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QUARTERLY MARKET REVIEW

July 28, 2022

Shepherd FINANCIAL

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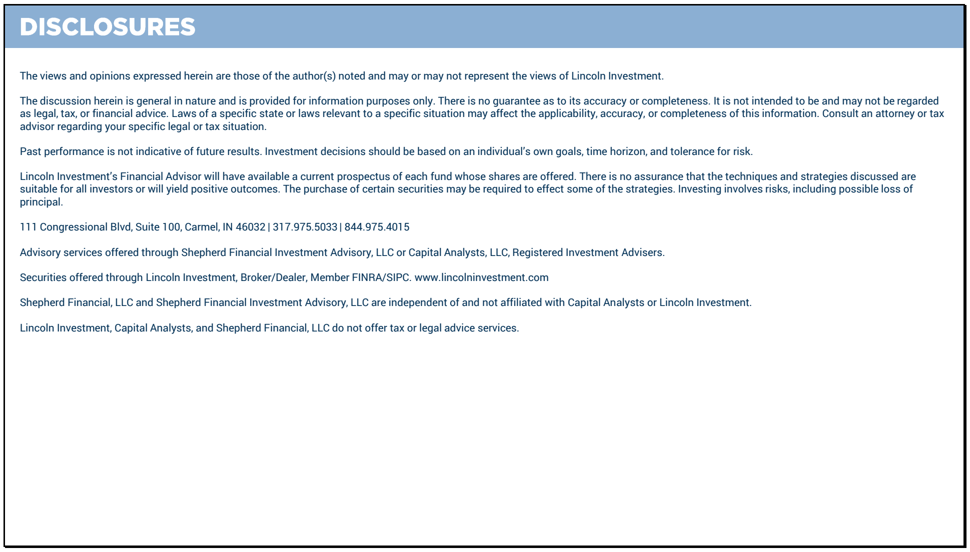

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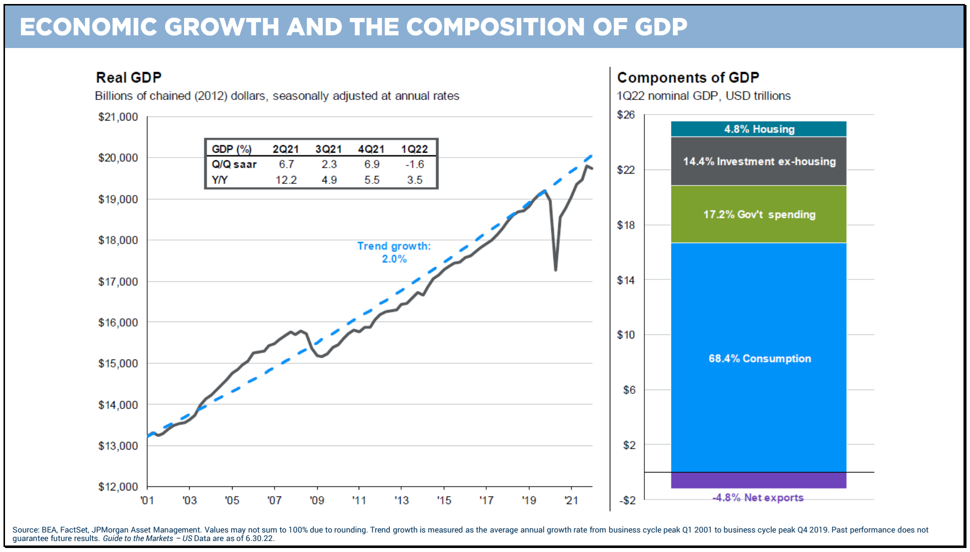

