HEFREN-TILLOTSON
QUARTERLY MARKET REPORT

July 1, 2022 • Portfolio Management Team

Your Money and You

"What are you investing *for?*"

That question has been asked countless times by Jim Meredith over the course of decades hosting Hefren-Tillotson's radio program, *Your Money and You*.

Callers ask whether they should buy or sell a stock, bond, or mutual fund. But before he can give an answer, Jim wants to know: what is the purpose of the investment?

It's a simple question, but a powerful one. It reveals the *why* behind the investment. Is the aim to grow capital? Preserve it? To generate income? Without knowing the goal, it's hard to say whether an investment is a good one.

But there's another reason to know the goal of your investments, especially in times like today. If you know *why* you're invested, it is easier to stick with your portfolio when markets are down.

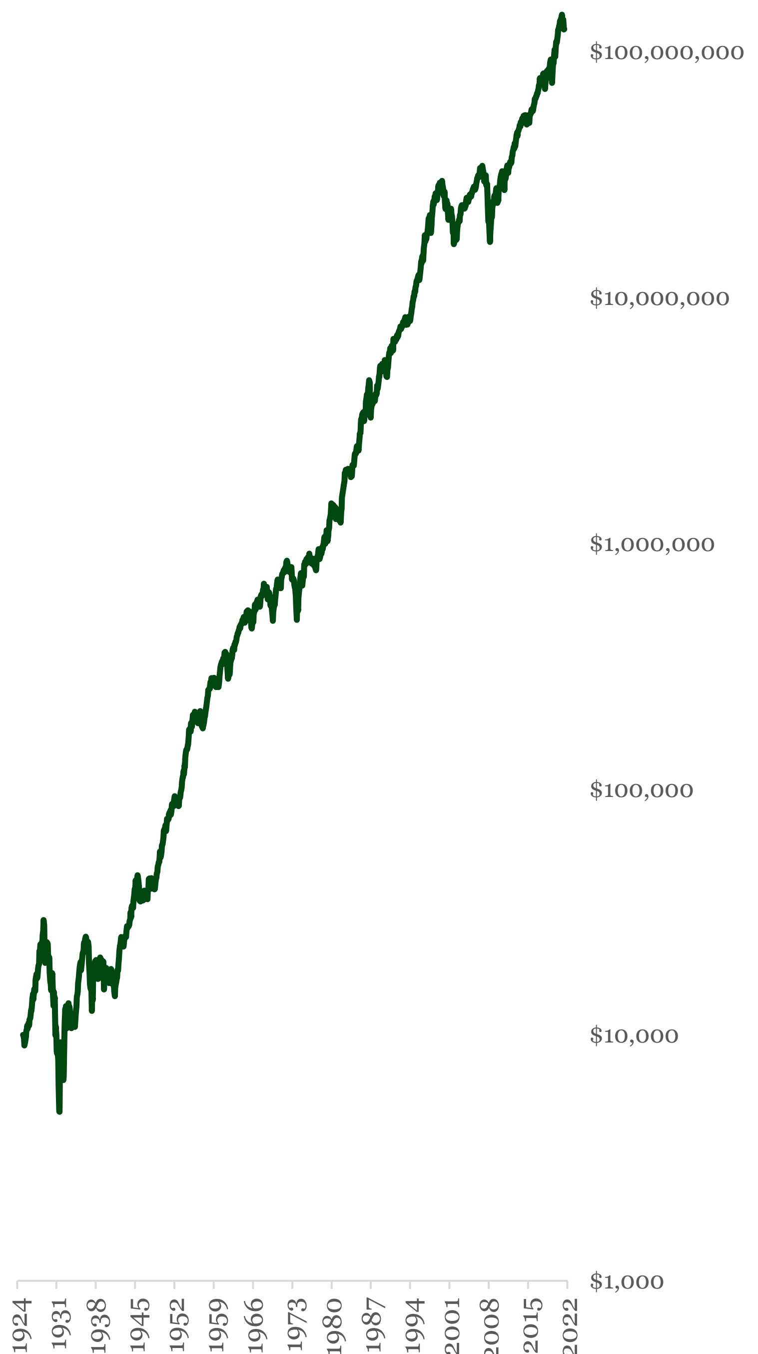
For instance, if your goal is to fund a retirement or a child's education, you have a reason to stay invested. Giving up on your portfolio may mean giving up on attaining your dream.

Yet, it is surprisingly easy to lose sight of your goals when markets are down. Volatility can cause investors to focus on the here and now, and to replace their long-term goals with a short-term one: to stop the pain of a declining portfolio. Hence, the temptation arises to sell and move to cash.

Psychologist Viktor Frankl famously said that humans can bear any "how" in life if they know the "why." He argued that people can overcome challenges if they find purpose and meaning in their experiences. This principle can help investors to persevere when markets are down. Remember *why* you're invested and it becomes easier to stay the course.

In this quarter's report, we review this year's market decline, give suggestions on where to invest, and review timeless investment principles that can help investors during a difficult market.

