Market Commentary

The Quarter in Review – 1Q 2022

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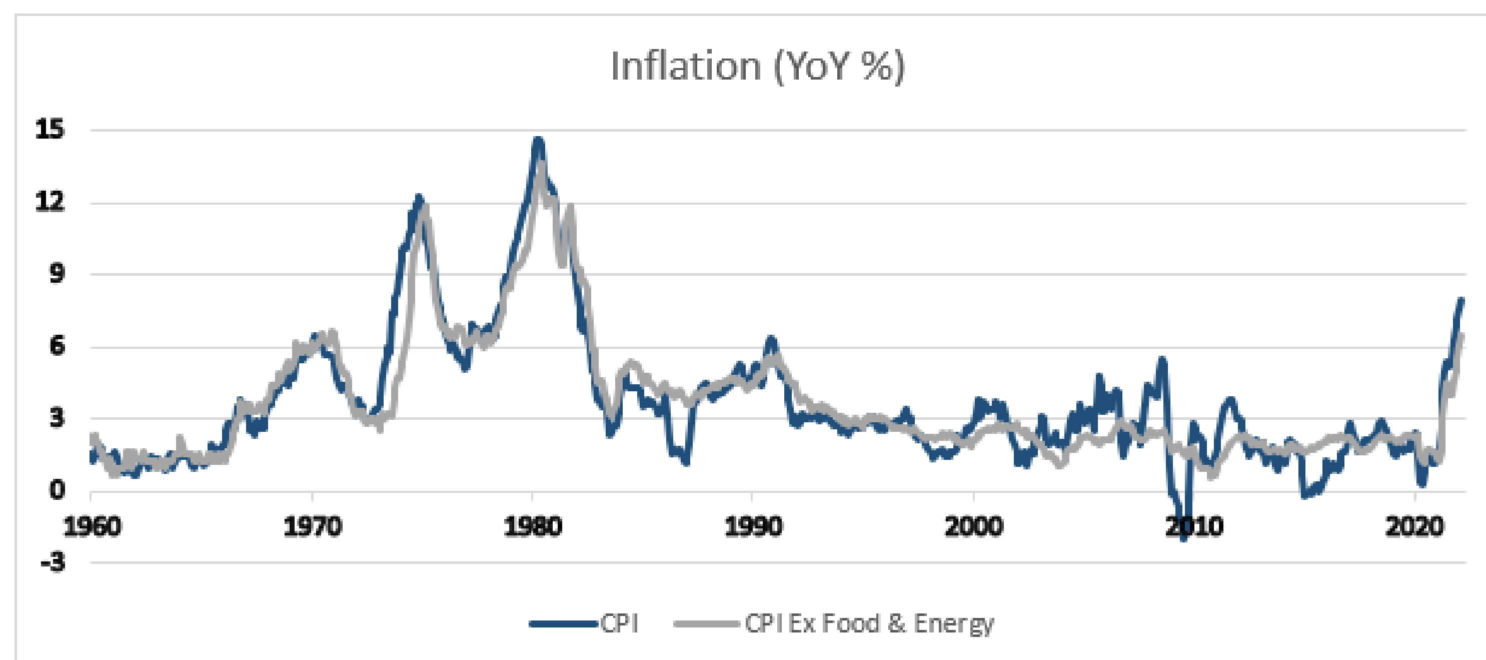
Performance

Most major equity indexes started the year at or near all-time highs, the culmination of a nearly two-year rally off the Covid-induced lows in March 2020. After holding up incredibly well during the pandemic and lockdowns, the bull market came to an abrupt end during 1Q 2022, as stocks reacted to the emergence of inflationary pressures and the Fed shifting into rate-hiking mode after two years of very accommodative interest rate policy. The Fed essentially took the punchbowl from the party, and growth stocks suffered the most due to this new sobering reality. According to Morningstar, nearly 90% of U.S. equity funds lost money during the quarter. The S&P 500 Value was a relative outperformer in this environment, declining just -0.16% in 1Q 2022 versus the S&P 500 Growth's negative return of -8.59%. Stocks started to find their footing after January's losses and appeared to be putting a near-term bottom in place until geopolitics threw fuel on the fire when Russia invaded Ukraine the last week of February. The second half of March was better, but it was still the worst quarter for domestic equities in two years. According to Ned Davis Research, it was the first time since 1981 that U.S. large and small cap stocks, developed and emerging international stocks, long term treasury and corporate bonds, and REITs, all were negative for the quarter. It was a crazy start to the year in which the average stock experienced a bear market, declining at least -20%, and the Energy sector was the only real winner with an incredible +39.03% return on the heels of higher oil prices. The DJIA led the major U.S. indexes with a decline of just -4.10% for the first quarter, while the S&P 500 and the tech-heavy NASDAQ declined -4.60% and -8.95%, respectively. Non-U.S. equities suffered similar results amidst the turmoil as the MSCI EAFE Index lost -5.79% and the MSCI Emerging Markets Index fell -6.92%.



