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February 14, 2022 – Weekly Notes

Economic Commentary:

Inflation continues to dominate investor concerns, but now amplified by the additional uncertainty of a potential war in Ukraine. Beyond the deeply troubling possibility of a direct confrontation between Western and Russian military forces, the situation in Ukraine is contributing to oil market price increases and the overall feeling that inflationary pressures will not be reduced any time soon. At the same time, it should be recognized that this is yet another example of the unusual forces behind current inflation, forces not easily addressed by raising interest rates. Whereas normally the Federal Reserve might be prepared to mitigate markets thrown into disarray by an armed conflict, such typical mitigations – including postponing any rate hikes—would go against the strong bias for acting against inflation sooner rather than later (with inflation "hawks" on the Federal Reserve, such as St. Louis Fed President Bullard, believing it is already "later".)

Centrists at the Federal Reserve appear to be lining up behind a steady but moderate movement of interest rates towards "neutral", a number defined as that associated with steady growth with stable prices ("stable" defined as 2% inflation). Unfortunately, interpreting exactly what interest rate is that neutral rate is often a hind-sight exercise. For the moment, it would seem that raising the Fed Funds rate approximately 150 bps over the course of this year would, in the view of some at the Fed and in conjunction with reducing the Fed balance sheet, put monetary somewhere close to "neutral." Chairman Powell is generally considered to be a centrist, and will have substantial influence on the course of action. However, there is a lot of additional economic data about both inflation and growth which will be in the Federal Reserve's hands before the next FOMC meeting, leaving the future path of interest rates more ill-defined at the moment than investors would like.

Data to Watch:

- US Producer Price Index for January, released Tuesday, Feb 15
- US Retail Sales, Month over Month for January, released Wednesday, February 16.
- US Federal Open Market Committee (FOMC) minutes, released Wednesday, February 16.
- Speeches by Fed Presidents Chris Waller and John Williams on Friday, February 18.

Suggested Reading:

- https://www.wsj.com/articles/ukraine-changes-the-playbook-for-the-market-selloff-11644858772
- https://www.nytimes.com/2022/02/14/business/economy/olympics-china-economics.html
- https://www.wsj.com/articles/deals-are-booming-but-antitrust-scrutiny-has-deal-traders-worried-11644678001

Investment Commentary:

Markets

Another macro heavy week with inflation/rates again taking center stage. Last week, the S&P 500 fell 1.8%, while the Russell 1000 Value Index outpaced Growth -0.5% to -2.6%. The MSCI EAFE (non-U.S. developed) and MSCI EM (emerging markets) returned 2.3% and 2.5%, respectively. The U.S. yield curve continued to flatten, driven mainly by the 2 year which rose by about 20bps. German 10-year Bunds saw their first yield fall in 12 days and ended the longest run of increases since reunification in 1990 ending last week at 0.29% (its highest closing level since Q4 2018).

Time to Transition from the Fed to Fundamentals

As we transition into an era towards positive real interest rates, and from quantitative easing to quantitative tightening (removal of excess market liquidity) we expect the drivers of equity returns and the leadership of the market to be different. Of the 72% of S&P 500 companies that have reported 4Q earnings, 77% have surpassed expectations and the Investment Office is monitoring quarterly guidance this week from the hotel sector, in particular.

The Investment Office remains focused on the Fed and potential changes in interest rate and balance sheet policy along with fundamental corporate earnings and guidance. Volatility for Treasury bonds and global equities has risen, with Treasury volatility as measured by the MOVE index breaching levels not seen since the onset of the pandemic, and U.S. equity volatility as measured by the VIX index remaining elevated. We are certainly in a period of transition, with central bankers around the world grappling with inflation and investors in the near-term struggling to reprice global assets in the face of policy and geopolitical uncertainty.

Interestingly, when we look at longer-term inflation expectations 5 and 10 years out, we see a consistency in market pricing. Over these longer time horizons, investors see a reversion of inflation down to a lower level. The 5-year inflation breakeven rate has fallen over the past few weeks, from a November 2021 high of 3.2% to 2.8%. Similarly, the 10-year breakeven rate also peaked in November 2021 at 2.8% and has since declined to 2.5%. The Investment Office agrees with this long-term outlook where many of these inflationary pressures (supply & demand) will abate and the trend will revert to the lower average over time. This is not reflecting any kind of stress that we are entering into a 1970s era of wage price spiral-driven inflation. While we remain in the long-term disinflationary camp, the Investment Office believes that the economy will be plagued by greater-than-expected inflation in certain asset classes in the medium-term including housing, with certain structural supply/demand imbalances. As a reminder, housing is heavily represented in the Consumer Price Index, with an over 30% weighting. This creates opportunities for certain investors to consider the suitability of alternative investment strategies focused on single family rentals.

Wealth Planning Commentary:

Going back to the Plan

We are experiencing volatility and uncertainty in the market these days and it’s likely to continue for some time. Now is a good opportunity to understand how the current environment will impact your long-term Wealth plan and to confirm that you are track.

By reviewing your long-term wealth plan, we may find that it is resilient against adverse conditions such as: high transitory inflation, increased long term inflation and interest rates, a market correction or lengthy bear market, and performance returns that are less than historic averages.

If your plan is not resilient, it’s better to know sooner rather than latter so we may take actions to improve your likelihood of success.

How much does inflation impact a long-term plan?

A recent analysis published in Rethinking65 reviewed how a long-term increase in inflation impacts the likelihood that a portfolio funds a client’s retirement. The study focuses on a case where the client has $1mm of assets and withdraws 4% of the portfolio in the first year and $40,000 thereafter for 30 years.

In an environment where inflation rises 2% each year:

- A conservative portfolio with 40% equites and 60% bonds had an 84% chance of success.
- An aggressive 80/20 portfolio had an 83% chance of success.

Assuming long-term inflation rises 4.5% each year:
- The conservative portfolio's success rate reduced from 84% to 29%.
- The aggressive portfolio's success reduced from 83% to 57%, a much higher success rate than the conservative portfolio.

As inflation rises bonds appear worse than stocks. The higher expected returns of equities are needed to help retirement income keep pace with higher inflation.

If you are near or in retirement and plan to withdraw significant amount of your portfolio each year, it's good time to review you plan with us.

Disclosures