INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

FIRST QUARTER 2022: INFLATION, UP, UP AND AWAY

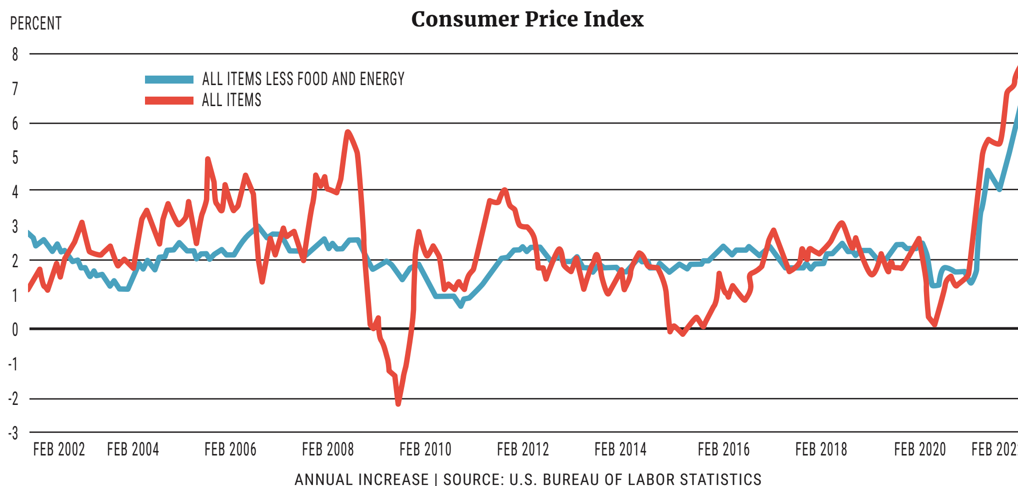
Would you like to ride in my beautiful balloon?
Would you like to glide in my beautiful balloon?
We could float among the stars together you and I

For we can fly, we can fly
Up, up and away
My beautiful, my beautiful balloon
-The Fifth Dimension

At any given point in time, there are numerous issues that compete for investors' attention. Where we are in the business cycle. The outlook for corporate profits. Ballooning budget deficits. Emerging geopolitical events. Technical analysis. The presidential election cycle. On and on.

We are at a moment in time, however, when there is one issue that completely dominates investors' thoughts, and that issue is elevated, persistent inflation. All over the US—on line at the grocery store or while filling the car with gasoline, in Congressional hearings, on the nightly news, on Twitter, and in the hushed halls of the Federal Reserve—it's the same conversation. Inflation has gotten out of hand. Inflation appears to have gotten so untethered from the hand of the Federal Reserve that it is like a helium balloon whose string escaped the grasp of a small child, floating away, out of reach.

As the chart indicates, the widely followed Consumer Price Index has spiked to 7.9% year-over-year, the highest level in 40 years. Even if the volatile but frequently purchased food and energy categories are omitted, inflation is running at an annual rate of 6.4% in February, according to the Bureau of Labor Statistics. The significance of this dramatic jump in inflation can't be overstated—it bears on consumer spending and confidence, it bears on Fed interest rate policy, it bears on corporate profit margins, it bears on the midterm election cycle, and so on.



ANNUAL INCREASE | SOURCE: U.S. BUREAU OF LABOR STATISTICS

DOWN, DOWN AND AWAY

Suspended under a twilight canopy
We'll search the clouds for a star to guide us
If by some chance you find yourself loving me
We'll find a cloud to hide us, keep the moon beside us
-The Fifth Dimension

Inflation concerns, certainly, weighed on investors during the first quarter. Stocks slipped for the first quarter since the arrival of the COVID pandemic in early 2020.

"Of all the markets, in all the world, you had to walk into mine."

Equities of all stripes—domestic, international, large, small—all turned in mid single digit declines, as did real estate equities. Bonds, disappointingly, provided no relief from the downturn, as yields rose—in anticipation of Federal Open Market Committee ("FOMC") interest rate increases—and bond prices dropped. Even as bond returns suffered from the inflationary impulse, commodities were a big beneficiary of higher prices, rising an eye-popping 26%.

