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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

A World Turned Upside Down

With war in Europe, annualized inflation of over 8%, unprecedented economic sanctions, and supply chain disruptions, the first three months of the year truly felt like a world turned upside down. Many of the foundational beliefs we have relied on in recent decades have been challenged in recent months. Russia's invasion of Ukraine shattered 77 years of peace in Europe and galvanized NATO allies. The United States' strategic rivalry with Russia went from theory to reality overnight. Following almost a decade of ultra-easy monetary policies, recent inflation data precipitated action from global central banks, which have begun the process of raising benchmark interest rates while curtailing open market bond purchases. Central bank tightening was reflected in broader interest rates, and the yield on the two-year U.S. Treasury Note rose from 0.73% to 2.28% during the first quarter.

The increase in interest rates, along with surging inflation and the war in Ukraine, also led to a sell-off in most investment assets during the quarter. The broad stock market, as measured by the S&P 500, had a total return of -4.6%. In another example of "the world turned upside down," bonds underperformed stocks during the quarter, and the Bloomberg Intermediate Credit Index had a total return of -6.9%. Growth stocks, which are more directly impacted by higher interest rates, underperformed the broad indices, and the S&P Index of growth stocks had a return of -8.6%.

Although only three months have passed since the start of the year, the first quarter felt like an eternity. While it is not possible to gauge the duration of the developments in this quarter, the impact of the war in Ukraine, higher inflation, and tightening monetary policy are likely to be far-reaching, extending well into the future.

The Fever May Be Breaking

Over the last year, we have regularly written about areas of speculative excess that are of concern to us. These have included crypto currencies, special purpose acquisition companies (SPACs), "meme" stocks, and elevated valuations for "hyper growth" stocks. As we wrote last quarter, many of these speculative sectors have undergone meaningful corrections. It would appear that a good portion of the speculative fever has broken. However, valuations for many of these categories remain elevated compared to historical standards.

More recently, another kind of fever has taken center stage in the minds of most citizens: inflationary fever. Prices have risen across the board, and the recent increase in energy prices has only exacerbated the trend; since the start of the year, spot prices for U.S. natural gas and crude oil have risen 105% and 41%, respectively. Inflation is a particularly vexing phenomenon to analyze because its causes can be manifold. We have written about the extraordinary monetary and fiscal policies of recent years, and these have likely contributed measurably to current levels of inflation. Also, the COVID-19 pandemic disrupted supply chains, which led to supply shortages and backlogs of many goods. The collapse of energy prices in 2020 had the effect of curtailing exploration and production spending in the oil and gas industry, which, along with demand recovery, led to the current spike in energy prices. Following a post-pandemic snapback, labor markets have remained tight, and there is a shortage of workers in many industries. The labor shortage has many root causes, including aging populations, skills shortages in certain subsectors, and the lingering impact of policies and programs established during the pandemic. The current inflationary environment in the United States has taken hold against a backdrop of combined monetary and fiscal stimulus estimated at over $5.5 trillion during the years 2020–2021 (equivalent to 26% of the 2021 GDP). This stimulus occurred at a time when many sectors of the economy were operating well below capacity. Stated simply, extraordinary monetary and fiscal actions collided head on with an economy that was operating below its full potential.

As is the case with making guesses about the weather, stock market, or results of the upcoming baseball season, experience has taught us that predictions are rarely worth more than the paper on which they are written. With that caveat, we would like to share a few observations about the current inflationary environment. Starting with the demand side, central banks in the United States, Europe, and Japan have begun a cycle of tightening that, as noted above, has already had a meaningful impact on benchmark interest rates. Also, the Federal Reserve has begun the process of "tapering" open market purchases of securities; monthly open market purchases are expected to decline from over $150 billion in 2021 to less than $15 billion by mid-year 2022. In terms of fiscal policy, it is important to note that the $1.9 trillion COVID-19 relief package, which was approved in early 2021, will have diminishing effects as we move through the year ahead. The impact of lower stimulus levels, along with the reduced purchasing power due to higher prices, is having an impact on consumer's disposable income, which, according to Piper Sandler research, is expected to flatten year-over-year in 2022. Consumer sentiment, as measured by the University of Michigan, recently reached its lowest reading in over two years.

On the supply side of the economy, it is more difficult to measure the response to increases in demand; the myriad of industries and individual companies cannot be easily analyzed in a timely fashion. However, there are a few indicators we are watching that may prove helpful in thinking about the direction of inflation. According to Kimberlite Research, in response to higher energy prices, the domestic rig count is expected to rise by over 20% in 2022. Furthermore, the domestic production of oil and gas has already begun to recover and is expected to reach 12 million barrels per day later this year, according to the Energy Information Administration. Retail inventories, adjusted for inflation, rose 5% during the first quarter of 2022, according to Piper Sandler research; this growth is well above the trendline. As inventories have been replenished, the demand for trucking services has declined. FreightWaves, which measures U.S. trucking volumes, reports that, on average, demand for trucking services has declined more than 30% since the start of 2022. Used car prices, which surged over 50% from 2020–2021, have also begun to decline, and the Manheim car auction service reports that used car prices declined 5% during the first two months of the year.

Another part of the economy that has seen strong inflation is the housing sector. Housing prices have surged in recent years, and the Case-Shiller National Index of home prices has risen by over 30%

since the start of 2020. Inventories in many markets are tight, with little new supply available. Like other parts of the economy, the law of supply and demand is at work. Tighter monetary policies have had a significant impact on mortgage rates, and the average rate for a 30-year fixed-rate mortgage has risen from 3.2% in 2020 to 5% in the spring of 2022. The combination of higher prices and more expensive financing has reduced affordability; the National Association of Realtors Index of Housing Affordability recently declined to its lowest level since 2010. Concurrently, new mortgage applications and pending home sales have also declined since the start of the year.

We do not know the future course of inflation. However, the recent developments in monetary and fiscal policy, combined with the supply/demand dynamics discussed above, offer a contrast to the conditions of 2019–2021.

A Very Mixed Picture

An overriding consideration in evaluating the current investment setting is the recognition of how different the current circumstances are from how they were in the recent past. Global frictions—economic, diplomatic and military—are taking a very real human and economic toll. Inflation, which has been quiescent for decades, is now a fact of day-to-day life with a clear impact on living standards. In most regions of the world, monetary policies have reversed almost a decade of "easy money," and we are still in the early stages of this process.

Our positioning of client portfolios has remained consistent in recent months. Owing to the relatively unattractive risk/reward of fixed income, our balanced portfolios continue to be underweighted in bonds. With an emphasis on quality, the average maturity of our bond holdings remains below the benchmark. Within equities, we continue to emphasize companies with resilient revenue characteristics, strong free cash flows, and attractive dividend yields. We are well represented in the consumer staple and healthcare sectors, and we have recently added to our existing holdings within the aerospace and defense sectors. We also retain a position in the gold iShares as a hedge against inflation and geo-political risks.

As always, we welcome your comments and questions.