BLUE GRANITE CAPITAL, LLC

INVESTMENT COMMENTARY, JULY 2022

We're all certainly hearing a lot about inflation and recessions lately and are likely to hear about it a bit longer. So, let's get the statistical milestones out of the way and then focus on the good news amid these messy markets.

The S&P 500 Index fell more than 20% in the first half of 2022, the worst performance in over 50 years, while the technology-heavy Nasdaq fell 29.51%, the lowest first half performance on record. Perhaps most surprising, the Bloomberg U.S. Aggregate Bond Index (the standard benchmark for fixed income) fell 10.7% year-to-date, an outcome not seen since 1975. The primary culprits were inflation, which grew to 40-year highs, along with the Federal Reserve's aggressive interest rate policy. The result has been shaken confidence and heightened concern that the economy is tipping into a recession.

The impact of near record inflation slowing our economy is evidenced in recent consumer spending, manufacturing, and home sales reports. While slower economic growth is not the optimal outcome, it's preferable to the possibility that a series of rate hikes by an over-aggressive Fed could instigate a recession. The higher cost of food, gas, rent, travel, entertainment, clothing, and many other goods and services has led consumers and businesses to slow their discretionary purchases. This snowballs into less money being spent across the country which inevitably slows GDP (economic) growth. The good news is that lower growth manifests in reduced inflation as the demand for all goods and services declines.

Despite concerns brought about by inflation and a potential recession, we do see silver linings that can give rise to a recovery in equity markets. One oddity of the current slowing economy is the continued demand for labor. The U.S. unemployment rate of just 3.6% provides solid footing for the economy despite slowing GDP growth in contrast to high unemployment rates in prior recessions. Also, as mentioned in the previous commentary, market declines historically lead to market rallies. As an example, the record setting loss in the first half of 1972 was followed by a 23% stock market rally in the second half of that year. The current selloff has reduced recent market excesses by lowering stock valuations and suppressing investor expectations—which improves conditions for a turnaround in equity markets.

While this year's losses are unwelcome, we also point to the 2020 Covid shutdown that triggered a 3-week stock market selloff of 34% and first quarter loss of 26.70%. At that time, it was awfully hard to find any good news, yet stocks rallied through the remainder 2020 for a yearly gain of 18.40% for the S&P 500 and continued to rally in 2021 as stocks gained 28.71%. The message here is bear markets and investor fears do end and tend to be followed by significant stock market rallies along with price rebounds in the stocks we hold.

Despite negative headlines that the Fed's interest rate hikes will slow economic growth and curtail the recent home buying craze, there is an upside as well. Higher rates have now raised the yields on interest-bearing investments (i.e. bonds) of all types. Because bond yields have been so low for over a decade, investors are now noticeably more inclined to add bonds to their portfolios. Since fixed income and other bonds are the mainstay of the Blue Granite portfolios and help mitigate risk, we are beginning to enjoy better returns as yields move higher across the spectrum.

We are also seeing signs that imply lower inflation ahead and indications that we may avoid a recession. Energy and other commodity prices have fallen rather significantly over the past month, while recent government data reflects decreased demand. The impact of slowing demand and lower commodity and raw materials prices can take a bite out of inflation. Higher mortgage rates have also helped slow the booming real estate market which mitigates potential excesses in the sector.

Admittedly, the Fed has a challenging task at hand—balancing inflation and economic growth—however, we are not only hopeful but believe we've seen much of the worst as it relates to inflation and the stock market's decline. While global issues remain noteworthy, better times lie ahead.

Wishing you a wonderful summer, and please contact us should you have any questions or concerns.

Best,

Scott, John, Dave, Richard, & John