Asset Class	Index	1st Quarter Returns
US Large Cap Stocks	S&P 500 Total Return	-4.6%
US Small Cap Stocks	Russell 2000	-7.5%
International Developed Markets Stocks	MSCI EAFE	-5.9%
Emerging Markets Stocks	MSCI EM	-7.0%
Real Estate Securities	MSCI US Real Estate	-4.1%
Commodities	Bloomberg Commodities Futures	25.6%
Bonds	Bloomberg Barclays US Aggregate	-5.9%
Cash	FTSE 3-month UST Bill	0.03%

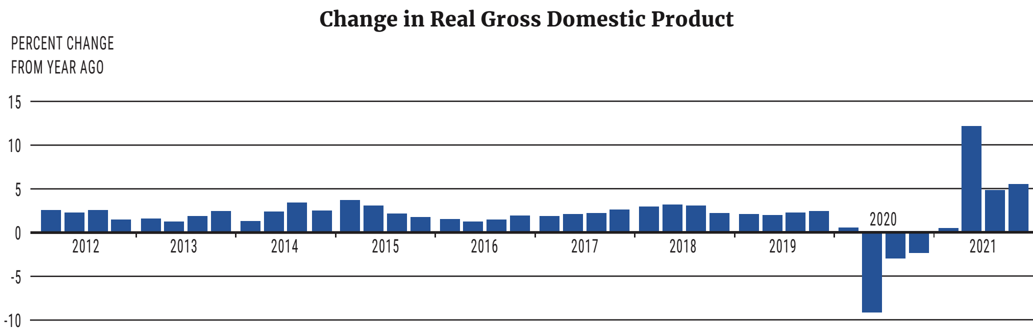
SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

When inflation flares as brightly as it has in the last few months, there are no clouds that can hide markets, and no stars that can guide us.

DOUSING FLAMES ON AN ECONOMY ON FIRE

He knew he had to come down
He just didn't know how
-Catherine Bullock, 'Icarus'

Coming into the new year, the US economy exhibited strong momentum. GDP increased 5.7% for all of 2021, and increased 7% year-over-year in the fourth quarter. That momentum was driven, to a very substantial degree, by extraordinary policy accommodation, with massive fiscal stimulus (the $1.9 trillion American Rescue Plan) and super-easy monetary policy (zero percent interest rates and $120 billion monthly Fed bond purchases). An improvement in the COVID healthcare environment, driving consumers to indulge pent-up demand, also contributed to the robust economic picture.



SOURCE: U.S. BUREAU OF ECONOMIC ANALYSIS

But an over-stimulated economy gives rise to excess demand. Supply chains, already weakened by COVID worker shortages, have been unable to increase production adequately to meet demand, and even when sufficient goods are produced shippers and truckers lack the capacity to transport goods to warehouses and end markets. The inevitable result is inflation.

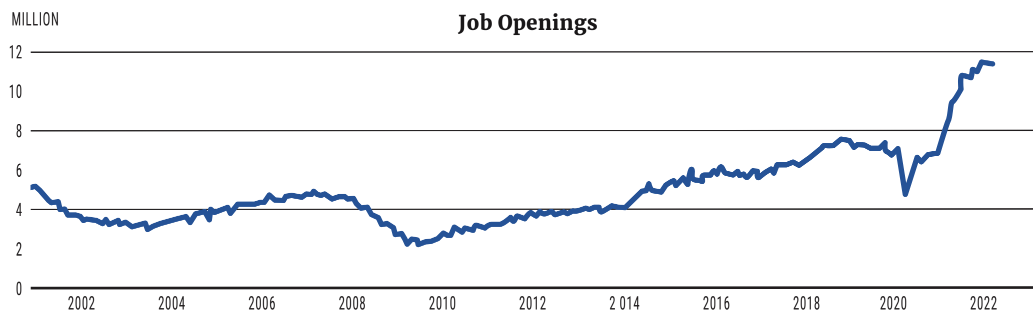
So, with a backdrop of rising prices and labor market pressure, 2022 confronts investors with a dramatically changed policy environment. Rapidly shrinking budget deficits and Congressional stalemate translate to fiscal tightening. And the dramatic rise and persistence of inflation have driven the Fed to begin increasing interest rates and to terminate its quantitative easing policy.

