Economic & Market Commentary

Winter 2022

Sic Transit ‘Transitory’

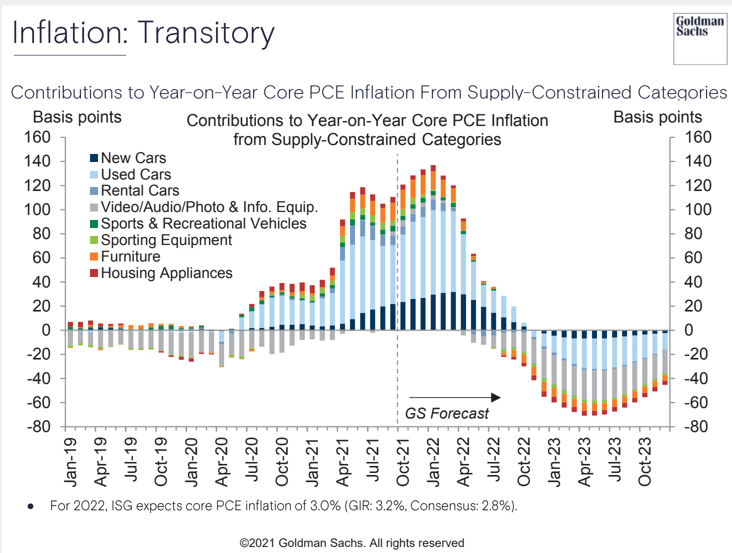
The Federal Reserve implemented its ‘average inflation targeting’ a year ago, justifying its decision to let inflation ‘run hot’ for a period of time before changing its accommodative policies. The rationale was that, in unprecedented times, discretion was the better part of valor. Support for this position was its view that higher inflation is transitory, caused by temporary factors that were expected to fade as supply constraints eased in key areas. See the bottom left chart from Goldman Sachs Global Investment Research for a clear representation of this outlook.

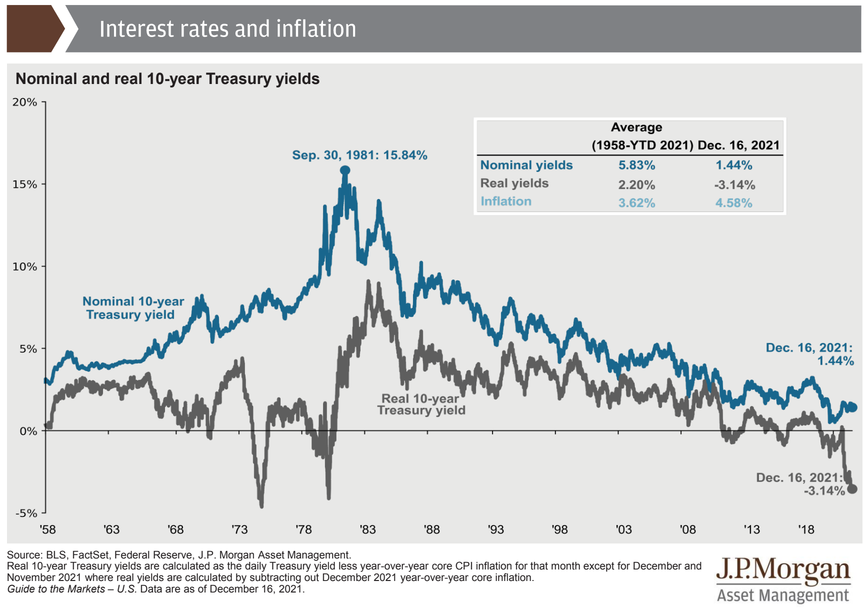
This micro view of the sources of inflation pressure was overwhelmed by the bigger macro factors. Record levels of savings, seemingly endless fiscal stimulus, and pent-up demand for goods, services, and housing pushed prices higher and faster than the Fed expected. Wage pressures are now rising across the board, particularly in service sectors. Yields on ten year Treasury debt – adjusted for inflation – are at their lowest level in forty years. Negative real interest rates are stimulative – in and of themselves they encourage economic activity, and do nothing to dampen inflationary pressures.

Sic Transit Gloria Mundi

Sic transit gloria mundi is a Latin phrase that translates to ‘thus passes the glory of the world’. Its usage is traced to Roman times, when victorious generals returned from battle to great public adulation. Courtiers whispered the phrase to their leader; a reminder that all fame is fleeting. The passage of time changes everything.

In his November testimony to Congress, Fed Chairman Jerome Powell acknowledged the Fed is behind the curve. His comment, ‘Perhaps it’s time to retire the term transitory…’ shook markets, and various Fed officials followed by indicating their support for an accelerated withdrawal of longer term bond purchases. This reversal was affirmed in the December meeting of the Fed’s Open Market Committee. In addition to doubling the size of the planned monthly reduction in bond purchases, the median expectation of Committee members is for three hikes in short term interest rates in 2022. Interest rates will start rising sooner – and ultimately go higher – than expected just a few short months ago.





Where Does This Leave Us Now?

Rising interest rates are compatible with a rising stock market – to a point. The graphic on the right, courtesy of J.P. Morgan, illustrates this view. The correlation between stock and yield movements is plotted over two periods, before and after the 2008-2009 global financial crisis.

