Credit Check.

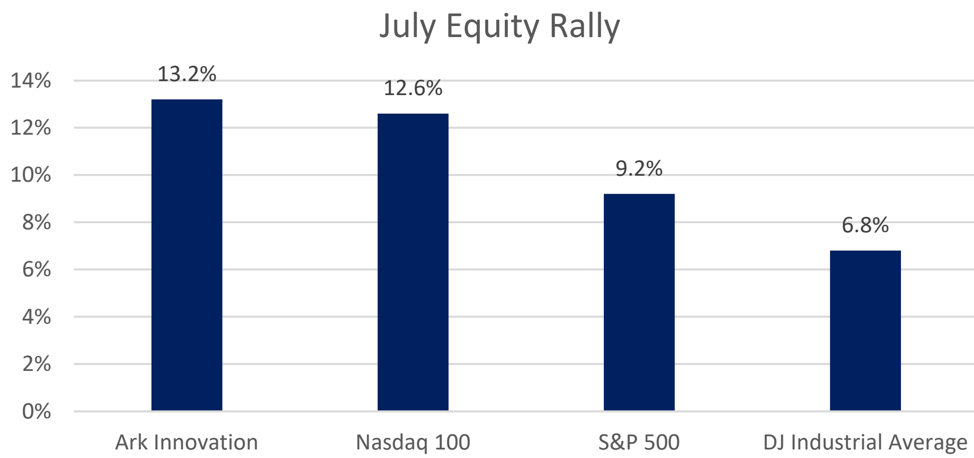
Markets started off the second half of the year like a bat out of hell, up and to the right. Something that investors across the globe welcomed with open arms (maybe too open, brb) coming off the worst start to a year on record for many asset classes, as well as diversified portfolios[1]. It's no secret that July was going to be a pivotal month for the 2022 campaign, and possibly the 2023 one as well. But we entered the month with a mentality that it wasn't so much a "make or break period" mindset, but more so a "break or don't break" mantra. Here's a look at why we think the rally in July needs to be handled with caution by investors as we hit the home stretch of the Dog Days of summer.

Reality Check

The S&P 500 drew down 20% through June 30, only the sixth drawdown of that magnitude over the last 50 years[2]. What's been tagged as a Fed driven selloff, some additional headwinds have included multi-decade high inflation and pockets of the tech sector reaching dot.com level valuations. While the rally in July might have given the illusion that these forces were no longer at play, I can assure you we're not out of the woods just yet.

Where do we stand through the first seven months of the year? Well, the recession debate is louder than ever (we can all agree we're seeing slowing growth), rates are still on the move higher (perhaps higher than the current futures market is pricing in), and some technology company valuations are *still* extraordinarily high. Yet July saw the S&P 500 rally over 9%, the best monthly performance since the COVID vaccines were announced in November 2020. The market rally was led by the most richly-valued technology companies, with ARK Innovation and the NASDAQ gaining 13%, while the more traditional old-economy stocks in the Dow Jones Industrial Average rallied only 7%[3].

[1] Data provided by Bloomberg database.
[2] Data provided by Bloomberg database.
[3] Data provided by Bloomberg database, chart generated by GFG Capital.



Stocks weren't the only thing moving higher in July. Bonds caught a bid too. Long-term government bonds finished the month higher, and meaningfully under 3%. High-growth technology stocks are theoretically more sensitive to long-term discount rates: valuations should rely more on cash flows far in the future, while value stocks depend more on current cash flows. The market's logic appeared to be that an economic slowdown would rein in inflation so much, that the Fed would therefore not have to hike rates as much. Thus, technology stocks became instantaneously undervalued. This was also supported, perhaps, by a hint of dovishness coming out of Chair Powell's press conference.

We're not so sure on this.

The question on everyone's mind is what happens next. Does this rally mean this contraction is over? Or is this pump fake, preceding further losses? We looked at 50 years of bear markets in the S&P 500 to develop a sense of historical precedent. The below chart shows how many days it took the S&P 500 to recover after it entered a bear market (a 20% drawdown) and the further drawdown from that point[4].

	1974	1987	2001	2008	2020
Months to Recovery	56	15	52	40	4
Further Drawdown	*-28%*	*-8%*	*-40%*	*-47%*	*-17%*

Counting on a "V-shaped" recovery is something most investors abandoned a few months ago. Typically, upon entering a bear market, it often takes more time than most are willing to tolerate to claw back to positive territory. So far, we're more than 210 days into this drawdown.