Growth of $10,000 Invested in U.S. Stocks, Since 1924



Source: Hefren-Tillotson, Ibbotson/Morningstar, Data as of 6/30/2022; Ignores costs of investing. Past performance does not future results.

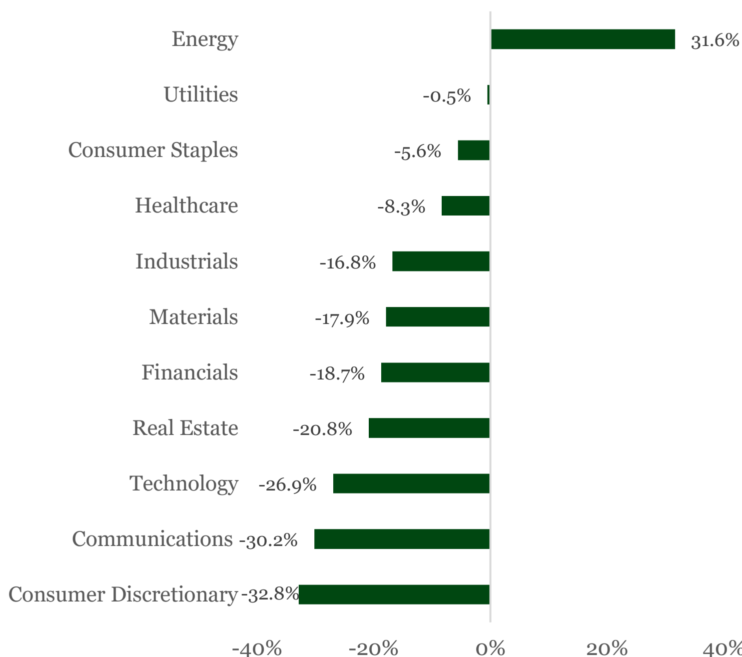
Asset Class Returns as of 6/30/2022

		Latest Quarter	Year-to-Date	1 Year	Annualized Return 3 Year	5 Year	10 Year	Current Yield	Forward P/E
Fixed Income	**Domestic Taxable**								
	Barclays Capital US Treasury Index	(3.8)	(9.1)	(8.9)	(0.9)	0.7	1.0	3.1	
	Barclays Capital US Aggregate	(4.7)	(10.3)	(10.3)	(0.9)	0.9	1.5	3.7	
	Barclays Capital Corporate	(7.3)	(14.4)	(14.2)	(1.0)	1.3	2.6	4.7	
	Barclays Capital High Yield	(9.8)	(14.2)	(12.8)	0.2	2.1	4.5	8.9	
	Domestic Tax Exempt								
	Barclays Municipal Bond Index	(2.9)	(9.0)	(8.6)	(0.2)	1.5	2.4	3.2	
	BarCap Muni High Yield	(5.6)	(11.8)	(10.4)	1.1	3.6	4.4	5.3	
	International/Global								
	Barclays Capital Global Aggregate	(8.3)	(13.9)	(15.2)	(3.2)	(0.6)	0.1	2.9	
	Barclays Capital Emerging Market Bond	(9.6)	(18.5)	(19.8)	(4.3)	(0.9)	2.0	6.9	
Equity	**Domestic Equities**								
	S&P 500 Index	(16.1)	(20.0)	(10.6)	10.6	11.3	12.9	1.7	16.6
	Dow Jones Industrial Average	(10.8)	(14.4)	(9.1)	7.2	10.0	11.7	2.1	16.2
	S&P Mid Cap Index	(15.4)	(19.6)	(14.7)	6.8	7.0	10.9	1.8	12.2
	Russell 2000	(17.2)	(23.4)	(25.2)	4.2	5.1	9.3	1.6	20.0
	Investment Styles								
	S&P 500 Value	(11.3)	(11.4)	(4.9)	8.2	8.2	10.9	2.4	14.5
	S&P 500 Growth	(20.8)	(27.6)	(16.4)	11.6	13.4	14.3	1.0	19.8
	Foreign Equities								
	MSCI World	(16.1)	(20.3)	(13.9)	7.5	8.2	10.1	2.2	14.9
	MSCI EAFE	(14.3)	(19.2)	(17.3)	1.6	2.8	6.0	3.5	11.9
	MSCI Emerging Markets	(11.4)	(17.6)	(25.1)	0.9	2.5	3.4	3.0	11.4
Other	**Other Assets**								
	Bloomberg Commodity Index	(5.9)	18.0	23.8	13.6	7.2	(1.4)	0.0	
	Dow Jones Global Real Estate Index	(17.8)	(20.7)	(11.3)	(0.0)	2.6	5.4	3.7	21.3
	Gold	(6.7)	(1.5)	1.7	8.1	7.4	0.8	0.0	

