2 KNIGHTS
WEALTH MANAGEMENT

Market outlook as of July 2022

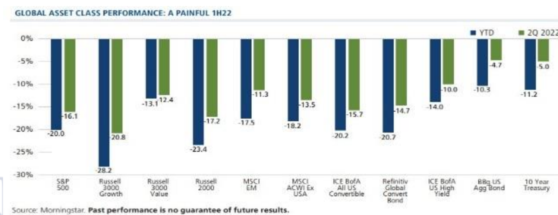
"There are decades where nothing happens; and there are weeks where decades happen."

Vladimir Lenin (1870 – 1924) … Russian Revolutionary making Russia a one-party Socialist State.

My thinking goes to another Vladimir, Putin, who has single handedly woken up the free world (especially Europe) with the invasion of Ukraine. To me, it's follow the money… Ukraine ranks fourth in the world by total value of natural resources – it has massive reserves of iron, titanium and manganese ores; it is a top exporter of wheat, barley, sunflower and sunflower oil, potatoes, and rye, to name just a few. This is all about strengthening Russia's power which he has failed to achieve with Russia itself which already has the largest land mass of any country on the planet.

At the beginning of this year, very few stock market professionals or portfolio managers (including us) could have predicted that 2022 first six months would have been one of the worst starts in decades, not only for equities, but also for bonds. The economy was robust, the consumer was well positioned with strong job growth, rising wages, and good savings. Two key factors changed. The first being ***Russia's Invasion of Ukraine***, which sent commodity prices soaring, mainly oil and gas into stratospheric levels. This had an additional rippling effect on the second, ***inflation*** which was already running hot due to a tight labor market, supply chain shortages and very low unemployment numbers.

Very few markets were spared during the first half of the year with the most damage being done in the second quarter. (See Chart below). Areas that were once darlings have been pulverized such as Cathy Woods, ARK Innovation funds a favorite of Millennials and Gen Z generation which was down 57.8% for the six months. Even bonds and 10-year treasuries had losses of over 10% for the first half of the year.



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Looking forward to the second half of the year, corporate profits will now play a key role in how the markets hold up. Individual security and sector weighted will play a crucial role in navigating what we think will be continued volatile markets due to many uncertainties as yet to be resolved.

Markets are very rational over the long term, but short-term investor sentiment sets in and either pushes valuations to manic or depressive levels. On a positive note, consumer confidence is as negative as ever and is already pricing in a lot of negative events. Analysis shows that since 1975 this has only happened 4 times and markets were up 75% one year later, and 100% of the time 3 years later. With 2008 being the outlier due

to the Housing Financial bubble which is presently not in the cards.

Areas where we see as silver linings:

- Even though interest rates have risen from zero, the global economy remains in a much lower rate environment than was seen in the past, and typically lower interest rates favor elevated valuations (or certainly NOT depressed) which have already corrected a lot.

- With all the negative news one may be tempted to go into "cash". Bear markets nearly always bottom way before the economy goes into a recession, and rallies are generally very fast and furious gaining 15% on average in the first 30 days. Our conviction is that price wise we are closer to the end of the market decline than the beginning, but the economy could still get worse. <u>Since 1950, the S&P 500 has rallied about 15% on average and is positive 70% of the time after a 20% index drop</u>. Attractive valuations, mid-single-digit earnings growth, increased dividends, and robust stock buybacks continue to be supportive. (see table below)

Equity market bottom	GDP bottom	Days in between	Equity market return by the time that GDP bottomed	Equity market return by the time that GDP started rising again
3/31/2020	6/30/2020	91	20%	30%
2/28/2009	6/30/2009	122	25%	44%
10/31/1990	3/31/1991	151	23%	22%
7/31/1982	9/30/1982	61	12%	31%
9/30/1974	3/31/1975	182	31%	50%
12/31/1957	3/31/1958	90	5%	13%

Source: Bloomberg, JPMAM. 2022.

` As is key to our strategy, we always favor companies with strong "moats", quality balance sheets and higher returns on capital. We are long term focused, and are overweight healthcare, defense stocks, software (cyber defense) and feel very comfortable longer term going forward. Dividend growers in the past have proved to be relatively shielded from volatility and could see relative benefits from a rising-rates environment. In a recent note, *Goldman Sachs analysts, David J. Kostin, argued that dividend stocks present value moving forward. "Dividend stocks look particularly attractively valued, in our view,"* the analysts wrote. *"Dividend stocks typically outperform in environments of elevated inflation. In addition, dividends currently benefit from the buffer of strong corporate balance sheets." "History shows that dividends move with inflation, so you're still getting a real return,"*

We are also seeing plenty of companies that are trading at or below pre-covid valuations, while earnings are up significantly, resulting in attractive valuations., particularly for companies with improving fundamentals going forward. In this regard we have started replacing companies that we think will be "dead wood" for now due to inflationary pressures and rising interest rates. (I.e. Home depot replaced for Volkswagen!).

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We added to energy to our ETF tactical tilt portfolios earlier in the year. We also are favoring financials due to relatively good valuations, and healthcare due to its recessionary, defensive characteristics and long-term demographic trends. We still underweight Europe due to their reliance on Russian energy, especially natural gas which is currently almost three times the cost of the US. ($9 vs $26!)

We think small cap equities are starting to look relatively attractive when things settle down, especially for investors with a longer-term horizon. They are ale beneficiaries of a strong dollar.