STEWART CAPITAL

Market Commentary – First Quarter 2022

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It's happening already. As sure as night follows day. When a yield curve flattens, as has happened since the Federal Reserve Open Market Committee (FOMC) began increasing its Fed Funds rate in March, all order of pundits and television talking heads began warning that the impending yield curve inversion (longer-term interest rates lower than shorter-term interest rates) indicates that a recession is coming. Indeed, some are already pointing to minor inversions occurring at various points of the yield curve and touting the certainty of a recession.

Are they right? Are the talking heads right?

Is the yield curve inverted and will we get a recession because of the inversion?

Simplistically, the answers are kind of and no…

As indicated in the plotted yield curve(s) to the right (Source: Bloomberg Professional), the yield curve is indeed modestly inverted between three and 15 years. The swap curve shows a little more substantial inversion beginning at about one year and, if we were to stop there, we would conclude that, yes, the curve(s) are inverted, and a recession might be imminent.

But wait! Does the inversion cause the recession or is there something else in the works? For that matter, are we even looking at the correct data?

We have talked about yield curves in past commentary and have noted that the yield curve basically tells you what the market believes interest rates will look like in the future. This forward view generally includes expectations for the economy, as a growing economy generally produces positive economic growth and inflation—sometimes modest and other times not so modest.

In a normal environment, the economy grows and the difference or spread between short-term and longer-term rates indicates the potential for growing inflation and economic activity.

When the yield curve flattens, the outlook for growth moderates; and when it inverts (longer rates below shorter-term interest rates) it is supposed to indicate a potential economic decline. In other words, the yield curve can be an indicator of the direction of economic growth.

That there is a modest inversion between three and 15 years really isn't flashing an economic *danger signal* because it is the wrong indicator. The indicator (one among many) upon which we should focus our attention is the Fed Funds to 10-year spread. It is this spread that is one of the 10 leading economic indicators that the Conference Board uses to forecast future economic activity. With Fed Funds currently in a range of 0.25% to 0.50%, and the 10-year treasury currently at roughly 2.42%, no danger signal is flashing.

But will we have a recession? Though the answer to that simple question is a definitive yes, the more important question should be *when*?

The Economy

We have said that investors and the market look to the most recent memories in order to try to understand the now. Take inflation, for instance.

The market's biggest worry is that the inflation we are now experiencing is of the 1970s and '80s variety.

We don't agree, but that the markets seem to be so fixated on that period of economic history might seem to explain why another term of that era is being bandied about today.

Stagflation was a term coined in the 1970s to describe a time when many developed world economies were experiencing a period of very high inflation, low economic growth and high unemployment. While it is true that inflation is quite high (the highest level in nearly 40 years), and economic growth as measured by GDP is moderating (the Federal Reserve Bank of Atlanta's GDP Now is estimating Q1 2022 GDP of just 1.5% annualized), it is hard to use that term today in its proper context. This is because the employment situation today is vastly different from the employment situation of the 1970s and '80s.

First of all, the unemployment rate is still declining. At its recent reading of 3.6% it is, arguably, well within the range to be considered full employment. Additionally, average weekly hours of non-supervisory workers are still well above the depressed levels of the COVID recession and are more in line with the late 1990s. Interestingly, Average Weekly Hours did not decline noticeably below the levels of the 2015–2016 non-recession slowdown. Finally, average hourly earnings continue to expand—not something that happens in a recessionary environment.

If we look at the other leading indicators, we see a similar story. Continued expansion with no clear indication of recession. However, through some less well-followed statistics, we can see a situation where we might be viewing the beginning stages of a slowdown.

A freight publication called *FreightWaves* publishes an "Outbound Tender Reject Index" that measures the rejection of actual electronic load requests, or *tenders*. As the shipping economy strengthens, the number of load *rejects* increases as shippers have more load options from which to choose. Conversely, when the economy slows, the number of load rejects falls as shippers have fewer product shipping options. While this tends to signal more of a shipping recession than an actual recession, the reality is that it should also indicate more broadbased economic slowness. This is because as consumers slow their buying activities, retailers have less need to ship product, which then backs up to suppliers, etc. While the current reduction in load rejects is probably equally tied to supply chain issues, particularly within the automotive sector, it might also be pointing to potential slowness in consumer activities. Which, in our mind, only makes sense.

