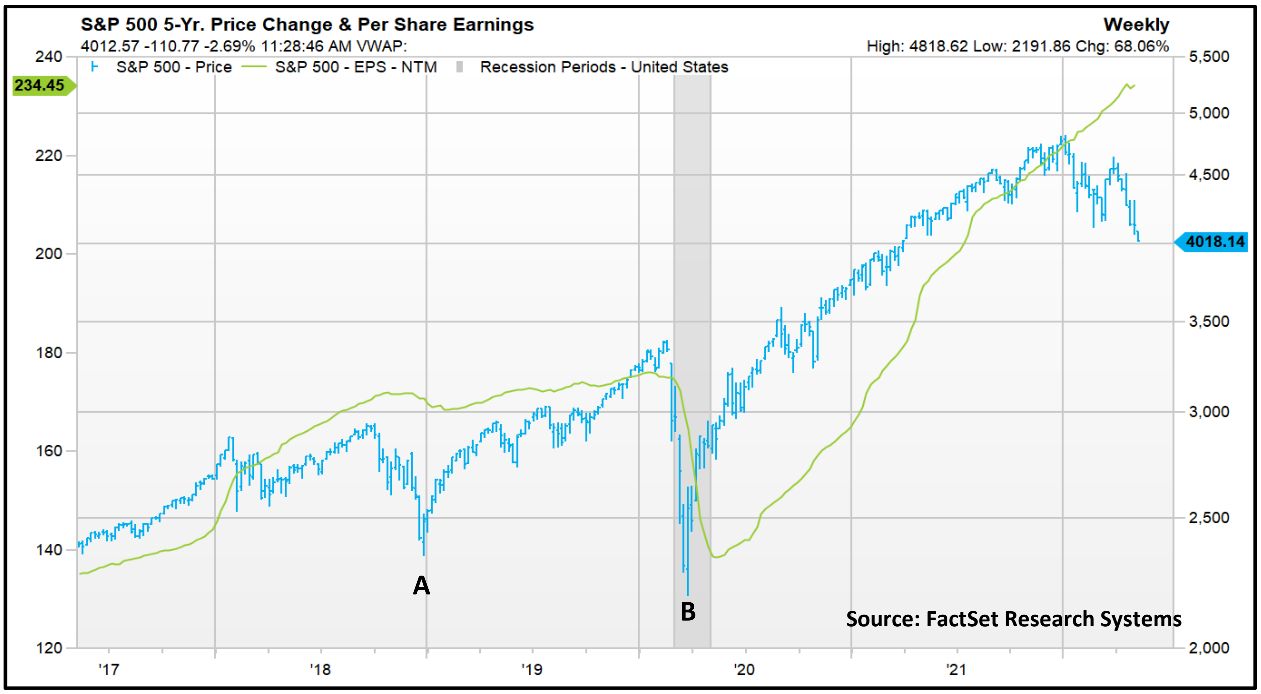
Volatility & Uncertainty

Discipline, The Process and Time Frame Are Critical

Concerns regarding tighter global monetary policy (raising interest rates), a rapid increase in inflation, and the worry that this combination of events will lead to a U.S. recession are the factors responsible for the S&P 500's worst yearly start since the end of World War II[i]. Several bond indexes (the 20+ year U.S. Treasury[ii]) have fared even worse.

Investors and consumers are concerned and sentiment indicators for both groups are near historic lows. Why? Inflation erodes consumer purchasing e.g., a dollar purchases less today than it did "yesterday" and lessens future demand. Less demand limits production, and slows corporate revenue, earnings, and cash flow growth. Lastly, higher bond yields become greater competition for long-term stock returns. The combination of these occurrences often leads to recession.

Any decline in the stock market (S&P 500 is a proxy) is disconcerting. However, the chart below helps to put the recent decline, as well as several previous declines into a longer-term perspective.



The recent decline is meaningful, but the late 2018 and early 2020 (A & B) declines were as dramatic[iii]. The reasons for the 2018 decline were like today's. Investors were concerned about Federal Reserve tightening leading to an economic slowdown, the resultant decline in corporate earnings growth, global trade policy, and a partial government shutdown. The 2020 decline was the result of the Covid-19 pandemic and its unknown effect on the future.