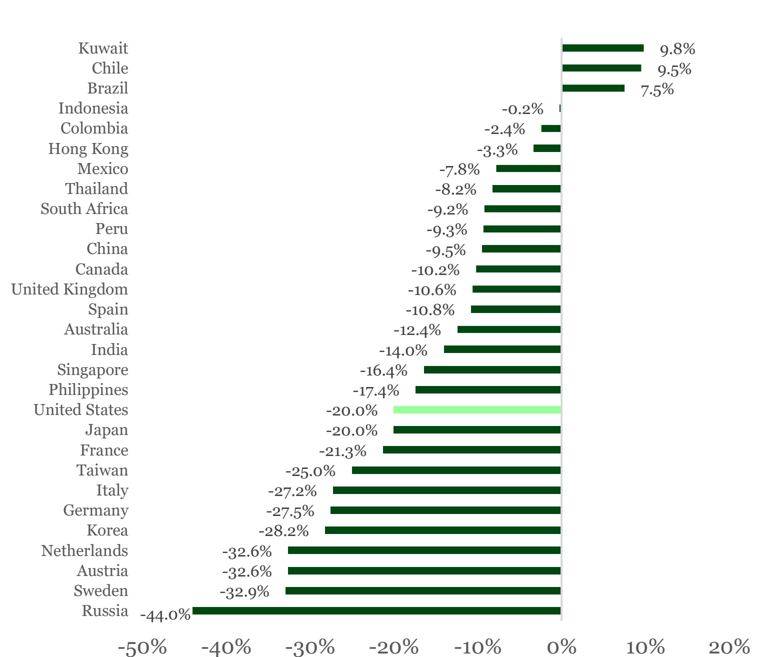
Source: Hefren-Tillotson, Bloomberg

Data as of 6/30/2022

S&P 500 Sector Returns



Country Returns



Source: Hefren-Tillotson, Bloomberg, Data as of 6/30/2022; Country returns are from the perspective of a U.S. Dollar-based investor.

Boom, Bust, or Both?

Drive across the Pennsylvania turnpike and you'll get a glimpse into the state of the U.S. economy.

The roadway is overrun with semi-trailer trucks. Over the course of just three minutes on a recent trip, we counted more than ninety passing trucks on the opposite side of the highway. The fevered pace continued for most of the drive, and is the best anecdote we know to tell the story of the U.S. economy.

So many trucks indicates that the economy is still buzzing with activity (top chart). It's the opposite of what one would expect to see in a downturn. We recall traveling during the 2009 recession along a very quiet turnpike (and paying under $2 per gallon for gasoline).

But so much truck traffic isn't necessarily a good thing. It suggests an economy that can hardly keep up with a very high level of demand. The economy lacks the necessary workers, materials, and fully functioning supply-chains to support so much activity. The result, of course, is the topic on everyone's mind and the main reason for a difficult year for investors: high inflation.

The economy usually lends itself to a simple narrative: boom or bust. But today good things like full employment and robust consumer demand coexist with worrisome developments like high inflation. It all makes for a confusing time for businesses, consumers, and investors.

Let's sort it out.

