

First Quarter 2022



Figure 1 – S&P 500



Figure 2 – U.S. 10-Year Treasury Yield

Market Recap

Markets fell hard early in the first quarter but recovered most of their losses by the end of March. The S&P 500 dropped 12.5% in February (**Figure 1 – S&P 500**), notching an official “correction”, but ended the quarter -4.6% as confidence in corporate earnings steadied. Other indices registered similar losses, with the S&P 400 Mid Cap index -4.9% and the Russell 2000 Small Cap index -7.5%. In a reversal of the previous quarter’s action, value stocks (-0.2%), led by the energy sector, outperformed growth (-8.6%) by a substantial margin. International markets also suffered. Developed country stocks fell 5.9% and emerging markets, which led briefly in January, dropped 7.0%.

Headlines darkened in the past quarter shaking investor sentiment badly. The year began with persistent inflation. Consumer and producer price indexes rose at rates not seen since the early 1980s. This in turn led to expectations of tighter monetary policy, and forecasts of additional interest rate hikes. Growth stocks were particularly hurt by the inflation outlook, leading the broader indices lower. Stocks steadied briefly until Russia invaded Ukraine in February. The prospect of a major war led many to exit stocks. Fears were exacerbated by the stress on energy supplies and potential for significant grain shortfalls. In addition to the horrible human costs, war tends to be inflationary, diverting scarce resources, disrupting the regular flow of goods and services, and destroying production capacity.

Earnings growth, though still robust, continued to moderate in the fourth quarter, rising 32.4% after the prior quarter’s 41.4% increase. The fourth quarter was the last to have easy year over year comparisons following the 2020 recession. Looking ahead as earnings season begins, first quarter profits are expected to rise a meager 3.6% on revenue growth of 10%. These numbers illustrate the challenge faced by corporations of maintaining profitability while costs are rising rapidly. Full year 2022 earnings for the S&P 500 are now expected to grow 7%, a decline from the +9% expected at the beginning of the year. Margin pressures are expected to hamper earnings even though demand across the economy remains strong. As companies begin to report, investors are likely to reward those that demonstrate pricing power and strong supply chain management.

Economic Perspective

Fourth quarter gross domestic product jumped 6.9%, well ahead of the 5.5% consensus estimate. Both consumer and business spending were very strong as the economy posted its strongest full year (+5.7%) since 1984. Manufacturing and services purchasing readings remained strong and indicated further expansion. The impact of COVID on the economy waned steadily through the quarter, as cases in the U.S. fell sharply. While it’s impossible to determine the future path of the pandemic, at this point the outlook is positive. In one sign of strength, the

total number of businesses in the U.S. increased 7% from 2019 to 2021, another reading to surpass pre-pandemic levels.

Employment continued to grow in the quarter. March was the 11th straight month with job gains above 400,000, the longest stretch on record. The unemployment rate fell to 3.6% from 3.8% in February, nearing the February 2020 rate of 3.5%, which was a 50-year low. The labor force participation rate, which measures the percentage of employed across the population, rose to 62.4%, still shy of the pre-pandemic reading of 63.4% but well off the low of 60.2% in April 2020.

Average hourly earnings have also risen substantially above 2020 levels. However, many workers are struggling to keep pace with inflation. Costs for goods and services again rose sharply in the first quarter, and no one is calling inflation transitory anymore. Oil prices had already risen in 2021, and spiked higher with the onset of war. Other commodities followed suit, and the U.S. producer price index rose 10% in the twelve months ending in February, the highest reading since record keeping began in 2010. As of this writing, consumer balance sheets and spending power appear to be intact. However, with rising costs of necessities like food and gas, consumer discretionary spending may suffer in the coming months.

After much signaling and market anticipation, the Federal Reserve raised interest rates a ¼% in March, the first increase since 2018. Fear of tightening monetary policy has been perhaps the biggest weight on investor sentiment this year. The Fed will continue to raise interest rates this year and will also allow its balance sheet to shrink. This will remove liquidity from the economy and increase borrowing costs. Mortgage rates have already risen in expectation. The 30-year fixed mortgage rate is now 4.72%, the highest reading since December 2018. This will have a direct impact on housing affordability, although demand for housing may remain strong in the near term, because the supply of available houses is still near historic lows.

Looking Ahead

The 10-year Treasury rate also rose sharply in the quarter (**Figure 2 - U.S. 10-Year Treasury Yield**). Bond holders suffered sharp losses, in many cases worse than stocks, with the Bloomberg U.S. Aggregate Bond Index -5.9% year-to-date. While bond fund investors can expect higher interest payments in the future, it will take time to recoup these losses. It's uncertain how long before interest rates will catch up to the current inflation rate. Until then, fixed rate bonds, especially the most conservative, will remain under pressure. Fixed income investors may be well served with allocations to floating rate loans, which adjust with changes in interest rates, and with Treasury Inflation Protected Securities (TIPS), whose value rises with increases in the consumer price index (**Figure 3 – iShares TIPS Bond Fund**).



Figure 3 – iShares TIPS Bond Fund



Figure 4 – Financial Select Sector Fund

Stocks have struggled to find their footing this year. Both the S&P 500 and Dow Jones 30 Industrials fell over 10% before recovering partially. The technology-heavy Nasdaq fared worse, and entered a bear market, dropping over 20%. At this time a repeat of 2000's dot-com bubble burst seems unlikely. Earnings and cash flows of the leading tech and communications companies are much stronger than twenty years ago. However, these companies' stocks may continue to underperform as their relatively high valuations are squeezed by rising interest rates. Value stocks, including energy and financials (**Figure 4 – Financial Select Sector Fund**), may do better, as they start with relatively low valuations, and their earnings tend to increase with inflation and rising interest rates.

This quarter has been challenging for many reasons. We understand how troubling this can be for investors. Historically, stocks have generally bounced back quickly from difficult headlines, including war. As always, we encourage you to contact us anytime if you have concerns or questions about your investments. We hope that you are enjoying spring and hope to speak with you soon.

Best regards,

A handwritten signature in cursive script, reading "Kenneth M. Bernard".

Kenneth M. Bernard, CFA