The Fed, propelled into overdrive when COVID shut down the economy, was reluctant to remove policy accommodation too quickly. And it infamously opined, incorrectly, that inflationary pressures were 'transitory.' Icarus-like, Fed Chairman Powell and his colleagues at the FOMC flew the economy too close to the sun, for too long. Let us hope that cooling the over-heated, wax-melting economy doesn't result in it falling from the sky.

IT'S TOO DARN HOT

I'd like to coo with my baby tonight
And pitch the woo with my baby tonight
But brother, you fight my baby tonight
'Cause it's too darn hot
-Cole Porter

It's not a struggle to amass arguments that the US economy is running too hot, and is in need of tempering. Growth is well above trend; real growth is the fastest it's been in many years. Jobs are plentiful, with unemployment low at 3.6% and wages rising (up 5.6% in the past year). Weekly new unemployment claims are the lowest they've been in over 50 years. Manufacturing is healthy, capital expenditures are up, and consumer spending is well supported. On the trade front, both exports and imports are growing.

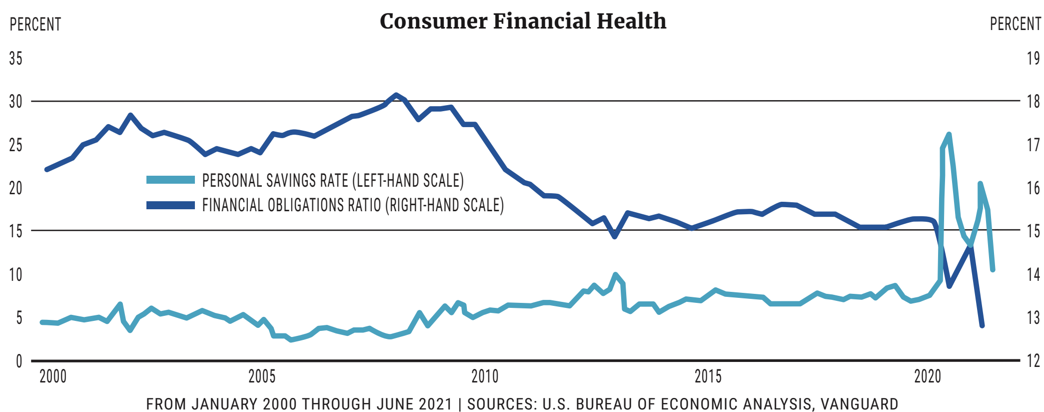


SOURCE: U.S. BUREAU OF LABOR STATISTICS

Perhaps the strongest data supporting the need for tighter monetary policy comes from the labor market, where the demand for workers vastly outstrips the supply. The chart above shows unfilled jobs at a record level of 11.3 million. The Bureau of Labor Statistics also tells us that workers are quitting at historic levels, given the widespread availability of jobs and the potential for higher wages and salaries.

That said, US employment today remains lower than pre-pandemic levels, with 2 million fewer people working today. Baby boomer retirements, increases in 'gig' workers and the self-employed, and changing societal attitudes toward work may all be factors in this limited recovery in the labor force participation rate.

The US economy is driven by consumption. Fortunately, consumers generally are in good shape, and should be able to weather higher inflation and higher interest rates. Debt levels are down and, with benign interest rate levels, debt service ratios are lower than they've been in 20 years.



FROM JANUARY 2000 THROUGH JUNE 2021 | SOURCES: U.S. BUREAU OF ECONOMIC ANALYSIS, VANGUARD

The personal savings rate of 10% is almost double the average rate in the 21st century. With high savings rates, plentiful jobs, and rising wages, consumers are well positioned to maintain their spending.