Source: Federal Reserve, Maryland Capital Management

ABOUT THE FIRM

Maryland Capital Management (MCM) is an independent, employee-owned investment management and advisory firm serving high net worth and institutional investors nationwide.

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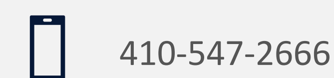

Bonds provided no relief to investors as the Fed's shift in policy caused yields to move abruptly higher in March. The 10-Year U.S. Treasury bond finished the quarter nearly 70 basis points (+0.70%) higher than where it started, with a yield of 2.32%. This move higher in yields over the three-month period, the largest in decades, prompted a move lower in bond prices and the worst quarter for performance in over forty years. The Barclays Intermediate Government/Credit Bond Index and the Barclays 5-Year Municipal Bond Index declined -4.51% and -5.10%, respectively.

Behind The Curve?

After making a case for much of the past year that inflationary pressures were "transitory" in nature, the Fed finally conceded this argument. The most recent data from the Bureau of Labor Statistics (BLS) revealed that two widely-followed inflation indicators, the Consumer Price Index (CPI) and the Personal Consumption Expenditure (PCE) Index, grew +7.9% and +6.4%, respectively, from year-ago levels. This represents the fastest rate of growth for both in nearly forty years and is well above the Fed's 2% target. According to Moody's Analytics, inflation is costing the average U.S. household an additional $296 per month and many pundits expect the situation to get worse before it gets better. So, the Fed now finds itself behind the curve and likely on a path of aggressive rate hikes in the coming months. After their meeting in March, Fed officials raised the target federal funds rate from 0-0.25% to 0.25-0.50%, the first increase since 2018. They also signaled the equivalent of six more quarter-point hikes for 2022, along with more in 2023, as well as plans for balance sheet reduction. Market participants, according to how fed funds futures are trading, expect half-point hikes in upcoming meetings in what could be one of the fastest rate-tightening cycles since at least the 1960s. The bond market has already done some of the heavy lifting with yields from two to ten years rising considerably in March and early April alone. For example, the 2-Year U.S. Treasury and the 10-Year U.S. Treasury now yield more than 2.50%. This represents an approximate 100 basis point (+1%) move higher for the 2-Year, and a 50 basis point (+0.50%) move for the 10-Year in very short order. The 2-Year was even yielding more than the 10-Year for multiple sessions, a situation referred to in market parlance as an "inverted yield curve." This is not an insignificant event and usually indicates a monetary and/or fiscal policy mistake, hence our reference to the Fed being "behind the curve." Some may argue that the more important relationship is between 3-Month and 10-Year yields since this represents the difference between bank and consumer lending, but the fact is that a 2/10 curve inversion has predicted a recession in each of the last six occurrences going back to 1980. The average length of time from an inversion to a recession has been fourteen months, with a range of six to twenty-two months. The Fed will need some pretty nifty maneuvering to engineer a soft landing. We agree with Strategas Research Group's Chief Economist Don Rissmiller's recent remark that the Fed is now likely in a "tighten until something breaks" mode. The key question is whether it's inflation or growth that breaks first.

