DIVERSIFIED PORTFOLIOS, INC.

Investment Insights

A Resource for Investors, Attorneys and CPAs

July 2022

at a glance

Market Update

Investors are excited to turn the page to the second half of the year after a poor start to the year for both stocks and bonds

Reason for Optimism?

We take a deep dive into the health of the U.S. Consumer—typically the engine of the economy

Financial Planning Update

Losses in stocks and bonds may provide one silver lining through potential planning opportunities

Market Update

July 2022

Asset Class	2nd Quarter 2022 Return	YTD
Large U.S. Stocks: S&P 500 Index	-16.1%	-19.8%
Small U.S. Stocks: Russell 2000 Index	-17.2%	-23.3%
Developed International Stocks: MSCI EAFE Index	-14.5%	-19.5%
Emerging Market Stocks: MSCI Emerging Markets Index	-10.4%	-17.4%
Bonds: Bloomberg Barclays U.S. Aggregate Index	-4.7%	-10.4%
Cash: FTSE 3-Month Treasury Bill Index	0.1%	0.2%

Source: Charles Schwab - Returns Calculator as of June 30, 2022

Global equity markets struggled throughout the quarter as inflation and geopolitics caused market losses

Market participants are excited to turn the page to the second half of the year after a difficult first half. Inflation remains a major issue with CPI in the United States reaching a cycle high of 9% last month and energy prices starting to pressure consumers. In addition, some investors believe that the United States is in a technical recession, with the second quarter on track to be another quarter with negative GDP (Gross Domestic Product) growth.

Not all news was negative, however. Jobs data in the United States remains solid and certain service industries are as strong as ever as the shift from goods to services takes shape in the economy following the pandemic. Additionally, valuations look much more attractive. Looking ahead, investors will be closely monitoring earnings season for clues on the strength of the economy.

International exposure lagged in 2021 and has not bounced back in 2022. The Russian invasion has roiled European energy markets, causing significant concerns, raising prices, and pressuring supply chains. In addition, weaker currencies are creating another headache for global investors. Finally, Emerging Market broad indices still struggled but outperformed in the 2nd quarter as China relaxed some COVID related curbs.

In Fixed Income, bond investors continue to look for relief from a historically poor start to the year. Higher inflation and a "hawkish" Federal Reserve have caused bonds to sell off at a pace not seen in a generation. The silver lining is that as a mathematical asset class, certain sectors of the bond market look as attractive as any point since the financial crisis of 2008.

Deeper Dive: The U.S. Consumer

Consumption by U.S. citizens has historically contributed about 2/3 to United States GDP. Below, we check in on the health of the U.S. Consumer

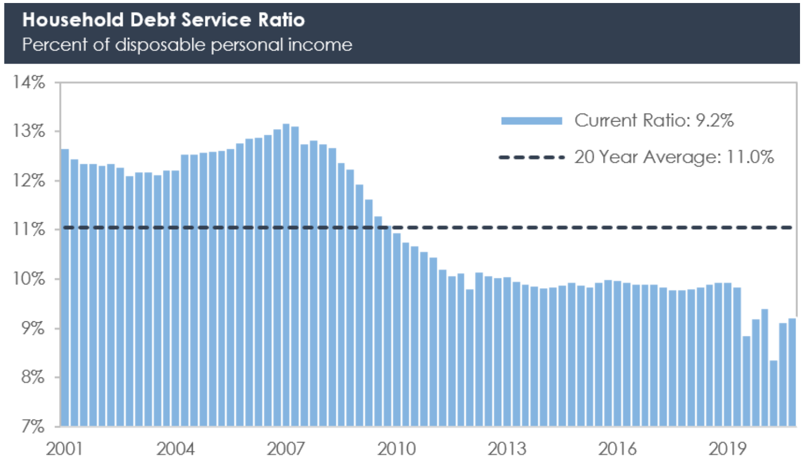
The equation for GDP is Private Consumption + Government Spending + Investment + Net Exports. Unsurprisingly, of all large developed countries, the United States consistently ranks as the nation which relies on its citizens the most for economic growth. Americans are certainly known for excess when it comes to buying all sorts of things—especially compared to citizens of other countries who tend to save more.

G 7 Countries*	% of GDP contribution from consumption
1. USA	67%
2. UK	61%
3. Italy	58%
4. Canada	57%
5. Japan	53%
6. France	53%
7. Germany	51%

With all of the concern over inflation, economic growth, and a potential recession, taking stock of the U.S. Consumer can provide clues about the strength of the U.S. economy in the short term.

Consumer balance sheets look strong

The average personal balance sheet came into 2022 in great shape, with low debt levels, home equity at all-time highs, and a financial cushion still in place from some of the COVID related benefits passed by Congress.



