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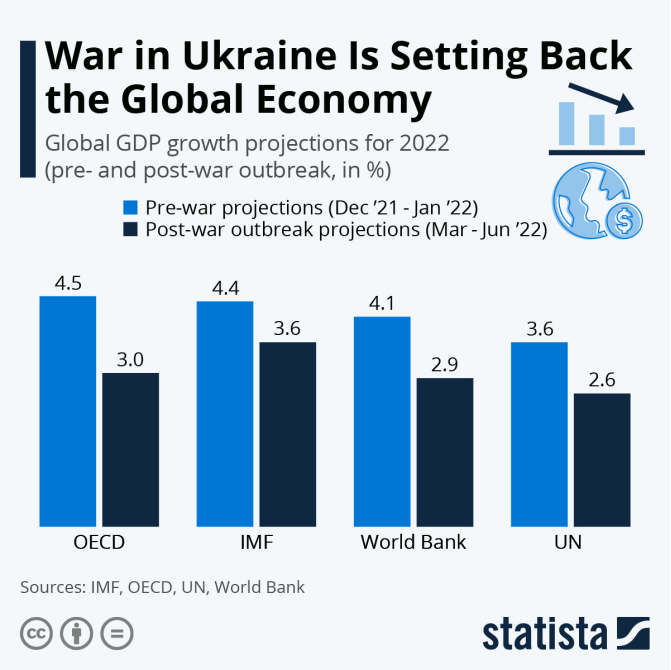
Second Quarter 2022 Market Commentary

This year started with high expectations for a strong recovery of the global economy after the pandemic. But the unprovoked Russian invasion of Ukraine has shattered those expectations.

Commodity prices – including grain, oil, natural gas, and several precious metals – have surged, and the war is threatening food security in some countries, further straining the already stressed global supply chain, and increasing financial uncertainty around the globe.

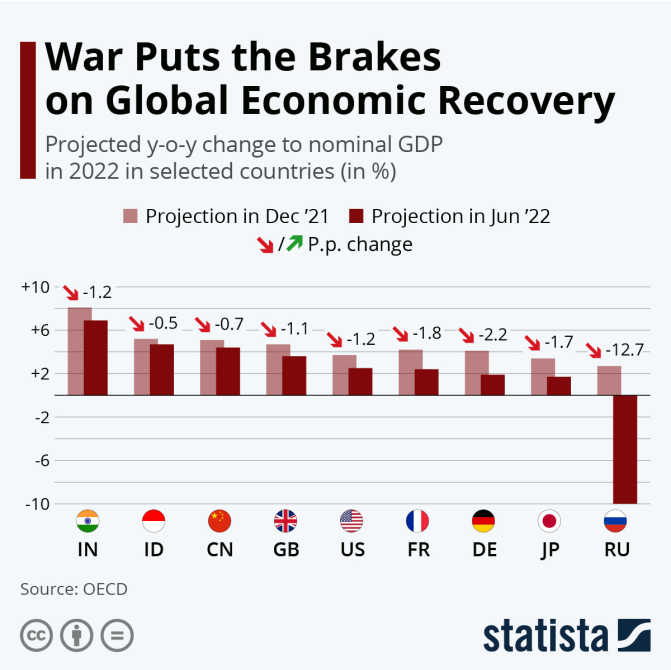
As a result, all of the major international organizations – including the International Monetary Fund, the World Bank, the United Nations, and the OECD – have lowered their forecasts for the growth of the global economy in 2022. Coupled with these lower growth projections is inflationary pressure, which has reached the highest levels seen in decades in many developed and developing economies.

The chart below shows the impact of the war in Ukraine on the global economy:



Source: Statista

The chart below shows the impact of the war on several of the world's largest economies.



Source: [Statista]

The Economy

New data indicate that the US economy is weaker than expected, with the federal government lowering its figures for gross domestic product.

The third estimate of GDP released by the Commerce Department showed personal consumption increased 1.8% in the first quarter, a downward revision from the 3.1% previously reported.

