MJM INVESTMENT ADVISORS, INC.

Second Quarter 2022 Investment Outlook

Scared Straight

“There is an obvious need to move expeditiously to return the stance of monetary policy to a more neutral level, and then to move to more restrictive levels if that is what is required to restore price stability.…“If we conclude that it is appropriate to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings, we will do so.”

– Federal Reserve Chair Jerome Powell

“We’re at more risk now than we’ve been in a generation that this [inflation] could get out of control,”…. “One scenario would be ... a new surprise that hits us that we can’t anticipate right now, but we would have even more inflation. That’s the kind of situation that we want to make sure it doesn’t occur.”

– St. Louis Fed President James Bullard

“Obviously, we need to be moving toward a more neutral monetary policy certainly by the end of the year, so that we’re within striking distance of taking a position that would deal more forcefully with inflation,” Evans said. “I have said ‘wrong-footed’ [on policy], and I think that’s the right term. It happened very quickly.”

– Chicago Fed President Charles Evans

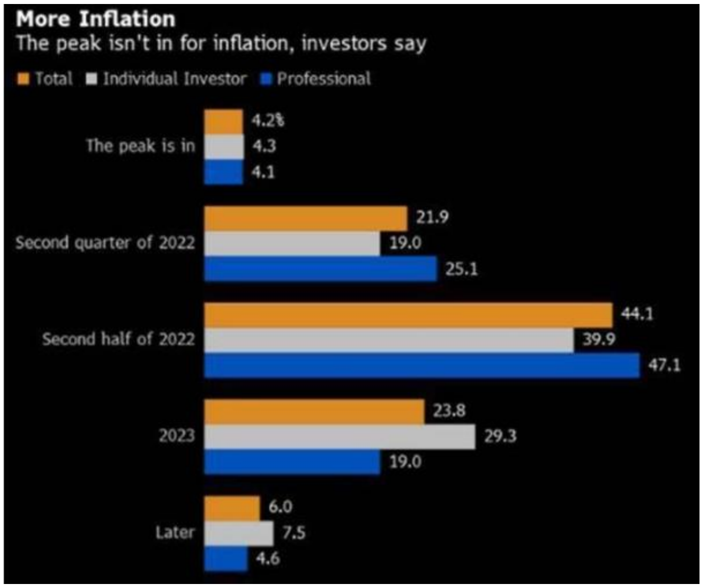
“We're prepared to do whatever it takes to get to price stability.”

– San Francisco Fed President Mary Daly

The U.S. Federal Reserve has two objectives as mandated by Congress: full employment and price stability. As indicated by the 3.6% unemployment rate in March, the former has been reached, while the latter is out of control, with the Consumer Price Index at 7.9% in February and March CPI expected to exceed 8%. Make no mistake about it, Fed officials have been scared straight. The catalyst for the change has been elevated levels of inflation (oops, not transitory, our bad) that have persisted for over a year and have reached late 1970s-like pain levels. The Fed is way behind the curve and knows it must act aggressively to reign in rising future inflation expectations. As a result, the Fed is about to embark upon an aggressive reversal of its long held ultra-accommodative monetary policies. It is a watershed event for financial markets, especially given how positive the Fed’s ultra-accommodative monetary policies have been to financial markets since 2008.

The Fed pivoting towards a hawkish stance is challenging enough for financial markets to handle and now the Russia/Ukraine War has thrown gasoline on the bonfire and it couldn’t have come at a worse time for both the global economy and global inflationary pressures. Since the February 24th invasion, the geopolitical landscape has been thrown into major upheaval and taken a major turn for the worse. Russia has been ostracized and cut-off financially via severe economic sanctions. Over 600 western companies have exited Russia in rapid fashion, which will set back Russia’s economy and society a decade or more. Global inflationary pressures are being magnified as Russia produces around 7% of world’s oil and Europe is overly reliant upon Russian for approximately 40% of its natural gas consumption. The war has caused both commodities to spike and will lead to increased inflationary pressures throughout the world. There is already civil unrest in Peru due to food inflation and cooking oil rationing has already started in Spain and some Asian countries as Ukraine is a major supplier of sunflower oil. Ukraine and Russia are responsible for 30% of global wheat supplies and reduced supplies could lead to increased civil unrest in other areas of the world including the Middle East and Africa. As just one example, Egypt relies upon Russia and Ukraine for 85% of its wheat imports.

