Market Commentary
March 31, 2022

ADVANCED ASSET MANAGEMENT ADVISORS

# Inflation Is Key To Everything

We have written about inflation frequently over the last 18 months.

> *"Transfer payments from Washington to the people have surpassed the baseline trend by a staggering $26 trillion. This increase in payments has, predictably, led to increased purchases of consumables, durables, and real estate."*

> *"Surely some components are transitory. However; the 29% increase in home prices over the last two years will increasingly filter into rental costs as leases are renewed."*

We continually write about inflation, because it affects everything—from stock prices to consumer sentiment and the average American's quality of life.

## So What's Going On With Inflation Today?

Federal Reserve policy stance has moved from "inflation is transitory" to the most hawkish policy projection in years. One month ago, the Fed was predicting baby steps of quarter-point rate increases, "as necessary", and potential balance sheet reduction "at a future (unspecified) meeting". In just the last week, Fed comments suggest one or two half point increases and an announcement of plans to sell securities at the next meeting. We've seen a complete change of attitude.

## How Did We Get Here?

As we stated in January, 2021:

> "…there is clearly a recipe for accelerating inflation. Year-over-year growth of the M2 money supply is a record high 24% (four times the average growth rate of the last 40 years). The inflation cake is baked to perfection."

It seemed clear to almost everyone. Fed officials are political appointees and may be motivated to preserve their positions. It is interesting that the Fed's pivot towards fighting inflation came on the heels of the chairman's reappointment.

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The hundreds of PHD economists on staff at the Fed represent (collectively) the consensus economic forecast. They are no better than anyone else at predicting the future. They simply react differently. They delayed their pivot towards fighting inflation for 15 months. They now run the risk of tightening monetary policy in a slowing economy, having potentially squandered safer opportunities from a year ago.

## Interest Rates

Short term interest rates have continued their move higher in lockstep with pronounced Federal Reserve policy projections. Two year Treasuries normally price in the expected trajectory of overnight rates over the next two years, and this cycle is no exception.

Longer term rates march to long term inflation expectations. Ten year and longer rates have moved higher, but are still priced well below current inflation. If we ignore the cumulative market impact of the Federal Reserve buying $8 Trillion of bonds over the last 14 years, the long term Treasury market suggests that either current inflation rates will not continue much past the next two years and or there is elevated risk of economic slowdown.

Current inflation is high, expectations are for inflation to moderate, and the Fed has pivoted towards an aggressive stance. These factors suggest we will continue to see volatile bond prices until the disparate readings converge. For now, our fixed income portfolios remain invested in shorter term, high quality bonds that are less volatile than long term bonds—given specific changes in yields.

| Investment | Current Yield | Real Yield (After Inflation) |
|---|---|---|
| Savings Account | 0.06% | -7.84% |
| 2 Year Treasury | 2.28% | -5.62% |
| 10 Year Treasury | 2.32% | -5.58% |
| 30 Year Treasury | 2.44% | -5.46% |
| Inv. Grade Corporate Bonds | 3.50% | -4.40% |
| High Yield (Junk) Bonds | 5.44% | -2.46% |

Data as of March 31, 2022

## Economic Growth

In 2022, economic growth is expected to slow from the torrid recovery we witnessed after the shut-down recession. Consensus expectations are for 2.8% growth this year and 2.2% in 2023.

Remember, in the last two years of extreme everything we witnessed a historically deep and fast recession and a similarly robust and fast economic recovery. The labor market remains robust, and federal and state government tax receipts are at new highs. Both measurements indicate a healthy economy. However, just as easy money policies and fiscal transfers accentuated economic growth, the reversal of these factors has the potential to accentuate the slowing economic trend.

We expect forecasts for economic growth to fluctuate widely as we exit the extreme everything world.

## Corporate Profits

Corporate profits have recovered quickly and are projected to improve by 8.5% for the full year of 2022, down slightly from the 9.5% growth forecasted a few months ago.

