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After a dismal first half of 2022, stocks rallied in July. Large cap stocks in the S&P 500 index surged 9.22% for the month bringing their year-to-date loss to -12.58%. Small cap stocks in the Russell 2000 were up 10.44% leaving them with a year-to-date loss of -15.43%. International stocks in the MSCI EAFE index were up 4.98% and emerging market stocks were down -0.25% so now their year-to-date returns are -15.56% and -17.83% respectively. Yields declined in July resulting in a 2.44% monthly gain and -8.16% year-to-date loss for the Barclays US Aggregate Bond Index.

GDP growth for first quarter was -1.6%. Initial estimates for second quarter GDP growth also showed contraction at -0.9%. Two consecutive quarters of negative growth is normally the marker for indicating a recession. The National Bureau of Economic Research factors in additional measures of economic health when determining whether we are actually in a recession or not. Because unemployment is so low at just 3.6% and job and wage growth is strong, the economy does not necessarily feel like a typical recession so the NBER may not label the decline as such. However, we are seeing parts of the economy – such as housing – slow so recession risks are rising even if we aren't currently deemed to be in a recession.

Inflation had been the major factor affecting returns. In June, the inflation rate was 9.1% - the highest it has been in 40 years. Inflation is a comparison of current prices versus a year ago which means prices can stay at their current high levels and the inflation rate can decline. Many economists think we are at or near peak inflation and that inflation rates will start to decline which could be why the markets have rallied even though the news has not improved.

Wages have also grown but not at the same rate of inflation so purchasing power has declined. When consumers are spending more of their monthly budget on food and energy, they have less to spend on other discretionary items which has impacted retailers recently and helps fuel recession concerns.

The Fed's primary tool for combatting inflation is raising interest rates. Higher interest rates also slow the economy which is adding to recession concerns. Strategas Research says that if the Fed needs to fight inflation alone, the Fed Funds rate would need to be higher than the inflation rate. The Fed acted aggressively by raising the Fed Funds rate another 75 basis points in July bringing it up to 2.25% to 2.5%. David Kelly of JPMorgan believes the Fed will raise another 50 basis points in September and then 25 basis points at the November and December meetings. First Trust economist Brian Wesbury believes the significant growth in money supply from the pandemic stimulus is adding to the problem and it will take time to work off the excess supply before rate hikes are effective at lowering inflation.

Even though the Fed Funds rate was higher in the month, the 10-year Treasury bond yield has fallen in July from 2.97% to 2.64%. This decline resulted in positive returns in the aggregate bond index for the month. With the short term Fed Funds rate expected to rise another 1% by year end, if the longer-term yields don't also rise, the yield curve will be inverted. An inverted yield curve often is a precursor to recession.

The rally in stocks last month is somewhat contradictory to an economy on the edge of a recession. Strategas continues to label it a bear market rally because of the lack of momentum and breadth. This means they believe the rally could be short lived and that volatility will return. Brian Wesbury is also concerned that inflation will be higher and last longer than expected. We continue to encourage investors not to try and time the market by trading in and out. Instead, we advocate for investing according to risk tolerance.

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