MARKET REVIEW AND OUTLOOK

First Quarter 2022

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Market Review

The first quarter of 2022 saw a retreat from 2021's positive market performance with the S&P 500® index down 4.6% and volatility returning to the market. Small-cap growth experienced the largest quarterly loss, while large-cap value faced the least amount of damages among domestic equities. Rising interest rates particularly hurt growth, as valuations on information technology had reached elevated levels.

Within fixed income, longer-duration bonds faced headwinds, but short-duration bonds, including bank loans, were generally flat.

Outlook

Inflation has been running at its fastest pace in four decades, and it's become a multifactor problem that will require multiple solutions—a Herculean job that threatens to overwhelm the Federal Reserve (Fed). The sticky inflation issue has been a result of many fundamental and geopolitical disruptions, including supply-chain woes, elevated oil prices, shifting consumer demands, and now the Russia-Ukraine war.

The question everyone has been asking is how to properly knock down inflation, especially in a pandemic-driven world. The pandemic led to business slowdowns and shutdowns, leading to a shortage of goods that people want to buy. Next, transporting those goods turned out to be complicated by the lack of infrastructure investments. This underinvestment issue has been evident by the slow progress in the supply-chain recovery, which has been a major reason for this stubborn inflation that few had predicted.

Energy and gas prices also have fueled price increases. Even before the Russia-Ukraine war, energy and gas prices were on the rise and becoming a global economic threat. Now, sanctions on Russia have further driven up prices on oil and other commodities, including wheat.

Finally, China's heavy-handed COVID-19 strategies have been an important additional factor to global inflation.

So, what has kept the economy stable? It's low unemployment, which suggests people still have money to spend. But again, this situation has led to more inflation, since the consumers have had only a few places to spend their savings.

With so many factors pushing prices higher, there is no simple solution to fix today's rising inflation. The Federal Reserve has started its interest-rate hike regime, and the balance-sheet quantitative tightening is expected to be not far behind.

Raising rates would make borrowing more expensive, which means less spending and less demand for large-ticket items such as houses and cars. The problem with addressing inflation with rate hikes is that it takes time before these hikes are felt through the broader economy.

Recently, more Fed members have spoken with a hawkish tone to, in part, dampen fear of continued increases in inflation. When everyone anticipates a rise in inflation, businesses and workers tend to charge more, self-perpetuating the cycle. The idea is to reduce this expectation of future inflation before it spirals out of control as it did in the 1970s.

But a danger in this hawkish strategy is that it could lead to the Fed moving too aggressively on rates, which could risk the chances of a soft landing where the economy and inflation are slowed to a manageable pace.

While the Fed tries to adjust inflation expectations, there is very little it or the White House can do about price increases caused by supply-chain disruptions, COVID-19 variants, and a war in Ukraine. As we said, today's inflation has been caused by multiple factors and will require a multipronged and potentially painful solution, which will likely include raising interest rates, quantitative tightening, fixing supply chains, getting COVID-19 under better control, and, hopefully, ending the Russia-Ukraine war.

Those are a lot of moving parts. In the coming months, it will be interesting to see if they will work together to bring down inflation while keeping the economy healthy.

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