Quarterly Outlook

JULY 2022

Tandem Collective Funds®
Tandem ETF Portfolios®

Second Quarter 2022

A 1970s-style inflation shock and aggressive Fed tightening pressured first-half returns across most asset classes. World economies, stocks, and bonds struggled as the excess liquidity injected into the economy during the pandemic continued to drain from the system.

Index/Instrument	Category	Q2 2022 Total Return	2022 YTD Total Return (as of 6/30/2022)
S&P 500	Large-capitalization stocks	–16.11%	–19.97%
S&P 400 Midcap	Mid-capitalization stocks	–15.44%	–19.57%
S&P 600 Small Cap	Small-capitalization stocks	–14.13%	–18.97%
NASDAQ 100	Large-capitalization stocks	–22.30%	–29.22%
Russell 2000 Index	Small-capitalization stocks	–17.21%	–23.45%
MSCI World ex USA	Developed markets international stocks	–14.47%	–18.42%
MSCI Emerging Market	Emerging markets international stocks	–11.40%	–17.57%
Bloomberg Barclays US Aggregate Bond Index	Investment-grade US bonds	–4.69%	–10.35%
Bloomberg Barclays US Treasuries	US government bonds	–3.77%	–9.14%
Bloomberg Barclays US Investment Grade Corps	US investment-grade corporate bonds	–7.26%	–14.39%
Bloomberg Barclays US Corporate High-Yield Bond Index	US corporate high-yield bonds	–9.83%	–14.19%
Bloomberg Barclays US MBS Index	US mortgage-backed securities	–4.01%	–8.78%
Bloomberg Barclays Global Aggregate Bond Index	Global investment-grade bonds	–8.26%	–13.91%
Bloomberg Barclays Global High-Yield Bond Index	Global high-yield bonds	–11.85%	–16.87%
Bloomberg Barclays Investment Grade US Convertibles	US high-grade convertible bonds	–8.20%	–9.34%

Until we advance into the next expansion, the importance of adhering to time-tested investing principles cannot be overstated.

Doubling down on first-quarter losses, the S&P 500 fell again in the second quarter, dipping into bear market territory and marking the worst first half since 1970 for the index. Within the US, every stock sector, style and size experienced losses during the quarter. Most of the destruction over the past six months was due to price-to-earnings (P/E) ratio compression—an overall reset of the stock market's valuation downward to account for a new investment backdrop with a higher cost of credit.

Defensively oriented sectors performed best during the quarter, including Health Care, Consumer Staples, and Utilities, while cyclical sectors performed the worst. Energy remains the only sector in the black for the first half of the year—a beneficiary of extreme supply and demand imbalance. Central bank tightening, the war in Europe, and China's lockdown created economic uncertainty that led to investment losses across international markets as well.

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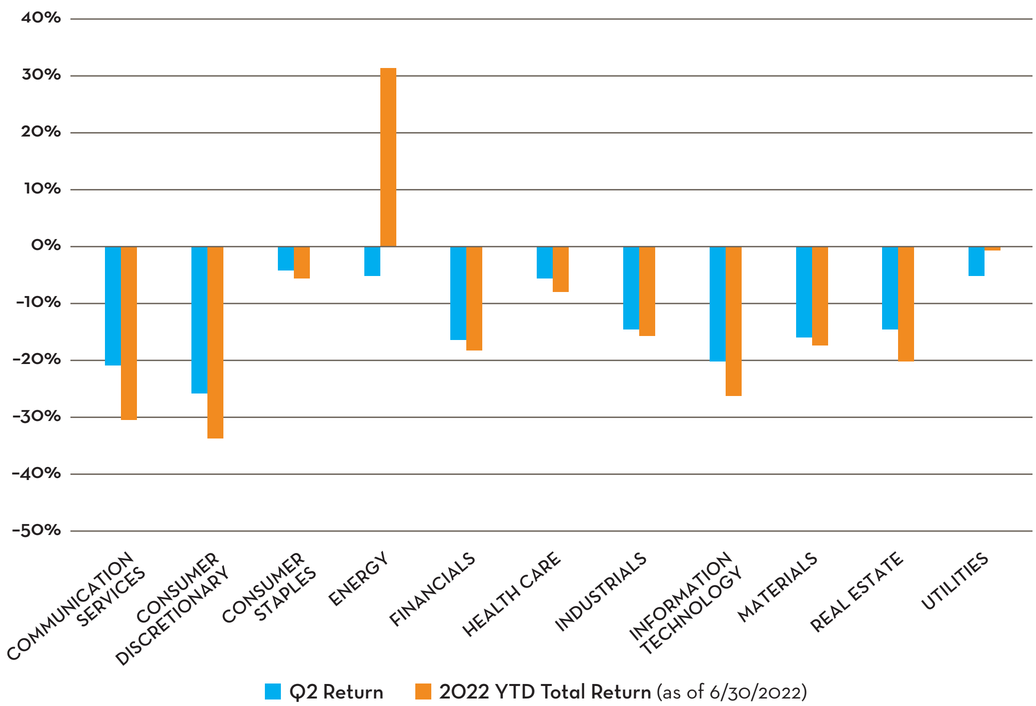
S&P 500 Sector Returns



