Client Note

April 11, 2022

Stock markets struggled during the first quarter of 2022. The high was January 4, the second day of trading, and fell through mid-March, hitting a low at 4118, almost 15% below the all-time high struck on January 4. Markets climbed and fell back to test, but not undercut that level in mid-March. Equity markets climbed by more than 10%. Recently, the S&P500 fell 5%. If this sounds like a lot of back and forth, it's because it is. And looking back further, over the past 6 months, the S&P500 gained 500 points going into January, then fell by 700! **Very little forward progress has been made in the large-cap index over the past 6 months.** Currently the S&P500 is down 7% and was down 5% at quarter end. Tech stocks, small cap have fared worse, and ex-US stocks have slightly underperformed the US.

Most asset classes have struggled in 2022. Besides the stock market, bonds have been a steep downward trend, as market interest rates have climbed further and faster than any other time over the past 10 years. The Aggregate bond index has fallen almost 10% year to date. Rates are now back at the high levels last seen in 2018. On the other hand, **commodities have performed very well. Oil** has risen almost 40% over the past 6 months and 36% during the first quarter. **Gold** hit a high at $2078/oz in early March rising from $1830 on December 31, and at quarter end was up 6% year to date.

Fortunately, **oil stocks and gold mining companies have done very well**, gaining 37.6% and 20.3% respectively. Our overweight allocation to these areas enabled client portfolios to be very stable over the quarter, with the average portfolio gaining **a modest 1%.** Very conservative and very aggressive investors fared slightly worse.

EARNINGS

Earnings growth has been robust and is accelerating. Current sales, earnings, and free cash flow are at all-time highs. Full 2021 earnings are up more than 40% compared to 2019. Earnings for the first quarter of 2022 are expected to have grown **more than 20%** over the first quarter of 2021.

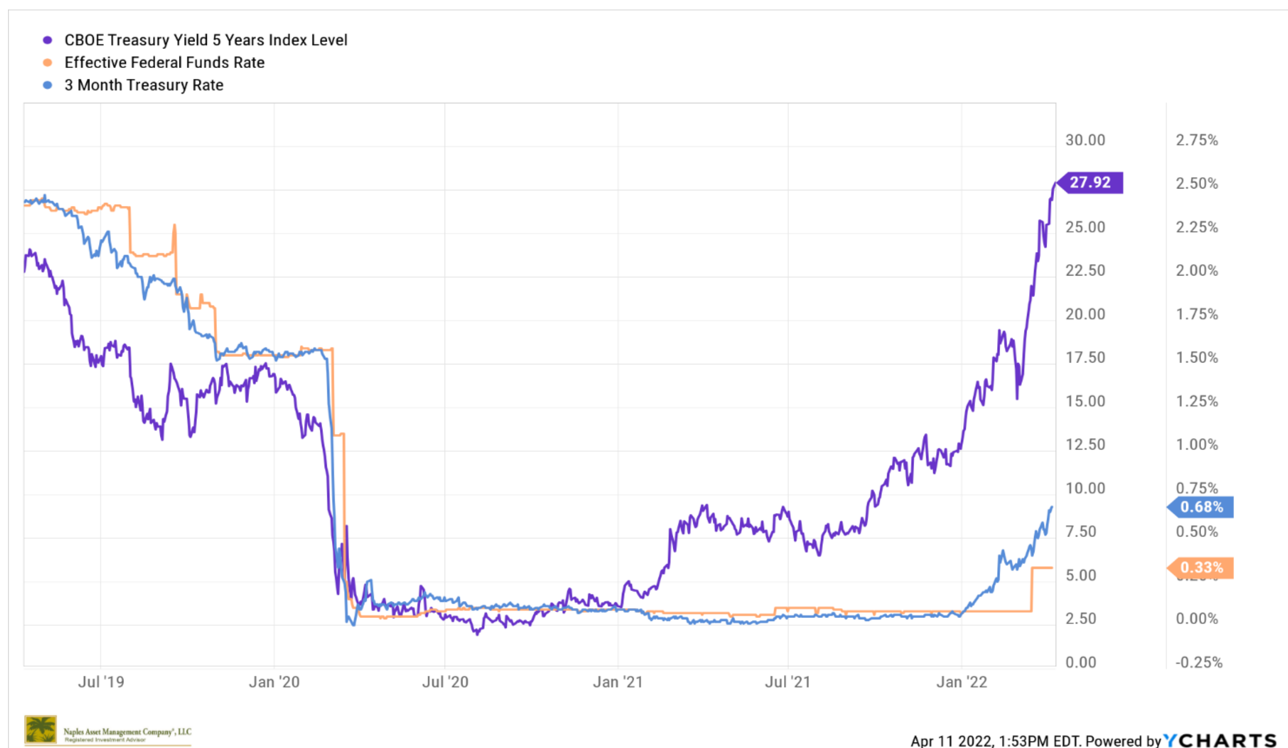
Corporations' leverage and ability to cover their interest payments have improved beyond 2019 levels. Despite calls for a coming recession (isn't one always on the way?) corporations have **never been in a stronger position.** Inflation gives companies the ability to raise prices while keeping most costs fixed. If revenues grow faster than the variable side of expenses (wages primarily, and they have) net income increases giving stock prices room to move upward.

