Graves Light Lenhart
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Graves Light Lenhart January '22 Market Commentary

New Year Brings Frosty Chill to Markets

Market Overview:

New Year optimism quickly turned to caution as the major U.S. stock indices that have led the world for more than a decade suddenly ran into trouble in the thin trading just after Christmas. The initial decline evolved into more frenetic moves as the Federal Reserve committed to an increasingly hawkish approach to inflation. This marked a rapid reversal from 2021 as markets would have spent most of last year trading on assurances from central banks, particularly the Fed, that inflation would prove transitory and that monetary policy would continue to remain in uber stimulus mode. While this powerful conditioning propelled the "everything rally" across markets, 2022 has already proven to be much different as the financial ecosystem shifts into a new environment where the Fed has little choice but to deal with the reality of stubbornly persistent inflation. Market assets have taken notice, as this year's increased volatility and correction in stocks is indicative of less friendly monetary policy.

Increasingly hawkish central bank rhetoric coincided with yet another wave of COVID-19. The highly transmissible Omicron variant has by and large proven less fatal than previous variants witnessed. As a result, many governments around the world have opted for less stringent restrictions which has left most of the global economy open, although coupled with rife employee absenteeism. As such, recently published data is generally showing that the economy is decelerating from what was a very strong pace, and not in a way that is alarming. Employment reports for January were constructive, on balance. Additionally, global and domestic PMIs – which reflect economic trends in the manufacturing and service sectors – indicate the Omicron soft spot wasn't very soft at all (at least so far). Positively, regional Fed surveys show that general business conditions remain healthy with improving forward expectations. Fundamentally, this is good news for the economy. Practically, market participants are worried that the Fed may now push harder with policy that could eventually slow economic activity.

Asset Performance:

Market performance was decidedly weak to commence the year, with intramonth swings and rotations witnessed across various asset classes. The leading culprit appeared on January 5th, when the minutes from the mid-December Federal Open Market Committee (FOMC) meeting were released. While the minutes were laden with detail, the focal point was the mere mentioning of the Fed reducing its balance sheet while also increasing the policy rate (which had already been telegraphed). The resulting effect on both bond yields and share prices was immediate, with the former surging while stocks sold off.

While the leading domestic indices showed marked declines for the month of January, a late month bounce concealed the worst of the drawdown. For example, the maximum drawdowns before the end-of-month turnaround were 16.6% for the tech-heavy Nasdaq 100 and 12.0% for the S&P 500, on an intraday basis. By adjusting market expectations for rates going forward, the Fed-related worries have taken a great deal of air out of the various speculative pockets in the financial markets – including meme stocks, cryptocurrencies, SPACs (special-purpose acquisition company stocks), and large-cap tech stocks. At one point, the latter accounted for nearly 40% of the decline in year-to-date returns for the S&P 500(!). The reality of rising interest rates quickly proved penalizing for assets benefitting from their dormancy.

Key US Index Returns	2021	January '22
S&P 500	+28.7%	-5.2%
Nasdaq	+22.2%	-9.0%
Dow Jones Industrial Average	+21.0%	-3.2%

Relevant Fixed Income Yields	YE 2021	January '22
US 10-Year Treasury Note	1.51%	1.78%
Investment Grade Corp. (C0A0)	2.4%	2.8%
High Yield Corp. (H0A0)	4.3%	5.3%

Source: Factset as of 02/01/22

Key benchmark interest rates were equally swift and erratic, as markets quickly came to terms with a prospective higher interest rate landscape. Indeed, the policy driven 2-year US Treasury rate rapidly ascended to 1.16% at month's end. This reflecting a more aggressive policy approach from the Fed which is now being priced for the path ahead. The market now thinks that rates will be raised at each of the next three FOMC meetings, and perhaps as many as five increases this year. With interest rate curves shifting upward, most securities with a fixed-rate coupon would have experienced a decline. For instance, the Bloomberg US Aggregate, representing a large consortium of bonds from government to corporate securities, was 2.2% lower for the month of January. This marked the 2nd worst month for the index in the last 10 years.

Closing Thoughts:

For years, financial assets have leaned into the notion of a "Fed put", which has been in and out of play since the Alan Greenspan era. The underlying principle from market participants was the belief that the central bank would step in if markets became turbulent. Given the need to counter inflationary pressures, we do not count on this assumption as central bankers chart their tightening course. Ultimately, as excess liquidity is reigned in, we reiterate our preference to invest in businesses and assets that are neither dependent on artificially low interest rates nor poor pandemic sentiment to buttress their valuations.

Warm regards,

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