

Economic Overview

The second quarter of 2022 was a decidedly weak environment for almost all traditional financial assets. For most of the quarter, through early June, the global economy had been contending with three continuing shocks: 1.) disruptions to supply chains exacerbated by the omicron coronavirus variant, 2.) price spikes in most commodities largely driven by supply issues brought on by the war in Ukraine, and 3.) a slowdown of the Chinese economy (the world's second largest) driven by housing market weakness and Covid lockdowns that have suppressed normal economic activity. On June 10th, a fourth shock materialized: the release of May's inflation data showed an increase of 8.6% from the year prior, the largest increase in inflation since December 1981. The Personal Consumption Expenditure (PCE) price index—the Fed's preferred price gauge—reached 6.3% in May after hitting a record high of 6.6% in March. Food costs rose 10.1% year-over-year and energy prices rose 34.6% from last year's levels. Core CPI, a measure that excludes the more volatile food and energy prices, was up 6%, on an annualized basis. This single event appears to have caused panic among many investors, as well as the Federal Reserve. The S&P 500 had declined 11.3% for the quarter, as of June 9th. On June 10th, when the CPI data became known, it fell another 2.9% that day, and proceeded to decline another 3.0% as June came to a close. Prior to the CPI data release, consensus expectations had been established for a June rate hike by the Fed of 50 basis points, like the one that occurred in May. The Fed ended up increasing its federal funds rate by 75 basis points—the largest single rate hike since 1994, leaving the benchmark rate at a range of 1.5%–1.75%. These events represent a dramatic departure from established Fed norms: rather than base monetary policy decisions on core inflation, the Fed suddenly allowed headline inflation concerns to force its hand. Unfortunately, the Fed's rate increases do not ameliorate food and energy price spikes. Additional crops will not be planted, nor will oil rig or crude refining capacity increase as a result of interest rate hikes. Many of the economic woes facing consumers are beyond

the Fed's control. Market expectations for Federal Reserve rate hikes this calendar year have risen from 75 basis points in December to 175 in March; currently, futures contracts suggest the fed funds rate will likely reach 3.25%–3.50% before year-end. This doubling of expected rate increases every few months has suddenly turned market participants' fear of inflation into a fear of Fed-induced recession (Paul Volker-esque inflationfighting techniques are being conjured by the financial media). The FOMC sees rates rising to 3.8% in 2023, a full percentage point higher than what was expected in March of this year. As of this writing (mid-July), the most recent CPI data shows a 9.1% year-over-year increase (4.5% for food and energy) and reflects oil prices of mid-June which were nearing \$120 per barrel. Currently oil is trading under \$100 per barrel, suggesting June's CPI print is already outdated.

Constructive Observations

- Tangible evidence on many fronts suggest supply chain issues are improving.
- Consumer spending trends remain intact with a shift from goods to services underway as pandemic restrictions ease.
- Consumer balance sheets are healthy, marked by high savings and low debt levels.
- Leading economic indicators are strong and do not suggest an imminent recession is likely.
- Despite slowdowns in the rate of growth, manufacturing activity is still in an expansionary mode.

Cautious Observations

- Geopolitical risks abound with the Russian war in Ukraine exacerbating tensions as countries seek to balance ethical and economic dilemmas.
- Negative sentiment could create self-fulfilling feedback loops that cause trends to exacerbate and extend.
- With travel restrictions easing, surges in Covid cases are possible as variants continue to develop and spread.

- The risk of an economic “hard-landing” increase as monetary officials’ hawkishness increases.

Macro Overview

The Fed currently projects the U.S. economy will grow 1.7% both in 2022 and 2023, a dramatic downgrade from the 2.8% and 2.2% rates forecasted in March for those years. The World Bank recently cut its forecast for global growth to 2.9% this year, down from its 4.1% prediction made in January. Despite the dramatic repricing of risk assets, many measures of financial conditions suggest the near-term outlook may not be as dire as many recent headlines suggest. Supply chain bottlenecks are becoming less problematic. Consumers are still in decent shape in terms of high savings levels and low indebtedness. Corporate profits are still near all-time highs. U.S. unemployment is still quite low at 3.6%, basically returning to pre-pandemic levels. Labor markets appear robust as hiring remains elevated by historical standards. Faster wage growth in low-wage industries suggest workers are finding better jobs when they quit and obtain new jobs. Economists are quick to point out that recessions and strong labor markets generally do not co-exist; recessions typically result in layoffs and job cuts as companies seek to downsize and lower costs.

