Lowe, Brockenbrough & Company

1st Quarter 2022 Commentary

Biding Time

In Q1 equity markets shuddered, but by quarter-end the damage in the broader averages wasn't as bad as it felt. Chained to the news cycle, as we are, at times it really was nerve-wracking. The S&P 500 flirted with correction (down 10%) several times, but ended down only about 4.5%. The tech-heavy NASDAQ entered a bear market (down 20%) in early March, but recovered some by the end of the quarter. Large value was actually flattish, propped up by the surging energy sector, up nearly 40%. Obviously, growth stocks ended lower with the tech and communications sectors down approximately 9% and 11%, respectively. And small caps, the red-headed step-kids of 2021, ended down 7.5%.

Honestly, given the way 2021 ended, these returns aren't particularly provocative. Recall, tech stocks led a full-throated, reckless charge higher in the fourth quarter, curiously ignoring the Fed's mea culpa on inflation (oops, not transitory). After such a speculative spasm, some atonement was almost certain. But the market absorbed a hell of a lot more than just foolish excess. How will we tackle the highest inflation in 40 years? And what to make of Putin's bloody bid in Ukraine—the final chapter of the Russian menace or another phase in the rolling estrangement of East and West? Taken separately or together, these problems present a highly unpredictable situation, both short term and long. Outside of the energy and commodities sectors, which were already surging on tight supplies, stock indexes have been volatile, but they haven't gone anywhere since early last September. It looks to us like the equity markets are more or less taking a wait and see approach. Wall Street has some innocuous jargon for this: choppy, consolidation, sideways. But often it's really just collective uncertainty.

Bond prices, on the other hand, don't wait and see; they reflect yield changes (bond prices move inversely to yields). The broadest measure of bond returns fell nearly 6% in the quarter. And even though that's one of the worst quarters on record, the result wasn't shocking. Real yields (stated yield minus inflation) began the quarter historically negative—by definition, a very unusual circumstance--and when the Fed finally abandoned its ill-judged bond buying, there weren't any other takers, given blaring inflation readings; yields had nowhere else to go but up. That's an oversimplification, but it'll do for this note.

The spike in yields will have consequences. For instance, a 30-yr fixed mortgage is now above 5.25%, up from below 4% just a few months ago. This is another slap to the face of housing affordability. By now we've all heard stories of preposterous bidding wars. The housing shortage is real, but this is certain to take some heat off of it. Housing is 10% of the economy, enough to have a measurable effect on economic growth. How much, though, largely depends upon how the exceptionally large excess savings built up during the pandemic is ultimately spent. Our guess is the glut is sufficiently large to cushion the slowdown in housing. But that's only a guess; there's no pandemic playbook, no rule of thumb. However, there is a limit to how high yields can go given debt levels. Too high (not a lot further from here) and the economy slows, taking rates back down. A large debt load is a natural governor on growth and rates.

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Biding Time (continued)

After two plus years of quasi-existential threats, it getting tougher to make these notes entertaining. Try harder and you run the risk (first-hand experience is a great teacher) of sounding pathetic or offensive or both, so we'll do the next best thing. Make it short. Here goes. The economy is growing, and corporate fundamentals have never been stronger. That's rear-view, but companies were already battling through Covid-19 (Omicron), supply chain chaos, and spiking inflation. Valuations are reasonable and excesses have been mostly wrung out. Supply chains will recover, and inflation readings will improve as comparisons ease. A recession this year seems a rather remote possibility given pent-up demand and the aforementioned savings glut. Of course, the Fed (ever vigilant) could push us into one next year or after, but it would likely be mild, given there's been no threatening investment cycle and the banks are in good shape.

Markets will remain volatile as we work through these overhangs. We freely admit to not knowing when or even exactly how that's going to look, but we're quite confident the news will eventually improve. Markets will sniff that out long before it's obvious. As the 2022 JP Morgan Asset Management Retirement Guide points out, miss the 10 best days from 1/1/2002 to 12/31/2021 (returns based upon S&P 500 total return) and you cut your total return nearly in half. That's 10 days in 20 years, 7305 days! We'll use the volatility to improve our positioning, hopefully. But the news isn't nearly bad enough to ignore those odds.