Stocks marked their worst performance for the first half of any year since 1970 with the S&P 500 Index dropping -19.97% by the end of June.[1] Only the first-half declines of 1962 and 1932 were worse. Bonds also had one of the worst first six months of any year on record with the Bloomberg U.S. Aggregate Bond Index falling -10.35%.[1] As a result, the traditional 60/40 stock-bond mix produced one of the worst half-year declines in many years.

Factors contributing to the weakness in the financial markets included surging inflation, the sharp rise in the price of oil, supply disruptions caused by the war in Ukraine and the interest rate hikes by the U.S. Federal Reserve (Fed). The Fed raised rates three times during the first half of 2022, including a hike of 75 basis points in June, the largest increase since 1994.[1] Mortgage rates surged to 5.78% in June, which included the largest one-week increase since 1978.[1] One bright spot in the inflation picture was that the prices of raw materials weakened and base metals suffered their worst quarterly slump since 2008. Oil prices in June also recorded the first monthly decline since November 2021.

For June, the S&P 500 declined -8.26%, the NASDAQ-100 Index dropped -8.94%, the Russell 2000 Index was off -8.23% and the Dow Jones Industrial Average (DJIA) fell -6.56%.[1] Year-to-date as of the end of June, the NASDAQ-100 was down -29.22%, the Russell 2000 was lower by -23.45% and the DJIA was off -14.44%.[1] Equity valuations continued to decline from their peak levels of a year ago due to lower stock prices. Nonetheless, equities remained in overvalued territory and were still high when adjusted for inflation. Bond returns were far more competitive with stocks, which will likely create a significant headwind for stocks going forward.

On the monetary and credit front, the team's rate-of-change models for interest rates — for both Treasurys and corporate bonds — remained in negative territory. One hopeful sign was that the 10-year U.S. Treasury yield, which had climbed as high as 3.48% early in the month, fell to 2.98% at month-end, which was almost back to where it started the month.[2] Investor sentiment was also a bright spot in the investment team's work. Sentiment grew very pessimistic in mid-June, which is positive from a contrary point of view.

The investment team retained its maximum defensive portfolio position throughout the market's decline in June. The team's momentum models continued to register negative readings while the team's risk management process indicated a zero net exposure to the market as a potential way to weather any future market volatility. The team would raise market exposure if volume and breadth momentum improved, particularly if there were upside thrust readings given by our volume and breadth models. The team would also raise exposure if interest rates stabilized, credit spreads narrowed and investor sentiment remained pessimistic. The team would maintain its maximum defensive position and would consider initiating short sales in the future if interest rates continued their rise, credit spreads widened or if the team's short-, intermediate- and long-term volume and breadth momentum models deteriorated further.

Our assessment of the four pillars of our investment process is as follows:

_Valuation_: Equity valuations have continued to improve but remained in overvalued territory. The median price-earnings (P/E) multiple on the S&P 500 declined from its high of 33.9x in early 2021 to 21.7x as of the end of June 2022 — the lowest level in over two years. Nonetheless, valuations were still above the 58.3-year median P/E ratio of 17.4x.[3] The team's measure of valuations adjusted for inflation also remained high.

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*Monetary factors and credit conditions*: Interest rates edged up modestly in June. After reaching a 3.48% yield early in the month, the 10-year U.S. Treasury Note closed the month with a 2.98% yield, up only slightly from 2.94% at the beginning of the month.[2]

The Fed's June interest rate hike triggered the "Three Steps and a Stumble" rule. The rule was first introduced by stock analyst Edson Gould in the 1960s and states that when the Fed raises any of the rates under its jurisdiction — the discount rate, prime rate or federal funds rate — three consecutive times, the stock market will be weak thereafter. This rule has been triggered 17 times since 1915.[4] The median decline from the day of the hike to the bear market low point has been -17%. Fourteen of the 17 triggers were followed by a recession. However, the investment team would caution that it is possible that the Fed's relatively recent policy of "forward guidance" may have changed things — the market may have already stumbled prior to the actual hikes as the Fed signaled its moves — even though the Fed's "guidance" has not always been very accurate. Nonetheless, it is wise to heed the warnings of historical precedent and it is one of many indicators and models considered by the team.

Credit spreads rose steadily in June. The spread between 10-year U.S. Treasury Notes and high-yield bonds rose above its 22.5-year median of 506.1 basis points and closed the month with a spread of 591.0 basis points.[3] This is the widest spread in almost two years. The team will be watching credit spreads closely as the Fed raises rates. A widening of spreads would be indicative of a deterioration in credit conditions, which could further negatively impact economic growth.

*Sentiment*: Ned Davis Research's Crowd Sentiment Poll, a composite of a variety of sentiment indicators, has recently shown the most pessimism since the pandemic low two years ago. From a contrary point of view, this is a positive development. This indicator has now reached levels comparable to the 2018 and 2016 market lows. This is an indicator to watch closely, as maximum pessimism is usually associated with market low points.[5] From a short-term point of view, the team would not be surprised if the market staged a rally in view of the recent high level of pessimism.

*Momentum*: The team's intermediate-term volume and breadth momentum models continued in negative territory throughout June. Downside volume (supply) has exceeded upside volume (demand) since February. Since 1998, during those periods when supply has exceeded demand, the market has experienced a -6.32% annualized return while this condition persisted.[3] A rise in upside volume above downside volume would be a positive development, particularly if the team's upside thrust models of volume and breadth were to indicate a potential reversal in trend. Until then, the team believes the saying "Don't fight the tape" remains wise advice during these volatile markets..

[1] *Source: Bloomberg. July 1, 2022*
[2] *Source: U.S. Department of Treasury. July 1, 2022*
[3] *Source: Ned Davis Research. June 30, 2022*
[4] *Source: Ned Davis Research. July 1, 2022*
[5] *Source: Ned Davis Research. June 28, 2022*

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