Inverness Counsel

1Q 2022 Commentary

Off to a Bumpy Start

In our 2022 outlook, we noted that we expected to see more volatility this year. Two possible sources of risks were highlighted: interest rate hikes by the Federal Reserve and the mid-term elections. With that said, we did not anticipate such an anxious first quarter for the S&P 500, in which we experienced both an all-time high and one of the worst starts to a calendar year.

During the height of the pandemic in 2020, the Federal Reserve and Congress acted quickly with enormous stimulus plans equal to 40% of gross domestic product (GDP). These programs helped drive the V-shaped economic recovery and the strong rally in the S&P 500 since March of 2020. With GDP surpassing its 2019 peak at the end of 2021, the Fed entered 2022 looking to end the emergency measures they had put in place.

Throughout 2021 the Fed described inflation as transitory and developed a plan to begin normalizing interest rates, with increases planned for the second half of 2022. In late November, the term "transitory" was dropped as the Fed acknowledged inflation was present, but not a concern. Early in 2022, inflation figures came in higher than expected – hitting its fastest pace since 1982 (driven by shortages in labor, shipping bottlenecks and volatile commodity prices). This resulted in a significant pivot in Fed policy. Not only would the number of rate increases expected in 2022 be increased 2-3X, but the time frame would be moved up to March.

This market unsteadiness was heightened in February when Russia invaded Ukraine. In addition to the humanitarian crisis being witnessed, prices on many commodities have skyrocketed, further complicating inflation both in the U.S. and globally. Russia and Ukraine account for more than one-fourth of the world's wheat exports and are an important source of many different kinds of metals and materials.

As a result, the Fed increased rates in March for the first time since 2018. Current projections are now calling for six more 0.25% rate hikes in 2022, with the possibility of one or two of these rate hikes at 0.50%. The Federal Reserve is stuck in a difficult position, as it attempts to rein in inflation by raising interest rates without triggering an economic recession. We believe this combination of market uncertainties will keep volatility elevated and have adjusted portfolios accordingly.

Figure 1

2022 Performance by Sector

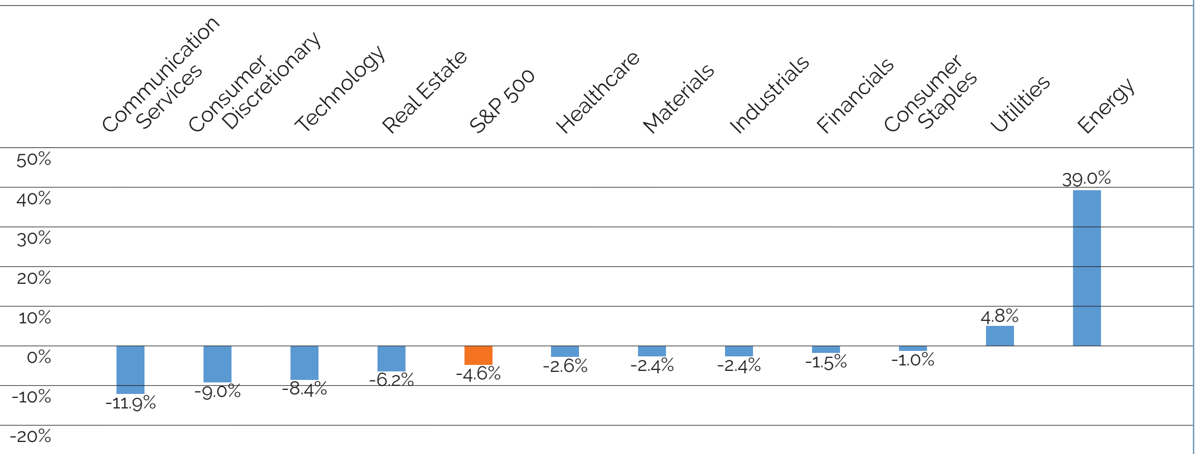

Figure 1 Source: Bloomberg. All performance based on total returns. Data as of 3/31/2022.