GDP was revised down by 0.1% to a 1.6% decline, the first contraction of the economy since mid-2020. The decrease reflected declines in exports, federal government spending, private inventory investment and state and local government spending.

The larger-than-expected downward revision in consumer spending suggests that the economy carried less momentum into the second quarter than was previously assumed.

Inflation

The annual inflation rate in the US rose slightly to 8.6% in May, the highest level since late 1981, and higher than the market's expectation of 8.3%. The increase was driven by surging energy prices (up over 34%), and to a lesser extent by food costs (up over 10%).

Source: [Trading Economics]

In a bit of good news, core inflation – which excludes food and energy prices – declined for the second straight month in May.

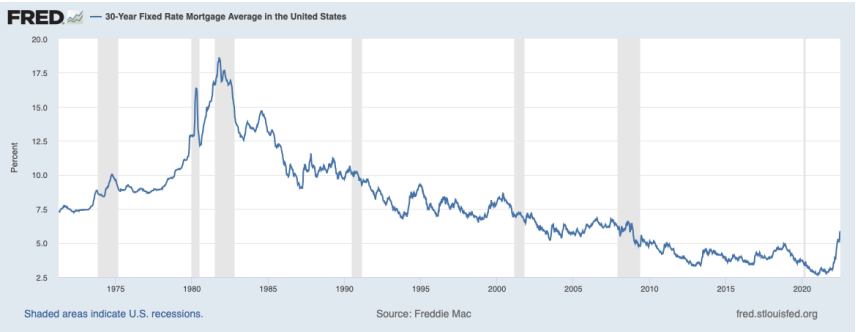
The bond market is projecting that the average annual inflation rate over the next decade will be 2.33%. This figure has been steadily declining over the past several weeks.

Source: [Federal Reserve St. Louis]

As we have pointed out in our previous writings, historically high inflation is not unique to the US. German inflation reached 8.2% June, as the government introduced transport and fuel subsidies introduced to soften the impact of higher prices. Spanish inflation rose to 10%, the highest level in 37 years. Eurozone inflation is estimated at 8.3%.

Mortgage Rates

The average rate on a 30-year fixed-rate mortgage fell for the first time in a month to 5.84% for the week ended June 24th, down from 5.98% for the previous week. Still, borrowing costs remain close to levels not seen since 2008.

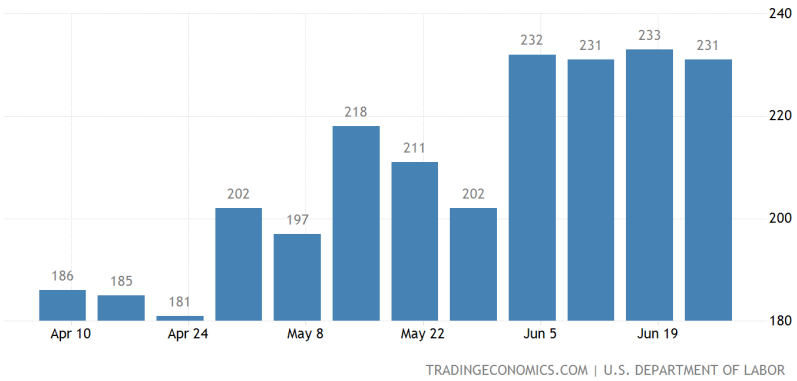


Source: [Federal Reserve St. Louis]

The Labor Market

The number of Americans filing new claims for unemployment benefits decreased by 2,000 to 231,000 for the week ending June 25th. This figure was slightly higher than the market's forecast of 228,000. The 4-week moving average of claims was 231,750, an increase of 7,250 from the previous week's (upwardly revised) average.

