STRONGBOX
WEALTH

MARKET UPDATE: INFLATION, INTEREST RATES, AND INVASION

APRIL 27, 2022

With the unfolding Russia/Ukraine war, commencement of the U.S. Federal Reserve's long expected monetary policy change to hike overnight interest rates, widespread concerns over shortage-induced price increases for energy and food, and further COVID-related lockdowns in China, these conditions have produced a high degree of uncertainty to start 2022 and have caused material adverse financial market conditions along with elevated price volatility. As many have heard us comment throughout the years, the markets typically deal well with bad knowns, but otherwise do a remarkably poor job of dealing with unknowns.

In this commentary, we want to give you StrongBox Wealth's straightforward perspective on inflation, interest rates, the Russian invasion, and the associated impacts on your money.

It is important to read our point of view with an understanding that capital markets price underlying assets based on anticipated future changes rather than those of the past. As ice hockey star Wayne Gretzky famously said, "I skate to where the puck is going, not where it has been." Likewise, a portfolio of stocks and bonds is a present value reflection of future expectations. Because there is a general lack of clarity on multiple fronts such as when rapid inflation abates, how high interest rates will go, and how protracted the Russia/Ukraine war and its associated global impacts will last, asset price volatility has become amplified in the absence of confidence to reasonably predict these eventual outcomes. Just this week, market participants are additionally becoming worried that the Federal Reserve's now commenced tightening cycle (interest rate hikes) could tip the economy into a recession late next year.

For our readers desiring a high level general summary rather than detailed perspective, please read the "Quick take" sidebar in each topic section.

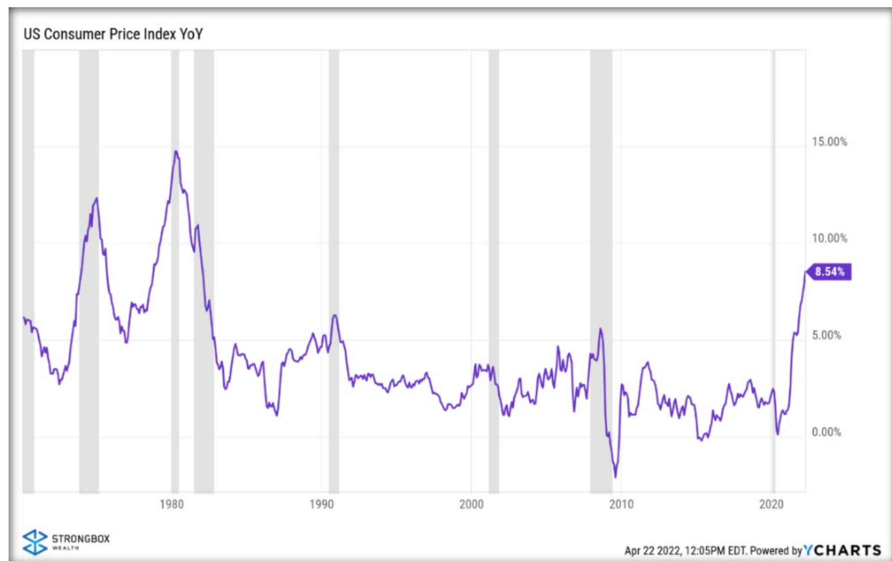
Inflation

Inflation

Quick take: Central bank policy makers need to walk a fine line to address rising prices. They must stamp out the trajectory of hot inflation caused by a convergence of multiple reasons while ensuring the current strength in the economy is not completely driven out.

The "inflation" narrative is everywhere we turn in the media these days. Simply put, inflation is the rate of increase in prices over a period of time. Importantly, those increased prices equate to a decline in the purchasing power of your dollar over that same period of time. *Modest* inflation is critical to a healthy capitalistic economy, as it provides the incentive to invest and take risk while increasing short-term demand for products and services. For now, a near perfect storm of multiple circumstances have converged to create a year over year increase of 6.5% in U.S. core consumer prices (as of March 2022 month end), the biggest annual increase since August 1982. When factoring in food and energy costs, the annual U.S. inflation rate is 8.5% - the highest since December 1981.