Markets Overview

Equities

Equity markets suffered dramatic declines in the second quarter. The S&P 500 index fell 16%, bringing its year-to-date return to -20%, the classic definition of a ‘bear’ market. The S&P MidCap 400 declined 15% this quarter and the S&P SmallCap 600 index fell 14%; these indices are down -20% and -19%, respectively, year-to-date. Growth stocks fell more than value stocks this quarter, across all market cap segments. Every sector declined this quarter. Consumer Staples fell the least: 4.6%, whereas Consumer Discretionary stocks fell the most: 26.2%. The only sector that is positive this year is Energy, up over 30%, driven by the dramatic increase in oil prices since Russia invaded Ukraine. Utilities stocks, considered a very defensive sector, were down 5% for the quarter and are slightly negative for the year, falling 0.6%. Seven of the eleven major economic sectors of the U.S. economy are down more than 15% year-to-date.

Earnings estimates for companies have come down

marginally in recent weeks, but corporate guidance has not shown signs of sharp declines. Earnings and revenue beat rates are likely to fall from some of the historically strong post-Covid seasons of the recent past. Nothing suggests a dramatic collapse in business performance relative to expectations is likely in the near-term.

International markets declined this quarter in a similar manner as domestic markets. Developed international markets, as proxied by the MSCI EAFE index, fell -15%, bringing year-to-date results of -20%. Emerging market stocks fell -11% this quarter, and -18% for the year. China was one of the few countries experiencing positive returns for the quarter (+3.5%).

Fixed Income

All major bond indices fell this quarter, with the Barclays Aggregate down -5% for the quarter and -10% for the year. High yield bond spreads rose dramatically this quarter from 3.4% to 5.9% based on the ICE BofA High Yield OAS index. The Fed’s tightening actions led to yield increases across all maturities of U.S. Treasuries. The shorter-end (0-2 years) moved the most (110bps+) with rates in the 2-year to 30-year realm moving up by 55bps – 70bps, depending on the specific maturity. Although the front-end (shorter maturities) of the yield curve is quite steep currently (78 basis points differential between 3-month and 6-month T-bill yields), most of the curve beyond 2-years is very flat (19 basis point differential between 2-year and 30-year yields). There have been brief inversions of the yield curve at different points this year, but no persistent trend has emerged.

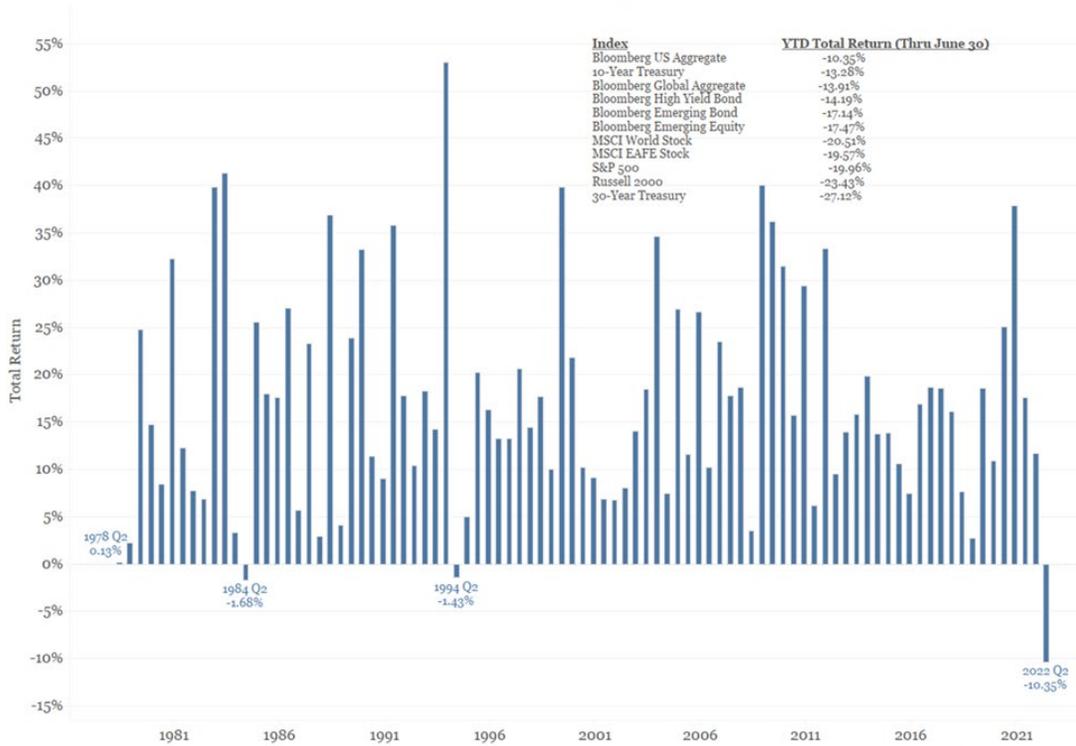
China’s Ministry of Finance is considering allowing local governments to sell \$220 billion of bonds in the second half of this year to buttress their slowing economy (driven primarily by Covid lockdowns and a housing slump). This is noteworthy because the sales would be brought forward from next year’s quota and represents the first time bonds are sold in China before the start of the year—a signal that authorities are concerned about an economic slowdown.

