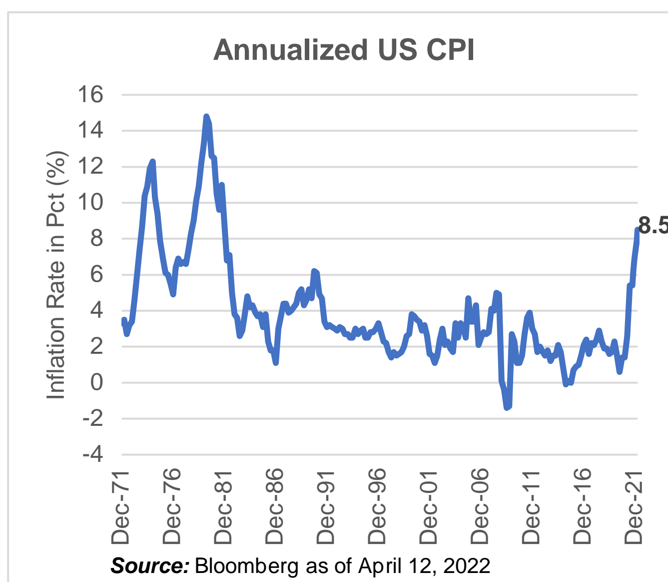
AndCo's Monthly Market Update

April 2022

THE ECONOMY

The world's attention remains firmly fixed on the crisis that continues to unfold in Ukraine. Despite little headway made during the month to resolve the conflict, there were signs that both sides are seeking an end to the crisis with several rounds of negotiations being held. From an economic perspective, global markets continue to experience volatility as the combination of higher-than-expected inflation, increasing commodity prices, clogged supply chains, a surge in Covid infections, and the threat of future interest rates increases all act as headwinds to economic growth. While we wait for the initial first quarter GDP report, the market consensus is for much lower growth than we experienced in the fourth quarter of last year. As of April 5th, the Atlanta Federal Reserve Bank is forecasting GDP growth of below 1%.[1] While the slowdown in growth is reasonable given the headwinds the economy is facing, our concern is these factors could persist, resulting in slower economic growth and increasing the potential of a 1970s-era stagflation environment.

Market watchers are growing increasingly vocal about how the Federal Reserve Bank (the Fed) has been "behind the curve" by keeping interest rates low. This has contributed to inflation remaining well above the bank's stated target of roughly 2.0%. For their part, the Fed met on March 16th, and raised interest rates by 0.25%, which was largely in line with the market's expectations.[2] Importantly, the Fed signaled that it is considering raising interest rates faster and higher with the goal of dampening inflation. Annual inflation in the US as measured by the Consumer Price Index (CPI) rose to 8.5% during the month of March, up from 7.9% in February.[3] This is the highest annualized inflation rate reading since 1981.



Source: Bloomberg as of April 12, 2022

We continue to watch the real estate market closely given its importance to the overall economy. With the Fed keeping interest rates low and consumers trying to get ahead of future rate increases, mortgage money flowed into the housing sector, resulting in a relentless rise in home prices. According to the Case-Shiller Composite 20 Home Index, home prices in the US rose by more than 19% year-over-year as of January.[4] While we expect home prices to continue to appreciate, the pace of growth should begin to moderate as the Fed begins to raise interest rates. Part of this slowing can be attributed to the fact that 30-year mortgage rates have risen by nearly 1.5% since this time last year.[5] Rising home mortgage rates affect home affordability by deterring homeowners from moving and putting downward pressure on new household formation. So, why is this important? Historically, many homeowners have used the equity in their homes to maintain their lifestyles, effectively using their homes as another source of disposable income. This act is predicated on the belief that home prices will continue to appreciate, thus allowing an ongoing cycle of debt-fueled consumption. Those of us who are old enough to remember the Great Financial Crisis in 2007-2008 know this “trade” doesn’t always hold. As a result, when homeowners are no longer able to tap their equity, larger discretionary spending for items like appliances, electronics, and travel decline. While we do not believe another housing crisis is imminent, it is worth noting that the Fed is expected to increase interest rates significantly this year. These increases could have negative implications for not only housing, but also other sectors of the economy.

