Davenport Asset Management Quarterly Update | Q2 2022

June 30, 2022

Market Returns	Q2 2022	YTD
U.S. Large Caps	-16.1	-20.0
U.S. Mid Caps	-16.9	-21.6
U.S. Small Caps	-17.2	-23.4
International Developed Markets	-14.5	-19.6
Emerging Markets	-11.4	-17.6
Intermediate Term Bonds	-2.4	-6.8

Source: Morningstar Direct. Please see below for index definitions.

Stocks were under significant pressure in the second quarter and officially entered bear market territory. The S&P 500® Index and Russell 2000® Index declined 16.1% and 17.2%, respectively, during the quarter and finished the period down 20.0% and 23.4% year-to-date. This is the S&P's worst first half since 1970. Market conditions are clearly very different from a year or two ago, when risk taking was rampant and asset values were propped up by rock-bottom interest rates and aggressive economic stimulus spawned by the pandemic. Now, we are on the back side of said stimulus and dealing with the challenging cocktail of rampant inflation, higher interest rates and slowing growth.

- Inflation has dominated headlines. Rising post-pandemic demand, supply chain snarls, war in Ukraine and years of under-investment in production of some commodities have coalesced to elevate prices for most goods. In fact, the Consumer Price Index (CPI) surged 8.6% in May, a 40-year high. Consumers are being squeezed with the cost of everything we buy going up, and the value of our assets going down in many cases. Many like to focus on gas prices, which get the most attention since they are most visible to people. We estimate higher gas prices alone are costing the average driver roughly $1,500 per year (roughly 10% of the average American's discretionary income). Couple this with other considerations such as higher food costs and mortgage rates (a 30-year mortgage is now close to 6% versus roughly 3% a year ago) and you can see why consumers are feeling pinched.

- The Federal Reserve is tightening monetary policy in response to inflation. While policymakers can do little to address supply chain issues, they hope higher borrowing rates will combat inflation by quelling demand. The Fed recently raised benchmark interest rates 0.75%, the biggest hike since 1994, and plans for further increase in coming months. This has clearly raised the probability of an economic slowdown or even a recession. Indeed, Fed Chairman Powell and his colleagues seem perfectly willing to accept a slowdown to get inflation under control. We have already seen weakness in leading economic indicators and the consensus gross domestic product (GDP) forecast for the year has been revised down from 4% at the start of the year to 2.5% (and heading lower).

- Now, the question has become whether we experience a "soft landing" (i.e. a mild slowdown) or a "hard landing" (i.e. outright recession). Many economists are starting to lean towards the latter and recession fears are starting to steal headlines from inflation. In fact, it sometimes seems a recession is now assumed rather than suspected. As a consequence, valuations are under pressure for many asset classes, including stocks. Not only do you have the specter of slowing growth and downward corporate earnings revisions weighing on stocks, but also bear in mind that higher interest rates have finally made bonds a more viable alternative to stocks. For example, a U.S. 2-year Treasury was yielding 0.5% around last Thanksgiving and now yields roughly 3%.

- So what's the good news? The big silver lining is that the market's pullback has improved the risk/reward proposition for stocks. The overall economic/policy backdrop has no doubt deteriorated, but stocks have at least partly discounted some pain already (for what it's worth the Wall Street Journal recently reported that prior recessions have produced an average decline of 24%). As equity investors, we are now being better compensated for taking risk in many situations. At a minimum, we are being much better compensated than we were a year or two ago. Indeed, many stocks that were formerly classified as "growth" stocks can now be classified as "value" stocks following extreme price declines. We also have to bear in mind that numerous investor sentiment indicators have turned decidedly negative and, as noted above, many are starting to treat a recession as a foregone conclusion. Widespread negativity can be a contrarian indicator and suggests stocks may have already discounted significant fear.