Fed Chairman Jerome Powell said last week that the central bank is committed to bring down inflation by raising rates "expeditiously." He also offered that "It's absolutely essential to restore price stability."



The reasons for this inflation spike include:

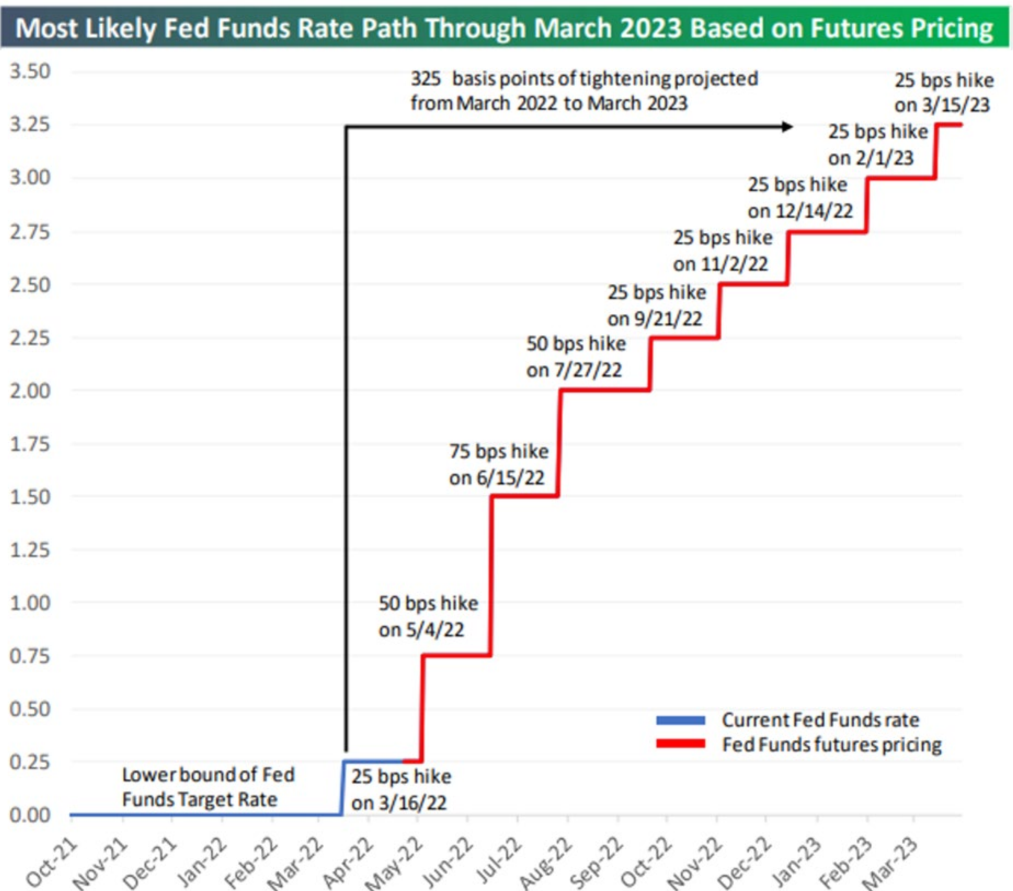
- COVID related U.S. government stimulus
  - COVID relief package costs totaled $5.2 trillion. By comparison, in today's dollars World War II cost $4.7 trillion.
- The Federal Reserve's balance sheet ballooned by $4.5 trillion in carrying out a quantitative easing policy designed to increase the money supply through asset purchases that provided liquidity to financial institutions. This policy was chosen to increase the money supply and stimulate economic growth by encouraging lending and investment through lower rates.
- Supply chain issues
  - Logistics involved with global trade remain challenged
  - Several parts of China are back on COVID lockdown, thus reducing goods supply
  - Domestic warehouse space, truckers, seaport slots remain in short supply
- Demand surge for consumer goods
  - Cars, homes, electronics, furniture, beauty and personal care, and apparel
  - Food and grocery
- Higher production costs
  - Fewer workers in the labor market
  - Raw material inputs and commodity price increases
- Russia's invasion of Ukraine
  - Energy prices up
    - Russia supplies 11% of global oil exports
    - Russia's invasion of Ukraine accelerated an already upward trajectory of oil and gas prices
  - Wheat
    - Ukraine supplies constrained - 11.5% world market share
    - Russia export ban – 16.8% world market share
    - U.S. winter wheat crop is in worst shape on record
  - Fertilizer
    - Russia suspends exports as the largest global supplier until payments are guaranteed
    - Fertilizer costs up over 125% in the last twelve months
    - Sanctions, ex U.S.