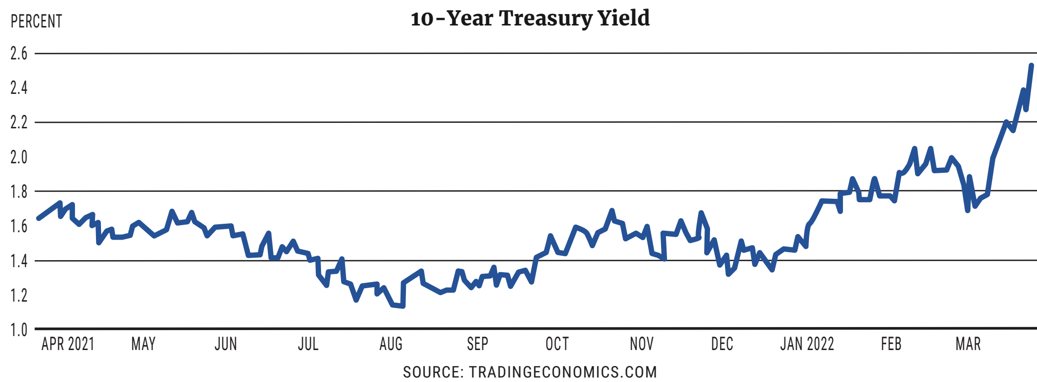
Over the past two years, the housing market nationally has been *en fuego*, but there are nascent signs that it is beginning to cool down. Home prices (up 15% from a year ago) have been rising faster than wages, and the increase in mortgage rates to a recent national average of 4.4% has lifted financing costs. These two factors, in concert, have driven down home affordability. New home sales fell for the second consecutive month in February; existing home sales fell 7.2% versus the prior month and 2.4% from year ago levels. If ultra-low interest rates have stoked the demand for housing over the past two years, it stands to reason that higher mortgage rates will tamp down that demand.

BOND MARKET MELTDOWN

A thing is worth what it can do for you.
Not what you pay for it.
-John Ruskin

As noted, it has been a challenging year for bond investors, as higher interest rates led to attendant lower bond prices. Indeed, the volatility in the bond market has been as noteworthy as the volatility in the stock market, as participants debated the prospective effectiveness of the Fed's inflation-fighting prowess.

It would seem that fixed income investors determined that bonds now do less for them, and thus re-rated downwards what they were willing to pay for them.



The benchmark 10-year US Treasury bond yield has climbed from 1.56% at the start of the year to 2.49% in late March. And the 2-year US Treasury note yield, more sensitive to Fed Funds rate moves, has climbed even more steeply, from 0.61% at the start of the year to 2.28% in late March.

Note that the yield difference between 2-year and 10-year Treasury bonds has been shrinking, or flattening. Investors are hyper-attentive to these relative yield movements, with an eagle eye trained on the possibility that the 10-year yield could actually fall below the 2-year yield. Such a condition (an 'inverted' yield curve) usually indicates that the bond market believes that the Fed has, or will, tighten financial conditions excessively. More importantly, an inverted yield curve has sometimes—although not invariably—presaged a recession a year or two later.

STOCK MARKET COOL-DOWN

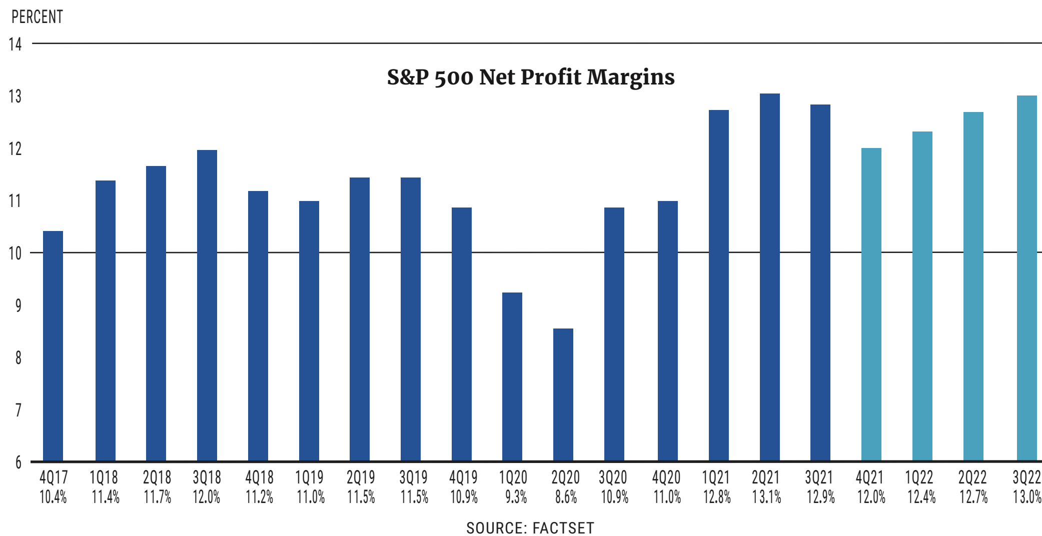
According to the Kinsey Report, ev'ry average man you know
Much prefers his lovey-dovey to court
When the temperature is low
But when the thermometer goes 'way up
And the weather is sizzling hot
Mr. Gob for his squab
A marine for his queen
A GI for his cutie-pie is not
-Cole Porter