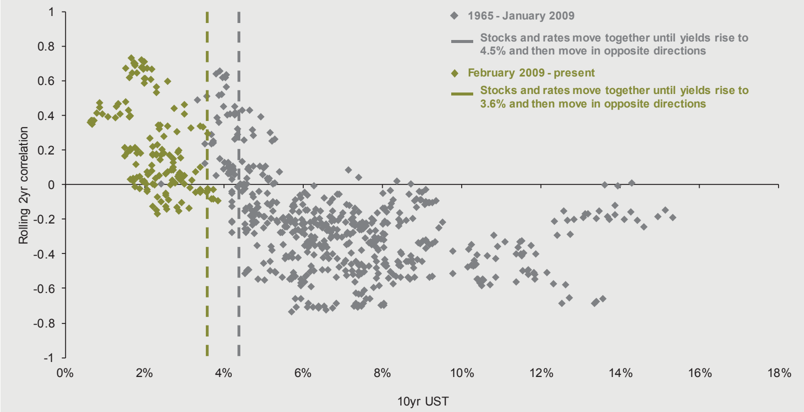
What does this show us? First, there is a tipping point. Stocks can advance alongside rising interest rates – but only so far. In the last decade or so, that breakpoint is a 3.6% yield on a risk-free ten year U.S. Treasury Note. Once interest rates advance much beyond the rate of inflation, they become effectively restrictive. The logical follow-through is that economic activity slows and stock prices decline.

'History doesn't repeat itself, but it does rhyme' is attributed to Mark Twain. It is a bit of wisdom particularly applicable to financial markets. The 3.6% number is not a line in the sand beyond which stock prices cannot advance. With inflation running well above recent trends, that threshold is likely higher. The probability that the Fed acts aggressively to raise rates beyond current inflation is low, and the chances of Congress and the Administration reining in expansionary fiscal policies is lower. The bottom line is that fiscal and monetary policies will, in the absence of a reprise of the early 1980's Volcker-era all-out attack on inflation, remain generally supportive of economic growth and financial markets.

Interest rates and equities

Stock returns and interest rate movements before and after the Global Financial Crisis

Monthly S&P 500 returns, 10yr UST, rolling 2yr correlation, 1965 - present



Source: FactSet, J.P. Morgan Asset Management. X-intercept for each data set is calculated using a quadratic regression where interest rates are the independent variable and the rolling 2-year correlation of stock returns and interest rate movements is the dependent variable.
Guide to the Markets – U.S. Data are as of December 16, 2021.

J.P.Morgan
Asset Management

That Said…

Investors have sailed with the wind at their backs for several decades (with occasional squalls). Low and stable inflation and falling interest rates provided a favorable environment for nearly all asset classes, here and abroad. These times are behind us.

In addition, we have written extensively on the impact of current valuations on future returns. Simply put, the higher the starting measure, the lower the probability of superior returns going forward. We are at multi-decade valuation peaks for many market sectors – particularly large-cap growth themes. Double-digit returns will be the exception, not the rule, going forward. At the same time, as noted previously, monetary policy will remain stimulative, but substantially less so. Fiscal policy will be additive to economic activity (and inflation). Markets should continue to advance, but at a lesser pace and with more volatility than we have seen for some time.

Let's put numbers to this. The table to the right, courtesy of Montreal-based BCA Research, shows its projected returns for major asset classes over the next decade. Balanced portfolios are expected to produce about half the return recorded in the last thirty-one years – and even less on an inflation-adjusted basis. This outlook is consistent with others we review.

Long-Term Return Scenarios In A World With 3% Inflation

	COMPOUND % RETURNS P.A.		
	THE PAST 1990-2021	THE FUTURE 2022-2032	PORTFOLIO WEIGHT
US EQUITIES	11.1	3.7	30
OTHER DEVELOPED EQUITIES	5.5	4.9	15
EM EQUITIES	8.2	6.1	5
10-YEAR TREASURIES	5.9	1.2	20
CORPORATE BONDS*	7.0	2.9	10
ALTERNATIVES**	10.5	6.6	20
TOTAL PORTFOLIO* **	**8.5**	**4.0**	
US INFLATION	2.1	3.0	
TOTAL PORTFOLIO REAL RETURN	**6.5**	**1.0**	

* BASED ON MARKET CAP WEIGHTED AVERAGE OF INVESTMENT GRADE & HIGH YIELD RETURNS.
** BASED EQUALLY-WEIGHTED AVERAGE OF PE, VC, HEDGE FUNDS, DIRECT REAL ESTATE, US REITS, COMMODITIES, FARMLAND AND TIMBERLAND. PAST COMPOUND % RETURNS STARTING 1992.
*** BASED ON WEIGHTS IN FINAL COLUMN.

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How We Will Respond

Our clients entrust us to invest their wealth prudently, with emphasis on achieving long term goals with controlled risk. Diversification is the foundation of our process, hand-in-hand with attention to valuation. As shown above, the best allocations over the last generation will likely not repeat. Portfolios under our management will be structured to take advantage of this changing landscape. Your success – and safety – matter to us.

Economic & Market Commentary is written by the Investment Services Department at Security National Wealth Management.