AndCo's Monthly Market Update

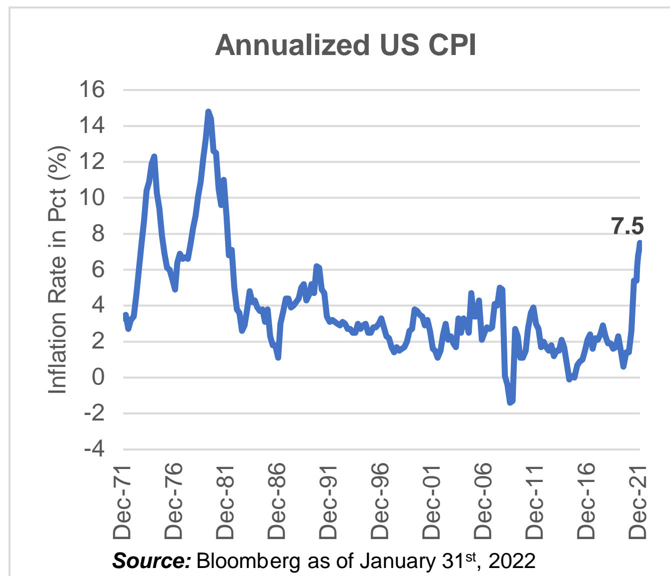
February 2022

THE ECONOMY

"I feel very bad about getting things wrong" Bill Vaughan

Very smart people often make mistakes and simply get things wrong. While some people may ignore their misgivings, others will ponder their mistakes to learn from them and gain greater self-awareness. In thinking about the current state with rapidly accelerating inflation, our question to the Federal Reserve Bank (the Fed) would be, what took you so long? Even the most ardent Fed supporters are now openly questioning the Fed's hands-off approach over the past year. Recently, Mohamed El-Erian, Allianz Chief Economist and former PIMCO co-CIO, was on CNBC and stated that the Fed decision to call inflation transitory was a "historically bad move."[1] While the Fed indicated that it would begin taking action in the form of ending its bond purchase program in the first quarter of 2022, Chairman Powell stated that Fed is, "likely to hike rates in March assuming that the conditions are appropriate for doing so."[2] Given the pace of increase in annual inflation, we are left to wonder if Powell has learned anything by letting interest rates remain near zero for so long. Rapidly rising housing, energy, and food prices are crippling to consumers balance sheets. The more income people need to devote to basic living expenses, the less there is available for discretionary purchases such as travel or dining out. Industries sensitive to consumer spending are already showing signs of stress. For those of us old enough to remember the early-1980s, inflation was running rampant and peaked at 13.5% in 1981.[3] During this time, Fed Chairman Paul Volker made the decision to begin raising interest rates, ultimately cresting at 20% in 1981.[4] Shortly thereafter, the US economy went into recession and unemployment increased significantly, but inflation ultimately fell. The lesson from that time period was once inflation becomes persistently higher than expected, actions must be taken to ensure that it does not spiral out of control. While we are not suggesting that interest rates will necessarily be raised to such high levels, we would have hoped that the current Fed pondered its own historical lessons and not waited so long to begin the process of normalizing interest rates.

Inflation in January climbed to 7.5% year-over-year, its highest level since 1982.[5] For the month, both headline CPI and the less volatile core CPI (excluding food and energy) rose by 0.6%.[6] Prior to the announcement, markets were pricing in four rate hikes in 2022.[7] Following the CPI release, expectations increased to five rate hikes, which would result in a year-end Fed Funds rate between 1.50% and 1.75%.[8] Despite market expectations, many Fed watchers are suggesting an emergency rate hike of 50 basis points is justified. While we understand the need to begin the process of normalizing interest rates, we are also cognizant of the potential knock-on effects that the moves have the potential to bring. The housing market, which has been a source of strength since the onset of the pandemic, has been driven by a tailwind of low interest rates acting as a boon for refinancing activity and supporting higher home prices. As interest rates begin to rise, the impact on the housing market will shift to a headwind. Companies that are dependent on short-term financing to fund business activities could also be adversely affected as borrowing costs increase and put pressure on profit margins. In the event these companies are unable to effectively pass along price increases to consumers, it is possible that unemployment may increase as companies cut back and retrench. If we look back in history and attempt to learn from our mistakes, each of these conditions occurred during the dramatic rate hikes in the 1980s and we're sure that Chairman Powell is keenly aware of what transpired during that time. Let's hope the Fed admits its mistake and acts sooner rather than later.



