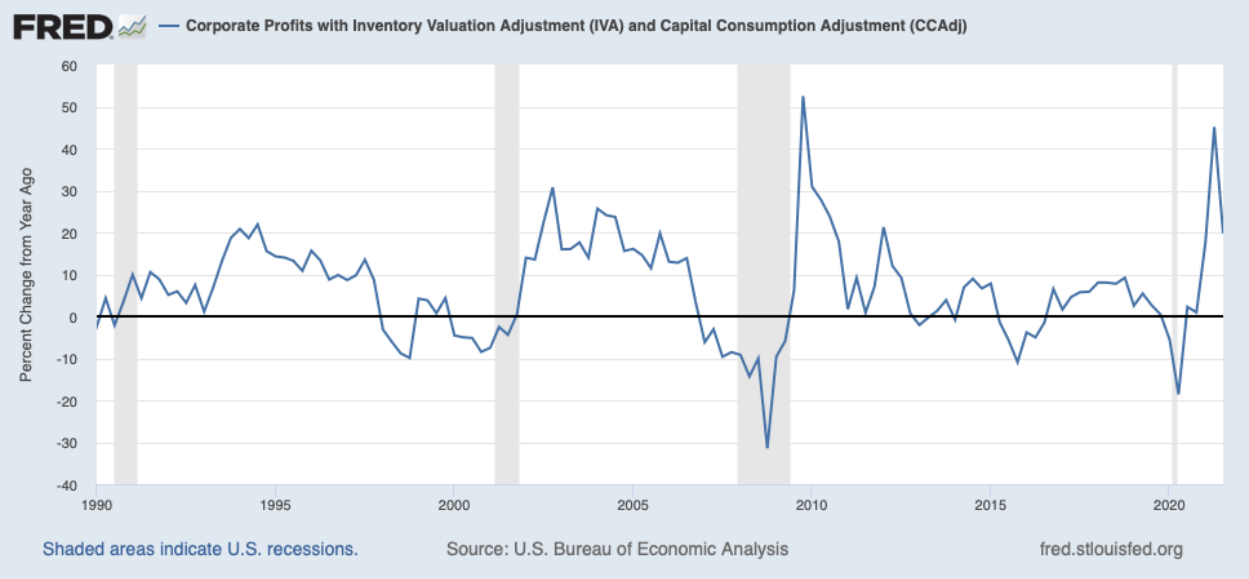
CLARO ADVISORS

Is the party over or just taking a pause?

Are investors being overly concerned about inflation and the upcoming policy response from the Federal Reserve? Both concerns seem to be doing a good job lately keeping investors nervous and could have further ramifications of curtailing growth.

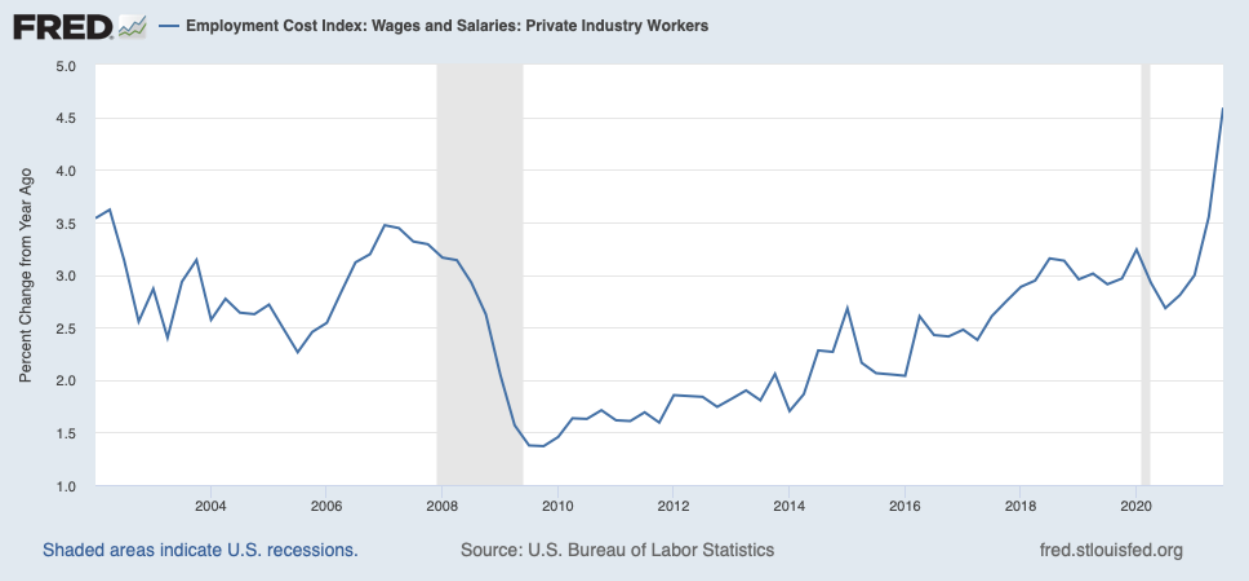
Coming out of the Covid recession, investors have benefited from a strong, recovering economy, fiscal and monetary stimulus, healthy corporate balance sheets and tepid consumer spending. Yet there is plenty of fear out there to go around. Whether it is fear that stock valuations are too high after a greater than 100% recovery from market lows in March 2020. Or because the pandemic simply won't go away, and that the health of people are still at risk. Or it's geopolitical risk with global eyes on the Ukraine, as Russia continues to make motions that it could be planning a hostile takeover.

