MARKET COMMENTARY – January 1, 2022

Are the Days of Low Rates Numbered?

It is customary to prognosticate in the first days of a new year. There are a good many things about which we may make predictions. Rather than cast a wide net in this case, we decided to focus on interest rates. We believe they will be among the most important tipping points in determining market prices for 2022.

All savers and borrowers are aware that interest rates have been expressly low for over a decade. They have been so low that when low inflation is factored in, some sectors have carried negative real interest rates. And when inflation reprised itself in 2021, the phenomenon of negative rates was amplified.

Low rates have helped propel asset prices higher. Negative rates even helped amp up returns in stocks that aren't expected to be profitable for many years to come. Low rates discouraged saving in CDs and bonds and shifted money toward stocks, in general. Real estate went up. Stocks went up. Then, when social spending soared and when supply shocks occurred due to our policy response to the coronavirus, prices of almost everything went up. Groceries, cars, t-shirts. Up, up, up.

In recent months the Federal Reserve has acknowledged that inflation is elevated. We have said this is a fine first step. And they took a solid second step when they agreed to end their rampant bond purchases earlier than previously expected. Now, they are teed up to steadily raise short term rates sometime in 2022.

A salient question at this point is that if low rates made prices go up, will higher rates make prices go down? We're glad you asked. The answer is no. Or yes. It depends.

The "no" scenario. A majority of market participants and very intelligent financiers say that in this case, higher rates will not result in a calamitous market sell-off. There is some wisdom in their thinking and to be very clear, we think this is still the mostly likely course of events for the coming year.

The fact that the Fed is "on the case" means that they will not allow inflation to remain elevated too long. It means they will raise rates enough to wash out rampant speculation, but not enough to squash the recovery. And speaking of recovery, it is thought that as more of the world truly re-opens in 2022, the sheer force of the economic

impact will outweigh slightly higher rates. Therefore, we have a quarter or two of rough market prices as investors adjust to the new, higher rates. But by year-end, the recovery is clear and prices will have at least bounced back.

The "yes" scenario for dramatically lower stock prices. We view this as less-likely, though not out of the realm of possibility. It is a real risk and if urged to express it in terms of probability, we'd say that it is significant, perhaps as high as a 20% chance. In this case, the Fed proves woefully behind in taming inflation. Inflation might be worsened by more policy mistakes from Congress. Or, in the face of inflation, the Fed might lose the stomach for raising rates due to the political fallout. One must only look at the Fed's actions in the '60s and '70s. In the case of non-action by the Fed, inflation would ramp and, belatedly, the market itself would react with rocketing rates.

Let's summarize what we've said for 2022. In our minds, there is an 80% chance that after several months of bouncing prices, interest rates stabilize at a new, higher (though manageable) level. The recovery from the governmental pandemic response continues for another year or so. However, there is also a 20% chance that inflation continues to go up and interest rates find themselves losing the foot race, never quite catching up.

Since there are such varied possible outcomes, what is an investor to do?

We advise all clients to have ample cash reserves. Today, it matters not that some of those reserves earn no return. We are simply paying for the flexibility that cash offers by accepting no interest. Second, bonds still make sense (some more than others). Yes, in the event of a sharp increase in interest rates, bond prices suffer. But absent a default, investors still get their principal back. In the event of a longer, sustained rise in rates, stocks will likely suffer far worse. Speaking of stocks, we suggest that it is time to pare back on holdings in highly speculative companies. They've already taken it on the chin. If rates go higher, this class of company will likely suffer more.

Stirling Bridge Wealth Partners, LLC is fortunate to count many of you as clients. In the good times and bad, we remain committed to providing customized investment solutions and robust financial planning wrapped in a package of exceptional service. We thank each of you for your dedication to us and for your trust.

Sincerely
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