Market Review

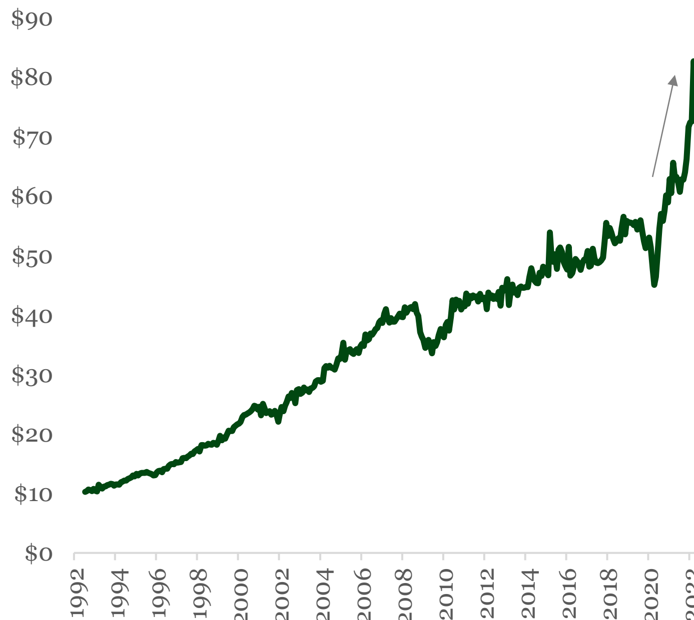
U.S. Stocks

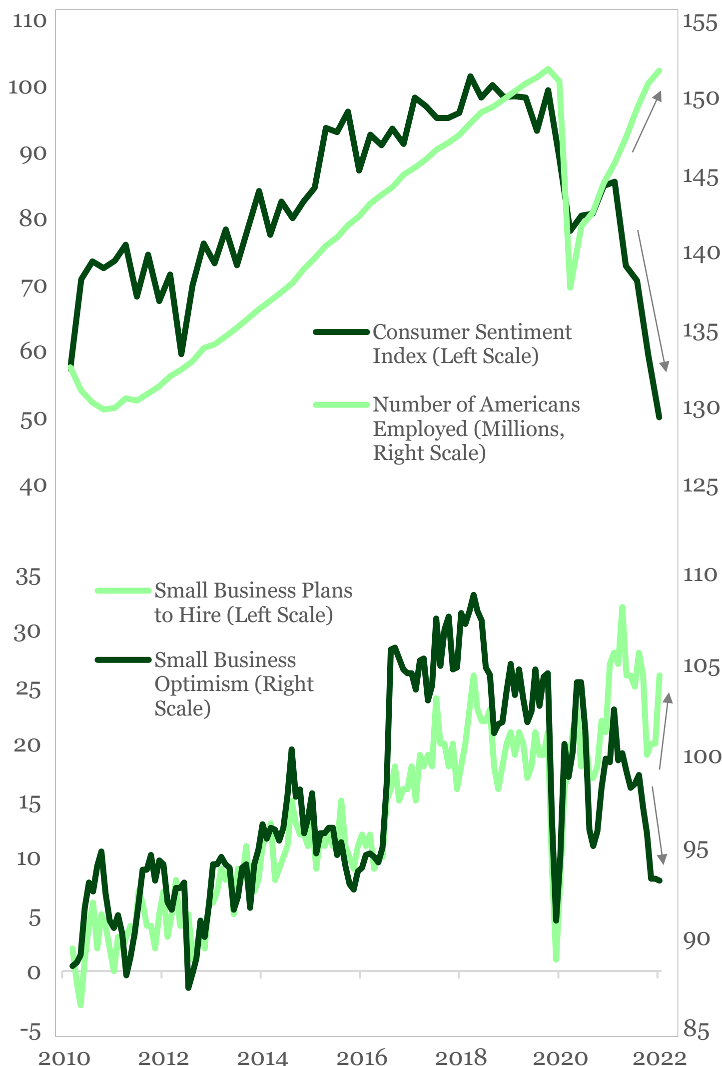
The S&P 500 index fell 20% in the first half of 2022. Although the losses are painful, they are not totally out of the ordinary. Stocks have lost 20% or more every three to four years on average since 1900.

That being said, the sell-off is unusual in one respect: it comes despite still-solid economic demand and strong company earnings.

The index of leading economic indicators, which includes employment trends, building permits, and other data that hint at the direction of the economy, continues to point higher. Likewise, corporate profits remain strong. Stock prices, economic growth, and corporate profits typically move together, but have diverged this year (as shown in the charts on page 4).

What accounts for this disconnect?





Source for charts: Hefren-Tillotson, Bloomberg, Data as of 6/30/2022

Market Review, Cont'd

Investors fear the Federal Reserve will raise interest rates aggressively to curb inflation, and in the process, cause a recession. Thus, although current economic trends are positive, investors expect turbulence ahead.

Another noteworthy development for U.S. stocks this year is the performance gap between winning and losing sectors. Energy stocks, which benefit from high inflation, were up 31% through June. On the flipside, technology stocks, last decade's big winners, were down 27%. Even harder hit were younger, next-generation technology companies, many of which initially prospered as the economy moved online during COVID. An index of stocks that recently underwent an Initial Public Offering (IPO) is down 60% from its high last year.

Foreign Stocks

Despite the war in Ukraine, foreign markets fared slightly better than U.S. markets, with the MSCI EAFE Index falling 19.2% and the MSCI Emerging Markets Index declining 17.6%. But those headline returns don't tell the whole story. Almost half of the losses were due to the stronger U.S. dollar, which reduced returns from the perspective of U.S. investors. In local currency terms, the MSCI EAFE Index fell 10.5%. Foreign markets have a different sector composition than the U.S. and benefited from more exposure to inflation-sensitive sectors like materials and energy stocks, and from being less focused on technology stocks.