Financial markets have subsequently responded with a sharp increase in volatility as investors are getting a bit unsettled. The Dow Jones Industrial Average reached a new high at 36,950 in early January before falling 3,500 points or -10% recently. The S&P 500 has suffered a similar fate, peaking above 4,800 before shedding -12% falling below 4,300. The technology heavy Nasdaq actually reached new highs back in November eclipsing the 16,000 mark before sliding to 13,000 recently, a drop of almost -19%. There is too much going on for the markets to digest making investors skittish and it will take some time to alleviate those fears. One such panacea could be corporate earnings. S&P 500 companies have delivered strong earnings growth since the economic trough and although one would expect the rate of growth to slow it should remain robust as the economy continues to expand and consumers continue to spend.



A clue of how much of a slowdown in earnings growth could be in margins. Wage increases could cut into profits as indicated by the employment cost index (ECI) which has been increasing steadily. JP Morgan recently stated in their earnings report that increased labor costs are a "headwind" in their profit outlook.[1] They won't be the only company to acknowledge that as earnings season gets under way.

[1] https://www.jpmorganchase.com/content/dam/jpmc/jpmorgan-chase-and-co/investor-relations/documents/quarterly-earnings/2021/4th-quarter/ae462261-4964-48c6-b947-4b69963d1143.pdf



So, which is the bigger risk? Inflation or the Fed's response? In one camp, investors are concerned that the economy is getting overheated and we're about to be faced with prolonged years of run-away inflation. Alongside that, they are concerned that the Fed is about to remove the punchbowl, signaling that the party is officially over. Hence the expression that you don't want to be the last one left dancing when the lights come on and everyone else is racing for the exits.

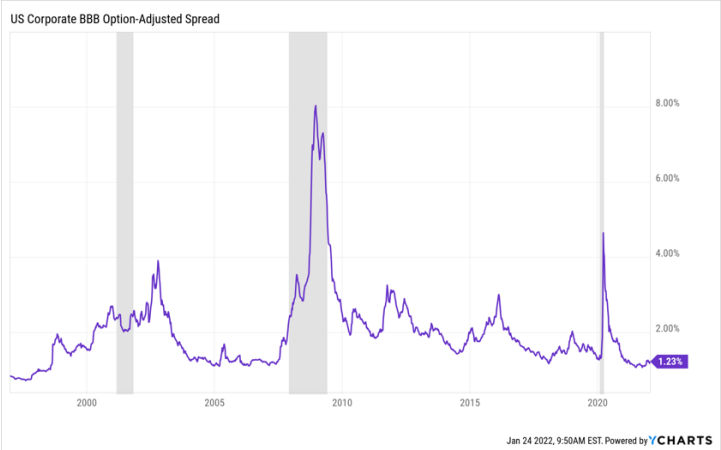
With rising costs resulting from supply-side imbalances in commodities and labor, many hawkish pundits have been calling for rate hikes of four or more this year. This has led 2-year treasury yields to rise above 1% after being as low as 0.20% at the end of August 2021. Meanwhile the 30-year treasury has barely moved over that time from 1.92% to 2.07% currently. This indicates that the long-term outlook on inflation has remained benign with long-term yields remaining low. This has also led to some Yield Curve flattening as the 10-2 year treasury spread has fallen from 1.59% in April 2021 to 0.74% currently. Is inflation then a short-term problem that will resolve itself or will it become prolonged?

In past cycles, the Fed has waited at least two years post-recession before initiating rate hikes. What does this cycle hold? Many are speculating that the Fed will raise rates at the March, May, and June meetings to help curb inflation. Goldman Sachs economists even predict the Fed could raise rates in March, June, September, and December while beginning balance sheet reduction in July. They cite that the Covid Omicron variant is prolonging supply chain imbalances, while wage growth has been robust and sticky.[2]

The answer likely will come from the data itself. The Fed, as in prior cycles, will take a "wait and see" approach. They indicated in past meetings that they see a transitory component to rising costs. They removed that language last year because the market didn't like it and near-term data reflected those inflationary pressures were remaining persistent. Yet, they still expect those pressures to ease in the coming quarters, so they could raise rates in March to give the market what it wants and then become data dependent.