Why? Think of it like a spending hangover effect. In an effort to help consumers recover from the negative impact of closing the economy due to COVID, the government provided significant stimulus in the form of direct payments to consumers. While some certainly saved those dollars, many also spent everything they got—much of it on improving their living environment. Whether it was remodeling or adding something to do while confined to the home (big-screen TVs, gaming systems, camping equipment, etc.), the consumer consumed. Once that spending was done, it didn't get repeated since the stimulus didn't continue.

As we look at inflation, we find another reason to believe that the stagflation of the 1970s and '80s is not in our future.

This is because the inflationary event we are experiencing is different from the inflation of the 1970s and '80s.

In our view, that inflation was more demographic in nature and was, therefore, more broadbased and long(er) lasting. Perhaps some charts will help illuminate the differences.

The two charts below are of the Consumer Price Index's yearly percent change. The first is from 1935–1955 and the second from 1957–present (Source: Yardeni.com and the US Bureau of Labor Statistics). You will note that there are three spikes in inflation from

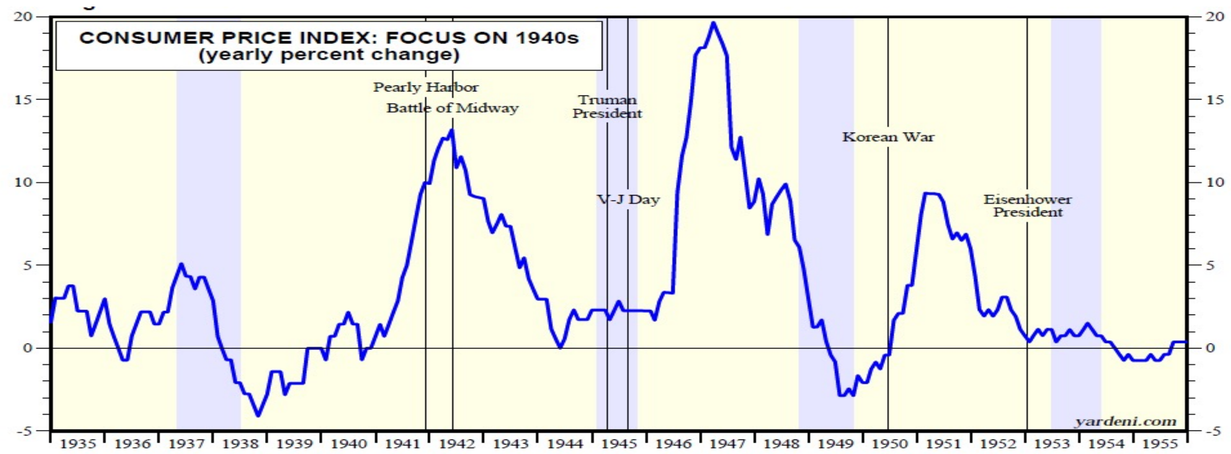
1936–1955. The first coincides with the entrance of the US into World War II (WWII). The second, from 1946 and peaking in 1947, is when the US servicemen returned home from the war and resumed their working lives. When they began buying stuff, US manufacturing had to retool from the war effort to make consumer goods. Demand rose, but supply was constrained due to the lack of consumer manufacturing during the war and the ongoing retooling. Inflation dropped relatively quickly once the domestic economy normalized.

Contrast that inflation with the inflation of the 1970s and '80s. In our view, this inflation was purely demographic in nature. This is because the Baby Boom generation was the largest generation in history, both in terms of absolute numbers of people and as a percentage of the population. As the Boomer generation entered the labor pool (beginning in 1962) and started buying stuff, demand outstripped supply for all kinds of products and services as they formed households, purchased homes, cars, etc. It was only when then Fed Chairman Volker took interest rates to double-digit levels that we were able to significantly reduce money-supply driven demand and break the back of inflation.