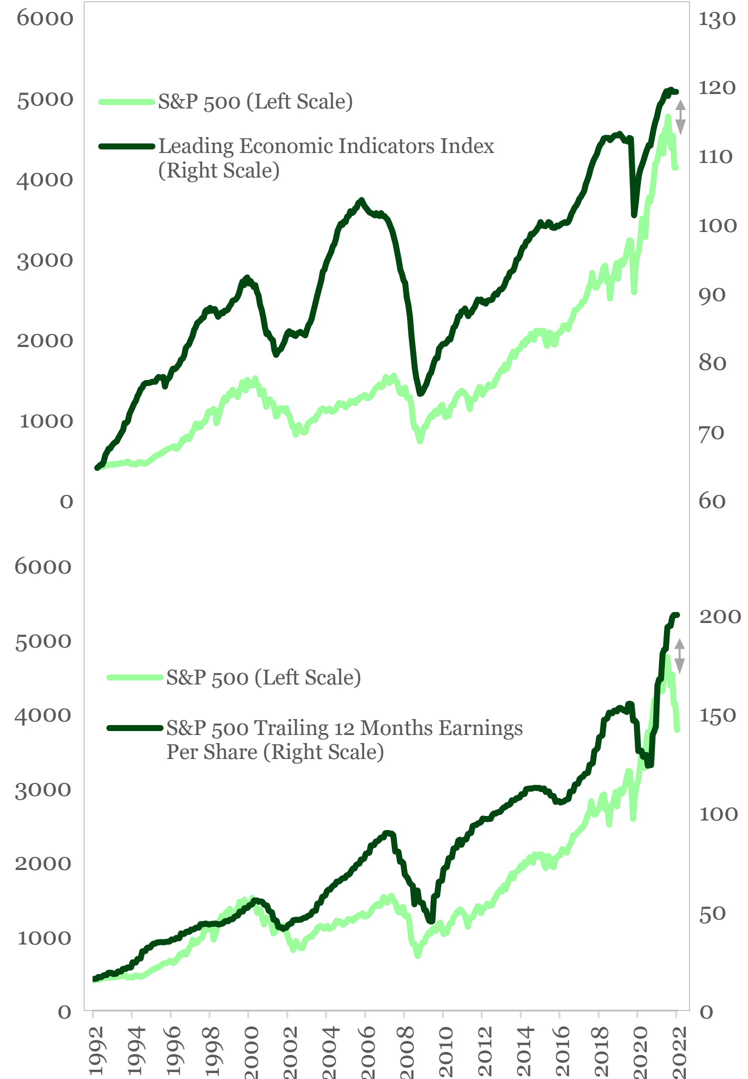
Fixed-Income

While the losses in the stock market were not entirely out of the ordinary, bond market losses were historic (bottom chart). The 10.3% decline in the Barclays Aggregate index is on pace for the largest calendar year loss on record. Long term Treasury bonds were especially hard-hit and are down 31% from their highs.

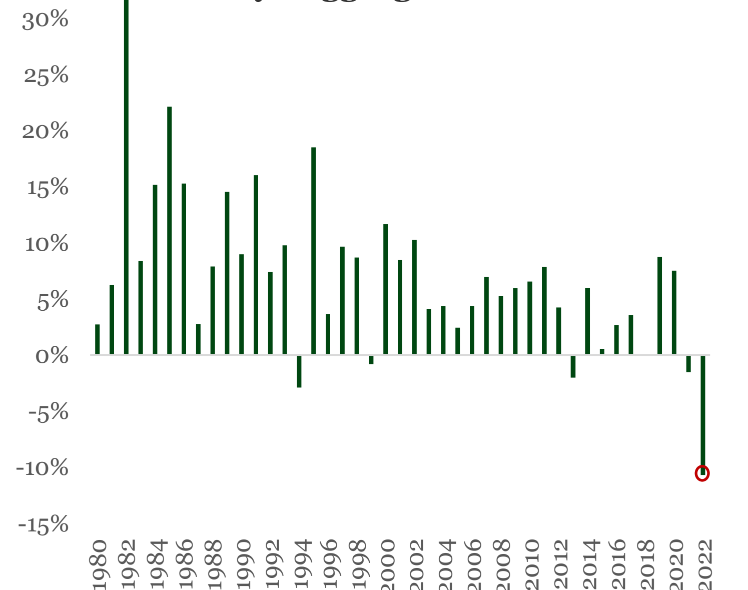
Rising interest rates are to blame. The 10-Year Treasury yield has doubled this year from 1.5% to 3.0%. Several factors have pushed rates higher: a strong economy, surging inflation, and Fed rate hikes. In addition, the Fed has begun to sell bonds that it purchased as part of its COVID stimulus program.

Rates may continue to drift higher, but we expect that most of the damage to the bond market is now done. Any further rise in rates is likely to be self-limiting because it would slow the economy and cause rates to fall again. A case in point is the 30-year mortgage rate, which has risen this year from 3.2% to 5.8%. As a result, housing activity has already begun to slow.

Disconnect: The Economy and Earnings vs. the S&P 500



Calendar Year Returns for the Barclays Aggregate Bond Index



Source for charts: Hefren-Tillotson, Bloomberg, Data as of 6/30/2022; Past performance does not predict future results.

Market & Economic Outlook

Where do the economy and markets go from here? While some investors fear a return to the inflationary 1970's, we think a better comparison is the years following the 2009 financial crisis.

During the 2009 recession, countries borrowed huge sums of money to stimulate their economies. This aided the recovery but created an overhang of debt, culminating in a worldwide sovereign debt crisis in 2011. In response, nations cut government spending and raised taxes. Investors worried that a recession would result, leading to a 19% decline in the S&P 500 in the summer of 2011 and fears about a lasting decline in prosperity (top chart).

Sound familiar? A similar dynamic is at work today except the problem is inflation instead of debt, and recession fears stem from Fed rate hikes instead of fiscal belt tightening. But just as the 2011 crisis ultimately gave way to a profitable decade for investors, we expect that today's inflation emergency will fade.

