Economic Outlook

By Dr. John McAlhany

The US economy grew last year at the fastest pace since Ronald Reagan’s presidency, bouncing back from the brief 2020 recession. As measured by GDP, the economy expanded by 5.7% in 2021, the strongest growth since the 7.9% surge following the 1984 recession. However, looking forward, to quote the prominent economist Ed Hyman, we are in “Unprecedented Times” and furthermore, for the future of our economy we “must accept the likelihood that outcomes will be particularly uncertain.”

The economy is currently strong as jobs are plentiful with wages and salaries increasing. This is adding to consumer savings and their desire to spend – 70% of GDP. Consumer spending increased by 6.7% in 2021 (Real Personal Consumption Expenditures), and the economy is still benefitting from the massive stimulus provided by the government and the Federal Reserve (Fed) during the pandemic. However, there is uncertainty surrounding the future of our economy which arises from the fact that our strength has created an unacceptable level of inflation.

As measured by the Consumer Price Index, the annual rate of inflation was 7.9% over the last 12 months and taking out volatile components of food and energy, core inflation was still an unacceptable 6.4%, well above the Fed’s target of 2.0%. The war with Ukraine and the sanctions placed on Russia will also put upward pressure on inflation as energy prices soar and supply chains become more disrupted. In addition, the virus situation in China is also impacting supply chains and adding to inflationary pressures.

At their March meeting, the Fed recognized that they had put too much faith in transitory inflation due to supply chain problems rather than embedded inflation caused by a wage-price spiral. Thus, they began what will be a series of interest rates increases aimed at slowing the growth rate of our economy and inflation. They increased the range for the overnight lending rate used by banks – Federal Funds Rate – from 0% to 0.25% to a range of 0.25% to 0.5%. The market is pricing in an additional eight hikes in 2022, taking the Fed Funds Rate to a peak of 3.25% in 2023 after which they anticipate a reduction in rates to 2.5% in 2024.

In somewhat of a change in Fed policy, Chairman Powell has singled out “job openings and quits” as a key measure of the strength of the labor market and a target of Fed interest rate policy. Chairman Powell has said that the central bank hopes to reduce the number of available jobs as a way of cooling wage increases and wage pressure inflation. They have their work cut out for them. The recent JOLTs – Job Openings and Labor Turnover – report on the labor market was the strongest on record.

There are nearly 5 million more job openings than there are unemployed Americans. Job resignations are also around 4.4 million, a sign of a strong market as laborers quit, seeking a new job or higher wages. Small businesses are particularly hungry for talent accounting for 47% of the job openings. The labor market remains strong as employers added 431,000 jobs in March and the unemployment rate fell to 3.6%, near the pre-pandemic rate of 3.5%. Jobless claims for unemployment insurance are also falling. During the week of March 19th, unemployment claims fell by 28,000 to 187,000, the lowest since September 1969.

Following the recent Fed meeting, Chairman Powell said, “we have expectations that inflation will peak and begin to come down this year.” The Fed is hoping that by gradually increasing interest rates and using other targets, they may create a soft-landing in the economy rather than a recession. Historically it has taken a recession to break an inflation spiral. They hope to avoid this outcome and Chairman Powell was quick to point out that “a soft landing has been common in US monetary history, e.g., 1965, 1984, 1921 and 1998.”

To summarize, the US economy remained resilient during the first quarter and is likely to remain so into the near future, especially if we get a resolution to the Ukrainian war. Most economist gauge the probability of a recession at less than 25%. There is a lot of Fed and governmental stimulus still affecting the economy. Consumers are flush with cash with savings of around $2 trillion and consumer net worth – which leads consumer spending by half year – grew by over 8% over the last 12 months.

These are “unprecedented times” – war, inflation, active Fed, etc. – all of which are creating more uncertainty than usual. We are watching the economic data and market signals carefully to see if the Fed can navigate a soft landing with declining inflation and a normalization in supply chain disruptions; thereby, decreasing the probability of a recession and allowing the economy to grow on into the future.

The Stock Market

By Walter Todd

Well we said that equity markets in 2022 would likely be more volatile vs. a relatively quiet 2021 (just the fourth year in the past 40 to have a 5% or less pullback), but man, I didn’t think it would all happen in the first three months. That was an interesting quarter to say the least. We started out on a high note, hitting a new all-time record in the S&P 500 the second trading day of the year, but less than three weeks later we were down over 12% from those levels (and that was before the war in Ukraine started). Then the yo-yo started – up 9%, down 10%, up 7%, down 5% up 11%. Back and forth with headlines from the Federal Reserve, the war in Ukraine and eye-popping commodity moves driving the market day to day. While certainly a harrowing ride, we did see some corners of the market hold up and the S&P 500 did finish higher for the month of March. Let’s take a look inside the numbers for the first quarter of 2022.

For the quarter, the S&P 500 Index closed down 4.6%, including dividends. The first negative quarter and the worst quarterly performance since Covid broke out during the first quarter of 2020. Small-cap stocks (as measured by the S&P 600) performed slightly worse, ending the quarter lower by 5.6%.

This was again different from another small cap index, the Russell 2000, which was off by 7.5% for the same period. International stocks, which started the quarter off strong, faded with the outbreak of war in Europe with Developed International Markets falling by 5.8% for the quarter (as measured by the EAFE Index). Emerging Markets (EM) fared worse, dropping 7.0% for the quarter (using the MSCI Emerging Market Index). Putting the US and International Markets together, the MSCI All-Country World Index (ACWI) finished lower by 5.3% for the three-month period.