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After experiencing a 13% correction during the quarter, the S&P 500 rallied in March and ended the quarter down 4.6% on a total return basis. The only two sectors with positive returns were Utilities and Energy. The more growth focused sectors - Communication Services, Consumer Discretionary and Information Technology underperformed (see Figure 1).

Figure 2

2022 Performance by Category

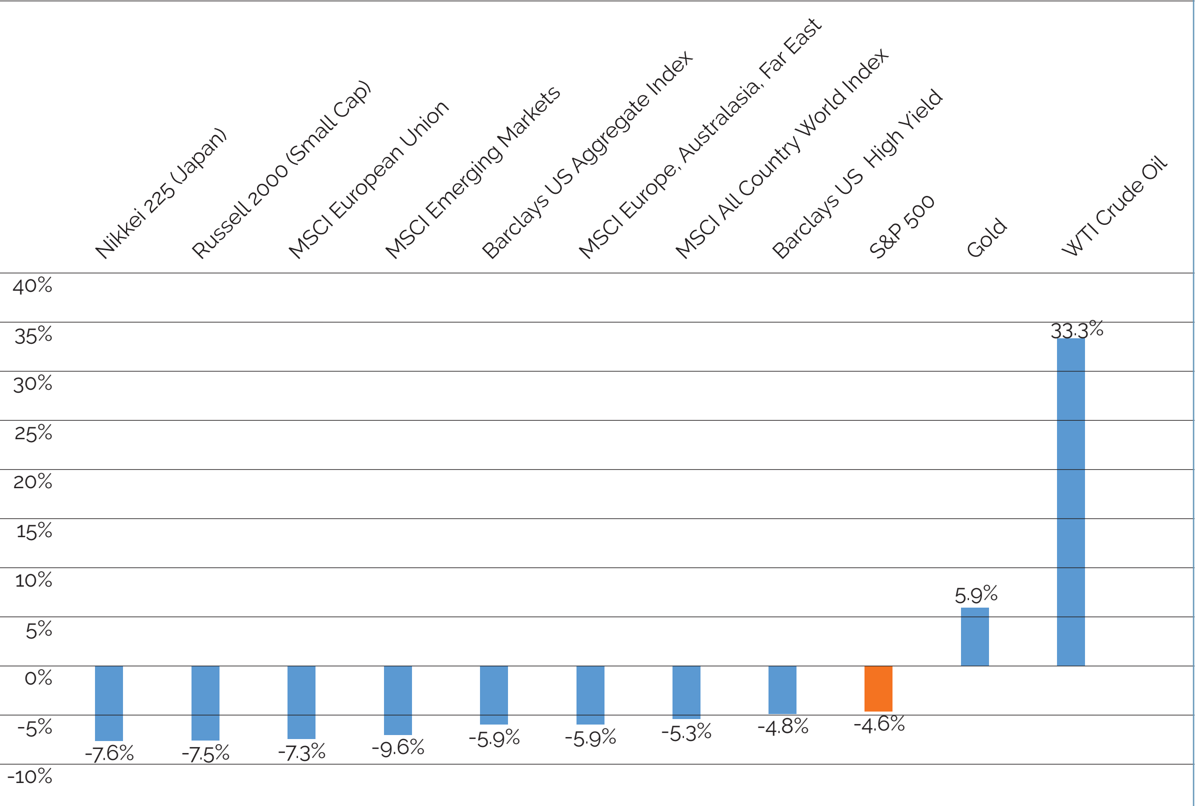

Figure 2 Source: Bloomberg. All performance based on total returns. Data as of 3/31/2022.

The Consumer Will Lead the Way

The domestic economy, as defined by Gross Domestic Product (GDP) grew by 5.7% in 2021, with the impact of inflation boosting nominal GDP growth to 10.4%. Consumer spending, which makes up 70% of our economy, was robust with many participants engaging in "revenge spending" to make up for lost time during the height of the pandemic in 2020. This consumption, along with ongoing disruptions from Covid-19, collided with a global supply chain that was too fragile to keep up with demand.

