MARKET REVIEW & OUTLOOK

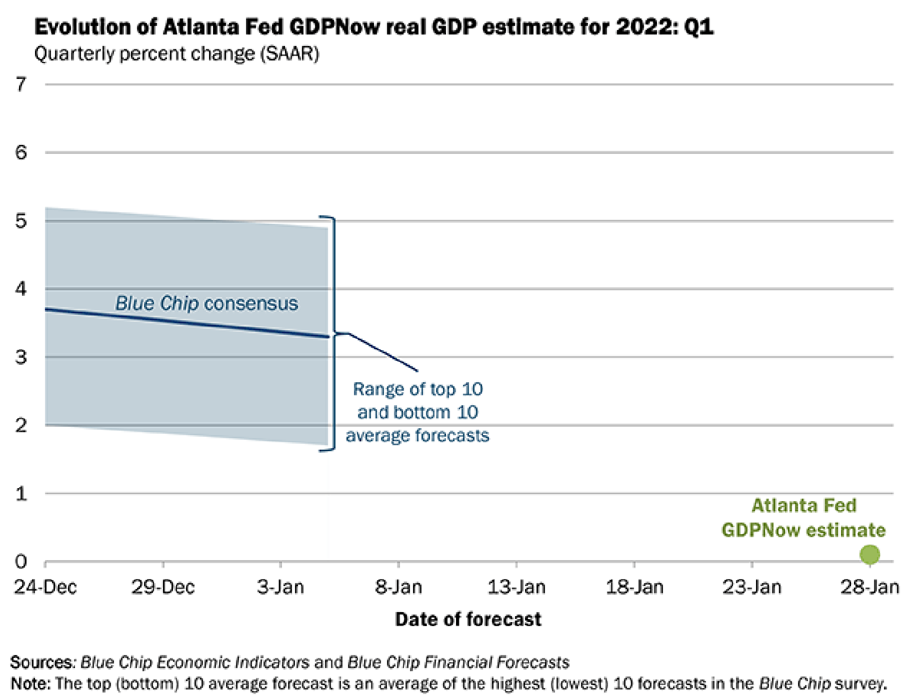
January 2022

KEY TAKEAWAYS

- The year started off on a high note with the S&P 500 entering the new year at all-time highs, but the bloom quickly fell off the rose. January ended as one of the worst starts in years and the worst start since 2009 at the tail end of the Great Financial Crisis bear market. The strong last 2-day rally kept it from being the worst start ever.
- Interest rates wasted no time starting the new year with immediate strong pushes higher in yields, which is eventually what brought equities to their knees. The short end of the curve spent the month progressively pricing in more and more rate hikes as the Fed seems poised to begin hiking rates in March.
- 4th quarter GDP growth was as strong as the forecasters predicted, I guess good thing I am not an economist. 😊 Though as we will discuss below, 1st quarter may not be as cheery.

The U.S. Economy

The first release for 4th quarter GDP came in stronger than expected at 6.9%, beating forecasts of 5.5%. The strength was buoyed by the 2nd largest inventory restocking at 4.9%, which given all the issues with supply chains, may be a good thing. Turning to the 1st quarter GDP forecast, just released from the Atlanta Fed, arrived with a big thud. The consensus is still a solid 3.5%, but based on current data, the GDPNow forecast is estimated at 0.1%. Maybe that's the Omicron variant catch up, I don't ever recall a time in my life when it seemed so many people were sick. Please see the chart below.



Source: https://www.frbatlanta.org/cqer/research/gdpnow

Stocks and Bonds

The fixed income interest rates traded mostly in unison the first half of the month with a steady march higher in rates. As the “talking” heads kept one upping each other on how many rate hikes were in store, the longer end of the yield curve started considering the likely economic slowdown that would occur with too many rate hikes. While the 2-year yield continued moving higher, the 10 and 30-year yields eased. Nonetheless, the prospect of Bond purchases ending and Fed interest rates going higher were much too strong a headwind for fixed income markets to generate positive returns. The result for High-quality fixed income, as measured by the iShares US Aggregate Bond ETF, finished the month with a deep loss of -2.09%. The U.S. 10-year Treasury bond yield ended the month off the upper end of the range, 1.86%, at 1.78%, but up significantly from December’s close of 1.51%.