The sector performance can really be summarized as Energy and everything else. Given the 30%+ rise in WTI crude oil, the Energy sector dominated performance, rising 39% to start the year. Utilities was the only other positive sector during the quarter, up just under 5%. Consumer Staples, Financials and Industrials rounded out the top five but finished lower by 1% to 2%. Materials and Healthcare were two of the remaining sectors that outperformed the overall market, down between 2% and 3%. Real Estate, Technology, Consumer Discretionary, and Communication Services were at the bottom of the list, falling between 6% and 12% for the period. Despite ending the final month of the quarter higher, the market definitely had a defensive tone to it, with Utilities leading the move up, rising over 10% in March.

We talked last quarter about the influence of the largest names in the S&P 500 and while these holdings did get hit hard in the first two months of the year, they resumed leadership in March. We still believe there is better value overall down the market capitalization spectrum. Given the price movements in other parts of financial markets including significantly higher commodity prices and interest rates, it is no surprise that the equity market is starting to show signs of concern regarding economic growth in the US and globally. We can see this not only in the price direction of the overall market (generally lower), but also the sector performance in recent weeks as investors are gravitating toward less economically sensitive parts of the market like Healthcare and Utilities. Between these two areas, we favor Healthcare given the long-term growth prospects in this group and we have recently added weight to this space.

The first quarter earnings season will be interesting as companies provide an update on how they are navigating continued supply chain challenges and higher input costs. Diversification, valuation levels, and sensitivity to both geopolitical and supply chain issues are currently even more of a priority than usual. The ride could continue to be bumpy for equities in 2022, but we will endeavor to look for the opportunities these price movements create.

The Bond Market

By John Wiseman

Well, that escalated quickly!  Bond yields jumped higher resulting in one of the worst quarterly performances for fixed income on record.  As mentioned in the Economics section, inflation has not abated, the job market remains strong, and the consumer is excitedly adding post pandemic spending on services along with the continued buying of goods.  The war in Ukraine supplanted Covid as the reason for stressed supply chains with the focus on worldwide food and energy stores.  The higher inflation and central banks pivoting to a more hawkish stance sent bond prices sharply lower (and yields higher).

The Federal Reserve increased its Funds Rate range by one quarter percent and is expected to hike it by two more percentage points at its meetings throughout the year.  The yield on the 2-Year Treasury note increased by 160 basis points (1.60%) this quarter to 2.33% while the yield on the 10-Year Treasury Note moved up 83 basis point (0.83%) to 2.34%.  This resulted in total returns of -2.50% and -6.75%, respectively.  As noted above, the yield curve is flat which means yields at various maturities are roughly the same level. This is historically not a great sign for future economic activity.  We think inflation will remain persistent and is not fully reflected in long bonds, but shorter maturities offer attractive opportunities due to the sharp move higher in yields.

Corporate bonds were equally challenged during the quarter.  Not only did the underlying rates move higher, but the spreads at which corporates trade above the underlying rates also moved higher.  The spread of the Bloomberg Intermediate Corporate Index reached its highest level since the pandemic of 122 basis points (1.22%) before settling the quarter at 92 basis points (0.92%).  For perspective, this index was 58 basis points at its lows last year and has averaged 105 basis points over the last 10 years, including the spike to 380 basis points in March of 2020.  The total return of this index was -5.25% for the quarter – the third worst reading in the near fifty-year history of this Index.  Corporate bond issuance has been robust from investment-grade companies.  We are favorable to corporate bonds as spreads have moved higher and the weakness in risk assets is not a broad-based credit event.

Municipal yields held stable in the initial move higher in rates late last year, but finally joined other fixed income investments in the difficult environment as the calendar turned to 2022.  The Bloomberg 5-Year Municipal Index ended the quarterly period with a total return of -5.10%, which was the worst quarter for this index dating back to 1988.  The ratio of the 5-Year Municipal to Treasury, a measure of relative value, is 78% which is slightly below the ten-year average.  According to Strategas Research Partners, for the 2021 calendar year State & Local Governments produced their largest budget surplus since 1941 thanks to funds from the federal level.  That money is just beginning to be spent.  The lack of fixed income alternatives and low rates post pandemic attracted non-traditional investors to the municipal market.  We think this dynamic will fade and municipals will remain attractive for investors in higher tax brackets.

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|  | **Market Indicators** | | | |
| Source: Bloomberg | | **QTD 2022**  **Total Return1** | **YTD 2022**  **Total Return2** | **52 Week**  **Total Return3** |
| **S&P 500** | | -4.60% | -4.60% | 15.63% |
| **DJIA** | | -4.10% | -4.10% | 7.11% |
| **NASDAQ** | | -8.94% | -8.94% | 8.09% |
| **S&P 400** | | -4.89% | -4.89% | 4.56% |
| **S&P 600** | | -5.64% | -5.64% | 1.15% |
| **MSCI EAFE** | | -5.77% | -5.77% | 1.70% |
| **MSCI Emerging Markets** | | -6.99% | -6.99% | -11.13% |
| **MSCI ACWI** | | -5.26% | -5.26% | 7.74% |
| **Bloomberg Barclays Int. Gov’t/Credit** | | -4.51% | --4.51% | -4.10% |
| **Bloomberg Barclays Aggregate Bond** | | -5.93% | -5.93% | -4.15% |
| **Barclays 5-Year Municipal** | | -5.10% | -5.10% | -4.48% |
| 1. 12/31/21 to 03/31/22 2) YTD through 03/31/22 3) 12 Months Ended 03/31/22 | | | | |

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