Non-inflation adjusted GDP is expected to grow 3.2% in 2022. Consumer spending is again expected to be a major contributor, but this is one area we are watching closely. Currently there appears to be balance. Consumers still have access to record level savings; they are employed and have gotten raises; and for many, their largest asset, their home, has appreciated considerably over the last two years. Conversely, headwinds include inflation eating into their household budgets (rent, food, and energy); the end of government stimulus plans; and rising interest rates, which make general debt and mortgages more expensive. The low-end consumer segment has begun to show some signs of trading down with sales of non-branded goods now above 2019 levels for the first time in nearly two years.

Sentiment data serves as an indicator for how consumer spending may trend in the future. The University of Michigan Consumer Sentiment Index, a monthly survey of how consumers feel about the economy, personal finances, business conditions, and buying conditions, ended March 2022 at 59.4% - a decade long low. Inflation was cited as the primary cause of rising pessimism. Meanwhile,

another sentiment indicator, the Conference Board Consumer Confidence Index, improved slightly in March from February levels, as many participants feel supported by strong employment growth. Why the difference? The Conference Board Consumer Confidence survey puts a greater emphasis on employment and labor market conditions, while the University of Michigan Consumer Sentiment assessment emphasizes individual household finances. With initial jobless claims falling to their lowest level since March 1968, people feel confident in their employment, but less confident in the ability of their finances to keep up with inflation (see Figure 3). Housing is also an important area to

Figure 3

University of Michigan vs. Conference Board Sentiment Surveys

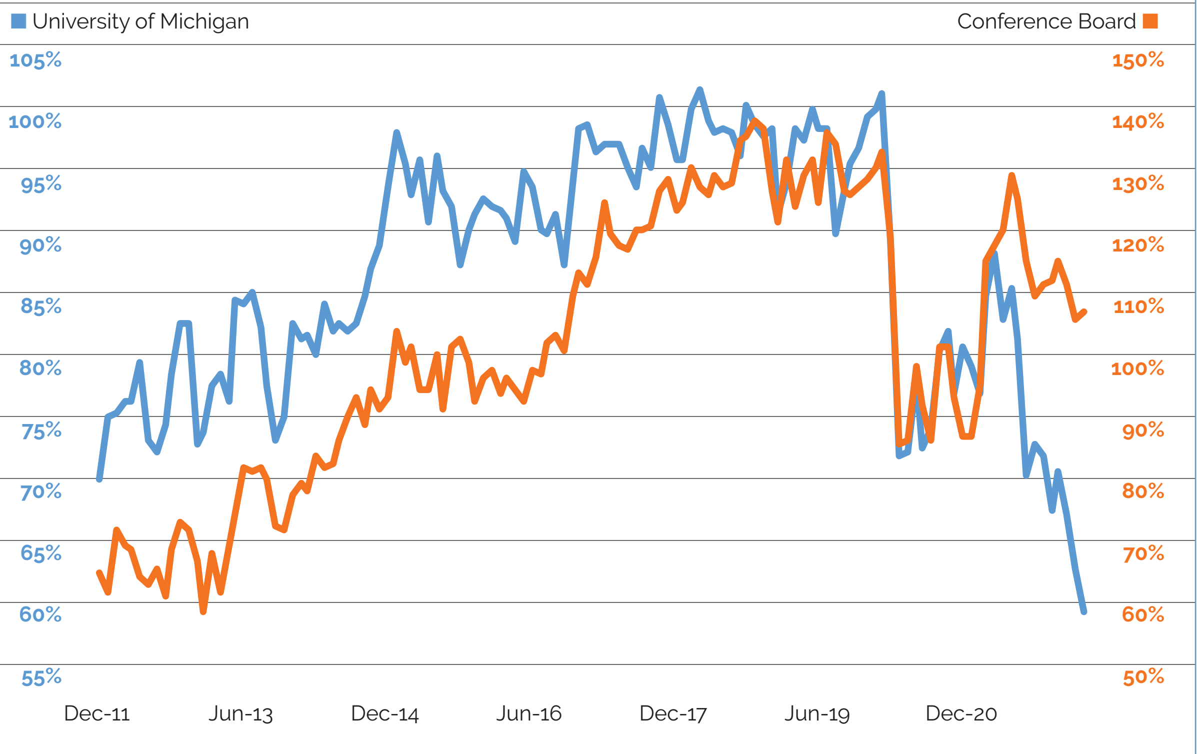

Figure 3 Source: Bloomberg. Data as of 3/31/2022.

