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TRANSCRIPT: Q1 2022 Market Update

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Hi everyone, this is Steve Elwell, chief investment officer of Level Financial Advisors, and this is your first quarter 2022 market recap. The stock market and the bond markets both struggled here in the first quarter of 2022 with the US stock market down 5.28%, international stocks down a little less than that, emerging markets stocks down around 7%, global real estate, the best of the bunch down about 3.8%, and the bond market in the US down around 6% for the quarter, which is a pretty dramatic drop for bonds in a three-month timeframe and one of the worst we've seen in quite a while. The markets had all sorts of different things to be concerned about in the first quarter of 2022 as there was another variant and wave in COVID cases, the Omicron variant spreading across the globe and in the US here. And that was a big pause for concern or a reason for concern for investors.

And then along with that, a spike in interest rates as the market was responding to commentary from the Federal Reserve and the Board of Governors indicating that they are absolutely going to change their focus to try and tackle inflation, stubborn inflation that they originally thought was going to cool off as we came out from the last COVID wave and clearly did not cool off and has stuck around longer than they thought it would. And then beyond that, of course, geopolitically, Russia invading Ukraine and markets having to deal with the repercussions of what that might mean across the globe and across the commodity markets.

So as we look at specifically the stock market, at least the US stock market, there was a big divergence in which categories did best and which categories lost less. There was basically almost nothing that really did positive this quarter with the exception of commodities in cash. Things had declines across the board, but value stocks very clearly outperformed growth stocks in the first quarter to a big margin. So for instance, large value doing the best as you can see on this slide here losing approximately 1% for the quarter, small value losing about 2.5%, like I said, the market itself losing about 5.28%, but if you look at growth stocks, big US growth stocks and small US growth stocks, losing 9% and 12.6%.

US small growth and US large growth over the last few years have really been the categories that have led the way. Last year, 2021, was a bit of a reversal of that, but if you're looking at 2018, 2019, 2020, growth stocks were just on an absolute tear, partially fueled by low interest rates. And now that those interest rates have started to reverse course and reverse course quickly, you've seen some of the effect that it ended up having on those companies, particularly the growth companies that have not yet really turned the corner on scale and profitability. So what some people might call the expensive stocks that don't really earn any money.

Those categories, if interest rates keep rising and doing what they're doing, that type of category is probably going to struggle because the runway of how long they can continue to borrow money to try and gain scale and profitability, that runway gets shorter once the cost of capital is rising for them. And that becomes a more difficult environment.

And speaking of those interest rates, if we take a quick look over at the bond market, we can see here for the quarter, the different categories of how different types of bonds had performed. As expected, really short term bonds or like a Treasury bill, a three-month Treasury bill, those didn't lose any money because of course, if you bought one on January

1st and it matured on March 31st, you got your money back and then a tiny, tiny, tiny bit of interest, but one-year bond Treasury notes lost about 1%. Short term bonds lost about 2.5%. The US TIPS market lost about 3%.

Outside of the US, bond market was down, high yield corporate bonds down about 5%. Like I said, the bond market is a whole down 6%. And if you're in US government long bonds, the long term treasure bonds down 10.57% for the quarter. So a volatile quarter for sure on the bond market. And it's pretty rare to see both the stock market globally and the bond market across the board both have negative quarters to this large of a degree. So it feels like a really unique environment given kind of all the moving pieces of what's happening. And we're going to dive a little deeper into that here in a second.

And so as we turn our attention here to, well, what is actually happening with the economy? Well, if we look at how the recovery has happened here since 2020, the COVID first shutdown really of 2020 back in March, this chart shows real gross domestic product, which is the fancy term economists use to basically describe the amount of goods that we are creating and selling in the US economy, and you can see on the chart how, this goes back about 20 years, how dramatic the shutdown in the economy was in 2020, but also how dramatic the recovery has been since we came out of that. And that's part of the reason why the stock market had had such a powerful 2021 is because corporate profits and sales and revenue had really grown quite a bit faster and recovered quite a bit faster than what I think the market was originally thinking would happen.

So from an economic standpoint, growth has been really good on that front. And that's part of the reason why the stock market had recovered. And right now it's kind of in a period where there's a lot going on, right? There's higher interest rates coming, there was the Omicron variant that was taking hold in January, there was war in Russia. And right now what's happening is the market and investors are trying to figure out, well, just how big of an effect are all these things going to have on economic numbers and corporate profits going forward.

