



Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Second Quarter of 2022

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Executive Summary

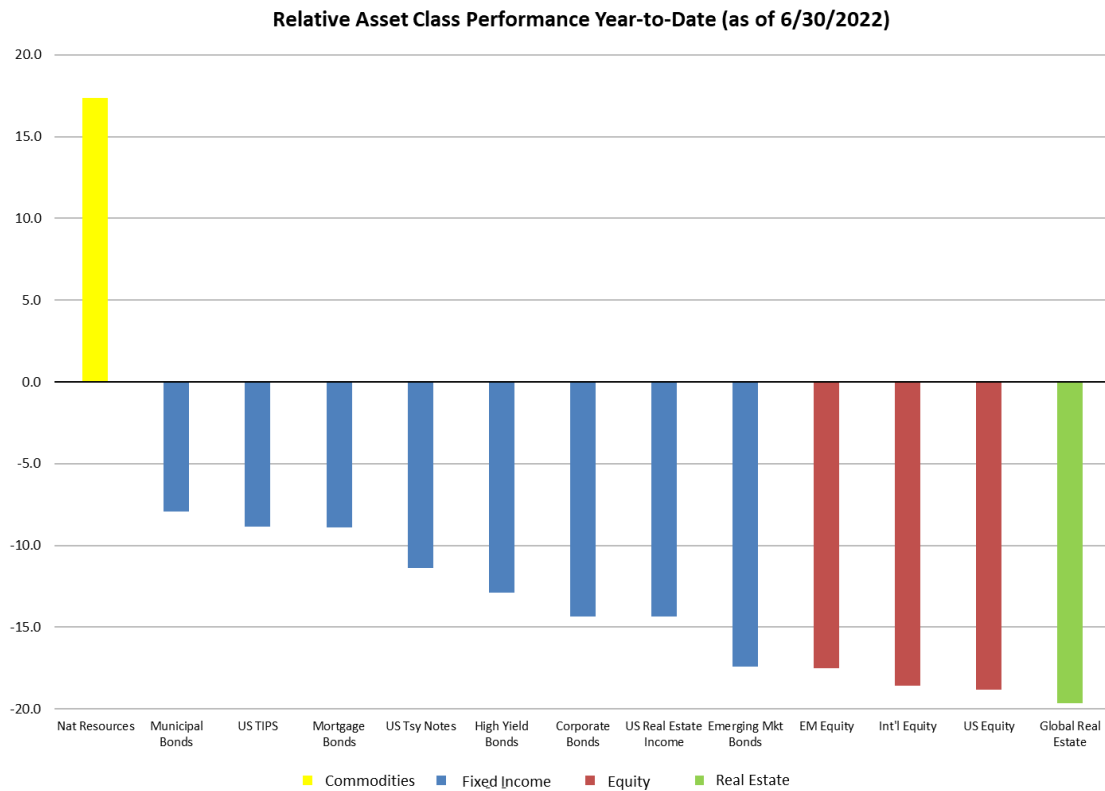
- It was a truly awful quarter to be an investor. The main culprit was higher-than-expected inflation, leading the Federal Reserve to be more aggressive with interest rate increases to slow the economy. The U.S. market was the worst-performing major market, declining by -16.8% in Q2, on top of its -5.3% decline in Q1. International developed markets actually fared a bit better, declining by -14.7% during the quarter while emerging markets fell -11.5%.
- Fixed income also had a dreadful quarter. In general, higher-than-expected inflation during the quarter translated into a faster-than-expected pace of Fed tightening, which prompted a backup in bond yields. During the quarter the Fed implemented a series of interest rate hikes, raising the policy rate by 75 basis points in June for the first time since 1994. By the end of the quarter, the US 10-year bond yield rose from 2.34% to 3.01%, briefly going as high as 3.5% (an 11-year high!), and the two-year yield increased from 2.33% to 2.93%.
- As for “alternatives,” it has been anything but fun outside of the commodities complex this year. Cryptos have been decimated, with the price of Bitcoin, for example, down -58% during the first half of the year. Real estate has also performed poorly and gold, a traditional inflation hedge, has lost value. In addition, the average long/short hedge fund is down -18% since the start of the year, about the same as the S&P 500. In short, there have been few places to hide, except in cash.
- Our report this quarter focuses on how a downshift in globalization is ushering in a new economic cycle. We discuss the structural changes to the economic landscape that have occurred, how this cycle could differ from its predecessors, and build on our last letter to discuss the implications of investing in what appears to be a new economic cycle.
- **Artemis strategy.** We did make some investment changes this quarter, including increasing our tilt toward high-quality/dividend and value-oriented companies, while modestly reducing large-cap growth and small-cap. Additionally, for those of you with fixed income in your portfolios, we are starting to walk back into the bond markets as we believe interest rates have staged a large move upward and may have come close to topping out, providing some more compelling opportunities for yield.