This has been a hard year for investors – heavy losses in both equity and fixed income markets. But the economic impact of COVID-19 continues to fade, which is positive. While real GDP growth shrank in the first quarter, monthly data suggests it logged more solid growth in the second as the Omicron wave subsided and spending picked up in travel, restaurants, leisure, and entertainment. Of course, there are new challenges in its place, like Russia's invasion of Ukraine and China's zero-COVID policy. Both of those has contributed to sustained high inflation. As we enter the second half of 2022, there is a growing danger that the US economy could slip into a recession. There are gathering forces slowing economic momentum. The most important is fiscal drag, with the federal budget deficit likely to fall from 12.4% of GDP last fiscal year to less than 4% of GDP this year, which is the single biggest decline as a percentage of GDP since the demobilization following the end of World War 2. There are a lot of things contributing here, like the end of stimulus checks, enhanced unemployment benefits, enhanced child tax credits, and a lot of other programs that were supporting the income and spending of lower- and middle-income households. The housing sector is also being battered by more than a 2.5% surge in 30-year mortgage rates while US exports are being impeded by a more than 8% rise in the trade-weighted dollar since the start of the year. So pair all that with collapsing consumer confidence in the face of skyrocketing food and energy prices and a slumping stock market, and we're looking at a slowing of the economy, which leads to the risk of recession.

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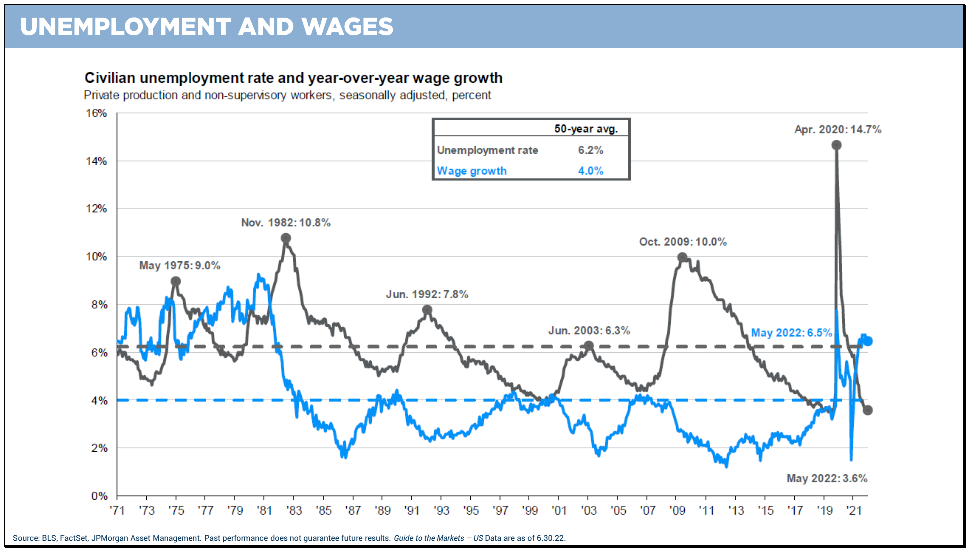

The labor market continues to be a bright spot. The unemployment rate remained at 3.6% in May for the third consecutive month, which is just 0.1% above its 50-year low set in 2019. Even with this, there is a massive excess demand for labor. The latest data shows 5.45 million more job openings than unemployed workers. This excess demand should fade somewhat over the next few months, reflecting slowing economic momentum and diminished business confidence. But it could still contribute to further wage gains. The wages of production and non-supervisory workers are already up 6.5% year over year. And that could encourage some people to reenter the labor market, although labor supply continues to be hampered by the aging of the baby boomers and limited immigration. Strong wage growth will also slow any decline in inflation, which has become the biggest concern for consumers, investors, and policy makers.