Financial markets now face the dreaded double whammy. Rising inflationary pressures and slowing economic growth, also known as stagflation. The highest inflation readings since the late 1970’s is forcing the Fed to act more aggressively than it normally would in the face of rising economic uncertainty caused by the residual impacts of the Russia/Ukraine War. The next chart below shows that the majority of individual and professional investors believe inflation hasn’t peaked yet. This higher future inflation sentiment is a big problem and one that the Fed needs to address through a more aggressive policy response.

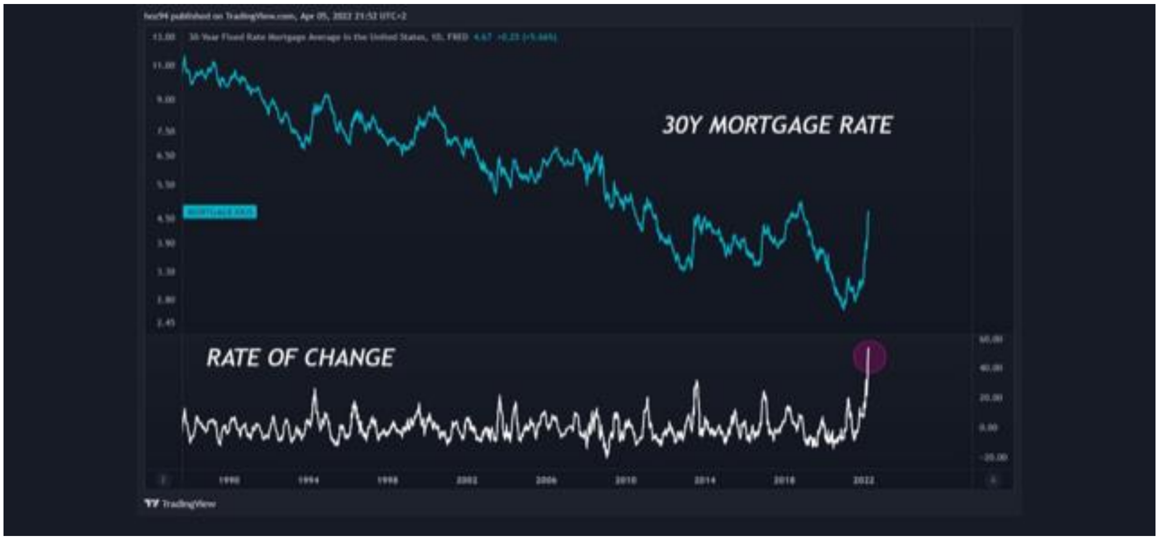


Source: Bloomberg

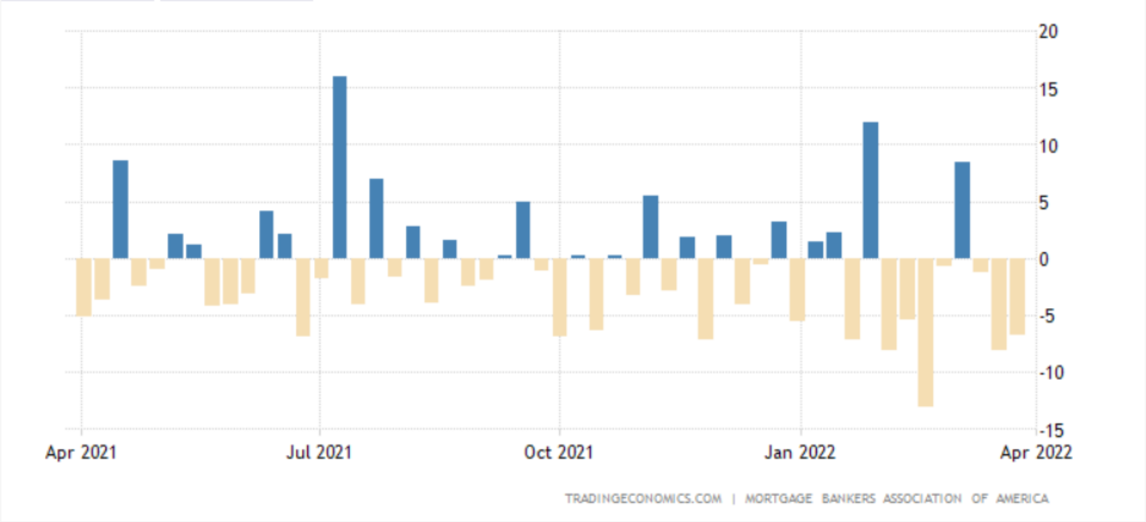
Normally, the Fed will telegraph to financial markets what is coming in advance and make policy moves in a very deliberate manner, such as it did when it raised interest rates by 0.25% at its mid-March meeting. However, with recent inflation data showing no signs of weakening combined with additional commodity price increases caused by the Russia/Ukraine War, the Fed is now forced to accelerate the pace of its removal of monetary policy accommodation. At its early May meeting, the Fed most likely will raise interest rates by 0.5% and it could also raise interest rates another 0.5% at its June meeting. The last time the Fed raised interest rates 0.5% at one meeting was in 2000 and only did it once that year. In addition, the Fed will begin to reverse its Quantitative Easing policy by reducing the size of its balance sheet that has built up to over $7 trillion of Treasury and mortgage-backed bond holdings.