Markets in Review – Q2

It was a truly awful quarter to be an investor. In a change from recent years, the U.S. market was the worst-performing major market, declining by -16.8% in Q2, on top of its -5.3% decline in Q1. (See Figure 1.)

Figure 1. Asset Class Returns in USD for Q2 2022 (%)



As many news outlets reported, the poor showing resulted in the weakest first half performance since 1970. The main culprit was higher-than-expected inflation, which led many to believe that the Fed is now going to be very aggressive with interest rate increases to slow the economy. Value, which tend to outperform when inflation is high, continued to outperform Growth by a wide margin and is now leading Growth by over 15 percentage points thus far in 2022. The decline in Growth, a major component of the U.S. market, is the main reason for U.S. underperformance relative to other major markets in 2022. (See Figure 2.)



Figure 2. Returns by Style in 2022 (thru June 30)

	Value	Blend	Growth
Large	-12.9%	-20.0%	-28.1%
Mid	-16.2%	-21.6%	-31.0%
Small	-17.3%	-23.4%	-29.5%

International developed markets actually fared a bit better, declining by -14.7% during the quarter while emerging markets fell -11.5%. These results are especially surprising given that the dollar appreciated strongly against most currencies during the quarter due to both its safe-haven appeal and rapidly rising US interest rates.

However, most markets within the international complex declined. Chinese equities were the only exception, increasing +3.4% as prolonged lockdowns were lifted in several major Chinese cities, which signaled that economic growth might soon accelerate. In addition, inflation is very low in China, giving authorities room to be accommodative in terms of monetary policy (i.e., keeping interest rates low), which will provide a support as the economy recovers from Covid and the slump in its real estate sector.

Fixed income also had a dreadful quarter. In general, higher-than-expected inflation during the quarter translated into a faster-than-expected pace of Fed tightening, which prompted a backup in bond yields. During the quarter the Fed implemented a series of interest rate hikes, raising the policy rate by 75 basis points in June for the first time since 1994. By the end of the quarter, the US 10-year bond yield rose from 2.34% to 3.01% and the two-year yield increased from 2.33% to 2.93%, barely escaping inversion. (An inverted yield curve is one in which shorter-dated bonds have a higher yield than longer-dated bonds, traditionally signaling that a recession is on the way.) There was a brief bond rally at the end of the



quarter as recession fears took hold, but the rally only slightly curtailed the negative returns.

As for “alternatives,” it has been anything but fun outside of the commodities complex this year. Cryptos have been decimated, with the price of Bitcoin, for example, down -58% during the first half of 2022. Real estate has also performed poorly and gold, a traditional inflation hedge, has lost value. In addition, the average long/short hedge fund is down -18% since the start of the year, about the same as the S&P 500. In short, there have been few places to hide, except in cash.

Changing of the Guard – Globalization downshift starts new economic cycle

The past 35 years since the mid-1980s have been characterized by a remarkable period of global economic stability and GDP growth. During that period, inflation and interest rates remained well below long-term averages, and growth was driven by a steady demand-based global economy. The minimal inflationary pressures were due to two structural shifts: increasing globalization, which led to steadily expanding production (supply), and the technology boom.

Problems during this cycle arose when excess borrowing led to overheating or overextension, which resulted in declining sentiment and spending, but these were able to be quickly remedied by central bank intervention in the U.S., Europe, and elsewhere. In our opinion, this era has ended, and the new cycle will likely be driven by a different set of global macro conditions and priorities.