Another indicator we track closely is consumer sentiment, which is a measure of how consumers feel about their financial future. Having been hit with higher energy and food prices, it is not surprising that consumers feel increasingly uneasy. As evidence, the University of Michigan’s Survey of Consumers Index fell to 59.4, down from 59.7, registering its lowest level since March 2008.[6] The decline in sentiment can be attributed to the fact that, while nominal wage growth has generally been strong, workers continue to fall behind rapidly rising inflation. For March, average hourly earnings increased by an annualized rate of 5.6%.[7] Despite these gains, real wages fell by -2.7% during the same period.[8] As it becomes more difficult to keep pace, consumers are increasingly turning to credit cards to bridge the gap. For the month of February, the Fed’s Consumer Credit Report showed that household debt levels rose by nearly $42 billion year-over-year, an increase of nearly 11.3%.[9] In aggregate, we believe these indicators are significant as the inability of wages to keep pace with inflation induces consumers to rely on credit. However, as interest rates begin to normalize, credit also becomes more expensive. Eventually, consumers will have to make a difficult decision about maintaining their lifestyles or cutting back on spending, especially for non-discretionary items.

While there are many developing economic concerns, there are also positives factors to highlight. One area of continued strength in the economy is the job market. The US unemployment rate fell to 3.6% in March, down from 3.8% in February, as 431,000 new jobs were recorded during the month.[10,11] While the strength of job market remains encouraging, there is still a significant amount of labor that remains idled with more than 99 million eligible people

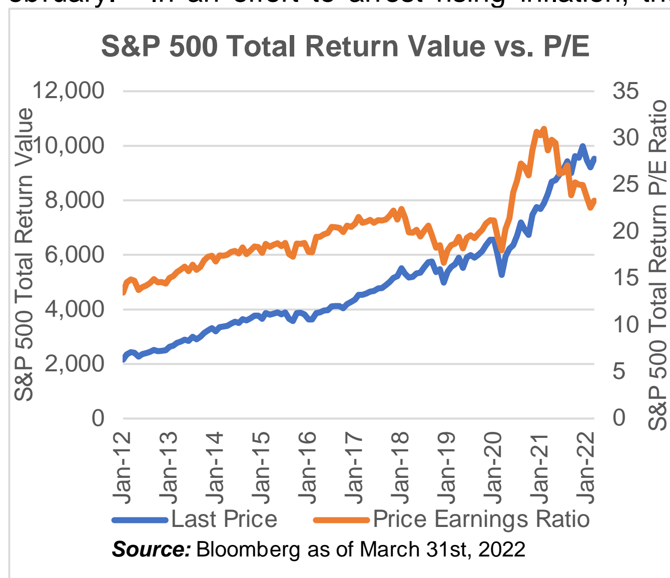
not in the workforce.[12] Hopefully, the recent strong wage growth will continue to entice workers back into the workforce, which would be a tailwind for the overall economy.

EQUITIES

Despite continuing concerns over to the crisis in Ukraine, elevated inflation, and the Fed's anticipated path of interest rate increases, the S&P 500 posted a solid month, climbing roughly 3.7%.[13] However, the index declined by -4.6% for the quarter due to earlier declines.[14]

Digging deeper into the month, growth stocks generally outperformed value stocks and large-cap issues outperformed small-caps.[15] The performance outlier for the year continues to be energy stocks, which led the market both in March and for the full quarter.[16] Discretionary and consumer staples stocks lagged during the month over concerns that rising input prices and declining discretionary income will detract from future earnings.[17]

Similar to the US, international developed equity markets rose during the month with the MSCI EAFE Index gaining 0.6%.[18] Despite the positive return, international developed stocks were down -5.9% for the quarter.[19] The primary drivers of the negative performance for the quarter `were the conflict in Ukraine and rising inflation. In Europe, the annual rate of inflation hit a record high of 7.5% in March, up from 5.9% in February.[20] In an effort to arrest rising inflation, the European Central Bank confirmed that it would end its bond purchase program in June in an effort to drain liquidity from the market. Additionally, the Bank of England raised interest rates by 0.25% in March, its second increase this year, to a level of 0.75%.[21] As monetary policy is normalized through rising interest rates, companies that are sensitive to borrowing costs will likely face headwinds to both growth and profit levels.



