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Economic & Market Review

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Dear Clients and Friends,

I was optimistic that May would be better than April, but it hasn't started out that way. There is an old saying that the market has a way of making fools of the most people possible. When everyone expects one thing, it tends to do the opposite. May isn't over yet, and neither is 2022. I believe we are in the eye of the storm now and things will get better, but they might get worse first. Let us take a look at what is going on through our normal lens: the economy, inflation and interest rates, earnings, valuation, and trends.

The economy is strong. There is a lot of hand wringing in the financial press about whether the economy will slow, and surely it will at some time but right now it's strong. I am a little surprised at the negativity I read about the economy when the unemployment rate is 3.6% and people's houses have increased in value by 20% or more. Summer is here. People are traveling again. Covid is still with us, but hospitalizations are way down. I've said before, think of the economy like a light switch. It's either on or off. Right now, it's on.

If you follow the news (and who doesn't?), you are bombarded with negativity. We are so polarized, we are told, and I suppose we are. The U.S. has divided into tribes. The Supreme Court decision regarding Roe is only going to separate people (and states) further apart. There is a war in Ukraine. China is shutting down entire cities to fight Covid. Gas cost $4 a gallon (national average). Climate change is creating fires, heat waves, drought, and famines. It is little wonder that there is a lack of consumer confidence; but most of this is temporary – albeit longer lasting than we would like. The musician Jon Batiste was on the news last night, and he was asked how could he bring so much positivity to his music. His answer was "go to a hospital, or a school, or a community center… you'll see people coming together… we aren't always and everywhere divided".

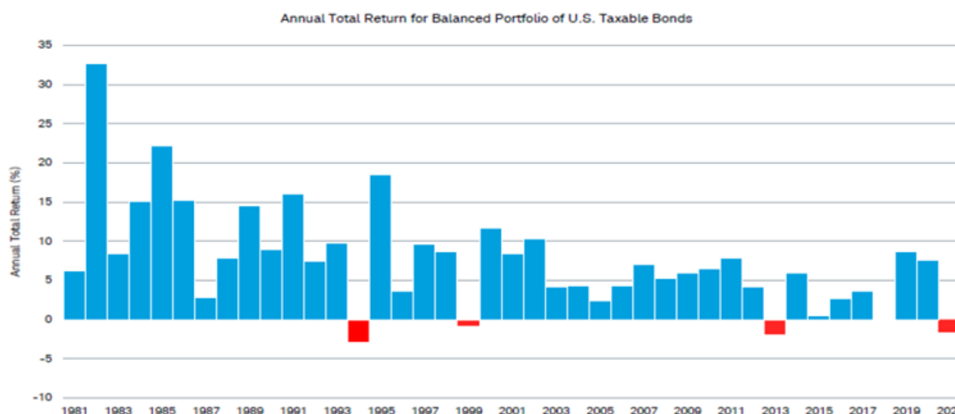
This spike in inflation is the problem, and it is not easy to solve. As I said in our last newsletter, in hindsight there were some policy mistakes; but this inflation spike was caused by the issues surrounding the Covid pandemic. There was no playbook. Policy makers are still fumbling around. Look at China. They are still shutting down, which continues to interrupt supply chains. Companies and countries are making adjustments, but it will take years. Building plants to make computer chips takes years. Taiwan Semiconductor and Intel have both announced new fabrication plants costing billions that won't be operational until 2024 or later.

Neither the Federal Reserve nor the U.S. government can fix supply problems. The Fed brings inflation down and the economy into balance by raising rates until demand is reduced. This is happening in certain industries such as housing where mortgage applications are falling; but the demand for vehicles continues to outstrip supply – why? Because of chip shortages. Unfortunately, the Fed is going to have to continue on this path until demand is reduced, or supply chains begin working again. Despite a bunch of noise from Congress and Administration, there is not much they could do

even if they were functional, which they aren't. It's just going to take some time. Inflation should be down to about 4% by the end of 2022. Granted, it has been higher and for longer than we expected, which is why we missed some investments like gold or TIPs; but with inflation likely to peak soon, and begin falling, we think it is too late to jump into those assets.

So, what happens to interest rates? Rates tend to move from one level to the next and then stay there for a while. Here is a look at the last 10 years. You can see consolidation periods around 2%, 2.5%, and 3%. I previously thought that rates would pause at 2.5%, but that was wrong. With inflation running as high as it is, and with the Fed now expected to raise rates to 2½% - 2¾% the bond market just ran ahead. It will probably consolidate around the 3% level, but that's all dependent on inflation slowing as I've projected.

