June 3, 2022

Graves Light Lenhart May '22 Market Commentary

Markets Are No Longer Spoon(Fed)

Market Overview:

Markets roundtripped during May as key benchmarks flirted with "bear market" territory – defined as any peak-to-trough drawdown of 20% or more – with most market segments clawing back to close out the month broadly unchanged. The cautious backdrop stemming from inflation concerns coupled with Fed rate hikes continued to loom large as real gross domestic product (GDP) contracted in the first quarter, with estimates for the second quarter flashing at anemic levels, although positive thus far. Much of the current landscape, for both the economy and the financial markets, is directly linked to the ongoing decline in liquidity. Annual growth in money supply – measured by M2 – peaked at 27% in February 2021, and is now decelerating significantly, edging closer to its pre-pandemic rate. In conjunction with the Fed now raising rates at an aggressive pace (one 25 basis point and one 50 basis point hike so far) *and* commencing its balance sheet reduction in June, markets continued to adjust to a monetary policy regime which is quickly transitioning from being accommodative to restrictive.

Rising inflation, rate hikes, supply-chain issues and the Russia-Ukraine war have all contributed to growing recession fears, both domestically and for many international economies. While such economic events are seemingly impossible to predict, the risk of an economic recession has indeed picked up. However, signals remain mixed with many recessionary harbingers continuing to suggest that the US economy is on solid footing. Positively, recent global PMIs (Purchasing Managers' Index) show evidence that stresses on supply chains are finally starting to somewhat ease. Ultimately, in order for pricing concerns to lessen, global central bankers need to cool demand by tightening financial conditions. The effects of inflation are seen as being *worse* for the economy than the secondary wealth effects from falling stock prices. In this context, we are sensitive to decelerating economic metrics while recognizing that a normalization in policy to offset years of overwhelming monetary stimulus will inevitably cause growth to taper. With central banks driving the proverbial bus, the overarching question for the economy is whether the stimulus punchbowl can be removed without causing a sugar crash.

Asset Performance:

Before a late-month rally, US stocks briefly dipped into bear market territory on an intra-day basis, with the S&P 500 bottoming out with a 20.5% decline from its record high at the close of trading on

January 3. Driven by a comeback in the final week of the month, the S&P 500 eked out a positive total return +0.2% in May. The poor undertone witnessed during the month was exacerbated by a flurry of poor retail earnings, with investors concluding that the US consumer was cutting back on spending and that corporate profits were starting to get squeezed. Notably, dispersion amongst various factors in the market persisted, with the S&P 500 Value index returning +1.6% for the month compared to a 1.4% decline for the S&P 500 Growth index. Year-to-date, the performance gap between value-oriented securities and their growth-biased brethren widened to >17%, following years of relative underperformance.

Having experienced a drubbing through April, US fixed income performance was mostly positive for the month of May. While benchmark interest rates rose swiftly to commence the year, bond markets took a breather as rates consolidated over the last month. Importantly, the inflation-linked bond market is suggesting that longer-term inflation expectations have started to decline. To this extent, the 10-Year Treasury Inflation-Protected Securities (TIPS) yield closed the month at a positive level of 0.2%. While paltry in absolute terms, this marks the first time in over two years in which implied *real* yields are now positive over this time horizon. The continued normalization of real interest rate levels has had a rippling effect through financial markets, while directly improving the entry yield for many subsegments of the bond market. While much of the fixed income market has been characterized as “return-free risk” over the last few years as a result of overly accommodative policy, the resultant impact of the Fed’s swift change of course is now creating opportunities.

Key US Index Returns	YTD '22	May '22
S&P 500	-12.8%	+0.2%
Nasdaq	-22.5%	-1.9%
Dow Jones Industrial Average	-8.4%	+0.3%

Relevant Fixed Income Yields	YE 2021	May '22
US 10-Year Treasury Note	1.51%	2.84%
Investment Grade Corp. (C0A0)	2.4%	4.3%
High Yield Corp. (H0A0)	4.3%	7.1%

Source: Factset as of 06/01/22

Closing Thoughts:

Market dynamics provide the perception that the recent selloff looks and feels similar to the prior retreats of late 2018 (caused by fears of the Fed tightening, which ended in a pivot), the decline of 2011 (Treasury bonds downgraded, once again alleviated by the Fed’s “Operation Twist”), and the summer of 1998 (Russian debt default, followed by market mayhem, ending with the Fed cutting rates). The common thread was the US central bank providing a life raft, however, in all instances inflation was not a material problem. Therein lies the prevailing “fly in the ointment”. In our view, it is highly unlikely for the Fed to blink while inflation is uncomfortably high. While timing market “peaks and troughs” is invariably a fool’s errand, we remind our clients of the importance of diversification (both across and within asset classes), periodic rebalancing (trimming high and adding low) and a laser focus on sticking to your long-term financial plan.

Warm regards,

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