CETERA® INVESTMENT MANAGEMENT

COMMENTARY

January 31, 2022

Investors Position for the New Phase of the Economic Cycle

- The average daily trading range was high last week at nearly 3.5% compared to 0.97% in 2021.
- Investor concerns may be more about valuations rather than fundamentals.
- Volatility may remain as we enter a new economic environment with a less accommodative Fed.

We are now entering a new phase of the economic cycle. The first phase of the economic recovery was driven by a very accommodative Federal Reserve (Fed), which kept financing costs low in two ways. First, it cut the Fed Funds Rate to essentially zero, which did the job keeping short-term bond yields low. Additionally, the Fed went a step further and engaged in quantitative easing or QE. What this means is that the Fed bought long-term bonds, creating artificial demand and pushing down long-term bond yields and everything tied to them such as mortgages rates, long-term leases and corporate financing projects. This bond buying was very helpful because at the same time, the Federal government was increasing its debt and issuing long-term bonds to pay for massive amounts of stimulus. The economy was thus supported by both fiscal stimulus and the Federal Reserve.

Now, the Fed is becoming less accommodative. Their plan is to stop bond purchases soon and the first of many expected Fed Funds rate hikes is likely in March. The Fed is pressured to act soon due to how well the economy has rebounded, particularly the labor market. Given GDP growth rebounded from a low number, last year was the highest rate of economic growth since 1984 at 5.7%. In addition, the labor market is recovering with the unemployment rate under 4%, but more importantly wage inflation is rising. While supply-side disruptions are causing increases in inflation, there are signs that more persistent inflation, like wage and shelter inflation, are also on the rise. By becoming less accommodative, the Fed can slow down economic growth and inflation. The Fed didn't have to deal with high inflation in the last cycle. The consumer price index (CPI) climbed to 7% year-over-year at the end of 2021, the highest since 1982.

This is a pivot point for the recovery. The economy will soon be in an environment with higher short-term interest rates and likely long-term rates as well. This has many impacts as different companies and sectors do better in different interest rate regimes. In general, technology stocks have struggled when bond yields rise, because their future earnings are discounted more. More established companies that tend to have dividends and have decent earnings can perform better. Their future earnings are less uncertain than high growth companies. This new paradigm has investors rebalancing portfolios, analyzing the Fed's every word and reassessing corporate earnings forecasts. With all the new information, stock market volatility is climbing. The average daily trading range this week was nearly 3.5% (2.04% YTD), compared to an average of 0.97% in 2021. Huge swings from positive to negative and vice versa were experienced last week. Investors are weighing the headwinds and tailwinds carefully.

Headwinds

1. The Fed has communicated it will begin hiking interest rates soon and will stop its long-term bond buying program. Clearly, inflationary pressures haven't abated since December and the Fed will have to move faster than it previously anticipated.
2. While GDP growth was a whopping 6.9% last quarter, economic growth is expected to slow. If we dig deeper into the GDP growth number last quarter, much of this growth was driven by companies building inventories and this may take away growth from the first quarter of 2022. Some forecast that GDP growth could even be negative this quarter as we saw in Germany in the fourth quarter of 2021 because of similar reasons.
3. Corporate profit margins are at record highs, but companies are lowering future guidance or afraid to provide any guidance given rising wages and supply-side issues.
4. The geopolitical backdrop is worsening with Russia/Ukraine and China/Taiwan news adding to uncertainty.

Tailwinds

1. Despite the Fed's hawkishness, there is still significant stimulus in the economy that can be spent.
2. The consumer is in great shape with low debt/income levels and increased wealth. Consumers benefited from high savings rates early in the pandemic, recent stock market and home appreciation, and the ability to refinance mortgages at low rates.
3. The larger sell-off in riskier parts of the market suggests more of a valuations concern and not a concern around fundamentals.
4. Tight high-yield spreads also suggest there is no canary in the coal mine. Current spread widening was 0.41%. The average spread widening in the past five stock market corrections was 3.97%.
5. Inflation caused by supply-chain issues is anticipated to abate this year.

When we combine the headwinds with the tailwinds, we get a mixed outlook for equities and bonds and for this reason, we expect more volatility while investors get a clearer picture navigating through this new economic environment. We spoke about many of these factors in our 2022 Outlook and continue to watch these factors carefully. We do expect more volatility but still don't expect a big sell-off as we saw in early 2020. We maintain that diversification is the key in this market. In these times, your financial professional can help you stay focused on your long-term risk and return goals and help you with your personalized investment objectives.

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