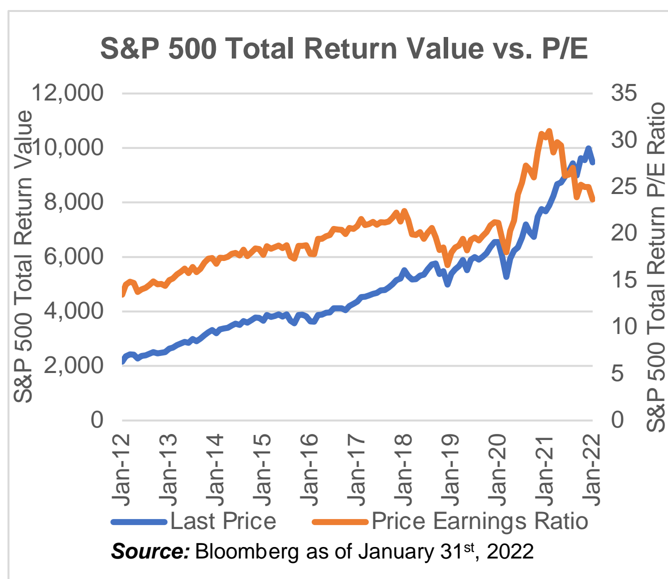
Source: Bloomberg as of January 31st, 2022

Despite several notable winter storms and an uptick in Covid-19 cases due to the Omicron variant, not everything was doom and gloom in January. Job growth was better than expected with the US adding 467,000 new jobs during the period while December's gains were revised higher from 199,000 to 510,000.[9] The market had been expecting new job growth to be between 100,000 to 200,000. What is important to note is that much of the growth can be attributed to seasonal adjustments. For the month, the unemployment ticked higher to 4.0%, up from 3.9% previously, as the labor participation rate rose meaning more people are available to work.[10] Overall, labor markets remain tight with too few workers to fill job openings. Unfortunately, despite recent gains, wage growth has not kept pace with rising inflation. The report for January showed that wages grew 5.7% for the year, trailing the headline inflation reading by 1.8%.[11] Not surprisingly, consumer sentiment, as measured by the University of Michigan, was down for the month with the index closing at 67.2, down from 68.8 previously in December.[12] The key question moving forward is, what will the impacts of rising interest rates and inflation be on consumer

spending. If wage growth is insufficient to keep up with rising costs, consumers will be forced into making some very difficult decisions about where and how they spend their money.

EQUITIES

Stocks were down broadly in January as investors considered the implications of rising inflation and interest rates as well as geopolitical concerns with Russia and Ukraine. In the US, growth-oriented stocks sizabley lagged value stocks across the market capitalization spectrum. Similarly, small companies underperformed both their mid- and large-cap counterparts. For the month, the S&P 500 Total Return Index declined by roughly -5.2% while the small cap Russell 2000 Growth Index fell a steeper -13.4%.[13] From a valuation perspective, the recent decline in stock prices has improved the valuation of the S&P 500 on the basis of P/E (price/earnings ratio). That said, the index is still trading at roughly 23x forward earnings.[14] Should investors further question the ability of companies to increase earnings growth in the future, stock prices will likely move lower and move them more in-line with historical P/E valuations.



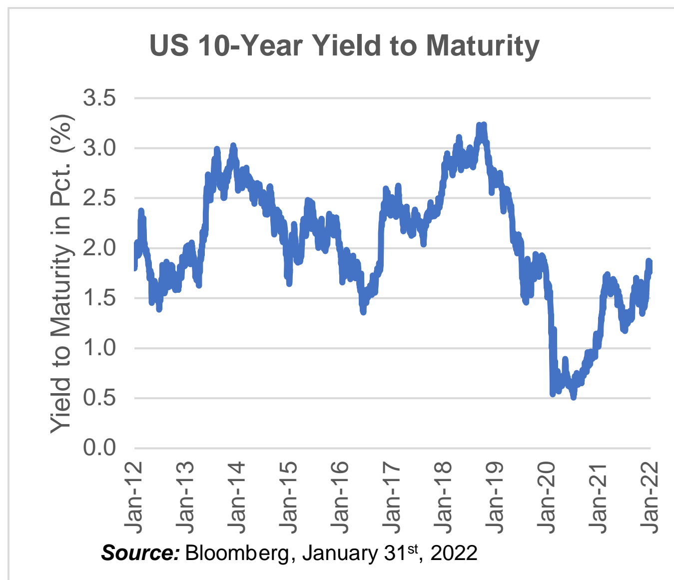
Source: Bloomberg as of January 31st, 2022