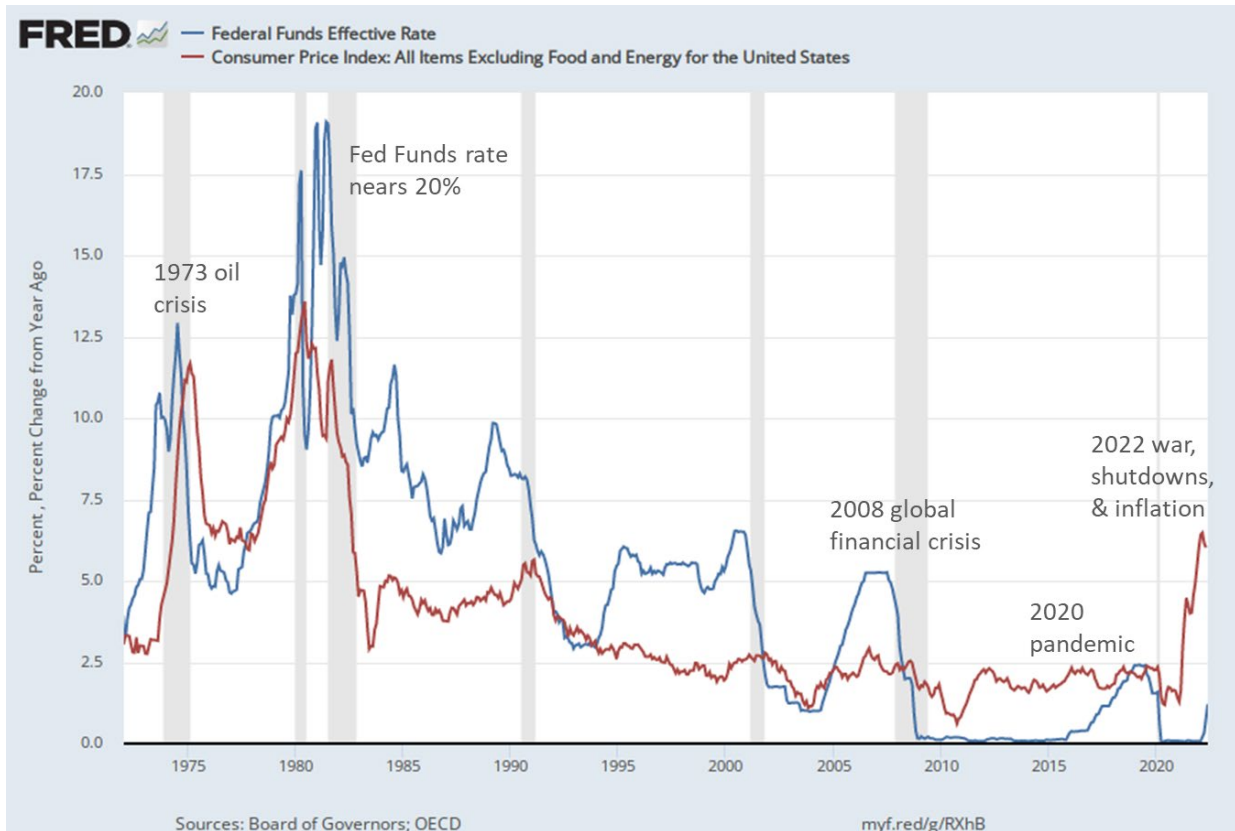
The previous cycles

The ‘Traditional Investment Cycle’ (pre-1980s) and the ‘Modern Cycle’ (mid 1980s-now) each had distinctive characteristics.

The Traditional Investment Cycle was typically shorter and more volatile, with boom and bust periods driven by more big swings in inflation, interest rates, and economic activity. Resource scarcity/insecurity and geopolitical conflict were commonplace, due in part to the 1973 oil crisis that sent inflation and interest rates skyrocketing. (See Figure 3.) In these cycles, to compensate for the risks in equity investments, investors typically required a higher dividend yield and often preferred ‘value’ oriented companies with stable growth and profit margins.



Figure 3. Consumer Price Index (red) and the Fed Funds Rate (blue) from 1972-2022



By comparison, the Modern Cycle, coined “The Great Moderation” by academics Jim Stock and Mark Watson, was the period since the mid-1980s of steadily lower volatility in inflation and economic activity that drove U.S. profit growth and GDP to record highs. (As shown in Figure 3, the red line for the Consumer Price Index, a common measure of inflation, has been low and fairly stable since the decline from 1980-1983.) In this modern period, high corporate revenue growth was favored by investors as lower interest rates and rapid technological advancements lowered risk premia and stimulated high growth assets.