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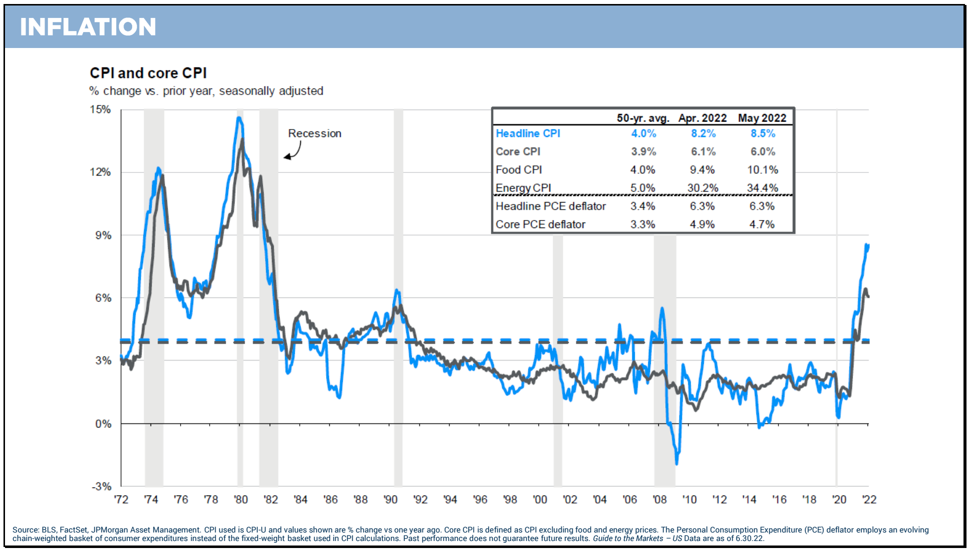

Let’s talk about inflation. It’s pretty hot right now. A May headline CPI shows an 8.6% year-over-year gain, which was well above market expectations. Today’s high inflation largely reflects the impact of surging consumer spending, fueled by fiscal stimulus, colliding with supply shortages across major sectors of the economy. And we mentioned that we have seen this amplified in the general recovery of airfares, hotel rates, and rents from their pandemic lows. And the Russian invasion and China’s zero-COVID policy are extending supply chain problems. Year-over-year CPI inflation may not have peaked yet. By the end of 2022, I’d expect some of the supply chain issues to fade, which would allow headline inflation to ease. But the longer high inflation persists, the stickier it gets. Core consumption deflator inflation could remain above 3% year-over0year throughout this year and next. Longer-term forces could cut inflation further by the middle of the decade, but the potential persistence of inflation well above the Fed’s 2% target over the next couple of years has major implications for monetary policy.

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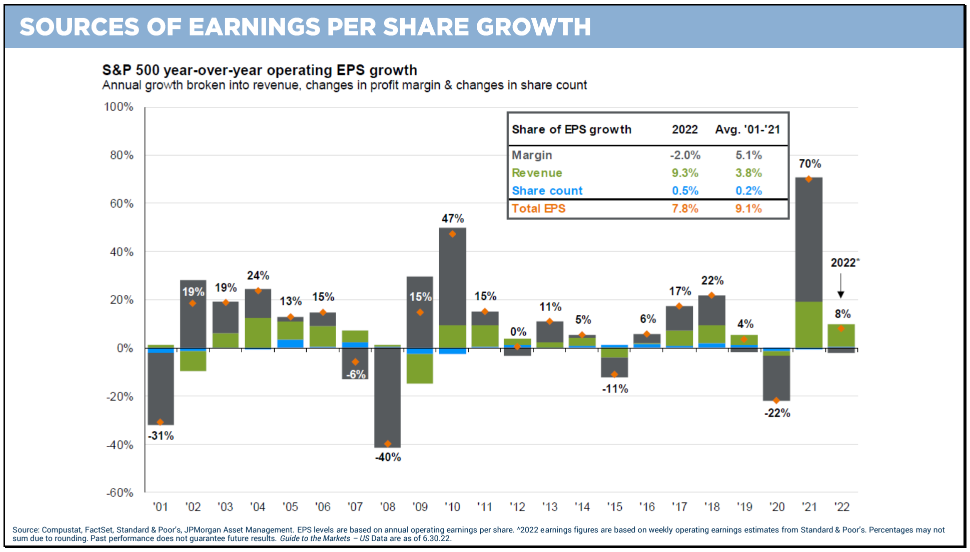

