Investment Update

FIRST HALF: CHALLENGING BY ANY STANDARD

The word "historic" has been thrown around a lot in the last 2 ½ years, nevertheless it still seems like the appropriate term to describe the first stanza of 2022. So far, 2022 stands as a year marked by the highest inflation in 40 years, lowest consumer confidence in 50 years, lowest unemployment in decades and the first major invasion in Europe since WWII.

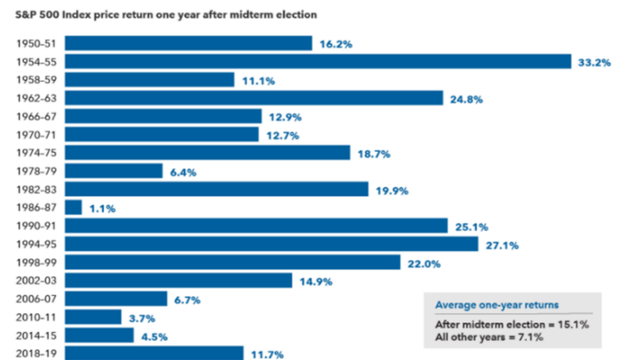
Furthermore, it's tough to argue that returns for risk assets in the first half were any less historic. Few asset classes were left unscathed. Both equities and bonds posted meaningful losses in the first half. For the S&P 500, it was the worst first half since 1970 and for bonds the worst on record. For perspective, below are a few returns for key indices:

- S&P 500: -20%
- Russell 2000: -23.4%
- Russell Mid Cap Growth: -31.0%
- Bloomberg Agg Bond Index: -10.3%
- TIPS (Treasury Inflation Protected Sec): -8.53%
- DJ Wilshire US REIT Index: -21.8%
- Bitcoin: -60%

As you can see, a lot of damage has been done in a reasonably short period of time. Equity valuations have gone from "stretched" by historical standards to "fair" on the heels of the year-to-date selloff. Furthermore, dispersion between "high quality" and "speculative" has widened considerably.

From a recent call with First Trust Investments, Americans now sit on over $4.5 Trillion in liquid reserves (vs. $1.2 Trillion pre-Covid). Spending has shifted materially from goods to services in the first half and recently has shown some slowing, however spending remains strong by most historical metrics. All 34 banks recently passed the 2022 Stress test with relative ease. Corporations currently sit on an estimated $7 Trillion cash hoard (add another $1 Trillion for Private Equity "dry powder") and most have refinanced their corporate liabilities at record low yields in the last 36 months.

While there is no shortage of negative headline material, positives from here can be gleamed. The 1970 example saw the year end positive (with a return of ~26% in the second half (and don't forget the 2020 drawdown and recovery). Mid-term elections have ushered in gains each of the 18 cycles (on average 15.1% higher a year later). Similarly, and surprisingly to many, equities have rallied after the Fed raised rates during many previous episodes.



Sources: Capital Group, RIMES, Standard & Poor's. Calculations use Election Day as the starting date in all election years and November 5th as a proxy for the starting date in other years. Only midterm election years are shown in the chart. As of 12/31/21.

S&P 500 Index Price Change

	Before Rate Hike		After Rate Hike			
Date of First Raise	-6 Months	-3 Months	+3 Months	+6 Months	+12 Months	+18 Months
February 4, 1994	4.7%	2.7%	-3.9%	-2.4%	1.9%	19.0%
June 30, 1999	11.7%	6.7%	-6.6%	7.0%	6.0%	-3.8%
June 30, 2004	2.6%	1.3%	-2.3%	6.2%	4.4%	9.4%
December 16, 2015	-1.1%	3.9%	-2.2%	0.2%	8.9%	17.4%
Average	**4.5%**	**3.7%**	**-3.8%**	**2.8%**	**5.3%**	**10.5%**

A "CAUTIOUSLY OPTIMISTIC" LOOK AHEAD…

Much of the damage appears to be priced into pockets of the bond market. Some equity managers are finding high quality "bargains" again for the first time since the onset of Covid-19. That's not to be interpreted as an "all clear." alert! Investors will be intently focused on two key items during the back half of 2022: inflation and economic growth.