Interest rates

Quick take: Interest rates equal the cost of money and the cost is going up. When interest rates go up, bond prices reflexively go down. Although the Federal Reserve has increased the Fed Funds rate just once in this tightening cycle, bond prices have already declined in anticipation of several coming rate hikes. "Interest rates are like gravity on valuations. If interest rates are nothing, values can be almost infinite. If interest rates are extremely high, that's a huge gravitational pull on values." - Warren Buffett

Interest rates

We are less concerned about interest rates directionally on the rise or the pace of these Federal Funds hikes, but rather the terminal (end target) point that will define when this tightening cycle finishes. If we do see a Fed Funds Rate in excess of 3.25-3.50% by next March, it will be tied for the steepest one-year of tightening since 1989. If that target moves much beyond current expectations of 3.25%, our judgment is that amplified volatility will continue in the form of bond prices fading and stock prices facing additional headwinds. Still, our central bank wants to avoid triggering a recession by engineering a soft landing for the U.S. economy, aiming to tighten monetary policy to combat the hottest inflation since the early 1980s. Note that although the Federal Reserve is appropriately sounding the alarm to rapidly fight inflation and has taken a distinct hawkish tone, monetary policy continues to be quite accommodative.



Source: Bespoke Investment Group

Fixed income investors need to be vigilant as to the potentially harmful effects of rising interest rates on bond prices because if interest rates increase, investors will no longer prefer the lower fixed interest paid by a bond, thus resulting in a price decline.

It is also important to keep in mind that the Federal Reserve has already announced plans, possibly commencing as early as their May 3-4 meeting, to begin reducing its massive $8 trillion portfolio holdings of U.S. Treasury and mortgage-backed bonds. This process is known as Quantitative Tightening and takes place by allowing securities to mature, by not reinvesting interest inflows, or even by active sales from its portfolio. All these effects create further upward pressure on borrowing costs and mortgage interest rates.

Over the last couple weeks, the notion of an approaching U.S. recession has developed, buoyed by the relationship between short- and long-term interest rates of debt issued by the U.S. Treasury. Under normal conditions, debt with longer maturities typically carries higher interest rates than nearer-term issues. An "inverted yield curve" is considered unusual when short-term U.S. Treasury securities have higher yields than long-term U.S. Treasury securities. This phenomenon has been a reasonably reliable predictor of pending economic recession by signaling every recession since 1955, with only one false signal in 1998. Although it is possible to experience a yield curve inversion without an ensuing recession, no recession since 1955 has occurred without an inverted yield curve.

Fed hiking cycles and recessions

Start of hiking cycle	Start of recession	Gap from start of hiking (# months)
Aug-58	Apr-60	20
Nov-67	Dec-69	25
Mar-72	Nov-73	20
Dec-76	Jan-80	37
Aug-80	July-81	11
Mar-83	July-90	87
Jan-87	July-90	42
Feb-94	Mar-01	85
Jun-99	Mar-01	20
Jun-04	Dec-07	41
Dec-16	Feb-20	38

