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2022 First Quarter Review
"Russian Roulette & The End of Easy Money"

Fortune magazine recently published an article with a title suggesting that investors should congratulate themselves if their portfolio was down 5% for the first quarter of 2022. "If so, …you're an investing genius," it ruefully claims. For stocks, it was the worst quarter since the start of the pandemic 2 years ago. For bonds, it was the worst start for the year in decades. Deutsche Bank's research team stated it well, "Q1 was a dramatic time in financial markets, featuring Russia's invasion of Ukraine, accelerating inflation, the start of another hiking cycle from the Federal Reserve, as well an inversion of the 2s-10s yield curve." It was a tough quarter.

The NASDAQ index (featuring more tech-related and "growth" stocks) fell almost 20% from the beginning of the year through early March, then recovered enough to close the quarter down *only* 9%. Long term treasury bonds have lost as much as 16% of their value from their recent peak in early December. Even 5-10 year treasuries suffered the worst quarterly losses in a generation. Bonds did not provide the counterbalance to stocks that would conventionally be expected. The S&P 500 suffered the least of the bunch as it declined 12% through early March, then rallied to finish the quarter down 5%. However, these index returns masked the absolute carnage in the more speculative stocks that had been so popular over the last few years.

Speculative investments like "meme" stocks, "SPACs," and tantalizingly new but not-established technologies can act like the canaries in the coal mine of the investment markets. They can fly high when conditions are right, such as we had with zero interest rates and the central bank pumping liquidity into the economy (through a peak in February of 2021). They can also come crashing down when the environment turns harsh. In early March, fully half of the NASDAQ stocks were down by almost 50% from their highs.

Market risks are currently elevated by several cyclical as well as a few "exogenous" factors. Overall valuations are still relatively high, inflation is the worst in 40 years, interest rates are rising, liquidity is being withdrawn, and earnings are no longer being favorably compared to those of the pandemic-induced slump. Current geo-politics add another level of uncertainty.

I can't add anything of value or substance to what you probably already know about the human toll of the tragic events in Ukraine. However, the range of possible economic outcomes are somewhat akin to a game of Russian roulette. There are several scenarios with manageable repercussions for securities markets, and at least one that could be catastrophic. Assuming we dodge the bullet of nuclear escalation, the war still adds less lethal risks. Inflation pressures increase with energy and agricultural markets roiled. Shortages of metals and agricultural products may be unavoidable. Unprecedented products may be unavoidable. Unprecedented sanctions may stress the economic system in unforeseeable ways, perhaps leading to a financial domino effect from possible Russian-related defaults, e.g. the Long-Term Capital Management crisis of 1998 or the Lehman Brothers collapse in 2008. Such events would be difficult but survivable.

The Federal Reserve appears to be late to act in countering inflation and is now playing catchup with plans to hike rates regularly into next year. They also appear to be planning "aggressive balance sheet reduction" starting in May. After the tsunami of money supply increases in the last several years, liquidity is now scheduled to be reduced. The Era of Easy Money appears to be ending. Accordingly, mortgage rates have increased quickly in the midst of an over-heated housing market, causing concern that the housing industry will suffer as affordability is now at record lows. Wage inflation will likely reduce profitability for corporate America and could add to inflationary pressures as well. The recent "inversion of the yield curve" means that the interest rate on a 2-year Treasury note is now higher than the rate on the 10 year bond. An inverted yield curve is bad for banks (who borrow short-term and lend longer-term), and it is very often a sign of an economy heading into a recession.

Our penchant for value, as well as our smaller allocation to fixed income, has helped to protect portfolios during this decline in both stock and bond prices. We are continuing to position ourselves for protection and for profit in several ways. First, we are paying close attention to the allocation of assets between stocks, bonds, and cash reserves. We are emphasizing high quality stocks in established business leaders with good dividend yields. As rates rise, we are taking some cash reserves and investing in "ladders" of short-term Treasury and other fixed income securities with maturities "stepped" from 1 to 5 years. This provides more income than money market funds but without the risk of buying long-term bonds.

Crisis often creates opportunities. The trick is to maintain the financial and psychological resilience to take advantage of them when they arise. Supply disruptions in energy, metals, and agricultural products may present opportunity. Secondary effects are sure to follow. For example, the high price of energy will likely accelerate the move to alternative energy sources and electric vehicles, while the prices of some related stocks have come down dramatically with the cooling of speculative excess. (*Fun Fact: 14% of all new cars sold in Europe and 11% in China last year were electric, while here in the US it was only 3%.*) We will continue to look for value across the market sectors as events unfold.

Looking to history, we see that markets have often recovered nicely after a bad start for the year. However, we think it is appropriate, and may prove beneficial, to be a little more cautious during this geo-political game of Russian roulette at the end of an era of easy money.

Please review these reports and statements at your convenience and give us a call with any questions, suggestions, or concerns you may have. As always, we are happy to provide you with extra copies of your tax documents should you or your preparer need them. Good luck with tax time!

Best regards,

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