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1Q22 Review - Volatile Start to the Year

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Investors faced wide swings in stocks, bonds, and commodity markets around the world during the first quarter of 2022. At its worst levels, the broad U.S. stock market, represented by the Morningstar U.S. Market Index, was down 13.6% from its January 3rd peak but rallied to finish down only 5.33% by the end of the quarter. The S&P 500, which dropped 4.95% during the quarter, suffered its first quarterly decline since the start of the pandemic in 2020.

From an investment-style perspective (Exhibit 1), value stocks significantly outperformed growth. Most of the outperformance within the value benchmarks was attributed to the relative underweight of the technology sector (one of the worst performing sectors) and the overweight of the energy sector (the best performing sector for the quarter) when compared to the growth benchmarks.

Exhibit 1. Investment-Style Returns

	Morningstar Index Market Returns	2015	2016	2017	2018	2019	2020	2021					2022
								1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	2021	1st Qtr.
Growth	U.S. Growth	5.54%	3.16%	29.52%	0.78%	35.90%	44.65%	0.61%	13.90%	1.50%	7.29%	24.79%	-11.97%
	Large Growth	7.71%	1.79%	31.15%	2.94%	33.81%	38.86%	-0.73%	15.42%	2.35%	3.59%	21.47%	-13.55%
	Mid Growth	-0.71%	6.46%	25.67%	-3.16%	36.01%	46.17%	-1.62%	11.33%	0.20%	4.76%	14.97%	-16.01%
	Small Growth	-0.18%	9.61%	23.77%	-5.67%	27.60%	43.52%	-0.42%	4.79%	-0.35%	-0.65%	-1.00%	-13.37%
Value	U.S. Value	-2.16%	20.79%	14.23%	-7.51%	25.09%	-1.31%	12.49%	4.03%	-1.36%	7.40%	23.98%	2.35%
	Large Value	-1.43%	18.91%	15.09%	-5.90%	25.70%	-0.62%	10.13%	3.82%	-1.26%	7.62%	21.49%	1.63%
	Mid Value	-2.57%	25.21%	13.02%	-10.63%	24.81%	-3.76%	17.21%	4.19%	-1.49%	7.25%	29.02%	4.85%
	Small Value	-8.65%	27.96%	8.40%	-16.61%	19.96%	1.01%	21.41%	5.41%	-2.06%	5.13%	31.79%	1.80%

Source: Morningstar

But stocks weren't the only area that had negative results for the first quarter; bonds experienced their worst quarter in 20 years, with long-term core bonds down 11.3% for the quarter. Historically, bonds have often moved in the opposite direction to stocks, but the higher than anticipated inflation experienced by the economy this year had the Federal Reserve embarking on a path of more aggressive rate increases than were expected at the start of the year. U.S. Treasuries were down 5.5% for the first quarter, a larger decline than broad stock benchmarks.

The increased volatility in the stock market was amplified in January as the December Federal Reserve meeting minutes were released. These disclosed that participants generally noted that, given their outlooks for the economy, labor market, and inflation, it may be warranted to raise the funds rate (short-term interest rates) sooner, or at a faster pace, than had been anticipated earlier. As we stated in our 2022 outlook published earlier this year, any time there is a transition in monetary policy by the Federal Reserve, there can be increased volatility. Technology stocks in January sold off significantly but remarkably recovered some of the underperformance by the end of the quarter. Within bonds, the 10-year treasury yields jumped to 1.78% by the end of January and eventually finished the quarter near 2.5%. As interest rates rise, bond prices fall, accounting for the dramatic underperformance of bonds in the quarter.

In our 2022 outlook, we focused on three factors that will have a material impact on the market over the next year and beyond: Covid, central bank actions, and inflation. Covid's effect on the economy influences the Fed's actions (central banks) and also inflation by adversely impacting the global supply chain. The Covid-19 Omicron variant had a significant impact on corporate earnings in the fourth quarter, disrupting both labor and the global supply chain. With the closing of various cities throughout China as a result of its zero-COVID policy, the supply chain disruption will continue. As Covid infections have diminished in the United States, there is a high likelihood that we have transitioned into the endemic phase and will likely continue to experience unplanned economic disruptions in the future.

