Market Commentary – April 10, 2022

The first quarter of 2022 was another chapter from “Mr. Toad’s Wild Ride.” We saw wide swings in stocks and bonds, along with the continuation of a strong real estate market. Let’s look at some of the reasons for the volatility and see what lies ahead for the next few months.

Stock volatility was initially the result of continued reassessment by the FED of interest rates and inflation, and when and how much interest rates would need to move up to slow inflation. The inflation rate on an annual basis is about 8%. Interest rates, although having moved up slightly, have not been officially adjusted by the FED. The increases have been more of an adjustment by lenders in anticipation of the FED’s action. Consumer loans and home mortgage rates began to increase quickly. The 2% mortgage rates are probably a thing of the past for the foreseeable future. The average 30-year mortgage rate is about 4.7% now. Bond prices, which move in the opposite direction of interest rates, have declined. Short term bonds of 5 years or less were less impacted than long term bonds. The Morningstar U.S. 10-year Treasury Index was down 5.9% from its peak in August 2020.

In February, the stock and bond markets seemed to be adjusting to anticipated interest rate increases and showed some stability. Then Russia invaded Ukraine and a new global threat to stability caused big swings in the financial markets again. Stocks fell into correction territory, a decline of 10% from their most recent highs. Since the invasion, some progress has been made on negotiating a peaceful resolution, but a large amount of risk remains in those talks and the market impact is still pending.

By the end of the quarter, the U.S. financial markets had begun a strong recovery. Stocks in the technology sector had been most affected by the two situations above, and they continue to advance, but we can expect their gains to be choppy throughout the short and midterm. The obvious intentions of the FED to increase rates had been largely factored into stock prices and bonds had revalued as well.

The response of the FED to increase interest rates to slow inflation is a normal event. The FED uses higher interest rates to slow down increasing prices and to slow down purchases and reduce demand. This is normal policy initiative and can be observed many times in the past. What is not normal, are the market disruptions that occur when the FED is slow to react to rising inflation or we have a Russian invasion that challenges U.S. policy and causes global disruptions in supply chains and trade agreements. As an example, when the current administration canceled pipeline construction and practically ended fracture drilling, the U.S. became dependent on importing oil and LPG (liquefied petroleum gas) from several countries, including Russia. This situation existed prior to Russia’s invasion of Ukraine. Once the invasion took place, the U.S. and several other countries responded by cancelling their purchases of Russian oil and gas. These events led to a reduced supply of resources to the U.S. market, which was strongly recovering from the pandemic. The result of this shortage led to rapidly increasing gasoline prices, higher prices for everything manufactured using petroleum products, and higher freight costs for all shipping venues. While we cannot look ahead to accurately forecast the invasion, we have once again experienced how vulnerable we are to foreign suppliers and manufacturers in an emergency. During the pandemic, it was masks and ventilators. We still are dependent on foreign sources for vital medicines and have exported much of our technology to China and other countries to save money. At some point, paying more for these to have secure access will be more valuable than just saving money on them. The FED shares some blame in our situation. Being overcautious to the financial market’s response to higher rates has caused the FED to fall way behind in timing the rate increases. This has been true for several years. The FED will now have to rapidly catch up the increases to effectively deter serious inflation damage. The CPI (Consumer Price Index) numbers come out tomorrow and it will be interesting to see the impact they have on the FED reaction. These numbers will not account for the recent price spike in oil prices. So, the real numbers will be lower than our current reality.

The result of "catching up fast" to inflation in our current situation will be painful for some of us. The housing market has been of fire for several years due to the very low mortgage rates. We should expect 30-year mortgage rates of 6% or higher by year end.

Wage increases have been implemented in many sectors recently and we are now seeing "wage-based inflation." Some examples we all recognize are Starbucks-$15/hr., Costco-$17/hr., McDonalds-$13-$20/hr., Taco Bell $15 per hour. Wage inflation simply means that wages are a cost factor for an employer, and that higher labor costs lead to higher consumer prices for the product or services the employer offers to the consumer. Most of these examples are not technical positions or positions that require skilled training or education. However, these examples show how the cost of labor directly impacts each of the products they sell. So, higher wages bring higher, inflated costs in several sectors of the economy. The result of this is a cycle of higher wages bring higher prices bring higher wages and on and on. The FED has advocated for higher wages and in the past 12 months we have seen wages increase 5.6%. That is a big number, compared to an average of 3% before the pandemic. We still have 11 million job openings in the U.S. and employees are in a position of strength to continue asking for higher wages. They also have the incentive to do so because inflation is higher than wage gains. More fuel for wage-based inflation.

