MARSHALL & SULLIVAN
WEALTH MANAGEMENT

viewpoint

Spring 2022 newsletter

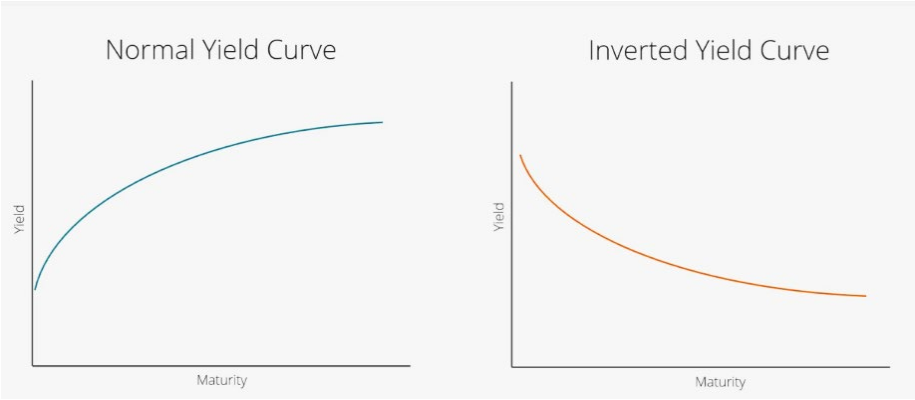
# Patience is Key

In our last newsletter, we suggested the Federal Reserve's inevitable rate increases would likely lead to a couple of 10% selloffs before year-end and provide us with opportunities. Overall, we expected the 2022 market to end up 5-7%, with most of the return coming in the fourth quarter.

A lot has happened since we wrote our last newsletter – Russia's invasion of Ukraine being at the top of the list. Yet our thoughts about the market in 2022 remain largely unchanged. Currently, we anticipate volatile markets during the first half of the year and higher Fed rates than originally expected. We still think the market will end the year ahead of where it started.

Oil prices have increased over 40% since the beginning of the year, causing inflation to run higher than expected and the Federal Reserve to lift short-term interest rates to slow inflation. This is causing two very different worries on Wall Street: First, is that the Federal Reserve might increase rates too high and cause a recession, Second, that inflation will continue at a high rate and cause investment income and returns to lag.

A common indicator used to predict a looming recession is an inverted yield curve because it reflects nervous investors. Under normal conditions, fixed-income investors are rewarded with higher yields by purchasing bonds that mature farther out in time. The relationship between yield and maturity is often shown graphically as an upward sloping yield curve. When this relationship reverses, we have an "inverted" yield curve with short-term bonds pay higher yields than long-term bonds.




Most market watchers keep an eye on the relationship between 2-year Treasury vs. 10-year Treasury as a leading indicator. If the yield curve inverts, like it is today, it may signal a recession. While there is historical significance to using this inverted yield curve as a gauge for the economy, it is far from perfect. Indeed, even if a recession does occur, it typically lags 12-24 months after the inversion. It's hardly an exact science.

With the 2-year Treasury vs. 10-year Treasury yield inverted, several financial pundits are forecasting a recession. We think that call is premature. One reason is because we believe the relationship between the 3-month and 10-year is a better predictor. We have not seen the two invert yet.

If the Federal Reserve continues to raise short-term rates in its attempt to cool inflation, we could see a broader and deeper inversion – particularly if they do it too quickly. We feel such an inversion would be short-lived and unlikely to predict a recession. This is because of the strength of the economy and our record low unemployment rate.

The more immediate concern for the economy is probably inflation – a little bit is good for investors, but a lot is bad. The current inflation rate is hurting longer-term bond positions because it puts downward pressure on their valuations, causing returns to be lower than the inflation rate. Therefore, we are continuing to stick with shorter maturities for our clients.

The best guard against inflation is to own companies that can increase prices as their cost of goods rise, have growing earnings, and are fairly valued. This is what we will be focusing on when adding to portfolios. With the war in Russia and the Fed raising rates, we expect the resulting volatility to provide ample opportunities to purchase good companies. The key to this year is patience.

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