In recent weeks, chatter and fears about inflation have shifted toward fears of an inevitable recession. Statistically, a recession has been the "logical" conclusion for many economists given that one has followed many past Fed hiking cycles. What is less publicized is how different the current "set-up" is compared to past recessions. Below are a few key stats from JP Morgan's Guide to the Market we believe are important to be aware of:

- Unemployment is running at 3.6% with 2x the number of job openings to unemployed workers (and "quits" sits right at its all-time high)
- Wage growth in May posted a +6.5% (supportive of some resilience)
- Debt Service as % of personal disposable income sits near a 40-year low at 9.5% (vs. a 40-year high in Q4 '07 of 13.2%)
- Per the FHFA, 3.7% of outstanding mortgages are adjustable and nearly every buyer since 2009 has positive equity in their home (mortgage delinquency rate in May fell to new all-time low of 2.75%)
- Per Black Knight, nearly 20 Million homeowners refinanced their mortgages since the onset of Covid, leaving less than 500K candidates in the marketplace
- Aggregate personal savings post-pandemic sits at the highest on record
- The 4 prior consumer sentiment bottoms below 60 each saw S&P 500 gains of >15% the following 12 months

We are not dismissing the possibility of a recession, but rather believe that it's important to differentiate the current environment from the one preceding the last three those investors remember so vividly (Tech Bubble, Global Financial Crisis, and Covid). ***Ultimately, we believe investors are best served by investing through a recession rather than try "investing around one."***

The media will continue to point out the negatives--what can and, to match their narrative, will go wrong. For example, they point out that home sales declined and that mortgage applications fell 15%. Rates have skyrocketed to 6%. Most of us recall when 6% was a dream rate. What the media won't likely share is that more than half of the population owns a home with a no mortgage or a rate below 4%.

The same can be said of corporate America. Less than 5% of all high yield debt matures over the next 18 months. Cruiselines, however, recently came under pressure because of concerns about leveraged balance sheets and higher costs to refinance their debt. Most of corporate America did what consumers did…locked in low rates for longer. Not every business was able to do so. There are business casualties in every business cycle. We believe such cases will continue to be exceptions rather than commonplace.

Statistically, inflation will likely calm in the second half. Oil's recent drop below $100/barrel and copper and food prices pulling back more than 10% signal that there likely is some easing ahead. Wage inflation and housing figure to be more "sticky." In both instances, one can easily argue that the Fed can do very little to solve those challenges.

Our base case is that inflation will trend lower from it's 8.6% reading to somewhere near 5% by year-end. Growth outside of China is expected to slow. We expect a Fed Funds rate near 3% at year-end. Certainly, that paints a picture that is improved from where we sit, but with work left to be done.

What else will likely improve in the second half?

- China is expected to soften its "Zero Covid" policy and stimulate its economy aggressively

- Supply chain disruptions gradually improve (evidence of improvements in autos recently)
- The existing fleet of cargo ships is expected to grow by ~27% in 2023
- Demand for consumable goods will normalize with business travel and global leisure travel are expected to continue edging higher
- Washington DC will likely see gridlock once the mid-term elections are over (and history shows that Wall Street likes knowing the rules of the game…aka gridlock)

Price to earnings multiples are again back to fair value. Stocks in total aren't particularly expensive, nor cheap. Specific stocks, however, can present managers with a compelling risk/reward over the coming months.

Goldman Sachs' research shows that the average 12-month return (since 1975) where GDP was slowing but still growing and the 10-year yield was rising saw an average 8% S&P 500 return.

Finally, when one thinks of recent recessions, financial leverage and credit have been front and center over the past few decades (think Savings and Loan and 2008 banking crisis). JP Morgan recently published its expectation to see high yield (aka junk bonds) defaults rise over the next 18 months to 1-1.25%. For context, historical averages for the asset class are 3-4x that figure. Leverage remains low, banking capital is high, and cash is plentiful. If a recession is eminent, it will likely look far different from the last few.

POSITIONING FOR THE 2ND HALF

This quarter's updates for key asset classes are found below. We are not advocating timing any of these, but rather sharing our thoughts on overweight / underweight positioning as things sit today.

Credit-sensitive fixed income: Despite the YTD selloff in bonds, we don't believe investors can afford to abandon fixed income. Cash flow now exceeds 5-6% in several segments of taxable fixed income. Municipal bonds just logged their worst half on record (despite record tax receipts in many areas of the country). We believe active portfolio management and credit management provide ample opportunity to outperform in bonds over the next 12-18 months.

Cash: In our opinion, cash is only a temporary repository for investors and has limited value as a strategic asset. In some instances, we have begun using short-duration US Treasuries (< 1 year) as an alternative to cash for temporary reserves.