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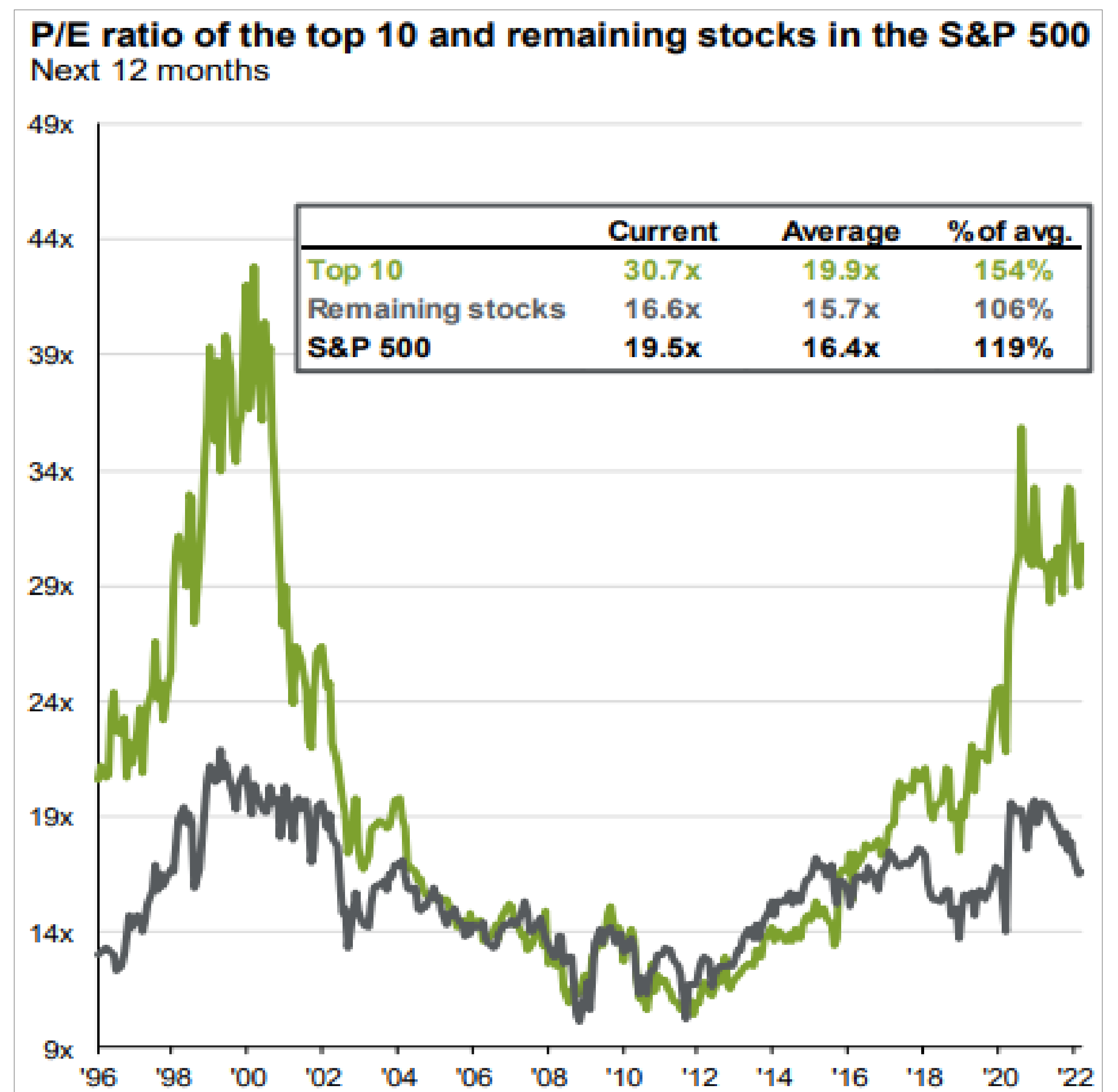
Labor Market Strong, But Recession Could Be On Horizon

While an inverted 2/10 yield curve has been an accurate predictor of recessions, it in not a "fait accompli." The U.S. economy typically does not go into recession without labor market weakness. Despite record high inflation, the U.S. economy added 431,000 jobs in March, and the labor market grew increasingly tighter. Jobless claims totaled 166,000 at the end of March, the lowest level in more than fifty-three years. The unemployment rate has now dropped to 3.6%, just shy of pre-pandemic lows of 3.5%, and a major improvement from the lockdown-induced 14.8% peak level reached in April 2020. Based on government data, there are five million more job openings than there are interested workers. This, of course, is driving up wages which is a good thing, but also exacerbates the inflation situation.