In 2021, we saw S&P operating earnings per share rise by 70%. But it's much slower this year. Operating EPS rose just 4.2% year-over-year in the first quarter. Analysts are expecting less than an 8% for 2022 as a whole. Frankly, even that number could be optimistic. While energy companies will continue to benefit from high margins, if you look elsewhere, rising labor costs, higher interest rates, and slowing nominal sales growth should bite into profits. In addition, a much higher dollar will erode the value of overseas sales, while recession concerns could cause managements to take some discretionary hits to the bottom line while they have a macro-economic excuse to do so. A recession would lead to a sharp decline in profits, but if this eventually led to less wage pressure and easier monetary policy, it could set up a better long-term environment going forward. And while various dynamics in Washington reduce the likelihood of any further fiscal stimulus, they also make any increase in corporate taxes less likely. So after-tax profit margins would remain at high levels relative to history.

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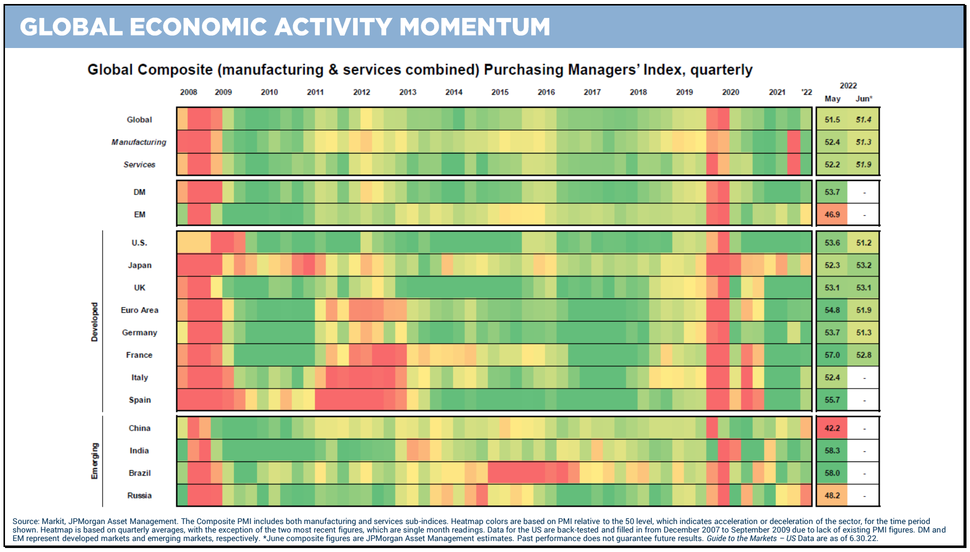

The global economy presents a mixed picture entering the second half of 2022 as is reflected here in the PMI heatmap. On the positive side, the effects of the pandemic are fading in most parts of the world due to widespread immunity gained from inoculation, infection, and the dominance of the Omicron strains of the virus. They appear to be more contagious than the original but less deadly. But the Chinese economy continues to be impacted by the pandemic because they struggle to sustain the zero-COVID policy, and European economies are also being badly impacted by the war Ukraine, which has boosted energy prices to very high levels. Inflation has become a global concern, and most central banks are tightening policy to combat it. While I don't think this will result in a global recession, it should slow the pace of economic recovery around the world. But I think it will relieve some of the pressure on commodity prices. This gives some hope for next year that we'll see positive economic growth but less inflation around the world.