Despite the challenging periods in 2018 and 2020 the S&P 500 achieved a compound annual price-only return of 10.7%[iv], during the five-year period shown. Over a longer 10-year period that also ended on May 9th, 2022, and includes a meaningful decline in 2015, the 10-year compound annual return of the S&P 500 was 11.0%[v].

The future is always uncertain and past performance is no guarantee of future results but putting capital to work at times like this has historically been the correct decision. This is a particularly relevant strategy now since portfolio equity positions were reduced multiple times during the past twelve months when equity prices and valuations were higher.

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A Tight-Rope Walk

The Federal Reserve's dual mission is to maintain price stability and maximum sustainable employment[vi]. That's a challenging job during times of rising inflation. Inflation is slowed when interest rates are increased to curtail demand. However, when demand (and then production) slows, the need for workers lessens and unemployment rises.

Covid caused demand for "everything" (except sanitizer) to collapse because people were "shuttered," jobs eliminated, and millions laid off. When the impact of Covid declined, the government spurred the economy by authorizing stimulus checks and incremental unemployment benefits[vii] to reaccelerate demand and increase employment. The result, a great deal of consumer cash was used to satisfy pent-up demand for goods, but at a time when a fractured supply-chain could not deliver sufficient products fast enough to meet that demand. The recipe for inflation: too much demand and not enough supply = higher prices.

Our Thoughts

Clearly there are factors that heighten our concern. The Russian/Ukraine conflict that effects lives, and impacts the global economy, the highest rate of U.S. inflation in forty years[viii], the ambiguity of future Federal Reserve actions, and a supply-chain that limits production and supply. In addition, Consumer and Investor Confidence are at low levels[ix], mortgage rates have spiked, and oil prices remain stubbornly high.

On the other hand, the U.S. economy is strong. There have been twelve consecutive months of 400,000 new jobs each month, the unemployment rate is at a 50-year low[x], corporate (S&P 500) earnings are expected to increase 10%[xi] this year, consumers balance sheets are sound, and wages are rising. In addition, there is evidence that while inflation will remain at higher than optimal levels near-term, those levels are decelerating, and supply-chain disruptions are moderating[xii].

The negative performance of the financial markets in 2022 reflect expectations of the worst outcomes and a challenging future. We do not expect that extreme and believe there is a likelihood of a "softer landing." A "soft landing" would occur if The Fed is able to increase interest rates at a pace sufficient to slow demand and inflation, but not restrictive enough to cause a recession. A challenging job that we monitor closely.

As always, our objective is to preserve and grow client's capital and to do so in a tax efficient manner with as little volatility as possible. We will monitor each of the factors that are impacting the markets, the economy, and the geopolitical environment and will keep you appraised of our evaluations and strategy.

We will also continue to be opportunistic managing assets and strive to preserve capital, but also remain focused on longer-term objectives. Just as we previously modified the structure of the bond portion of portfolios by shortening maturities to potentially reduce volatility and benefit from rising interest rates, we have modestly added to equity holdings as stock valuations have declined this year. We will continue to be opportunistic and add to equities as the market exhibits weakness, volatility, and opportunity. As the price earnings ratio of the equity market (S&P 500 proxy) has declined to pre-covid and even late 2016 levels[xiii], the timing seems appropriate.

We highly value our relationship with you, appreciate your continued confidence and look forward to meeting with you in the near term. Please let us know if we can be of any assistance in the interim.

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There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio.

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[i] Barron's magazine 5/9/22
[ii] Barron's magazine 5/9/22
[iii] FactSet Research Systems
[iv] FactSet Research Systems
[v] FactSet Research Systems
[vi] United States Federal Reserve
[vii] CARES Act, 3/27/20; Pandemic Unemployment Assistance Program 12/27/2020
[viii] U.S. Bureau of Labor Statistics 4/18/22
[ix] University of Michigan Consumer Confidence Survey; Bloomberg Consumer Survey 5/4/22
[x] U. S. Bureau of Labor Statistics 4/30/22
[xi] Yardeni Research, Inc. 5/9/22
[xii] Bespoke Investment Group 5/6/22
[xiii] FactSet Research Systems