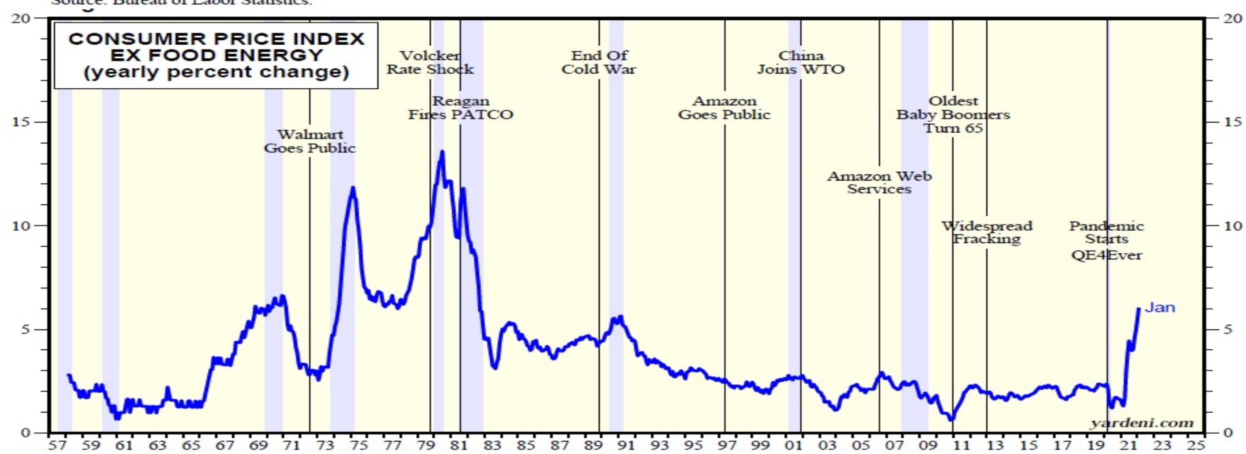
We believe that the inflation experience of today more closely resembles that of the post WWII period than that of the Great Inflation of the 1970s and '80s. This is because, in our view, the current inflation is being caused by a supply/demand imbalance created by shutting down global production while supplying consumers with a means to continue spending. Once production catches up to demand, inflation should abate. Which points to another issue.

In many cases production can't catch up to demand due to supply chain issues. While those issues will eventually be resolved, that resolution takes time. Meanwhile, prices rise for goods and services as demand outstrips available supply.

And so the Fed responds by raising interest rates…



Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: Bureau of Labor Statistics.



Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: Bureau of Labor Statistics.

Interest Rates

As we indicated at the beginning of this commentary, the FOMC has begun its process of increasing rates, increasing the Fed Funds rate by 0.25% to a range of 0.25%–0.50%. We admit that in our initial expectations for Fed Funds, put forth in the year-end commentary, we were focusing on what was likely at that time rather than what the market would like to see.

We were wrong on how quickly the market would force the Fed's hand, as Fed Chair Powell indicated following the March meeting that the FOMC would likely increase rates at each of the remaining FOMC meetings in 2022.

While initial indications were that the rate actions were likely to be 0.25% increases, the Fed and the market now expect one or two 0.50% hikes over those six meetings. As such, the likely year-end Fed Funds rate is now roughly 2.50%. If we get there (and we actually think it possible that we end up even higher) it will be the biggest single-year upward move since former Fed Chair Allan Greenspan took rates up by 3.00% in 1994. But let's not get ahead of ourselves.

We have been warning for some time that the ultra-low interest rate environment we have been in for the last decade had/has created a scenario where if we got even a very modest increase in interest rates, bond returns would turn negative. That has happened in spades. The best performing sector of the bond market for the first quarter of the year is 1–2 year municipal securities, which only lost 1.6%. Assuming interest rates rise as expected for the year, we would not be surprised that bonds finish even farther in the red than they are already.

Given higher expectations for short-term rates and the yield curve moving sharply higher across the curve, we are reevaluating our expectations for rates. The 10-year treasury bond has now eclipsed the 2.5% rate we had expected for year-end and the 30-year is approaching the 2.60% target. While we are adjusting our expectations higher, we are not moving them notably higher. We now expect the 10-year to end at 3.10% and the 30-year at 3.40%. This does not, however, preclude rates from moving through those levels at times over the balance of this year.

