HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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We like the description of our current situation as an "anti-Goldilocks economy": an economy that will be both too hot in terms of inflation and too cold in terms of growth. The global economy and policymakers are confronted with a stagflation supply shock that is negative for growth and will tend to push up inflation further. There are four main forces at work: 1) higher energy and food prices, 2) disrupted supply chains and trade flows, 3) tighter financial conditions, and 4) lower business and consumer confidence due to heightened uncertainty.

So, yes, the financial markets are nervous and confused. Three months ago we foresaw the possibility that the stock market might dip "for some period" into bear market territory. That dip has occurred but the question now is: How long will that period last? The forecasts from the Wall Street analysts are all over the place with regards to the length of the current bear market. The forecasts vary depending upon judgements about the course of the Ukraine war, when supply chains might improve, how well the Federal Reserve will navigate, and the impact of so much uncertainty on corporate earnings.

At Hudson Advisors, we expect the stock market to remain negative and probably worsen in the second half of the year. Looking to 2023, we hope the market will turn around if somehow inflation subsides and we avoid a deep recession. But we have no prediction on the timeframe for that market turnaround. Nonetheless, as before, we think U.S. equities remain among the best and safest long-term investments. We encourage our clients to be positive on equities even though our investment approach in the period ahead is careful and defensive.

MARKET TRENDS

The accompanying chart summarizes stock and bond market trends in the second quarter and first half of 2022. Both markets took a strong hit from all the negative economic news and from the prospect of much higher interest rates.

Equity Market: A bear market that began on the first trading day of 2022 drove down the S&P 500 for its worst first six months in a calendar year in 52 years. Investors now head into the second half fearing aggressive monetary tightening by the Federal Reserve and other major central banks could tip the economy into recession. The other major indexes all saw steep declines.

The S&P 500 ended the second quarter with a decline of 16.1%. and was down 19.96% for the half. The Dow Jones Composite Average was off 12.49% for the quarter and 13.97% for the year-to-date. The Russell 2000 was down 17.2 % for the quarter and 23.43% for the year. The worst performer was the Nasdaq Composite which was down 22.28% for the quarter and 29.23% for the year. In the first days of July the indexes have fluctuated but declined overall.

Fixed Income Market: The U.S. bond market was highly unsettled by the economic events. The yield on the benchmark 10-year U.S. Treasury Note (which moves inversely to prices) ended on June 30 at 2.973% up from 1.496% at the end of December. That was actually an improvement from June 14 when the 10-year yield reached an end-of-day high of 3.482%. Despite this late June rally, the 10-year note cemented its largest two-quarter decline since 1994.

MAJOR MARKET INDEXES

	YTD Return
Dow Jones Composite Average TR	-13.97
S&P 500 Index TR	-19.96
Russell 2000 Index TR	-23.43
NASDAQ Composite TR	-29.23
EAFE Index NR	-19.57
Bloomberg Aggregate Bond Treasury TR	-9.14

Source: Morningstar® as of June 30, 2022

THE OUTLOOK

The Economy: The major force in the U.S. economy, and globally, is the persistent and sustained inflation, driven largely by the Ukraine war and supply chain problems. The U.S. Consumer Price Index is running above an annualized rate of 8% with no signs of relenting. The Federal Reserve is firm in its intent to push inflation down to its target goal of 2%. In June, Fed officials penciled in getting the interest rate up to near 3.5% by the end of this year and close to 4% in 2023.

The big question mark is the possibility of higher interest rate pushing the economy into recession. Economists had predicted a U.S. GDP growth rate of about 3 % for the 2022 year and 1% for the first quarter. Instead, surprisingly, GDP declined at a 1.4 % annualized rate over the first quarter. Are we already in a recession? Or was the first quarter number just quirky?

There is much evidence of economic strength. The labor market and consumer spending remain relatively healthy. Some further encouragement comes from the recent survey of the Institute of Supply Management. "The relative resilience of the ISM services index in June should help to dampen speculation that the economy is at risk of imminent recession," said U.S. economist Michael Pearce of Capital Economics. "The surveys paint a consistent picture of an economy expanding at a below-trend pace, rather than one on the brink of a recession."

The Market: Investors will be watching closely in coming weeks as corporations report their earnings for the second quarter. At the start of 2022, analysts were generally predicting earnings growth of about 10%. Those predictions held up in the first quarter. Whether earnings will continue to meet expectations in the face of higher interest rates will be an important bellwether for the future direction of the market. We also look closely at Price/Earning ratio. The forward 12-month P/E ratio is now 17.6, which is below the five-year average (18.6) but above the 10-year average (16.9). It is also below the forward P/E ratio of 19.4 recorded at the end of the first quarter (March 31), as stock prices have decreased. Good corporate earnings in the second quarter will continue to help the recent years' problems of overvalued stocks. Some analysts are encouraged by the historical record which shows that the S&P 500 has bounced back after past first-half falls of 15% or more. The sample size, however, is small, with only five instances going back to 1932. At Hudson Advisors, we certainly believe the stock market will recover at some point. We are just uncertain of that time frame particularly with the will-it-or-won't-it speculation around whether the Federal Reserve's aggressive tightening agenda will sink the economy into recession. We will be looking for more consensus among Wall Street analysts.

OUR STRATEGIES

As**set Allocation:** Most clients should stick to portfolio strategies previously identified. We advise against an increased allocation to equities at this time.

For new clients, we will recommend a 50% allocation to equities to be phased in over a 12- to -18- month period. The other 50% of assets will be short to intermediate term bonds, cash, and alternative investments.

Preferred Equities: As always, despite market conditions, we look for long-term equity opportunities. Our focus is on companies that can weather both the short-term period and flourish in a longer time frame. We want fundamentally sound companies with reasonable valuations and that pay dividends. In that context, similar to last quarter, we are looking at these sectors:

HEALTH CARE: This sector has interesting opportunities in biotechnology and in the variety of new treatments and devices being developed for the aging population.

INDUSTRIALS/MATERIALS: The legislation to promote infrastructure investments, as it rolls out, should create opportunity for many companies in this sector.

TECHNOLOGY: We are interested in selective technology companies with emphasis on innovation. These companies can provide opportunities for a portion of client portfolios.

ENERGY: This sector has opportunities worth exploring in the electric companies that will be modernizing their power grids, and in some of the new alternative energies.

CONSUMER STAPLES: These companies can actually do well in an inflationary environment where consumers watch their spending and stick to basics.

Other Assets: Our aversion to long-term bonds remains and is reinforced by this interest rate outlook. We like bond durations under two years where positive returns can be realized, and cash.

We also are looking at alternative investments through Broadly Syndicated Loan vehicles and Collateralized Loan Obligations which can provide investors with greater security through collateral, yields, and a hedge against inflation through floating rate structures.

Dow Jones U.S. Sectors Total Return
(Percent Change for YTD, Ending June 30, 2022)
Source: Morningstar®

Oil & Gas	**29.97**	**Consumer Services**	**-31.35**
Basic Materials	**-15.68**	**Telecommunications**	**6.95**
Industrials	**-21.85**	**Utilities**	**-0.89**
Consumer Goods	**-19.82**	**Financials**	**-18.37**
Health Care	**-10.20**	**Technology**	**-30.14**

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