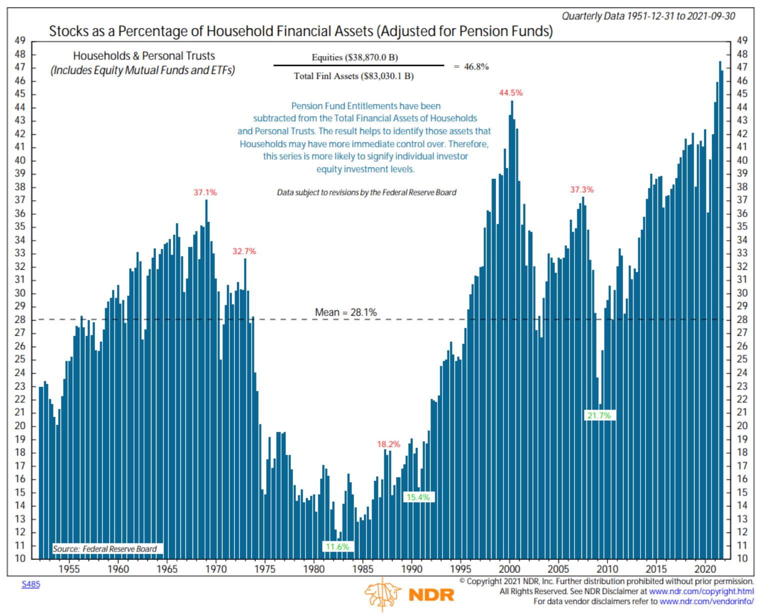
2022 Quarter 2

May 2022

Does the Future Look Like the Past?

The last 12 years have, quite frankly, been astonishing for the US equity market. The bond market has kept pace as well. Foreign equites have lagged dramatically since the mortgage melt down of 2008. Here we find ourselves in an expensive stock market, similar to 1999, with different circumstances. We have talked about this for three years, so we won't expand on that any further. However, this time we also have an expensive bond market. The last 12 years have seen massive amounts of money injected into the system with a simultaneous lowering of interest rates to near zero.

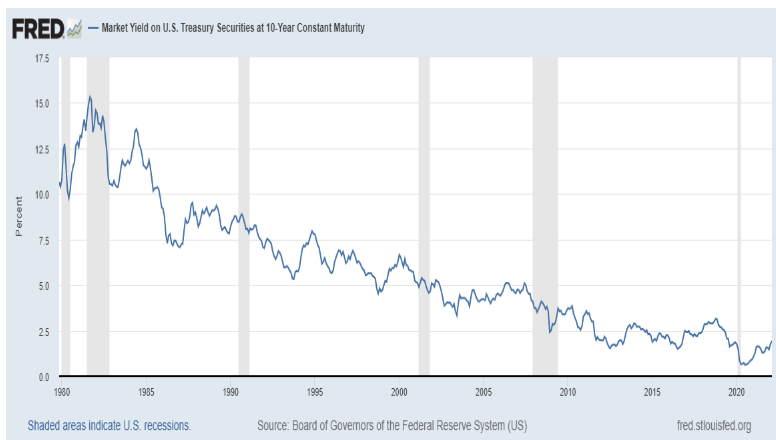
Tech stocks have rallied much like the late nineties! Enthusiasm for stocks, as represented by the percentage ownership of households, is at an all-time high. Employment is now back to pre-pandemic levels. It hasn't been this solid since February 2020. One small distinction, however, is that about 2% of the workforce has left. That represents about 3.0 million people give or take.



Inflation has ticked up from the last 22 years. Is this systemic or transitory? We suggested a year ago that it was not transitory. We still feel that way. Interest rate increases are here. Probably not fast or high enough to slow secular inflation in the near term. What's different? Wages! Average wage increases from 2011 until 2021 were 2.76% versus just over 5.5% in the last 12 months. Wages are much more sustainable than commodity or supply chain driven factors. We aren't saying those things don't matter but they are more cyclical than secular. Another way of saying that is – wages are more "sticky." The Fed may get some relief from resolutions of some supply chain related reductions and some oil price relief at the conclusions of the Ukraine - Russia conflict. However, the only way to ease wage growth is slow labor demand or increase supply. This means higher unemployment leading to a slower economy.

What's different? Why now for inflation and wage growth? Early easing was filling the banks with reserves. It wasn't in the hands of consumers. It was there so banks could lend and at reasonably low rates for investment and growth. Growth was slow coming out the Great Recession and didn't really accelerate until well after housing bottomed. This was about 2012 and caught fire by 2016. Then came COVID and a change in policy. Checks were now going directly into the hands of consumers. Bottlenecks in the supply chain and oil companies were going bankrupt from low prices. Everything has now turned 180 degrees.

What does all this mean? Stocks and bonds are still expensive! We have been saying this for a about 3 years. What's different – inflation and capacity! The Fed has limited room to continue a decade of easy monetary policy. Does this mean stocks and bonds are going down? Not necessarily but with a 20% drawdown in the first 5 months it certainly feels like the end of a 13-year run. Valuations are not a great predictor of near-term stock returns. Valuations do matter and are highly correlated to long-term returns (i.e., 10 years or so). What about bonds? Rates have been coming down from 1982 until 2021. Approaching zero in the most recent couple of years. A whopping 40-year bull market in bonds!



The real rate of return on bonds is negative. If inflation is 7% and yields are 3%, this means you are losing 4% a year against purchasing power! Is this sustainable? Probably not, either the demand for bonds goes down, inflation comes down, or rates rise to compensate investors. Possibly you get a little of both moderating inflation and rising rates to get to equilibrium.

A Path Forward in Investment Management

Regardless of the near drawdown, we expect that investors will have to transfer risks. What does that mean? The risk of buy and hold is that portfolios will suffer low returns. This means we must think about being more tactical. More changes more often in both equity and bond portfolios. We don't mean day trading. We do see a need to think about moving between asset classes more frequently. This is not a riskless endeavor and, therefore, a shift in risk from buy and hold to more trading. More to come on this as we progress through the balance of the year. Just know we are paying attention to the fundamentals and tracking the math.

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