Spring 2022

Investment Commentary

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WEALTH MANAGEMENT

Q1 2022 Review — Volatility Strikes, but Clarity is King

After the most volatile quarter since the Pandemic broke out in March of 2020, the market looks to move on to better times. Between a reversal in the Federal Reserve's policies to combat inflation, war breaking out in Eastern Europe and the US Treasury yield curve inverting, the S&P 500 ended the quarter down -4.6% on a total return basis. As we know, things are never so simple. The world and markets were a much scarier place just several weeks ago. However, as with the changing of the seasons, we are making progress towards hopefully brighter days ahead.

Clarity is King

Fear of the unknown is one of the markets worst enemies. The first few months of this year we have had elevated uncertainty and more questions than answers.

In January, February and March, inflation hit consecutive new highs with the latest reading reaching 7.9% on an annualized basis, the highest reading in nearly 40 years. Investors were worried and unknowns plentiful. Would the Fed be able to get this under control soon? How fast would they need to raise rates to combat inflation? Were they too late to act?

Adding to uncertainty, Russia invaded Ukraine in late February. Would Russia invade a NATO nation next? What are the global implications for China's rocky relationship with Taiwan? Would the U.S. get involved, and, if so, to what degree?

In addition, towards the end of March, certain segments of the U.S. Treasury yield curve inverted. This inversion has preceded most previous recessions (please see below for more details on this). What does this mean for the U.S. economy in the months and years ahead? Is a recession now imminent? What does this mean for our portfolios? The goal of posing these questions is not to instill fear, but to demonstrate just how easy it was to point to any issue as a reason to sell stocks.

Combatting Inflation

One of the largest issues we are surely going to grapple with for the remainder of this year will be inflation. The Consumer Price Index showed prices increased at the fastest rate in 40 years through the first several months of 2022. There are myriad of factors affecting price increases, from supply chain woes to pent up demand, to fiscal and monetary policy aid to combat COVID 19. Inflation can be tamed in several ways – fixing the supply chain issues, reducing demand for goods and services or reducing the money supply in our economy. The first is something that will take time due to the nature of COVID 19 and this virus, but the second two items can be addressed by tightening monetary policy.

In January, the Federal Reserve indicated it would be lifting the benchmark overnight interest rate above zero at their next meeting in March. By the time March rolled around, inflation had continued rearing its ugly head and the market was concerned about the possibility that the Fed should have taken action sooner. If the Fed was late, they would need to overcompensate, raise rates quickly and possibly severely retard economic growth. Ultimately, this could cause a recession and the Federal Reserve does not have a good track record of successfully engineering a "soft landing" – i.e., not causing a recession.

Leading up the FOMC meeting in March, the S&P 500 was down -12.2% for the year. While some called for more aggressive moves, Jerome Powell signaled they were willing to do what it takes, even be too aggressive, to get inflation under control throughout the remainder of the year. We typically refer to Fed-speak as being "dovish" or "hawkish" – dovish meaning they are taking a more accommodative stance, and more hawkish meaning they are aimed at tightening monetary conditions. This speech was possibly the most hawkish that we have seen in years, but it gave the market a sense of confidence. Everyone knows money cannot be cheap forever, so maybe it's in everyone's greater interest to nip inflation in the bud. The market had a historic rally off the lows despite the news being negative for long term market conditions. Clarity helped in this sense.

See important disclosure on last page

Ukraine/ Russia Conflict

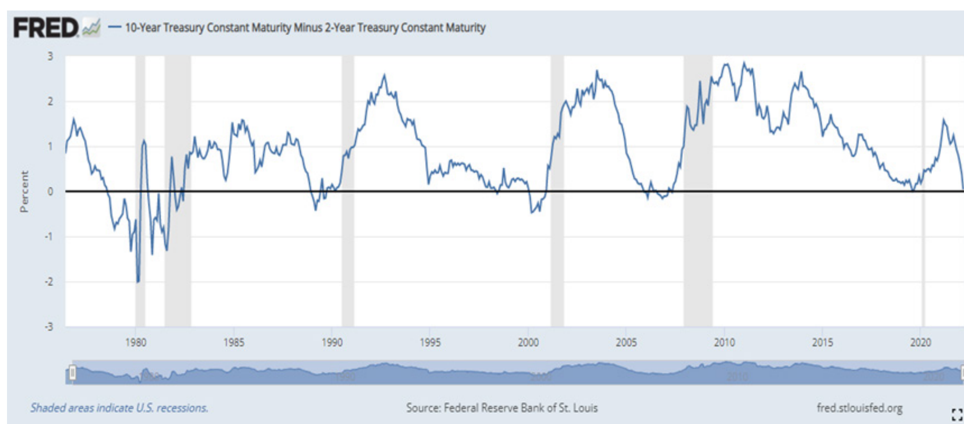
Our hearts go out to the innocent victims of this tragedy. The morning of the Ukraine invasion, the S&P 500 opened down, touching -14% for the year. This was a significantly swift correction; however, the market has not dropped below that point since. There are several implications that are horrible for humanity and the global economy, but it was quickly evident that Russia was met with unexpected resistance. As with most geopolitical disputes, markets react negatively, fearing the worst outcome and rebound quickly. The sanctions of U.S. and other NATO allies have crippled the Russian economy, which likely has negatively affected the Russian effort.