Equity markets, too, have encountered some turbulence in the new year. For stock investors, unseasonably hot inflation readings make them want to sit it out, just like lovers in a heat wave.

Other things being equal (and they rarely are), stock prices are driven by earnings expectations and the multiple that investors are willing to pay for those earnings.

In 2021, earnings for the companies in the S&P 500 rose 49.9% over the prior year, as the economy recovered from the year-earlier pandemic shut-down. And, as low interest rates made bonds a less attractive alternative, investors were willing to pay 21 times those earnings to purchase the stocks comprising the S&P 500.

Fast-forward to 2022, and the picture is less rosy. Earnings growth this year will be harder to come by, as the base for comparison is the robust results from last year. Economic growth will slow markedly, without the fiscal and monetary stimulus that characterized 2021. And inflation will challenge businesses to manage higher costs for raw materials, shipping and transportation, labor, and so on. It remains to be seen if companies will be able to pass along these higher input costs, thereby maintaining profit margins.



Net profit margins have consistently exceeded 12% since the depths of the pandemic—a level notably higher than before COVID. As the chart reflects, currently investors believe that companies will be able to maintain and even increase their margins. We can't help but to inject a note of caution regarding these expectations, as not all companies will be able to fully pass along higher costs, and as employees demand a larger share of corporate profits.

The consensus view, according to FactSet, is that corporate profits will rise about 6.5% in 2022. Even if companies achieve such earnings growth, a higher interest rate environment implies a lower multiple investors should be willing to pay for those earnings. After all, if low interest rates supported higher stock prices, would it not be (unfortunately) logical that higher rates are less constructive for stock prices?

At the start of the year, the S&P 500 was trading at 21.7 times expected earnings for the next 12 months. Earnings growth was estimated at 9% for the year. Three months later, with a worsening inflation environment, earnings growth estimates have fallen, and the S&P 500—having dropped 5%—trades at 19.5 times the revised earnings estimate. This valuation compares unfavorably to 5- and 10-year average price/earnings multiples of 18.6 and 16.8 times, respectively.

Our observations would be that there is heightened uncertainty about companies' ability to achieve earnings estimates, and that the market is only modestly less expensive than it had been, notwithstanding the substantial rise in interest rates. The foregoing suggests some fragility in the stock market, at least until there is greater clarity around corporate earnings specifically and the overall economic environment generally.

WHAT ABOUT GEOPOLITICS?

I never saw a pessimistic general win a battle.
-Dwight Eisenhower

As hard as it is, we cannot avoid thinking about the various implications of the Russian invasion of Ukraine. We begin with the obvious. This is a profound humanitarian tragedy, with lost lives well into the thousands, and displaced refugees in the millions. The images and stories coming out of Ukraine are heart-breaking. And on the political front, it marks the end of the post-Soviet Union rapprochement, a realigning of alliances, a furtherance of the nationalist/deglobalization movement. And, of course, it isn't over, and we don't know how and when it ends, with threats of chemical, nuclear, and cyber attacks as Russia's ground offensive stutters.

