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A Good Walk Spoiled

Dear Clients and Friends: July 19, 2022

We borrow this letter's title from John Feinstein's 2014 bestselling book about golfers' lives on the PGA Tour. The book follows the experiences of players as they travel from course to course playing a familiar game in unfamiliar places. We find ourselves in a similar situation. The current state of markets and economies reminds us of playing a round of golf on a course we have never seen. The fairways, greens, bunkers, and other hazards all look familiar in isolation; however, the combination this time around is unique. We have experienced monetary and fiscal stimulus, inflation, interest rate changes, pandemics, and wars before, but never in this combination and all at once.

Since the Financial Crisis, global central banks have used easy money policies, globalization, free trade, and deflationary forces working together to keep inflation and interest rates low and economies growing. There were hiccups along the way, but tremendous progress was made. It even appeared they had managed to successfully maneuver through a global pandemic. It had been a good walk.

Recently, that good walk has turned into a rough ride. Many of these trends have reversed and central banks are now "in the rough" while managing the current environment. Focused on both their mandates and reputation, their eyes are squarely on the ball.

The sell-off in financial markets accelerated in the second quarter as concerns about inflation, interest rates, the Russia/Ukraine war, and the economy grew. The first five months of the year marked the worst start for the S&P 500 since 1970 – and the sixth worst back to 1928. U.S. large cap stocks were down -16.2% for the quarter, -20.0% year-to-date. Growth stocks were down -21.1% with value outperforming but still down -12.3%. Small cap and international markets performed similarly, down -17.3% and -14.3% respectively with both down -20% or more for the year.

There has been a lot of talk recently about commodities, and rightly so. The Goldman Sachs Commodity Index has bucked the down trend by posting a +35% gain in 2022. However, investing in commodities can be tricky. Even with this year's stellar performance and last year's 40% return, the index is still down almost -40% over the last 10 years. In fact, the index is down -20% from its peak in June.

The most disappointing asset class performance was fixed income. The Barclay's Aggregate Bond Index, representing the total U.S. investment grade bond market, lost -4.7% for the quarter. This pushed year-to-date losses to -10.3%. Bonds with longer dated maturities have done significantly worse. For example, a 20-year Treasury's total return was down -22% for the first half of the year.

We build client portfolios based on diversification. Bonds traditionally serve as a defensive and anticorrelated asset class. Stocks and bonds rarely post negative returns at the same time. Typically, when stocks go down, bonds go up, or at least hold their value. The culprit making things different this time is inflation.

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Inflation and Performance

We continue to experience levels of inflation not seen in 40 years. The June Consumer Price Index (CPI) just printed a new high of 9.1%. The reasons are well-known now: pent-up demand, disrupted supply chains, labor shortages, energy and food costs, etc. These problems were seen as temporary and supposed to dissipate throughout 2022 as the world normalized. Russia's invasion of Ukraine and ongoing COVID restrictions in China have instead amplified the issues.

To be sure, inflation is not a U.S. phenomenon. A glance abroad shows that inflation is running historically hot around the world. The one-year inflation gauge in the European Union was up 8.1% last month and grew even faster in the U.K, hitting 9.1%. Even Japan is enduring elevated inflation, bucking a decades-long trend of stagnant price growth.

Instead of being patient and waiting for the temporary inflation forces to ease, the Fed has chosen an aggressive path of interest rate hikes in hopes of choking off excess demand. By raising rates much faster than originally signaled, the Fed has surprised markets. Exceptionally low starting rates combined with the now expected speed for which the Fed will reach its rate target have caused asset prices to be hammered across the board. The new worry is that the Fed go too far.

"Duration" is a financial term that reflects an asset's price sensitivity to changes in interest rates. In layman's terms, duration measures how quickly you expect to realize a return on an investment. Shorter duration investments, like bonds that mature soon or stocks with high **current** earnings and dividends, are not as affected by interest rate changes because you expect to realize more of your return in the near future. On the other hand, longer duration investments, like bonds maturing well into the future or stocks with little current earnings but expected to earn a lot **later** are very influenced. As interest rates move up, assets whose current value are determined further in the future become worth less today. This helps explain why the faster growing, more speculative stocks, along with longer maturity bonds, have been under so much pressure lately.

Having anticipated the Fed's increases, we had positioned clients' bond portfolios in a way we thought would mitigate much of the damage from rising rates. We did this by owning very short-term bonds, bonds that had adjustable rates, and bonds we thought were uncorrelated and undervalued. Our strategy was successful; however, the speed and the extent of the interest rate moves made it difficult to avoid all losses.

Questions we're getting

"Will inflation moderate?" The simple and incomplete answer is, yes. Most economists believe the July CPI print should be the peak in inflation. Between year-over-year base effects, real evidence that supply chains are easing, a build up in inventories at large retailers like Walmart and Target, used car prices coming down, and commodity prices rolling over, the worst is probably close to being behind us. Market forces of increased supply meeting reduced demand should start having a real impact on the prices we see.

There is a more important question with an elusive answer. *"At what level will it settle?"* CPI is comprised of 20% food and energy, 20% core goods, and 60% services. Core goods inflation should see relief in the second half of the year for the reasons mentioned above. The Russia/Ukraine war continuing to drag on has kept upward pressure on food and energy prices. A break may be coming there as well. Locally, gas prices have fallen from

above $5 a gallon to slightly below $4, a trend poised to continue. Rents, the largest component of services, have been increasing at a 15% annual clip. They, too, are showing signs of slowing as higher mortgage rates start to cool an overheated housing market.

So, our expectations are that reports of record inflation will soon wane. It will almost certainly remain above the 2% we have become used to, but well below recent figures.

"Are we headed into recession?" We suspect the market's primary focus in the second half of 2022 will shift to concerns of recession, leapfrogging inflation to the top of the list. We believe the causes of most of today's inflation are beyond central banks' powers. While they can control interest rates, they cannot print oil, wheat, or semiconductors. However, the Fed has chosen to fight anyway. Attempts to slow the economy by curtailing demand have increased the probability of their pushing us into a recession.

The first quarter registered a rare negative GDP surprise; the second quarter has a chance of doing the same. If this does happen, we would have met the technical definition of a recession, two consecutive negative GDP quarters. However, we want to caution about too much concern. Most people immediately think of the Financial Crisis or 2000-2001 when they think of recession. Those recessions were outliers, not typical at all.

Today's economy is in a much different place than either of those two times. Recessions come about when segments of the economy build up too many excesses and too much capacity. The economic pain we feel is when those excesses get wrung out. Currently, there are very few excesses anywhere. Most of our problems stem from the lack of supply. So, any recession we experience will likely be mild and could actually result in a healthier economy overall and provide investors with more profitable opportunities in the future.

Outlook

The question for investors is *"How much inflation, how much tightening and how much of a slowdown is already priced in - and is it enough?"* We believe a good bit has been. Markets wrangling with these questions have been the root of this year's losses and volatility. The S&P 500's forward price-to-earnings ratio has fallen from 22.5 to below 16. The same measure for the MSCI World Index is at its lowest level since 2014. Both suggest equity valuations have come down considerably. Consumer sentiment is also the lowest on record. Additionally, most of the Fed's rate hike intentions have now been incorporated into asset prices. To get another aggressive sell-off in equities from here would require an even worse deterioration in the inflation, growth and earnings outlook than currently anticipated. At the very least, while caution may be warranted over the next quarter, we don't think it makes sense to be gloomier now than six months ago.

To finish our golf analogy…While we may find ourselves in a divot with greater uncertainty than usual, we are on the course and must be ready to finish the round.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Please stay safe and well.

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