Q1 2022: New Normal or Just a Point In Time?

By Peak Trust Company's Chief Investment Officer, Lisa Russell, CFA. May | 2022

HIGHLIGHTS

- Geopolitical conflicts, inflation pressures, and rapidly rising rates have all put pressure on both the equity and bond markets this quarter
- Will the Federal Reserve be able to get inflation under control by raising the Fed Funds rate without stifling economic growth?
- Value equities, Growth equities and other asset classes

Rising Inflation and Global Uncertainty; Rough Start for Equity and Bond Markets

This year has so far been tough sledding for both the equity and fixed income markets. The most surprising aspect of what occurred this quarter is not the –4.62% return of the S&P 500 but the Bloomberg Barclay Aggregate Bond (AGG) return of –5.93%. While negative quarterly returns for both the equity and bond markets are not an impossible event, it is still considered a rare occurrence, as these assets are typically negatively correlated, meaning they move in opposite directions. Extraordinary circumstances caused this to occur this quarter, which most likely will prove to be temporary in nature. Chatter surrounding the longstanding debate over whether the 60/40 portfolio is dead has been picking up. But if history proves to be correct, which it so often has in matters involving financial markets, the 60/40 portfolio is far from dead. Sometimes markets go through periods in which everything sells off. It is the inherent risk of owning financial assets.

Q1 2022 was plagued by a double whammy of rapidly rising inflation on one front and the Russian invasion of Ukraine on the other. Most client questions revolved around the latter, but inflation—and, more importantly, the Federal Reserve's response to it—is more of a concern to me. While what is happening right now in Ukraine is a human rights tragedy and a threat to regional stability, the impact on the equities markets has not been horrible. Unless some form of chemical or nuclear war takes place with more countries getting involved, the war's fallout in the equities market should remain limited. Commodity prices, however, have surged as a direct result of the conflict; this uptick has been partially aggravated by a high inflationary environment, which is often seen as well.

Fed Raising Rates; Unemployment Lowest in 50 Years

As expected, the Federal Reserve (Fed) did raise the Fed Funds rate by 0.25% (25 basis points) in March of 2022, which was the first increase since December of 2018. The reasons for this policy decision are twofold. First, this is one of the few levers the Fed can pull to combat inflation and slow down economic growth. Last quarter, only three 25 basis-point hikes were priced in the bond market for 2022. That number has now increased to 7 in total, with a 50 basis point-rate hike most likely as early as the next meeting. The Fed wants to reach a federal funds rate of 2.75% by 2023, meaning the hikes will most likely continue into 2023. Based on the Fed's recent hawkish commentary, it seems they will be very aggressive until inflation is under control. With the most recent unemployment rate of 3.6%, the Fed feels confident in raising interest rates aggressively as long as the number remains low. It remains to be seen if they will be able to manufacture a "soft landing," although there are growing concerns that this will not be possible. Rates have been low for such a long period of time that the rise in rates may not curb inflation without hurting growth more than anticipated. Inflation will, however, eventually come down. The likelihood of it remaining stubbornly high at 8.5% is slim. A more likely scenario is that inflation will remain above the Fed target of 2% but not as elevated as it may become once the Fed campaign really gets underway. Supply constraints have persisted longer than the Fed anticipated, which will help relieve inflationary pressure once they subside. Rental and wage inflation are lagging indicators and, most likely, have not peaked. This is a concern that bears watching.

There are positives to the current environment. With higher rates comes higher savings rates, which will benefit everyone. The gain in household net worth is growing exponentially, which supports consumer spending. The increase in housing prices and stock markets have been the main contributor to this. As evidenced by the low unemployment rate, the labor market is the tightest we have seen in 50 years. Business spending is looking good as investing in technology to help offset their hiring struggles continues to climb. For now, the bull market is currently intact but will have continued bouts of volatility.