It would also seem as if inflation has become an endemic. In 2011, Japan was hit with an earthquake and tsunami that was the costliest natural disaster in history at that point in time. Though the event was short-lived, the economic ramifications were felt for nearly a year afterwards, as the supply chain for electronics and automotive industries were negatively impacted. While we may never know whether Covid was lab-based or naturally occurring, the impact it has had on the global economy clearly makes it the costliest disaster ever. As Covid outbreaks have been occurring for over two years now, the disruptions related to this will take much longer to resolve. Additionally, with the war in Ukraine, it looks doubtful that the "shortage of everything" will get resolved by the end of the year.

The "shortage of everything" impact on inflation can best be illustrated in the new automotive and home markets. Over 80% of all new cars sold in the United States are being sold at thousands, and sometimes tens of thousands, of dollars over manufacturer's suggested retail price (MSRP). Before Covid, this was a rarity. Dealerships have few cars to sell and lots of space for buyers to park. Additionally, homes are being listed and then sold for tens of thousands over their asking price. Inventory levels of both new automobiles and homes are well below "normal levels" to support a balanced market. This same phenomenon is exhibiting itself in multiple end markets.

The sanctions against Russia for initiating its war with Ukraine have taken more resources off of the global market, such as oil, natural gas, and wheat. Commodity prices surged in the quarter, with oil finishing up 33% despite a decline of 20% from its mid-quarter high.

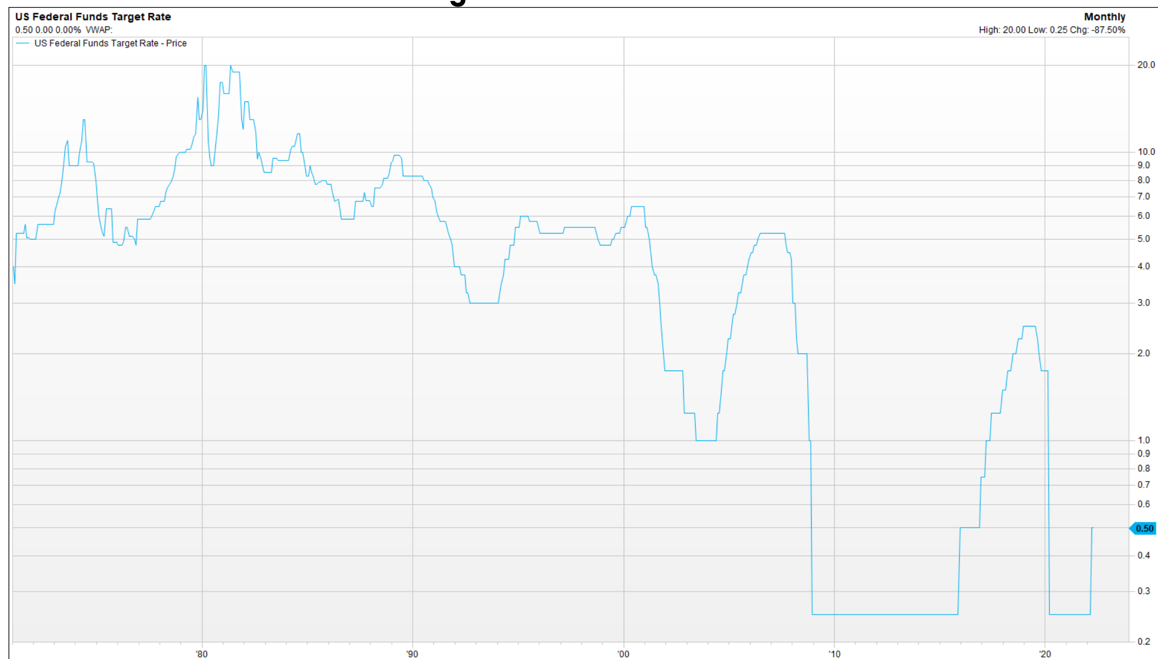
Exhibit 2. Crude Oil Price and United States Recession Periods