The Dow Jones Industrial Average slid -3.32%, the S&P 500 dropped -5.26%, and the small cap Russell 2000 plunged -9.66%. The international markets traded in a similar fashion as the U.S. The MSCI EAFE iShares Core International Developed Markets ETF Index fell -4.19%, and the MSCI Emerging Markets iShares Core ETF Index eased -0.62%.

In January, we saw a lot of red across the board, though one sector shined with a lot of green.

The best performer was…

- Energy: +18.77%

The lagging performers were…

- Consumer Discretionary: -13.23%
- Technology: -10.09%
- Real Estate: -8.48%
- Communication Services: -8.27%

Source: https://www.sectorspdr.com/sectorspdr/tools/sector-tracker

Oil Report

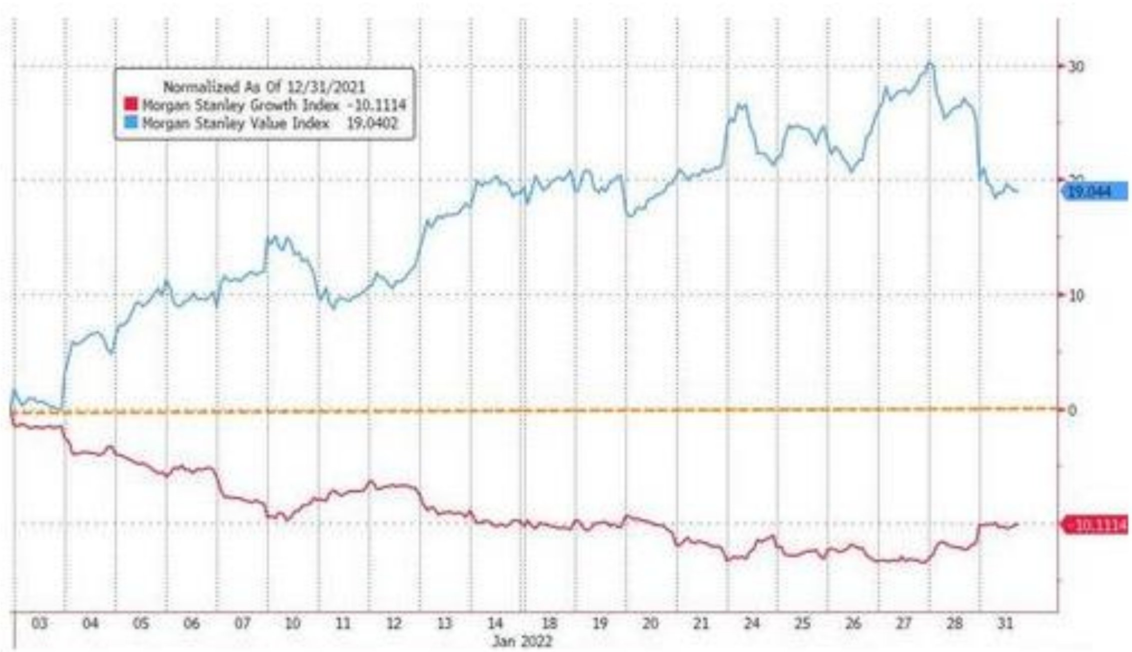
The vicious sell-off in the energy complex on the initial reports of Omicron, and the release from the Strategic Reserve are distant memories. The oil market is now focused on the lack of capital expenditures to maintain existing oil production along with the heavy US rhetoric that Russia is going to invade Ukraine shortly. Though the US seems to be the only one that wants the war as Russia and Ukraine both continue to say war is not the path. Either way, Russia produces a lot of oil, and the oil markets love to run up oil prices on real or perceived geopolitical hostilities. The current NYMEX WTI Crude Oil futures settled at $88.15 and posted a gain of over 17% from the prior month close of $75.21 a barrel, the highest levels since 2014. The rebound in price for RBOB gasoline was similarly strong as crude oil, again with a gain of over 14% vs December's close. The rapid rise of energy prices is very important to note, and the ramifications will be discussed in the next section.

