Shearwater Creek Investment Matters

1st Quarter 2022 Market Update

Inflation, War and the Federal Reserve…

1st Quarter 2022 Review:

Equity and fixed income markets sold off sharply in Q1 2022 as news of Russia's invasion of Ukraine on February 24th further inflamed interest rate and inflation concerns. High P/E growth suffered the biggest setback as the Nasdaq fell -9.1% for the period while the S&P 500 Index snapped a seven quarter streak of positive returns, declining -4.6%. Small-cap stocks were punished as well as the Russell 2000 dropped -7.5%. Chinese stocks were the worst performing sector globally, declining over -14% as a new wave of Covid infections triggered massive lockdowns throughout the country. European stocks were also hit hard in response to the Russia/Ukraine conflict, falling -7.2%.

Accelerated signs of inflation and tough talk by the Federal Reserve on tighter monetary policy led to sharply higher global interest rates and bonds experiencing their steepest declines since the late 1980's. The Bloomberg U.S. Aggregate Bond Index fell -5.9% in Q1 2022 while the Bloomberg Global Aggregate Ex-U.S. Bond Index declined -6.1%. Emerging market bonds were the worst performing fixed income sector, declining -9.2% for the period. U.S. CPI rose +7.0% in December versus the year before, +7.5% in January and 7.9% in February—the most since 1982. Fears that the Fed was "behind the curve" and would have to act aggressively to curb inflation weighed heavily on sentiment early in the quarter.

Investors also worried about the omicron variant of the coronavirus as the year began with data showing a sharp decline in spending in bars and restaurants. Retail spending rebounded in January, however, as online retailers and furniture stores saw large spending gains. An easing in omicron variant trends seemed to result in the economy regaining further momentum early in February as service and manufacturing activity rebounded from an 18-month low. Services activity drove the rebound, but manufacturing output also improved, benefiting from a slight improvement in supply bottlenecks. Durable goods orders fell 2.2% in February, however, the first decline in five months. Conversely, the labor market remained robust throughout the quarter. Continuing claims for unemployment insurance fell to a 52-year low, while job openings hit a record high. Finally, the University of Michigan's gauge of consumer sentiment hit a new decade low, with consumers continuing to cite inflation as a primary concern.

Strong sanctions on Russia raised concerns about supply chains already stressed by the coronavirus. On March 8, the White House announced that the U.S. was cutting off all oil imports from Russia, while European countries adopted less stringent measures. In response, oil prices surged to their highest level in a decade, while prices of other commodities rose as well in anticipation of falling Russian supply. Russia's threat to ban nickel exports—it provides over 9% of the world's supply—caused prices to double before trading was halted on the London Metal Exchange.

The European Union and the UK joined the U.S. in imposing sanctions on Russia, curtailing Russian access to their capital markets and financial system. The EU also closed its airspace to Russia, tightened export controls on high-end technology, and took steps to freeze some assets of President Vladimir Putin and Foreign Minister Sergei Lavrov, among others. However, the EU stopped short of banning Russian energy imports, unlike the UK, which said it would phase out its oil and gas purchases from the country by year-end. Many large European companies said they would limit, freeze, or exit business with Russia. The London Stock Exchange excluded all Russian businesses from stock market indexes.

Despite the new source of fragility in the global economy, Fed officials communicated their resolve to act quickly to head off inflationary pressures which they acknowledged were no longer "transitory." Shorter-term Treasury note yields increased sharply in March as investors now expect official short-term rates to rise by 1.75% in 2022. Fed officials increased rates by a quarter point following their March meeting, their first hike since 2018.

Similarly, elevated inflation expectations prompted the European Central Bank (ECB) to stick to its intention of withdrawing economic stimulus as well. The ECB indicated that it could end its asset purchase program in the third quarter rather than at the end of the year. However, the bank also said that because of the heightened uncertainty, it could revise the schedule to reflect how the macroeconomic situation evolves. ECB President Christine Lagarde warned that "the longer the war lasts, the higher the economic costs will be and the greater the likelihood we end up in more adverse scenarios." The Bank of England (BoE) raised its key interest rate in February and March, aiming to curb inflation that it now expects to reach 8% by the end of June, in part due to Russia's invasion of Ukraine.