The chart below shows weekly initial jobless claims:



Source: [Trading Economics]

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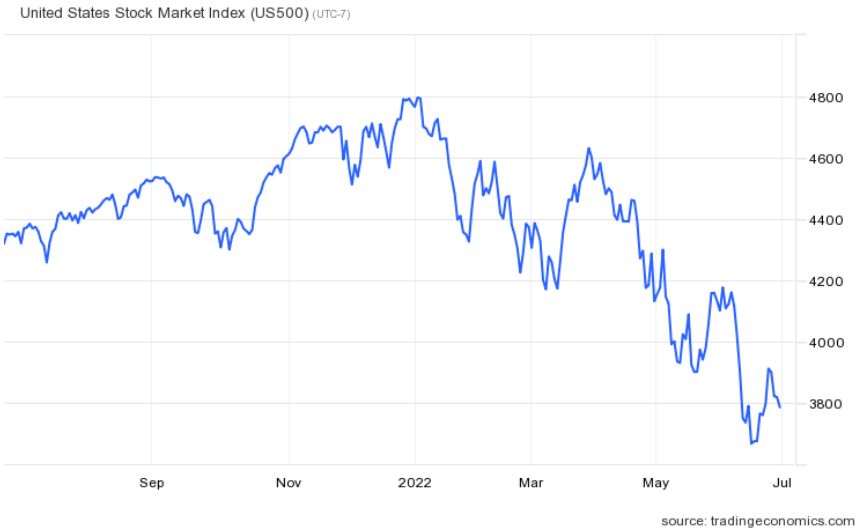
The Capital Markets

US Stocks

All of the major US stock indices closed the second quarter on a down note, with the benchmark S&P 500 index falling 0.9% on the final trading day. For the first half of the year, the index was down 20.6%, its biggest decline since 1970. Over the past 12 months, the index is down 11.9%.



Source: Trading Economics

The tech-heavy Nasdaq index closed down a little over 1.3% on the last trading day of the quarter. Over the past four weeks, the index declined by 8.9%, and over the past year it is down nearly 21%.

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Source: Trading Economics

International Stocks

The Stoxx 600 index – a proxy for large European companies – closed down 1.5% on the last trading day of the second quarter. Over the past four weeks, the index declined by 8.2%, and over the past 12 months it is down 10.6%.

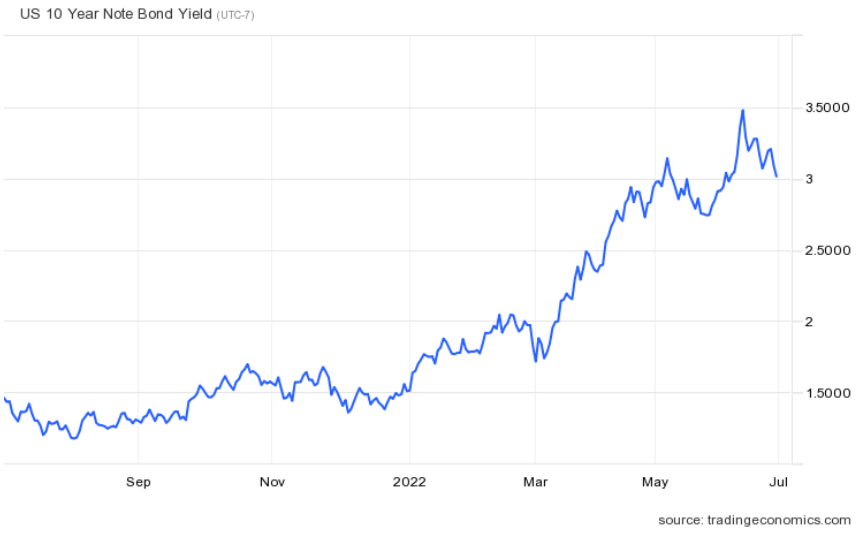
Source: Trading Economics

The Bond Market

The yield on the benchmark 10-year US Treasury note fell just below 3% on the last trading day of the second quarter, as investors moved out of risky assets like stocks and into perceived "safe haven" investments like government bonds. The move was driven by concerns that the Federal Reserve may tip the US economy into a recession through its efforts to tamp down inflation. The aforementioned weak economic data has reinforced those concerns.

Nevertheless, the Federal Reserve has reiterated its commitment to reining in inflation, and is widely expected to raise interest rates another 0.75% this month.

