**Investment Review and Outlook** **July 2022**

One of the fundamental laws from the iconic spoof called "Murphy's Laws" goes as follows: "Left to themselves, things only go from bad to worse." On that "happy" note, it may be useful to recap the performance of the financial markets in the year's first half. The hope is to determine whether market conditions are likely to get worse before they improve.

The year began with investors' growing concerns of rising inflation, rising interest rates and an increasingly hawkish Federal Reserve monetary policy. Adding fuel to the fire was the Russian invasion of Ukraine, which caused heightened fears of growing geopolitical risk, not to mention more severe global shortages of food and energy. The result is that nearly all asset classes have been under sustained selling pressure. In fact, the 29.5% decline in the Nasdaq Composite index and the 23.9% decline in the Russell 2000 index were the sharpest first half declines on record.[1] Meanwhile, the bond market was no help for investors who depend on their bond allocation to help buffer the risk and downside of equity holdings. The Bloomberg U.S. Agg index of fixed income securities was a major disappointment, generating losses of 10.7%, which represented the worst first half performance dating back to 1975.[2]

But not all the news was that bad. The energy sector generated strong positive returns. The Energy Select Sector Index returned 31.71% in the first half of 2022.[3] Moreover, in our judgement, from a historical perspective, valuations of the overall stock market are now more comfortably in the "fairly valued" zone rather than "overvalued."

So perhaps it is not the most ideal time to reduce allocation to equities. But we believe that it is now more important than ever to recognize that not all stocks can be characterized as fairly valued, even after the sharp sell-off in the first half. Focusing on strict valuation principles could be the key to generating strong returns over the next several years. We continue to pay attention to value and to proactively re-allocate assets to the most attractive and conservatively valued stocks in the market.

## Thinking Small(er)

As highlighted above, we believe that the market remains bifurcated between attractively valued stocks and more speculative, highly priced stocks. Yes, there are many formerly beloved technology stocks that have fallen dramatically in the past half year or so. But we are not chomping at the bit as we believe that many are still trading at levels that do not yet offer compelling value propositions. In fact, many overlooked stocks from the past bull market have continued to lag. Thus, their depressed prices could represent compelling entry points.

One sector that seems to not have caught a break is the small cap sector. According to Dow Jones Market Data, the S&P 600 index of small-capitalization companies was recently trading at 11.5 times expected earnings for the next 12 months, while the S&P 500 was recently trading at around 16.4 times expected earnings. One analyst points out that this is the largest gap since the dot.com boom in the late 1990's.

To be sure, we are generally agnostic to investing in any particular theme or sector. Moreover, just because small cap stocks seem cheaper than large cap stocks, that does not necessarily mean that small stocks are absolutely cheap. We believe in investing in what we deem undervalued in the market today given the attendant risks and potential upside. That said, we are finding many more bargains in the small cap sector and will endeavor to differentiate between what is relatively cheap and what is absolutely cheap and invest in those opportunities that appear to have strong long-term return prospects.



[1] https://www.barrons.com/articles/stock-market-dow-nasdaq-sp500-51656720367
[2] https://www.barrons.com/articles/stock-market-dow-nasdaq-sp500-51656720367
[3] https://www.ssga.com/us/en/intermediary/etfs/funds/the-energy-select-sector-spdr-fund-xle