Real Assets

Most energy-related commodities continued to rise. West Texas crude rose 9% and Brent crude rose 10% this quarter. Most metals pulled back this quarter in anticipation of slowing economic growth, as did agricultural commodities.

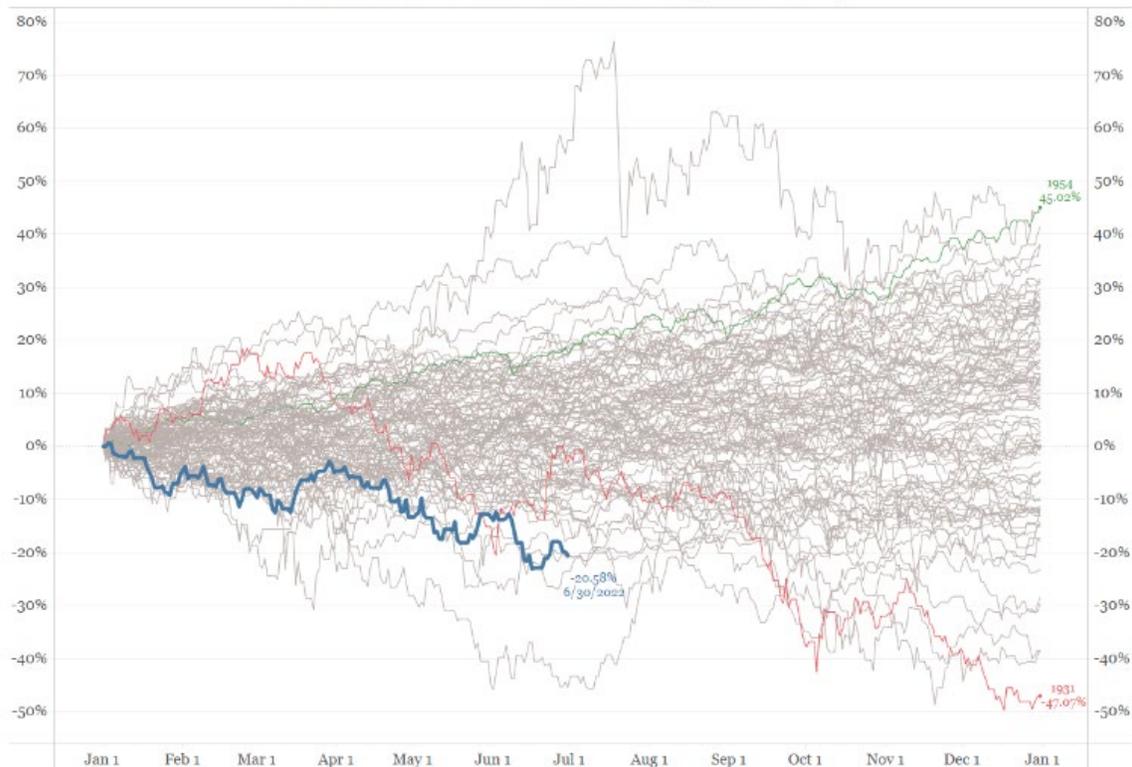
Charts of the Quarter

Best 6-Month Total Return Among Basket of Assets



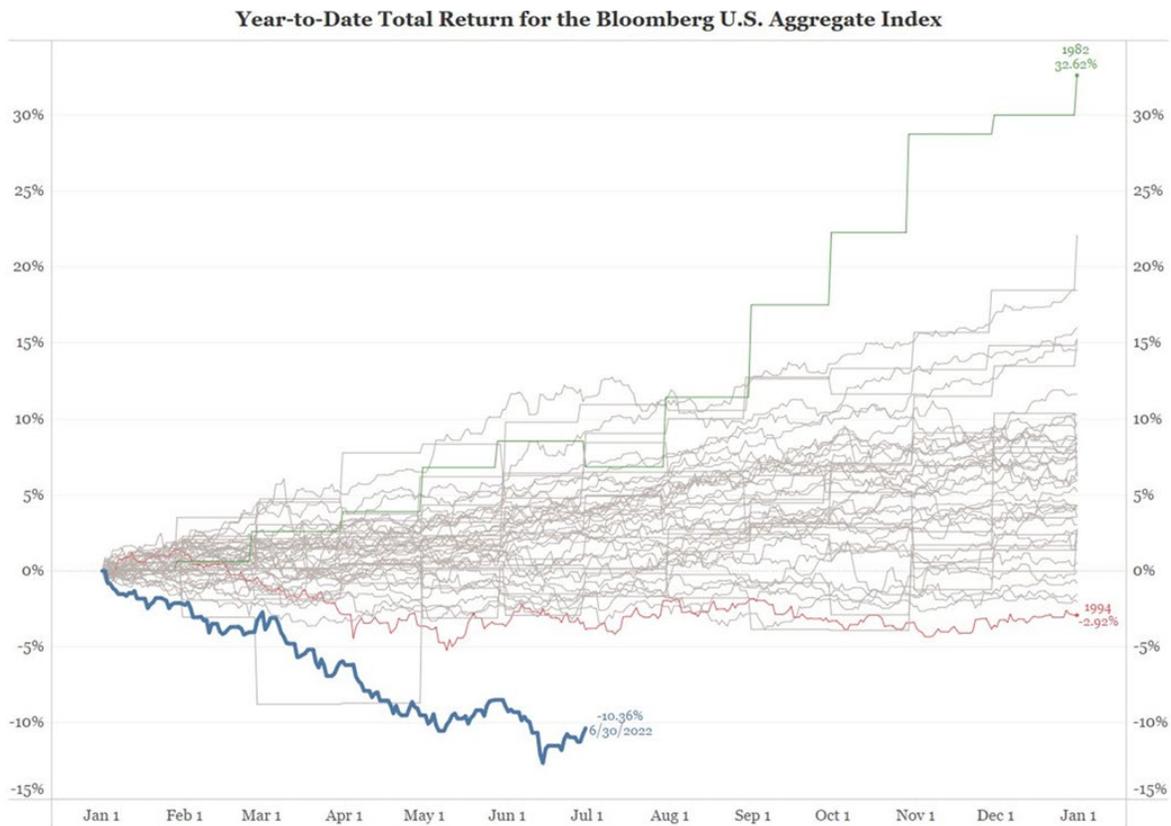
Source: Bianco Research.

Year-to-Date Total Return for the S&P 500 Price Only



Source: Bianco Research.