From a market perspective, are we already in a correction and potentially entering oversold territory? The Dow Industrials are down -6.5% year-to-date, the S&P 500 is off -9% and the Nasdaq is off -13.5%. It could be worse, some sectors such as consumer staples, energy and financials have helped buoy the indices while some stocks are positive such as Chevron, Merck, Verizon, and Coca-Cola. Meanwhile the average stock is down -15% while the average technology stock is down -20%.

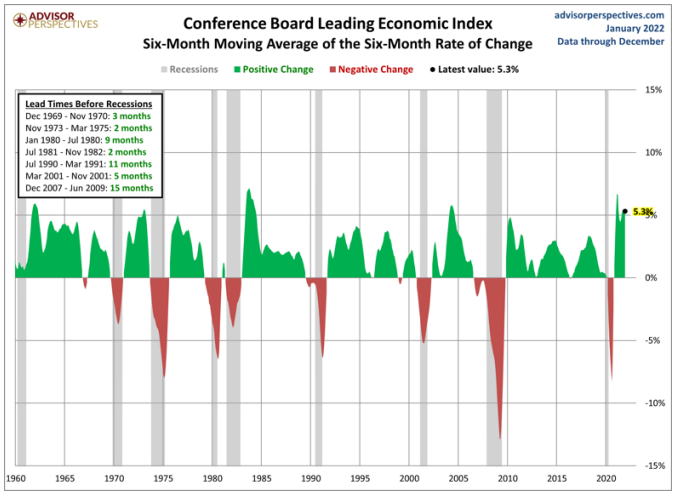
One would think the bond market would be showing signs of crisis, yet amazingly credit spreads are being well behaved whether it's the aforementioned Treasury yields, or corporate credit spreads which have also remained rather calm and benign. Typically, corporate spreads will spike as the market expects higher-risk corporate balance sheets to deteriorate. Less volatility in the bond markets show that fears in the equity market may be unwarranted.



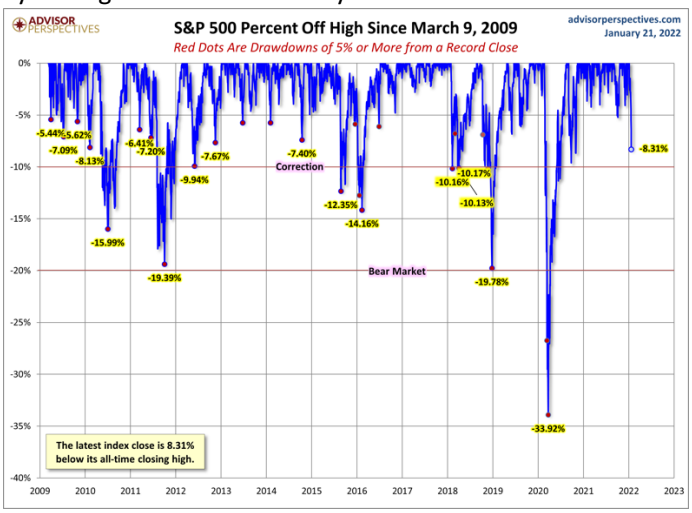
Inflation expectations have also been trending down, despite the 7% year-over-year rise in the Consumer Price Index (CPI). The 5-year forward expected rate of inflation is below 2% after spiking this past fall at 2.4%. Real yields also are trending well for those less hawkish. The 10-year treasury inflation adjusted yield increased from -1.17% to -0.50% the past two month indicating that inflation fears could be waning. Break even yields on the 10-year Treasury have even started to roll over from 2.76% to 2.33% as real yields push higher. And last week, in particular, 10-year Treasury nominal yields held steady around 1.8% despite all the market volatility.

[2] https://www.bloomberg.com/news/articles/2022-01-23/goldman-sees-risk-fed-will-tighten-at-every-meeting-from-march

Lastly, we can look at the economy. Even if we expect growth to slow, it is still expected to be robust. Forecasts have the U.S. economy growing at 3.5% at least in 2022.[3] In addition, eight of the ten components of the Conference Board's Leading Economic Indicators and the index rate of change are positive signaling a continuing expanding economy.



Therefore, we expect that the market volatility we're seeing currently to be typical of a market cycle, especially when the future gets a little cloudy. Inflation expectations, monetary and fiscal policy changes, geopolitical risks, etc.… all can factor into market gyrations. When markets get a bit over-extended, they need to adjust and correct. In real-time it's not a fun experience for investors seeing their portfolios being tossed around, but we know from past experiences that when fears subside and things settle down, then markets can get back on a path of growth. As a matter of illustration, the below graph demonstrates that there can be quite a few periods of market volatility throughout an economic cycle.



In our estimation, the party might be winding down or taking a break, but it's not over. Investors should acknowledge that and use the market correction as an opportunity to reposition portfolios for the long-term.

Michael Mullin, CFA
January 24, 2022

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[3] https://www.conference-board.org/research/us-forecast