April 2022

Market Madness 2022

"The Federal Reserve..is in the position of chaperone who has ordered the punch bowl removed just when the party is really warming up"
~William McChesney Martin, Federal Reserve Chairman, 1951-1970

In 2014, Warren Buffet made a bold offer. If anyone could pick a perfect NCAA March Madness bracket, 63 games in total, he would pay them one *billion* dollars! Twenty million people took the challenge. No one won. As a matter of fact, no one has ever had a perfect bracket. The record was set in 2019 when someone got 49 straight games correct, only to lose - in overtime - Game 50.

Each year there are stunning upsets, colossal chokes and Cinderella team that simply cannot be predicted. Chris Chase of *USA Today* suggests the odds of picking a perfect bracket are one in 9.2 quintillion (that's eighteen zeros). A math professor at Duke (of course) estimates the odds of picking a perfect bracket can be reduced to "only" one in 2.4 trillion just by doing a little homework.

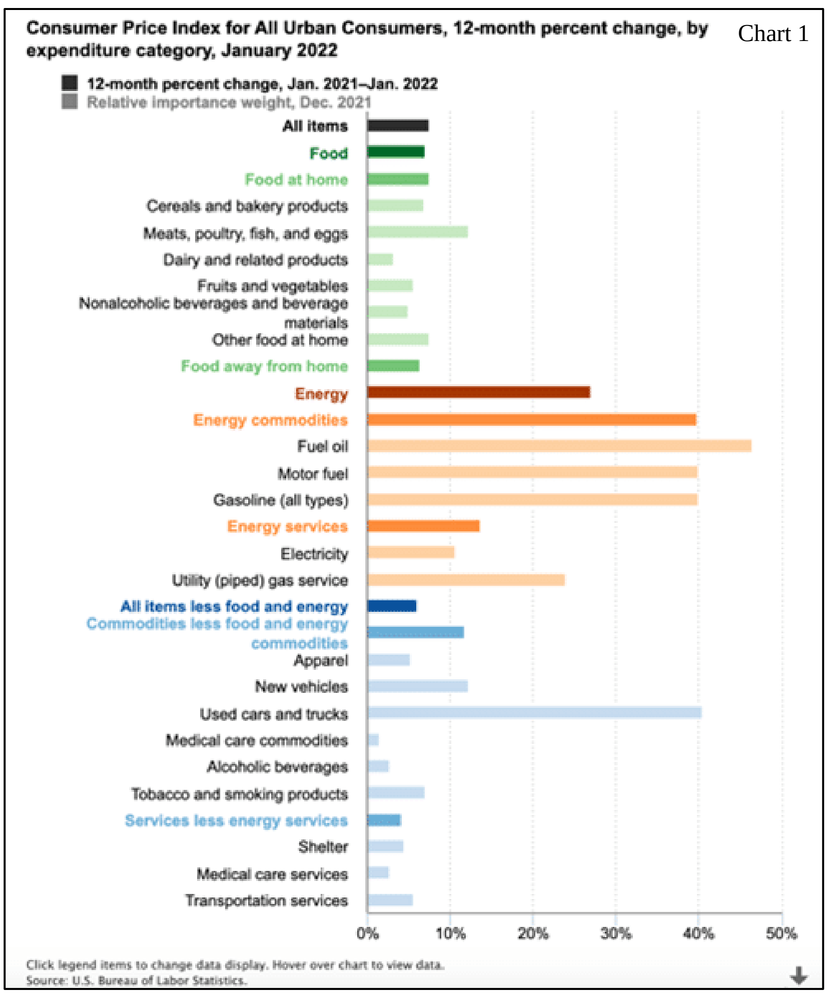


Chart 1

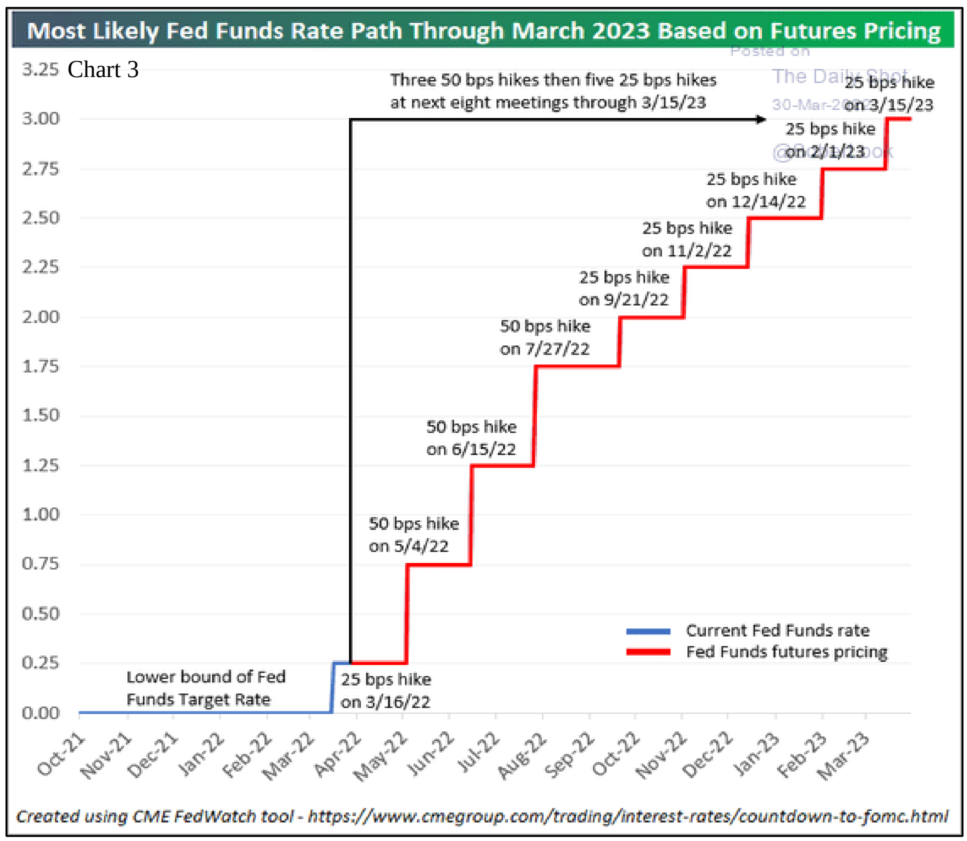
Market Madness 2022 has proven to be as unpredictable as the NCAA March Madness 2022 tournament. There have been larger competing issues coupled with dark horse nuances that have cast an especially wide cone of uncertainty on both markets and the economy. Interest rates are rising, Treasury yield curves are flattening or inverting, the Fed hit the inflation panic button and has finally begun to moderate monetary policy, the war in Ukraine continues to sow the seeds of dysfunction in the commodities markets, consumer sentiment has returned to Covid-like levels, GDP is beginning to slow, but US stock indexes have been surprisingly resilient, relatively speaking. With all of these disparate factors at play, how does one put together an ideal bracket to combat this Market Madness?

Bracket 1: Top Seed-Inflation for Longer is a Slam Dunk

Before the Russian invasion of Ukraine, inflation stood at a 40-year high with a stated CPI at around 7.9% in February. The war ensures it will remain elevated for some time. The invasion sparked one of the most significant commodities shocks the world has ever experienced thanks, in part, to a massive increase in the money supply and, most recently, draconian sanctions placed on Russia by the US and Europe. Russia provides 40% of Europe's natural gas, it is the third largest oil producer in the world, and also a large exporter of other products including wheat, silver, palladium, gold, fertilizer, and nickel. Shortages in these items had already propelled commodity prices, as a group, up 30% over the previous year according to the Bloomberg Commodity Index (see Chart 2) before the war began. However, additional losses of supplies to the market have simply shocked an already inflated market and caused short squeezes in some financial commodity contracts resulting in a net increase in prices of 35% in just the past month alone.