Charts of the Quarter



20%+ Two Quarter Drops for the S&P 500: Post WW2				
Quarter	2-Qtr Drop (%)	Next Quarter (%)	Next Half (%)	Next Year (%)
Jun-62	-23.48	2.78	15.25	26.70
Jun-70	-21.01	15.80	26.72	37.10
Sep-74	-32.39	7.90	31.19	32.00
Dec-74	-20.28	21.59	38.84	31.55
Sep-02	-28.94	7.92	4.04	22.16
Dec-08	-29.43	-11.67	1.78	23.45
Mar-09	-31.59	15.22	32.49	46.57
Jun-22	-20.58	?	?	?
	Average	8.51	21.47	31.36
	Median	7.92	26.72	31.55

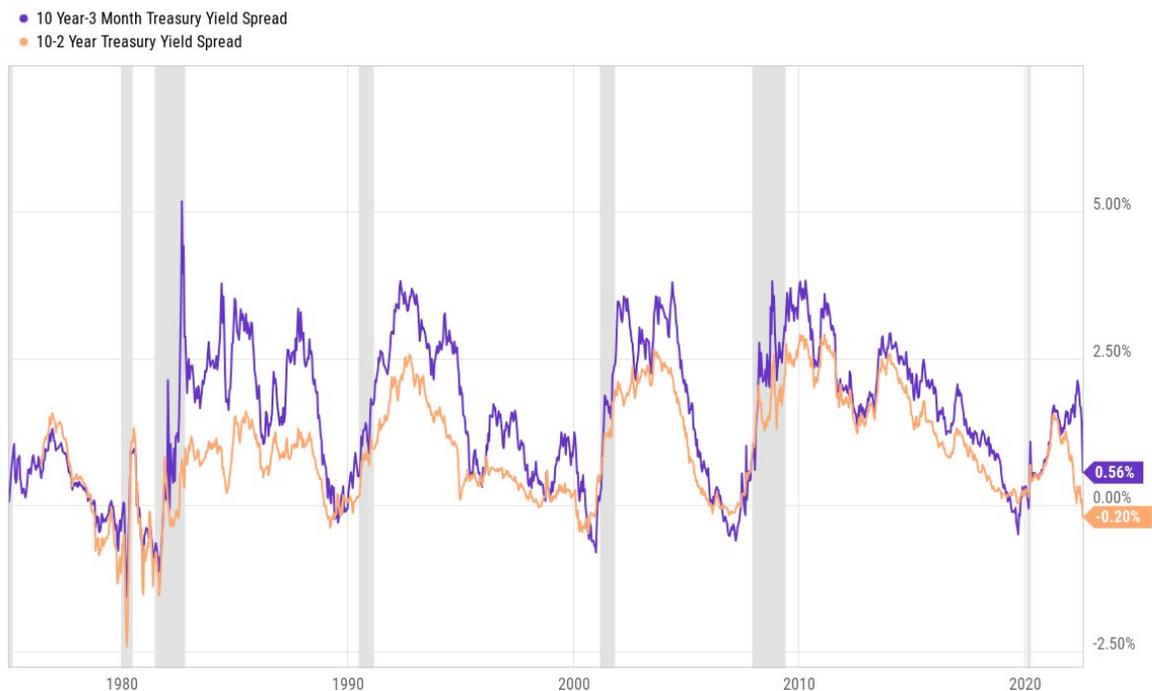
Source: Bespoke.