The Rest of the Data

The December ISM Manufacturing Index fell 2.4 points to 58.7 from November's reading of 61.1. Additionally, the ISM Services Index dropped to 62.0 in December from November's print of 69.1, falling from an all-time high. The prices paid component plunged for the Manufacturing survey but held strong in the Services survey. Any reading above 50 generally indicates improving conditions. Consumer confidence decreased to 113.8 in January, which compares to a downwardly revised figure of 115.2 in December. The unemployment rate dropped again, coming in at 3.9% and the economy added 199,000 jobs in December vs. consensus of 450,000 jobs, though at odds once again with a strong household survey. The Consumer Price Index for All Urban Consumers (CPI-U) was up +0.5% in December, further easing from last month, on a seasonally adjusted basis. Over the last 12 months, the All-Items Index increased to +7.0% on a non-seasonally adjusted basis, still the highest since June 1982. The CPI ex Food and Energy, increased to 5.5% from last month's 4.9%. This last data point is the one to focus on in conjunction with the point brought out in the Oil Report above. Everyone seemed so happy the "headline" number wasn't a bigger 7 number that they missed the forest for the trees. We now know the drop in energy prices was transitory, if everything else, simplistically, other than energy went up in December and now energy has gone up 17% in January, the headline number when reported in February is likely going to be a big number. Overall, these numbers show an economy on solid footing with clear levels of high inflation that are not showing signs of abating. Thus, the Fed has painted itself in a corner, where markets and the economy are likely going to be pushed further onto the back burner until we see meaningful or quick drops in broader terms around inflation. Otherwise, the Fed risks runaway inflation which has only one resolution, as the early 1980's showed, and that was a hard recession. The end of Fed tapering bond purchases is on track for March, along with an interest rate hike, the question is 0.25% or 0.50%. We will continue to closely monitor economic activity to see how long and hard the Fed needs to raise rates.

Summary

So, the promised strong 4th quarter GDP growth was delivered, but now 1st quarter GDP growth looks on pace to be weak or flat. Headline inflation was less severe in December than feared, but the oil price decline around Thanksgiving and early December turned out to be transitory. This paints a very tough scenario for the Fed. Since the inflation pressure turned out not to be transitory, will the projected 1st quarter slow growth turn out to be transitory? If not, the Fed is potentially raising interest rates into a declining economic environment at the same time inflation pressures remain high. Will a couple of rate hikes kill the inflationary pressures without killing the economy, or is inflation more resilient and leads to additional rate hikes that do kill the economy? I may not be an economist, but I am sure glad I am not a Fed head looking this potential mess in the face. Ultimately, the Fed is largely responsible for the pickle they are in, hopefully they have the magic touch to get out of it. On the bright side, it has been a long slog, but at least initially, the long-awaited rally in Value vs Growth exerted itself with force in January as seen in the chart below. As a reminder, we are full overweight Large Cap Value vs Growth.



Source: Bloomberg

Source: https://www.zerohedge.com/markets/nasdaq-crashes-worst-january-ever-rate-hike-odds-soar

However, after digesting all of that, we retain our focus on what we can control, which is the amount of equity risk that is taken in a clients' portfolio in concert with the clients' risk tolerance and long-term goals. The markets will always face different "worries", today it is inflation vs. growth expectations, tomorrow it will be something else. We have built our asset allocation models with dynamic features and quarterly rebalancing, both in fixed income and equities. If the markets continue to march higher, we will capture some of those gains and reallocate to less volatile high-quality bonds. If the equity markets enter a period of negative performance, we have dynamic investment vehicles that utilize rules-based defense mechanisms to reduce the risk of the portfolio. Further, if the market gets too extended on the upside, some of the vehicles will capture partial gains and wait for the extension to correct.

If you have specific questions about your portfolio or financial situation, we are here to help. Long-term financial planning is designed to deal with uncertainty like those we discussed above. Our portfolio management process is to design a prudent allocation across many asset classes. Equities are for long-term growth and several vehicles that we utilize offer defensive mechanisms to mitigate equity market declines.

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