And so that's why you see some of that extra volatility is because of course there's all this new information and the market is going to digest that information every day as it comes out like it always does. And that's not anything new. It's just that there's a lot of that information right now. There's a lot of new things to digest.

But if we turn our attention to the labor market, the numbers are almost staggering to kind of look at what's happening out there. So on the left side of this chart here, you can see that job openings are like the highest by far, the highest they've been in the last 20 years, or just outrageous just how many job opening... And you can see it as you just drive around. You hear stories on the news, you see billboards, you see signs, you see some of the advertising that you hear on the radio and on TV, which would typically be trying to sell you products or sell you services. Some of the advertising now is trying to sell you on joining the workforce of certain companies. Think about how big of a change that has to be, how desperate you must be to find and hire people. If you're no longer advertising to sell your products or services, you're advertising to try and find additional workers that you're struggling to be able to find.

And that's because... A lot of things actually. Two big things really. Immigration has slowed down in quite a big way through COVID because of course that makes things a lot more difficult to get a green card or things like that to come work at a different country when things are shut down, but on top of that, you had a whole bunch of people leave the workforce and they just haven't come back. They have done something else. They have retired, they have taken a break,

they've had babies. There's just a ton of things that have happened that has really sort of put the labor market upside down.

If you're someone who's looking for a job, what an incredible time. If you're someone who's trying to hire, there's a lot of people kind of just scratching their heads and saying, "What am I supposed to do here?" And that's why you end up seeing so many high starting wages and jobs that traditionally did not have that high of starting wages because of just simply desperate to find people.

So interestingly enough, when you think about the job market and how good that looks, and that sort of ties all in together as we start to think about what's happening in the investment markets. If you look at that and then you look at this next chart for inflation, which is like the hottest topic out there right now. Everybody wants to talk about how high gas prices are or how high oil prices are or how high the prices are for food at the grocery store, how it's hard to even find the things that you want to go buy. The used car market is on fire, lumber prices are through the roof, housing prices are through the roof. It just feels like a bombardment of higher prices everywhere you look. And rightfully so, people are very concerned about that.

And I would add as you look at this chart, historically, the 50-year average for what would be considered headline inflation, the numbers they talk about in the news, the 50-year average would be 3.9%. But if you look at the last 20 years, inflation here in the US has been like 2%, 2.5%, 3%. So to all of a sudden go from that to going to 7.5%, 8%, feels unbelievable for those in the last 20 years that just haven't seen that, in their adult lifetimes haven't seen that.

Obviously, if you go back to the early '90s or the late '80s or any part of the '70s for sure, you remember some of those higher inflation events, you remember the oil embargo and high gas prices and long gas lines. And then the Federal Reserve started to try and tackle inflation. So that's a segue into partially what's happening with interest rates right now.

So let's point out exactly what the Federal Reserve's job is. And they have a dual mandate that they are in charge of trying to, I don't want to say control, but moderate as best they can. Two things. Number one, full employment. Help provide a stimulant if needed in the form of low interest rates or buying bonds to bring down longer term interest rates, to help the economy in which turn hopefully helps more people get jobs or less people lose their jobs. And as we take a look at that piece, again, job market looks fantastic when we were on the earlier slide. There's no question that mission accomplished on that front. Job market looks incredible.

The flip side of that of their dual mandate, the second part is to keep inflation, not zero, not negative, because deflation is bad, but to keep inflation within a certain allowable range. And that range might look like something in the form of like 2%, 2.5% per year. And inflation, which gets studied in so many different ways from an economic standpoint, but also from a psychological standpoint because inflation is kind of a psychological problem. And let me further describe what I mean by that. Think about deflation where prices are going down. If you were in the market, I'm going to make something up, in the market to buy a vacuum, and you wanted to buy a new vacuum and the price was $200 and then next week it was $195 and the week after that it was $190 and the week after that it was $185, you might scratch your head and say, "Huh, I think I'm going to wait. I'm going to wait to buy this because the price keeps going down. And so I might be able to save myself some money if I just wait a little bit."

And so that's part of the reason why deflation is something that from an economic standpoint, you really don't want is you might end up seeing. And keep in mind, the consumer, you and me and everybody else spending our dollars, the consumer represents like 70% of the US economy. So you and me buying vacuums and everything else is 70% of what makes up the economic output of what's happening here in the US. And that's not really too different from a global standpoint either.

