BlackDiamond Financial

INVESTMENT INSIGHTS

SECOND QUARTER 2022

Key Topics

- Inflation and Geopolitical Risks Continue to Weigh on Markets
- Federal Reserve is Raising Rates to Tackle Inflation
- Historical Stock Market Declines During Recessions
- Gas Prices Approach All-Time Highs

Picture by Black Diamond Analyst, Brigitte Strobl
Kitzbühel, Austria – May 2022

MARKET UPDATE

Economic Indicators Signal an Increased Likelihood of Recession

Inflation and Geopolitical Risks Continue to Weigh on Markets

The Covid pandemic clouded the markets in 2020 leading to a quick 33% drop in the S&P 500, before bouncing back to end the year up 18%. In 2021, the market rocketed forward with very little volatility climbing more than 28% on the back of massive government stimulus and near zero interest rates.

Today, we are experiencing substantial headwinds as persistently high inflation is forcing the Federal Reserve to raise interest rates and reduce its balance sheet. Rising interest rates effectively increase the cost of money throughout the economy as borrowing costs rise for credit cards, corporate loans and real estate mortgages. Rising rates also slow economic growth and reduce corporate investment.

Unfortunately, there is no way to avoid market cycles. Virtually all risk assets, including domestic and international stocks and real estate, were down double digits this quarter. The S&P 500 declined 20% YTD, the second worst first half total return in over 60 years (1970: -21.0%). Bonds declined nearly 5% in the quarter.

What has changed since the first quarter? Inflation is now proving to be more broad-based than the Fed previously thought. Initially, used car prices were the issue, then rising energy and food prices resulting from the war in Ukraine. May's CPI report of 8.6% highlights housing as the incremental factor to higher inflation.

Economic headwinds and rising interest rates have increased the likelihood of a recession over the next 12 months. Uncertainty and above-average stock market volatility will undoubtedly persist in the second half of 2022. Patient investors will be rewarded in the future as every recession has been followed by stocks rising to new all-time highs.

Comparative Returns

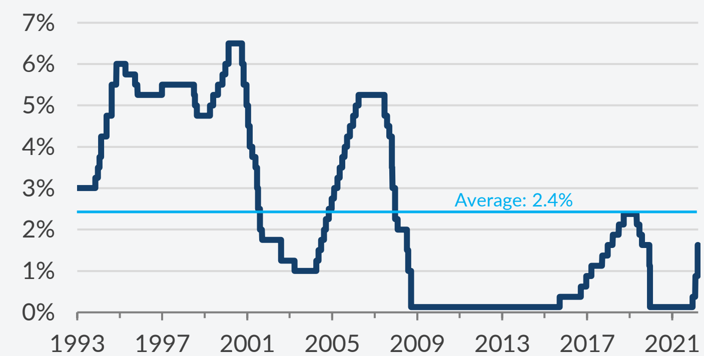
			Annualized Performance			
	Q2 2022	**YTD**	**1 Year**	**3 Years**	**5 Years**	**10 Years**
Large Cap U.S. Stocks[1]	(16.1%)	(20.0%)	(10.6%)	10.6%	11.3%	13.0%
Small Cap U.S. Stocks[2]	(17.2%)	(23.4%)	(25.2%)	4.2%	5.2%	9.4%
International Stocks[3]	(13.7%)	(18.4%)	(19.4%)	1.4%	2.5%	4.8%
Real Estate[4]	(17.2%)	(20.7%)	(7.3%)	2.9%	4.1%	6.0%
U.S. Bonds[5]	(4.7%)	(10.3%)	(10.3%)	(0.9%)	0.9%	1.5%

1 S&P 500 index, which includes 500 of the largest U.S. companies in all sectors of the economy
2 Russell 2000, which includes the 2000 smaller stocks of the Russell 3000 index
3 MSCI ACWI ex-U.S. index, which includes large and mid capitalization stocks from developed and emerging international markets
4 MSCI U.S. REIT index, which includes domestic publicly traded real estate stocks
5 Bloomberg Barclays Aggregate Bond index, which includes a representation of the performance of the entire U.S. investment grade bond market

Federal Reserve is Raising Rates to Tackle Inflation

In March, the Federal Reserve began raising the federal funds short-term interest rate to combat 40-year highs in inflation. Higher interest rates tend to slow economic growth and reduce inflation. At the beginning of 2022, the Fed expected the federal funds rate to rise from 0% to 2.75% by the end of 2023. However, three increases totaling 1.5% have done little to dampen persistent inflation which has forced the Fed to be more aggressive. Market expectations now call for the rate to rise to 3.75% by the end of 2023. The Fed's most recent move was a 0.75% hike in the second week of June, the largest rate hike in 28 years. The Fed is now focused on raising rates enough to cool inflation without causing a recession, which by Fed Chair Jerome Powell's own admission, may be difficult to accomplish.