In sum, it's hard to know how long current market conditions will last, and there certainly appear to be more headwinds than tailwinds (the average bear market is roughly 13 months). Markets had become very accustomed to ultra-low interest rates and the Fed's efforts to taper cheap and abundant liquidity won't be easy. We believe, however, that market conditions can quickly change and it may not be long before inflation starts to peak and the Fed reigns in its tightening efforts. We also believe that many investors who were once chasing risk are now aggressively running from it. Sometimes this can yield opportunities. We will be hard at work looking for these opportunities while remaining attune to risk.

The headline drivers continued in the second quarter. How to address runaway inflation, an aggressive Fed that continues to telegraph hikes, and geopolitical concerns regarding Russia and North Korea. Investors saw the inversion of the U.S. Treasury curve, highlighting the interconnectedness of inflation and economic growth expectations on interest rates. The Fed faces three critical challenges in its quest for a "soft landing", inflation, recession and stagflation risk.

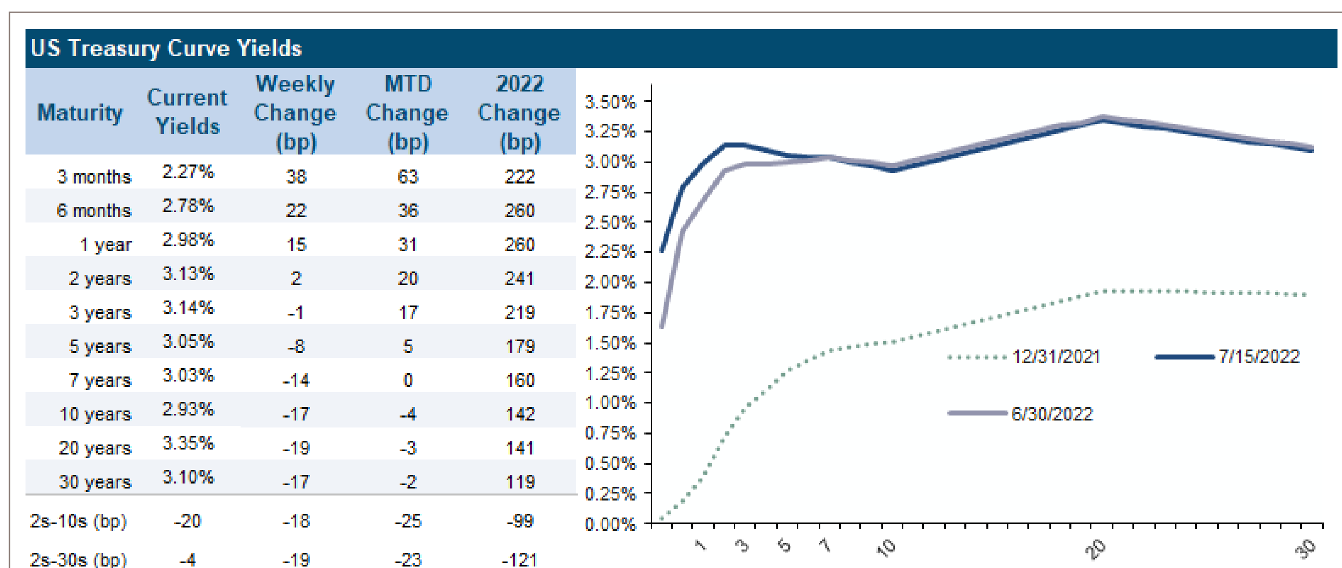
Comparative Total Returns

Jul 15, 2022	Short-Term Cumulative Returns						Annualized Returns			
	YTD	WTD	1Mo	3Mo	6Mo	1yr	2yr	3yr	5yr	10yr
US										
Treasury	-9.13%	1.00%	2.59%	-1.07%	-7.48%	-9.72%	-6.35%	-0.67%	0.82%	0.99%
High Grade Corp.	-13.42%	1.05%	2.16%	-2.77%	-11.55%	-14.04%	-5.98%	-0.54%	1.47%	2.61%
High Yield Corp.	-12.43%	0.28%	-0.26%	-6.53%	-11.71%	-11.26%	0.42%	0.50%	2.26%	4.52%
Leveraged Loans	-1.36%	0.38%	1.47%	-1.77%	-1.88%	0.34%	5.41%	3.07%	3.54%	3.92%
Municipals	-7.89%	0.30%	3.01%	-0.27%	-7.03%	-8.10%	-1.97%	0.20%	1.79%	2.52%