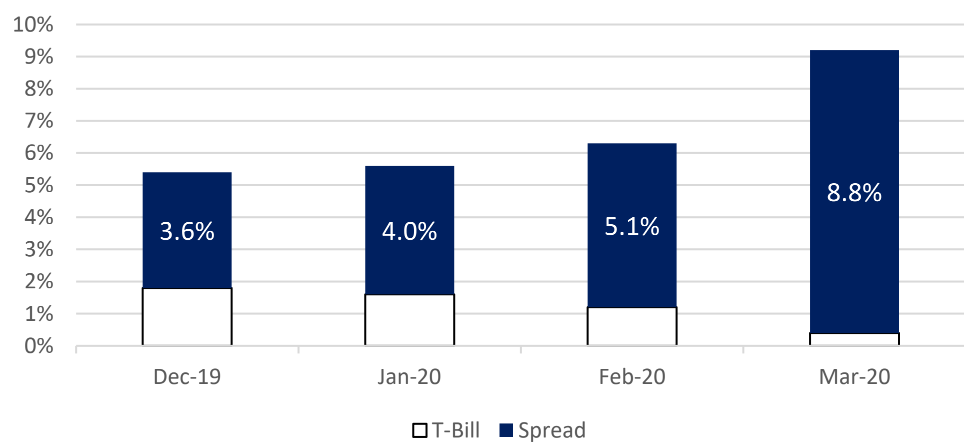
If investors were interested in trying to determine if the tides had turned completely when it comes to the appetite for risk assets, we'd suggest they focus on fixed income. Aside from the discounting role long-term rates play, the health of the credit markets typically act as a barometer of overall health, as well as appetite, for assets on the risk spectrum. It even acts as an amplifier of the real economy. Deteriorating credit market conditions (such as increases in insolvency and rising real debt burdens) feed back into the economy, which in turn worsen credit conditions.

[4] Data provided by Bloomberg database.

The wider the spread (the gap between the yield on a corporate bond vs the yield of a Treasury bond on the same place of the yield curve) the lower the appetite, and conviction, there is in those assets.

Today, even after July's rally, high-yield spreads remain elevated. Spreads today are still around 500bps, well above the 10-year median. Spreads this wide tend to be very dangerous times for equity investors. Every equity drawdown of -30% or more has occurred within six months of high-yield spreads crossing the 10-year median of 430bps[5].

What's different about today's environment relative to other points in recent history where "risk-on" was the mindset, is the level of the reference rate. We know we're in the midst of a slowing economy, which increases the probability of an uptick in insolvencies and defaults for corporations moving forward. Especially with Treasury yields hovering at 3% (across the entire curve). For this reason, we're not so sure we've seen the widest spreads this cycle has to offer just yet. And if the equity rally in July were a turning point for the year, then we should have seen spreads compress more than they did. It's tempting for investors to see 8% yields on below investment grade debt and think we've reached a historically attractive entry point. But here's a look at high yield spreads leading up to the pandemic in 2020[6]:

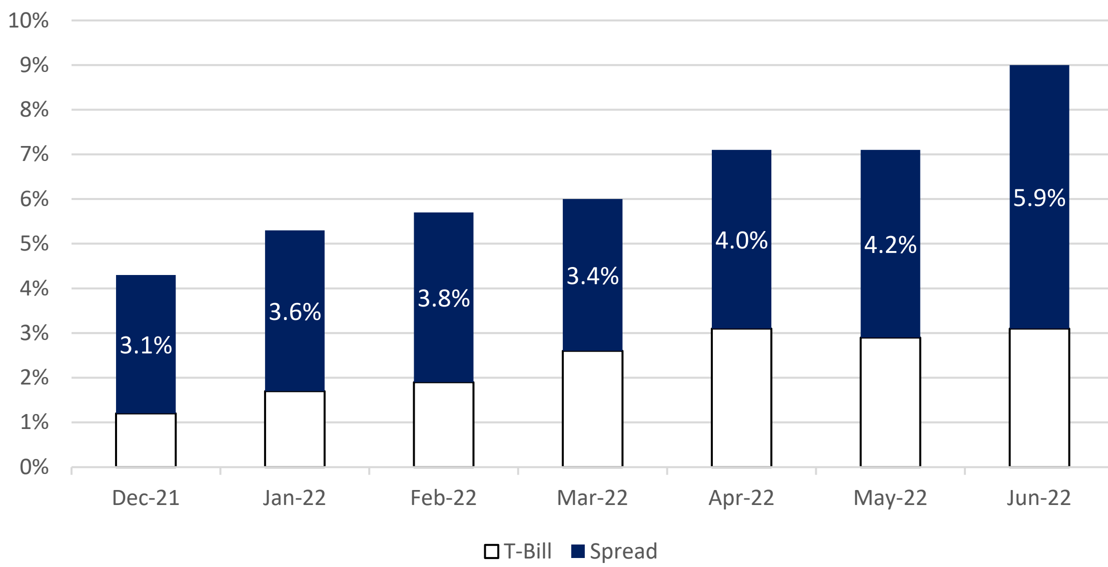


Over the past six months, the Treasury portion of the yield was first to move. Only recently, especially in the past month, has the spread component started to rapidly widen. Despite the longer selloff, we may still be early on in the credit-widening environment. Inflation has changed the story.

Today, with the Fed constrained by the risk of inflation, it is not at all certain that they will be able to act as aggressively to reduce default risk—nor is it at all clear that they will be successful in containing inflation. High yield could continue to get hit from both sides. Take a look at the difference in spreads below vs where investors were pricing these risks in March of 2020:

[5] Date provided by FRED, as of 7/31/2022

[6] Data provided by Verdad, charts generated by GFG Capital.