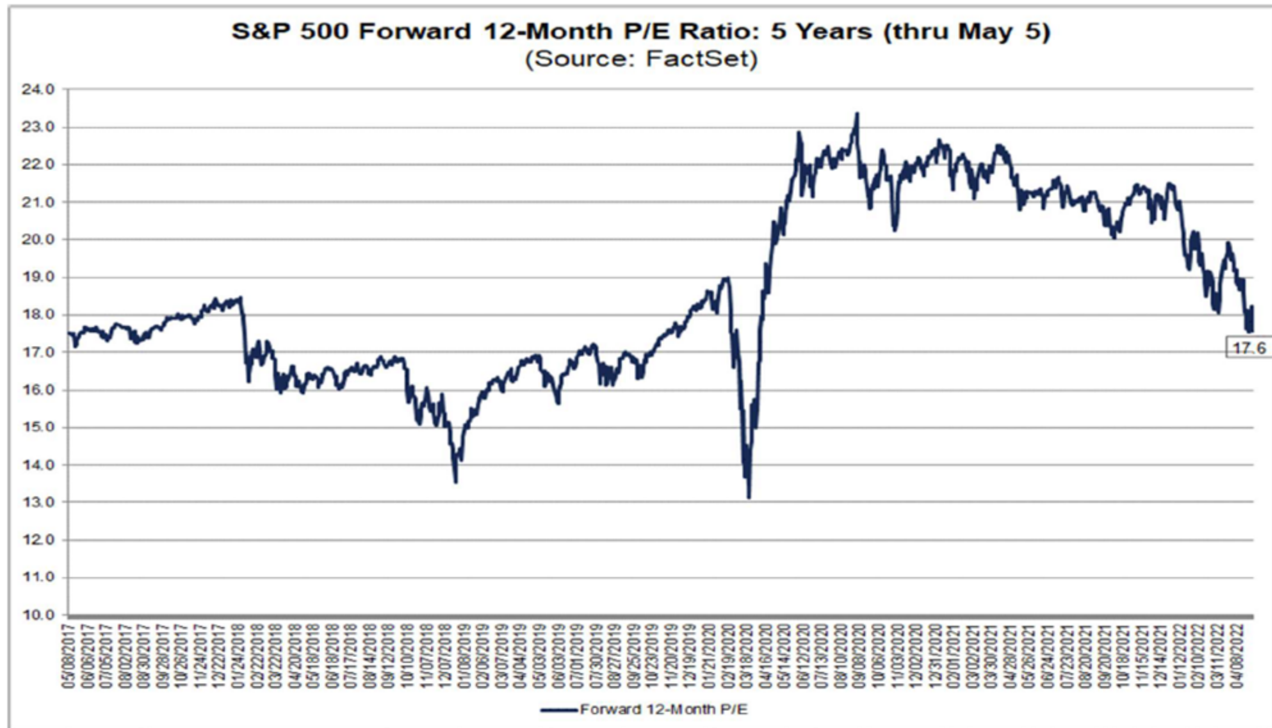
The returns on bonds have been really bad – we know; and surprisingly so. Rates have rarely, if ever risen this far this fast. A 1% rise in rates results in a 5% - 10% drop in bond prices (depending on the length of maturity). Since rates have risen from 1% to 3% over the last 1 ½ years, this has resulted in significant declines in bond prices. We mitigated the losses in a number of ways: i) we under-weighted bonds; ii) we reduced maturities; and iii) we used alternatives such as high yield bonds and other strategies. Additionally, for most clients we hold individual bonds. These will be held to maturity and the change in price is truly on paper. At maturity these bonds are redeemed at face value. All these helped but were not enough to lead to positive returns. The only positive returns in fixed income have come from cash.



Looking forward, positive returns will come back to bonds. It is a mathematical certainty, but it won't happen until interest rates stop rising – and that goes back to the previous discussion about inflation.

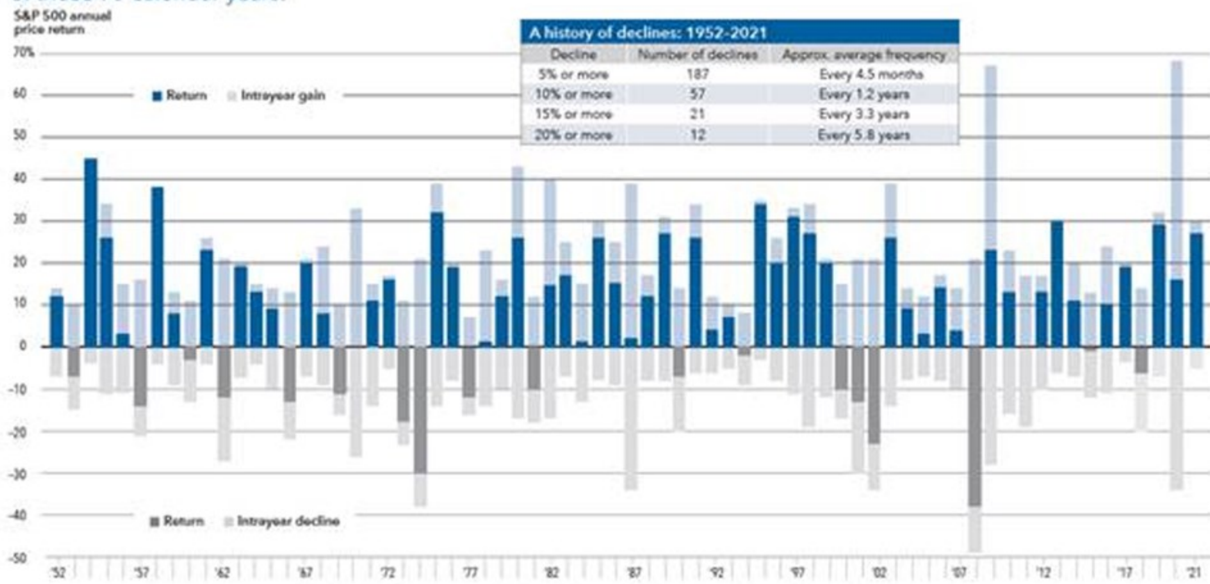
Corporate earnings continue to grow. For the first quarter, 79% of S&P 500 reported positive earnings surprises and 74% positive revenue surprises. The growth rate was 9.1%. Analysts are still projecting

