HALLMARK CAPITAL MANAGEMENT

Hallmark Capital Management, Inc.
888-794-7940
www.hallcapmgt.com

ECONOMIC AND MARKET LETTER - SPRING 2022

THE WALL OF WORRY GETS STEEPER . . .

As the pandemic started to recede, returning to a more normal life finally seemed within our grasp, but once again events intervened. It's often said that "life is what happens when you are making other plans." Russia's invasion of Ukraine upended many rosy projections for 2022, horribly so for too many Ukrainians. Undoubtedly, the world will feel the ramifications of the war for some time and the full effects will only be completely understood years from now by future historians. We will leave geopolitical analysis to the foreign policy experts, but we have been forced to focus on the potential economic and market effects of the invasion.

The immediate leap in gasoline prices and the worsening rate of inflation were clear for all to see. Oil prices shot up almost 39% in the first three months of 2022, helping to push the Consumer Price Index (CPI) to the highest year-over-year gains in forty years. Agricultural prices also jumped, since Russia and Ukraine are each important grain exporters. Unfortunately, the war's impact on U.S. inflation has yet to be totally reflected in the widely followed inflation statistics. A large portion of the spike in gasoline prices occurred in the second half of February and they were not included in the Consumer Price Index (CPI), which is complied mid-month. These higher oil prices should show up in the March numbers, so we are braced for the possibility of even higher inflation numbers in that report.

Of course, inflation was already rising too quickly, even before the war, COVID's havoc on global supply lines doesn't look to be disappearing any time soon, with China's leaders shutting down entire cities again due to new Omicron outbreaks. Prior to the war, oil prices already were rising due to the increased reopening demand from commuters returning to the office and travelers booking long-delayed vacations. Shortages of semiconductors continue to impact production delays in everything from autos to appliances. New home construction had lagged population growth since the Financial Crisis, leading to higher inflation in rents and real estate. None of these issues are likely to be resolved in the next few quarters, which puts additional pressure on the Fed to act.

. . . AS THE FED TIGHTENS ITS GRIP

Given how unusual the past two years have been, policy makers at the Federal Reserve have had their hands full. They spent most of 2021 hanging back, hoping that as the economy returned to "normal" that pre-pandemic disinflationary pressures would begin to reassert themselves. All these hopes were dashed, however, after the invasion of Ukraine. The Fed needed to shift gears and move quickly.

Their first step was announced in their March press release, when the Open Market Committee announced a 0.25% rise in the Fed Funds rate and indicated that additional increases were likely this calendar year and next. Initially, the investment community assumed that these increases would be made in 0.25% increments. Within days of the FOMC meeting, however, Chairman Powell signaled that policy makers would consider larger, half-point increases at the next two meetings. This more hawkish announcement was a surprise and the financial markets immediately repriced assets to account for higher interest rates. Futures markets have placed a 90% probability of a half-percentage point move in May, with similarly high odds for another 50-basis point increase in June. Bond prices fell as interest rates moved up, and by March 31, the overall fixed income market had posted its worst quarterly results in four decades.

While investors have been focused on the potential size of future rate increases, less attention has been paid to another aspect to monetary tightening. It had been previously announced that the Fed's massive Quantitative Easing program (QE) would be wound down, under which the Fed had been purchasing billions of dollars a month in fixed income securities. Based on comments from officials, it now seems likely that the next move will go beyond just refraining from additional purchases, to actually shrinking the Fed's balance sheet. Foreign central bankers also indicated a similar change in policies. In February, the Bank of England started monthly sales of £20 billion, and the European Central Bank and the Reserve Bank of Australia also signaled some degree of quantitative tightening was imminent. Since there were no previous instances of such massive QE, there also are no guideposts on how the combination of higher interest rates and Quantitative Tightening will act on the economy. Investors may have anticipated some level of Quantitative Tightening, but globally the central bankers seem more aggressive than had been anticipated.

The world's central bankers are walking a very narrow tightrope. If their policies are set correctly, economic growth would slow, but remain positive. If monetary tightening goes too far, however, then a recession would be likely to follow. Many investors are highly skeptical that the Fed will find the sweet spot this time, since their track record during past monetary tightenings isn't stellar. Monetary policies act with a significant lag, so by the time that tougher monetary policies have taken effect, the risks of going too far also rise. Fortunately, investors are forward looking, however, and financial markets tend to anticipate much of the impact of changing monetary policies. Buried within market action, therefore, measures might be found to determine how likely a recession may be. Currently, the topic obsessing many investors is the shape of the yield curve, which has had a good record of accurate recession predictions. This was also the discussion of our recent monthly comments.