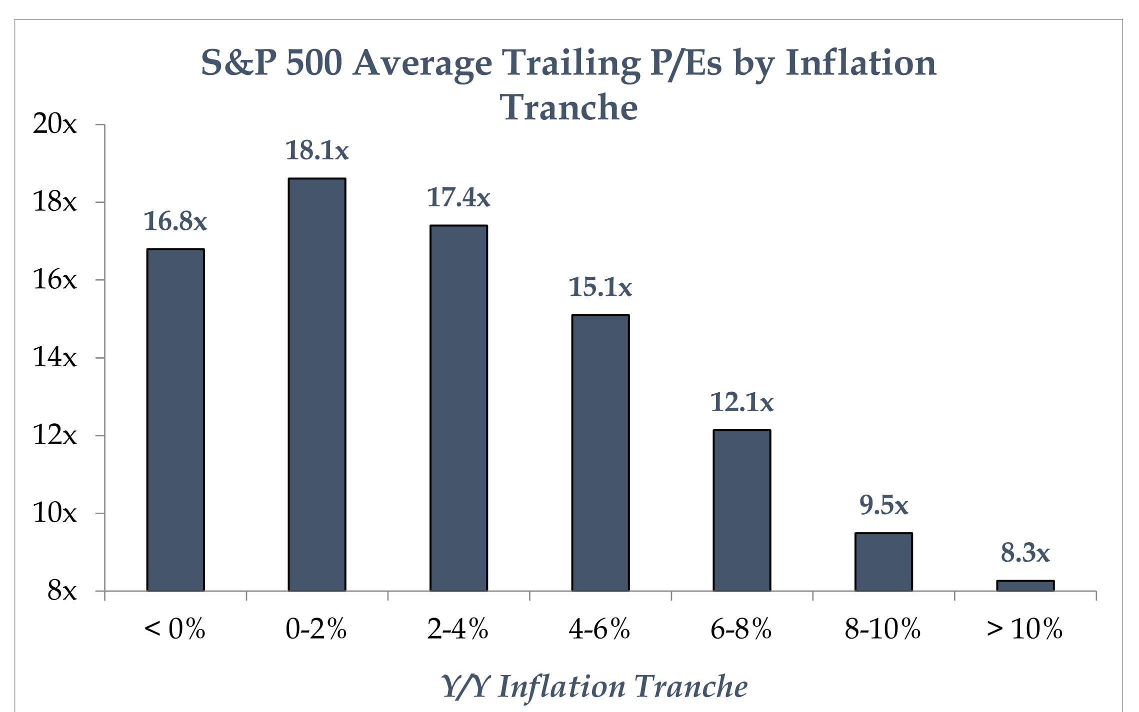
The Conference Board's consumer confidence index for March showed that consumers are optimistic about the Covid situation and the job market but are concerned about the future impacts of Russia's invasion of Ukraine on inflation. We will be monitoring consumer spending data closely for cues on the direction of the economy. Inflation is likely to be an eventual drag on the consumer, especially if wage increases cannot keep pace with increases in the prices of goods and services.

Market action has clearly signaled a shift to a new regime, and we need to be mindful of and adapt to these new conditions. Two things that continue to concern us are equity indexes being too top-heavy and the realization that stock valuations may need to decline further if interest rates and inflation continue to move higher. The ten largest companies in the S&P 500 currently make up approximately 30% of the index, the highest reading on record, and they trade at a combined Price-to-Earnings (PE) ratio of 30.7x. The historical average PE for the top ten is 19.9x. The remaining 490 stocks currently trade at a PE of 16.6x, versus an average of 15.7x. A case could be made that the S&P 500 Index may move closer to 16-17x earnings if we see some deterioration in the high-growth, mega-cap companies that are skewing the averages.

Based on quarter-end data from FactSet, the current forward 12-month PE multiple for the S&P 500 is 19.5x. Nowhere near the record high 24.1x level set in 4Q 1999 before the tech bubble burst, and lower than the 22.6x at the end of 2020, but well above its ten-year average of 16.8x. Going back to 1950, the average S&P 500 PE multiple when inflation was between 0-2%, was 18.1x. But when inflation is in the range of 2-4%, that average declined to 17.4x, and the 4-6% inflation range commanded a 15.1x PE multiple. The math is pretty simple: using round numbers, if the S&P 500 annual earnings power is $200, every multiple point lower could equate to a 200-point (-4%) decline in the index.



Source: FactSet, Standard & Poor's, JP Morgan Asset Management, DailyShot



Source: Strategas Research Partners

Outlook

The Conference Board's recent forecast for U.S. Real GDP growth calls for a slowing to +1.7% (quarter over quarter, annualized rate) in 1Q 2022, versus +7.0% growth in 4Q 2021. Estimates for the full year 2022 are now for +2.3% growth (year over year) down from previous estimates due to higher inflation and geopolitical tensions. According to FactSet, the expected earnings growth rate for the quarter versus the same period one year ago is +4.7%. If that number is realized, it would mark the end of a four-quarter streak of earnings growth above +20% and would be the slowest growth rate since 4Q 2020. As we wrote last quarter, the pace of growth over the past several quarters followed trough-level earnings from when the economy shut down in early 2020 and were bound to slow down. That said, growth expectations are still very healthy based on normal, historical comparisons and standards. 2022 S&P 500 revenue growth is expected to be +9.3%, with earnings growth of +9.5%. Both estimates have increased since year-end. Despite some negative crosscurrents in the economy and markets, the resilience of corporate earnings has been impressive thus far.

