First Quarter 2022
American Portfolios Quarterly Market Commentary
by Chief Investment Officer Clifford T. Walsh, CFA

THE FIRST QUARTER of 2022 was a wild one. Economic and market complications piled up to start the year, weighing on equity and fixed income prices. Equities were down double-digit percentages at its worst, but a late rally following the first Federal Reserve (the Fed) hike of the cycle allowed the S&P 500 to end the quarter down only 4.6%, outpacing small caps (-7.5%), developed international stocks (down 5.9%), high-yield bonds (-4.8%) and U.S. Treasuries (-5.8%). The U.S. dollar was the only major asset class that we track to have a positive quarterly return (+2.4%).

Only two equity sectors put up positive returns in the quarter. Energy posted a 39% return, while utilities returned 4.7% as the defensive nature of the sector seemingly overshadowed its interest rate sensitivity. Growth stocks have lagged the broader market as interest rates moved higher, a determinate of the value of future earnings with the tech sector contracting 8.5%. Outside the U.S., emerging debt fared worst of all (-9.2%) as the war in Ukraine weighed on sentiment.

THE CURRENT STATE OF THE ECONOMY

Despite the considerable talk about the strength of the economy, we're not seeing it. Perhaps the focus has been on nominal data (fueled higher by soaring prices) or the declining unemployment rate, but a look at real growth indicates very little strength. The Atlanta Fed's Nowcast model stood at 1.1% real GDP growth for the first quarter as of April 8, which is hardly strong. Not to mention, a 3.6% unemployment rate is perhaps good for the economy in the short term, but the jobless rate is a classic late-cycle data point, which is often followed by a recession. What's more, we've experienced seven months of contraction (at a 5% annual rate) of real disposable personal income, last occurring during the 1973-75 recession.

The U.S. housing market is also flashing signs of concern. The price-to-rent and price-to-income ratios are forcing first-time and low-income home buyers out of the market. Late payments on credit cards and subprime auto delinquency rates are also rising, although household debt service as a percentage of disposable income is still reasonably healthy. While rising from 9.2% to 9.9% recently, it is still below the 11% average. We think given rising prices, lower real wages and some wiggle room, economic activity will be fueled, in part, by more debt in the coming months. This could prolong economic growth or, at least, help offset downward pressure from elsewhere.

Overall, we expect weak real GDP growth to persist in the coming quarters as businesses and consumers grapple with higher prices and rising interest rates. We think the odds of a recession have risen substantially since the invasion of Ukraine, taking a still manageable inflation situation and complicating it heavily. Supply chain shocks abound, and food and oil production will decline. Given the likely aggressiveness of the Fed, which is set to destroy demand in an effort to stifle piping hot inflation, we think the least likely scenario is a soft landing, which seems to be the general equity market consensus and Fed plan.

THE FED, INTEREST RATES AND INFLATION

Recent inflation measures continue to top expectations. March CPI increased 8.5%, ahead of expectations but showed some positive signs. Core CPI (excludes food and energy) came in light of expectations (0.3% versus 0.5% est.), albeit modestly. Many commodity prices have rolled over and hard, including oil, from recent peaks. Used car prices, another area driving recent CPI numbers higher, are down as well. We expect to see CPI ease in the back half of the year, but expect food prices to remain high for longer. The war in Ukraine has led to sanctions in the fertilizer industry, as well as less planting, leading to less food production in the months to come. Regardless of recent direction, current price levels are significant. Couple them with the conflict in Ukraine that shows no sign of abating and we will likely see a Fed forced to act—and act significantly—in upcoming meetings.

The Fed dot plot has little tangible long-term value and is fraught with wide swings. However, there is value when assessing shorter time frames. Currently, the Fed dot plot indicates rates of 1.9% in 2022 and 2.8% in 2023. The interest rate futures market is pricing in two 50 bps hikes in May and June, and forecasts a year-end rate target of about 250 bps and 325 bps by July 2023, significantly ahead of the Fed. We think the market is factoring in well beyond what is likely to happen and even think the Fed's estimates for 2023, and even the back half of 2022, may prove to be too aggressive. A 50 bps hike in May is all but certain. Should the Fed tack on another 50 bps in June, we think economic growth will slow considerably and perhaps contract, giving the Fed reason to pause. We think there is downside to rate expectations for any time frame beyond the first half of 2022.