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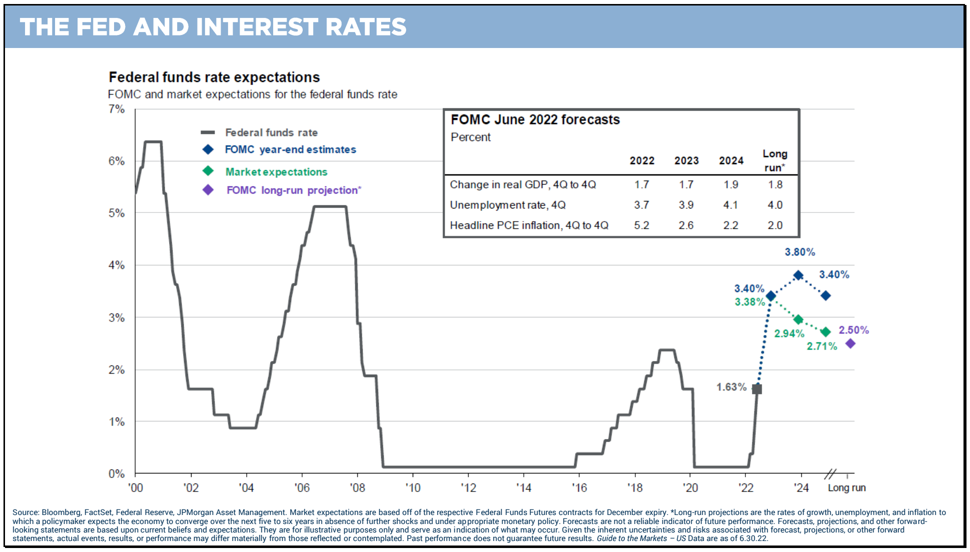

The rapidly improving labor market plus persistent inflationary pressures have pushed the Fed to adopt a much more hawkish stance. At the June meeting, the Federal Reserve increased the federal funds rate by 0.75% - and that was following a March increase of 0.25% and a May increase of 0.50%. I would expect further increases of 1.75% this year and 0.50% next year, which would take the fund rate to a range of 3.25% - 3.50% by the end of 2022 and 3.75% - 4.00% by the end of 2023. The Fed is still reducing their huge bond holdings, and the pace of reduction is ramping up to the tune of $95 billion per month by September. The Summary of Economic Projections is forecasting the year-over-year core consumption deflator inflation rate will fall from its current 4.9% to 4.3% by the fourth quarter of 2022, 2.7% by the fourth quarter of 2023, and 2.3% by the fourth quarter of 2024. And it’s also significant that while futures markets now roughly agree with the Fed’s own forecasts of the federal funds rate for the rest of 2022, they are pricing in Fed easing starting next spring. That reflects the risk that too-aggressive Fed action could tip the economy into recession.

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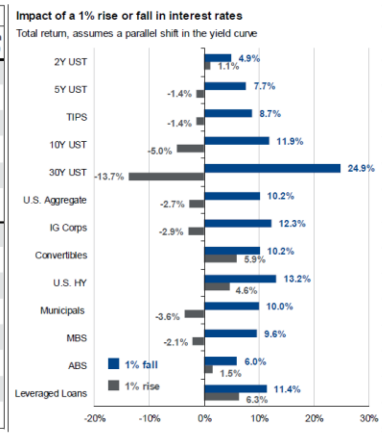
FIXED INCOME MARKET DYNAMICS

	Yield		Return			
U.S. Treasuries	6/30/2022	12/31/2021	2022 YTD	Avg. Maturity	Correlation to 10-year	Correlation to S&P 500
2-Year	2.92%	0.73%	-3.05%	2 years	0.69	-0.32
5-Year	3.01%	1.26%	-7.15%	5	0.92	-0.29
TIPS	0.65%	-1.04%	-8.92%	10	0.58	0.24
10-Year	2.98%	1.52%	-11.71%	10	1.00	-0.26
30-Year	3.14%	1.90%	-23.57%	30	0.93	-0.25
Sector						
U.S. Aggregate	3.72%	1.75%	-10.35%	8.6	0.85	0.10
IG Corps	4.70%	2.33%	-14.39%	11.4	0.46	0.43
Convertibles	7.63%	3.66%	-19.41%	-	-0.23	0.87
U.S. HY	8.89%	4.21%	-14.19%	5.9	-0.20	0.74
Municipals	3.21%	1.11%	-8.98%	12.8	0.42	0.14
MBS	3.77%	1.98%	-8.78%	7.8	0.80	-0.04
ABS	4.38%	1.96%	-2.87%	2.4	-0.41	0.62
Leveraged Loans	8.83%	4.60%	-4.06%	2.6	0.06	0.03



