Stirling Bridge
Wealth Partners, LLC

MARKET COMMENTARY – April 1, 2022

That inverted Bowl they call the Sky,
Whereunder crawling coop'd we live and die. ~ Edward Fitzgerald

The imagery conjured by Fitzgerald above reminded us of the current state of affairs with regard to the yield curve. Much digitally pixelated ink has been spilled over the previous several days about the inverted yield curve's ability to predict recessions. Thus, the question is, are we all destined to be cooped beneath its peculiar slant to crawl our way into an outright economic downturn?

In brief, we think the answer is yes.

In detail, it is important that our readers understand what exactly that means, the implications, and the beneficial steps we may take. So, let us give a short background. Under normal economic conditions, the yield curve is upward sloping. For example, investors demand lower rates for shorter maturities than they do longer ones. In the case of an inverted yield curve, investors are paradoxically demanding more for short term bonds than long terms.

It is helpful to picture it this way. As short term rates go up, whether by Federal Reserve action or natural market forces, long term rates would go up if investors thought the economic growth would continue unhindered. In that way, the normal upward slope is preserved. However, if they think that the higher short term rates or other outside factors will be enough to curtail expansion, investors begin buying longer term bonds to preserve wealth in the coming recession. That pushes the yield curve into a negative slope. And it turns out that this downward slope has been a reliable predictor of a coming slowdown because it encapsulates the collective wisdom of the entire bond market.

This means that bond market participants are taking into account a plethora of factors. Russia's war on Ukraine? Considered. Runaway inflation? Considered. Labor markets? Considered. On and on.

Yet, there are a few other factors we must consider before recommending the wholesale liquidation of stocks in favor of cash or bonds or some other holding. Most obvious among them is that the signal could be wrong. After all, a signal is just a fluctuating

1246 County Road Q, McClure, OH 43534 P: 419-832-1111
www.stirlingbridgewealthpartners.com F: 419-832-1211

data point that conveys information, which itself requires interpretation. If the yield curve is wrong, clients don't want to be completely out of the market.

Next, the inverted yield curve has indeed been a strong signal, but the timing of the recession it predicts is another question. Our reading suggests that a recession might follow the inversion anywhere from months to two years later. And in the interim, from the time of the inversion to the onset of recession, the equity market generally produces positive returns.

Another aspect to consider before a massive change to our portfolios is the state of our clients aside from their financial investments. After years of counselling clients, we are confident that our advice has been heeded – that sufficient liquidity is held elsewhere. And in those few places where ample cash is not held, we have therefore intentionally set the strategic portfolio allocation to be more conservative, taking all factors such as age and remaining work-life into account. So, whether cash is held in a bank or perhaps in the form of safer bonds in their investment accounts, the effects on their lifestyles of a market drawdown due to recession are mitigated.

Please understand, the above discussion is not an argument to do nothing. To the contrary, we have indicated in these very pages in recent months that we have begun to make alterations in portfolios as the risks in the economy have risen. We have reduced exposure to European holdings – where a recession is almost certain at this point. We have eliminated individual Chinese holdings as the political climate there and here does not support ownership. We have reduced exposure to unprofitable, high-flying technology companies that depend on zero rates. We have worked to reduce fixed income duration in portfolios where we have that flexibility with the use of individual bonds. Each of the above steps reduces risk, or volatility. But they do not eliminate it.

And we believe that we DO NOT WANT to eliminate risk. We want to manage it, to right-size it to the extent we can. To employ an overused example, Warren Buffett does not buy and sell stocks just because a recession or expansion is coming. No, he buys businesses he believes in. Then, at the fringes, he prunes or tweaks holdings as opportunities arise and disappear. Though a billionaire, his holdings suffer a drop in value just like ours. He keeps his head, and his liquidity, for times when bargains are aplenty, but buyers are few.

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Returning to Mister Fitzgerald's couplet, we believe we can unequivocally say we are NOT forced to crawl in the cage beneath the yield curve. Sure, a recession may come. But our clients have portfolios intentionally set up for their individual circumstances to weather the storm. Due to their individual positioning, some may feel little more than an increase in the surf. Others, because they are better able to withstand true waves, might well prepare to traverse the peaks and valleys of true swells. In either case, we remain confident that when any coming clouds at last clear, our clients will be equipped to once again soar on this incredible capitalist journey.

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
Jason Born, CFA
President

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