From an economic and market perspective, the consequences of both the war itself and the sanctions on Russia are likely to aggravate the troubling inflation situation. Russia is the third largest oil producer, and is also a major exporter of other commodities, including coal, wheat, iron, and aluminum. Ukraine is also a commodities exporter, particularly corn, wheat, iron ore, and sunflower oil. Prices of these commodities have spiked on fears of possible supply shortages.

In the not-too-distant future, commodities prices could well come down, as global producers meet the supply challenge. But there are broader effects that the conflict in Ukraine may have on the world economy. Capital Economics estimates that the war in Ukraine will reduce global growth by 0.5% this year, to 3.2%, reflecting higher inflation, further supply chain disruption, and recession in Russia. The chance of a recession in the Eurozone has increased. Overall, the growth deceleration could act as a brake on central banks' plans to fight inflation with interest rate increases.

THE POWELL DILEMMA

Whenever I'm caught between two evils,
I take the one I haven't tried.
-Mae West

The Fed governors are bedeviled by the conflicting paths of their two mandates, full employment and stable prices. At this juncture, they have been wildly successful on the former and woefully unsuccessful on the latter. They now face a Hobson's choice, whether to protect the hard-won vigor of the labor market, or to put that at risk in order to face down inflation. Last year, the FOMC was reluctant to put at risk the nascent jobs recovery, and sat by as inflation proved not to be as transitory as they wanted to believe it would be. Now, with its preferred inflation measure (Personal Consumer Expenditures) at 5.2% (6.1% if you include food and energy), the FOMC is compelled to address its stable prices mandate. At its last meeting, in March, it raised the Fed Funds rate, and offered a forecast of six further rate increases for the balance of the year. It also suggested that it would reduce holdings of bonds on its balance sheet in the near future. Even with these policy prescriptions, it predicts that inflation, measured by PCE, would end the year at a still-lofty 4.3%.

In the near term, we anticipate that inflation readings will rise further, as economic data begin to fully incorporate higher shelter, energy and food costs. Yet forecasts of inflation abating somewhat in the second half of the year have some credibility. As we cycle through high year-ago price levels, we will see smaller year-over-year price increases. Some supply chain bottlenecks are easing, such as the back-up of container ships seeking to unload cargoes in US ports. Used car prices have come off recent highs, and US automotive factories are expected to increase production as chip shortages lessen later in the year.

Positioning portfolios in this environment, fraught with uncertainty as it is, is distinctly challenging. It is hard to predict if the Fed will be able to engineer the proverbial soft landing—to bring inflation down without stalling the economic recovery. It seems it may be easier for a camel to pass through the eye of a needle than it may be to tame inflation without causing a recession.

Elevated risk conditions lead us to increase our focus on high quality investments and also to intensify our sensitivity to valuations. Small cap value stocks sport the most gentle valuations versus their historical averages, and may warrant committing some capital to the space. In the US large cap space, health care stocks screen well for modest valuations, strong balance sheets and cash flows, and growth. Internationally, valuations are more modest, but visibility of growth and earnings is less good—this is true for both developed and emerging markets.

In the fixed income arena, the flattening of the yield curve has reduced the attractiveness of intermediate to longer term bonds. Thus, we are keeping duration fairly short. A short duration portfolio allows investors to take advantage of reinvestment opportunities at higher interest rates. Spreads for corporate bonds have widened somewhat recently, versus US Treasurys, but remain somewhat tight. Lower quality debt instruments carry equity-like risk; it will be interesting to see if higher rates feed through to this space.

The takeaway is that investors of all stripes might be wise to curb their enthusiasm. It is not a time for the kind of wide-eyed optimism that characterized earlier eras.

Like, say, the mid-1960s. The Fifth Dimension taught us that, in a beautiful balloon, the world's a nicer place as you go up, up and away. And so it is with portfolios: the last three years have been a glorious ride up, up and away. Let us hope that the Fed succeeds in slaying the inflation dragon, allowing us to chase our dream across the sky. And so we can fly. But please, Chair Powell, not so close to the sun, this time.

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