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2nd QUARTER OUTLOOK

Those Pesky Headwinds

In our 1st quarter 2022 outlook, in a section titled Winds of Change, we addressed the headwinds that the economy and the markets would be facing as we entered the new year. We knew that inflation was running at a pace that had not been seen in decades. We also knew that the Federal Reserve and Chair Powell were about to embark on a crusade to fight the very inflation that they purposely helped create over the past decade. Note: they only helped create, as fiscal spending, political choices and a pandemic that shut down the global economy were also contributing factors to the inflationary pressures we see today. Then, as we know, Russia invaded Ukraine and those inflationary pressures were elevated as energy, metals, and grains all spiked in price. The first quarter of 2022 became a whirlwind of inflationary pressures, giving the Federal Reserve an even more vaunted task than they were already preparing to deal with entering the new year.

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It wasn't difficult to guess that with the headwinds that prevailed, 2022 was going to be a more challenging year for financial assets, and the first quarter surely gave us a taste of that. Stocks began to fall by mid-January and in short time major averages were either in correction or bear market territory. Interest rates began to rise in anticipation of the Fed raising interest rates and also ending asset purchases (quantitative easing), which sent bond prices tumbling. A balanced portfolio of stocks and bonds saw both sides of the ledger losing ground.

As we moved into the final weeks of the quarter, stocks staged an impressive rally erasing more than half of the previous months decline, but in the end, stocks were still down 5% to 10% in the market averages and the damage below the surface was much more destructive. Especially in the Nasdaq, as many as half of the stocks in the index were down 50% or more, some down as much as 80% or more. Because of the weighting in the market averages of the super mega cap growth names, which were only down mildly if at all for the quarter, the overall damage appeared minor in nature. But, as we mentioned along the way in our daily commentary, it felt like a bear market whether it was official or not.

So, the question going into the second quarter of 2022 is did we just see a bear market rally at the end of March that will end soon, or have we begun to rebuild the bull market of the previous year and a half, and are about to work our way back to the old highs and beyond?

The Federal Reserve and Monetary Policy

As we noted, the Federal Reserve has embarked on an inflation fighting journey in 2022. Monetary policy, which has been mostly dovish for more than a decade, now is becoming hawkish. The Fed has begun to raise rates, moving the Fed Funds rate off of zero to one quarter of a percent in March. At the next FOMC meeting they are likely to raise the Fed Funds rate another ½% and then continue rate hikes at meetings throughout the year. We are already seeing the effects of policy change making their way into the economy and the marketplace even before they happen. The 30-year mortgage rate has moved up to more than 5% already. Remember it was well under 3% just last year.

In addition to interest rate policy, the Fed has retired its asset purchase program, commonly referred to as Quantitative Easing or QE. This has been a powerful monetary tool for the Fed in recent crises (the financial crisis of 2008-2009 and the pandemic crisis of 2020), adding liquidity to the system when needed and some might say when it wasn't needed. Whatever the case, that liquidity driver is no longer in motion. The next step is to attempt to get the Fed's balance sheet back to "normal" which will likely include asset sales or at least asset run off. You might have already guessed that this monetary tool is called Quantitative Tightening or QT.

The Fed hopes that these steps will help begin to alleviate inflationary pressures by tightening the purse strings, so to speak. Of course, there are inflationary pressures that the Fed has no control over. Whether the Fed's actions will be successful in helping curb inflation will only be determined in time. But the markets appear to be concerned with the unintended (or are they?) consequences of the Fed's new hawkish policies. Will the speed and aggressiveness of the policy pivot actually cause the economy to retreat and possibly move into a recession. You see, inflation is a about the dynamic between supply and demand. Coming out of the pandemic supply was lacking and demand for goods and services was extremely high. The Fed does not have much if any power over the supply side of the equation. But the Fed through its policies can affect the demand side of the equation. The path that the Fed is now on should, and likely will, at some point cause demand destruction in areas like housing. Destruction in demand happens when prices of goods get so high the consumers simply cannot or refuse to purchase them. If mortgage rates continue to rise, demand for new homes from buyers who must borrow will decline.

Will higher interest rates and less liquidity in the system be helpful tools in curbing inflationary pressures? Will the Fed's aggressive pivot actually slow the economy to the point of causing a recession? These are the questions that market participants pondered during the first quarter of 2022 and likely will be pondering for quarters to come.