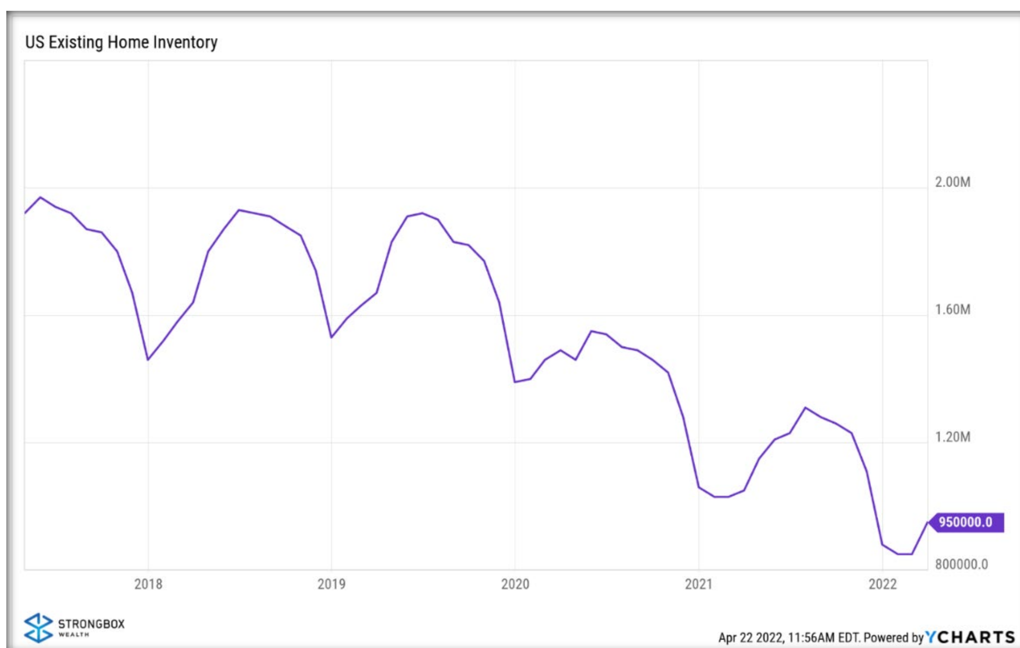
Source: Deutsche Bank Research

Mortgage rates and housing

Quick take: We do not foresee a collapse in home sales even with higher mortgage rates. Keep in mind that Millennials are now the largest living generation in the US and have begun to enter the housing market in force, making up over 50% of new mortgage issuance for the first time in 2019. This represents a demographic tailwind for home sales into the foreseeable future.

Mortgage rates and housing

Existing home sales fell 2.7% in March for the second month in a row, marking the slowest pace since 2020. Sales are down 4.5% versus a year ago. Average prices are up 9.6% versus last year. However, recent volatility shows that the housing market is struggling to find its footing so far in 2022, with falling affordability likely playing a role. The prime culprit recently appears to be the 30-year mortgage rate, having already risen roughly 2% since December to be well over 5%. On top of that, potential buyers are also dealing with a mismatch between supply and demand that has pushed median prices up 15.0% from a year ago. Although the March supply of existing homes for sale rose slightly, inventories are still down 9.5% from a year ago. Despite the lack of options, demand remains strong with buyer urgency so high that 87% of existing homes sold were on the market for less than a month.



Implications of the Russian Invasion of Ukraine

Reflecting increased equity, bond, foreign exchange volatility and heightened anxiety since the February 24 Russian invasion of Ukraine, financial markets, global economic data, and worldwide public opinion have been highly sensitive to news accounts of the conflict. It is fair to say that the first months of the incursion have not unfolded as Russia had anticipated. Despite intensive bombardment, Ukraine has inflicted significant military casualties on the the country and have caused several million Ukrainian refugees to flee into neighboring countries.

More intensive cyberwarfare attacks on local and intercontinental resources have remained a constant threat. Senior NATO officials have warned Russia against the use of chemical, biological, radiologic, or nuclear weapons. A significant unknown remains as to what specific threshold would prompt further escalation and more direct confrontation with the NATO alliance.

Implications of the Russian Invasion of Ukraine

Quick take: Capital markets do not deal well with unknowns, especially unprecedented ones that significantly impact the delicate balance of global supply and demand. Commodity, energy, and global stock volatility will likely continue in a headline driven manner until perceived or actual conflict resolution. The supply-chain disruptions resulting from the war and the sanctions placed on Russia are far-reaching and have had rapid inflationary consequences in a world already struggling to contain price pressures. The longer the conflict persists, the greater the range of potential outcomes.