Charts of the Quarter

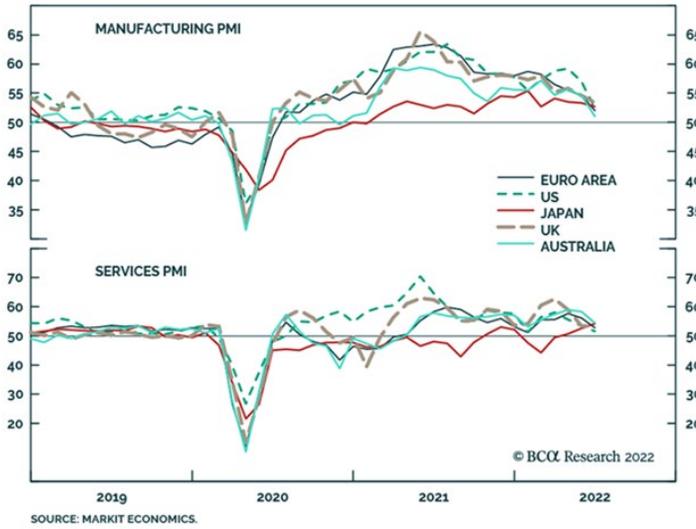
Post-WW2 S&P 500 Bear Markets*										S&P 500 % Change Once -20% Threshold is Hit				
Start	-20%	Days to		Days from -	% Chg from -	Full Bear	Full Bear	Next	Next	Next 3	Next 6	Next		
		Bear	End	20% to End	20% to End	% Chg	# of Days	Week	Month	Mths	Mths	Year		
5/29/46	9/3/46	97	5/19/47	258	-8.20	-28.47	355	-2.73	-0.13	-3.40	2.73	2.20		
6/15/48	6/13/49	363	6/13/49	0	0.00	-20.57	363	3.84	9.08	16.16	22.80	42.07		
8/2/56	10/21/57	445	10/22/57	1	-0.43	-21.63	446	3.24	3.40	5.49	9.66	30.96		
12/12/61	5/28/62	167	6/26/62	29	-5.73	-27.97	196	3.19	-1.96	5.93	11.93	26.14		
2/9/66	8/29/66	201	10/7/66	39	-1.78	-22.18	240	3.88	2.39	7.90	16.44	24.62		
11/29/68	1/29/70	426	5/26/70	117	-19.14	-36.06	543	0.25	4.45	-4.53	-8.93	11.89		
1/11/73	11/27/73	320	10/3/74	310	-34.92	-48.20	630	-2.20	2.13	0.73	-7.44	-26.92		
11/28/80	2/22/82	451	8/12/82	171	-8.22	-27.11	622	1.54	1.06	2.96	1.28	30.37		
8/25/87	10/19/87	55	12/4/87	46	-0.41	-33.51	101	1.26	6.76	10.89	14.71	23.19		
3/24/00	3/12/01	353	9/21/01	193	-18.16	-36.77	546	-0.79	0.28	6.41	-7.42	-1.24		
1/4/02	7/10/02	187	7/23/02	13	-13.34	-31.97	200	-1.57	-1.29	-12.66	0.77	7.41		
10/9/07	7/9/08	274	11/20/08	134	-39.55	-51.93	408	0.05	4.15	-26.90	-28.47	-29.08		
1/6/09	2/23/09	48	3/9/09	14	-8.99	-27.62	62	-5.72	10.71	19.33	38.05	47.26		
2/19/20	3/12/20	22	3/23/20	11	-9.81	-33.92	33	-2.87	12.46	22.60	34.68	58.96		
1/3/22	?	161+	?	?	?	?	?	?	?	?	?	?		
Average		244		95	-12.05	-31.99	339	0.10	3.82	3.64	7.20	17.70		
Median		238		43	-8.60	-30.22	359	0.15	2.89	5.71	6.19	23.90		
% Positive		--		--	--	--	--	57.1	78.6	71.4	71.4	78.6		
Avg. All Periods Since 1945								0.30	1.01	2.42	4.88	9.89		

*Bear Market definition of 20%+ decline that was preceded by a 20%+ rally, all on a closing basis.
 = Recession began within two years of bear market start.

Source: Bespoke.