Market Overview

Unsurprisingly, energy has been the biggest winner from a return standpoint thus far in 2022. We say unsurprisingly because it almost had to get better. Energy had extremely poor performance for much of the past decade as supply/demand was unbalanced to the supply side. Drilling, particularly in US shale, had produced a gusher of supply at a time that demand was declining globally. For the first time in more than two decades, the United States became a net oil exporter.

With the advent of ESG mandates, pushes for large institutional investors to divest, and the current administration in Washington pulling back on drilling and pipeline permits, supply was dwindling as demand kept marching higher. As such, oil and natural gas prices crept higher.

European dependence on Russian natural gas in conjunction with reduced production in the North Sea, Norway, etc. as Europe pushed toward alternative energy caused the price of natural gas in Europe to become unhinged from prices in the West (i.e., the United States), putting a significant strain on European consumers and producers dependent on natural gas.

While not nearly as elevated as Europe, domestic energy prices have also risen fairly significantly. Since most energy companies have reduced their finding and development costs, and rationalized exploration, they are seeing pretty substantial profits. The Street is pushing up energy company stock prices in concert.

With the markets becoming more concerned about the likelihood of recession, defensive names are leading the way, particularly in large cap equities. Consumer discretionary is lagging among smaller companies and are near the bottom in large-cap stocks. Again, this makes sense if we are concerned about a potential recession. That consumer discretionary stocks are performing poorly also makes sense given generationally high inflation. As prices rise, consumers will make decisions about what they really need and move toward necessities.

Bonds. . . well bonds did not do, and are not doing, well.

As we said earlier in this commentary, because of our ultra-low rate environment, we had reached a point at which nearly any movement in interest rates would mean negative returns in bonds.

Negative returns we got, with the only saving grace being that shorter maturities did relatively less bad than longer maturities. This is on top of negative returns in bonds for all of 2021. Investors that have looked to bonds as safe investments are facing the first real bear market in bonds in a generation.

Outlook

What can we say?

Given that we expect interest rates to continue rising, and given that the Fed will very likely be much more aggressive than even the most pessimistic year-end punditry, we believe there is nearly no way that bonds can avoid a second consecutive down year.

A recession (which we do not believe will happen in 2022) might stem the red ink in bonds, but that will only happen if the Fed reverses course and/or a serious inversion happens. And that only stems the red ink if longer rates dip below current rates—something we do not view as likely. At least for now.

Equities should also have a difficult time as the markets worry about the potential for lower earnings. While revenues may well be helped by inflation, the bottom lines of many companies will be squeezed by higher personnel costs and higher product and service input costs. This will cause problems for most companies, but those whose values are dependent on rapidly growing future revenues and earning should be the most negatively impacted.

We expect that equities will continue to face difficulties into the second half. While earnings should get the benefit of the calendar flipping (from an analyst's perspective) from 2022 to 2023 in the second half, it will likely not be enough to push equity returns much higher. While we are still expecting year-end returns to be in a range of -7 to 7%, at this point we are thinking that it is more likely than not that returns end the year in the red.

Strategy Overview

We currently view the short-term future much as we did at the end of 2022. Expectations for rising rates (although not as much as we have seen so far this year), slowing earnings and higher-than-desired inflation paint a rather ugly picture.

As such, we still believe that downside risks outweigh the upside potential.

This means that investors need to remain vigilant of the relationship between risk and return and try to ensure that they are adequately paid for risks taken.

Taking a little extra time to fully understand what is happening in the economy and market can help avoid bad surprises and potentially identify situations where risks have either been overpriced or find situations where the potential downside may be relatively limited.

Gauging appropriate valuation and purchase prices relative to risks has always been, and will always be, our primary focus. Linking investment decisions to something tangible like the cash generating capabilities of a business or investment and assuming a minimum acceptable rate of return for each decision should add value. Elevated risks should translate into higher return requirements and lower calculations, all else equal.

Looking at investments as would any rational person helps us focus on those things that are most important: return of and return on capital invested.

Regardless of the environment or level of market uncertainty, when we see investment opportunities that allow us to earn returns in excess of our requirements, we jump. Over time, this should allow us to be well compensated for the decisions made. In our mind, the real risks are those not taken.

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