There are however knock-on effects from this war that leave us asking questions about the resilience of our globally intertwined economy. If China takes a lesson and decides to go to war with Taiwan, would that be a large enough world power and economy to put a dent in global trade and cause a recession? Oil and Wheat, among other commodities, have seen their supply chains disrupted only to send already fragile markets shooting higher. High oil prices have been present during previous bull market peaks, however whether it causes the recession or not is another debate. The bottom line with the war going on in Eastern Europe is that each day that passes allows more investors to digest the information present and realize that the worst possible outcome is unlikely, and the U.S. economy and market can still grow. While there continue to be unknowns, the outcome appears clearer today than it was a month ago.

Yield Curve Inversion

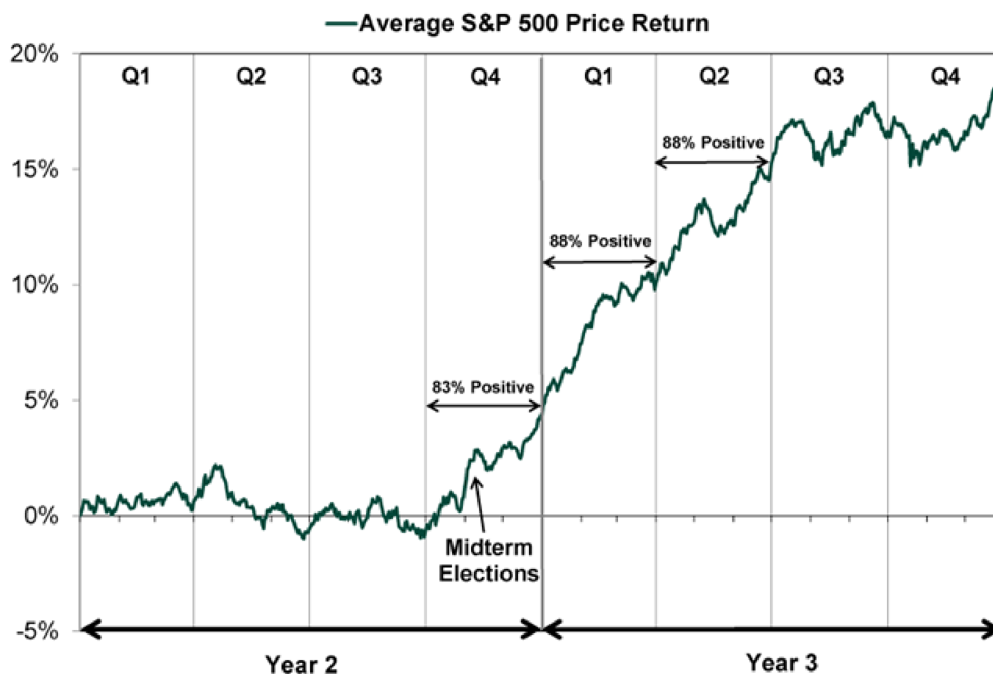
The most recent development this past quarter came with the U.S. Treasury yield curve having its first inversion since the late summer of 2019. An inversion occurs when shorter duration U.S. Treasuries, typically measured by the Two-year Note, have a higher yield than longer dated U.S. Treasuries, typically measured by the 10-year Bond. As of April 1st, the Two-year Notes were yielding 2.46% and the 10-year Bonds had a yield of 2.39% but a few days later this inversion reversed. Since then, the yield curve has steepened. The common understanding is that an inversion disincentivizes banks to lend money (longer time frames) because the interest they pay (shorter time frames) is higher. While this may be true when an inversion occurs for a long period of time, it really just means that the financial system is fragile. Yield curve inversions occur to some extent before nearly every recession; however, they can also be a false indicator at times. Our understanding might be more that the next major negative catalyst might be enough to tip the economy into a recession, but we should be aware of the context.

First, in the summer of 2019 when the yield curve inverted, bond market participants surely did not know a pandemic would occur in March of 2020. Second, the Federal Reserve has artificially held interest rates lower for years by buying bonds. Through March, the Federal Reserve was still buying bonds via Quantitative Easing policy, so eventually when they stop their accommodative policy, or even begin selling bonds in the future, this could cause the long bond yields to rise and the curve to steepen again. Lastly, there is a war going on and during flights to safety, bonds are desirable, so as geopolitical tensions ease, this too could steepen the curve again. When it comes to investments, the worst four words we can utter are "this time is different", but these are uncharted waters to some degree. History rarely repeats itself, but it often rhymes, so exhibiting some caution here could be prudent. What we also know is that markets tend to fare well immediately following the first signs of a yield curve inversion.



Midterm Elections and the Path Ahead

In the coming months, as Russia related tensions hopefully calm down, investors will turn their attention to the upcoming midterm elections. A phenomenon that is often underappreciated is that we should be headed towards gridlock. President Biden's approval ratings are low, and we expect the Democrats to lose their power in the Senate and possibly even the House. Gridlock is frustrating to citizens because not much gets done but is typically good for business owners or major corporations to plan around spending as they have clarity with taxes and a lack of policy changes. As the chart below shows, typically the first two to three quarters of midterm election years exhibit more muted returns, however markets tend to rally at above average rates in the three quarters following midterms and into the following year.



Source: Global Financial Data, Inc., as of 8/10/2021.
S&P 500 Index price returns in second and third years of the presidential cycle, 1925 – 2019.

As stewards of your wealth, we are constantly evaluating the investment landscape for ways to generate income in a low yield environment, protect wealth by mitigating downside losses and keeping the portfolio diversified. Many companies that did extremely well following the pandemic have been hit the hardest as the market corrected. Paying attention to reasonably valued companies and gearing the portfolio towards inflation hedges has benefited our clients so far this year. As always, please feel free to reach out to our team if there are any questions or concerns we can help address.

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