We've experienced a huge supply-side inflation shock. The only method to reduce inflation is to destroy demand. With real growth teetering at 1% in the most recent quarter, we can't see how it is possible for the Fed to tame inflation without causing a recession. The math simply doesn't work. Will it be a hard landing or a soft landing? We think it probably lands somewhere in-between. To answer that question, one must ask another, how will the Fed react to the significant economic and financial market volatility it is about to cause by raising rates by 75 -100 bps in the next few months? We think they buckle, avoiding a worst-case scenario, but not before inflicting notable damage. History supports no other response.

GEOPOLITICAL RISKS

As if the inflation and the Fed hike cycle wasn't enough, geopolitical risks abound--even if they've slipped from the nightly news cycle. The war in Ukraine rages on; early hopes of a ceasefire or a quick end are all but gone. We are concerned at how aggressive Russia might get if it is continually thwarted and what the NATO response will be with respect to sanctions. The recent energy spike has abated for now as emergency reserves have hit the market, but those are temporary measures. The longer the war continues, the greater the consequences for food and energy production, if not a Russian debt default. Russia recently moved toward a potential default on its foreign currency debt after making payments to dollar-denominated bonds holders in rubles, prompting flashbacks to the Asian financial crisis of 1997-1998.

Meanwhile, a weaker Russia means a stronger China. If there is only one significant buyer of Russian energy in the long-term, assuming Europe looks to other sources, China's competitive position strengthens and is likely a bigger geopolitical threat. It could also lead to the re-emergence of Venezuela and Iran, which is not exactly an ideal situation. But those are long-term concerns.

In the short term, we need to assess the Chinese shutdowns. Recently, China reported a record number of local COVID-19 cases, prompting the government to issue further lockdowns in Shanghai. The Chinese service sector is now the lowest since the depths of the 2020 global lockdown-recession. Deep contraction in the world's second largest economy is a significant negative for world growth. The longer this continues, the worse it gets; although, it could help on the inflation front.

Here at home, there is bound to be a significant shakeup in the mid-term elections. We will likely begin hearing much more about mid-terms in the coming months, which we think would benefit the economy in 2023, perhaps providing a boost after the economy bottoms. This would not be from massive government spending, at least we'd hope not, but from more energy-friendly policy, if not broader opportunities.

INVESTMENT OUTLOOK

Despite the recent equity rally, we continue to recommend a defensive posture. The combination of still relatively high valuations and a Fed likely to be aggressive, at least in the early goings of this hike cycle, likely means downside for cyclicals and perhaps broader indices. The equity market peaks before recessions and we're pretty certain a full recession is not factored into prices. Long-dated bond yields also peak before a recession. Given the sharp bond selloff, we wonder if tops are in for both equity prices and bond yields for a while.

While we do expect the Fed to ease up on the brakes before the broader market expects, perhaps good for equities, one must also consider that the Fed's plan to shrink its balance sheet by more than $1 trillion in the coming year adds to the headwind. The correlation to the Fed's balance sheet and S&P 500 has been stronger than most financial market relationships in recent years; we expect it to continue, pulling equity prices down as the balance sheet contracts. The equity markets doubled as the Fed expanded its balance sheet during the pandemic, 70% driven by multiple expansion. Even if earnings don't contract as we expect, the loose liquidity that drove speculation and multiple expansion has to work in reverse.

We have been surprised by the bond selloff throughout the Treasury yield curve, especially at the long end. The jump in Treasury yields we've seen in the past month hasn't happened too frequently throughout history (it's a 2+ standard deviation event), which has typically been a good buying point. We think adding duration is the best bond bet this late in the cycle and favor this exposure over the short end—although one could do worse—with both being more attractive than corporates, investment grade or not.

Based on the recent BofA fund manager survey, investors are long oil and commodities in record numbers, while significantly short technology stocks and bonds. Certainly, this has been the correct trade, and the momentum has fed on itself, but we wonder just how much more there is to run. We think the Fed meetings in May and June—which result in at least 75 bps in hikes, if not 100 bps—will be the catalyst behind a reversal of recent stock, bond and commodity action. Until then, we think conditions warrant caution.

QUESTIONS AND COMMENTS

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