As the Fed removes monetary policy accommodation at a faster pace, it will end up causing the U.S. economy to slow down and increase the risk of the U.S. economy going into a recession. The Fed is in a tough spot. It needs to take aggressive action to get future inflation expectations back under control but in doing so it increases the risks of causing a recession. Orchestrating a soft landing, or a slowdown of economic activity without causing a recession, is not something the Fed is particularly good at. Of the last 11 Fed rate hiking cycles, 8 of them ended up in a recession.

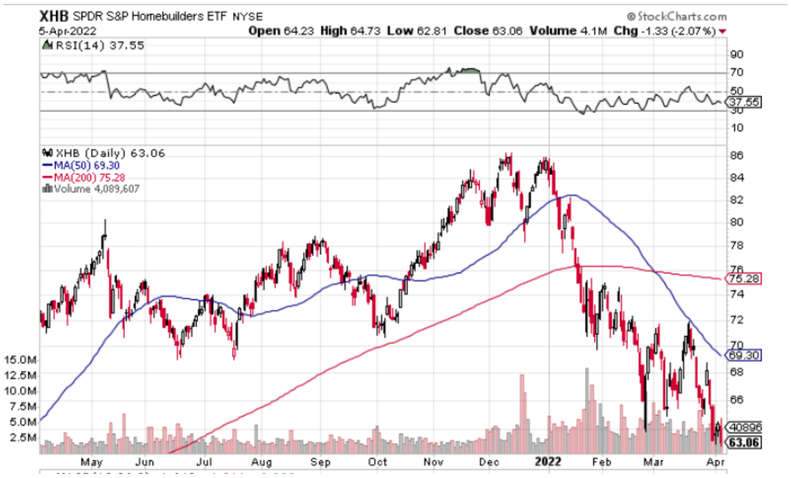
The Fed hasn't even started to materially raise interest rates yet but the impact on the economy is already being felt in a major way. The next chart shows the interest rate on a 30-year fixed rate mortgage going back to late 1980s. At the end of 2021, mortgage rates were sitting at all-time historic lows near 3% and the housing market was on fire, with many local markets seeing 20% price gains over the past 12 months. Who was responsible for this setup? The Fed was, by holding interest rates near zero for way too long and even after the economy had mostly recovered from the C-19 pandemic. Today, the mortgage market is quickly adjusting to the Fed's pending changes in interest rate policy. Mortgage rates have seen a significant move higher over the past three months with the 30-year mortgage now over 5.0%, up an astounding 2.0% since 12/31/21, and the highest since 2013. The bottom of the chart shows the rate of change and it is the second largest year-over-year increase in the 30-year mortgage rate on record. Although current mortgage rates are still cheap in a historical context, such a rapid move higher in mortgage rates will have a negative effect on the housing market and economy for the rest of the year because the monthly P&I payment needed to purchase a $500,000 home has doubled from just 3 months ago. House bidding wars brought on by cheap financing are pretty much over.



