Making Sense of Finance

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First Quarter 2022 Review

STOCK MARKET

After a strong finish to 2021, the stock market began the new year in a downward trend. By late February, the S&P 500 index had decreased by 12% (correction territory) and the Nasdaq Composite index was down 20% (typically the measure of a bear market). After a March rally, the S&P 500 finished the first quarter of 2022 down by almost 5%. The Dow Jones Industrial Average index had a similar drop while the Nasdaq Composite experienced an even greater decline of 9 %, due largely to the significant weakness in technology stocks. While earnings reported last quarter for companies in the S&P 500 index rose for every stock sector except utilities, a contraction in the price/earnings multiple (price per share an investor is willing to pay for a given earnings per share) caused the index to decline as investors were trying to grasp how the actual and predicted rise in interest rates would affect the economy and in turn their stock holdings. This struggle between higher earnings and rising rates (not to mention the Russian invasion of Ukraine) created volatility in the market. Last quarter alone had 32 trading days with a movement in the S&P 500 of 1% or more, compared to only 55 trading days in all of 2021.

The overall uncertainty and worries in the market resulted in the majority of S&P 500 stock sectors posting declines last quarter. Only two groups had a positive return: energy and utilities. Both saw their price/earnings multiples expand over the prior three months and in the case of energy stocks, earnings also rose. This led to a 38% aggregate increase in the value of the energy sector in the first quarter. Energy stocks continued to benefit from the rise in oil and natural gas prices since the early days of the pandemic. The price of oil rose over 30% and natural gas prices increased over 50% during the first quarter of this year alone. Three of the top five largest positive contributors to the S&P 500 index were in the energy sector (Chevron, Exxon, and Conoco Philips). The worst performing S&P 500 sectors were communication services, consumer discretionary and technology (technology stocks had posted a double-digit percentage gain in the fourth quarter of 2021).

Foreign stock markets performed even worse than U.S. markets in the first quarter in general. The MSCI EAFE index measuring developed markets outside of the U.S. lost over 6% last quarter in U.S. dollar terms. The best international stock performance was in countries that have a high concentration in oil, gas and commodity businesses such as

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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Australia and Canada. Some of the worst performing foreign stock markets were in the countries that by contrast are dependent on importing energy products, for example Germany, Ireland and Austria. The Chinese stock market was among the worst performing stock markets in the first quarter amid new covid lockdowns in the country, which led to many manufacturing plants closing. The Russian stock market was closed for nearly a month. Many countries and companies are ceasing operations in Russia due to the war on the Ukraine.

BOND MARKET

The bond market, which is typically considered to be a safe haven when the stock market experiences turbulence, did not provide that security last quarter as interest rates rose significantly. (Bond prices fall when interest rates rise). In fact, the bond market as measured by the Bloomberg Aggregate Bond index, an index of domestic investment grade bonds, declined by almost 6%, worse than the stock market in the first quarter. We are still coming off a low interest rate base as the economy recovers from the pandemic. However, the first Fed Funds rate hike since 2018 has caused a rise in interest rates across all types of bonds and maturities. The Fed fund rate was raised 25 basis points to a range of 0.25%-0.50%. with a strong indication of many more increases to come in the near future. (To put in perspective how low of a base from which we started, the average Fed Fund rate since 1990 is 2.7%, if you go back to 1960, the average is 4.8%) The inordinate reaction in the bond market was to the Federal Reserve acting sooner and in larger increments than previously expected. The Fed is focused on trying to bring down a high inflation rate that hasn't been experienced in decades. Not only are they raising short term rates but they have also discontinued their buying of bonds (Treasuries and agency mortgage backed securities) which was part of the quantitative easing that was in response to the pandemic induced shock to the economy.

The 10 Year Treasury yield started the quarter at 1.52% and ended it at 2.32% and has continued to rise since then. Longer term bonds performed worse than the shorter term bonds last quarter as the further out the maturity the more sensitive a bond is to moves in interest rates. Municipal bonds and investment grade bonds were the worst performing bond sectors.

OUTLOOK

Stocks have remained resilient given the recent global developments and are following historical patterns. Usually, when there is a military conflict that involves the U.SA, there is an initial dip in prices with an eventual recovery. This pattern has been true since the second World War, which is as far back as we have good data. There have been other extenuating circumstances that have drawn out the recovery, such as the "Internet Bust" in the early 2000's and hyperinflation of nearly 15% in the 1970s. Even then, the recovery process only took a couple years to recoup losses; an opportunistic time for savvy investors.

While higher inflation seems here to stay, we deem the current 8.5% increase mild compared to the inflation rate in the teens during the 1970s. Recall that much of this increase is due to the pandemic, specifically in China, where they have mandated lockdowns. We conclude from our research that once the Omicron variant cycles through China, which will inevitably happen and happen quickly, that we will see a reversion to lower single digit inflation. The Russian invasion is a different story and seems more political in nature. Oil drillers are hesitant to drill given the murky future and the Biden administration has made it clear they are no friend to fossil fuel companies. Ignoring these facts, the USA is actually the largest producer of oil and gas and theoretically could be energy independent.

Bonds are not in a great position given The Fed's anticipated rate hikes. Our strategy with fixed income is to keep them high credit rating and short term. We are seeing yields nearing 3% for under 3 years, vs still about 1% for bank CDs.

The real estate market still confounds us as it continues to perform well. Commercial occupancy rates continue to stay steady around 12% around the country, down from a high of 17% and a pre-pandemic 10%, but Residential remains fairly hot. Our interpretation of commercial and retail space is that work life will be hybrid for the foreseeable future and people will continue to buy on line. Given rising interest rates, we would expect all markets to moderate. However, historically real estate is considered a good inflation hedge, which could continue to prop up asset prices.