The chart below shows the performance of the 10-year Treasury over the past 12 months:



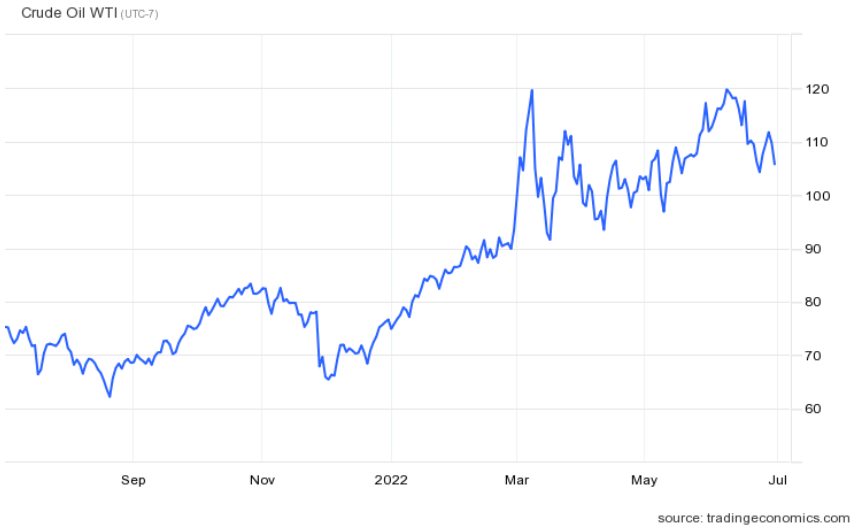
Source: [Trading Economics]

Oil

Futures contracts for the benchmark WTI product fell nearly 4% to just under $106 a barrel on the last trading day of the second quarter. For the month of June, WTI prices fell just under 8%, the first monthly decline since November 2021.

Since the start of the year, though, crude prices have risen over 40%, Considering the first half of 2022, WTI crude oil futures have soared 41%, supported by an increasingly tight market, with major OPEC producers running close to maximum capacity, and as Western sanctions on Russian crude left many oil companies scrambling for alternative suppliers.

The chart below shows the performance of the benchmark WTI contract over the past 12 months:



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Source: Trading Economics

Benchmark Returns

For comparative purposes, the S&P 500 index (a proxy for large US stocks) returned -11.9% for the twelve months to June 30, and fell -16.5% in the second quarter.

The Russell 2000 (a proxy for small US stocks) fell -25.2% for the twelve months to June 30, and declined -17.2% in the second quarter.

The Wilshire 5000 index (a proxy for the broad US stock market) fell -13.2% for the twelve months to June 30, and declined -16.8% in the second quarter.

The MCSI EAFE index (a proxy for large international stocks) fell -19.9% for the twelve months to June 30, and declined -15.4% in the second quarter, as measured in USD. When measured in EUR, the picture was slightly better, with the index falling -9.1% for the 12 months to June 30, and falling -9.9% for the second quarter.

Finally, the MSCI Emerging Markets index fell -27.2% for the twelve months to June 30, and declined -12.4% in the second quarter.

In the fixed income segment, the Bloomberg Barclays US Aggregate Bond Index returned -10.2% for the twelve months to June 30, as rapidly rising interest rates pushed down bond prices.

Looking Forward

If there is a bright light ahead it is that the markets have not always performed poorly after declining in the first half of a year. In fact, history has shown that they often rebound.

When the S&P 500 index has fallen at least 15% in the first six months – as it did five times since 1932 – it has rebounded an average of 24% in the second half of the year.

As we mentioned last quarter, and as we remind ourselves (and you) from time to time, successful investing is not a sprint, but a marathon.

Springwater's investment philosophy is based on decades of robust, peer-reviewed academic research. One of the principles of that philosophy is that, over time, investors can expect to generate higher returns if they tilt their portfolio's equity allocation toward small stocks (the "size" factor) and value stocks (the "value" factor). The important caveat is that these tilts don't consistently deliver higher returns, day in and day out, just as stocks don't always out-perform bonds and cash.

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