Value Beating Growth in a Rising Rate Environment

I have been talking about my deep conviction that the future potential of value equities will outperform growth equities for over a year now, which definitely came to fruition this quarter. Large-Cap growth stocks were relentlessly punished as long-duration assets sold off with the rapid rise in rates. Small-Cap growth stocks were punished even more, which continued the trend we saw last year. These were punished for having extremely lofty future valuation expectations. As rates rise, the net present value of growth stocks in general will decline. Value stocks (both large and small) tend to do better in a rising rate environment as the financial sector is much more sensitive to higher interest rates, which make up a large sector of the indices, with the caveat that it is most beneficial to have a steep yield curve. The yield curve briefly inverted between the 2- and 10-year treasuries earlier this year, which has always occurred in every recession. This will spook financials. This trend has recently reversed and will be watched closely. In addition to high rates, the energy sector has benefited from rising commodity prices, utilities have benefited from their defensive nature, and consumer staples continue to outperform. Not all value is treated equally. Companies with high debt levels, or Zombie companies, will likely be punished with higher rates. Quality in value stocks is important and buying companies just because of a high yield is not prudent, as they can be subject to substantial price depreciation.

Energy and Utilities Only Positive Returners

The S&P 500 was down 4.62%, but, as usual, it is worth looking under the hood to see what the key drivers of the returns were. As discussed above, Value (S&P 500 Pure Value) reversed course in a large way this quarter, returning 6.39% versus Growth (S&P 500 Pure Growth), which returned –12.84%. The energy and utilities sectors were the only positive returners, while telecommunications, consumer discretionary and information technology were the biggest laggards. Small-cap stocks (Russell 2000) once again underperformed the S&P 500 with a return of –7.53%, heavily weighed down by the growth portion of the index. The Russell 2000 Value index fell 2.4%, while its style counterpart, the Russell 2000 Growth Index, was down 12.6%. We continue to see a stubbornly high dollar, which continues to plague international equity returns. This, coupled with geopolitical concerns, has put unsurprising downward pressure on international markets. They (MSCI EAFE) returned –6.77%, while Emerging Markets were down by approximately 7%, although they were partially buoyed by high commodity prices. Overall, these equity returns were not too terrible considering the quarter's global turmoil.

Rough Quarter for Bonds; Municipal Bonds Hit Hard

It was an exceptionally rough quarter for the bond market (Barclays AGG), returning –5.93%. The Barclays Municipal Bond Index actually fared worse with a –6.23% return, creating one of the worst quarterly returns for municipal bonds in history. This was mostly due to the rapid rises in rates and the pronounced tax-loss harvesting that was available in the fixed income markets this year. The 20-year treasury market was down over 10%! While rising rates are the enemy of long-duration bonds, it is important to remember that we do want to keep some duration in portfolios as it is what adds protection during a recession. Rising rates are temporarily painful but very healthy for the bond markets in the long term. It was the fast and furious nature of interest rates going up this quarter that took most people by surprise.

Summary: Is the Equity Bull Market Sustainable?

Q1 2022 has undoubtedly put a question mark on the sustainability of the equity bull market. One thing to remember is that we are in the late innings of this business cycle. Estimates of economists' predictions for a recession are anywhere from late 2023 to the end of 2024. Most are predicting a shallow one as long as there is not some sort of Black Swan event. However, even without a Black Swan event, return projections for the next decade for a 60/40 portfolio are around 5%. This is a far cry from the approximate 11% return investors have achieved in this last decade. It is important to keep recent expectation bias in check, as one only has to go back to the lost decade of the 2000s, during which a 60/40 portfolio returned 2.3%. We have added a diversified basket of commodities, gold, floating-rate loans, and inflation-protected bonds to accounts in which they are appropriate. Not only do these asset classes benefit from rising inflation, but they also add important diversification benefits to portfolios when traditional asset classes like stocks and bonds act similarly. The Peak team is always evaluating portfolios to seek out ways to combat current market conditions that make sense.

About Lisa

Lisa Russell started with Peak Trust Company in 2003 and currently serves as Chief Investment Officer. Lisa brings over 25 years of investment experience to the Peak team. She specializes in designing unique investment programs for high-net-worth clients and trust accounts. She is highly attuned to the tax consequences of investment actions.

Lisa holds a Master of Business Administration in Finance from Emory University and a Bachelor of Science in Business Administration from the University of Southern California. Lisa holds the designation of Chartered Financial Analyst (CFA), and is a member of the CFA Institute and the CFA Society of Seattle.

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