

“You always reap what you sow; there is no shortcut.”

-Stephen Covey

The S&P 500 achieved bear market status this quarter, declining more than 20% from its record high set in January. Several factors led to the deterioration of stock prices but the most significant reason for the decline was the higher rate of inflation. Supply chain disruption, the war in Ukraine, and the consecutive series of fiscal spending programs to combat the pandemic slowdown were among the factors that helped to ignite the higher rate of inflation.

Inflation may have had the chance of simply being “transitory” if the Federal Reserve and/or the Federal Government had taken appropriate actions sooner. In the early months of 2021, there was evidence of an improving U.S. economy. In March of 2021, the unemployment rate had fallen from its recent high of 14.7% to 6%. By April 2021, the Consumer Price Index increased 4.16% (*see chart below*), its fastest pace since 2008. The Federal Reserve was adamant in its belief that inflation would mitigate on its own, despite economic theory that overly stimulative policies portend an economy to higher rates of inflation. Dismissing the evidence of higher prices as transitory, the Fed continued with its monetary policy of quantitative easing, adding \$900 billion in debt to its already expanded balance sheet and maintaining interest rates, the Fed funds rate, at 0%. This continuation of an easing monetary stance provided fuel to the already ignited fire of inflation. There was no hedge or, for example, any offsetting policy, in the case that its assessment of inflation as “transitory” was wrong. Adding more fuel to the fire, in March of 2021, the \$1.9 Trillion American Rescue Plan was approved by Congress.

U.S. Consumer Price Index



Source Bloomberg

During this time, the AHB investment team prepared for the prospect of higher inflation, higher interest rates, and higher commodity prices. During the past year, client portfolios in all AHB strategies have been positioned to withstand the possibility of a contraction in stock valuations and a decline in bond prices.

June 2022

Client portfolios reaped the benefits of what we sowed by our investment decisions. It is timely now to reflect on our recent quarterly commentary.

July 2021, Living and Investing During Rapid Change, “AHB’s macroeconomic outlook expects stronger economic growth to bring a return to a more normal, higher inflation rate and in turn, higher interest rates. As the market anticipates changes such as tapering of monetary and fiscal policy, investors will realign the valuation that they will be willing to pay for earnings growth when compared to the anticipation of a higher interest rate environment.

April 2022, Two Black Swans, “We have experienced very low interest rate rates during which investors were handsomely rewarded as valuations were able to expand. We may return to the days when investors must consider how their investments will beat inflation to maintain purchasing power. The move back to this normalized state will not be a straight line and will require an astute investment management team to delicately balance the portfolio to maneuver through the transition.”

In another version of reaping what you sow, the U.S. is now confronted with the concerning prospect of materially higher prices for longer because of both the monetary and fiscal policies that were implemented during the past year and half. The Federal Reserve has a mandate to achieve price stability and yet cannot solve supply chain issues or resolve the war in Ukraine. To reduce inflation to its 2% target, the Fed has stated that it will raise interest rates (the Fed funds rate) and simultaneously reduce its balance sheet by allowing a portion of bond holdings to mature without reinvestment each month. These policy actions are expected to moderate demand for goods and services enough to quell the rate of inflation. Although cliché, it is consummately appropriate to say, “better late than never.”

The stock and bond markets are forward-looking and therefore have begun to re-value on the basis that future U.S. GDP growth and corporate earnings growth will likely slow because of both higher interest rates and the higher rate of inflation. It has been an unusual investment period during which both stocks and bonds have both experienced negative performance for the year. AHB has positioned client equity portfolios to defend against this challenging environment by investing in sectors of the economy that are either recession resistant or beneficiaries of higher interest rates. Financial Services, specifically Insurance, as well as Health Care and Consumer Staples are areas of sector preference. Fixed income investors are dealing with the most challenging bond market in forty years because of the dramatic increase in interest rates in such a short period of time. Bonds have been reinvested in shorter maturities to protect client portfolios from the impact of bond price declines. This strategy has proven successful to ameliorate risk, while the capital markets adjust to higher levels of inflation. We expect to adjust the positioning of reinvestment maturities again when there is more clarity in the outlook for inflation.

In sum, global central banks policies to reduce inflation often result in an economic recession. Our team, with over 40 years of investing experience, recognizes both the difficulties and the opportunities for both equity and fixed income investments considering this possibility. We will monitor the dynamic situation and take action to achieve the long-term investment growth objectives for our clients.

Have a safe, healthy, and enjoyable summer.

AHB Investment Team