2022 Outlook:

A four decade bull market for bonds, marked by low inflation and declining rates, may finally be coming to an end. For bond investors, this is a precarious time given that current yields still remain historically low and provide little income to offset capital losses as rates rise. For the Federal Reserve, the tables have also turned. In recent years, the Fed has been able to counter multiple crises without stoking inflation. Now, due largely to COVID and the war in Ukraine, inflation has spiked higher, forcing the Fed into a battle that they haven't had to fight in decades.

Ultimately, it will be interesting to see what clues are revealed by the shape of the yield curve over the next 2-3 years. Recall that short-term rates are determined by the Fed while long-term rates are determined by investor expectations based on a myriad of issues including inflation, economic activity, currency exchange rates, etc. In Q1 2022, the yield curve flattened considerably as 2yr U.S. Treasury rates increased +1.41% to 2.14% on 3/31/22 from 0.78% at the end of 2021 while the 10yr U.S. Treasury increased only +0.86% to 2.38% from 1.52% over the same period. While the market expects the Fed to remain steadfast in its tightening campaign over the course of this year, if short-term rates exceed long-term rates, the market will be sending a clear signal of stagflation concerns of high inflation and a weakening economy.

Although stagflation is not our base case, and we remain hopeful for a resolution in Ukraine, the potential for low-probability, tail risk events is heightened and warrants caution across all assets.

Here's a recap of major market indexes for Q1 2022:

Equity Indexes:

	Q1 2022
S&P 500	-4.60%
Dow Jones Industrial Average	-4.10%
Nasdaq Composite (Principal Return)	-9.10%
Russell 2000	-7.53%
MSCI China	-14.19%
MSCI Europe	-7.23%
MSCI Emerging Markets	-6.92%

Bond Indexes:

Bloomberg Barclays U.S. Aggregate	-5.93%
Bloomberg Barclays Global Aggregate Bond Ex-U.S.	-6.15%
Bloomberg Barclays Emerging Markets Bond	-9.26%

Note: Returns are for the periods ended March 31, 2022. The returns include dividends and interest income based on data supplied by third-party provider RIMES and compiled by T. Rowe Price, except for the Nasdaq Composite Index, whose return is principal only.
Sources: Standard & Poor's, LSE Group, Bloomberg Barclays, MSCI, Credit Suisse, Dow Jones, and J.P. Morgan (see Additional Disclosures).

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Sources: [1]Thomson Reuters. Past performance is no guarantee of future results. Yields may be lower or higher than quoted above. Yields fluctuate as market conditions change. An index is unmanaged and not available for direct investment. The indices are presented to provide you with an understanding of their historic long-term performance and are not presented to illustrate the performance of any security. Large Cap = S&P 500 Index (The S&P 500 index is weighted by market value, and its performance is thought to be representative of the stock market as a whole.), Mid-cap = Russell Midcap Index (The Russell Midcap Index measures performance of the 800 smallest companies (31% of total capitalization) in the Russell 1000 Index, with weighted average mark et capitalization of approximately $6.7 billion, median capitalization of $3.6 billion, and market capitalization of the largest company $13.7 billion.), Small-cap = Russell 2000 Index (The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index.), DM Ex-U.S. = MSCI EAFE Index (The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada.), Emerging Markets = MSCI EM Index (The MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) designed to measure equity market performance in global emerging markets.), Bloomberg Barclays U.S. Aggregate Bond Index (The Bloomberg Barclays US Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type.), ICE U.S. Treasury 20+ Year Bond (The ICE U.S. Treasury 20+ Year Bond Index measures the performance of Treasury securities and is selected by a Market Value process.), Markit iBoxx USD Liquid High-Yield Bond Index (Consists of liquid USD high yield bonds, selected to provide a balanced representation of the broad USD high yield corporate bond universe. The index is used as a basis for tradable products, including ETFs.)

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