Nothing New Under The Sun

Q2 2022 Report

Concord Asset Management

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Nothing New Under The Sun

Key Observations

- Inflation has hit a 40-year high. We expect "demand destruction" to cause a significant decline in inflation by year-end, but remain elevated above normal levels.
- Once behind the curve, the Fed is front-loading large interest rate hikes in order to cool the economy and fight inflation.
- Stocks are off to their worst first half of a year since 1970, and bonds their worst start ever, but markets are resilient, and they recover.

Economic Commentary

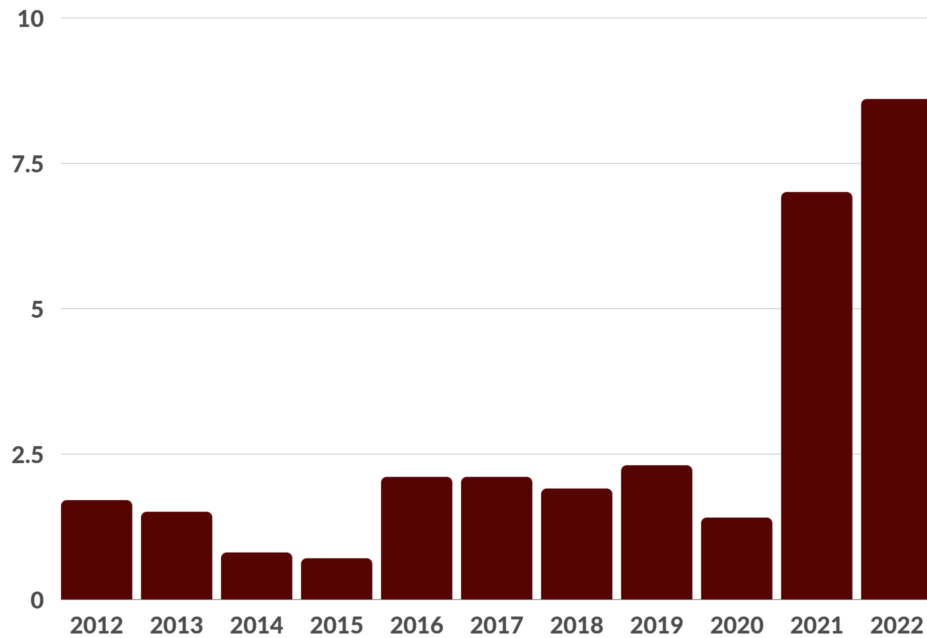
As the second quarter ends, the hot topics on everyone's minds are:

- Has inflation peaked, and if not, when will it peak?
- What is the Fed doing about it?
- Will the Fed drive the economy into a recession? If so, how severe will it be?

We know why we have inflation. It's the result of unequal supply and demand caused by the pandemic. The combination of a money supply expansion during the Covid-19 lockdown, the release of pent-up demand once the lockdown ended, and supply chain disruptions have sent inflation to a 40-year high.

This year, two new supply constraints arose - the Zero-Covid Policy in China, where many goods are manufactured, and the Ukraine War, creating shortages in energy and food.

The result? According to the U.S. Labor Department, inflation has jumped to 8.6% for the 12-month period that ended in May.[1]



So, what can we look forward to? It is likely that supply chain challenges will remain as China and Russia will remain wildcards. However, it's unlikely that inflation will be this high at the end of the year as the demand side of the equation becomes front and center. Pent-up demand will eventually wane, a natural cure for high prices is high prices, and the Federal Reserve is finally acting with conviction.

The Fed has kicked the wheels of demand destruction into motion. They are front-loading significant interest rate hikes, the latest a 0.75% hike in June. Fed member expectations of future hikes indicate 3.4% by year-end. In addition, the Fed commenced "quantitative tightening" in June – an activity that reduces money supply and slows down the lending activity of banks.

There is evidence that the Fed is starting to get what it wants as higher interest rates on mortgages are taking a toll. Housing starts have fallen off a cliff, declining 14.4% from April to May and -8.6% from a year earlier. New mortgages have plunged an incredible 32% year-over-year as well. The housing market is the first shoe to fall as demand destruction becomes a reality.[2,3]

The Fed's aggressive actions are not without risk. At this point, the Fed's position has changed from "not moving fast enough to curb inflation" to "moving so fast it will cause a recession." But this change in perspective just shows how complicated things are. The aggressive, front-loaded interest rate hikes have ironically increased expectations that the Fed will cut rates as soon as 2024. We know from history, that interest rate cuts and loosening of monetary policy lead to robust growth. Expect the recession, if it comes to fruition, to be relatively mild and short-lived.

Market Commentary

With inflation surging to 40-year highs, supply chain issues lingering, and the Fed instituting the largest rate hike in 28 years, the financial markets have plummeted. The S&P 500 and NASDAQ indices have sunk into bear territory, down 21% and 30%, respectively. The Dow (DJIA) keeps flirting with that unfavorable distinction and is currently down 15% through the first two quarters. For the S&P and DJIA, this is the worst start to a year in over 50 years. For the NASDAQ, it is the worst ever.[4]

While bonds should provide a buffer when markets crash, U.S. Treasuries have also delivered double-digit losses to start the year. The 10-year Treasury has lost more than 10%, and declines in longer-term Treasuries exceed 20%. Investment-grade corporate bonds have dropped a staggering 16%, and the Bloomberg US Aggregate Bond Index, tracking all maturities of Treasuries and corporate bonds, is on pace for its worst year in history, currently down over 10%. Unfortunately, this means the usually reliable balanced portfolio of 50% stocks and 50% bonds has declined