Convertibles	-20.25%	-1.16%	0.23%	-14.33%	-17.07%	-19.80%	4.66%	10.64%	10.84%	11.79%
Preferreds	-12.02%	0.73%	2.25%	-2.95%	-11.31%	-11.92%	-1.40%	0.14%	1.93%	4.18%
Mortgage Markets										
Mortgage Master	-8.26%	0.93%	3.18%	-0.77%	-6.93%	-8.86%	-4.58%	-1.25%	0.47%	1.19%
US Equity Market										
S&P 500	-18.27%	-0.91%	2.05%	-11.69%	-16.50%	-10.09%	11.08%	10.43%	11.42%	13.22%

Source: CreditSights, BofA/ML, S&P/LSTA, Bloomberg.
Treasury=G0Q0, HG=C0A0, HY=H0A0, LL=SPBDPL, Muni=U0A0, Convert=V0S0, Pref=P0P1, Mortgages=M0A0, S&P 500=SPX

Relative Value

Relative value analysis illustrates the broad fixed income challenge across investment grade products. Year-to-date and one year performance show the magnitude of Treasury and High Grade Corporates negative returns. Treasury markets have experienced elevated interest rate volatility that has weighed on Treasury and IG Corporates. Continued aggressive monetary policy pushed rates higher and prices lower. On the positive side, recent rate improvement is noted in the one month data. High Grade Corporates underperformance versus Treasuries is the result of corporate spread weakness. Our IG Corporate overweight versus Treasuries is supported by annualized returns from its two to ten year outperformance.



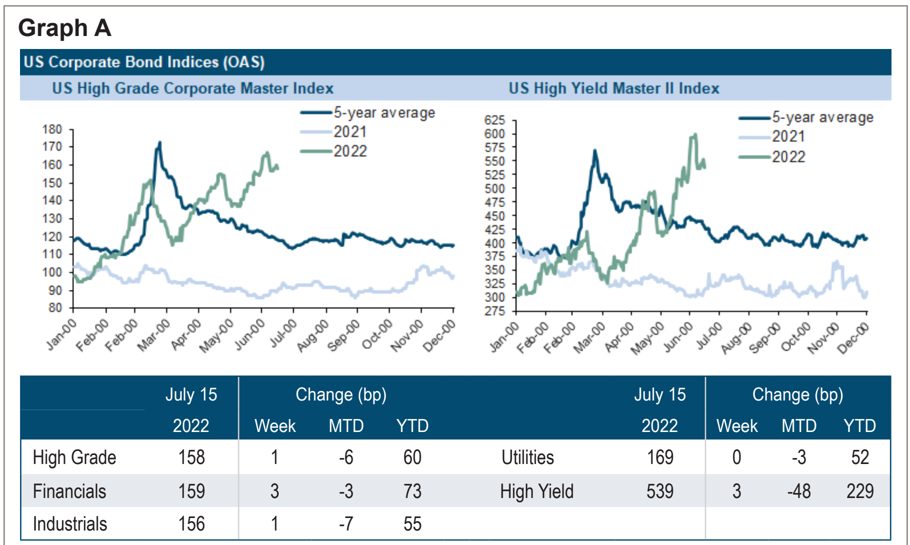
US Treasury Curve Yields

Maturity	Current Yields	Weekly Change (bp)	MTD Change (bp)	2022 Change (bp)
3 months	2.27%	38	63	222
6 months	2.78%	22	36	260
1 year	2.98%	15	31	260
2 years	3.13%	2	20	241
3 years	3.14%	-1	17	219
5 years	3.05%	-8	5	179
7 years	3.03%	-14	0	160
10 years	2.93%	-17	-4	142
20 years	3.35%	-19	-3	141
30 years	3.10%	-17	-2	119
2s-10s (bp)	-20	-18	-25	-99
2s-30s (bp)	-4	-19	-23	-121