Admittedly, we have underestimated how persistent inflation pressures would be. Even so, if the reasons for high inflation -- COVID, the war in Ukraine, and record government stimulus -- are not repeated or do not continue over many years, then inflation should fall. Even more importantly, the Fed is intent on extinguishing inflation by raising interest rates.

Remember: inflation does not mean that prices are high; it means that prices are rising. Consumer prices will likely remain high, but we doubt that prices will continue to rise at the current pace.

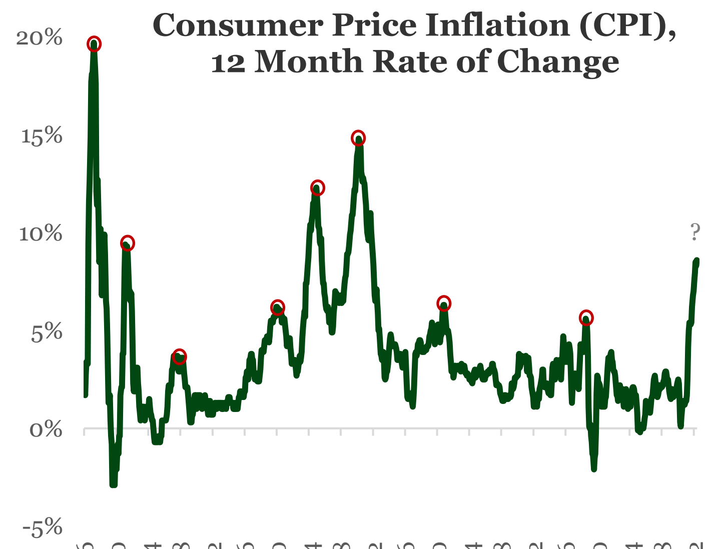
That is not to say that the stock market has surely bottomed. As long as investors fear aggressive rate hikes and a potential recession, another leg down may occur. A recession is very possible if the Fed raises rates too far. But with stocks already down so much, whether or not there is a recession becomes less crucial to the outlook. The market has already priced in substantial economic weakness. For perspective, since World War II, there have been twelve recessions. The median market decline in those periods was 24%, not far below the market's low point in June. Once stocks are down 20% or more, ensuing long-term returns have been quite positive on average (middle table).

We expect markets to rebound once investors have a line of sight on how and when inflation will fall. Precisely when that will occur, we do not know. But history suggests that when inflation does turn, it could happen rapidly. Peaks in inflation almost always have been spike-shaped (bottom chart). Rounded peaks that take many months are rare. If that pattern holds, then the rebound in stocks, when it does come, may happen suddenly.

S&P 500: Earthquakes and Aftershocks

S&P 500 Returns Following 20% Declines

		Cumulative Total Returns			
Year	**Event**	**3 Mo**	**12 Mo**	**3 Yr**	**5 Yr**
1957	Recession	5%	29%	38%	46%
1962	Cuban Missile Crisis	7%	26%	61%	67%
1966	Inflation, Fed Rate Hikes	8%	25%	25%	31%
1970	Recession, Inflation	-12%	19%	28%	-4%
1973	Recession, Energy Crisis	-1%	-30%	2%	-3%
1982	Aggressive Fed Rate hikes	3%	33%	62%	148%
1987	"Black Monday" crash	11%	22%	38%	86%
1990	Recession, start of Gulf War	7%	28%	56%	97%
2001	Bursting of Tech Bubble	6%	-2%	-2%	8%
2008	Global Financial Crisis	-26%	-18%	-4%	34%
2020	COVID-19 Pandemic	21%	56%	-	-
	Averages	**3%**	**17%**	**30%**	**51%**



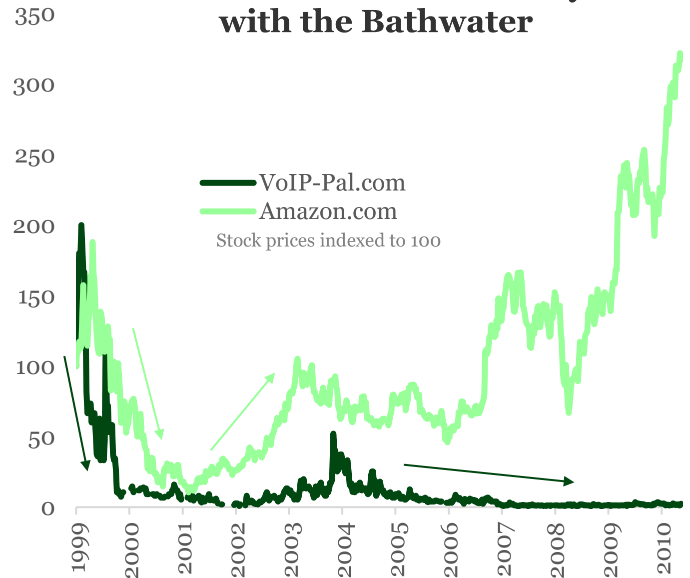
Source for charts: Hefren-Tillotson, Bloomberg, Data as of 6/30/2022; Past performance does not predict future results.