Source: Bloomberg, FactSet, Standard & Poor's, US Treasury, JPMorgan Asset Management. Sectors shown above are provided by Bloomberg unless otherwise noted and are represented by – US Aggregate; MBS: US Aggregate Securitized – MBS; ABS: JPMorgan ABS Index; Corporates: US Corporates; Municipals: Muni Bond; High Yield: Corporate High Yield; Leveraged Loans: JPMorgan Leveraged Loan Index; TIPS: Treasury Inflation-Protected Securities; Convertibles: US Convertibles Composite. Convertibles yield is as of most recent month end and is based on US portion of Bloomberg Global Convertibles Index. Yield and return information based on bellwethers for Treasury securities. Sector yields reflect yield-to-worst. Convertibles yield is based on US portion of Bloomberg Global Convertibles. Correlations are based on 15-years of monthly returns for all sectors. Past performance does not guarantee future results. *Guide to the Markets – US* Data are as of 6.30.22.

High inflation, falling unemployment, and the Fed's much more hawkish stance led to a sharp backup in bond yields in the first half of 2022. That led to negative returns across fixed income markets. Persistently high inflation suggests continued tightening from the Federal Reserve through the end of the year, but increasing worries about recession could limit further increases in long-term Treasury yields. Credit spreads have also widened out in anticipation of a slowing economy. This presents some opportunities in areas like high yield bonds and convertibles, provided the economy can avoid a deep recession.

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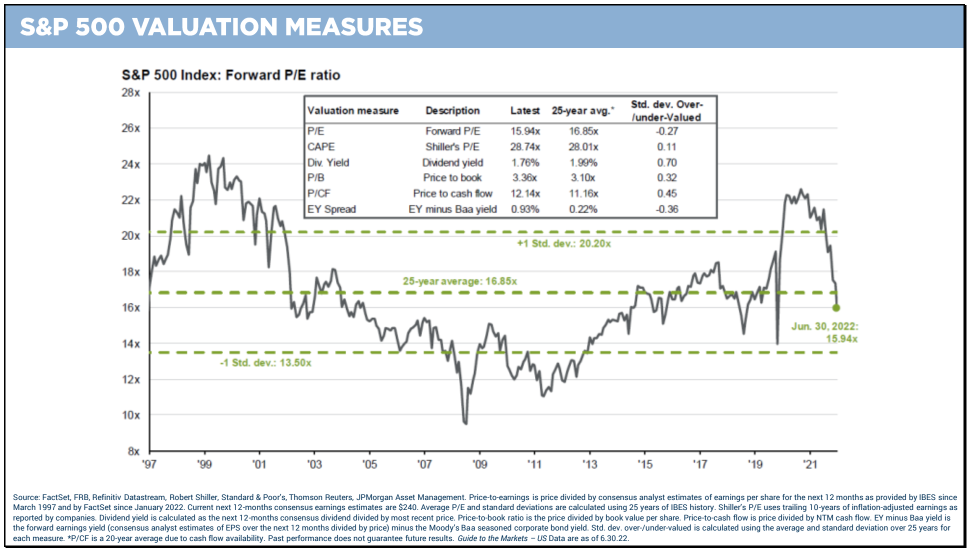

US equities slumped, so we moved into a bear market in the first half of 2022. It's a common theme, but investors are worried about inflation, aggressive Fed tightening, and the threat of recession. While all of these issues are very real, the S&P 500 forward P/E ratio is now below its 25-year average of roughly 16.9 times. It should set investors up for better returns in the long run, particularly if today's stressful environment is eventually replaced by one of slow growth, low inflation and interest rates, and high profitability, which would be reminiscent of the last decade. In the meantime, though, higher interest rates will likely continue to cause a compression in valuations across financial markets with US value stocks and international equities in general being the best positioned to outperform.

