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The first half of 2022 was memorable for investors for all the wrong reasons. Accelerating inflation and rising interest rates roiled the financial markets. Painfully, there was nowhere to hide. Equities experienced their worst first half since 1970. Many bond indices experienced their worst start in history. The selling was largely indiscriminate and spared few asset classes.

Using history as a guide, the good news for investors is that the second half of the year following a difficult start tends to be strong. According to Dow Jones Market Data, when the S&P 500® index has declined 15 percent or more in the first two quarters, it has risen an average of 24 percent in the third and fourth quarters.

> As the economy and the markets begin to normalize following the pandemic, a less speculative investing environment should emerge. Expect to see more discriminating investors weighing fundamentals against valuations as the year progresses.

Inflation is unquestionably the primary culprit agitating the equity markets. Rates of inflation have hit levels not seen in 40 years. Both the Federal Reserve and the presidential administration miscalculated the risk of inflation following the unprecedented fiscal stimulus and accommodative monetary policies designed to respond to the pandemic. They were not alone. Many central banks around the world believed inflation would be "transitory." Higher inflation rates erode earnings and cause investors to lower the price that they are willing to pay for a future dollar of earnings. Inflation is also the domino that triggers higher interest rates, rising mortgage rates, and an erosion of consumer confidence. The Federal Reserve has made it abundantly clear that they will take any actions necessary to control inflation, even if doing so induces a recession.

Expect monetary policy to tighten further–both domestically and globally. During the second quarter, the Fed implemented its largest interest-rate increase since 1994. The central bank has also signaled that it intends to raise rates several more times this year to tamp down inflation. The chances of a recession have increased significantly due to these actions. The Fed is optimistic that it can engineer a so-called soft landing, whereby it slows the economy enough to harness inflation but avoids tightening monetary policy to the point of causing a recession. Based on history, their probability of success is low.

It is futile to attempt to predict when the market will bottom. History, however, suggests that longer term investors may be at a favorable point. Most of the market pain has likely already been suffered as the equity markets are a forward-looking indicator. Valuations have become more attractive. In fact, according to JP Morgan, domestic small cap stocks are currently trading near their lowest historical valuation levels. Investor expectations are low. Most expect the economy, consumer confidence, and other economic indicators to worsen before they improve. The benefit of pessimism is there is likely a greater probability of an upside surprise than downside risk.

The Riverbridge portfolio companies are well positioned fundamentally in this economic environment. In a period whereby wage and other input cost inflation is becoming a formidable growth obstacle, many of our portfolio companies deliver goods and services which help corporations control costs, operate more efficiently, and make better decisions. While it is difficult to forecast economic activity levels, market bottoms, and geopolitical risks, the Riverbridge investment team is confident that our companies will continue to build their earnings power by leveraging their strategic market positions. Maintaining a long-term focus is a tremendous advantage in these less certain times.