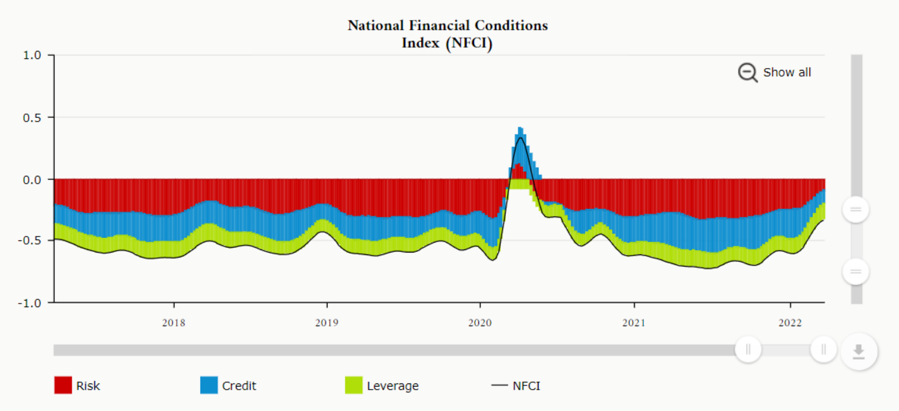
As proof, mortgage application data for both refis and new purchases are starting to show large declines as indicated in the next chart of weekly mortgage applications from the Mortgage Bankers Association. Applications hit their lowest levels since December 2019 as mortgage rates surged the most in 11 years.



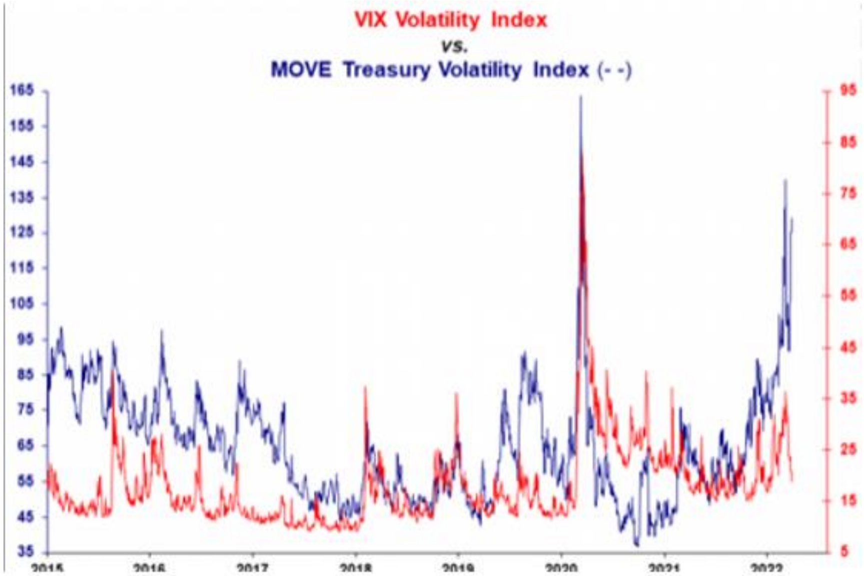
Investors are already looking ahead to a more challenging housing market and dumping homebuilder stocks, as shown in the next chart of Homebuilders Exchange Traded Fund.



When the Fed raises interest rates or reduces its balance sheet via Quantitative Tightening, it causes a tightening of financial conditions. The next chart shows the St. Louis Fed's National Financial Conditions Index, which captures a broad measure of a financial conditions across money market, debt, and equity markets. U.S. economic conditions are tightly correlated with financial conditions. In this chart, the lines going higher means tightening financial conditions and economic slowdown. The large gap higher followed by a reversal lower in early 2020 was caused by the large negative reaction to the C-19 pandemic outbreak and then the Fed quickly taking aggressive policy actions to supply liquidity to financial markets. The Fed has maintained ongoing liquidity support and financial conditions were quite positive through the summer of 2021. Stock and housing markets generated large gains and household net worth increased 37% from March 2020 through December 2021. Towards the end of 2021, when the Fed first started to telegraph that it would begin to reverse its easy monetary policy stance in the ensuing months, financial conditions started to tighten and will continue to do so as the Fed raises interest rates and implements QT. Tightening financial conditions helps to explain why both stock and bond markets started to exhibit rising volatility and both asset classes experienced negative returns during the first quarter.