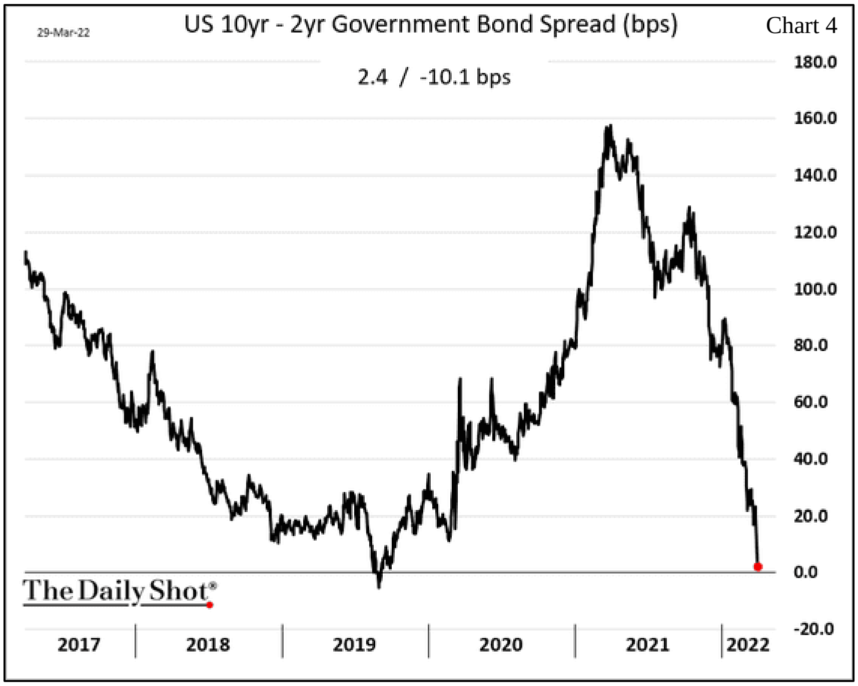
Bracket 2: Top Seed-Rising Rates Keep Rising Until Fed Cuts the Game Short

The Federal Reserve is now attempting to put out the inflationary fires. Months after the rest of the world realized inflation was not transitory, the Fed switched to panic mode and now believes the antidote to this current financial scourge is to aggressively tighten fiscal policy. So far in 2022, the bond market has reacted by pushing rates upward in a dramatic fashion. The 10-year Treasury has gone from 1.5% at the beginning of the year to almost 2.4% today, while the 2-year has risen from .75% to 2.45% (see Chart 3), creating an inverted yield curve for the first time since 2019.



Historically, Fed rate hikes are an appropriate response to high inflation. The bond market is suggesting the Fed will hike rates by about 225 basis points over the next 12 months (see Chart 3). Typically, the Fed curtails demand for goods and services by simply draining liquidity from the monetary system. However, the Russian/Ukraine conflict has thrown inflation into overdrive due to supply shocks in the system. Monetary policy, at its core, addresses *demand* not *supply* and, of course, the main issue now is supply shocks. A 25-basis point rate increase is not going to magically make extra bushels of wheat or additional barrels of oil available to the market. But if the Fed manages to slow the growth of the economy enough, demand for high-priced goods and services will begin to evaporate.

This "Whip Inflation Now" mantra emanating from the Fed is actually triggering alarm bells in the bond market as multiple yield curves are now inverted. When shorter maturity Treasuries begin to yield more than longer-maturity Treasuries, it is a signal that a recession is coming. Why? Typically, banks borrow on the short end of the yield curve and lend on the longer end. When the yield curve inverts, banks cannot book a spread on their loans and economic activity slows because available credit becomes scarce. The spread between the 2-year Treasury and the 10-year Treasury is considered the Holy Grail of yield curves to the financial markets. When the yield differential between the 2-year is much lower than the 10-year, the economic forecasts tend to be rosy. However, when they turn negative, views on the economy become more bearish. In fact, last week, the 2/10 spread went negative!