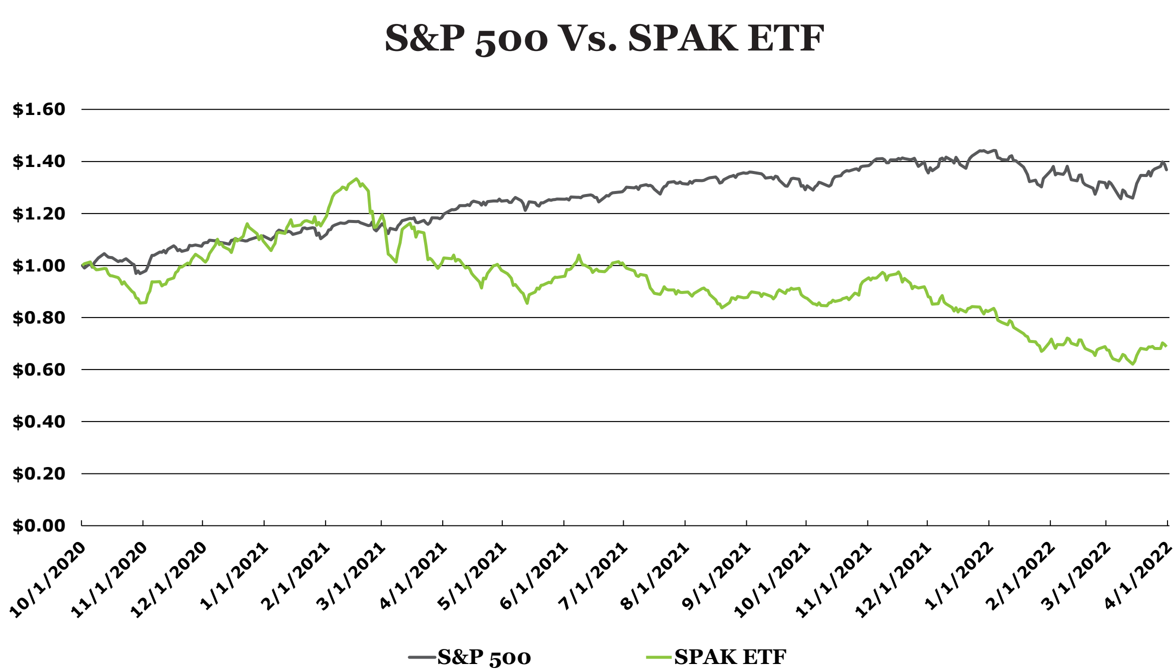
We expect profit forecasts to be volatile going forward as inflation winds its way through the economy. The ability of companies to pass along price increases will be key to profits this year. Rising labor costs and raw material costs are headwinds for profit growth. Inflation, which will be key to growth, will increasingly differentiate companies, industries, and sectors that have pricing power. The consumer is in good shape financially, but spending patterns will increasingly be impacted by rising prices of necessities and discretionary purchases may decline on the margin.

## Stock Prices

Stock prices have suffered as higher inflation, higher interest rates, and the prospect for slowing economic growth have upset the perfectly priced market. Unprofitable companies that were trading on expectations of high growth continue to be punished while larger companies in more stable businesses have suffered less. The poster child for the former is the Defiance Next Gen SPAC index which trades 48% below its high from 14 months ago.

Valuations have improved a bit. Three months ago, the priced-for-perfection market traded at 21.6 times expected earnings. Given the 4.6% S&P 500 first quarter decline and stable earnings expectations, the forward P/E ratio is now 19.6 and higher than 91% of the observations over the last ten years. Valuations are better, but remain elevated.

The decline of stock prices over the first quarter is not remarkable, but the intra-day and daily price volatility is. Elevated inflation, rising interest rates, and changing Fed policy will likely continue to provide ample reasons for volatility to continue.




## An Update On Ukraine And The Global Economy

The Russia-Ukraine war has introduced new sources of strain to the global economy and markets, and a new source of stock price volatility. Supply chain disruptions and reduced supply of food and natural resources on the global markets will exacerbate already hot inflationary trends.

The West has imposed broad economic sanctions against Russia, including the freezing of its central bank reserves and removal from the global payments system. These actions are unprecedented, and the long-term effects are yet to be realized. A trend away from globalization of supply chains had already started due to the pandemic, and these extreme sanctions will likely accelerate it. Deglobalization could have persistent and significant inflationary impacts around the world as the lower costs enjoyed from 30 years of globalization are reversed.

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Exactly how this will play out is unknown at this point, but we can imagine the topic in corporate boardrooms is more focused on how to onshore supply vs. offshoring.

## How Does Inflation And Volatility Impact Our Equity Portfolios?

Overall, our approach to the equity markets remains consistent with what we've communicated over the past year. Our equity portfolios are generally focused on large cap companies, making sure more defensive sectors are represented. The Healthcare sector continues to stand out in the over-valued market with a median valuation and above-market earnings growth forecast.

**Your AAMA Team**

### Want to Discuss?

If you would like to discuss this content, please feel free to reach out to our President, Bob Baker, at **614-726-3622** or our National Sales Manager, Aaron Ploscowe, at **614-726-3627**. We'd love to speak with you.



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