INVESTMENT INSIGHTS

Market Outlook

April 2022

Markets Shifting Gears on Inflation Outlook

Market/Economic Update

For the better part of thirty years, inflation has been "the last war" as technology driven productivity gains and globalization have worked in concert to keep both consumer prices and wages in check. The inflation rate would reach the 4-4.5% level on occasion triggering modest rate hike cycles by the Federal Reserve which readily brought the situation under control. In fact, deflationary threats from the global financial crisis in 2008 and Covid-19 more recently have been of greater concern for investors until now as a combination of factors have pushed inflation to its highest level since the early 1980s. Supply chain bottlenecks and tight labor markets are both Covid related factors that have contributed to this. While the supply chain situation should improve in the second half, higher wage levels are likely here to stay with unemployment edging below 4% in recent months. These issues were of concern to investors prior to the Russian invasion of Ukraine which has exacerbated conditions by pushing energy and commodity prices higher causing a stock market pullback. Investors are adjusting accordingly to an environment where profit margins are likely to be lower because costs of doing business have risen.

With these shifting expectations on inflation, the Federal Reserve has begun to nudge rates higher and has indicated that this process will continue in earnest over the course of the year. As a result, the yield curve has flattened between two year and ten year maturities which has generated much speculation about what the risks are for recession in the months ahead. The relationship between short and long term interest rates is an important one because it reflects bank profitability from lending and the prospects for future credit activity which is a key economic driver. Yield curve shape has been a useful indicator which should be watched carefully as it has inverted 28 times since 1900 with 22 episodes foreshadowing a recession.

This is certainly helpful information in terms of flashing a yellow light of sorts, but it is a single piece of data that needs to be put into the context of the broader economic environment in order to become actionable in managing portfolios. It is important for us as investors not to anticipate events when making decisions as the burden of higher capital gains taxes and opportunity costs can derail clients from achieving their long term goals. We prefer to take a weight of the evidence approach that incorporates additional factors including labor market conditions, consumer attitudes, industrial production and corporate earnings that will confirm that the economy is slowing down in order to maximize the potential to add value for clients. The yield curve is a leading indicator with some variation in timing due to the amount of economic momentum that is present when the curve flattens. History tells us that the economy can continue to perform well for several months when the curve is flat and that risks increase when the Fed is no longer confident in raising rates. These important junctures typically present some broader deterioration across a variety of economic indicators and we have not yet reached that point in this economic cycle. As a result, some profit taking to realign asset allocation strategy with long term objectives is warranted given the amount of market appreciation that occurred in the Covid recovery rally over the last two years, but it is likely premature to shift to a more defensive posture until some erosion is seen in other leading and coincident indicators. With that said, some measure of caution is warranted with regard to more speculative high growth, high valuation companies where the potential for PE multiple compression is high.

— Charlie Mathews, CFA

Inflation is no longer the last war as Covid has impacted the supply chain and labor markets.

War in Eastern Europe has pushed energy and commodity prices higher.

Investors are adjusting expectations to the new environment.

Fed policy shifts toward an inflation fighting posture.

Yield curve shape has been a good predictor of future economic activity.

Risks are heightened when the Fed is no longer confident in raising rates.

Bank of New Hampshire
WEALTH MANAGEMENT

INVESTMENT INSIGHTS

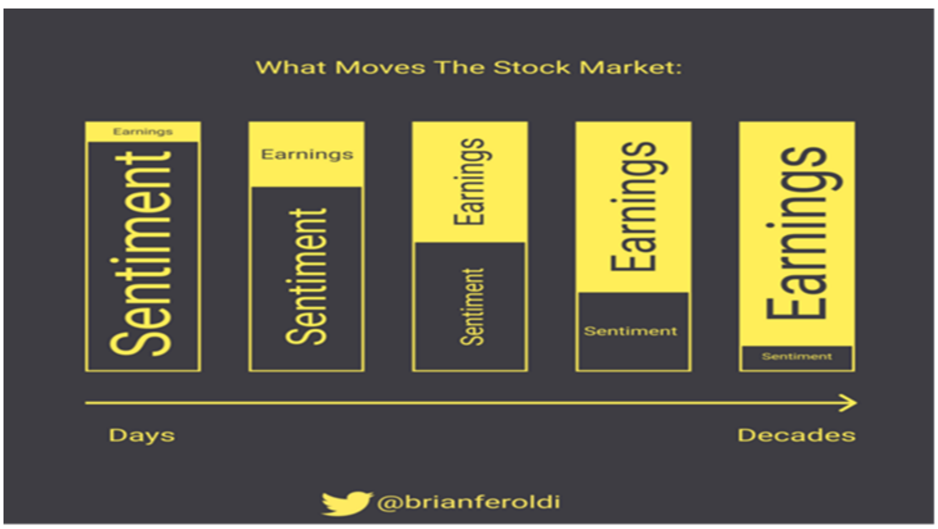
April 2022

Equity Markets

Stocks have had a turbulent start to the year as geopolitical turmoil, rising inflation pressures, supply chain imbalances, and central bank monetary tightening all create challenges for financial markets. The decline in prices across markets marks the worst quarter for stocks in two years. The tech heavy NASDAQ lead the downturn with a -8.9% return. Small Cap and midcap companies were down -7.5% and -4.9% respectively. Large cap names, as measured by the S&P 500, had the best return of the group only down -4.6%. International markets were solidly in the middle with developed international down -5.8% and emerging markets with a -7.0% return.