Commodities: Commodities can serve as a potential hedge against further geopolitical tensions, as well as a strategic hedge against some inflationary pressures. On the other hand, commodities produce no income and cannot benefit from management skill, etc. We believe commodities belong in the portfolio moving forward, but in reasonably modest scale.

Growth Equities: With inflation high and economic growth slowing, growth equities are now far more attractively valued than entering 2022. We do not believe investors can afford not owning quality growth equities, but that they should own them in the hands of an active and disciplined manager. When growth becomes scarcer in the economy, growth equities have historically fared well.

Income-focused equity strategies: Strategies in this bucket can include traditional dividend growers, as well as covered call solutions. Conceptually, a strategy with a 5-7% distribution yield has a lot smaller gain required to reach an 8-10% target return. In practicality, these strategies are often among the most resilient and best performers in choppy / sideways market environments. We have meaningfully added to this bucket in the last few months, including a recently introduced Nasdaq-based covered call solution.

Buffered "core equity" strategies: buffered solutions structurally build in their potential for index-outperformance. Recent market volatility has reset terms for the next 12 months on many of these offerings to

extremely appealing risk/reward levels. By structurally buffering against a portion of potential losses, they allow investors a concrete way to mitigate some market risk from current levels.

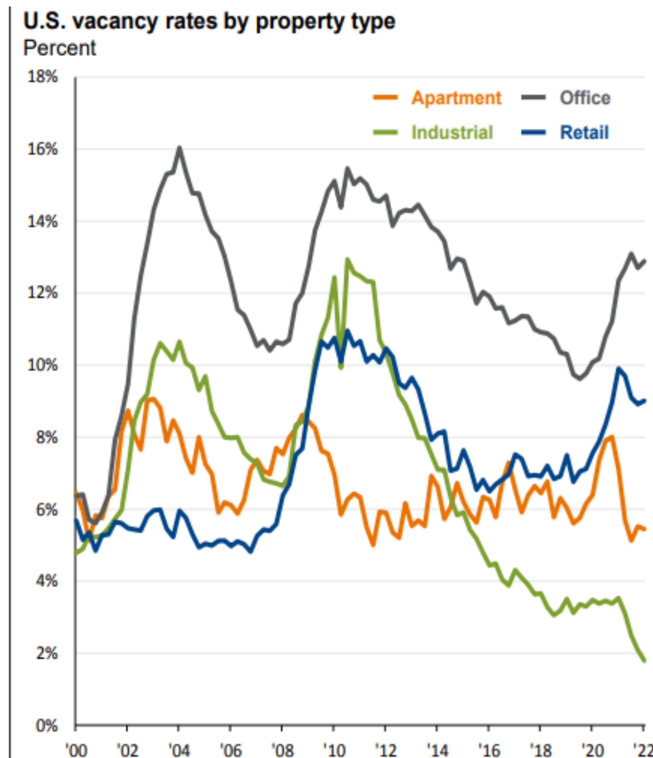
Custom Structured Notes: In the last month we created 2 custom notes (more custom notes coming in Q3). Each of the first offered full protection of principal against loss with ~8% upside over the coming 3/4 years. These strategies, like buffered ETFs, allow an investor to structurally create a return profile. Unlike buffered ETFs, the choices on actual structure are nearly endless. ***Stay tuned for more offerings soon and contact us if you would like to learn more!***

Alternative Investments: this category encompasses a wide array of strategies, many of which have fared relatively well in 2022. We have selectively added exposures to managed futures, long-short equity, market neutral, and merger/arb strategies in the first half. Objectives vary by strategy, but all offer the potential to perform in a challenging and choppy market.