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Stocks and Bonds and The Economy

So where does that leave us as we look into the second quarter of 2022 and beyond? Don't fight the Fed is an old Wall Street adage. It has worked for more than a decade. The Fed has been accommodating and financial assets, namely stocks and bonds, have been the beneficiary. Now, with the Fed's pivot to a very hawkish monetary policy, the opposite comes into play. The Fed's fight against inflation may continue to create a challenging time for stocks and bonds. If the belief is that the Fed will win the battle with inflation (and it likely will but at what cost?) then stocks can continue to do relatively well. If the belief is that the Fed will either fall further behind in its inflation battle or maybe worse, become too successful in destroying demand, then stocks may continue to struggle for a period of time.

When all is said and done, earnings are how we measure a company's stock value. In the coming quarters we will find out just how much inflation and potential demand destruction is affecting corporate America. Demand for goods was high during the pandemic and coming out of the pandemic. The demand for services has now exploded as we have come out of the pandemic. Companies that produce goods had fared well, but scarcity, inflation and demand destruction now is beginning to come into play. On the other hand, companies that provide services (travel and leisure for example) are seeing no slowing whatsoever. Remember, the service sector accounts for nearly 70% of GDP. So, at the moment, a recession seems like a remote possibility with 70% of the economy humming along nicely. Indeed, analysts who are predicting that the Fed's actions will cause a recession are indicating that the coming recession may not be until 2023 or even beyond.

So, companies that produce goods are certainly being challenged and their earnings will be in question over the coming quarters. On the other hand, service providers have been able to raise prices without any drop off in demand as Americans desire to travel and have fun. The likelihood is that many companies will struggle to meet earnings expectations in the coming quarters based on input costs and possible demand destruction, but there will be some companies that continue to benefit from the surge in demand for services.

Bonds had an even more difficult time than stocks in the first quarter of 2022. Interest rates are rising (bond prices fall as interest rates rise) and bondholders are feeling pain that they haven't experienced in quite a while. "Don't fight the Fed" is not only reserved for holders of stocks. The Fed's toolkit to fight inflation mainly centers around raising interest rates, kryptonite for fixed income investments. So, if the inflation threat to stocks is somewhat nuanced, the threat to bonds is not.

Summary

We are in an inflationary environment which we have not seen in decades. The Federal Reserve has now begun its battle to fight the very inflation that they had a hand in creating. Inflation and the battle to tame it comes at a cost for holders of financial assets. We talked about the pressures that companies feel when their input costs are rising. As interest rates rise, the cost to borrow money also rises -another pressure on corporate America. But rising interest rates don't only affect the borrower, the lender (bond holder) also sees his bonds lose value as those rates rise. So, holders of financial assets are challenged when inflation rears its ugly head.

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If interest rates rise, then bond prices fall. That is a given and if the Fed is going to continuously raise the Fed Funds rate throughout the year, holders of bonds, particularly of longer maturities, will be under pressure. On the other hand, what stocks will do during an inflationary period is much more difficult to predict. Some companies are less vulnerable to inflationary pressures than others. Also, history has told us that stocks, in general, have fared reasonably well during inflationary periods. But stocks do not do well in a recession, and there is fear that the Fed’s battle with inflation will lead to one, later if not sooner.

We haven’t seen the Fed take on inflation in more than 4 decades, so it’s understandable that markets are very unsure as to what is going to unfold over the coming months. With regards to stocks, have they discounted the potential trouble ahead? Are they properly priced given the uncertainty of the success of the Fed’s monetary policy pivot? This is the challenge to investors for the remainder of 2022. Beware of those who claim to have all of the answers to these questions. Many of these “pundits” are the same ones who have been wrong for more than a decade. We will all discover the answer to these questions together.

As always, we appreciate that you entrust us to manage your money and guide you on your road to financial success. We strive to keep you informed and to provide you with the best service in the industry. These are difficult and confusing times, but hopefully our daily updates are providing you comfort.

Do not hesitate to contact us with any thoughts or questions. If you feel that we can help someone you know and love, find their way to financial success don’t hesitate to let us know. Buckle up, it’s going to be an interesting year, but we’ll get through it together.