Overseas, international developed and emerging equity markets suffered losses during the month with the MSCI EAFE Index falling roughly -4.8% while the MSCI Emerging Markets Index lost -1.9%.[15] In Europe, the primary drivers of the performance were soaring energy prices and geopolitical concerns related to Ukraine. Looking at emerging markets, performance dispersion across geographies was significant and was led by oil exporting countries. Those countries that have significant export-related exposure to the US underperformed based on concerns over the trajectory of future economic growth.

FIXED INCOME

Like stocks, bonds performed poorly in January as interest rates rose. During the month, the benchmark US Treasury 10-Year Bond yield closed at 1.77%, up nearly 30 basis points for the month.[16] The move in the shorter-term rates was even more dramatic with the US Treasury 2-Year Bond increasing by more than 40 basis points to 1.15%, up from 0.74%.[17] As a result of the shift in rates, the Treasury curve flattened considerably during with short-term rates rising more than longer-term rates during the month. As we discussed, the primary catalyst for the significant

move in US interest rates was the Fed's statement concerning the pace of inflation and its intent to begin raising interest rates faster than many in the market had anticipated. While far from inverted, the flattening of the Treasury curve is a sign that investors are increasingly concerned about the potential for future economic growth. With the Fed concluding its bond purchase program sometime during the first quarter and beginning the process of normalizing interest rates, this combination of events will most likely reduce the amount of liquidity in the economy. We are watching closely to see if the Treasury curve flattens further or inverts for signs that investors are anticipating a recession.



Source: Bloomberg, January 31st, 2022

Performance was broadly negative across the credit spectrum during the month. The higher quality Bloomberg US Aggregate Bond Index declined by approximately -2.2% in January.[18] A significant contributor to the broad decline was the corporate bond sector. Performance of investment grade and lower quality high yield bonds were down by roughly -3.4% and -2.7%, respectively.[19] A key indicator we follow to assess the health of the corporate bond market are credit spreads. Historically, credit spreads tend to widen later in the economic cycle when growth begins to slow as the Fed begins the process of cooling the economy by raising interest rates. During the month, investment grade credit spreads widened by 12 basis points while high yield spreads widened by 53 basis points.[20] The widening of spreads in both investment grade and high yield bonds was significant in absolute terms. However, in relative terms, credit spreads remain historically tight relative to their long-term averages. Moving forward, we will be watching to see if investors begin migrating into higher quality areas of the bond market, including shorter duration strategies, which could offer some protection against both wider credit spreads and rising interest rates.

APPENDIX

1. https://www.cnbc.com/2021/12/13/el-erian-says-transitory-was-the-worst-inflation-call-in-the-history-of-the-fed.html
2. https://www.reuters.com/business/finance/inflation-fighting-fed-likely-flag-march-interest-rate-hike-2022-01-26/
3. https://courses.lumenlearning.com/boundless-economics/chapter/historical-federal-reserve-policies/
4. https://courses.lumenlearning.com/boundless-economics/chapter/historical-federal-reserve-policies/
5. Bloomberg, February 10th, 2022
6. Bloomberg, February 10th, 2022
7. Bloomberg, February 10th, 2022
8. Bloomberg, February 10th, 2022
9. Bloomberg, February 4th, 2022
10. Bloomberg, February 4th, 2022
11. Bloomberg, February 4th, 2022
12. Bloomberg, January 28th, 2022
13. Morningstar, January 31st, 2022
14. Bloomberg, January 31st, 2022
15. Morningstar, January 31st, 2022
16. Bloomberg, January 31st, 2022
17. Bloomberg, January 31st, 2022
18. Morningstar, January 31st, 2022
19. Morningstar, January 31st, 2022
20. Bloomberg, January 31st, 2022

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