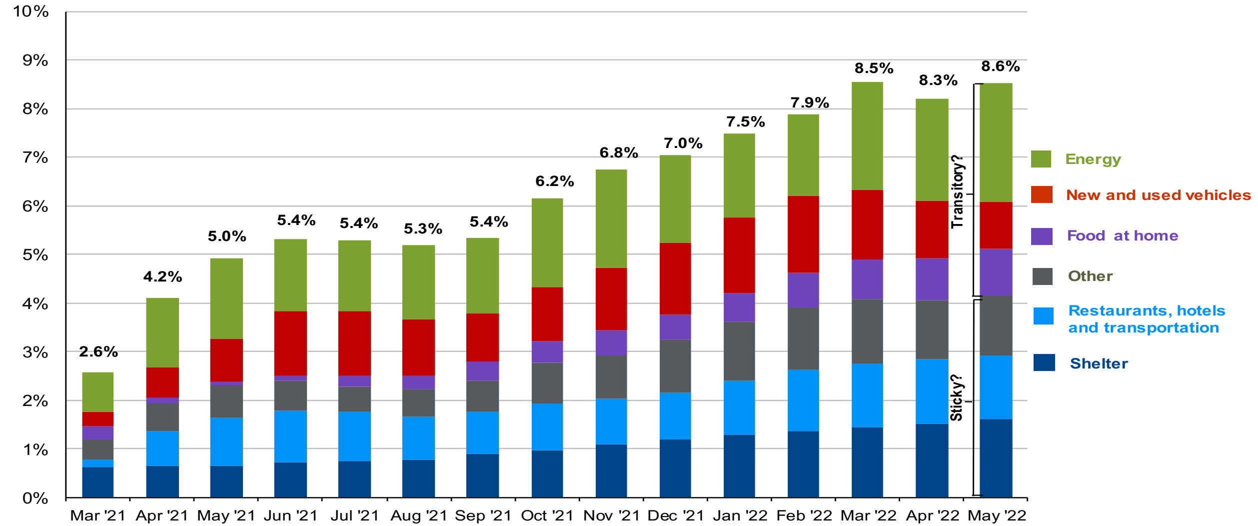
Non-US Opportunities: we remain cautious about developed Europe (despite conceding cheap valuations and higher dividends). With that said, we do believe there are opportunities in the Emerging Markets that bear watching closely. We don't anticipate any large allocations soon but would also not rule out a modest allocation increase in the months ahead.

Our team firmly believe that constructing a portfolio in 2022 must look different that it did 2-3 years ago. We still believe in diversification and asset allocation but believe the components must be well thought out. The role traditionally played by long-duration core fixed income for most investors should be meaningfully transferred to other solutions. We believe an investor today can still garner a healthy return and risk-adjusted return in the years ahead…but we suspect it may not be as easy as it was the last decade.

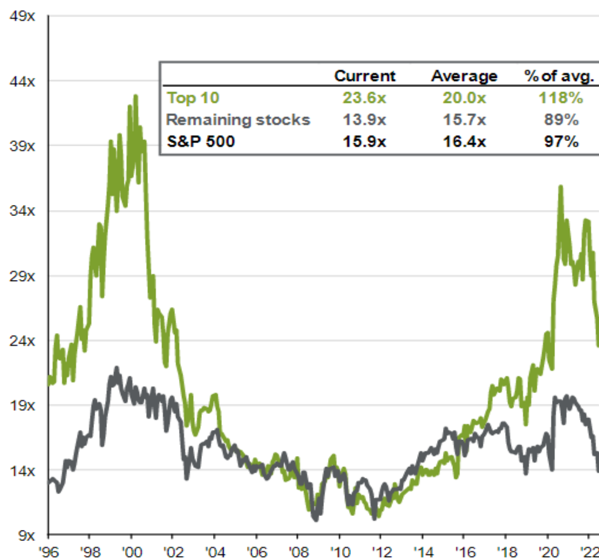
A FEW CHARTS WORTH SHARING

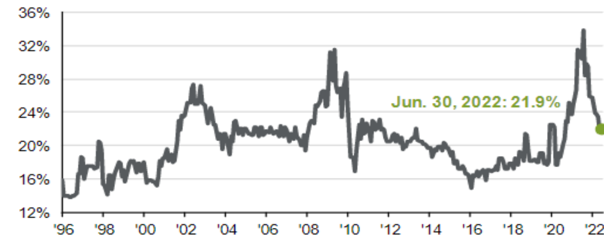


The chart at left may surprise many, but income-producing real estate remains quite healthy by most historical standards.



The above chart lays out the challenges and "sticky" elements the Fed is trying to combat. Energy, food, and transportation have recently shown some improvement. Below shows market concentration and a visual of why we believe there's opportunity well outside of the FAANGMA names that dominated the last decade.





Head Investment Partners
2280 Valley Vista Road
Knoxville, TN 37932

865-999-5332 | www.headinvestmentpartners.com

Past performance is not a guarantee of future results. Securities offered through ***Triad Advisors, LLC (Triad)*** *member FINRA/SIPC. Investment Advisory services offered through* ***Osaic Advisory Services, LLC (Osaic Advisory)****.* ***Triad*** *and* ***Osaic Advisory*** *are separately owned and other entities and/or marketing names, products or services referenced here are independent of* ***Triad*** *and* ***Osaic Advisory****.*