watch. The 30-year mortgage rate fell to a record low of 2.7% in late 2020. This helped home prices increase nationally by 19% in 2021, after an increase of 10% in 2020. At the end of March 2022, the average 30-year fixed-rate mortgage jumped to 4.8% which is above the pre-pandemic level of 3.7%. These rates are still attractive when compared to history, with housing inventory and demographics remaining favorable. However, some cooling off seems inevitable. We also expect to see some impact from home equity loans that have become more expensive.

The Federal Reserve — Stuck on a Tight Rope

With the Fed now looking to raise rates aggressively, the discussion of a “soft” landing versus a recession is now a popular debate among investors. A “soft” landing is when the Fed attempts to raise interest rates just enough to slow the economy and tame inflation, without causing a significant increase in unemployment and an economic recession. In this scenario, the S&P 500 could experience more volatility, but would most likely not enter bear market territory which is defined as a decline greater than 20%.

A recession is a much longer duration event (typically 22 months) with the average decline in the S&P 500 reaching -39% (see Figure 4).

Figure 4

Recession Period Characteristics

Market Description	Market Peak	Bear Return*	Duration (months)	Macroeconomic Environment		
				Commodity Spike	Aggressive Fed	Extreme Valuation
1. 1937 Fed Tightening - Premature policy move	Mar 1937	-60%	61		X	
2. Post WWII Crash - Demobilization, recession fears	May 1946	-30%	36			X
3. Eisenhower Recession - Worldwide economic downturn	Aug 1956	-22%	14		X	X
4. Tech Crash of 1970 - Economic overheating, civil unrest	Nov 1968	-36%	17	X	X	
5. Stagflation - OPEC oil embargo	Jan 1973	-48%	20	X		
6. Volcker Tightening - "Whip inflation now" (WIN)	Nov 1980	-27%	20	X	X	
7. Black Monday - High trade deficit, tax bills, NYSE shuts down	Oct 1987	-32%	2			X
8, Tech Bubble - Extreme valuations, .com boom/bust	Mar 2000	-49%	30			X
9. Global Financial Crisis - Leverage/housing, Lehman collapse	Oct 2007	-57%	17	X	X	
10. Global Slowdown - COVID-19, oil price war	Feb 2020	-33%	2			
	Average	**-39%**	**22**			

Figure 4 Source: FactSet, NBER, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management. Data as of March 31, 2022.
*Bear returns are price returns.

Past Fed rate hike cycles have led to recessions 75% of the time over the last four decades. One of the indicators investors are watching closely is the yield spread, since this gauge has been a reliable indicator for predicting economic recessions. The yield spread measures the difference between the 10-year U.S. Treasury yield and the 2-year U.S. Treasury yield. At the end of 2021, these yields were 1.5% and 0.73% respectively, producing a yield spread of 77 bps. A stable or increasing spread signals confidence that the economy is expanding as the Fed increases rates towards its target. A declining or negative yield spread signals concern about growth and/or a recession since fixed income investors typically expect more compensation when investing for a longer time period. At the end of the first quarter, this spread briefly turned negative, perhaps signaling that the odds of a recession (the grey bars) in the next 12-24 months have increased (see Figure 5).