Among a range of outcomes, in its initial phases the conflict has led to:

- much-stricter-than expected financial sanctions imposed by a newly cohesive European Union, the United Kingdom, and the United States on the Russian government, central bank, companies, and specific individuals
- export and import limits or outright bans on trade, capital flows, and commercial activity
- severe disruptions to many global supply and demand channels for energy, industrial and precious metals, agricultural commodities, livestock, conventional and hybrid seeds, fertilizer, and numerous components of and final outputs of manufactured goods
- disruption to the deeply intertwined and critically important global ecosystem of semiconductor chip design, software tools, production equipment, and fabrication facilities

Faced with such a challenging set of background conditions, we believe it is prudent for investors to carefully consider the historically inflationary conditions that follow wartime activity. In addition to the inestimable human suffering, the tragic loss of life, and the enormous physical and psychological damage wreaked upon global confidence and economic activity, financial market participants may anticipate a heightened degree of concern about inflation and the resultant hawkish rhetoric and actions by central bankers in the Western world, ex Europe. At the same time, Western European authorities are likely to be seeking to provide stimulus to counterbalance the negative economic fallout in Europe because its proximity contributes to an overreliance on Russian energy sources.

Markets

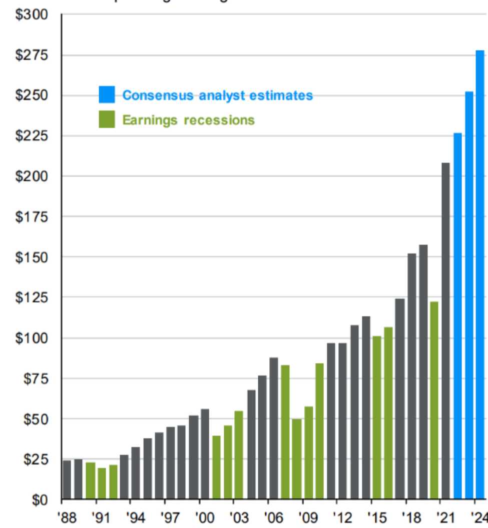
Following the S&P 500's well above-average total return performance of +31.5% in 2019, +18.4% in 2020, and +28.7% in 2021, and in the current environment of monetary policy transition, slowing yet still above-average economic expansion, upwardly-trending inflation, we believe that careful thought, planning, and attention needs to be devoted to the investor's most appropriate means for implementing the fundamental elements of portfolio asset allocation and prudent investment strategy.

Tightening conditions can negatively impact stock prices, as higher rates may cause a slowdown or even a contraction in economic growth, thus lowering corporate profits and the earnings multiple applied to such earnings that serve as a strong stock price determinant.

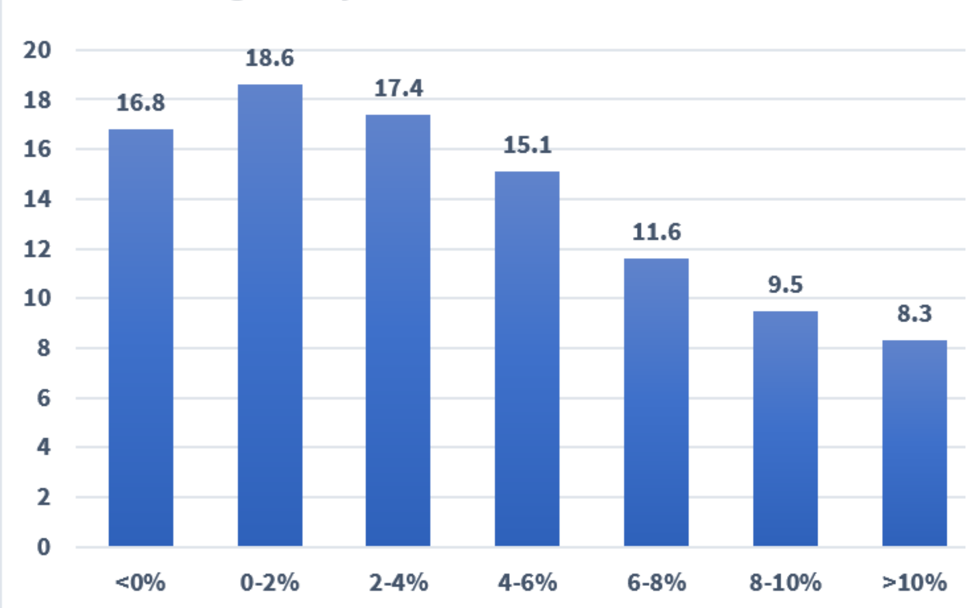
It is worth keeping in mind that an average year includes three separate -5% or more S&P 500 pullbacks, with only one such decline taking place in 2021. Except for the late February through late March 2020 COVID related market drawdown and subsequent rapid recovery, we haven't seen a 10% stock market correction since late 2018. Yet, these corrections historically happen on average every 18 months. Much has been made about stock market valuation. Two charts below illustrate that S&P 500 earnings are quite strong and forecasted estimates signal continued robust growth, while the price attributed to those earnings at various levels of inflation is an important consideration. Higher inflation typically means a lower price to earnings ratio (P/E) for the stock market. As of this writing, with an index level at approximately 4,200 and current earnings of $243.15, the S&P 500 trades at 17.27 times earnings.