The notes from the March FED meeting were released on April 6th, laying out the plan for reducing their balance sheet (amount of bonds they have bought). Today, they stated they would be allowing about 1% of these bonds to mature, which reduces the balance sheet. Chairman Powell stated, "over a period of about three months or modestly longer." This seems like too little too late, given the current interest rate market and the inflation level. I believe it will be difficult to contain inflation at this point without more aggressive action by the FED. Balancing the FED balance sheet is not an exact science. The track record for doing this is not that good. It is more of an experiment that will take some tweaking. They tried it in 2017-2019 and it didn't work out well. They quietly started reversing their position and adding more bonds to their balance sheet because of "strains on the money market." In October of 2019 they added another $200 Billion of bonds to their balance sheet. One analyst referred to the QE (Quantitative Easing policy) as "Hotel California", meaning you could check in, but you could never leave. This has not only been the situation for our FED, but for many Central Banks across the world. It all revolves around more control and intervention by Central Banks over the financial markets.

With all the focus on rising costs and the FED policy, it is also necessary to discuss some other issues that we face. The administration is on record with major infrastructure rebuilding initiatives, additional stimulus spending and tax reform. The White House released its 10-year budget proposal on March 28. It and the projections it contains are worth noting.

Spending; Tax receipts of $4.64 Trillion and outlays of $5.79 Trillion per year. $14.4 Trillion deficit spending in 2032.

Social Security outlay increases of 79%, Medicare outlays of 118% and interest cost increase of 213%.

National debt will increase to $44.8 Trillion, up from $30.3 Trillion 3/30/2022.

While this seems unbelievable to most of us, this is where the path we are on leads. Although we are individually limited in what we can do, we must as a collective call for responsible leadership and pray that our leaders will represent us as we would want to be represented. The "Golden Rule" of politics. While preparing for this scenario over the next decade is challenging, we are not required to navigate this without some tools. The current situation is not unique, nor is it impossible. With the challenges we face, there will be opportunities we will be able to take advantage of. History has demonstrated this many times and this is no different.

We currently have a very strong economy, despite almost everything discussed today, and the economy is growing and continuing to recover. Our unemployment rate is currently just 3.6% nationally, just a tenth percentage point above pre-pandemic levels, which were at a 50-year low. And while unemployment is near record levels, job growth is almost as strong as it was last year during the "back to work" phase following the pandemic.

Market opportunities have opened because of the moves in energy production and trade agreements. Energy was the best performing sector this quarter, up over 35%. Value stocks (dividend paying stocks) had a positive return of over 2.5% although the broader markets declined. Our trade balance has improved this quarter with exports and imports more balanced than one-sided, meaning we are making and shipping more goods out of the country. New opportunities in manufacturing have become a reality with several major manufacturers committing to new U.S. based plants. These all represent opportunities for us.

We have been proactive in addressing the changing marketplace by adjusting our portfolios to take advantage of these opportunities and reduce volatility. We will continue to monitor the markets and those decisions that affect it. Thank you for the trust you have placed in us. Your trust is always our greatest asset. If your financial situation has changed or if you would like to reassess your risk tolerance, please let us know. We look forward to the challenges of 2022 and visiting with you.

If your financial situation has changed, or if you would like to reassess your risk tolerance, please contact us and we will be happy to review your objectives and risk tolerance. Also, if you have not done so already, please contact our office to set-up your client portal. Thank you for your continued trust. Your trust is our most valuable asset.

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2) You change your "mailing" or "physical" address.
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Friday, April 15, 2022 (Good Friday)

Monday, May 30, 2022 (Memorial Day)

Monday, July 4, 2022 (Independence Day)

Monday, September 5, 2022 (Labor Day)

OFFICE HOURS

Please take note of our office hours:

Monday – Friday

8:00 a.m. – 4:30 p.m.

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