MARKET REVIEW & OUTLOOK

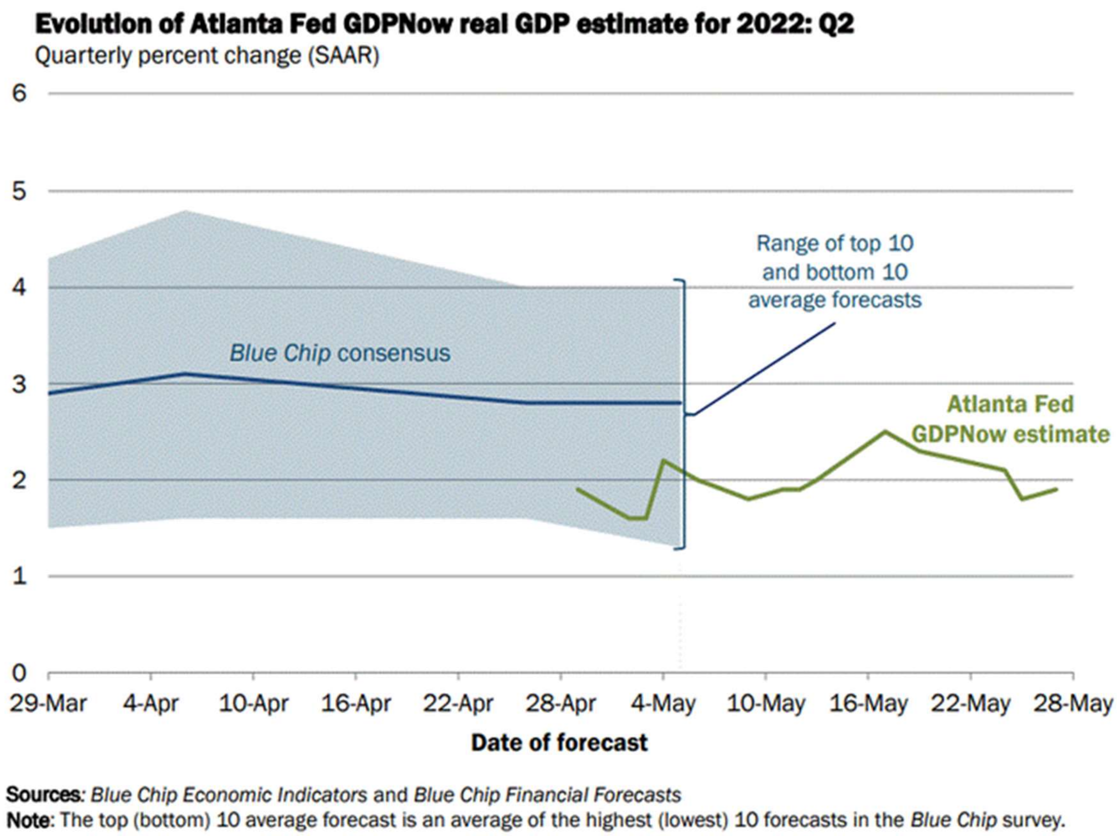
MAY 2022

KEY TAKEAWAYS

- The sharp decline of April continued into the first 3 weeks of May. Like March, a late month rally came to the rescue and reversed ugly monthly losses to end flat.
- Interest rates spiked early in the month on the back of the Fed hiking the Fed funds rate 50-basis points and promising more to come.
- The Russia/Ukraine conflict still isn't showing any signs of ending. Additionally, China finally seems to be easing the Zero-Covid restrictions, which is driving oil prices higher once again.

The U.S. Economy

The second release of 1st quarter GDP was slighter weaker than the initial print of -1.4%, coming in at -1.5%. There is a lot of conversation that recession won't hit until late 2022 or early 2023, though technically it could be happening right now. The second quarter estimate looks very similar to the forecast for 1st quarter, the Blue-Chip forecast is in high 2% range and the GDPNow estimate is in the high 1% range. I still struggle to see how the economic data is going to be materially different for the 2nd quarter than it was in the 1st quarter. If my feeling is accurate, then we will have the technical recession confirmed when the 2nd quarter print is published in July. Otherwise, the prognosticators may well be correct that it takes some more time for the recession to take place.



