Market Review & Outlook

April 2022

The current moment recalls the famous Mark Twain adage – "history doesn't repeat itself, but it often rhymes" – when comparing economic and geopolitical conditions to those of the 1970s. Clearly, the US and its Western allies find themselves in something of a new cold war, with the Russian invasion of Ukraine harkening back to the Arab states' attack on Israel in 1973, or perhaps the Soviet invasion of Afghanistan in 1979. Certainly, the implications of this conflict are more dire considering the actors involved, not to mention the non-zero risk of nuclear weapons being used. Furthermore, while inflation was already a problem before the invasion, the impact of the war on food and energy prices threatens to unleash a bout of stagflation (slow growth, high inflation) which could rival the economic malaise of the 1970s. Sure, if the war ended tomorrow, it would alleviate short-term market sentiment about the long-term risks, but the sanctions regime would likely remain in place for some indefinite period, along with the consequent negative economic effects. Russia is the world's 12th largest economy, so you can't just remove them from the global system without material downside, regardless of any moral imperatives.

Index	March 2022	1st Qtr. Perfomance	One Year Performance	Description
S&P 500	3.71%	-4.60%	15.65%	Large Cap US Stocks
DJ Industrial Average	2.49%	-4.10%	7.11%	Large Cap US Stocks
Nasdaq Composite	3.48%	-8.95%	8.06%	Large & Mid-Cap US Tech Stocks
Russell 1000 Growth	3.91%	-9.04%	14.98%	Large Cap US Growth Stocks
Russell 1000 Value	2.82%	-0.74%	11.67%	Large Cap US Value Stocks
Russell 2000 Growth	0.46%	-12.63%	-14.33%	Small Cap US Growth Stocks
Russell 2000 Value	1.96%	-2.40%	3.32%	Small Cap US Value Stocks
MSCI EAFE	0.64%	-5.91%	1.16%	Foreign Developed Stocks
MSCI EM	-2.26%	-6.97%	-11.37%	Emerging Markets Stocks
Credit Suisse High Yield	-0.83%	-4.17%	-0.24%	US High Yield Corporate Bonds
Bloomberg US Aggregate Bond Index	-2.78%	-5.93%	-4.15%	Primarily U.S. Government Bonds plus investment grade corporates

Even before the February 24th invasion, the financial markets had become increasingly volatile heading into 2022. While the S&P 500 and Dow Jones Industrial Average hit new all-time highs in the early days of the new year, many of the speculative, high-growth sectors of the market had been selling off since last spring. The tech-heavy Nasdaq Composite, the small company Russell 2000, and Bitcoin last made all-time highs in November when economic growth in the US was peaking. Subsequently, the month of January narrowly avoided being the worst January in market history as stocks staged a strong rally during the final two trading days of the month. Since November, both the Nasdaq and Russell 2000 have visited bear market territory (down 20%+) and bonds suffered one of their worst quarters ever, with the benchmark down almost 7% from its July peak. For those paying attention, it proved to be one of the wildest quarters in market history. Stocks have staged a strong rally since mid-March that has given the bulls hope and the bears pause. For a more detailed look at how various asset classes performed in recent periods, please refer to the table.

The economy has been strong, even as a wide variety of indicators point to slowing growth and economic conditions in the future. In the US, the economy grew at a 6.9% annualized rate in the 4th quarter and 5.7% for the year, the largest annual increase since 1984. However, sentiment has drastically worsened with the war and inflation in the headlines and as of April 1st, the Atlanta Fed's GDP Now model predicts that growth fell to a 1.5% annualized rate during the first quarter. Goldman Sachs recently lowered its 2022 US GDP forecast to 1.75% and said that recession odds have risen to 35% over the coming year because of the Ukraine crisis. To complicate matters, the Federal Reserve, facing the most challenging inflationary environment in 40 years, raised short-term interest rates by 0.25% on March 16, and markets are currently pricing in up to 11 rate hikes, including a strong likelihood of a 0.50% hike at the next Fed meeting. Despite the Fed's tough talk about hiking rates to cool the economy and fight inflation, more than a few pundits believe the Fed and other central banks are woefully behind the curve in the fight, should have begun raising rates a year ago, and are risking runaway inflation if they don't take drastic action, such as immediately raising short-term rates to 2%.

