CHASEFIELD | CAPITAL

2022 Mid-year Outlook

July 2022

Recap of Q1 and Q2

As many of you are aware, the first two quarters of the year have been poor for both equities and bonds alike. A large portion of portfolio positions in the equities space are down 20% or more, bond performance is negative, and real estate is down about 20%. Commodities and cash have been the only two positive asset classes in the first half. As bad as this sounds, we want to reiterate what our weightings were going into 2022. We were underweight equities, we were managing short duration bond portfolios, and we had a substantial amount of cash in the beginning of the year. In fact, our moderately aggressive tactical asset allocation, the red line, outperformed the strategic asset allocation, the black line, by about 330 basis points. This is just a representation of returns, and your returns may differ.

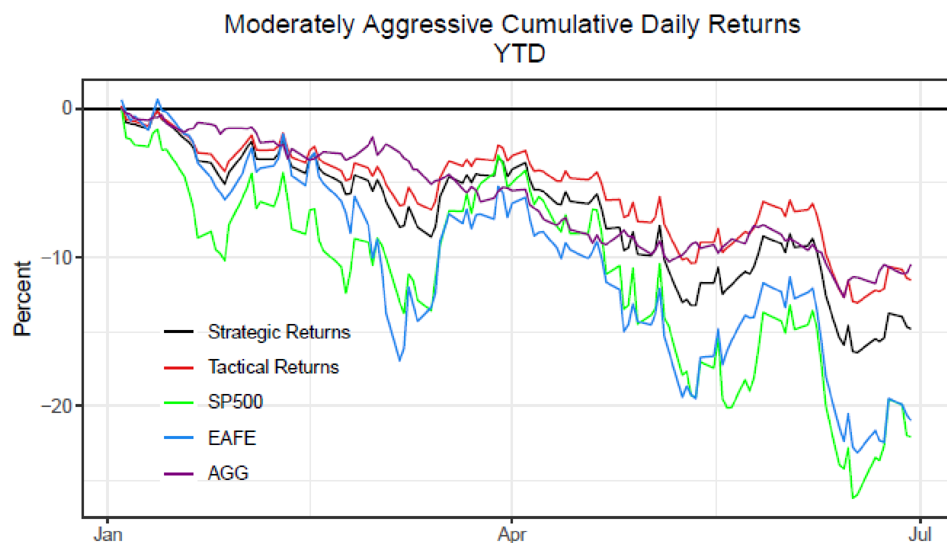


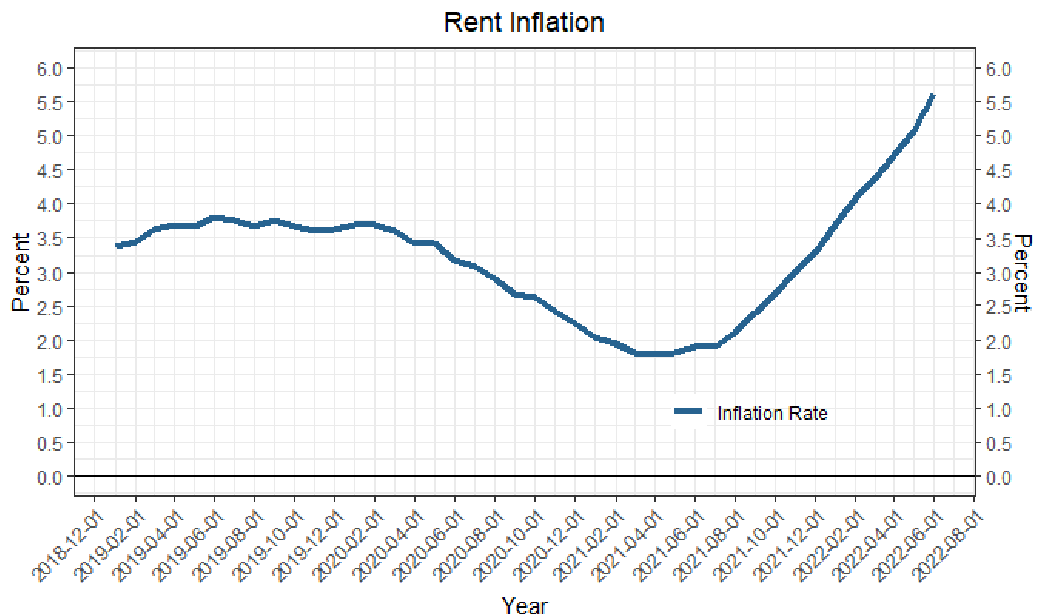
Figure 2: The plot is a cumulative return plot of both the strategic and tactical portfolios. Additionally we have added two major stock indices that heavily influence our returns, the S & P 500 and the EAFE Index, and the AGG.

That being said, many of the concerns mentioned in the *2022 Outlook* from January of this year, have come to fruition. To begin with, we want to touch on the indicator of "stocks as a percentage of household financial assets." In January of 2022, about 47% of household financial assets were in stocks which is over the average of 28.1%. This indicator shows that extreme values, such as 47% over the average of 28.1% are almost always followed by a bear market. Well, a bear market has occurred and because of our cash positions we are able to capitalize on this market downturn. Throughout the first half of the year, we added to the All Country World Index Fund and during the month of July we increased our weightings in large cap to neutral and added exposure to high yield. Short-term, these positions could move against us if the US falls into a deep recession but statistically speaking, a 20% drawdown is substantial and warrants some sort of action on our part.

