BRIDGES | TRUST

MARKET COMMENTARY

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THE HITS KEEP COMING

Higher rates, persistent inflation, a hawkish Fed and geopolitical risk roiled the markets in the first quarter.

Three months ago, we published our outlook for 2022, titled 'Less of a Sure Thing.' Therein, we suggested that monetary policy could go from tailwind to headwind, inflation remain stubbornly high, interest rates rise, equity multiples contract and investors should be prepared for elevated volatility. We commented that the 'everything rally' seemed unlikely to continue and we advised approaching markets with equal parts vigilance and opportunism.

Being 'right' has never felt less rewarding.

- The Federal Reserve raised rates in March and it expects persistent increases through 2023. Plans to reduce their balance sheet are forthcoming, which will further tighten credit.
- The most recent inflation reading was 7.9% year-over-year.
- The benchmark 10-year US Treasury rate has risen from 1.5% to 2.5%.
- Real rates (Treasury rates after inflation) are still negative but have increased 0.4%. As real interest rates rise, high-multiple growth stocks tend to do poorly.
- At one point, the NASDAQ Composite, which skews towards expensive tech, was down 19% year-to-date.

One quarter into the year, much has played out as we expected. But what we did not expect was Russia's invasion of Ukraine in February. While the humanitarian costs are far more important, this has exacerbated an extremely tight commodity market. Oil rose from $78 to $128, nickel rose 90% in roughly a week and fertilizer prices skyrocketed. The ultimate duration of this conflict is anyone's guess but combine this with additional Covid lockdowns in China and we no longer expect a reprieve from inflation in 2022.

The Fed has the unenviable task of taming inflation without causing a recession, a so-called 'soft landing.' They've done it before, most recently in 1994, but it's an exceptional feat of central bankery. More often than not, increasing rates slows economic growth, dampens risk-taking, reduces asset prices and can often trigger a recession. The temple priests of macroeconomics like to study the shape of the yield curve, suggesting that a flat curve portends a recession is looming. And you guessed it, the yield curve is currently flattening.

While the persistence of inflation has been frustratingly long, and each factor has a rational and seemingly temporary cause, the more 'the hits keep coming' the more likely inflation is to become entrenched. Since last July, average hourly earnings have consistently grown at 4-5%. This, combined with over $2 trillion of excess savings from the pandemic has the potential to create a wage-price spiral, a self-reinforcing feedback loop of higher and higher inflation expectations. Consumers have noticed and sentiment is down sharply from pre-pandemic levels. It hasn't resulted in demand destruction thus far, but it might, which would have negative implications for GDP growth.

Monetary policy is, by definition, a blunt instrument and increasing rates won't ease supply chain disruptions or lower the price of oil. But the Fed's patience is starting to look like a policy mistake. Many argue that they have let the economy run too hot for too long already, and they risk losing credibility with capital providers.

When it comes to higher rates and higher inflation, neither equities nor fixed income are immune. While equities may see their prices decline and their multiples contract, at least they could potentially earn their way out of it in the future. Bonds don't enjoy the same optionality and the first quarter represented the worst performance for fixed income as an asset class since 1949. After a 40-year bull market in fixed income, it's almost as if investors forgot they could lose money. Overwhelmingly, our clients remain short duration, which may help soften the blow from rising rates and allow them to reinvest at higher prevailing rates. But that's the thing about inflation. Unless you own commodities outright, there aren't many places to hide.

Like we said last quarter, we would advise moderating your expectations for strong returns in 2022. Markets price new information every day. Right now, it's repricing higher rates, higher inflation and geopolitical risk. Some will argue that the price declines year-to-date already sufficiently discount sharply higher rates. Others that the conflict in Ukraine will find a peaceable solution (something we ardently hope for). We consider these possibilities, but also recognize that the world has a lot of excess liquidity and there aren't many attractive homes for it, which despite short-term performance risk, leaves equities as one of the few games in town.

But that's the beauty of our process. We buy exceptional businesses with strong growth prospects at reasonable valuations which shouldn't require us to forecast inflation, interest rates or the outcome of military conflicts. While all investing involves risk, including the risk of loss, we adhere to our process because it seems a logical way to provide durable returns over multiple business cycles, whether rates are rising or falling and in times of peace and war. The returns may not be smooth and past performance provides no guarantee of future results, but thus far, they've been satisfactory.

Thank you for your continued support and should you have any questions, don't hesitate to reach out to your Relationship Manager.

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