Despite very strong corporate earnings, the weak stock market performance has more to do with the Russian invasion of Ukraine and its compounded impact upon US inflation. Six months ago, inflation was due to supply chain disruption and employee absenteeism stemming from Covid. Cargo vessels waiting to unload has **dropped by almost 50%** since November, and there are **4.5 million more people employed** since September 2021. We see stores a bit better stocked and almost all the jobs lost during Covid/2020 have been recovered. So, while those areas improved the invasion sent energy prices up very substantially and concerns that the conflict will continue to put upward pressure on oil prices, and thus inflation. Commodities tend to self-correct. If prices climb, more is produced, capping prices. If prices fall, less is produced, helping prices to recover. We are already seeing this in the energy sector**. US oil production increased in 2021 by almost 2%.** A release of the Strategic Petroleum Reserve should cause expectations of oil prices to decline in the near term. **From a high of $130/barrel in early March, oil has fallen to $94 recently. I expect oil to fall further into the mid-$80s over the coming months. Once the idea of falling energy prices takes hold, inflation expectations should fall as well, lowering interest rates**.

Energy consumption is *inelastic*, meaning that even as the price changes, total consumption does not change appreciably. The expectation of more or less oil coming to market, 3 to 6 months in the future is what causes prices to change. The likelihood of sanctions on Russia's energy exports, which have yet to occur drove the initial spike in prices. **Now that the SPR and other nations are increasing oil output should have a stabilizing effect on oil prices, which will also lead to a stabilizing effect on inflation expectations.**

Interest Rates and Inflation

Interest rates bottomed summer of 2020 during the 'lockdown' phase of the Covid pandemic. Rates were exceptionally low, disinflation was the concern, gas at the pump was under $2 (lower than pre-Oil Shocks of the early 70s). Only recently have rates climbed above late 2019 levels. A combination of supply chain disruptions, along with stimulus money to everyone; employed, unemployed and retired; and now rising commodity prices have caused inflation to come roaring back. For the past 10 years, inflation has rarely exceeded 3% and most often was less than 2%. Now we are seeing over 7% and are likely to continue to see over 4% for several years. **In the near term, if/when energy prices begin to recede, that, along with full employment and improving supply chains *could* allow for inflation rates to fall this summer**. This should give a reprieve to bond investors and allow the stock market to expand on the strength of earnings.