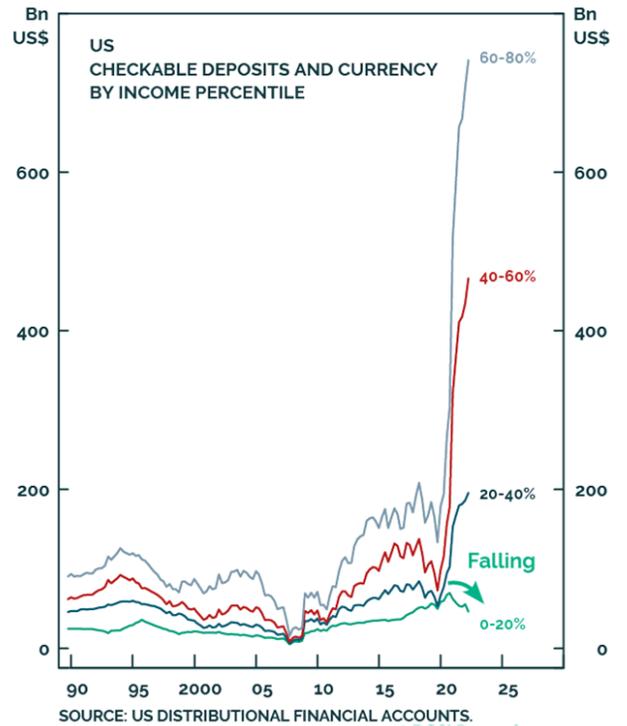


Charts of the Quarter

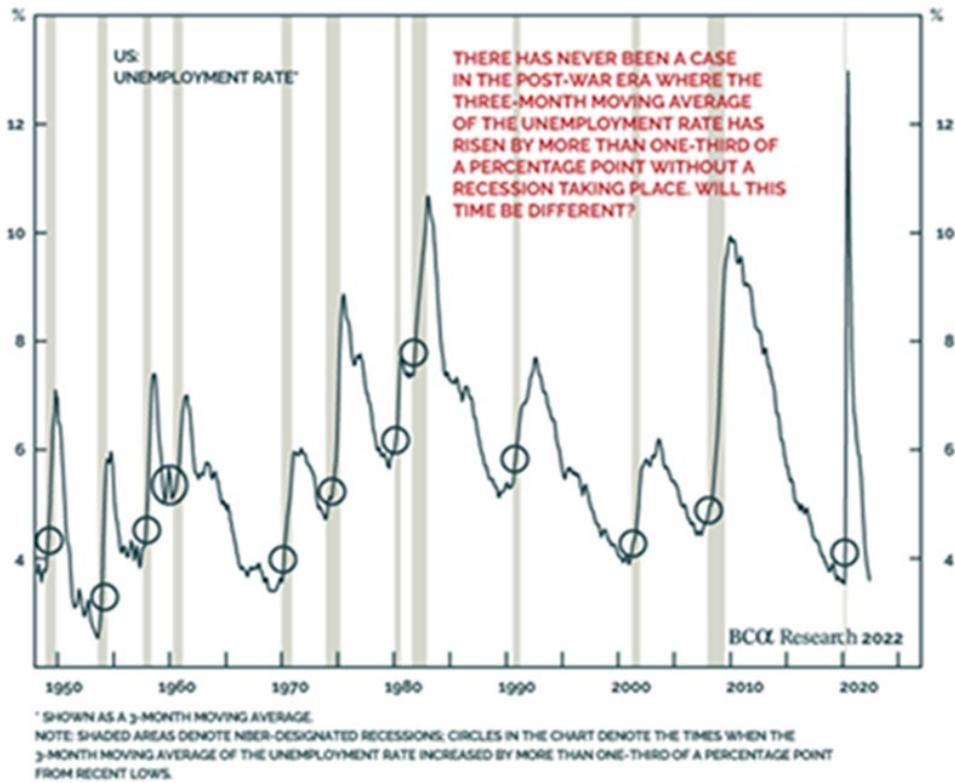


SOURCE: MARKIT ECONOMICS.