Figure 5

10-year minus 2-year Treasury yield curve spread (with Recessions and Inversions)

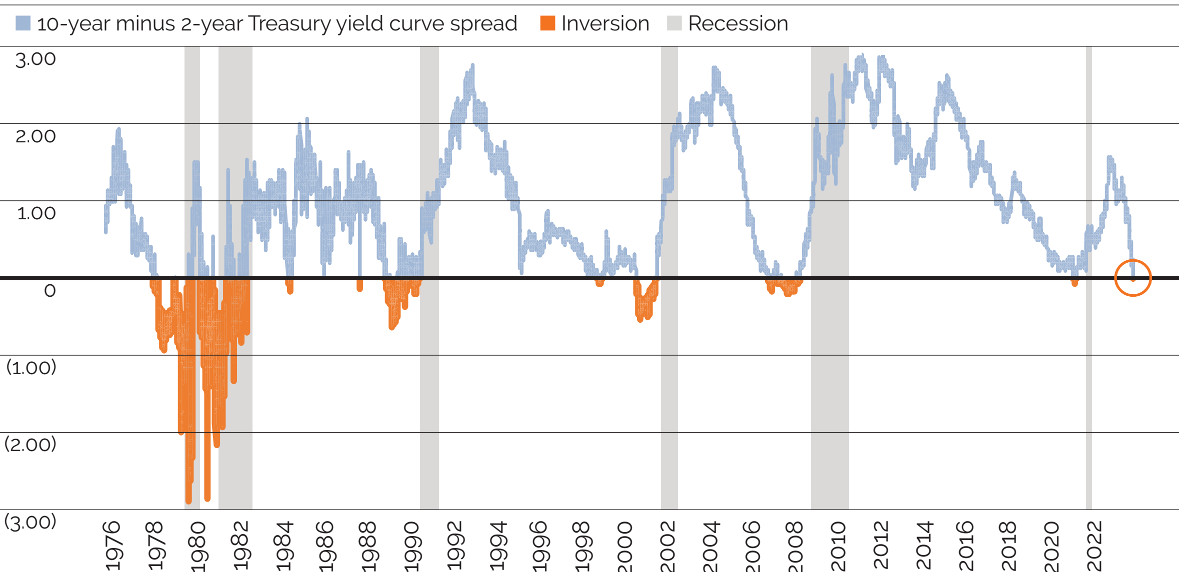

Figure 5 Source: Bloomberg. Data as of 3/31/2022.

Course of Action

Robust economic and earnings growth has been met with persistent inflation and rising interest rates, creating a difficult backdrop for markets. In general, cash balances have increased during the year. We expect volatility to remain elevated as investors grapple with a rapidly changing environment:

Reasons for Optimism	Reasons for Concern
Companies remain in good shape with robust balance sheets, perhaps making many less dependent on credit growth as interest rates rise. This is evidenced by stock buybacks and a rise in M&A transactions	Supply chain problems were expected to ease in the second half of 2022 as the pandemic transitioned to an endemic phase. China has now been shut down again, due to a new Covid strain
U.S. household finances are generally healthy, supported by excess savings	A downward sloping/inverted yield curve. The 2-10 spread ended the quarter at -1 bps, but has since rebounded to positive territory
Higher oil and commodity prices may depress demand for other goods	Oil prices and commodity shocks have a propensity to cause recessions; over the past 50 years, in the six instances where crude oil prices increased 50% or more, a recession occurred every time
Inflation may prove to be transitory as pandemic driven issues reverse (supply chain, labor shortages, shutdowns and sick days due to Covid)	Consumer confidence is plunging, as evidenced by University of Michigan data (latest reading of 59.4); these levels are comparable to economic slowdowns or recessions
Wage inflation, the key to long-term inflation, seems to be cooling off. Labor participation of 62.4% has been increasing in recent reports after averaging 61.7% in 2021	The Federal Reserve may be less likely to pause raising rates, due to global economic weakness or volatile stock markets

Fundamentals for many companies are still forecasted to be strong, although valuations, as mentioned in our outlook for 2022, may continue to contract. Historically, when interest rates increase, equity valuations decrease. With current market valuations still above long-term averages, this is something we consider in our investment analysis.

We continue to have significant exposure to the Healthcare sector, with many companies benefiting from secular tailwinds. During the quarter, we reduced our weighting in the Consumer Discretionary and Technology Sectors. Many of the companies in these sectors have experienced significant volatility and valuation contractions. Some caution on fundamentals is warranted as the Fed tries to slow the economy. Through our bottom-up research process, our team will continue to look for opportunities in these growth focused areas.

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