Markets

Quick take: Markets have outperformed historical averages for several years with remarkable consistency and low volatility given the benefit of low interest rates, modest inflation, strong corporate earnings, high liquidity, powerful health and technology innovation cycles, and relative geopolitical stability. However, as asset prices fluctuating more with the rising cost of money (interest rates), investor risk tolerance and underlying portfolio risk exposure are imperative to be aligned. Stock and bond repricing typically present long-term opportunity. Though not desirable, it is normal to experience elevated market volatility and price fluctuation, especially when inflation and interest rates are on the move.



Consequently, our view on the S&P 500 index price level is that it is more than fairly priced for an inflationary environment at the Federal Reserve's long term inflation target of 2%, fairly priced for a stable 3-4% inflation level environment, and likely overpriced if long term inflation trend levels settle in to exceed 4%. Thus, a significant determinant in future stock market price levels will likely hinge on the already elevated inflation rate and how it reacts to the Federal Reserve's imminent policy plans designed specifically to reduce the rate of inflation.



Source: John Lynch, Comerica Wealth Management

Having the bond market sell off alongside most stocks at the same time reveals itself much more in a diversified portfolio than weakness in just one asset class or the other. StrongBox Wealth's view includes a silver lining in that the bond market has already corrected by expecting and pricing in several Fed Funds rate increases with a terminal point of approximately 3%. In other words, the bond market has already done the Federal Reserve's "dirty work" by selling off rapidly as inflation fears quickly accelerated this year, although the Fed itself is just now commencing on its tightening cycle to increase overnight rates.

Keeping Things in Perspective

Bull markets are more fun than bear markets. Though we are technically not in a bear market, it sure feels like one. Every historical bear market has been followed by stock markets moving up at some point and beyond to new highs. It is important to review your plan, confirm risk tolerance, assess associated time horizons to any capital needs, and ensure adequate liquidity to provide now for potential future unplanned cash requirements. Most important and as difficult as it may be when portfolios draw down, remember that markets ebb and flow over time in normal fashion. A fragile sentiment has presented itself of late and in place of a typically euphoric state of the stock and bond markets over the last several years. There are always reasons to be concerned about investing and it is tempting to conclude that "it is different this time." While true that there is a convergence of several economic and geopolitical unknowns, these are today's circumstances only and should not derail a serious investor's long-term perspective grounded in the fundamental need to preserve purchasing power and increase income over time to combat the effects inflation and taxation. We must remain flexible around our convictions in formulating investment strategy, including an ever appropriate theme of focus on strength and balance sheet quality of stocks owned. StrongBox Wealth feels a representative core portfolio should favor balancing growth and value stock exposure, remain tactical in stock sector positioning, own names providing historical dividend growth, counterbalanced with high quality low duration fixed income, and with an eye toward including alternative investments and real assets to keep pace with inflation.

As always, should you have questions about the markets, thoughts regarding your portfolio, or need to update your financial plan, please give us a call.

Thank you!

StrongBox Wealth

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CONTACT INFO
Address:
3470 NE Ralph Powell Rd. , Suite A
Lee's Summit, MO 64064
Phone: 816-607-5410
Fax: 816-607-5415
Email:
Contact@strongboxwealth.com