Source: FactSet

With the exception of the brief recession resulting from the initial Covid worldwide economic shutdown, accelerating crude prices are typically a leading indicator of a recessionary period (Exhibit 2). Just as solutions to fix the global supply chain disruption are complicated because of the many facets influencing it, fixing the supply imbalance of crude oil is just as complicated. Simply stated, crude oil comes in two varieties, sour and sweet, and much of the refining capacity in the United States requires a mix of both in order to refine a barrel of crude into products such as diesel and gasoline. Several years ago, before Venezuela ran afoul with the United States, the Gulf Coast refiners imported much of its sour crude requirements from Venezuela. But in 2019, the U.S. imposed a ban on the importation of Venezuelan oil and refiners had to seek sour crude elsewhere, and that is the reason that U.S. refineries imported Russian crude oil. President Joe Biden recently announced the decision to release a million barrels of oil a day from the Strategic Petroleum Reserve (SPR) for 180 days to help lower crude prices. Besides the obvious ploy to help with the mid-term elections, the actual price reduction at the pump will depend the mix of sour and sweet crude and what refineries are able to utilize the release.

Assuming that oil demand does not abate and the supply doesn't normalize, the Federal Reserve is faced with a complex scenario regarding its interest rate policy. Exhibit 3 graphs the historical Federal Reserve target rate policy range since 1970. For the past twenty years, the Federal Reserve has undergone two time periods of increasing short-term rates, in the mid-2000s and late 2010s. The current policy change that started to see short-term rates increase earlier this year will be challenged on two fronts: how does the Fed raise rates fast enough to combat inflation while also not dampening the economy and at the same time, trying to allow the Federal Reserve balance sheet to be reduced. All of this is necessary to provide "dry powder" to help stimulate the economy in the future if it turns back into a recession.

Exhibit 3. U.S. Federal Funds Target Rate



Source: FactSet

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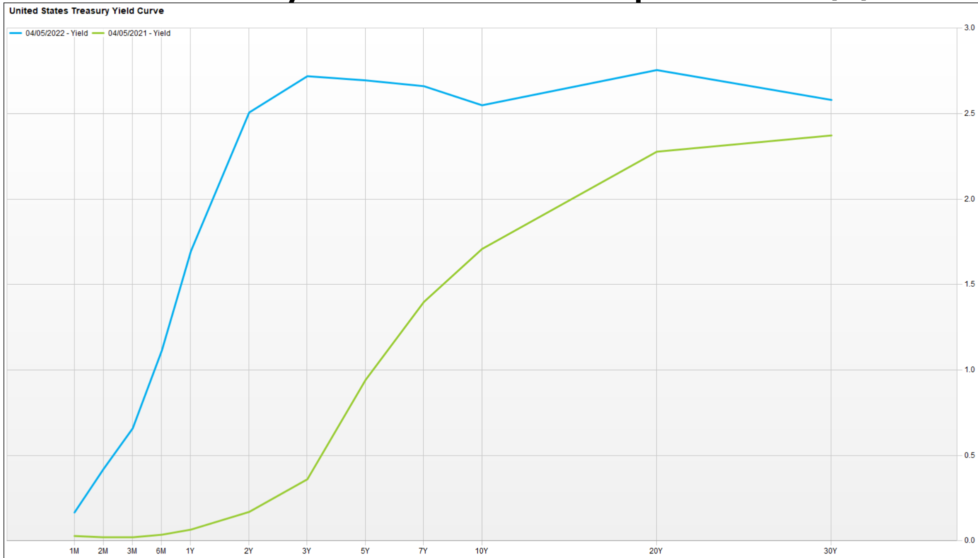
The move in the yield curve anticipates the changes of the economy, and for a majority of the time, whenever the yield curve (Exhibit 4) becomes inverted (near term interest rates higher than longer term interest rates), there is an increased possibility of a recession. While we aren't necessarily in the camp of predicting a recession this year, if the supply chain doesn't start to "normalize" soon, then it is a distinct possibility.