More pessimistic prognosticators think the Fed has put itself in a box with its post-Great Financial Crisis easy money policies, policies that have juiced asset prices and arguably resulted in speculative bubbles not just in stocks, but also in bonds and real estate. Whether the Fed will acknowledge that these policies are at least partially responsible for the broader outbreak of inflation, they nonetheless face the tall task of trying to engineer a soft landing for the economy while raising rates in the face of a weakening outlook. Interest rates have already shot sharply higher in anticipation of this tightening cycle. As bond prices move inversely to interest rates, the move resulted in the worst quarter (-5.6%) for US Treasury bonds since records started being kept in 1973. 30-year fixed mortgage rates have risen to 4.95%, up more than 50% just since the beginning of the year, one of the fastest and sharpest increases in history. Although rates are still relatively low historically speaking, it's really the magnitude of the increase from historically low levels, rather than the absolute level, that is key when considering things like home affordability and the broader levels of global debt. Government, corporate, and personal levels of debt all stand at all-time highs, and if interest rates go much higher, it could be a challenge to service that debt.

A risk for the Fed is that it raises rates until it tips the economy into recession, something not without precedent. Arguably, the Fed has only engineered three economic "soft landings" in the US throughout its history – in 1965, 1984, and in 1994. One could plausibly argue that all other rate tightening cycles have either caused or contributed to the economy falling into recession, typically accompanied by a bear market in stocks. While nothing is set in stone, one thing that is certain is that year over year comps for corporate earnings and economic growth in most developed economies face an uphill climb the likes of which we've never seen in economic history because of the COVID pandemic.

If one thinks back to March 2020, economies around the world shut down and business activity was meaningfully depressed for months, but particularly during that initial period of spring 2020. This means that when earnings and growth bounced back a year later in spring of 2021, investors witnessed year-over-year growth rates they had never seen before as they were being measured against a period of mandatory economic closures. Fast forward to this spring, and comps over the remainder of the year are almost certainly the most challenging ever. This dramatic change in the rate of growth will almost certainly have financial market implications.

Not only that, but broadly speaking, conditions which acted as market tailwinds for much of the pandemic period have become headwinds in recent months. To wit, the Fed, at least in its public posture, has become much more hawkish about raising interest rates, as it has finally acknowledged it can no longer ignore inflation with the Consumer Price Index rising at a 7.9% annual rate in February, the highest reading in 40 years. In addition, the COVID pandemic resulted in governments around the world enacting widespread economic stimulus measures on both the fiscal and monetary front. These stimulus efforts and their positive effects on broader economic activity are behind us.

On top of that, there's the recent yield curve inversion in the interest rate markets. Normally, investors demand borrowers (corporations and governments) pay a higher yield on longer-denominated debt, for example, a 10-year bond normally pays a higher rate of interest than a 2-year bond. Infrequently, short-term rates will rise such that they go higher than long-term rates, a basic indicator that investors' outlook for future growth has soured. Historically, yield curve inversions have been one of the best signals that a recession is on the horizon, but experts argue over various aspects of the signal, for example, how long until the economy goes into recession once the curve inverts, or which part of the curve inverting is the most important signal. It is true that historically there have been some false signals or brief inversions where the economy did not tip into recession. Still, comparing the current environment to the past is difficult given the unprecedented easy global monetary policy since the Great Financial Crisis, not to mention the economic distortions caused by the COVID pandemic and shutdowns.

While we wish we had a more sanguine outlook for the markets and economy, we believe conditions warrant caution. No doubt, stocks have been resilient given the challenges including an almost non-stop megaphone of bad news stemming from the Ukraine situation. While the economic data still looks mostly strong across a variety of metrics, most of these are lagging/coincident indicators and likely do not reflect the effect an extended period of higher prices will have on consumer behavior and spending, which accounts for about 70% of economic activity in the US. There are indicators that even high-income consumers have changed their spending behavior.

Moreover, the inflation wild card makes it less likely the Fed will ride to the rescue to support asset prices – stocks and bonds – if we experience meaningful declines in the markets. The Fed's two primary mandates are full employment and price stability, but Fed watchers know that a third, unspoken mandate is to keep asset prices flush and the wealth effect intact. For better or worse, the stock market has become increasingly important to the general health of the economy over the past 50 years, especially with tens of millions of Americans investing in 401(k) plans. However, if inflation rages out of control, it will ultimately hurt more people than a temporary financial market dislocation, hence the Fed's dilemma.

We are not necessarily predicting meaningful declines in the financial markets. Indeed, the S&P 500 closed trading today (April 4) only 4.5% below its January 3rd all-time high. The stock volatility of the first quarter could end up being a cyclical correction rather than the start of a bear market. Similarly, it could be that most of the pain in the bond market has already happened. However, investors should weigh all considerations and we believe that risks remain to the upside.

If you have a general administrative question about your account, please contact our customer service at 800-535-4253 option 1. If you would like to set up an investment consultation, please contact our customer service line or send us an email at advisors@wespac.net. We would be happy to schedule a call or Zoom meeting to discuss your portfolio.