Oil prices extended a streak of recent swings, with WTI crude oil futures ending the quarter around $100 per barrel. Consumers are feeling the effects of inflation, which will begin to effect overall economic activity. However, in the final two weeks of the quarter, global markets shrugged off news out of Ukraine, suggesting investors are putting headlines related to the conflict on the back burner, for now. The majority of indices have fully recovered all of the losses they experienced since the beginning of the invasion on February 24th, which has brought them out of correction territory.

As we look forward, volatility in the markets will likely continue as investors digest headlines about the same headwinds mentioned above. Market participants are nervously eyeing a flattening U.S. Treasury yield curve in the near-term that creates a clouded macroeconomic outlook over the longer-term. It's very dangerous at this point to use historical episodes of yield curve inversion to try to predict what will happen now and in the future. What we do know about equity markets is that in short-term time periods they react to sentiment driven by headlines. Sentiment over the long-term eventually gives way to a focus on corporate earnings.



Our investment process is designed to build portfolios with this same earnings focus. One of the primary factors we review in constructing portfolios is the quality of earnings provided by companies we invest in. Over the course of the next several months, we would expect markets to trade in a narrow range until some of the challenges begin to subside in the second half of the year, and this should provide the market the opportunity to move to higher levels as we close out 2022.

— Robert Magan, CFA

There are many headwinds that are challenging financial markets.

Inflation pressures will change consumer behavior.

A flattening US yield curve does not forecast an immediate recession.

Sentiment moves markets in the short-term, while earnings move them over the long-term.

Look for markets to trade in a narrow range, as headwinds subside. Markets should move higher in the 2H of 2022.

INVESTMENT INSIGHTS

APRIL 2022

Bank of New Hampshire
WEALTH MANAGEMENT

Credit Markets

Inflation is at a 40-year high, volatility is elevated, fixed income liquidity continues to wane, and the US Treasury yield curve has inverted. The Federal Reserve is on pace for rapid-fire increases in their overnight rate as well as reducing the size of their balance sheet to speed up the tightening process, and bonds had their worst quarter in decades. Yet, rates going higher can have positive effects. It can correct a housing market that is overpriced and squeezing out large segments of the populace, and it allows other areas of the economy to become more competitive and balanced.

Yields on Treasurys have logged their largest increase in decades, with the 10-year yield rising the most since 1994. The municipal market ended its worst quarter in about 40 years with a -6.4% loss, particularly unsettling as this is an asset class favored for its stability. Municipal bonds had become more attractive over the last year as their tax-equivalent yield grew more favorable compared to taxable bonds with the likelihood of increased taxation on the wealthy. However, this demand source was not enough to stem the selling of long-dated bonds by institutional investors anxious to protect themselves from rising rates. Lower quality junk bonds were also hurt as they suffered their worst losses in two years while continuing to be the best performing sector in fixed income. The Aggregate Index, comprised of higher quality bonds of various types, posted a -6% loss for the quarter. While current holdings have suffered, we are now able to purchase new bonds at higher yields.

Once it was apparent that the Fed would raise rates and that longer rates were likely to increase to reflect real inflation and growth, some longer duration bonds were sold in portfolios. Rather than redeploy all of that cash right away, some proceeds were held until higher yields started to materialize. As this process played out, we enhanced portfolios with floating rate funds and shorter maturity bonds at more attractive levels to offer some protection against rising rates.

Despite these setbacks, there are still advantages to investing in bonds. While it's difficult to know where yields may end up, the hope is that the Federal Reserve will move with transparency and a good sense of balance by raising interest rates quickly enough to stem the current inflation pressures, but not so quickly that the economic recovery is thwarted. With all of the geo-political and economic headwinds, we should expect it to take a period of time before things such as inflation and other aftershocks of the pandemic normalize. We expect volatility to remain elevated and for rates to ultimately end up higher over the longer term, and it's likely that most yield curves will remain range-bound. The United States is still considered a safe-haven for investors given its market liquidity and relatively stable currency which makes it the global market of choice in uncertain times. It's too early to tell if the Treasury curve will remain inverted, foretelling a possible recession, but for now it presents some real opportunities as we continue to navigate this ever-changing landscape.

— Dona Murray

Rising rates have led to declines in market value for fixed income securities.

Opportunities to purchase bonds with more yield exist for investors as older bonds mature.

Yield curve inversion can often foretell a recession, but it is too early in the cycle to make any predictions.

The Federal Reserve must find the balance between raising short term rates aggressively enough to dampen inflation without causing recession.

With an economy in flux, it will be important to remain nimble in finding value.

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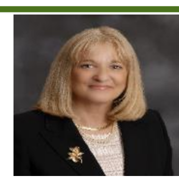

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