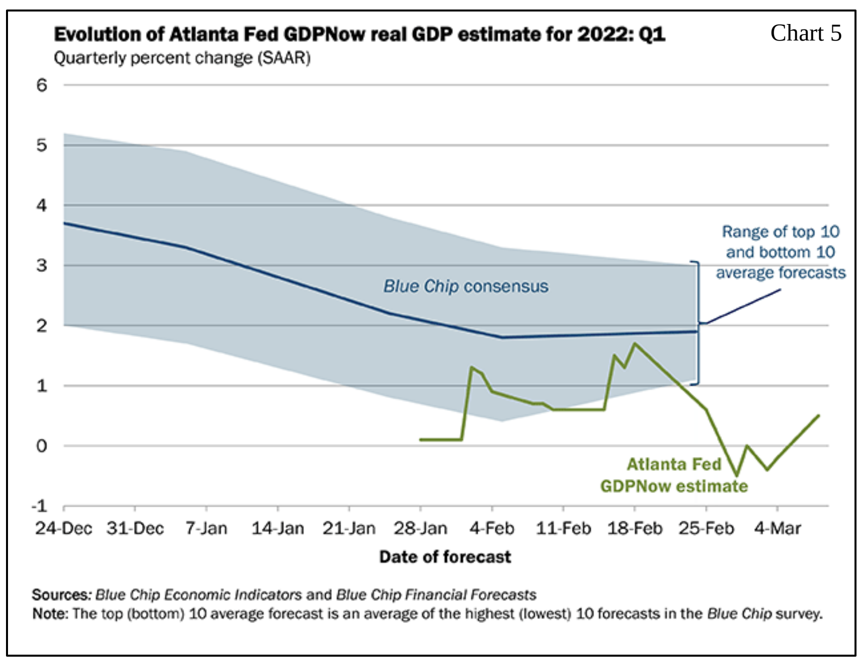


Five of the last six times the 2/10 yield curve spread inverted, the economy subsequently went into a recession. Ironically, the one exception was the 1998 Russian debt crisis (and Long-Term Capital blow up). "According to MUFG Securities, the yield curve inverted 422 days ahead of the 2001 recession, 571 days ahead of the 2007-to-2009 recession and 163 days before the 2020 recession." (Source: CNBC)

There is one school of thought that suggests *this time is different.* Some believe the Fed has artificially manipulated the curve into a false inversion and that alarm will be quieted once the Fed unwinds Quantities Easing (QE). The Fed holds $9 trillion worth of bonds on its balance sheet and there is little doubt it has suppressed the yield on longer maturity bonds through its various versions of QE since the Great Financial Crisis. To this point, "Richard Bernstein Associates notes that if the Fed had never engaged in QE, the 10-year yield could be closer to 3.7%" versus its current 2.4% (CNBC). The 2-year has climbed rapidly in anticipation of short-term rate hikes. If not for this manipulation would the 2/10 spread be positive 130 basis points instead of negative 5 basis points?

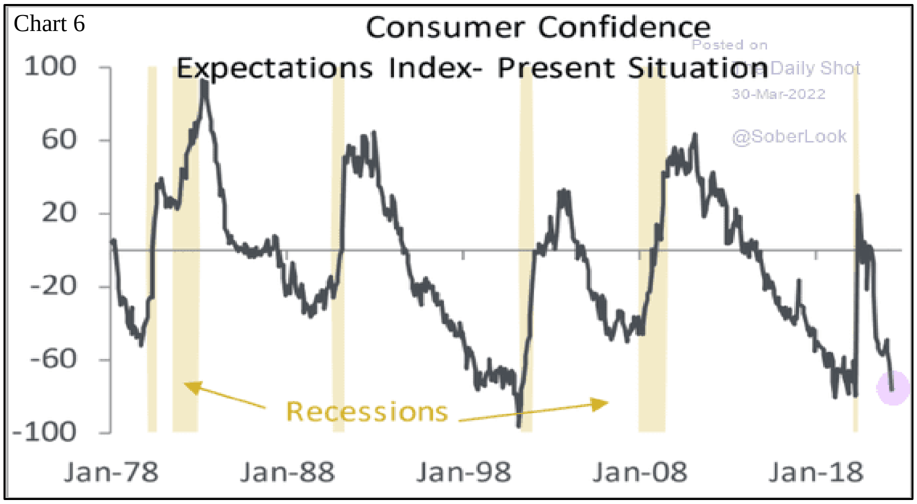
Bracket 3: Top Seed-Economy Slowing – Has It Already Taken a Timeout?

Whether the inverted yield curve theory is correct or not, there are signs that the growth in the economy is slowing. One example is provided by the Atlanta Fed in a report they put out called GDPNow (See Chart 5). It is a model that attempts to update their GDP forecast several times a month to give a more accurate current picture of what GDP will be when next reported much like a



meteorologist predicts the weather. Basically, the Atlanta Fed changes the model when real data is made available versus waiting weeks down the road to incorporate data into its model. What the survey now suggests is the first quarter of 2022 is expected to come in at an annualized rate of about 0.5%. It is important to remember that GDP is the market value of the final goods and services produced in a specific time period. Commodity inflation is up about 54% over the past 12 months and the CPI was up almost 8% in February. It may be safe to assume that less overall goods and services are being consumed today versus a year ago. Higher prices simply suggest the economy may be slowing more than people think.