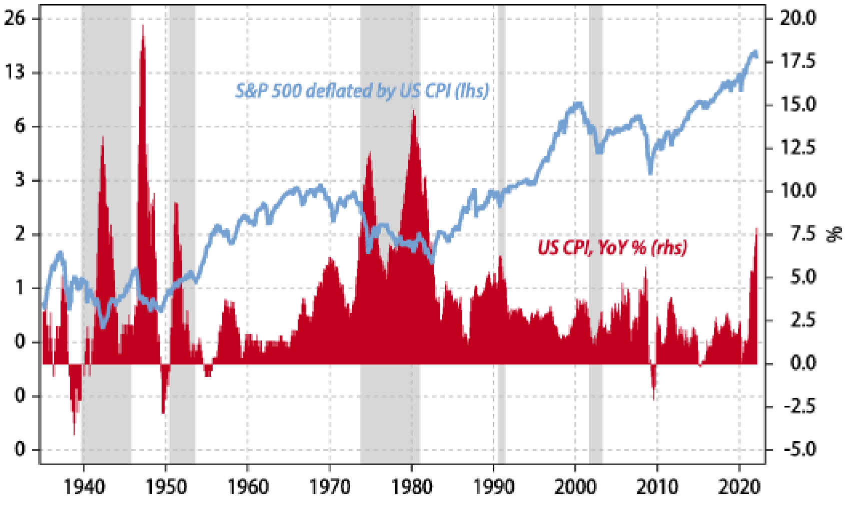
The next chart shows the volatility indices of stocks (VIX) and bonds (MOVE) and how price volatility has exploded higher in recent months. Note that bond volatility has reacted more dramatically than stock market volatility as Fed monetary policy and inflation have more immediate and significant impacts on bond prices. Stock volatility in the back half of March fell back, in contrast to bond volatility that remains elevated. This divergence won't last. Either bond volatility will decline or stock volatility will reverse higher again.



The Russia/Ukraine War has added another wildcard to the deck. Major wars are rare events but typically come with rising inflationary pressures. The next chart from GaveKal Research shows how CPI acted during prior war periods, which are identified by the grey areas on the chart. Note on the far right that inflation levels were already elevated in the U.S. even before the start of the Russia/Ukraine War. The price of oil and natural gas in the U.S. were up 34% and 53%, respectively, during the first quarter mostly due to the Russian/Ukraine War. The price increases for both commodities in Europe have been even bigger, especially natural gas. As rising energy input costs work through the supply chain, it is clear that global inflationary pressures will get worse in the months ahead even if there is a cease fire in the near future. As a result, companies face a difficult decision. Either raise prices in order to offset these higher input costs or take a hit to corporate profits. It should also be noted that when inflation levels experience a large inflection higher, stocks typically experience a correction, as noted in the blue line in the chart representing the S&P 500 Index return. Even though the U.S. is technically not a participant in this war, Russia is a large producer and exporter of oil and natural gas but economic sanctions are limiting its ability to export both so global commodity prices have adjusted higher to reflect this fact. While the U.S. is an oil producer, it still imports oil (including small amounts of Russian oil since ended) to satisfy total demand and will now have to source more oil from other countries like Canada. The U.S. has sufficient natural gas production but now Europe needs the U.S to replace the natural gas supply it will lose from Russia so this large and unexpected demand is why U.S. natural gas prices are also increasing.