Fed-Funds Rate Remains Historically Low



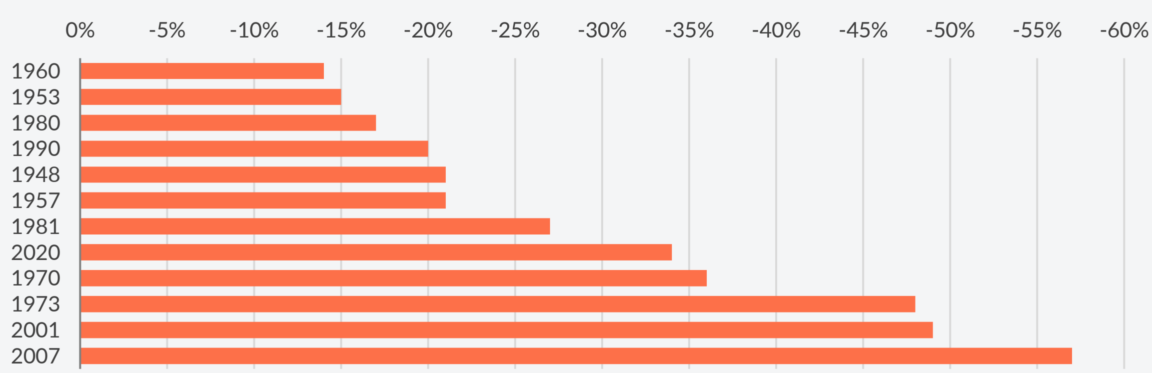
Source: Federal Reserve Economic Data

Targeting a specific source of inflation can be difficult. A recent Federal Reserve Bank of San Francisco study found that 50% of recent inflation could be traced to supply chain issues while only 33% could be traced to demand-based inflation. Since Fed interest rate changes only impact demand-based inflation, their ability to meaningfully reduce inflation may be limited relative to other economic cycles.

Historical Stock Market Declines During Recessions

Economic growth has slowed in 2022, and several leading indicators suggest that a recession may be on the horizon. There have been 12 U.S. recessions since 1946. The average decline for the S&P 500 during these economic downturns was 24%. The recent decline of 24%, measured in June, puts the market in line with the historical average drawdown. In the past, the Federal Reserve has significantly impacted the length of recessions, and markets have often reversed course quickly once the Fed signaled a plan to ease monetary policy.

S&P 500 Declines During Recessions



Source: Deutsche Bank

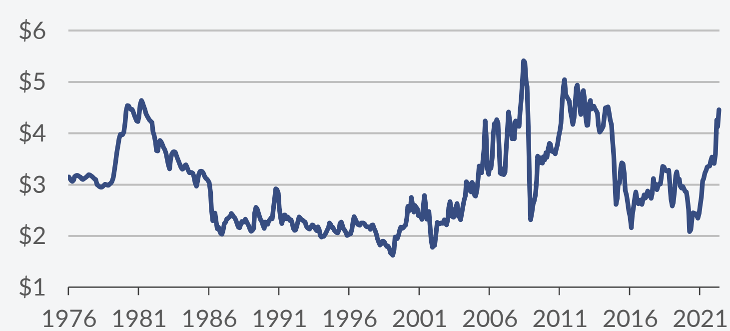
> *"...Inflation expectations are driven by gas prices. At least at the household level, that is what people see and that's how they think about inflation."*
> Treasury Secretary, Janet Yellen

Gas Prices Approach All-Time Highs

Persistent inflation has significantly impacted the financial markets and consumer prices this year. The most visible impact of inflation has been a 57% rise in gasoline prices over the last 12 months to a nationwide average high of $5.02 per gallon on June 14th. $5.00 gas prices have caused some consumers sticker shock, but inflation-adjusted gas prices have still not surpassed the all-time high of $5.44 seen in June of 2008. Fortunately, the national average gas price has declined from June's highs to $4.87 currently as oil prices have decreased. Gas prices are very cyclical and will likely retreat as the economy cools and supply constraints ease. A critical juncture will occur once the war in Ukraine ends. Longer-term, the increasing popularity of hybrid and electric vehicles will likely reduce demand for gas and help moderate prices.

U.S. Inflation-adjusted Retail Gasoline Prices

Per gallon, 1/76 to 6/22

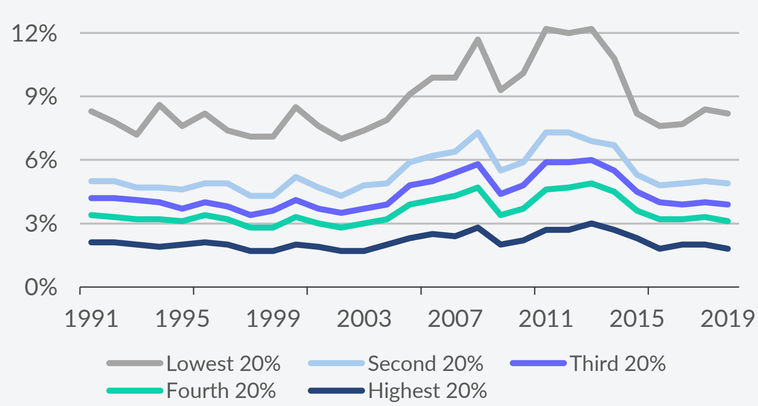


Source: EIA Short-term Energy Outlook

Higher gas prices impact households very differently depending on income. For the top 20% of earners, who only spend 1.8% of their income on gas, rising prices have more of a psychological impact than economic. On the other hand, the lowest 20% of earners spend 8.2% of their income on gas. Increasing prices at the pump tend to be disproportionately damaging to lower-income households, with the lowest earners spending four and a half times more of their after-tax income on gas than the highest earners. Gas prices are highly political, particularly as the midterms approach, since polling indicates that inflation is the number one economic concern among Americans. President Biden has proposed a three-month gas tax holiday to appease voters. However, the tax reduction would only be $0.18 per gallon and cost the government approximately $10 billion.

Percentage of After-tax Income Spent on Gas

By Income Bracket



Source: U.S. Bureau of Labor Statistics

BlackDiamond Financial

ABOUT US

Black Diamond Financial, LLC is a fee-only registered investment adviser with a unique and holistic focus on preserving and enhancing wealth. Our mission is to help you achieve your financial goals through the use of low cost, tax-efficient investment strategies. We create individualized investment portfolios for each client that are risk-appropriate, returns optimized, and tax-efficient. Furthermore, we believe cost is a critical factor in any successful investment strategy and therefore offer fully transparent pricing that is well-below industry standard. As an employee-owned firm focused on our fiduciary duty, we make our clients' interests our highest priority.

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