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

Stocks and Bonds

Interest rates continued spiking early in the month as inflation prints continued to rise, though moderated the second half on the month as growth waned and recession concerns creeped in. The last day of the month saw a sharp jump in yields as Europe seems hellbent on stoking inflation with additional cuts to Russian energy of which they are very dependent on, in concert with easing of China's Covid-Zero policy which is seen to raise energy demand. The Fed funds market continues to price in additional 50 bps rate hikes in June and July, though with the recession concerns weighing in, discussion is turning that the Fed may pause in September. Once again, the last day of the month notwithstanding, the longer maturity Treasury rates continue showing signs of stabilizing. That stabilization resulted in the first positive month of the year for High-quality fixed income, as measured by the iShares US Aggregate Bond ETF, coming in at a gain +0.65%. The U.S. 10-year Treasury bond yield ended the month near the prior month, at 2.84%, down modestly from April's close of 2.89%.

The Dow Jones Industrial Average "rose" 0.04%, the S&P 500 increased 0.01%, and the small cap Russell 2000 "fell" -0.00%. The international markets traded more robustly than the U.S. The MSCI EAFE iShares Core International Developed Markets ETF Index rallied +1.72%, and the MSCI Emerging Markets iShares Core ETF Index climbed +0.84%.

In May, we had a bifurcated market, equal shades of green and red.

The best performers were…

- Energy: +16.03%
- Utilities: +4.31%
- Communication Services: +1.90%

The lagging performers were…

- Consumer Discretionary: -8.56%
- Real Estate: -6.78%
- Consumer Staples: -4.08%

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

Oil Report

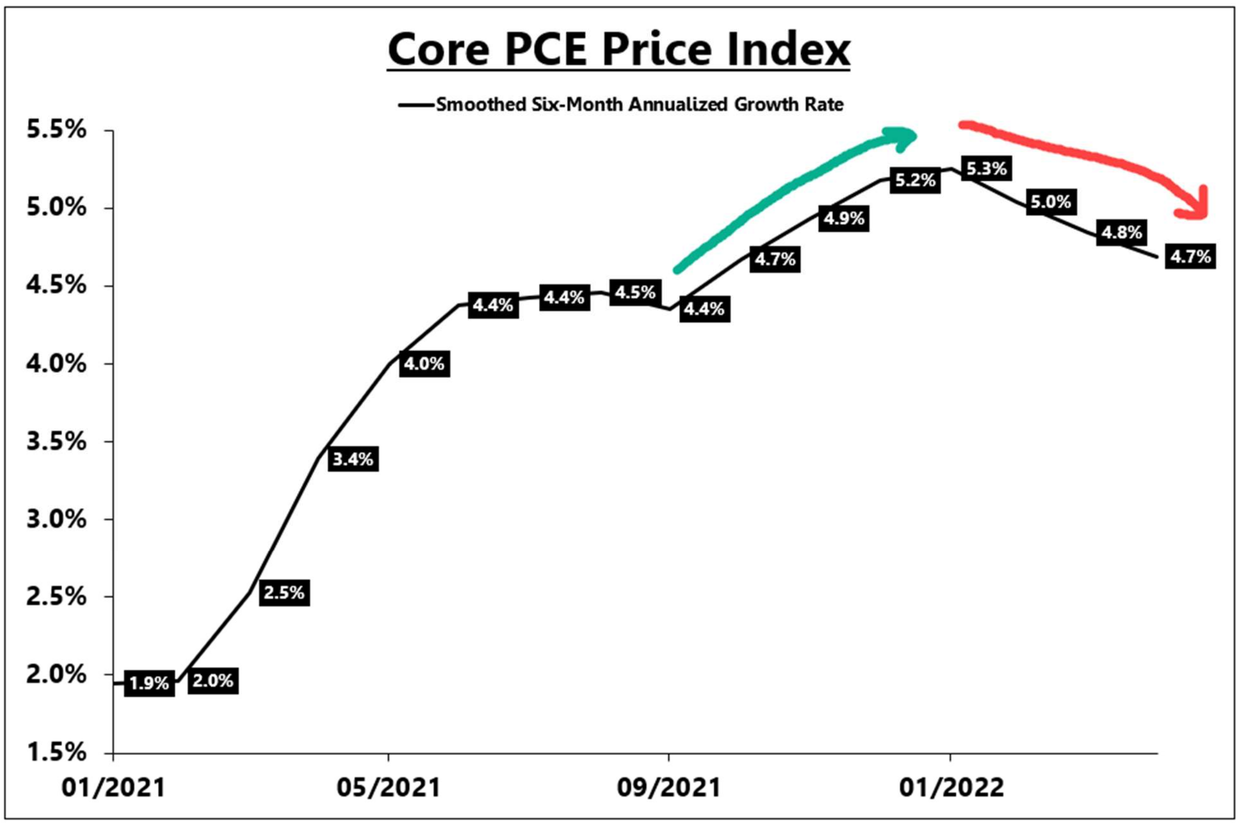
The oil market had a relatively steady climb higher during the month. The anticipation of more sanctions on Russian energy and the hopes that China would ease their Zero-Covid policy provided wind in energy's sails. The end of the month sparked more sanctions on Russia and less restrictions in China, thus curtailing supply and simultaneously increasing demand. Meanwhile, the West still seems completely disinterested in a peaceful resolution of the Russian/Ukraine conflict and NATO continues moving closer to engaging directly with Russia rather than just the current proxy war. The current NYMEX WTI Crude Oil futures settled at $114.67 and posted a gain of almost 10% from the prior month close of $104.69 a barrel. The strength in oil and strained production drove prices higher for RBOB gasoline, with a gain of over 25% vs April's close. Europe's situation and reliance on Russian Energy is dire, but the spillover effects to the U.S are becoming more pronounced. The U.S. does produce a far amount of energy products, but now a lot of that supply is being routed to Europe to take advantage of very high prices. However, the reduction in supplies in the U.S. is driving our prices ever higher as well. Now that summer is around the corner, let's hope the Hurricane season avoids the Gulf of Mexico or we will likely see another big spike in prices.

