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MARKET COMMENTARY

WHAT TO DO ABOUT INFLATION?

When T.S. Eliot penned "April is the cruelest month," it's unlikely he was thinking about the returns of common stocks. But after the Nasdaq index posted its worst monthly return since March of 2008, we're willing to misappropriate the quote. Not wanting to be left out, the S&P 500 is having its worst start to a year since 1939.

Our regular readers know that we write market commentaries quarterly, but more often in times of duress (like Spring of 2020, when we wrote five pieces opining on the pandemic). In our view, consistent communication helps clients understand our thinking, frame expectations and fosters alignment. While we just published a note in early April, recent events deserve comment.

Markets thrive off differences of opinion, yet seem relatively unanimous on the cause of the sell-off; namely interest rates. The US 10-Year Treasury began the year yielding 1.51% and is currently 2.96% (rates rise as prices fall). Higher rates aren't a bad thing in and of themselves. They often coincide with a strong economy and low unemployment. But the value of a productive asset goes down when interest rates rise as alternatives for capital become more attractive. When interest rates were at their lowest, it pushed investors into risk assets, driving up their prices. We're seeing that unwind now.

The length and duration of this repricing will depend on where interest rates ultimately find equilibrium and how quickly they impact economic activity. Last week the Fed raised their benchmark borrowing rate 0.50% and are expected to do so several times before year end. Higher interest rates have the primary objective of reducing demand, slowing the economy and taming inflation. Tightening cycles have tended to trigger recessions, which is why many investors are expecting one now.

So, falling stocks, higher rates, higher inflation and slowing economic growth, never mind Russia's invasion of the Ukraine, high energy prices and the risk of a resurgent pandemic. These are all headwinds for risk assets, especially in comparison to the recent past, when growth seemed highly certain, capital was cheap and stocks could do no wrong.

Our long-time readers probably know what's coming next. The outlook for equities in the next twelve months isn't great. A recession seems likely. Why not just take some chips off the table and wait and see? The temptation to market-time is always highest when things are most uncertain. Crisis after crisis (and we're not in crisis yet) has shown us that we're not particularly good market timers. When constructing portfolios, we intentionally gravitate towards companies that we'd be comfortable owning during a recession, because odds are that eventually we will.

We wrote in October of 2019 that we were suspicious a recession was imminent. It turns out we were right, but not for the reasons we suspected. COVID did eventually cause a recession and yet the total return of the S&P 500 has been 41% from that date until now. While past performance provides no guarantee of future results, we believe the old adage is true, it's not timing the market, it's time ***in*** the market, and history has shown us that equities eventually compensate investors for bearing risk.

Many investors are clustering around energy stocks and other inflation-sensitive equities. We have no special insight on inflation, its duration or its magnitude. We do own equities that are inflation beneficiaries, just as we own equities that benefit from deflation. Our goal has never been to design a portfolio that is a one-way bet on a binary outcome (high inflation or low), but to strive to generate an acceptable return regardless of the direction of the economy.

Perhaps most painful is the sell-off in large cap tech stocks. While many enjoyed higher than market multiples (and were thus deemed 'expensive') we didn't find their valuations particularly egregious relative to their fundamentals. While many benefitted from the pandemic and their fundamentals seem to be taking a breather, the trends of e-commerce, digital advertising and cloud computing are still very much early in their adoption curves. Regardless of the direction of the economy, we suspect we'll be ordering more from Amazon, watching more YouTube and using more apps hosted by Microsoft's Azure in 10 years than we do now.

While a dour outlook in the short-term, but a positive bent long-term is modest consolation, our job is to call them how we see them. We continue to test our assumptions, sharpen our pencils on valuation and allocate your capital to the best of our abilities. We thank you for your business and if you have any questions, please contact your relationship manager.

Sincerely,

Bridges Trust Investment Committee

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Sources: [1]Wall Street Journal, [2]CNN, [3,5]FactSet Financial Data and Analytics,[4]The New York Times.

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