[7]

We aren't intentionally [bringing an umbrella to a brainstorm](). But we were left a bit perplexed by the behavior in the market at the end of the last month. We still feel there is some time between us and the end of this environment, largely in part because the strongest headwind (the Fed) hasn't exited the group chat. In fact, I think Jerome Powell's cell service just blacked out while he was driving through a tunnel, because the messages he was sending didn't seem to make their way to everybody's inbox. Stay tuned, our next piece will focus on Earnings' Season, and whether or not we've seen enough evidence of a downgrade in expectations. One of our key signals that was pointed out in our Q2 Letter to Investors.

[7] Data provided by Verdad, charts generated by GFG Capital.

LEGAL STUFF

INFORMATION CONTAINED HEREIN HAS BEEN OBTAINED FROM SOURCES BELIEVED TO BE RELIABLE BUT IS NOT GUARANTEED. CURRENT MARKET DATA IS AS OF 08/01/2022.

THIS PRESENTATION (THE "PRESENTATION") HAS BEEN PREPARED SOLELY FOR INFORMATION PURPOSES AND IS NOT INTENDED TO BE AN OFFER OR SOLICITATION AND IS BEING FURNISHED SOLELY FOR USE BY CLIENTS AND PROSPECTIVE CLIENTS IN CONSIDERING GFG CAPITAL, LLC ("GFG CAPITAL" OR THE "COMPANY") AS THEIR INVESTMENT ADVISER. DO NOT USE THE FOREGOING AS THE SOLE BASIS OF INVESTMENT DECISIONS. ALL SOURCES DEEMED RELIABLE HOWEVER GFG CAPITAL ASSUMES NO RESPONSIBILITY FOR ANY INACCURACIES. THE OPINIONS CONTAINED HEREIN ARE NOT RECOMMENDATIONS.

OPINIONS AND PREDICTIONS ARE AS OF 08/01/2022 AND ARE SUBJECT TO CHANGE AT ANY TIME BASED ON MARKET AND OTHER CONDITIONS. NO PREDICTIONS OR FORECASTS CAN BE GUARANTEED.

THIS MATERIAL DOES NOT CONSTITUTE A RECOMMENDATION TO BUY OR SELL ANY SPECIFIC SECURITY, PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. INVESTING INVOLVES RISK, INCLUDING THE POSSIBLE LOSS OF A PRINCIPAL INVESTMENT. INDEX PERFORMANCE IS PRESENTED FOR ILLUSTRATIVE PURPOSES ONLY. DIRECT INVESTMENT CANNOT BE MADE INTO AN INDEX. THE S&P 500 INDEX IS AN UNMANAGED INDEX, WHICH IS WIDELY REGARDED AS THE STANDARD FOR MEASURING THE U.S. STOCK MARKET PERFORMANCE. INVESTMENT IN EQUITIES INVOLVES MORE RISK THAN OTHER SECURITIES AND MAY HAVE THE POTENTIAL FOR HIGHER RETURNS AND GREATER LOSSES. BONDS HAVE INTEREST RATE RISK AND CREDIT RISK. AS INTEREST RATES RISE, EXISTING BOND PRICES FALL AND CAN CAUSE THE VALUE OF AN INVESTMENT TO DECLINE. CHANGES IN INTEREST RATES GENERALLY HAVE A GREATER EFFECT ON BONDS WITH LONGER MATURITIES THAN ON THOSE WITH SHORTER MATURITIES. CREDIT RISK REFERES TO THE POSSIBLITY THAT THE ISSUER OF THE BOND WILL NOT BE ABLE TO MAKE PRINCIPAL AND/OR INTEREST PAYMENTS.
THE INFORMATION CONTAINED HEREIN HAS BEEN PREPARED TO ASSIST INTERESTED PARTIES IN MAKING THEIR OWN EVALUATION OF GFG CAPITAL AND DOES NOT PURPORT TO CONTAIN ALL OF THE INFORMATION THAT A PROSPECTIVE CLIENT MAY DESIRE. IN ALL CASES, INTERESTED PARTIES SHOULD CONDUCT THEIR OWN INVESTIGATION AND ANALYSIS OF GFG CAPITAL AND THE DATA SET FORTH IN THIS PRESENTATION. FOR A FULL DESCRIPTION OF GFG CAPITAL'S ADVISORY SERVICES AND FEES, PLEASE REFER TO OUR FORM ADV PART 2 DISCLOSURE BROCHURE AVAILABLE BY REQUEST OR AT THE FOLLOWING WEBSITE: HTTP://WWW.ADVISERINFO.SEC.GOV/.

ALL COMMUNICATIONS, INQUIRIES AND REQUESTS FOR INFORMATION RELATING TO THIS PRESENTATION SHOULD BE ADDRESSED TO GFG CAPITAL AT 305-810-6500.