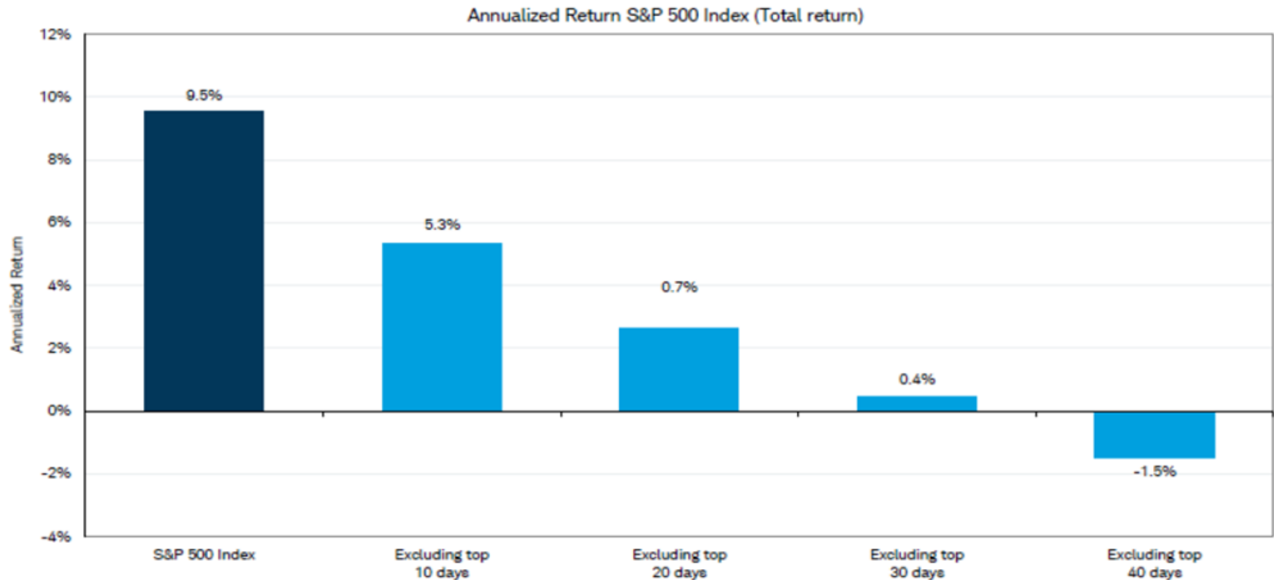
record high earnings for 2022 and 2023. Because earnings are expected to keep rising, and the market is falling, the valuation of the market is getting better. The P/E ratio based on estimated earnings is now 17.6, which is below the 5 year average and close to the 10 and 25 year average. Large cap tech stocks and speculative stocks have had significant declines. Valuations are looking better than they have for several years.



On the equity side of portfolio, we have made several changes this year. We reduced our over-weight to large cap growth and increased value. We have been under-weight international for years, and reduced emerging markets even further.

Here are a couple of reminder charts:

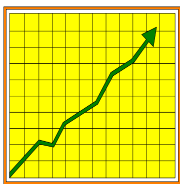




What is our strategy? What it has always been… manage risk through diversification. Make incremental changes. Don't try to make big timing calls. When it comes to changes in market trends such as growth vs. value, U.S. vs. international, or small vs. large, we look for changes that are longer term… years not months. Because our process is longer term, we will usually be late rather than early. Some assets like gold, commodities, or bitcoin do not have an intrinsic value, so they will rarely be in our strategies except in small amounts and for brief periods.

Don't panic. Rebalance. Stick with your plan.

Happy returns,



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