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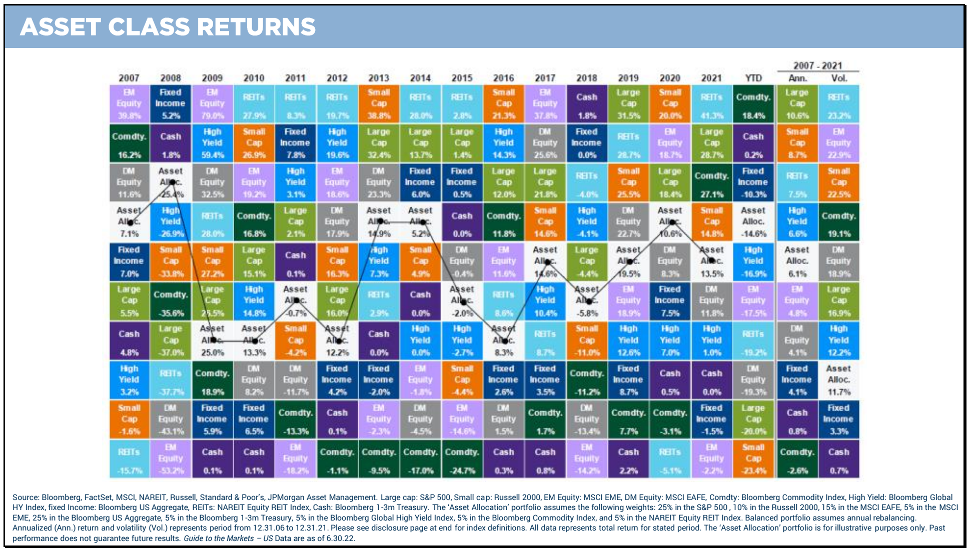

We've had significant losses in both global stocks and bonds in the first half of the year. Among the major asset classes, only commodities have posted significant gains. It's worth noting that a broadly-diversified portfolio could have risen by more than 50% between the end of 2018 and the end of 2022. Even with losses this year, many investors are well ahead of the game in their long-term plans and should reassess how much return they need, as well as the risk they are willing to undertake in order to achieve their long-term goals.

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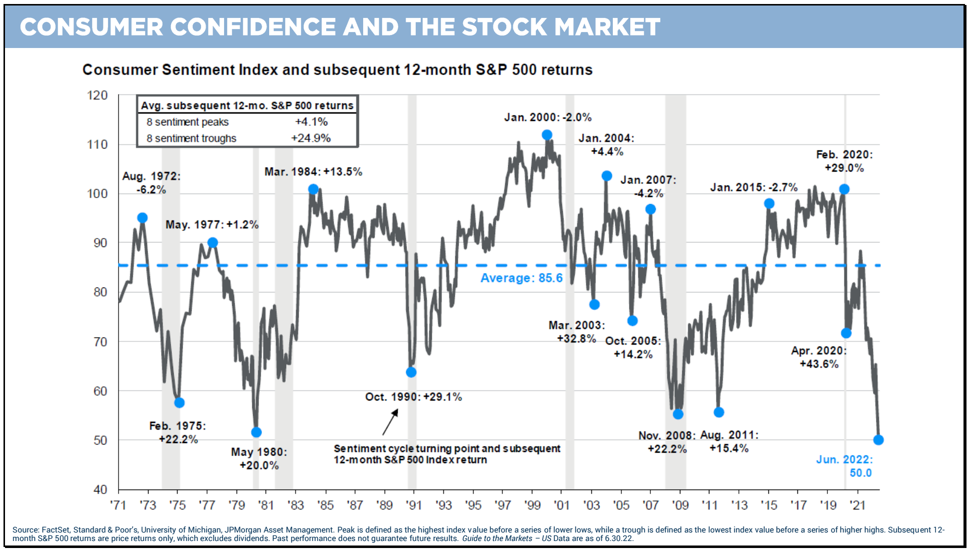