Chart 6



Source: University of Michigan

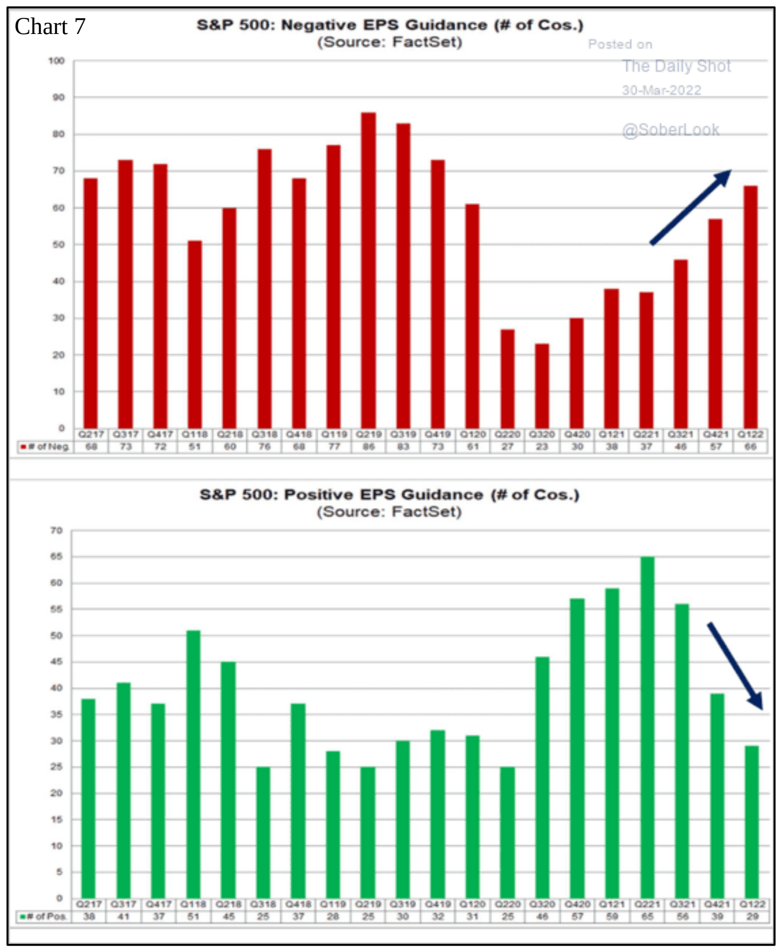
Equally alarming is the University of Michigan Consumer Confidence Index (see Chart 6) which suggests that consumer expectations are now where they were during past perilous economic times. Because prices have risen so much, retail sales and many other economic indicators have begun to soften. Now the question is, will the US consumer continue spending given their high level of savings even though they believe it is not a good time to make purchases like cars and homes?

Bracket 4: Top Seed-Are Markets and Earnings in Overtime?

An inverted yield curve, sky high commodity prices and rising interest rates have had very little effect on equity markets this far in 2022. The S&P 500 is down 5.25% despite an increase in earnings. The Bloomberg Aggregate Bond Index is down 5.93% suggesting stocks are being viewed right now as a safer haven for investors than bonds!

Multiples on stocks have compressed a bit in 2022, but the P/E multiple for the S&P 500 still stands at a historically elevated 23.23 times earnings. What will keep stock prices high is if the continued earnings growth through the end of the year. They are expected to rise by just over 8% this year. However, as evidenced by Chart 7 thus far in 2022, there have been more negative earnings surprises than positive ones for companies within the Index suggesting higher wages and inflation are beginning to pose a problem for some companies.

Chart 7



One Bull case for stocks for the remainder of the year is the likelihood of a recession is overstated, and the economy will continue to “run hot” as Fed Chair Powell suggests. As a matter of fact, most Wall Street analysts still expect outsized equity returns in 2022. FactSet suggests the S&P 500 will finish up almost 20% from current levels by the end of the year. Bespoke also supports a positive backdrop for stocks. They suggest that in the past six instances where the 2/10 curve did invert going back to 1978, “the S&P 500 was up an average 1.6% a month after the inversion but was up an average of 13.3% a year later.”

Conclusion-Clock Is Ticking on the Final Four

The number 1 seeds are suggesting a booming economy and runaway markets are not a great bets in the medium term. The Fed is way behind the curve and has now concluded inflation is not transitory. History suggests they will unwind monetary stimulus until they tame inflation, stymie economic growth, or kill financial markets...or all three. The 40-year high CPI reading is impacting the real economy in a noticeable way. Inflation is now creating demand destruction and margin headwinds for corporations. The 2/10 spread is suggesting a recession may be on the horizon in the next 6 to 18 months followed by a *stagflationary* period in the near term.

If the number one seeds prove correct prudence suggests investors should take advantage of positive news in the markets and right-size their portfolios, creating enough liquidity to take advantage of any market turmoil to come. The Indexes have shown a series of positive fast breaks over the past few weeks and the Fed is finally preaching a ball control offense. But the Market Madness we are in means the perfect bracket of economic and market stability is anything but a slam dunk.

Sincerely,

Chris L. Doucet, CEO

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