Where to Invest

With markets down so much, one doesn't have to look far for opportunities.

Equity Markets
Investors should treat the decline in stocks opportunistically. If you have extra cash on hand and don't need the money for several years, now may be a good time to invest or to exchange more conservative mutual funds for more aggressive ones.

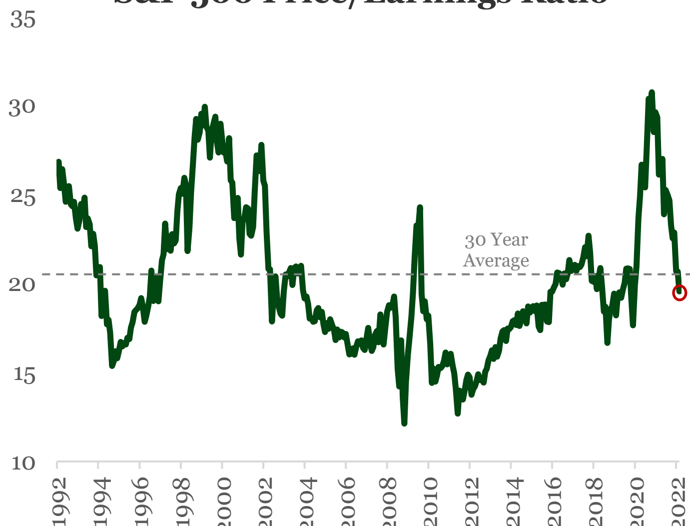
Aggressive investors who can withstand volatility can look to actively managed mutual funds that invest in the sort of high-tech, next-generation companies that have borne the brunt of this year's sell-off. This opportunity is reminiscent of the aftermath of the Tech bubble two decades ago. After the bubble burst, technology stocks suffered bruising losses almost irrespective of their underlying merits – the proverbial "baby out with the bathwater." Eventually, however, markets sorted between winning and losing companies (top chart). We expect a similar dynamic this decade.



Fixed Income
It has been a long time since bonds offered compelling return potential, but they do today. The Yield to Maturity on investment grade bonds has risen to 3.7%, as measured by the Barclays Aggregate Bond index (middle chart). That's a solid building block for returns within a portfolio. High yield corporate bonds also are increasingly attractive, yielding 8.9%. Owning a high yield bond fund or a multi-sector bond fund is a good option for many investors.

For investors with near-term spending needs, owning an ultra-short-term bond mutual fund may be a better option than cash at the bank. Ultra-short bond funds typically raise their dividends quickly when the Fed raises interest rates (the trade-off is that bond funds are not FDIC-insured and their price can fluctuate up or down.) Bank checking and savings accounts, on the other hand, typically change their interest rates slowly, and yields may stay very low.

What Not to Buy
We think it is too late to buy investments that are designed to protect against inflation, including Treasury Inflation Protected Securities and commodities. First, inflation-hedging assets tend to be very expensive today, similar to buying flood insurance when your house is already under water. Second, if the Fed is successful at curbing inflation, then inflation-hedging investments could lose value.



Source for charts: Hefren-Tillotson, Bloomberg, Data as of 6/30/2022; Past performance does not predict future results.

Bottom line: With bonds offering improved return potential and stocks now trading below thirty-year average Price-to-Earnings ratios (bottom chart) investors shouldn't have to look outside of stocks and bonds to generate solid long-term returns.

Reflections on 20 Years

July marks my 20th anniversary with Hefren-Tillotson. It has been a privilege to help so many clients on their journey to meeting their financial goals. I've learned many lessons about investing and investor behavior over these decades, some of which are shared below. I hope you find them useful.

