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Wealth Advisory Market Update

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Market Update

Volatility was the overall theme for the first quarter of 2022. As we review the quarter, we see that despite volatility from geopolitics much of the volatility was attributed to Federal Reserve actions and the continued surge in inflation. Economic inflation numbers came in at 40-year highs, putting pressure on the Federal Reserve to act and slow it down. The Fed has several tools to accomplish this with the main tool being raising short-term interest rates and/or by stopping Quantitative Easing (QE). QE is where the Fed purchases bonds to artificially keep interest rates low with the hopes of stimulating economic growth, which they are still doing. They are just beginning to let these bonds roll off, which in a sense, would be Quantitative Tightening. Over the past year, we wrote about our concern that the Fed was behind the curve in implementing these strategies and may be backed into a corner; and as anticipated, this is exactly what happened. Since the Fed did not act earlier, they are now going to have to be more aggressive and this increases the chances of a recession or a hard landing.

The Fed officially started their rate hike cycle in March when they increased rates from 0 to 25bps. They are now projecting up to eight more increases this year with a 50bps hike in May and another 50bps in June. When the Fed president started projecting this hawkish view, it sent short-term rates skyrocketing higher. We now have an inverted yield curve measured by the two-year and ten-year treasury bonds. This tells us that short-term expectations for growth are better than the longer term, hence the increased possibility of a recession in the near future. A recession is not guaranteed as the 2-10 spread has given false signals before, however it is important for investor psychology. We will be keeping a close eye on the front end and the 30-year Treasury. If the curve inverts here, historically speaking, there is a 100% chance of a recession on the horizon.

The Fed, of course, is not the only major factor in the markets, global impacts are taking front and center too. The Ukraine invasion by Russia continues. Geopolitical risks have not been this high in decades. The global pandemic in 2020 caused the world to shut down and in doing so damaged global supply chains. This then caused a major supply shock and sent prices soaring. Throughout 2021, we began to see these bottlenecks ease as things began to get back to a new normal. However, the Russian invasion impacted the fragile supply chain and sent new supply shocks in many areas. Global food and energy prices are now suffering the most pressure, and we expect these issues to persist for the foreseeable future.

With all of these major issues still ongoing, it is easy to see why markets have been volatile. A major short squeeze is the only thing that saved equity market performance for the quarter. Our thoughts from our last letter still apply as we continue to move forward in 2022. We continue to believe old economy stocks with strong cash flows and pricing power will begin to lead the way again. We want to continue to focus on quality. We still believe technology stocks are in a massive bubble even though they have seen a slight correction. If you look at where they are on a longer-term chart, the move down over the last few months has just been a blip on their bubble run. In our opinion, as rates rise, market participants will not want to own companies that are trading off expected cash flow 25 years from now; rather, they will want to invest in companies that are currently providing a strong cash flow stream and trading at a multiple well below the market. This is how we have positioned and how we will continue to manage money going forward.

Interest rates have finally given us the ability to get excited about bonds again. Short-term rates at over 2% may not sound like much, but it's 190 basis points higher than they were just 18-months ago. It appears to us that most of the risk in rates has been priced into the front end. Our current positioning will take advantage of this. We are going to continue to stay shorter in our duration and focus on the one-to-three-year area of the curve. At the moment, the belly of the curve and longer-term rates do not look attractive. Our focus is also on quality in the credit markets. If a recession is on the horizon, high yield is not a place we want to be positioned.

This is a snapshot of the current trends and it does not mean current conditions will persist. Economic data coming out in the near future could alter our outlook. If this occurs, we will be quick to assess and make adjustments to our portfolios. As always, we continue to navigate this difficult environment as aptly as possible. We at AMB thank you for your support and for allowing us to partner with you in reaching your financial goals.

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