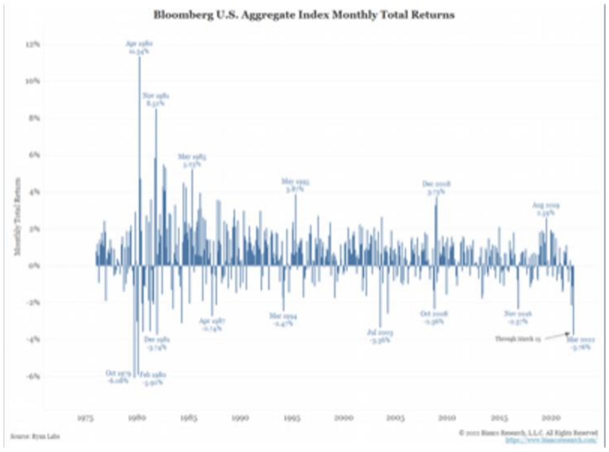
Wars, equity prices and inflation

US CPI and S&P 500 in real terms | shaded gray = major wars

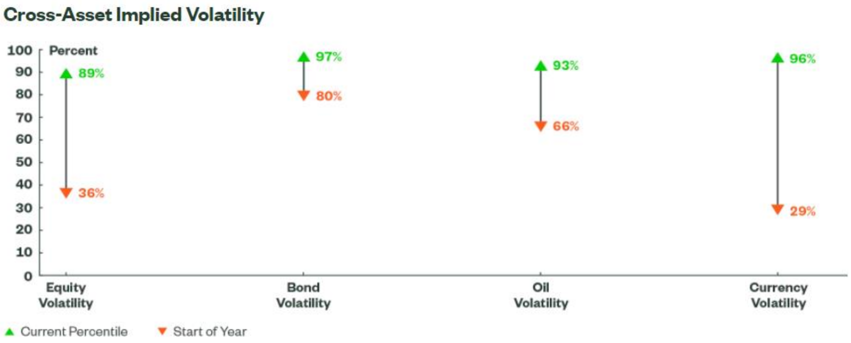


Gavekal Research/Macrobond

The current investment environment is not only challenging for the stock market but even more difficult for bonds. The next chart shows monthly total returns for the broad U.S. fixed income market as measured by the Bloomberg Aggregate Bond Index going back to the early 1970's. Historically, high quality bonds are lower risk investments and usually plod along with mostly positive but low monthly returns. Large negative monthly returns are rare events for the bond market. The worst monthly bond returns were back in 1979/1980 when inflation levels were extremely elevated and the Fed was aggressively raising interest rates. Sound familiar? More recently, bond investors absorbed one of the worst monthly returns in March (-2.8%) and the first quarter of 2022 was the third worst quarterly return (-5.9%) for bonds of the past 50 years. Rising inflation combined with the Fed embarking upon a monetary policy tightening cycle have hit bond investors hard over a short period of time. It was a very rare setup during the first quarter that bonds did as poorly as stocks and more conservative balanced portfolios with higher bond weightings were more negatively impacted than more aggressive portfolios with higher equity weights.



The long period of ultra-low interest rates is ending as the Fed intends to raise interest rates to address elevated inflation levels. One of the residual impacts of maintaining interest rates at artificially low levels for an extended period of time is that it suppresses financial asset price volatility. During such periods, investors rarely see large market corrections and if they do occur are small and short lived, as has been the case for many years. 2021 was one of the lowest volatility years for the U.S. stock market in its history but that is all about to change with the Fed policy pivot. The chart below shows how volatility across several categories of investments have seen large upticks since the end of last year. Using equities as an example, at the end of 2021, equities were only in the 36th percentile of their historical price volatility range but by mid-March were up to the 89th percentile. Much higher volatility was also present across bonds, oil, and currencies. In all likelihood, financial markets are entering a new period of elevated volatility until such time as the Fed completes its interest rate hiking cycle and reduces the size of its balance sheet via QT.



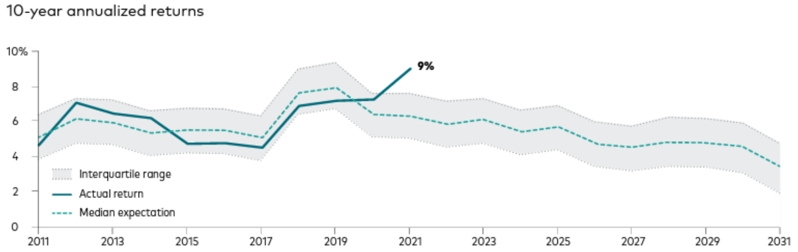
Source: Bloomberg Finance, L.P., as of March 14, 2022. **Past performance is not a reliable indicator of future performance.** Currency-implied volatility is measured by the Deutsche Bank FX Volatility Indicator Index. Bond-implied volatility is measured by the MOVE Index. Oil-implied volatility is derived from oil future contracts. Equity is measured by the CBOE VIX Index.