Source: CreditSights, Bloomberg, LP. Data as of 07/15/2022

Treasury Markets

The Treasury market has a 2s-10s curve inversion. Front-end rates spiked higher as long-rates tightened. This move is largely attributable to anticipated aggressive Fed rate hikes continuing to push front-end rates higher. We are witnessing a bear flattener, which is due to the belief that elevated short rates will weigh on economic growth which is reflected in lower rates out the curve. 2022 year-to-date rate movements have seen the most widening in the front-end but rates remain wider out the curve as well. Short dated Treasuries offer the most value as rates have moved higher this year. We remain open to extending duration through selective key rate duration positions but aren't compelled to do so immediately given the lower rates and limited room for rate compression from current rates.



	July 15 2022	Change (bp) Week	MTD	YTD		July 15 2022	Change (bp) Week	MTD	YTD
High Grade	158	1	-6	60	Utilities	169	0	-3	52
Financials	159	3	-3	73	High Yield	539	3	-48	229
Industrials	156	1	-7	55					

Source: CreditSights, BofA/ML Indices (C0A0) (H0A0)

In Graph A, corporate spreads remain significantly wider on an YTD basis. Additionally, spreads began the year inside the five-year average but have moved well above it during the course of 2022. Spread weakness can be attributed to many factors but the macro risk sentiment and inflationary concerns impact on corporate margins have played a significant role in this. One positive is that a lighter new issue calendar is supportive for tighter spreads.

We have included a new table this quarter that illustrates the movement in the YTW (yield to worst) so far this year. This includes the impact of higher Treasury rates and wider credit spreads.

In Graph B, we look at the YTW across the investment grade credit spectrum. Yields are much more attractive than the lows seen in 2020. The additional spread component on corporate bonds seems fairly priced but remains vulnerable. We expected greater sector/industry dispersion by this point but so far it has not materialized.

Graph B

US IG & HY Corporate Yield to Worst (%) by Rating, Tenor

	IG	AAA	AA	A1	A2	A3	BBB1	BBB2	BBB3	BB1	BB2	BB3	B1	B2	B3
Index	4.71	3.81	4.04	4.13	4.32	4.49	4.83	4.95	5.63	6.55	7.38	7.64	8.67	9.74	10.54
3Y	4.10	3.23	3.52	3.61	3.85	3.96	4.23	4.31	5.02	6.18	7.37	7.52	9.06	10.25	11.15
5Y	4.60	3.55	3.80	3.99	4.30	4.45	4.60	4.71	5.63	6.70	7.52	7.84	8.60	9.97	10.53
7Y	4.84	3.72	4.04	4.19	4.49	4.62	4.82	5.01	5.81	6.71	7.31	7.59	8.50	9.38	9.85
10Y	4.96	3.89	4.08	4.27	4.56	4.71	4.96	5.21	5.79	6.57	7.00	7.36	8.09	8.52	9.68
30Y	5.13	4.15	4.53	4.71	4.77	4.94	5.27	5.48	6.17	6.93	8.62	8.72	8.25	15.08	N/A

Source: CreditSights, ICE Data Indices, LLC. Data as of 06/30/2022

Pulling it all together, quality bonds from both a fundamental and relative value perspective are often trading at a discount. We always perform deep credit analysis on names we hold. Those with extra cash have an advantageous entry point. Existing positions trading at a discount which can be held to maturity, removing the current mark-to-market impact, offer an attractive entry point as well as the ability to lower the weighted average purchase price through increasing existing positions. We remain committed to our energy sector allocation, favor services over goods exposure and increased floating rate note allocation. With ratings, we expect BBBs to maintain financial prudence while A and higher rated borrowers present the possibility for unfriendly debt actions (M&A, buybacks programs and increased dividends) to counter margin and earnings pressures.

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