Q1

2022

Market Commentary

Higher inflation and rising interest rates have created a dismal start to the year.

1Q 2022 Market Commentary

LEEWARD FINANCIAL PARTNERS

It’s hard to put lipstick on a pig

Markets were off sharply to start the year. Both equities and fixed income saw pressure from higher inflation, the economic implications of the Russian invasion of Ukraine, and the need for a faster pace of interest rate hikes. Through April, the S&P 500 Index is down -13.3%, the Nasdaq Index is down -21.2%, and the Barclay's Aggregate Bond Index is down -9.0%, marking one of the weakest starts in the post-WWII era.

In January, the S&P 500 Index lost -5.3%, the most significant monthly pullback since the pandemic. Weakness was driven by rising inflation numbers (the Consumer Price Index (CPI) up 7.5% in January) and by the Federal Reserve Bank (Fed) formally acknowledging the need to raise interest rates aggressively. February brought little relief (down -3.1%%) as inflation marched higher, and Russia’s invasion of Ukraine rattled investors. March was better, up 3.6%. Investors absorbed the Fed’s March rate hike of .25%, the first increase since 2018, and the Russia/Ukraine war shock wore off. Treasury rates moved substantially higher throughout the quarter, with 10yr notes moving up almost a 1%, from 1.5% at the start of the year to 2.4% by March.

Negative trends continued in April. The S&P 500 Index and Nasdaq Index were down sequentially each week in April. CPI continued to increase, up 8.5%, and 10yr Treasury notes continued to move higher, closing at 2.9%. Fed Chair Powell made comments in a speech at the April International Monetary Fund meeting where he confirmed that a .50% rate hike in the U.S. was "on the table" in May. Markets have been pricing high odds for a .50% hike for some time now, but Powell's comments cemented them.

Despite the dismal start to the year, the U.S. economy is stronger than market returns indicate. January’s Omicron wave proved to be more of a blip than a resurgence. Covid hospitalizations moved lower throughout the first quarter and are now at their lowest levels since the start of the pandemic. Consumer confidence is high, supported by solid employment growth and wage increases. Employment markets remain tight. In March, there were 1.7 job openings for every unemployed worker, the lowest level ever recorded by the U.S. Bureau of Labor. New orders and production continue to grow in manufacturing as demand remains strong. These factors suggest the favorable operating environment for companies and workers should continue, helping the economy absorb future rate hikes.

Inflation at generational highs

The Consumer Price Index (CPI) rose 7.9% from February 2021 to February 2022, following a 12-month increase of 7.5% in January 2022. Food prices increased 7.9%, the largest advance since July 1981. Energy prices rose 25.6% from February 2021 to February 2022, while prices for all items less food and energy rose 6.4 percent. Fortunately, based on a variety of data we monitor, we believe inflation is close to peaking and will soon begin to ease. Unfortunately, inflation won't disappear. Recent developments in Europe, ongoing supply constraints, strong demand, and labor shortages likely mean inflation stays elevated for longer. Year-end inflation estimates are currently at 5.5%, much higher than the Fed's long-term goal of "about 2%."

The surge in energy costs.

When Vladimir Putin launched his invasion of Ukraine on February 24th, the impact on the U.S. economy appeared negligible. Russia is the United States' 23rd largest trading partner, accounting for less than 1% of total trade. Since then, there has been a reassessment due to higher sustained energy prices. The United States and its allies have responded to Putin's aggression with unprecedented economic sanctions on Russia. Oil prices spiked to over $130 per barrel before settling close to $100/bbl. As the war continues into its third month, it is apparent energy prices will remain elevated for the foreseeable future and may indirectly impact economic activity.

In economic terms, the Russian invasion of Ukraine represents a negative supply shock, an event that interrupts production and raises prices. Assuming the conflict doesn't spread outside Ukraine, the supply shock likely won't be big enough to derail the U.S. economy. The complicating factor, and the main danger, is that the Ukraine supply shock comes on top of global supply chain shutdowns from the pandemic and against a tightening Fed policy. In practical terms, the Russian invasion will accelerate pricing pressure when inflation is already elevated.