The Rest of the Data

The April ISM Manufacturing Index decreased 1.7 points to 55.4 from March's reading of 57.1. Further, the ISM Services Index decreased to 57.1 in April from March's print of 58.3. The prices paid component for both the Manufacturing and Services surveys remained at very elevated levels. Any reading above 50 generally indicates improving conditions. Consumer confidence was down modestly to 106.4 in May, which compares to an upwardly revised figure of 108.6 in April. The unemployment rate held steady at 3.6% and the economy added a solid 428,000 jobs in April, which is the 12th month of 400k+ of job adds. The Consumer Price Index for All Urban Consumers (CPI-U) was up +0.3% in April, on a seasonally adjusted basis, as higher base effects start to show prices holding at high levels, but not escalating as fast. Over the last 12 months, the All-Items Index increased to +8.3% on a non-seasonally adjusted basis, down slightly from last month's 40 year high. The CPI ex Food and Energy, decreased to 6.2% from last month's 6.5%. The Fed discusses the strong labor market and the need to reduce demand to curtail inflation pressures, which is usually a recipe for recession. However, the Fed continues to hold the line that they feel they can manufacture the first ever soft-landing in rate hiking history. Also, the same group that said inflation was transitory for 12 months. 😊 Lastly, Quantitative Tightening begins June 1st, so an indiscriminate buyer, at least for now, has removed their bid. We will continue to monitor economic and geopolitical activity to see how long and high the Fed needs to raise rates.

Summary

The details of the equity market returns are a very good illustration of the current economic/inflation/rate hike cycle. The headline reads that equity returns were basically zero for the month, nothing to see here. However, the daily gyrations, both up and down, reflect the greater uncertainty at play. We have had many interest rate hiking cycles in the last 40 years, but the added wrinkle is that we haven't had inflation perched at 40-year highs during the previous rate hike cycles post the early 1980's. So, the inflation hawks are in a pitted battle with the Fed doves as it has been 40 years since the Fed has shown staying power to their stated objective. The recent history shows that each time the equity markets hit some turbulence, the Fed caves and comes to the rescue. Again, the strength of inflation is the major difference this time. It seems there are two paths, continue to fight inflation, which likely drives down equity prices and causes a recession. The other path is to cave to market declines and pause or reduce the Fed funds rate, which ends up only strengthening inflationary pressures and ultimately forces Fed fund rates higher than otherwise would have been needed to curtail inflation pressures. Of course, this is a similar dialogue I have been having since former Fed Head Bernanke said he could fix inflation in 15 minutes. If the ultimate outcome of the last decade was to raise interest rates enough to kill inflation and the economy, why did we spend all that time creating bubbles rather than repairing the underlying structure of the economy? The chart below shows the path of inflation, as measured by PCE, the Fed's favorite measuring stick.



Source : https://www.zerohedge.com/markets/why-stocks-are-surging-and-what-todays-core-pce-data-means-next-months-cpi-print

However, as uncertain as that is, 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/war 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 decline, we will reallocate the overweight that occurs in Fixed Income back into equities. The decline in equity markets has triggered the rules-based defense mechanisms to reduce the risk of the portfolio via the dynamic investment vehicles that have been deployed. Further, if the equity markets get too extended on the downside, some of the vehicles will reallocate some capital back into their respective equity exposures.

These dynamic tools have been engaged, a couple of times during the increase in volatility. At month end a portion of equity has shifted to Treasury Bills for U.S. Large and Mid-Cap, as well as Developed International.

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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