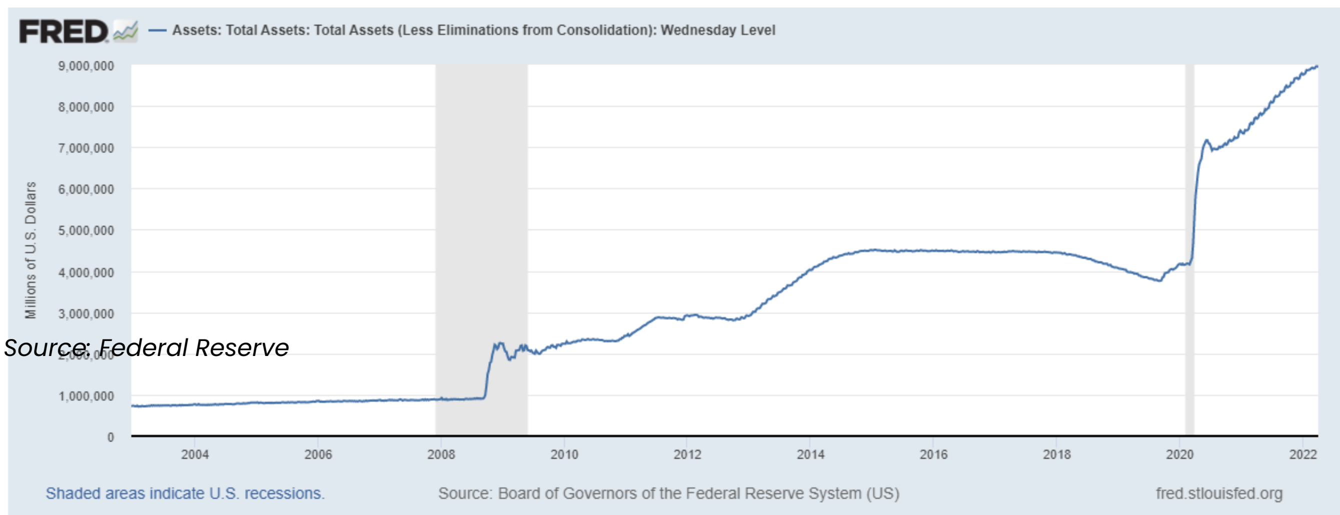
Exhibit 4. Year-over-year U.S. Yield Curve Comparison as of 4/5/22



Source: FactSet

The second factor that the Fed is wrestling with is the speed at which it will reduce its balance sheet (Exhibit 5). Since the Great Recession (2008), the Federal Reserve has utilized its balance sheet to buy bonds to help keep interest rates low. There was a brief period in 2018 through 2019 when the Fed started to reduce its balance sheet by not reinvesting its portfolio's maturities, which in essence takes money out of the economy. The trajectory of this process, also known as quantitative tightening, also influences interest rates.

Exhibit 5. Federal Reserve Balance Sheet



Source: Federal Reserve

During the 1970s, when the economy was going through a time of high inflation (OPEC oil embargo) and interest rates were much higher than current levels, equities still had decent returns, particularly over the decade. Bonds did less well during that time period. Nonetheless, bonds will work when interest rates move down if the Federal Reserve changes its monetary policy to address recessionary pressures.

The gradual interest rate declines from the early 80s to the near zero interest rates last year have given the false impression to investors that fixed income is conservative, which as seen by the markets so far this year, is far from the reality of the new environment. When interest rates are high, and rates are coming downward, bond prices go up, helping the total return for the bond holder. When interest rates go up, bond prices go down and negatively impact the total return to bond holders. If a recession does materialize, bond prices will benefit from the reduction in the interest rates to stimulate the economy, so not all is lost for the bond investor. Nonetheless, the reality is that there are limited areas of investment options that won't have volatility going forward.

In our 2022 outlook, we had concluded that there was a possibility that the market could drop 15% sometime during the year, but we believed that the market would have positive returns by the end of the year. We still believe that scenario is possible, but it won't be easy. We continue to be focused on large cap companies that have conservative balance sheets and are able to utilize their free cash flow for internal growth investments or returning capital back to shareholders. Those companies should be well-positioned to continue growth after the world has normalized through the growing pains that it is currently experiencing. While it is hard not to be consumed by the short-term volatility, the long-term growth prospects remain positive for most of the secular growth leaders.

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