ICR® 1st Quarter Newsletter – April 2022

Amid high inflation, rising interest rates, and geopolitical turmoil, markets fell in the first quarter of 2022. The S&P 500 lost 5.0%, with the biggest laggards being the technology, consumer discretionary, and telecom sectors. Energy and utilities were the only sectors to post positive returns for the quarter. Small cap stocks fared worse (-7.8%) than their larger counterparts and growth stocks underperformed relative to value.

Foreign stocks were outperforming the U.S. through the first half of the quarter, but that trend reversed following Russia's invasion of Ukraine as foreign markets faced more direct effects than the U.S. The MSCI EAFE index of foreign developed markets fell following the invasion and finished the quarter down 6.6%. The MSCI Emerging Markets index had been down only 2.0% prior to the invasion but was hit even harder than developed markets and ended down 7.3%.

Historically, stocks and bonds have had a low – or even negative – correlation, but bonds were hit just as hard as stocks in the first quarter as yields rose dramatically. The yield on 10-year Treasury bonds climbed from 1.51% to 2.34% causing the value of bonds to fall. The Bloomberg Aggregate Bond Index lost almost 6% during the quarter and that trend has continued into the second quarter.

Inflation and its effects have been weighing on both the stock and bond markets. We've written here in recent quarters about inflation and the threat it poses to markets and the economy more generally, but unlike some topics we've addressed in the past, this story has not gone away. At this point, it seems safe to say that the Federal Reserve's characterization of inflation as "transitory" was wrong.

While certain parts of the inflation story have subsided somewhat (used car prices, for example), prices in other segments have escalated their surge. Anyone who has gone to the grocery store or the gas station lately has seen that first-hand. Certainly, the war in Ukraine has not helped as Russia is the leading non-OPEC exporter of oil in the world. While Russian oil only made up about 2% of the annual U.S. supply, that number is far higher in Europe and so the spillover effects have been felt here, as well. Also, Russia and Ukraine combined account for more than a quarter of the total wheat exports in the world. Fortunately, the U.S. is a net exporter of wheat and not reliant on Russian or Ukrainian wheat, but in a global economic system, supply shocks are felt everywhere.

Given the persistent nature of the recent inflation, the Federal Reserve has taken the stance that inflation must be dealt with. After all, part of the Fed's mandate is price stability and 8.5% annual inflation hardly represents stability of prices. The main tool the Fed has for fighting inflation is raising the Fed Funds Rate, which they began doing in March. In a speech at the National Association of Business Economics conference, Fed Chair Jerome Powell said, "There is an obvious need to move expeditiously to return the stance of monetary policy to a more neutral level, and then to move to more restrictive levels if that is what is required to restore price stability." The message is clear: the Fed will continue raising rates until inflation is under control.

The markets have become accustomed to low rates which have served as a tailwind for risk assets. Rising rates and the promise of more to come have sent shockwaves throughout the stock and bond markets as investors have had to recalibrate their assumptions. Low rates meant cheap borrowing for companies and individuals alike which led to strong growth in corporate earnings. Higher rates will be a minor inconvenience for well-capitalized companies, but could be devastating for highly-indebted firms.

In the short run, rising rates are painful for bond investors as their bonds lose value in that environment. However, in the longer run, higher rates are a positive development for the more conservative investor as they'll be able to earn a higher yield on their bonds and savings accounts going forward. Zero interest rate policy has been a major challenge for the saver who is simply looking to earn a decent rate on their savings.

Money markets have paid next-to-nothing for years now and even longer-term bond rates weren't much to get excited about. That appears to be changing – especially on the shorter end of the term spectrum, where a two-year treasury note now earns around 2.5%. Still, that's well short of the current inflation rate, so until inflation subsides, bond investors are falling behind on a real basis.

One area that will be interesting to watch amid rising rates is the housing market. House prices have been soaring on the back of low mortgage rates and low supply. Both of those factors are reversing course, though. 30-year mortgage rates recently climbed above 5% for the first time since 2011. While that's still very low on a historical basis, the monthly cost of a $500,000 mortgage increased by about $650 per month just since last summer. That increased monthly expense will likely cause some homebuyers to think twice about getting into a bidding war on a house.

In addition, new housing units under construction just reached their highest level since 1973. As these new units come to market, the supply of houses for sale should increase, which could put additional pressure on prices. On the subject of real estate, one of the best inflation and interest rate hedges one can have is a low fixed-rate mortgage. Anyone who bought or refinanced when mortgage rates dropped to all-time lows over the past couple of years will certainly appreciate borrowing money at such a low rate for years to come.

In the next few months, we'll watch as the Fed tries to engineer a slowdown in inflation while simultaneously trying not to push the economy into recession. Threading that needle is a daunting and unenviable task that will likely have unintended consequences along the way. The message of higher rates has been sent to the markets and investors have reacted accordingly thus far. At this point, the direction of risk assets likely depends on whether the Fed ends up having to do more or less to tame inflation than what the markets expect. If inflation calms to more acceptable levels with relative ease, the markets would likely celebrate that development. And, of course, the reverse would be true if the Fed is forced to use more drastic action.

As always, we appreciate the opportunity to work with you and for you. If you have any questions, thoughts, or just want to chat, we'd enjoy hearing from you.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 3/31/22)

Index	2022 YTD (%)	3-Year Annualized (%)	5-Year Annualized (%)
S&P 500	-5.0	16.9	13.9
Dow Jones Industrial Average	-4.6	10.2	10.9
U.S. Aggregate Bond Index	-5.9	1.7	2.1
MSCI EAFE (Foreign Index)	-6.6	5.2	4.0

Disclaimer: The views expressed herein are those of ICR as of April 15, 2022 and are subject to change at any time based on market and other conditions. This is not a recommendation or solicitation for the purchase or sale of any security and should not be construed as such.