Brian Koble, CFA
Chief Investment Officer

1. **This Too Shall Pass.** These four words have been spoken by many a wise person over the years, and their wisdom applies to investing. Market conditions are always changing. Danger arises when investors lose long-term perspective and make decisions as if the present situation is permanent.
2. **Markets are not the main risk to investors.** The stock market has been an incredible wealth generator (see chart on page 1). It is not a falling market that typically gets investors into trouble, but rather actions like saving too little, spending too much, or not adhering to a financial plan.
3. **Meeting your investing goals requires planning and years of discipline…**There are no short-cuts to reaching your investing goals. It takes years of painstaking adherence to a plan.
4. **…But getting knocked off track takes only a moment of weakness**. Nobody plans to cash out their portfolio when markets fall. How can you avoid the temptation? By not taking too much risk for your situation in the first place.
5. **Fortune favors the patient, not the bold.** For the vast majority of investors, bold predictions backfire. A patient, buy-and-hold approach is best.
6. **You will sleep better during a down market if you own quality, reasonably valued investments**. Their price will fall, but likely only temporarily. Low quality or wildly expensive assets can go down and stay down.
7. **If you want to make money on your investments, own investments that actually make money.** Owning shares of successful, growing companies is the most reliable way to grow your wealth.
8. **Speculation takes many forms and almost always disappoints.** Speculation is trying to make money without actually earning it. Common attempts include market-timing, short-term trading, and owning assets that are trendy but have little economic merit.
9. **The stock market is driven by corporate profits.** Too often, investors equate the market with the general state of the country – the national mood, the political climate, or whether an investor thinks the nation is headed in the right direction. But the stock market is made up of companies, and the value of companies is determined by their profits.
10. **Corporate profits are generated by highly motivated and resourceful people.** Americans go to work every day with the goal of making their workplace and themselves successful. By investing in the stock market, you underwrite those efforts and also benefit from them. It is hard to keep the creativity and drive of the American people down, which is why it is hard to keep the market down.
11. **If a recession is not imminent, then stocks usually go up.** Market forecasters can over-complicate things. If you want to know where the stock market is headed, ask this simple question: is a recession imminent? If not, then stocks usually go up. If the economy is growing, companies find ways to make money. If profits are rising, stock prices usually follow suit. And because the economy has spent the vast majority of time expanding while recessions have been short-lived, the stock market tends to go up most of the time.
12. **Expect the unexpected.** The future will unfold in ways that even the most creative minds cannot predict. Diversifying your portfolio – and avoiding big bets on a single prediction or outcome – positions you best in an uncertain world.
13. **Don't get mad, get even.** Economic developments that lead investors to be worried or upset are sometimes good for stock prices. For example, if you're feeling the pinch from high prices at the gas pump, then owning energy stocks can potentially lessen the pain.
14. **Portfolios and politics do not mix**. I have rarely witnessed an investor predict an election outcome and profit on it. However, I have seen many investors draw the wrong conclusions about an election and put their portfolios at a disadvantage. Markets are not partisan, and have performed well under both political parties as companies adapt to the changing political landscape.
15. **It is realistic to be optimistic.** Investing requires a degree of optimism, and for some investors that can be hard to muster at times. But it is realistic to be optimistic when you remember what drives the stock market: profits. American businesses are incredibly talented at making money almost regardless of what's happening in society. And if companies thrived despite the traumas of the past century –wars, pandemics, financial crises – then we expect they'll find ways to prosper despite the inevitable challenges ahead.

Investment Strategy Summary

Outlook and Strategy Overview

- Our overarching recommendation is for investors to stay patient and to not lose sight of their goals during this unusual time in the economy and difficult period for markets.
- Stock market volatility will likely continue until investors have a line of sight on how and when inflation will fall. It may take only one decisively encouraging data point on inflation for stocks to bottom. Peaks in inflation have historically happened suddenly, which suggests stocks could bottom rapidly, although the timing is uncertain.
- Remember that the definition of inflation is not high prices, but rather *rising* prices. Prices are likely to stay high, but the rate of inflation should fall from current levels as the Fed raises rates and the effects of one-time inflationary shocks to the economy fade.
- A recession is possible as the Fed raises interest rates, but is not a foregone conclusion. Economic data and corporate earnings continue to be solid.
- Whether a recession occurs is less crucial to the outlook now that a significant weakening of the economy has already been priced into stocks. Even so, stocks could experience another leg lower if recession fears come to a head.
- Stocks fell 20% during the first half, a level that is too late for long-term investors to sell, and which historically has been followed by solid returns. If you have extra cash and don't need the money for several years, now is a good time to invest or to exchange more conservative mutual funds for more aggressive funds.
- Interest rates could continue to drift higher, but any rise should ultimately be self-limiting because it could cause the economy to slow. We think most of the risk to bonds from rising rates has been realized, and bonds offer a compelling risk/reward trade-off today. We expect solid returns from fixed-income portfolios over the next several years.
- Uncertainty in Washington will continue (as is almost always the case) but is mostly "noise" for investors. Focus instead on the healthy trends in corporate profits. Consumer fundamentals are also structurally sound, with historically low debt levels.

Fixed Dollar Assets

- Short-term interest rates have become more competitive this year and could continue to rise as the Federal Reserve continues to hike rates.

Fixed Income Strategy

- Stay diversified and continue to de-emphasize long-term Treasury securities, which have a similar yield as short-term Treasuries, but more risk.
- Outside of Treasuries, most mainstream parts of the bond market offer solid or even attractive return potential, including municipal bonds, corporates, high yield, and some bond markets overseas.

Equity Strategy

- Valuations tend to drive long-term returns, and U.S. stock valuations are now below the average of the past thirty years -- a period over which the S&P 500 returned greater than 10%.
- Maintain balance between Growth and Value.
- Beaten-down, formerly high-flying cutting-edge technology and biotechnology companies offer compelling rebound potential, but are best suited for aggressive investors and are best owned through a diversified fund with an active manager.
- Foreign and emerging markets offer a hedge against a weaker dollar and are inexpensive, in our opinion. However, foreign stocks generally perform best when there is peace and when there is simultaneous economic growth across regions.

Other Assets

- Avoid buying inflation hedges, including commodities. Inflation hedges are expensive today and could decline in price in a recession or if supply/demand forces normalize.

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