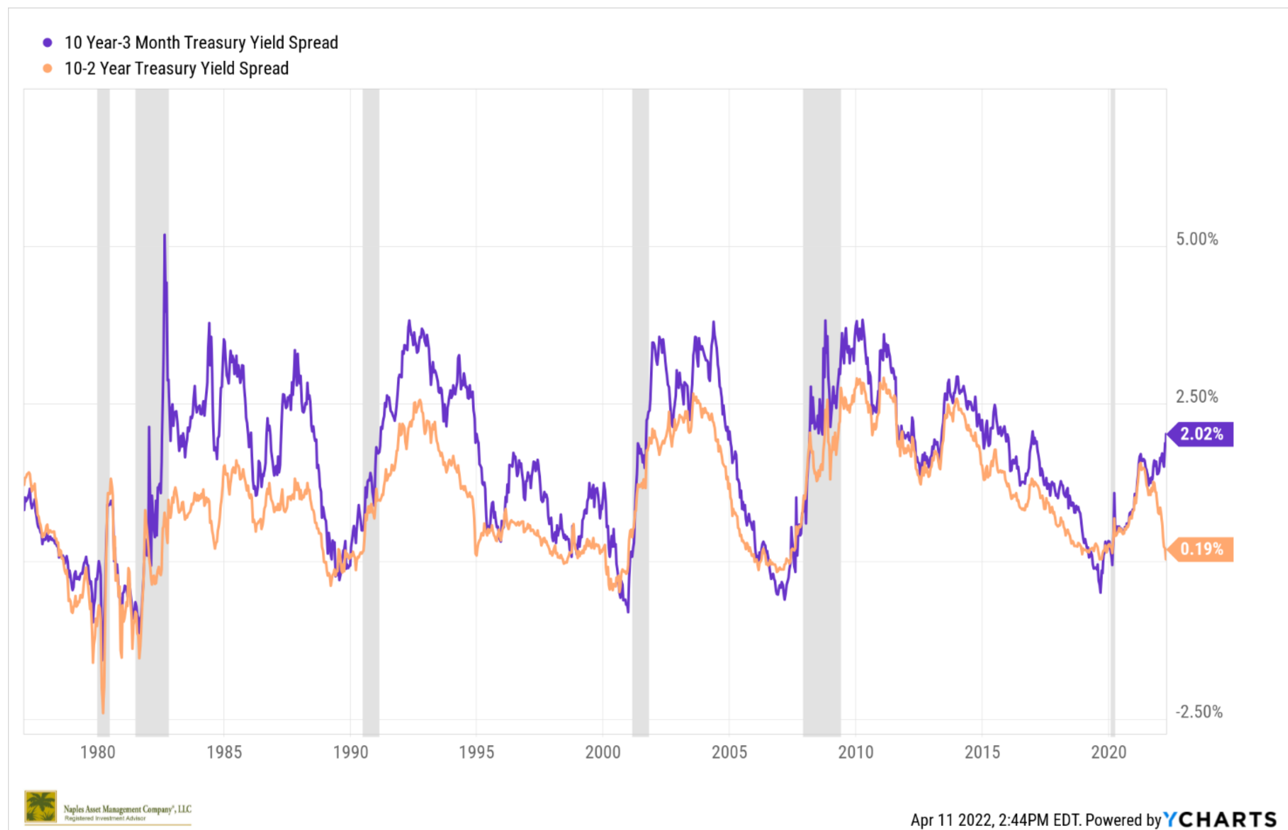


The risks are for continuation of the current environment. As China attempts to implement a Zero Covid policy, resulting in lockdowns are entire cities, supply chain risk is elevated. China is in a tough spot in that the more they lockdown, the more other countries will step in to replace China's output. China's economy is suffering mightily and will not recover as long as there are major lockdowns. In addition, should global oil supply actually fall, oil prices could climb again and bring expectations of further inflation**. While oil prices have fallen the past month, we have yet to see any kind of reaction in interest rates signaling a reduction in inflation expectations.**

In the chart above, the blue line is the 3-month Treasury bill rate, the orange is the effective Fed Funds rate (the rate the Federal Reserve controls). The Fed will raise rates to catch up to the 3-month rate. I expect only three more increases, totaling 1-1.5% for the remainder of the year. If market rates level off, while the Fed raises, this will impact the **Yield Curve**, having implications for the economy 1-2 **years** out.

Yield Curve

The ‘yield curve’ is back in the news again. The yield curve refers to rates/yields for Treasury securities for all maturities up to 30 years. A ‘normal’ curve will slope upward with longer term rates higher than shorter term rates. **Whenever a longer-term rate is lower than a shorter-term rate, the curve is said to *invert*.** Recently the 2-year yield has risen above the 10-year yield, creating an inversion. One can compare any shorter-term yield to a longer term and give an interpretation of what it means. Studies have shown that when the 2 and 10yr yields invert, a recession in the U.S. has occurred most of the time**. WHEN the recession occurs is more important** that saying one will occur, at some point. After all, there’s always a recession ‘on the way’. Academic studies though emphasize the difference or spread on the 3-month Treasury and the 10-year Treasury. This relationship has a much better record, in that the time frame telling us ‘when’ is much smaller. **The 2-10yr spread tells us its likely a recession in the US will occur 6 months to maybe 2 years from now.** On the other hand, the 3 month- 10yr spread is very positive and not indicating a recession at this time. The last time I wrote in depth about the yield curve was October 2019, when I stated that since the 3month-10yr spread had inverted, AND THEN uninverted and surpasses .32%, that a recession was imminent. This proved correct for the recession that was concurrent to the Covid pandemic. If you would like a coy of the October 2019 Observations and Outlook, I would be happy to give you a copy.



The difference between these two spreads is dramatic. I do not have an opinion on what this might mean. Although, if inflation expectation come down while the Fed raises rates, these two lines should close. It may just indicate how far the Fed has let market rates move before raising the Fed Funds rate.

The Economy

Economic growth, while positive continues to slow. When we began to come out of Covid, growth rates were extreme. Each successive quarter we have seen GDP growth come in slower. Inflation adjustments should continue to be a headwind to strong gains. **Currently, expectations for Q1 2022 US GDP growth are a mere 1.7%**. 2021 likely saw GDP grew at almost 6%. Forecasts for 2022 are hovering around 2.5% currently. However, stock prices and economic data do not necessarily run together. Stock prices can climb all the way right into the beginning of a recession, and they usually do.

Outlook

Given the robust earnings growth and outlook for a decline from high inflation rates to somewhat lower inflation rates, I am bullish on equity markets. While US markets have outpaced other developed countries and emerging markets, I expect **ex-US stocks to outperform** US. This is not a popular opinion and has yet to materialize. **Another unpopular opinion** currently is that bond prices will improve, as in, rates going down some. This too has yet to begin to work, but the metrics indicate **massively oversold bond prices**, so I am expecting better prices this quarter. For rates to continue any beginning of a decline, inflation expectations need to come down. Energy prices, oil that is, getting under $90 and staying there should open the door to this scenario. **Yield curve indicators work but take a long time to fruition**. The US economy will probably continue to grow, similar to recent years at a 2% real rate of growth for at least another year, maybe two. Keep an eye on the 3-month vs 10-yr Treasury spread for indications of a recession in the near term, otherwise I expect a bumpy but upward trend in stocks and the economy.

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