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FFG Market Pulse Newsletter, Q1 2022

The market as measured by the S&P 500 ended the first quarter with a 4.9% loss. This is the worst performance for the market in two years, ending a seven-quarter winning streak. Throughout the quarter the market experienced historic levels of volatility with daily swings of 2% or more not out of the norm. Leaving our desks, even for a minute, became a serious risk as the market swings were increasingly becoming more extreme and unpredictable. This was partly due to the growing levels of uncertainty that surrounded the market and economy starting towards the end of last year.

Since Covid-19 struck in March of 2020, the global markets were in consensus as to what the future was going to look like. At first, we were all doomed, and the markets reflected this outlook by basically going straight down. However, after some time, the markets reassessed the situation and determined that all hope was not lost. With the aid of cheap money and more effective medical therapies, the consensus shifted to one of unbelievable positivity. There was little disagreement in the market, which led to some of the best returns for back-to-back years in recent history.

However, towards the end of last year, the market consensus began to break down and uncertainty started to creep in. It was the first time in two years that the outlook for the general market was particularly unclear. It all started with elevated inflation readings that nobody wanted to believe were real. Rhetoric from the Federal Reserve was so untethered from reality that many investors had no choice but to question it. Serious debate started to ensue, and a divide began to form between different factions within the market. Some clung to the “transitory” narrative where inflation would quickly recede, and Fed intervention would be minimal. While others were convinced that inflation was here to stay in a big way and the Fed would need to be extremely aggressive in its pursuit to end it. The market became uncertain, and its members were forced to choose a side. This uncertainty was a major contributing factor to the volatility that began late last year and escalated during the first quarter of this year.

It is now clear that inflation has resurfaced, a phenomenon that has not been experienced in a major way for over 40 years. Supply chains breaking down due to the pandemic, increased demand from consumers and shortages of basic commodities such as food and energy from the Russian-Ukraine war have all contributed to the current inflationary environment. Unfortunately, it is difficult to envision these issues abating, let alone reversing, anytime soon. The near future looks similar to the recent past with nothing, outside of a severe shock to the system, changing that. We have therefore continued to position the strategy in a way to take advantage of the current dislocations in the global economy. We still have significant exposure to energy, agriculture, and commodities, as we believe these sectors will continue to benefit from an inflationary environment and supply chain disruptions. This has allowed us to sidestep much of the downward pressure that was experienced in the market so far this year.

The biggest risks on the horizon include continued and escalated food shortages and inflation, persistently high energy prices and a decrease in consumer demand. All three are key factors on their own and together their impact is immeasurable. Their interdependence is so significant that a deterioration in any one of them can create a downward cascading effect in the others. Food shortages would destroy consumer confidence, while higher prices for food and energy would deplete savings and limit discretionary spending. At

the same time, the Fed is signaling an aggressive approach to tightening the economy to try and battle inflation. This could also dampen economic activity and aggravate the factors mentioned above, quickly leading to severe demand destruction and social unrest across the globe. We are watching these factors closely and expect things may get worse before getting better.

At the risk of sounding like a doomsayer there are some positives in the current environment that may temper the negative effects of rising interest rates and high inflation. The US economy, led by consumer demand, is still extraordinarily strong. The job market is recovering, with unemployment approaching pre-pandemic levels, and hiring activity continues to accelerate. Real yields, that is after accounting for inflation, are still substantially negative, maintaining the easy money environment even after the recent rise in interest rates. Investment options are still limited with few alternatives outside of common stocks. If the Fed is able to thread the needle and raise interest rates enough to dampen inflation without destroying demand, we should see some more upside in the markets.

With so much uncertainty in the world, we have positioned the strategy to take advantage of whichever scenario unfolds. If inflation stays elevated and food shortages persist, we should continue to benefit from our energy, commodity, and agriculture exposure. However, if the Fed pulls off a miracle, our core holdings would likely outperform. Although the probability of a recession occurring has increased, we do not see signs of imminent demise on the horizon. We are optimistic regarding the strength of the US economy and its ability to withstand significant outside pressure before buckling into a recession.

Yours Truly,

Gabriel Levy, CFA
Portfolio Strategist, Fiori Financial Group

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