CLARO ADVISORS

May 2022

Claro Market Highlights - April Showers

In New England the weather is often used as a barometer for how things are going. Anyone residing here year round, or just visiting, knows that it is relevant since the weather is constantly changing, sometimes even hour-to-hour. This time of year is traditionally a rainy period where it can be 'cold and wet' one moment, yet 'sunny and dry' the next. It can be both miserable and forward looking as we patiently wait for those brighter days. One popular phrase that helps get people through is that "April showers bring May flowers." Following a particularly gloomy month of April and a tumultuous start to the year for financial markets, investors hope that this month of May will also yield more flourishing results.

Despite the relief as we move forward from the Covid crisis and return to some sense of normalcy, the ramifications of grinding the global economy to a standstill and trying to restart it are still trickling through, in particular the effects of inflation and the expectation of rapidly rising interest rates. Throw in a worrisome war in Ukraine and another China Covid lockdown which are further hampering supply chains and the markets have certainly felt the impact as both stock and bond prices have retreated.

Here are how some selected metrics performed in April and so far in 2022[1]…

- **Large Company** stocks were down -8.8% in April and are down -13.3% Year-to-Date (YTD)
- **Small Company** stocks fell -9.9% for the month and have fallen -16.7% so far this year
- **International** equities gave up -6.8% and have given back -12.9% so far in 2022
- **Emerging Market** stocks were down -5.8% and are off -12.7% YTD
- **Taxable Bonds** pulled back -3.8% in April and have retreated -9.5% this year
- **Municipal Bonds** declined -2.8% in the month while falling -8.8% YTD
- **Oil** prices rose +4.1%. The price of crude has jumped +39.2% so far in 2022
- **Bitcoin** had another volatile month down -18% and similarly is down -18% this year
- **Gold** price fell -2.3% in April, but remains postitive +3.7% in 2022

[1] The following indices were used for reporting purposes: Large company stocks (S&P 500 index), Small company stocks (Russell 2000 index), International equities (MSCI EAFE index), Emerging Market stocks (MSCI EM index), Taxable Bonds (Bloomberg Barclays U.S. Aggregate Index), Municipal Bonds (Bloomberg Barclays Municipal Index), Oil, Bitcoin and Gold prices are reported using prices from YCharts

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Inflation and Interest Rates

Milton Friedman once said that "inflation is taxation without legislation". It sure feels that way recently as the cost of goods and services has increased more than 8.5% so far in 2022 and the impact of it is being felt by consumers and businesses alike. This is the highest year-over-year cost increase since the early 1980s.

Consumers have especially felt it at the pump as gas prices nationally have risen to over $4 per gallon on average with some states, like California, around $6 per gallon. In perspective, two years ago consumers were paying closer to $2 per gallon. Food prices have also soared up 8.5% since April of 2021. Although higher prices haven't seemed to affect spending habits just yet, it's hard to believe that the consumer will be able to keep up with rising costs.

These escalating prices have prompted the Federal Reserve to act more swiftly and aggressively in setting monetary policy than they had anticipated. They are expected to raise the target Federal Funds range to 0.75% to 1.00% in their May meeting and will follow with several more increases throughout the remainder of the year. In addition, they anticipate shrinking their balance sheet by selling their bond holdings to the market by as much as $95 billion per month. The hope is that by raising rates and borrowing costs it will cool off demand and bring prices back under control.

GDP and Corporate Profits

Although the recent advance report on first quarter GDP issued by the Bureau of Economic Analysis (BEA) was negatively received as it surprised to the downside, there is some good news in that the economy actually expanded by $380 billion or 1.6% (6.5% annualized) during the first quarter, however that is in nominal terms. The bad news is that after adjusting for inflation it actually shrank by $70 billion or -0.4% (-1.4% annualized) in real terms. What this means is that inflation negatively affected the value of all goods and services produced. It's unfortunate because it shows that without inflation the economy would otherwise be expanding quite robustly.

We can find even more reasons to be optimistic in the report. It shows that despite the effects of inflation, economic activity has been increasing steadily and the overall direction of the economy is still positive. This is particularly true in the services sector which accelerated during the quarter by 2.2% and has increased by 11.6% over the past year as people are traveling and dining out more post-Covid. Consumer spending overall and business investment has also continued to increase as demand remained elevated despite rising costs. Overall, the economy has expanded compared to a year ago by $680 billion or 3.6% in *real terms* over that period. We are even ahead of where the economy was pre-pandemic despite the elevated inflation!

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In addition, corporate profits are strong and the outlook remains positive despite rising costs and margin pressure. This provides an interesting backdrop for stocks. For savvy investors, the time to buy great companies at great prices is often when the skies appear the darkest. With the recent pullback in the stock market this can provide an opportunity as there are often bargains to be had for patient investors who are willing to wait out the storm. Currently the S&P 500 is trading at 17x expected earnings for 2022 and 15.75x expected earnings for 2023. Historically that can represent value for long-term investors. If prices were to retreat further it would become even more of an opportunity for those seeking to invest for the long-term. After all, one of the biggest determinants of your return on an investment is the price that you pay.

Employment and Income

Another wrinkle of optimism is the current state of employment in the United States. In the latest report from the U.S. Bureau of Labor Statistics, total jobs increased by 431,000 in March and the unemployment rate dropped to 3.6% with notable job gains in leisure and hospitality as the economy continues to reopen. On top of that, there are currently over 11 million job openings according to the latest JOLTS report. Right now jobs are plentiful and it is a reason to be hopeful, although things can certainly change if the economy does continue to slip. Along with jobs, incomes have also been increasing although inflation has curbed the effect on the wallet in real terms. If the headwinds facing the economy continue to mount, one measure of reassurance is that household debt service as a percent of disposable income is still historically low at less than 10%. We shouldn't be too concerned about a credit crisis from too much borrowing as the ability to pay seems sufficient.

The Bottom Line

It's understandable that investors are on edge with the number of concerns currently facing the economy. The market volatility so far this year has certainly been a reflection of those fears. It comes at a time when we can finally see the sun on the horizon as we move beyond Covid. But the skies can quickly darken with inflationary and geopolitical risks in abundance. Once again we will need to rely on the Federal Reserve to navigate us through the storm. The Fed has indiciated that it will do what it takes to curb rising prices. If the Fed is able to combat inflation without damaging demand too much (soft landing), then it can get us to smoother seas and the economic expansion can continue.

In conclusion, we would not underestimate the U.S economy and its ability to handle stormy weather. Businesses and consumers alike are quite resilient and adapt quickly to the ever changing economic landscape. For investors, this current period once again demonstrates that financial markets are not always benign and can be quite volatile when they react in the near-term to issues facing the economy. The good news is that once the problems are known with more certainty and we address them, the future becomes a bit more clear and the animal spirits will once again take hold. Much like the April showers, the gloom and pessimism will eventually give way to brighter days and growing portfolios.

Michael E. Mullin, CFA
Chief Market Strategist
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