In addition to experiencing higher near-term price volatility, investors need to come to grips with lower return expectations in the decade ahead. The ultra-accommodative Fed policy position since 2008 created a major tailwind to financial asset returns. As the Fed reverses course and withdraws policy support, financial assets will have a more challenging return setup. The next chart provides some clue about what may lie ahead. It shows actual and forecasted return forecasts made by The Vanguard Group for a 60% stock / 40% bond balanced portfolio. The black line is the actual 60/40 portfolio return experience and shows that for the 10 years ending 9/30/21, a typical 60/40 balanced portfolio generated a 9% annualized return. The grey area represents Vanguard's forecasted range of return outcomes with the upper part representing the 25th percentile, the lower part representing the 75th percentile, and the middle dashed line representing the median return expectations. If Vanguard's 10-year forward returns forecast from 10 years ago had been spot-on, the dark line representing actual returns would have been near the median dashed line. The actual results of a 60/40 balanced portfolio for the 10 years ending 9/30/21 did substantially better than Vanguard's forecasts. In fact, the actual 9% annualized return was well above the 25th percentile of forecasted return outcomes.

There is no way to perfectly predict future investment returns but if the past 10 years was significantly better than expected, and today's financial asset valuations are rich relative to history, then it is rational to expect the next 10 years will not be as robust, especially if we no longer have the strong tailwind of the Fed's ultra-accommodative policies to support financial markets. The right side of the chart projects Vanguard's current 10-year return forecast for a 60/40 balanced portfolio out to 2031. Assuming Vanguard's median return forecast is close to actual experience, a typical 60/40 balanced portfolio will have a 10-year annualized return of just below 4%. The way compounding math works is if you earn a 7% annualized return over 10 years, your starting balance today will double in 10 years. If Vanguard's return forecasts are accurate and a 60/40 balanced portfolio earns just under 4% annualized over the next 10 years, then today's balance will be about 45% higher in 10 years. These are nominal returns or including inflation. If inflation levels remain elevated, then real returns or returns after removing the impact of inflation will be even lower. As a result, investors will need to think more about increasing savings to help grow future retirement balances because returns will no longer do all the heavy lifting.

FIGURE II-1

Returns on a 60/40 balanced portfolio are expected to be roughly half of what investors realized over the last decade



Notes: The chart shows the actual 10-year annualized return of a 60/40 stock/bond portfolio compared with the VCMM forecast for the same portfolio made 10 years earlier. For example, the 2011 data point at the beginning of the chart shows the actual return for the 10-year period 2001–2011 (solid line) compared with the 10-year return forecast made in 2001 (dotted line). After 2021 the dotted line is extended to show how our forecasts made between 2012 and 2021 (ending between 2022 and 2031) are evolving. The interquartile range represents the area between the 25th and 75th percentile of the return distribution. The portfolio is 36% U.S. stocks, 24% international stocks, 28% U.S. bonds, and 12% international bonds. See the Appendix section titled "Indexes for VCMM simulations" for further details on asset classes.

Source: Vanguard calculations, as of September 30, 2021.

Summary

The Fed is way behind the inflation curve and is now scared straight. The inflation genie is out of the bottle because the Fed waited way too long to withdraw its ultra-accommodative policies that it implemented after the C-19 pandemic hit. Future inflation expectations are still rising and the Fed must now act aggressively to reign them in. This significant change in policy direction will create a difficult return setup for financial markets and also cause higher levels of price volatility. Although too soon to call, it may also cause a recession. The Fed seems to believe it can make aggressive policy changes and achieve a soft economic landing. That may be the best case outcome but history suggests the odds are not in the Fed's favor.

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Chief Investment Officer

April 6, 2022

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