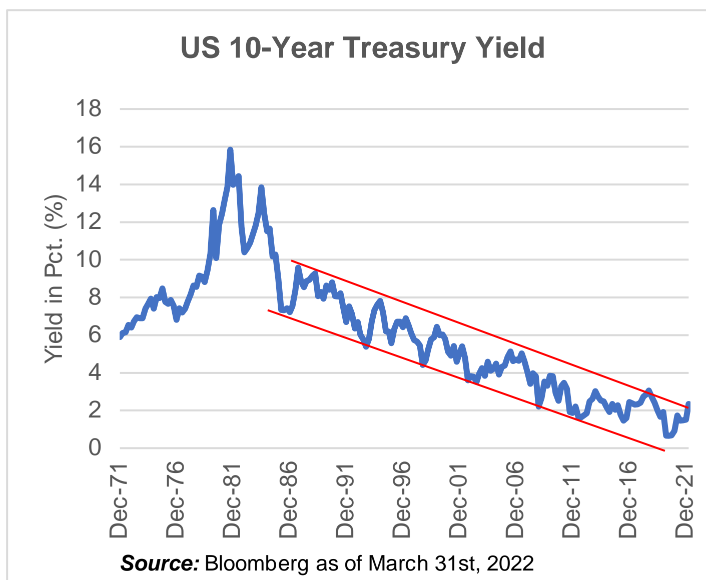
Source: Bloomberg as of March 31st, 2022

Emerging market stocks underperformed both domestic and international developed stocks for the month with the MSCI Emerging Market Index falling -2.3%.[22] For the quarter, the index fell by nearly -7.0% as the Russian invasion of Ukraine and the Chinese lockdown due to rising Covid-19 infections weighed heavily on these markets.[23] Importantly, during the month, Russian stocks were removed from both the MSCI Emerging Market Index and the FTSE Russell Emerging Market Index.[24] The decision to remove Russia from the benchmarks was largely due to sanctions levied on Russia by Western governments, which rendered the Russian market largely "uninvestable" by open market standards.

FIXED INCOME

To say that the month of March or the quarter was a difficult period for bonds would be a gross understatement. Bond returns were "routed" as market rates moved higher in anticipation of the Fed raising interest rates to combat inflation. The benchmark US Treasury 10-Year Bond yield closed at 2.34% on March 31st, up 0.51% for the month.[25]

Looking at the chart to the right, the US Treasury 10-Year bond has traded in a very narrow channel for the last 35 years. Each time the yield has risen to test the trend line, it has fallen back into the channel. During this period, the US also experienced three recessions in 1990, 2001, and 2007. The question we continue to pose is, "what's different this time?" The short answer is that inflation is running significantly higher than the Fed's target, which has pushed real interest rates into negative territory. To attract investors, interest rates need to be high enough to offset the loss of purchasing power through inflation. As a result, it is likely we have seen the end of this long-term trend and rates could persist outside the top of the channel.

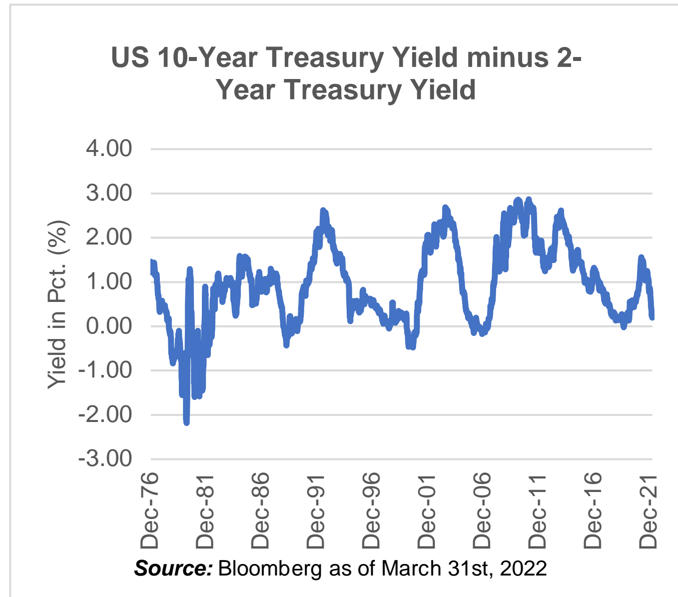


Source: Bloomberg as of March 31st, 2022

The bellwether Bloomberg US Aggregate Index fell by -2.8% for the month and -5.9% for the quarter.[26] Given the benchmark's duration of approximately 6.7 years, the negative performance of the index in a rising rate environment should come as no surprise.[27] This was the index's worst quarter since 1980, and its third-worst since its inception.[28] High yield bonds performed slightly better during the month and quarter with the Bloomberg US Corporate High Yield Index declining by -1.2% and -4.8%, respectfully.[29] The relative outperformance of high yield credit can be attributed to the cushion of its generally higher coupon rates and shorter duration profile.