Source: BCA Research.



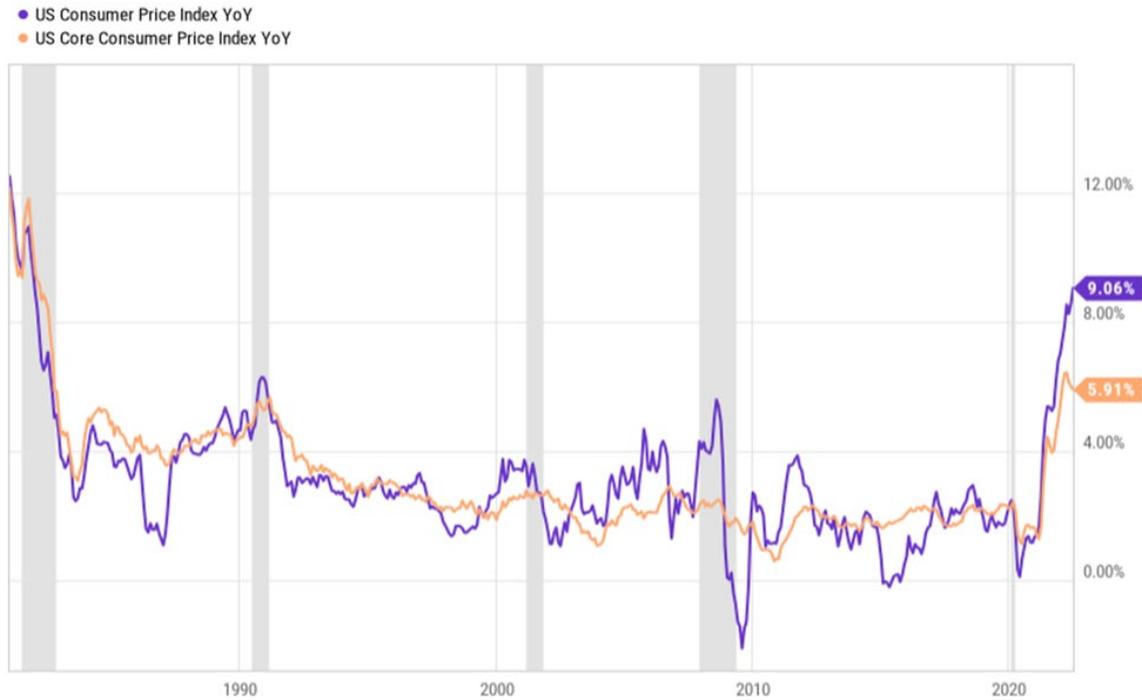
SOURCE: US DISTRIBUTIONAL FINANCIAL ACCOUNTS.



