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Q1 2022 Commentary: The balancing act…

Inflation, war, rising interest rates; The world has changed, and it has real implications for investing going forward. Reflecting these changes, it was a difficult quarter for most asset classes except commodities. Comments from federal reserve chairman Powell and other fed officials signaled an end to the zero interest rate policy that had been in effect for some time. The Fed's turn toward a hawkish interest rate stance was immediately felt on bond prices. Interest rates rose sharply this quarter leading to a 5.9% drop in the bond market. This drop was the worst quarterly performance for bonds in more than forty years. Just this week the 10-year US treasury bond yield broke above three percent for the first time since April 2019. In the face of rising interest rates, the stock market also turned down after a seven-quarter run of positive performance going back to when the pandemic began in March 2020. For the quarter the S&P 500 lost 4.6%.

The economy continues to hum along and expectations for continued growth in 2022 are widespread. The consensus estimate of economic growth is 3.0 percent. The unemployment rate has dropped to 3.5% and job growth has been strong. Strong economic growth and low unemployment has allowed the federal reserve to turn its focus to reining in inflation. The fed's dual mandate is for stable prices and maximum employment. We are arguably at full employment and there are 1.7 jobs currently available for every person unemployed. Inflation in March was 8.5% year over year, the highest since 1981. In response, the fed is now phasing out its asset purchases and has raised rates for the first time since 2018. The bond market has anticipated further fed rate hikes and pushed interest rates substantially higher across the yield curve doing much of the work for the fed immediately.

Often our commentary reiterates that the investment environment remains positive despite various concerns that pop up from time to time. Over a period of years, this positive environment has contributed to steadily rising market valuations. Well, the investment environment turned decidedly less favorable in the new year. The fed's move from an accommodative to a tightening monetary policy is a headwind for stocks. Inflation puts pressure on corporate profit margins which are now contracting from all-time high levels. The unfortunate circumstances in Ukraine signal an end to geopolitical calm that has benefited the global economy since the Berlin wall came own in 1989. Taken together, these factors raise uncertainty and lower stock market valuations. The price to earnings ratio of the stock market is used as a proxy for stock market valuation and it has been declining and will continue to decline if uncertainty rises.

Taken in isolation a lower price to earnings ratio is problematic for the stock market. However, the strong economy can offset lower stock valuations as corporate earnings continue to rise. The S&P 500 aggregate earnings are expected to grow by 10% in 2022 and 2023. Furthermore, some of the concerns may not be as long lasting as expected. Although it is too early to draw a definitive conclusion, there are signs emerging that supply and demand imbalances may be resolving. Prices for used cars have been falling after surging last year. In addition, shipping and trucking rates have been coming down for more than a month. If there are further signs of price pressures easing, then interest rates may stabilize. On balance, many of the worries are already reflected in stock prices and serious corrections in many market sectors have already occurred. In our hunt for good companies at great prices, we are seeing many more opportunities now than we were earlier.