Inflation

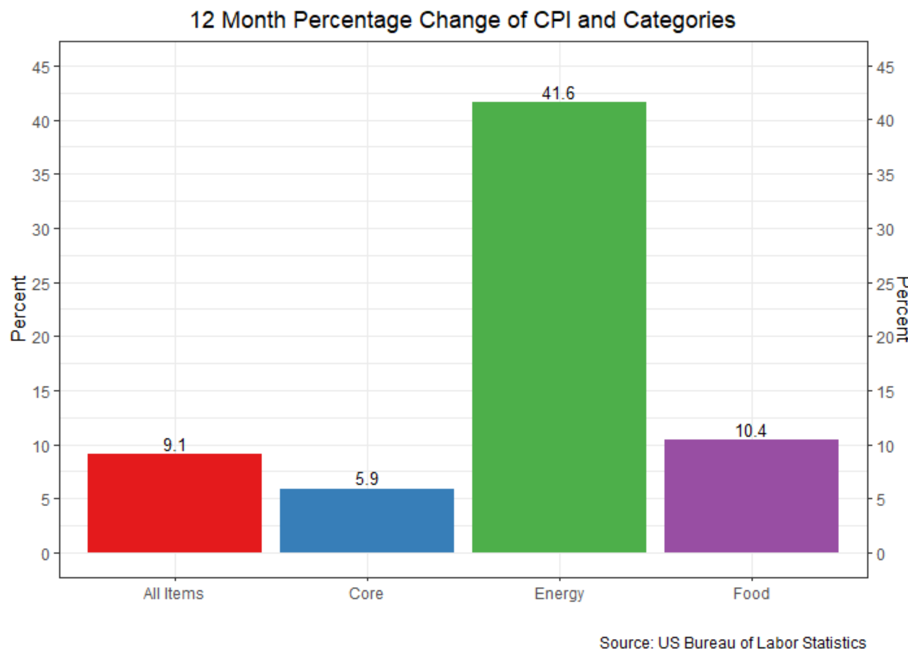
Currently, this is the most important issue the economy, the equity markets, the bond market, real estate, commodities, and cash is dealing with. Someone could write a never-ending book on the impacts of inflation, but we are currently looking at a few that have certain impacts on the present outcome. We are looking at Fed rate hikes, rent inflation, wage inflation, and the recent Consumer Price Index (CPI) numbers.

The "soft landing" the Fed was hoping for looks to be out of the question. In June, Jerome Powell said, "I think we now understand better how little we understand about inflation." We are at a loss for words with this statement but must deal with the consequences now. We understand the Fed does not know the exact level to raise interest rates to control inflation. Typically, they use 25 to 50 basis point rate hikes to gauge the impact and then adjust accordingly. This is not the case right now. The most recent increase of 75 basis points is the first of many potential rate hikes and indicates that they have made a big error. The Fed, at this point, seems to be more reactive than proactive with their decisions. In fact, many news outlets are reporting that another 75-basis point hike is coming. The last 75-basis point rate hike was in 1994 to give you an idea of how rare this is. We cannot rule out a 100-basis point rate hike at this juncture.



On another note, we have rent inflation. Two things to discuss here. The first issue here is that the lag in the reporting of rent inflation can give an inaccurate report of the present CPI. Current rental prices are increasing, double digits in some major cities, and have not yet been realized into current CPI. In total however, rent inflation across the US is 5.6% and climbing. An increase in rent inflation could very well offset any of the supply-side inflation decreases because of the issue of the lag of reported prices. We would expect that to happen in the coming months and possibly even add to the problem rather than offset it. The second issue impacting rental prices is the housing market and mortgage rates. As people stop buying homes because of higher mortgage rates, they look to rent, and this increases the demand in the rental market, driving prices higher.

As for wage inflation, we have seen this rise to over 6%. We would expect this as jobs are still widely available and are not being filled. People are still looking for better opportunities to not only grow their own incomes but also to afford the higher prices seen in energy, food, recreation, travel, and many others. We could see wage inflation begin to slow as unemployment rises and jobs become limited but that remains to be seen.



Lastly, CPI inflation numbers on July 13th reached 9.1% while core inflation accelerated to 5.9%. Core inflation is inflation of goods and services with energy and food removed. To be fair, core inflation has been decreasing over the past few months, which is a good sign. However, the price of items that consumers purchase frequently, such as food and energy costs, have gone up by 10.4% and 41.6% year-over-year, respectively. A change like this can impact the American people by forcing them to allocate a higher percentage of their spending towards non-discretionary items. We will see that consumption of total goods and services begin to reduce. If we are not in a recession now, then this is likely to put us in one as personal consumption accounts for 70% of GDP.

Q3 and Q4

What does all this talk of inflation mean for US Equities? Our previous outlook describes that the Fed in a fast-tightening cycle tends to negatively impact the performance of equities. This may have already happened. We went through a 75-basis point rate hike early in the year and the market fell. The 20% drawdown we have seen could have been the bottom and the stock market is now pricing in these aggressive rate hikes. If this is true, the next step would be to see inflation numbers start to decline, such as the core inflation numbers, throughout the year which could positively impact equities and add some attribution to portfolios. The biggest caveat is that if inflation is not tamed, we will see markets fall further from here.

What does this mean for bonds? We have an uphill battle and the outlook is bleak for the rest of the year. The Fed is going to raise their rates until they finally have a grasp on inflation. Higher rates will increase yields on bonds across the board and begin to push prices down further. The best move here is to continue what we have been doing previously. We had short bond durations going

into this and many of those bonds have come due this year. As they have been coming due, we will continue to purchase bonds that facilitate an underweight duration of our benchmark. This will allow us to capture some of the increased yields of while still protecting the portfolios against inflation as much as possible.

Throughout the rest of the year, equity and bond market movements will be heavily impacted by the reported inflation numbers and how the Fed handles their rate hikes. As they have said, they know little about inflation and their ability to figure it out from here will be vital. We are always managing the various risks impacting the portfolios and this time is no different. There is a lot of headwinds going into Q3 and Q4 but it is manageable.

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