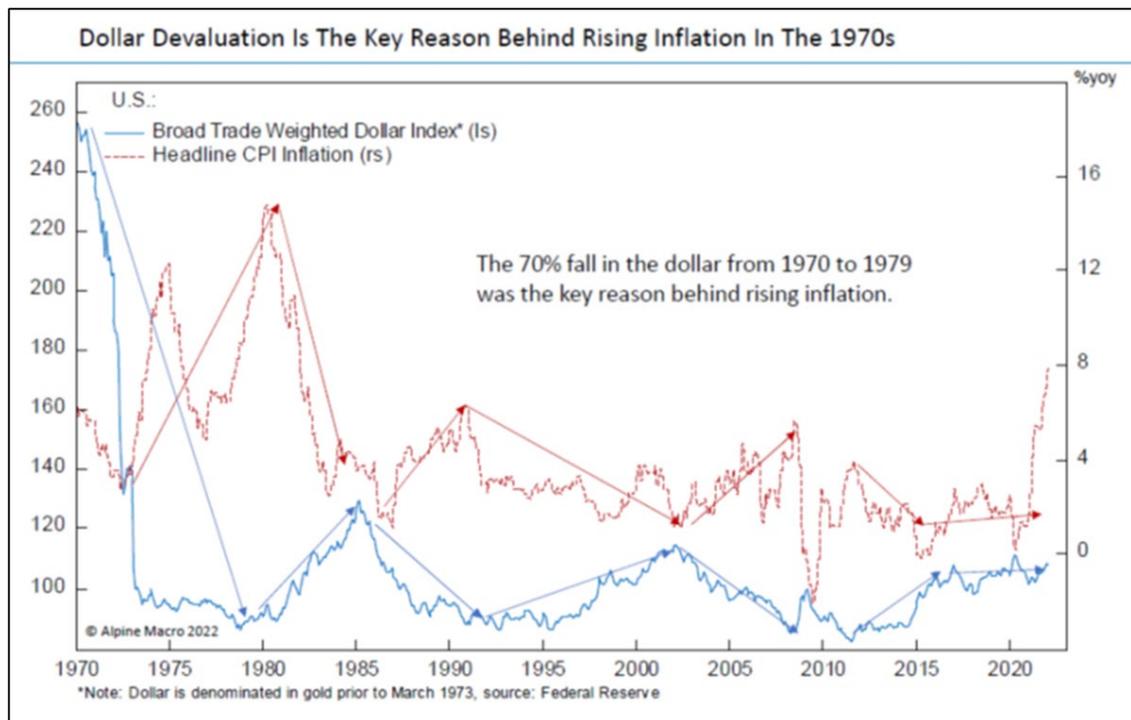
Source: BCA Research.

Charts of the Quarter

Headline vs. Core CPI



Source: YCharts.



Source: Alpine Macro.

Charts of the Quarter

ANNUALIZED ROLLING TEN YEAR RELATIVE TOTAL RETURN OF GROWTH VS. VALUE

As of March 31, 2022



Source: Strategas.



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