

As we move through this year... if things develop as expected, we'll be normalizing policy, meaning we're going to end our asset purchases in March, meaning we'll be raising rates over the course of the year... At some point, perhaps later in the year, we will start to allow the balance sheet to run off and that's just the road to normalizing policy.

Jerome Powell, Federal Reserve Chair Testifying in
Senate Confirmation Hearing, 01/11/2022

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In the 1st quarter of 2022, both stocks and bonds had negative returns. The U.S. stock market, as measured by the S&P 500, with dividends, lost (-4.6%). At its low during the quarter, the S&P 500 was down (-12.26%). The U.S. bond market, as measured by the Bloomberg Aggregate Bond Index, with interest/dividends, lost (-5.93%). That was the largest quarterly loss in the Aggregate Bond Index since 1980.

During the quarter inflation continued rising, with the increase of prices as measured by the consumer price index (CPI) reaching 8.5% year-over-year in March. The Federal Reserve (the Fed), responding to the inflation numbers, tapered its bond purchases/quantitative easing and raised its Fed funds overnight interest rate by $\frac{1}{4}$ of 1%, moving the range from the 0% - 0.25% level established early in the pandemic to 0.25% - 0.50%. On February 24th Russia invaded Ukraine, creating a humanitarian disaster and exacerbating the inflation surge by driving up the prices of energy, food and various metals.

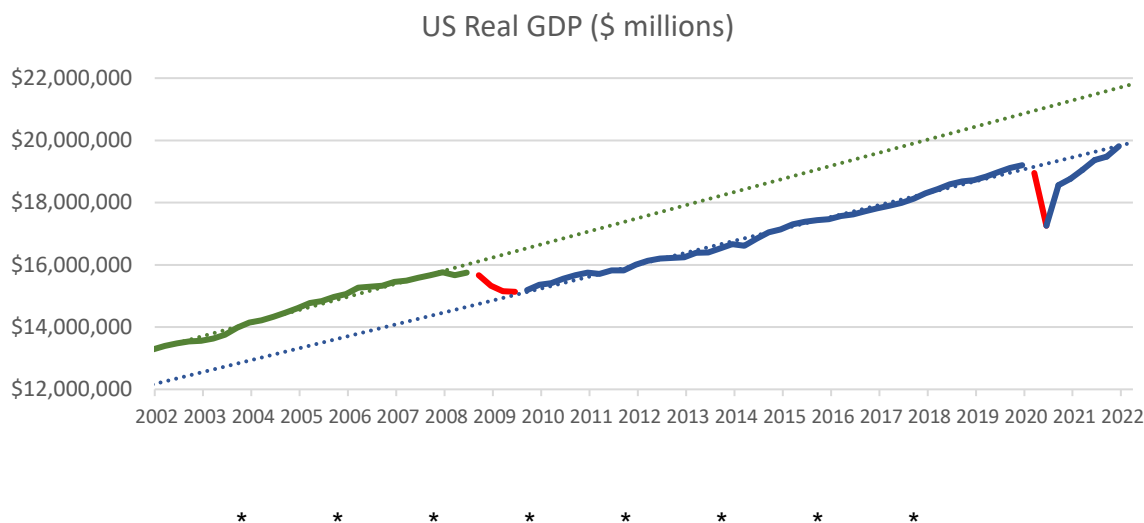
On the positive side of the ledger (though with its own inflationary impacts), the US unemployment rate dropped to 3.6% in March. There have been 11 straight months of over 400,000 job gains and there are still reported to be over 11 million unfilled job postings. Also, importantly, higher interest rates lead to higher future returns on cash and bonds. The Fed's suppression of interest rates, while supportive in a financial crisis, encourages misallocation of capital over time through higher risk taking and speculation, distorting market price signals and lowering the bar for future returns as investors reach to just earn something on their capital.

The last time both stocks and bonds dropped in value in the same quarter was in the 1st quarter of 2018. Not surprisingly, the Federal Reserve was raising interest rates at that time as well. In that rate hike cycle, the Fed also started from a 0% - 0.25% rate on the Fed funds, the level they established in the depths of the Great Recession in December 2008. Seven years later, in December 2015, they started hiking rates in $\frac{1}{4}$ of 1% percent increments until stopping at a 2.25% - 2.50% Fed funds range in December of 2018.

While the Fed has only raised interest rates one time so far this year, the bond market, based on forward guidance and commentary from the Fed, has already driven market interest rates higher. For example, the 2-year U.S Treasury note interest rate has already moved from 0.73% at the end of last year to 2.41% as I write this on April 12th. Likewise, the 10-year U.S. Treasury note yield has moved from 1.52% at the end of last year to 2.78% as of April 12th. Effectively, the market has already been creating the space for the Fed to take the Fed funds rate up into the same 2.25% - 2.5% range that it reached in 2018 (over a year before the pandemic sent the Fed into its latest easing cycle). For reference, in 2018 the 2-year U.S. Treasury rate briefly spiked up to a high of 2.98% and the 10-year rate briefly hit a high of 3.24%. In 2018, both the 2-year rate and the 10-year rate peaked before the Fed made its last rate hike of that cycle.

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I am pleased to note that the U.S. real (inflation adjusted) economic growth rate recovered to its pre-pandemic trendline in the 4th quarter of 2021. In my last couple of letters I have been tracking its progress to see if we would avoid the material loss of future growth that our economy experienced coming out of the Great Recession. As I stated in Peak's 1st Quarter 2021 Client Letter: *From where I sit, it is evident that policy makers, from both the Federal Reserve (the Fed) and the federal government, as demonstrated through the historic size and persistence of their stimulus programs, are committed to helping the economy avoid ratcheting down to a lower economic growth trajectory coming out of the pandemic recession.* Even though we are a long way from knowing if we will be able to sustain the trajectory over time, it is an impressive and necessary accomplishment to at least have that potential.



I started this letter with some comments from Fed Chair Powell about monetary policy “Normalization.” In a chaotic and complicated world, that word is always amusing to me. I picture the Federal Reserve Board of Governors working through a group visioning session defining what “normal” is and how to get there. In economic parlance, Chair Powell would probably say that normal is perched on the fulcrum point where monetary policy is not impacting the economy, where it is neither accommodative to nor restrictive of additional economic activity. Of course, they don't really know where that point is. Lately, I have been hearing/reading versions of a Wall Street expression that goes: “The Fed will tighten until something breaks.” Ideally, it would be inflation that breaks before the economy is sent into a recession.

In the last tightening cycle, I remember feeling like something was broken in the 4th quarter of 2018 when the stock market dropped (-18.93%) right into Christmas Eve. There were no more rate hikes after that. To be frank though, that was more like a sprain than a break. I think this time the Fed hopes that normalization means it can tighten policy enough to convince the naysayers that it is serious about halting an inflationary spiral without having to break anything too badly. Given that the Fed's monetary tools do not effectively address inflationary pressures from either the war in Ukraine or COVID induced supply chain disruptions, I know it (and the rest of us) is hoping those pressures will abate before it has to cross the line from removing accommodation to becoming truly restrictive, or before it needs to really smash something.

We hope this letter finds you and your family well. We appreciate your business and we continue to work hard to earn the trust that you have placed in us. Please let us know if you have a friend or a family member who could use our assistance.

John McCorvie, CFA