Finally, the recent rise in US interest rates in anticipation of the Fed's embarkation on a protracted cycle of raising interest rates resulted in a brief inversion of the US Treasury yield curve as 2-year rates exceeded 10-year rates. Typically, the yield curve will flatten as investors' expectations of recession increase. As such, this persistent phenomenon has been useful indicator for investors as Treasury yield curve inversions have predicted every recession since 1980.[30] While the indicator may have proven to be useful in past circumstances, we are hesitant to rush to judgement in anticipation of a potential recession. There are a number of factors at work that have never been observed in tandem previously including remnants of the pandemic

and the continued economic fallout, significant inflationary pressures, the Fed attempting to normalize interest rates while also reducing the balance sheet, and an ongoing geopolitical crisis. Given this combination of factors, it would be reasonable for investors to remain cautious and consider a defensive posture.



Source: Bloomberg as of March 31st, 2022

The remainder of this page is left intentionally blank.

APPENDIX

1. https://www.atlantafed.org/cqer/research/gdpnow
2. https://www.cnbc.com/2022/03/16/real-time-updates-of-the-big-fed-decision-and-jerome-powell-press-conference.html
3. Bloomberg as of April 8, 2022
4. https://ycharts.com/indicators/case_shiller_home_price_index_composite_20_yoy
5. https://www.mortgagenewsdaily.com/mortgage-rates
6. Bloomberg as of March 31, 2022
7. Bloomberg as of March 31, 2022
8. Bloomberg as of April 12, 2022
9. https://www.cnn.com/2022/04/07/economy/federal-reserve-consumer-debt-february/index.html
10. https://www.bls.gov/news.release/pdf/empsit.pdf
11. https://www.bls.gov/news.release/pdf/empsit.pdf
12. https://www.raymondjames.com/commentary-and-insights/scott-brown/2022/04/01/weekly-economic-commentary
13. Morningstar as of March 31, 2022
14. Morningstar as of March 31, 2022
15. Morningstar as of March 31, 2022
16. Bloomberg as of March 31, 2022
17. Bloomberg as of March 31, 2022
18. Morningstar as of March 31, 2022
19. Morningstar as of March 31, 2022
20. Bloomberg as of March 31, 2022
21. https://www.cnbc.com/2022/03/17/bank-of-england-hikes-rates-for-third-time-in-a-row.html
22. Morningstar as of March 31, 2022
23. Morningstar as of March 31, 2022
24. https://www.wsj.com/livecoverage/russia-ukraine-latest-news-2022-03-02/card/msci-to-remove-russian-stocks-from-emerging-market-indexes-JLIyiyPfAzYUEHvbX9Pm
25. Bloomberg as of March 31, 2022
26. Morningstar as of March 31, 2022
27. Bloomberg as of March 31, 2022
28. https://www.troweprice.com/personal-investing/resources/insights/global-markets-weekly-update.html
29. Morningstar as of March 31, 2022
30. Bloomberg as of March 31, 2022

Please see the next page for important disclosures.

Important Disclosure Information

This document is being provided solely for informational and educational purposes and should not be regarded as investment advice or as a recommendation regarding any particular course of action and additionally is not intended to provide, and should not be relied upon, for legal, tax, or accounting advice.

Any securities cited are for illustrative purposes only. References herein do not constitute a recommendation to buy, sell or hold such securities.

The material provided herein is valid as of the date of distribution and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available, or circumstances existing or changes occurring after such date. This document may contain opinions, observations, projections or forward-looking statements which are subject to various uncertainties whereby the actual outcomes or results could differ from those indicated.

Certain information is based on sources and data believed to be reliable, but AndCo cannot guarantee the accuracy, adequacy, or completeness of the information. The source for all data, charts and graphs is AndCo Consulting unless otherwise stated.

AndCo Consulting is an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Registration as an investment adviser does not constitute an endorsement for the firm by securities regulators nor does it indicate that the adviser has attained a particular level of skill or ability.