We believe we are in the very early stages of a new cycle that will share certain characteristics of each the previous cycles, but the priorities of investors and corporations will change. We expect they will be driven by a more fractured geopolitical environment, a return of resource insecurity, ongoing technological advancements, and significant changes to inflation/interest rate expectations.



What has changed, and why is this happening?

Many factors can be said to have influenced the incredible period of low inflation and declining interest rates that defined the last cycle, but none was greater than globalization. Globalization increased for two key reasons. The first is that geopolitics were favorable. After the Cold War ended, there was downward pressure on global military spending where the U.S. dominated. The “peace dividend” meant these funds could be spent more productively, helping to lower inflation.

At the same time, technology increased global interconnectedness, and both China and India embraced capitalist enterprise, entering the World Trade Organization in 2001 and 1995, respectively. This time period was a golden era when two key economic inputs, resources and labor, became cheaper and more plentiful.

The major shift is that globalization has been disrupted, bringing an end to the goldilocks period of steadily increasing production and lower price pressures. This had been brewing for a few years, and we can point to the U.S./China tariff-wars during the Trump presidency and Brexit, with the fallout from the United Kingdom leaving the EU, as two clear examples of early fracture points.

The pandemic and Russia’s invasion of Ukraine pushed us past the tipping point. We believe we are exiting a period of robust globalization and entering a period of de-globalization and regionalization. The two events occurring concurrently revealed that existing supply chains and just-in-time inventory systems is incredibly fragile, and the system is highly interdependent. In addition, as shown in Figure 4, global sentiment about globalization is decreasing and is down roughly 10% since 2019.

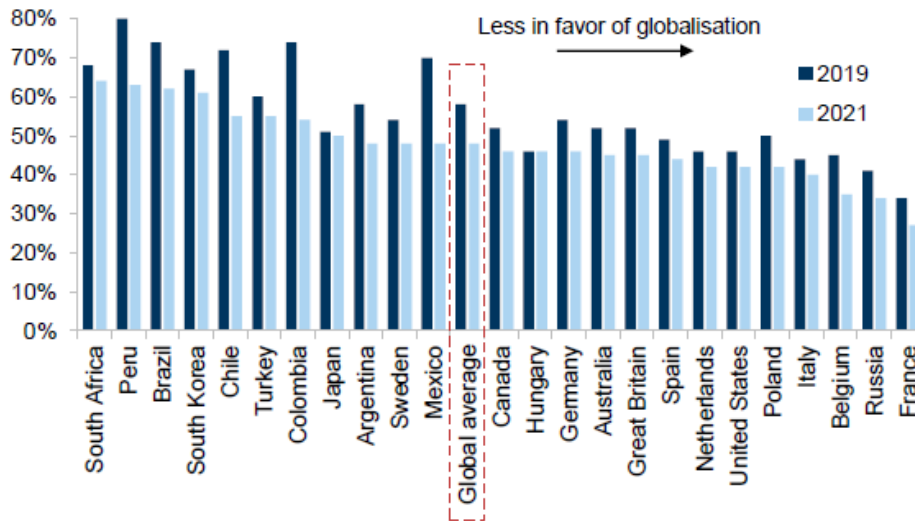
Political scientists and business leaders report they are seeing a seismic shift in national and corporate psyches that has sparked a movement to improve supply chain resilience, ‘re-shore’ (return production of certain materials from overseas), and increase energy and resource security.

The result will be continuing increases in costs (inflation), increased regionalization, and higher required capital expenditures to achieve the same economic output. As such, inflation is here, and we expect we will be living with above trend inflation and higher interest rates for some time.



Figure 4. Global sentiment about globalization

Exhibit 19: Positive sentiment about globalisation has declined
% of respondents that agree with the statement “overall, globalisation is a good thing for my country”



Ipsos World Opinion on globalisation and International Trade in 2021 (25-country survey for the WEF)

Source: Ipsos, Goldman Sachs Global Investment Research

What are the investment implications?

The priorities of investors will likely shift. For example, capital spending growth (capex), and innovation, which will drive much of the expansion in this cycle, is likely to be more focused on the need to simplify and secure supply chains. Decarbonization initiatives, and defense spending also are likely to increase providing additional opportunities for investors.