So when you think about, okay, if prices are going down and everybody's pausing to wait to buy things, that's bad. From an economic standpoint, that's bad. We don't want people to wait. We want them to buy things now preferably, but we don't want them to wait and wait and wait. So deflation from an economic standpoint, we don't want that. But of course, high inflation also has sort of the opposite effect. So if you... The same vacuum story. If it's $200 and then all of a sudden it's $210 and then it's $220 and then it's $230 and you see it going up and up and up, you're going to buy it sooner. You're going to buy things in advance of when you need them because you want to get a lower price because you think prices are going to keep going up so much. So you might not be able to afford it if they keep to doing that. And so you went to buy things faster than what you normally would.

And that kind of becomes something of a vicious circle in that if everybody keeps doing that and keeps doing that, then obviously we're buying a lot of and pulling forward demand that normally would've been spread out more thinly or equally I should say. We're pulling forward demand for everybody trying to buy stuff all at once to avoid those higher later prices. So the Federal Reserve has the mandate to try and keep that in a 1%, 2%, 3% range because a tiny bit of inflation will to encourage you to buy the things you need in the short term, but to not really pull forward the demand for things because you're worried that prices are going to be out outrageously higher if you wait another month or another six months. And then obviously if prices are slowly creeping up, then you're definitely not going to wait for lower prices because you don't think that's going to happen.

So it's kind of the acceptable middle ground is 1%, 2%, 3% annual inflation. That's kind of is it perfect? No. Is it better than the other options? Yes. And so 8% obviously is way beyond that. And so what will the Federal Reserve, what can they do to try and tackle and moderate inflation to be in that range that they want? Well, basically, what they can do is they can raise interest rates. And they initially last year were not really talking about doing that. They were concerned about stimulating the economy, helping the economy recover and the job market recover, and then they continued to say over the entire course of last year that they expected inflation to be transitory, which I think really just meant temporarily. And that once the economy reopened and the supply chains all sort of started to correct themselves because people came back to work and there were no more delays or less delays that inflation would start to moderate and it just didn't happen.

And so at the back part of last year or the fourth quarter of 2021, they started to change their tune quite aggressively where originally they said they weren't going to raise interest rates until 2023 and they were going to do it slowly, and then they changed their tune very quickly to say, nope, the economy looks good. So we're going to turn our attention to inflation. Turns out that we were kind of wrong. Inflation does seem to be stubbornly sticking around and we're going to tackle it. And so they made it very, very clear that in the March, 2022 meeting, they were going to raise interest rates probably by a quarter percent. And that's exactly what they ended up doing.

But the statements that they started to make along the way of the first quarter made it clear that not only were they going to raise rates in March, but they were going to be pretty aggressive through the whole part of 2022. And to have interest rates potentially go up to the tune of from basically 0% to possibly as far as 1%, 1.5%, 2%, which is quite a bit of

a move when you're talking about only one year, generally, they would do... A more traditional path might be like a quarter percent each quarter. So 1% in a calendar year. So to move 1.5% or even 2% is going to be much faster and certainly much faster than what they were talking about just six months ago. And so the bond markets absolutely digested that information and responded as you might expect. The interest rates shot up. And here's a nice chart of the differences of the yield curve. So this kind of tells you what interest rates are or what yields were for each length of bond that was out there for the US government Treasury bond.

So a three-month bond, a one-year bond, a two-year bond, a three-year bond, a five, a seven, a ten, twenty, thirty. So they call that the yield curve. The gray line here is what that curve looked like in December 31st, 2021. And you can see on the short end, interest rates are pretty low, and on the long end they got up to about 2%. Now what's happened is on the short end, interest rates have spiked ineffectively, like 150 basis points of movement on the three-year bond going from paying 1% back in December to paying 2.5% now at the end of March is just a monster move in interest rates. And they're reflecting all of the statements that the Federal Reserve has been making about what they plan to do with interest rates.

Now, don't get me wrong. They're not on autopilot here. If the economy starts to really cool off or cool off too much, then they will slow down or stop their plan. If the war in Russia, excuse me, the war in Ukraine escalates, I wouldn't be surprised if they slowed down, or if the economy hums along fine, job market keeps doing well, then they might very well follow through with exactly what they're talking about. But it's very clear the investment markets have already started to implement changes to interest rates and bond values based on what the Federal Reserve is talking about doing. So if you're looking for an explanation as to why the bond market had a really bad quarter, it's because generally interest rates don't move that much that fast. And that's exactly what they just did.

