Market News 2022

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Rates, Liquidity, and Asset Prices

By Scott Loyek, CFA,® Managing Director, Chief Investment Officer

As we discussed in our Town Hall Meeting in February, we expected 2022 to be a year of transition. Though the war in Ukraine has had a significant impact on the global economic environment, it does not appear to have changed the larger issues driving the investment landscape. The catalyst for this transition is the well-documented change in the policies of the Federal Reserve.

Scott consults with TWM clients and relationship managers to implement their financial plans through building diverse portfolios of high quality, low-cost investments relative to individual goals. Scott helps clients to gain better understanding and peace of mind in a complex and often confusing world. He strives to bring patience and objectivity to the investment process on a daily basis in order to avoid the destructive impact emotional reactions can have on financial decisions. Scott joined TWM in 2006.

Since the initial outbreak of Covid-19, the Fed has been taking extraordinary action to maintain liquidity and stimulate the economy. The primary tenets of this policy were quantitative easing and extremely low interest rates. The combination of these policies created an environment where there was an abundance of money in the system and a very low cost to borrow it. This dynamic stimulated a boom in asset prices as everything from cars and houses to equity prices and crypto-currencies benefited. The cause of this was simple economic supply and demand as an increasing number of dollars chased a relatively fixed amount of assets.

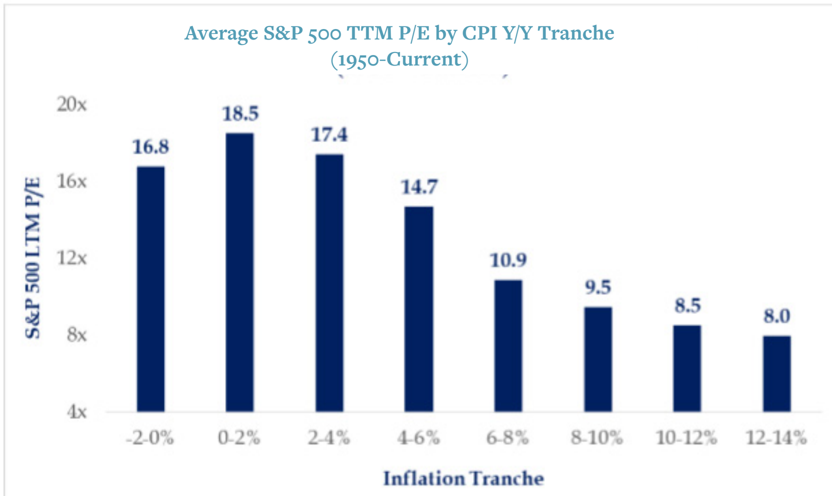
In the latter half of 2021, the Federal Reserve began signaling their concern that inflation and a potentially overheating economy would require a shift in policy. Though expected for some time, the initial move to tighten came in March 2022, when interest rates were raised for the first time since 2018. This was combined with the official end of quantitative easing at roughly the same time. Throughout the remainder of the year, we expect interest rates to continue to rise. Similarly, we expect the Fed will also take steps to reduce the size of its balance sheet, thereby taking money out of the system.

This policy shift creates the opposite environment from that which we have enjoyed for the last several years. We now have a shrinking pool of money with higher borrowing costs chasing what is still a relatively fixed pool of assets. We believe this likely will have a negative impact on asset prices.

For example, early in the pandemic, a 30-year mortgage at 3% was common. Now the rate on this same mortgage is around 5%. If a family can afford a $2,000 a month mortgage payment, with rates at 3% they could pay $600,000 for a house with a 20% down payment. However, at 5% that same $2,000 a month mortgage payment only allows them to afford a $475,000 home with 20% down. This principle applies to various types of assets. As the cost of capital rises, people's purchasing power declines.

Source: Strategas Research Partners, LLC

While every asset will behave somewhat differently, we would expect the present value of assets to decline as interest rates rise. In the case of the equity markets, we see this dynamic reflected in the valuation of stocks. As you can see in the chart as rates rise, the P/E ratio of the stock market declines. We anticipate that interest rates and inflation will settle out in the 2-4% range and we should be looking for P/E ratios near 17.4x the S&P 500 as seen in the chart below.



Source: Strategas Research Partners, LLC

Thus far, the transition in the market has hit the most highly valued stocks particularly hard. This is evidenced in the NASDAQ index, which is known for high growth names, being down roughly twice as much as the more diversified S&P 500 index. Much like bonds where the longer maturities are more sensitive to rising interest rates, high growth equities are more sensitive to rates because their anticipated cash flows are further in the future.

Diversification, as it often is, has been a useful defense against this shift in market conditions. Throughout last year, as valuations continued to rise and the Fed began to telegraph rate hikes, we were regularly trimming our successful investments in higher growth companies and redeploying those assets into either lower P/E value names or holding cash. This rebalancing is central to our process and combined with our decision to keep our fixed income investments very conservative, led to a very successful outcome in 2021. It has also left us well positioned to navigate 2022.

Source: Yahoo Finance

As we move through the remainder of the year, we will continue to monitor the ripple effects from the changing market environment. We believe our 2018 experience will continue to be a useful framework to view the market. This was the last time we saw the Fed focused on raising rates and withdrawing liquidity while the markets faced a major headwind caused by the trade war with China. While 2018 was a very frustrating year, it served as a healthy reset for the market to resume higher.

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