Growth and technological advancement will continue to be major themes, but there will be more disparity between the winners and losers as we shift away from a period where the “rising tide lifted all tech/growth ships.” This shift will change investor preference from high growth rates at any price to a focus on growing companies with defensible business models and strong and growing profit margins. Reflecting this expectation, we have recently been adding to investments in companies with strong track records both in terms of profitability and in payment of dividends.



Finally, the Fed “put” of keeping interest rates ultra low and providing a safety net with bailout funding is likely on hold in such an inflationary environment. As such we cannot expect rapid “V-shaped” recoveries from bailouts, such as happened in 2020 after the first wave of Covid. Instead, it will be corporate earnings, consumer strength, and economic growth that shift the tide within the cycle. As a result, downturns may be more prolonged than those we’ve experienced in the past decade as the economic engine takes longer to kick into high gear without additional stimulus to stoke the flame.

In summary, investment returns over the next decade are more likely to be modest and even more volatile in this new cycle, and we will look for those returns from companies that have solid fundamentals and defensible business models. The party may finally be over for high-octane growth companies with compelling stories but little else. We will be writing more about the investment implications of this new era in future reports.

Artemis Strategy

The most striking conclusion from our readings of current research and market commentary is that there is absolutely no consensus on how markets may perform over the next year. This may well be due to the fact that we are in the early stages of a new cycle as just described in the previous section. At least the economist Paul Krugman tried to be honest about this when wrote in the *New York Times* this month: “Some data suggest a weakening economy, maybe even on the verge of recession. Some suggest an economy still going strong. Some data suggest very tight labor markets; others, not so much.... In fact, given the wide discrepancies in economic data, economic pundits (including me) have unusual freedom to believe whatever they want to believe. Just pick and choose the numbers that tell you what you want to hear and glue them together.”

In such an uncertain environment currently, our approach has been to fall back on the some of the time-honored principles of good investing. These include holding a highly diversified portfolio, not making any big bets, and sticking with a plan. Our portfolios are now decidedly more diversified across Value and Growth and more defensive overall via the addition of a quality high-dividend fund to the mix.

The U.S. remains our preferred equity region due to some better fundamentals in our view – U.S. companies have stronger balance sheets on average, we have a greater degree of energy independence, and the U.S. consumer is in relatively better shape. This may seem obvious given that risks are clearly more elevated in Europe, but as and when the Fed begins to end the tightening campaign (or the Ukraine war ends), the euro, especially, is likely start appreciating, giving a boost to international returns. And don’t forget,



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international markets have modestly outperformed thus far in 2022, to the surprise of many.

As we wrote last quarter, we have been a bit more active on the fixed income side, primarily because it did not take a deep look into a crystal ball to conclude that fixed income was going to have a very difficult year. Why? Because the Fed telegraphed to all that they were going to be aggressive with interest rates as they saw that inflation was proving to be a lot stickier than they originally thought. As such, it seemed reasonable to step out of the bond market to some extent while the Fed did its work. Indeed, our decision to make this move is a major reason why most of our portfolios outperformed their benchmarks this quarter.

But markets are anticipatory and so interest rates will reflect projected Fed moves. In our view, yields may be currently topping out. In mid-June, for example, the 10-year yield reached almost 3.5% before ending the quarter at 3.0%. We think the decline is due to increased recession fears, which are leading many to believe that the Fed may start easing (i.e., reducing interest rates) if growth really starts to falter. Nevertheless, at 3% yields are far more compelling than they were at the beginning of the year, and we believe it sensible to start to walk back into the bond market with some of the cash we have had on the sidelines.



Market Index Descriptions (for Figure 1)

Equities:

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **MSCI Emerging Markets Net Total Return** is a market cap-weighted index representing the performance of large-, mid- and small-capitalization stocks in emerging markets.

Fixed Income:

ICE US Treasuries 7-10 Year measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years.

The **Bloomberg US Mortgage-Backed Securities** Index tracks fixed-rate agency mortgage backed passthrough securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The **Bloomberg Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities.

The **Bloomberg US Corporate** measures the performance of U.S. dollar denominated investment grade rated corporate debt.

The **Bloomberg EM USD Aggregate** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.

The **Bloomberg Barclays US TIPS (Series-L)** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.



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The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **S&P Global REIT Index** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade-rated corporate debt publicly issued in the U.S. domestic market with a maturity of at least one year remaining.