LOOKING FOR CLUES IN THE YIELD CURVE

Typically, interest rates on bonds get progressively larger as the time until maturity lengthens. This relationship makes sense, since the chance of an unhappy surprise occurring anytime in the next ten or fifteen years tends to be higher than something bad happening within a few months. Movements in the relationship between interest rates and maturities can indicate whether the market's outlook on the economy has changed. As the yield curve steepens, interest rates shift progressively higher across the maturity spectrum, which can imply an outlook for stronger economic growth and higher inflation risks ahead. A flatter curve suggests the opposite. If longer-term bonds start to yield less than shorter-term bonds, however, that may be a warning than investors have much, much lower confidence in the economy, with higher chances of a recession around the corner. Each of the last six recessions started between six months and two years after the yield curve inverted, although the last case was a bit unusual. The spread between 2-year Treasuries and 10-year notes inverted in August 2019 seven months before the March 2020 pandemic downturn. We are strong believers in the wisdom of crowds, but there were no cases of COVID-19 before November and investors couldn't have anticipated the outbreak that far in advance. Of course, we will never know if a recession would have occurred without the coronavirus lockdowns, so it is possible the signal would have proven to be correct.

Throughout the pandemic, the yield curve has been remarkably flat, with very little incremental return from longer-term bonds. That was consistent with the outlook on a longer, slower recovery, based on the difficulty of coping with ever-evolving variants of the virus. Things changed this March, when various portions of the yield curve inverted, first with the yields on 5-year Treasury notes moving below 10-year yields, followed shortly afterwards by 10-year yields falling below 2-year and 3-year Treasuries. Then, the spread between the 5-year and the 30-year Treasury notes inverted for the first time since February 2006. Bears have become far more vocal as a result, as many investors reassessed their outlooks.

TROUBLE WITH THE CURVE?

An inverted yield curve tends to have a long lead time in calling an economic downturn, sometimes longer than four years. According to figures from Bespoke, the previous six times that the 10-year Treasury yield inverted from the 2-year Treasury note yield, on average, stocks rose 4.8% over the next six months and 13.3% over the next twelve months. The worst return from the sample was a decline of only 2.5%. The last four times the 2-10 curve inverted; stocks were up an average of 28.8% before they peaked. One could make the argument that, at least in the medium term, an inverted yield curve is actually good for the stock market!

It should also be noted that the track record for using the inverted yield curve as a recession indicator is strong, but it isn't perfect. According to those who have parsed the data, the 2-and-10-year curve inverted 28 times since 1900, with recessions following 22 times. Historically then, the signal was wrong about one out of every five times. Also, not all market timers prefer to use the 2-10 spread as their primary recession indicator. Other widely used comparisons (and arguably more reliable ones) have been the difference between either 3-month Treasury Bill rates or 18-month Treasuries yields compared to 10-year Treasuries. Currently, Treasuries on the short end of the maturity range remain far below 10-year yields and, unusually, some spreads in the short-term area of the market have actually widened simultaneously with the 2-10 spread inverting. We can't recall ever seeing that happen before. Then again, the past few years have been filled with many weird events. The bond market has been distorted due to heavy purchases from the Fed's Quantitative Easing program and some analysts believe the fixed income markets won't begin to accurately signal investors' inflation expectations until the bond buying program is reversed. As we noted in our monthly comments, we view the signals from the yield curve to be more confusing than clarifying.

We also fall back on a rigorous study of the inverted yield curve and future stock returns done in 2019 by two Nobel laureates, Eugene Fama and Kenneth French. While the average citizen probably wouldn't recognize the names, they are giants in academia for their studies of the financial markets. The two professors examined the data to see if selling stocks and investing in U.S. Treasury Bills after the yield curve inverted would enhance an investor's returns. They concluded that the strategy did not provide any shelter from market downturns and that changes in the yield curve contained no guidance about changes in future equity premiums.

The difference between nominal rates and the "real" rate, i.e., the interest rate after taking inflation into account should be considered as well. In prior cases when the Fed tightened monetary conditions enough to cause a recession, not only did the yield curve invert, but interest rates were expensive, relative to inflation. Very high real rates not only dissuaded borrowers by imposing a high inflation-adjusted cost of money, but richer yields also encouraged increased savings. Fewer capital projects and less consumer spending eventually slowed economic growth. That is not the case today. Even after the recent increases in nominal interest rates, inflation-adjusted yields are about as low as they have ever been. Uninvested cash is losing its purchasing power rapidly and for many it is more attractive to borrow and spend than salt away money for a rainy day. It is possible that the Fed's interest rate increases may have less of an impact on the economy than the bears project.

ON CREDIT

There are additional economic signals hidden within the bond market beyond just the yield curve. Credit spreads have also served as an early recession indicator. The interest rate premium that corporate debt carries over Treasury notes with comparable maturities tended to vary based on investor's economic outlook. When bond investors began to fear a weaker economy, they demanded a higher yield cushion to protect themselves against a possible default. As one might expect, corporations with the weakest balance sheets were the most sensitive to recession fears, with premiums growing proportionally faster as worries rose. While the yield spread on U.S. high-yield ("junk") bonds has widened since the beginning of the year, they have not risen to levels that have preceded past recessions. Encouragingly, high-yield spreads narrowed in the wake of the first Fed rate hike, as junk bonds mirrored the rally in other risk assets, such as stocks and commodities. Junk bond investors seemed to share the same confidence as their equity brethren that corporate profits will remain reasonably healthy for the time being.