Now, that's not all bad news. If you are a saver or retiree who's living off their portfolio, yes, your bonds have probably gone down slightly in value anywhere from 2% to 5.5% depending on which category you're looking at, but also remember that generally, at least for our portfolios, we're on the shorter end of the maturity length for bonds, so generally shorter term bonds, which means as those bonds mature, that cash is used by the fund managers to turnaround and buy new bonds that are now paying these higher interest rates.

So what will happen on the bond side of the portfolio as they mature and start to pay higher interest? That higher interest will start to make up for some of the decline in value that they recently had here in the first quarter, and at a certain point of time, that interest will not only make up for that decline that had happened, but also you'll just start to continue to earn that higher interest and have already gotten back to even, which means now all the higher interest you're getting going forward is just simply more money for you, higher earnings for you.

If your short term bonds were paying 1.5% and over the next year or two or three, they start paying 2%, 2.5%, 3%, once you get back to even for this short term decline, then you're ahead going forward. So if you are a saver, to have interest rates go up is actually a good thing. It's a little painful in the short run, but in the long run, it's actually a good thing for you, a good thing for the likelihood for your portfolio to last as long as you need it to, but also as interest rates go up, hopefully ends up tackling what the Federal Reserve is trying to tackle anyways, which is to help bring inflation down, which also is good for you. So there's a lot of moving parts that are happening on the bond market.

I suppose the one thing that I will end with as we talk about interest rates and what the Federal Reserves doing and what's happening with the bond market, some investors are kind of saying, well, boy, bonds just had a rough run. Stocks are having a rough quarter. The Federal Reserves doing all this to try and tackle inflation. There's midterm elections coming up, there's war in Ukraine, there's COVID still around. Where's an investor to go? Number one, from a long term investment standpoint, I realize that's a lot of different things to digest, but none of which leads us to believe that there needs to be some earth-shattering change in the portfolio. In fact, I would argue that our portfolios are really well-positioned to deal with higher interest rates when you talk about tilting towards small stocks and value stocks and shorter term bonds, all of which, as we just walked through the last 20 minutes here, have done better than the stock market itself and the bond market itself.

So that's one part. But the second part that I would add, the point that I'm going to make here is you may have, if you pay attention to the content that we put out through the blog or through YouTube or various sources here, one thing for a lot of people that probably make a lot of sense right now if you have cash on hand that you aren't thinking about investing, but you have the ability to leave alone for at least one year and don't have a need to spend or take it out of an account within the next year, that the offering that comes directly from the US Treasury, the TreasuryDirect website specifically for a I bond, which stands for inflation bond, is about as good as it gets from an investment perspective if you think about a guaranteed type of return.

So these are US government bonds that are tied to inflation. Recently, they were paying 7.12% interest for a one-year timeframe. That interest is probably going to be adjusted upward here in May. So it might be paying something more like 8.5% over a one-year timeframe. These bonds reset their interest every six months. You can only buy $10,000 a year of these bonds, and you have to buy them directly through the TreasuryDirect website. So unfortunately, we can't go buy them for people, but we have found a lot of people... We've been contacted by a lot of clients specifically asking how to go about purchasing those. So if you are someone who sits on some cash that you know you won't need for another year. And like I said, a year is important because you have to hold them for at least one year. You literally cannot get that money back within the first year. And after the first year, if you redeem the bond, then yes, you have to surrender three months worth of interest, but you'll still be way ahead compared to what's been happening in the rest of the bond market.

So if that's of interest to you, feel free to reach out to us. We will try and help you get to the right website and understand how it is you can go about purchasing those if you're interested in that. But it's been, like I said, an eventful quarter and certainly will be from an economic standpoint. They will literally write in textbooks about what's happening at this moment when it comes to what the Federal Reserve is doing, what's happening with interest rates, what they're trying to accomplish. This is a moment where they kind of write about this stuff because this is kind of a big deal.

Certainly probably the biggest thing in my 15-year career when it comes to interest rates and inflation, probably the most eventful three months of my 15-year career on that side of the investment markets. The stock market, I would throw into a different category for. But nevertheless, we'll continue to monitor everything that's going on. If you have questions about your own portfolio or about how any of this impacts you or how our portfolios are positioned to deal with it, then reach out to your advisor and shoot us an email or give us a call. And until next time. We'll talk to you in three months. Thank you.