Greenlight to raise rates

We have officially entered a monetary tightening cycle. In March, the Fed raised the Federal Funds Rate by .25%, marking the first increase since 2018. Markets rallied on the news, comforted by Chairman Powell's reiteration that inflation is "much too high" and that the central bank will take necessary steps to maintain economic stability. The Fed also raised its inflation estimate from 2.7% to 4.3% for 2022 and noted the forecast through 2024 is materially higher than previous projections.

While markets traded higher on the announcement of the Fed's rate hike, investors soon began to worry that a potential over-tightening of financial conditions could accidentally push the economy into a recession. This risk, while low today, is increasing because the Fed is raising rates aggressively and removing liquidity from the market. Essentially, economic tailwinds (easy access to capital, higher liquidity) are being replaced

by headwinds (higher borrowing costs, lower liquidity).

How much and how fast should the Fed move? Lower inflation will require a series of deliberate, organized hikes throughout the year, including multiple .50% rate hikes in the near term. The U.S. economy should be able to absorb these rate increases due to the tight labor market and strong household balance sheets. The improvement in household balance sheets, particularly in the middle class, means lower debt service and greater resilience to monetary tightening. The situation will become more precarious if confidence in the Fed's ability to control inflation wanes and Federal Reserve Bank loses credibility. We believe the Fed will focus on raising rates quickly in the near term to provide flexibility to its policy later in the year.

Absorbing higher interest rates

We currently believe inflation should peak this summer and then subside throughout the year, although inflation is unlikely to return to historical levels in the near term. The Ukraine war will keep commodity prices higher for longer and supply chains have been hurt by manufacturing shutdowns in China. Once inflation ebbs, our focus will be on the U.S. economy's ability to absorb upcoming rate hikes and sustainably higher rates on asset prices.
Recession risks may continue to grow throughout the year, although we see this risk becoming a more significant issue in 2023. If there is a recession, we expect it to be short-lived as the primary driver of negative growth would be supply constraints versus lack of demand. That said, markets are forward-looking, and recessionary concerns have already started weighing on market performance.

Adjusting risk and exposure

We have taken an iterative approach to making client portfolios more defensive for the year. Initially, we stratified our process, adjusting based on portfolio risk tolerance. We adjusted portfolios quickly to reduce preserve capital for clients with lower risk. We cut equity exposures by 20% and repositioned fixed-income holdings to be more inflation-protected. We adjusted end-market exposure for clients with moderately aggressive risk tolerances but largely kept equity positions intact. We used market volatility to take advantage of weakness and make tactical trades to buy depressed equities for portfolios with aggressive risk profiles.
In April, as sentiment deteriorated, we started to allocate more heavily to defensive sectors – healthcare, consumer staples – and inflation hedged - industrials, manufacturing - sectors. We continue to hold financial sector Exchange Traded funds (ETFs) and have started to purchase commodity-sensitive ETFs when appropriate.

We remain strategically underweight in fixed income and have not increased our exposure to bonds. In the current rising rate environment, fixed income is less

protective than in previous cycles. We have reduced our position in government bonds within the fixed income holdings in favor of inflation-linked bonds.

Sentiment remains cautious but should improve.

Negative headlines are a critical risk in the near term. We expect companies to continue discussing inflationary pressures. The war in Ukraine will continue with little expectation of a swift resolution. Economic data should be stable but will slow in some areas. (Rising mortgage rates may cause housing prices to stall, for example.) The Fed could spark recessionary concerns by raising rates aggressively throughout the summer. Potential headlines created by these issues lead us to believe that markets will be volatile. The consumer should remain strong, and corporate earnings will grow, but the uncertainty around inflation and higher rates will dampen investment sentiment.

Notwithstanding the above risks, much of the negativity is likely priced in. Markets are forward-looking and may have already felt much of the poor returns for the year. For example, April's weakness was driven by the anticipation of higher interest rates over the next few months. There are no silver bullets during times like these. Attempting to time the market is fraught with risk. Suppose inflation begins to decrease over the next several months, and interest rate hikes are perceived to be helping manage prices. In that case, investor sentiment will improve, and risk tolerances will increase. Over-sold investments will perform nicely, and market returns will increase when this happens. The challenge is patience and timing. We believe many areas of the market are oversold, but it is unclear when share prices will increase. We remain diligent while maintaining defensive portfolio positioning, for now, adjusting as new information becomes available.

Please reach out to us with questions and comments. The current market environment often raises questions. We're here to answer them!

Thank you for your trust and partnership.

Sincerely,

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