SOLID ECONOMIC NEWS

While the Bears are focused on the arrival of the next recession, the employment picture has been holding up very well, despite being battered by higher energy prices and global disruptions. The U.S. job market has strengthened this year, with the unemployment rate falling to 3.6%, almost back to the 3.5% rate that was posted just before the pandemic hit. The more inclusive U-6 unemployment rate, which includes discouraged workers and also part-time employees who would prefer full-time work, is very close to its lowest level ever. The outlook for further improvements is good. In February, there were more than 11 million available job openings, which compares to 6.2 million unemployed. Historically, a trough in the unemployment rate also tends to be a reliable signal of an impending recession, with about a nine-month lead time. On average, the unemployment rate rose 0.4 percentage points in the months before an economic downturn and the trend, so far, remains one of steady improvement.

There are a couple of other positives in the current economic environment than seem different from the cusp of previous recessions. First, U.S. household wealth has exploded by 37%, or an estimated $40 trillion, since the start of the pandemic. That is almost the same increase in wealth that the U.S. economy generated in the seven years prior to 2020. According to government statistics, household net worth exceeds disposable income by more than 8 times, much higher than the levels that existed ahead of the Financial Crisis. It isn't all gains in the stock market either since real estate accounted for $5 trillion of additional wealth in 2021 alone. Yes, this abundance isn't evenly distributed, but those fortunate enough to have a larger nest egg would be in a position to provide at least a partial shock absorber for the economy.

Not only has household wealth increased, but an enormous amount of pent-up demand has grown as well. Many have decided to make up for the time lost during the pandemic. Searches on travel sites continued to trend higher in March and industry participants are expecting a surge in demand this summer. Spending at restaurants remains below pre-pandemic levels, but it has shown slow and steady improvement this year, despite rising prices. Although higher energy prices and depressing world events may weigh on spending, many people want to carry on living their lives after months of doing without.

WATCHING A FEW DARK CLOUDS

It should be noted that not all signs point to sunshine and roses ahead. There are other, more negative economic data that we have our eyes on as well. It isn't a surprise that mortgage applications, as measured by the Mortgage Bankers Association's Weekly Composite Index has fallen 41% from the same period a year ago, thanks to higher interest rates. Housing has often served as a strong engine of economic growth, and it is concerning to see a decline of this magnitude. Recent data on truck tonnage has also been disappointing, possibly due to price increases.

The outlook for international economic growth has also deteriorated in recent weeks from the COVID lockdowns in China. A Reuters article cited research from Nomura that pointed to 193 million Chinese citizens, or 13.6% of the population, were suffering from full or partial lockdown across 23 separate cities. Unsurprisingly then, economic data from China has been below par. Skyrocketing energy costs in Europe have sent shock waves across the region. Some German factories have seen their natural gas bills grow five-fold in just a few weeks. Americans may gripe about $4.50/gallon gasoline, but European prices average about $8 to $9/gallon. Unlike the U.S. where higher energy prices can help boost oil producing states like Texas or North Dakota, many European countries only see higher costs and no benefits. Weakness in two of largest economic areas of the world will ripple around the rest of the globe.

We will continue to use a high degree of caution when making investment decisions, however, and we will be parsing each additional bit of data for any additional signs of weakness.

OWNING BONDS IN A RISING INTEREST RATE ENVIRONMENT

When former Fed Chairman, Paul Volker, broke the back of the inflationary crisis of the 1970s and early 1980s, it began a disinflationary cycle that led to the greatest bond bull market of all time. While there have been a few short periods of reversal, investors saw a forty-year tailwind of rising bond prices and falling interest rates. The 10-year Treasury note rate hit an all-time low of 0.54% last July and has moved up sharply since. With the Fed indicating that higher rates and tighter monetary conditions are in our future, investors may be grappling with the beginning of the first long-term bond bear market in a generation. With interest rates poised to go up, many have questioned if it would be worthwhile to own bonds. We believe bonds still have a place within a portfolio, if they are structured with caution.

It has to be remembered that bond bear markets aren't like bear markets in the stock market. While the prices of bonds with very long maturities are highly sensitive to changes in interest rates, prices of intermediate term bonds tend to fluctuate far less. For example, during the long bond bear market from 1960 to 1981, long-term Government bonds had some declines that rivaled downturns in the equity markets, with the worst one-year return showing a negative total return of -17.1%. The worst one-year total return for five-year Treasuries, however, was a far more modest decline of -5.1%. While long-term treasuries were still in the hole over three-year and five-year holding periods, the five-year notes were already providing positive returns. Given the backdrop that interest rates increased from 3% to 16% in the period, it seems amazing in retrospect that any bonds generated a positive return. When building our fixed-income portfolios at Hallmark, we target an average maturity even shorter than the example above, about four years. This not only provides a higher degree of price stability than holding a longer portfolio, it also allows us to reinvest the many bonds that mature at higher available rates.