10 Worst Price Declines to Start a Year Since 1970

	January to June			Next 5 Years Total Return		
Date	**S&P 500**	**DJIA**	**NASDAQ**	**S&P 500**	**DJIA**	**NASDAQ**
2022	-21%	-15%	-30%	???	???	???
1970	-21%	-15%	n/a	30%	29%	n/a
2002	-14%	-8%	-25%	52%	45%	78%
2008	-13%	-14%	-14%	26%	31%	48%
1974	-12%	-6%	-18%	27%	9%	82%
1973	-12%	-13%	-24%	-8%	-8%	19%
1982	-11%	-7%	-13%	177%	198%	148%
2010	-8%	-6%	-7%	100%	80%	136%
2001	-7%	-3%	-13%	4%	6%	1%
1984	-7%	-10%	-14%	108%	116%	82%
Average	*-12%*	*-9%*	*-16%*	*57%*	*56%*	*74%*

Source: Morningstar, June 2022

more than 14% to start the year.[4,5]

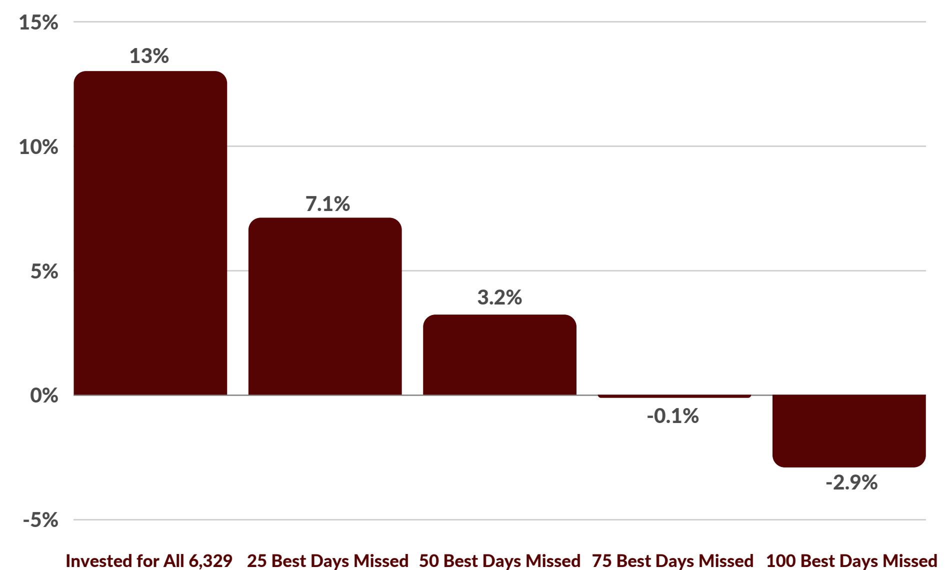
Final Thoughts

The constant barrage of pessimism, lingering inflation, and recession talk from financial news organizations has everyone scared and gloomy. Still, it's important to reflect on the past 25 years. We've seen dramatic conditions in the economy and markets before, so there is truly nothing new under the sun.

In the late 1990s, Russia defaulted on its debt. Then came the bursting of the Dot-Com Bubble, followed by 9/11. Soon after, a downgrade of U.S. debt, a housing market crash, and the bankruptcy of Wall Street bastion Lehman Brothers led to the Great Recession. And, most recently, a global pandemic shut down the global economy for months.

During those tumultuous periods, many people thought they knew what was happening and sold stocks or stopped putting money into the markets. However, one common theme has continually persevered – markets are resilient. Back in 1997, knowing all the pending economic and market calamities, would anyone have guessed the S&P 500 would generate an average annual of nearly 10% and a cumulative return of more than 900% over the next 25 years?[6]

In conclusion, there's nothing new here; we've seen this before. Markets are resilient, and they recover. With so much risk currently priced into the markets, there is opportunity. Forward-looking stock valuations have declined dramatically, and yields on bonds are at multi-year highs. Despite an unbelievable lineup of bad news, if you have a long-term focus, you need to look past these things, even if it's painful.



Times like these remind us how important it is to consult with your advisor to make sure your portfolio is aligned with your risk tolerance and time horizon. It's this valuable partnership between the Client, Advisor, and CAM that will help guide you through these uncertain times by making prudent decisions and avoiding costly mistakes.

About the CIO

Mitch York, CFA is passionate about the investment industry and understands the challenges advisors face as the industry landscape is constantly evolving. He brings over 20 years of investment leadership experience, including his prior position prior position as the head of Edelman Financial Services' $20+ billion investment division. During this tenure, Mitch provided oversight of asset allocation, security selection, and investment manager due diligence. He has an M.A. in Economics from the University of South Florida and a B.B.A. in Finance from Eastern Kentucky University. Mitch's professional credentials include the Chartered FinancialAnalyst® (CFA®) designation and FINRA licenses 7 and 66.

Sources

[1] Current US Inflation Rates: 2000-2022, *US Inflation Calculator*, June 10, 2022.

[2] Troy Green, "Existing-Home Sales Fell 3.4% in May; Median Sales Price Surpasses $400,000 for the First Time," *National Association of REALTORS®*, June 21, 2022.

[3] Mika Pangilinan, "Mortgage Applications Inch Higher in Weekly Survey," *Key Media, Inc*, June 29, 2022.

[4] Morningstar, June 2022.

[5] Bloomberg US Agg Total Return Value Unhedged USD, *Bloomberg*, June 23, 2022.

[6] Information based on a portfolio of 50% Bloomberg US Aggregate Bond Index, 40% S&P 500 Index, and 10% MSCI EAFE Index.

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