The above chart shows the amount of the average American's income goes to pay off their debts (mortgage, credit card, etc). This measure is near historic lows as increased savings during the pandemic combined with historically low interest rates has put the average balance sheet in good shape. So far we are not seeing the same type of leverage that was typical of the early 2000s—and we view this as a strength during an uncertain time for the global economy.

*Source from 2020: https://www.theglobaleconomy.com/rankings/household_consumption/
Household Debt Service Ratio – Market Desk White Label – March 2022

Deeper Dive: The U.S. Consumer

July 2022

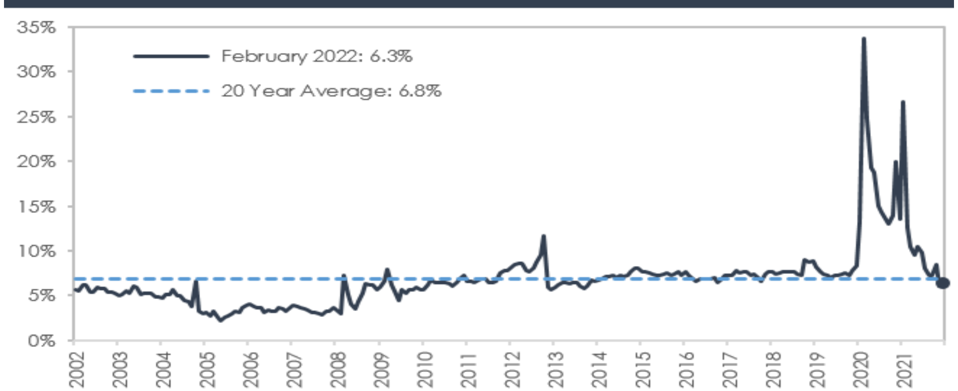
Job market, while changing, remains solid

For consumers to spend and be the engine of the global economy, firms need to be hiring and jobs need to be available. The shape of our economy is shifting rapidly since the onset of the pandemic. We are seeing layoffs from higher paying tech jobs while anyone who has been traveling or dining recently knows the service industry cannot find enough people to meet demand and wages are up significantly on a percentage basis in this sector. In fact, average hourly earnings are up 5% year-over-year, helping consumers somewhat manage an increased inflation rate. In aggregate, while the jobs picture is marginally weaker than six months ago, the unemployment rate is still relatively low while job openings are near all time highs, which is supportive of spending moving forward.

Savings rate moving below 20 year average

One data point which is moving in the wrong direction is the savings rate. Consumers are starting to dip into savings in order to support their lifestyles. While this supports short-term consumption, the pace is unsustainable and something to monitor in the second half of the year.

Personal Savings Rate
20 years of data; % of disposable income



Consumer confidence at an all time low

The canary in the coal mine is the latest consumer confidence readings. Sentiment hit a record low in the University of Michigan's Consumer Sentiment Index, which is the preferred measure the market uses to gauge how the average U.S. citizen is feeling about the economy. If consumers are feeling negative about their economic future, then they are less likely to spend on products and services. High inflation has been cited as the primary driver of the gloomy mood, and for good reason, with gas prices on the road a daily reminder to most people that interact with the economy that it is more expensive to pay the bills. While the U.S. economy has been in worse shape, the current mood of U.S. consumers has never been worse.

Overall, in this fascinating macroeconomic environment, the health of the U.S. Consumer is yet another area that earns a score of "incomplete." Low confidence from higher energy prices and a reduction in the savings rate give us some cause for concern. However, strong balance sheets and plentiful jobs give us reason to believe that in the end, the U.S. consumer will be resilient.

We will be closely watching the data this summer for validation of a trend that can give us some clues on the overall health of the economy.

Personal Savings Rate – Market Desk White Label – March 2022
University of Michigan Consumer Sentiment Index, University of Michigan June 2022

Tax Loss Harvesting

Oftentimes, financial planning is a joint effort between legal, tax, and investment experts. The losses experienced so far in 2022 give advisors an opportunity to coordinate on the tax and investment side.

One technique that financial advisors can use to lower tax burdens of clients is called Tax Loss Harvesting. For example, if an advisor bought an intermediate U.S. Treasury bond fund a year ago, it is trading at a loss. An advisor can swap the U.S. Treasury Bond Fund for a U.S. Core Bond Fund which contains similar instruments and risk characteristics. With this technique the client can maintain similar risk exposure in their portfolio while booking the loss for tax purposes.

Of course, there is no standard portfolio and every client situation is different, but for many realizing losses to use against future or current realized gains and lowering tax bills is a silver lining to the year-to - date performance for 2022.

If losses are available to harvest, this topic is something for advisors to consider when working for clients in the second half of the year.

We're here to help

The team at Diversified Portfolios is wishing you a wonderful summer. We are ready to help answer any and all questions!

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