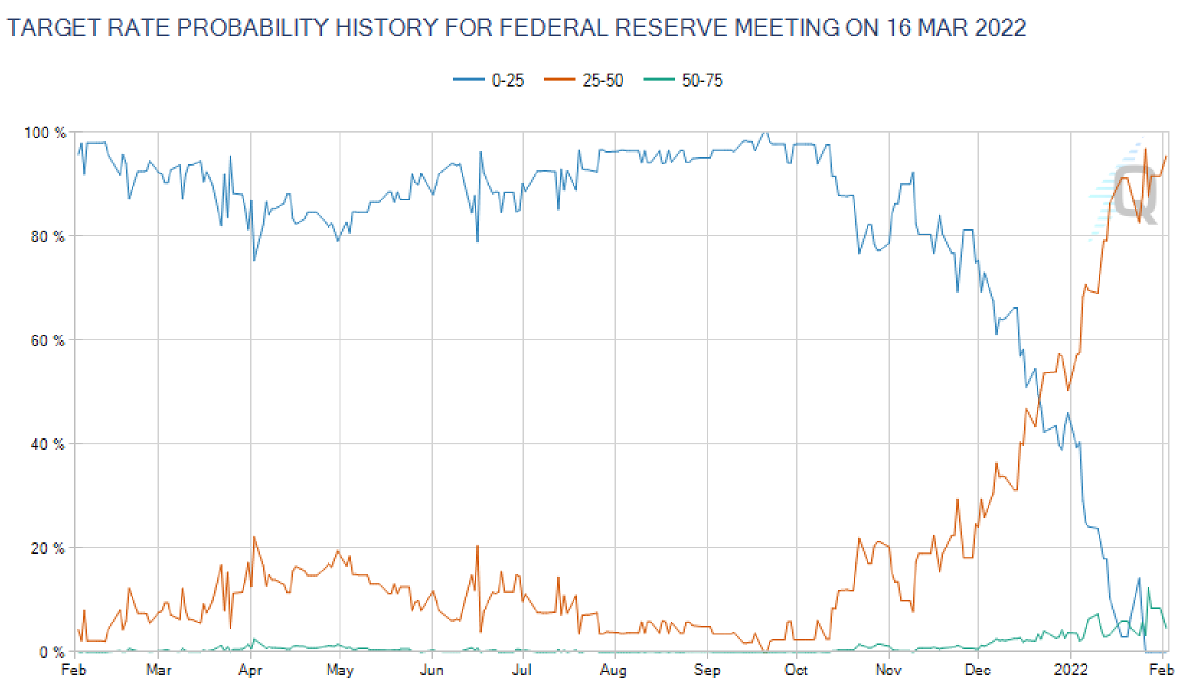
Market Commentary: Readjusting the Lens in Looking Past Current Market Headwinds

January 2022

The market has become quite complicated lately, with several negative events coming to the forefront of investors' focus, muddling the near-term picture. Here we zoom out to see the big picture and look at some of the primary story lines that the market has had to digest. We're interested in how these issues may affect the market long-term.

- **Upgraded inflation expectations: A hawkish Fed**. In late 2021, the Fed dropped the term transitory from their analysis of inflation. The term "transitory" itself is problematic as the time frame is not defined. Is transitory a month? A year? A decade? Fed Chief Powell briefly tried out "Intransigent" which feels more problematic then "transitory," but still does not provide a definition of the time frame. While the conversation about where inflation is going is an extremely complex and interesting one, the market's view of the Fed's direction is quite straight forward: up! Tightening credit is having predictable short term effects on the market with expectations of slower growth and an increased drag on valuations (note page 4 of our most recent Exploration which explains how increased interest rates negatively affect equity market valuations).

The following chart shows how quickly the market repriced expectations of a Fed hike in March 2022. As can be seen, for most of last year, the market was pricing in a 0% - 20% chance of a fed hike by March. From December on that probability increased to 100% with some low chance of a 50 bp rate hike:



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[1] Countdown to FOMC: CME FedWatch Tool (cmegroup.com)

- **Rotation out of Growth: The social distance rally is done**. A "lockdown" in the US was partially achievable through the incredible innovation developed over prior decades. We really can do everything from home! Need to converse with colleagues / workers? Zoom. Want to work out in style? Peloton. Need any product on Earth from the comfort of your own home? Amazon. The list goes on. The tremendous rally in tech-focused products (which tend to have growth-oriented characteristics) began petering out with the availability of vaccines and the reopening of the world.
- **Mature market leaders turning over: META (formerly known as Facebook), NETFLIX**. To add to the complexity of the moment, recent market leaders such as Meta and Netflix, the "F" and "N" of "FAANG"[2] stocks, both have dropped roughly 40% from their highs as both have had difficulties lately growing their active user base.
- **Geopolitical rumblings: The Russian gambit**. Exacerbating both inflation and the general market move is the fact that Russia is amassing troops on its border with Ukraine. If it is going to happen, winter is the period to attack because frozen ground makes transportation of heavy equipment way easier. We believe the only army in history crazy enough to attack in that region during the summer season were the Mongols. They were successful. Ukraine is the poorest country in the region and has limited trade with the US. The much bigger issue would be how to deal with a Russia that provides natural gas to Europe and about 12% of global oil[3]. That is their trump card. With inflation already raging, increasing energy prices is something that developed markets are definitely more sensitive to at the moment, never mind the obvious implications of an aggressive Russia generally.

Any one of the above-mentioned events could alone have created a market swoon. Yet, when we readjust our lens further out, we realize there are characteristics of each that lend to the natural longer-term health of the economy and capitalism in general.

In an earlier Market Commentary, we had noted that one big inflationary concern was the $4 trillion government bailout put in place to counter-act the deflationary characteristics of Covid. The Fed at the time also dropped the federal funds rate to 0% and started an asset purchase program. We mentioned how hard it would be to get right. And in fact, depending on whom you ask, a significant portion of the current inflationary pressures we are feeling can be traced right back to the bailout – which we would opine was necessary. Well, now the Fed is attempting to normalize interest rates and let natural markets resume their role as asset purchasers. This is good for the market longer term and while there will be market valuation pressures due to a tightening cycle, part of the story line provided by the Fed is a growing, healthy economy.

Similarly, the amazing innovations that have increased global wealth, coupled with intense competition—ultimately the way healthy, capitalist-based economies are supposed to work—have resulted in the pressure we are now seeing on Facebook and Netflix. Simply stated, competitors have caught up to the leaders. This is healthy.

While there is no doubt there are a number of near-term headwinds, as well as a real unknown about how Russia may proceed, when we focus on the longer-term trends we believe they point toward increasing innovation. This generally translates into increasing global wealth and, at least in the developed world, an aging demographic with a high government debt load, which tends to correspond to deflationary rather than inflationary trends.

[2] Facebook, Apple, Amazon, Netflix, and Google collectively assisted in leading strong market returns over recent years based on their dominating position in their respective industries.
[3] Russian oil industry - statistics & facts | Statista