Bonds losses on top of stock losses isn't the norm. The S&P 500 and US Aggregate Bond Index have never produced losses in the same year in the past 35 years. They came close in 1994, 2015, and 2018, but should this extremely rare event occur in 2022, it will come as the result of tightening monetary policy while the economy was already slowing, and in the face of white-hot inflation.

The Fed is committed to using interest rate increases to control inflation despite the damage it may do to the economy. With any tightening cycle comes the risk of recession as the Fed tries to engineer a slowdown without creating too many job losses, or a "soft landing". The job market is currently strong, but it is usually the last part of the economy to fall in a tightening cycle. Currently, economists' consensus expectations call for GDP growth of 1.8% next year, a level of growth consistent with the last expansion.

The Fed has increased interest rates (the short-term federal funds rate) by 1.50% this year and promised more of the same for the rest of the year. While most investors expected interest rates to rise at the beginning of the year, few expected them to rise so rapidly. For example, the average 30-year mortgage rate increased 2.5% in the first six months of the year. Additionally, the war in Europe exacerbated supply chain problems and inflation, especially energy and food inflation. Consequently, the Fed has vowed to "do whatever it takes" to beat inflation, increasing the risk of a recession over the next year. The Fed's job is difficult as inflation tends to be sticky and could plateau rather than retreat.

The uncertainty created by the pandemic led to record easing and now record tightening. Most of the quarter has been characterized by deteriorating economic data. The housing sector has slowed sharply, as have manufacturers' new orders. Investor confidence indices, indicators of future spending, have also declined. Consumer credit is rising rapidly, which is not a good sign when

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consumer confidence is falling. The labor market is strong now, but job losses are on the horizon as corporations will attempt to maintain profitability as the top line inevitably slows. Bond credit spreads have widened, indicating a riskier environment on the horizon. Corporate earnings growth has also slowed, and we expect overall profitability to decline from record highs (revert to the mean), presenting further challenges to equities.

The good news is that equity valuations and longer-term bond yields have reset substantially over the past 6 months. Since year end, the US 10-Yr Treasury yield has risen from 1.5% to roughly 3%. The S&P 500 P/E has been slashed from 26x to 16x.

Yet, analyst consensus expectations for the S&P 500 remain high for next year—an unrealistic expectation given a backdrop of rising costs. Elevated stock market volatility is expected over the rest of the year as these excesses are wrung from the economy.

While turns in the business cycle can be painful for investors, it is important to recognize that downturns are not the norm, but the exception (and thankfully, much shorter in duration than expansions). Inevitably, the economy grows over time. Until we advance into the next expansion, the importance of adhering to time-tested investing principles cannot be overstated. These principles remain unchanged—stay committed and invested, with diversified and balanced portfolios that are periodically re-balanced to long-term objectives.

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