As we've said, it's been a disappointing year for investors. Consumer sentiment is down to its lowest level on record. And when investors feel gloomy and worried about what's ahead, the natural tendency is to sell risk assets in general and stocks in particular. But history really does suggest that trying to time the markets like that is a mistake. This slide is the University of Michigan's Index of Consumer Sentiment for the past 50 years. We show eight distinct peaks and troughs here. And then you can see how much the S&P 500 Index went up or down in the 12 months following the peaks or troughs. This is really interesting. Buying at a confidence peak yielded an average return of 4.1%. But buying at a trough – or confidence low – yielded a whopping 24.9%! Of course, we're not saying US stocks are going to deliver that kind of return in the year ahead. A lot goes into it. But as you think about planning for 2022 and beyond, focus on what you own and valuations rather than focusing on when to buy and sell and how you feel about the world.

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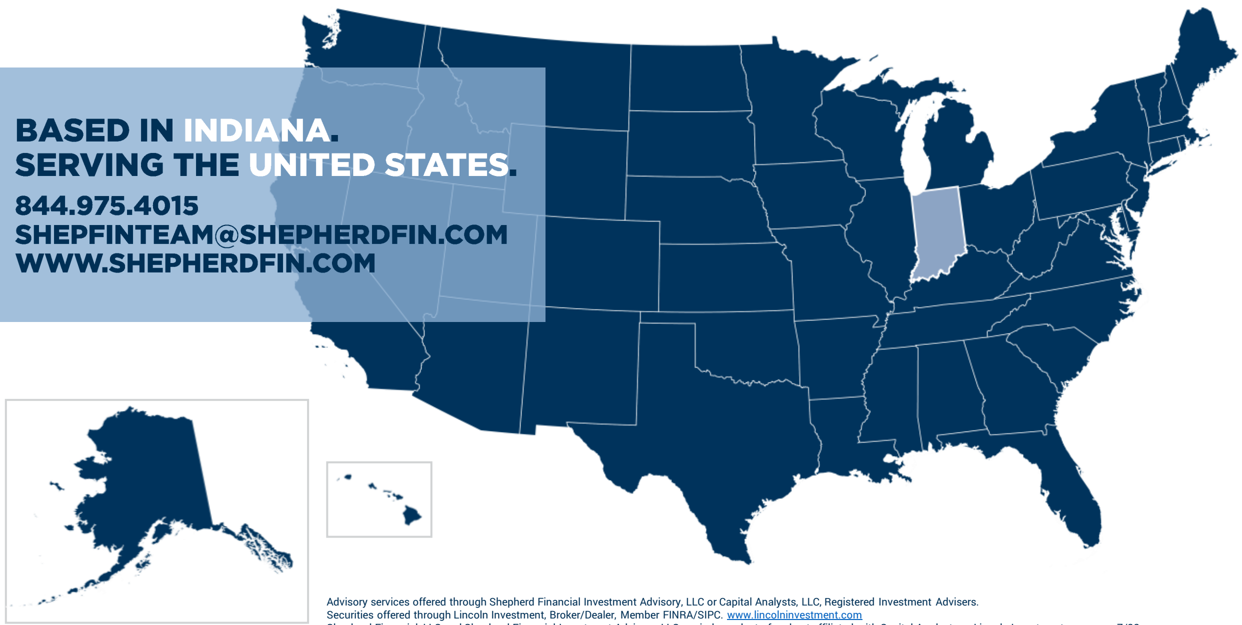

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