every bear market prior to the current one. We believe long term investors should remain in the market and ride out the volatility, noting the 1-year performance following a bottom in the table above. This can be summed up by the often-used quote "it's not about timing the market, it's about time in the market." At AMI, we construct portfolios centered around businesses with recurring demand, which should hold up well in times of economic duress, while steadfastly focusing on valuation to help protect downside risk in bear markets.

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The S&P 500® index is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

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