The odds of a recession have increased. Interest rates are moving higher, although still at historically low levels. The stock market corrected in the first quarter and the Russia/Ukraine war has prompted a move towards de-globalization. In this environment, we are focused on upgrading portfolios by finding high-quality, "shorter duration" companies with strong cash flows and lower valuations. The recent move higher in interest rates means that bond yields are finally more attractive for balanced portfolios, especially in the 2-5-year portion of the yield curve. Mid-term election years have a history of sharp sell-offs and very strong rebounds. 2022 has thus far not bucked this trend. We also know from studying market history that most of the annual return in mid-term election years comes at the end of the year, after the election(s) in November. Therefore, we anticipate continued choppiness over the next two quarters that could test investors' nerves but do ultimately expect positive returns for stocks in 2022. We remain committed to adding value for our clients, and steadfast in our pursuit of delivering competitive risk-adjusted returns across MCM's various investment strategies. Thank you for the continued confidence you have placed in us. As always, do not hesitate to contact us should you have any questions or concerns.

Market Commentary

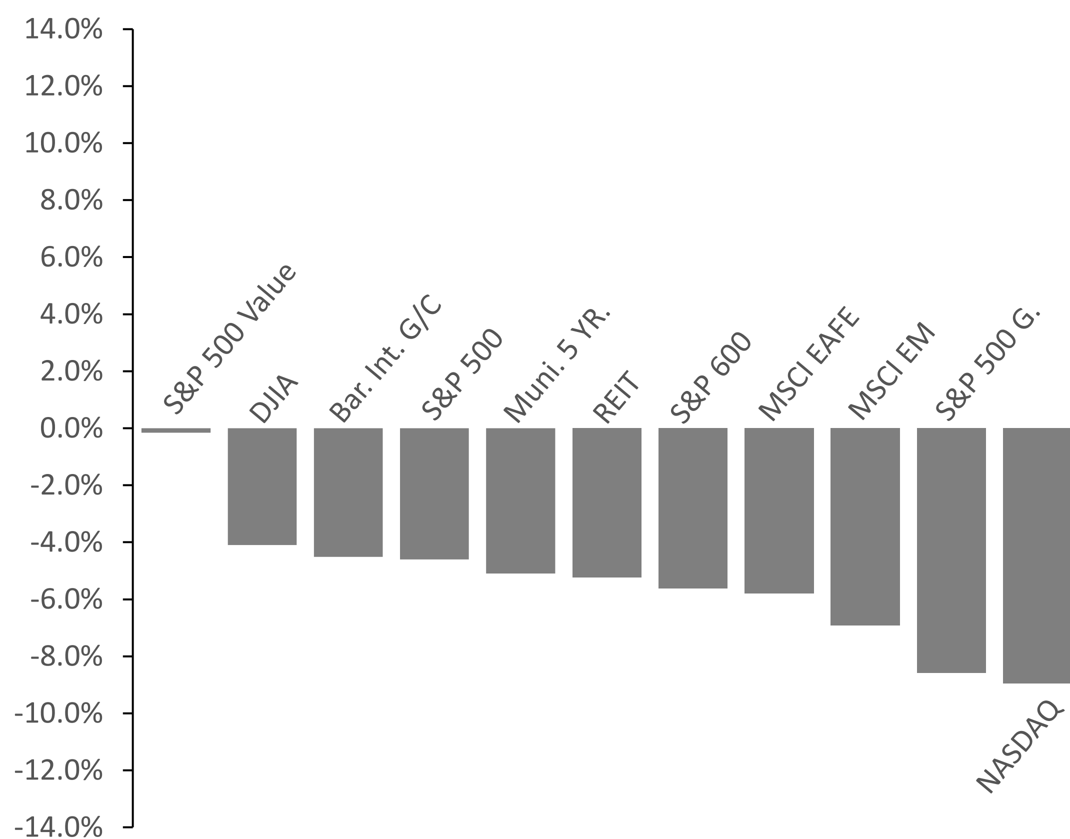
The Quarter in Review

Ranked by 1Q 2022 Performance

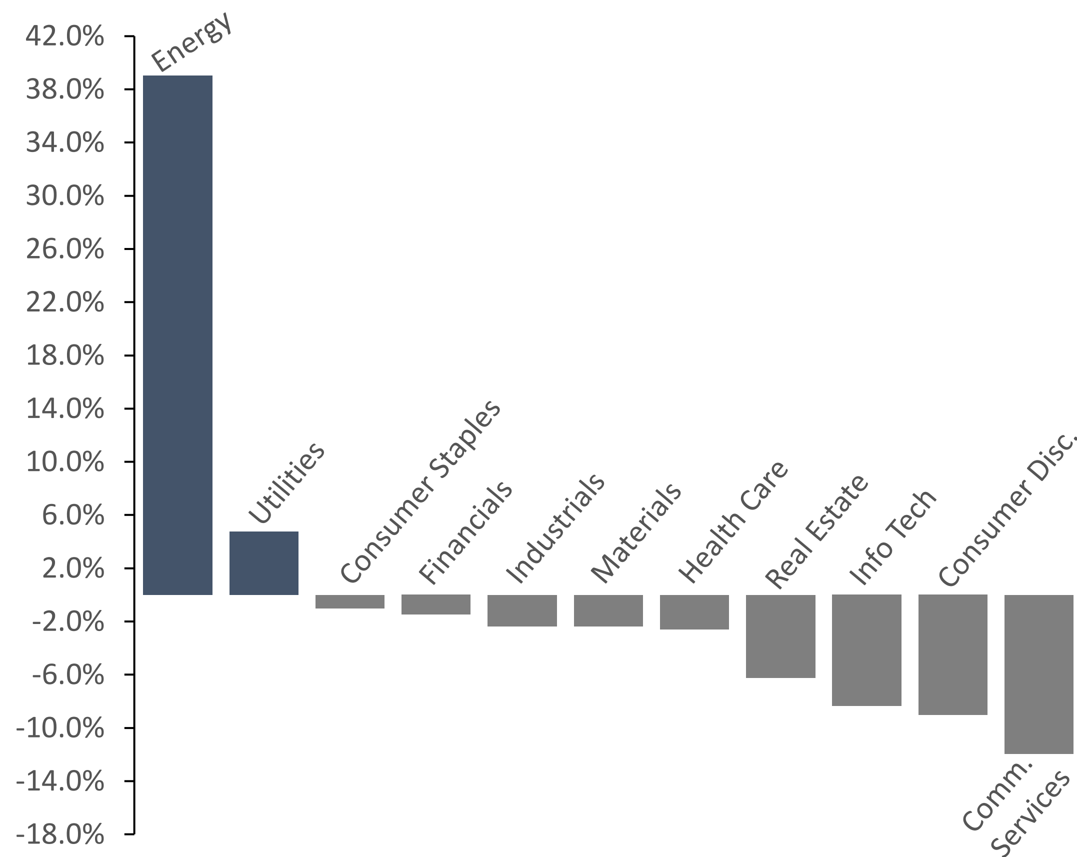
Major Market Indices	Jan	Feb	Mar	Qtr	YTD
S&P 500 Value	-1.62%	-1.44%	2.96%	-0.16%	-0.16%
DJIA	-3.24%	-3.29%	2.49%	-4.10%	-4.10%
Barclays Int G/C (Bond Ind)	-1.47%	-0.66%	-2.45%	-4.51%	-4.51%
S&P 500	-5.17%	-2.99%	3.71%	-4.60%	-4.60%
Barclays Cap Muni Bond – 5 YR	-2.42%	-0.40%	-2.35%	-5.10%	-5.10%
NAREIT All REIT	-7.71%	-3.92%	6.86%	-5.24%	-5.24%
S&P 600 (Small Cap)	-7.27%	1.40%	0.37%	-5.62%	-5.62%
MSCI EAFE (International)	-4.82%	-1.76%	0.76%	-5.79%	-5.79%
MSCI Emerging Markets (EM)	-1.89%	-2.98%	-2.22%	-6.92%	-6.92%
S&P 500 Growth	-8.37%	-4.50%	4.45%	-8.59%	-8.59%
NASDAQ Composite	-8.96%	-3.35%	3.48%	-8.95%	-8.95%

U.S. Industry Groups	Jan	Feb	Mar	Qtr	YTD
Energy	19.10%	7.13%	8.96%	39.03%	39.03%
Utilities	-3.27%	-1.85%	10.36%	4.77%	4.77%
Consumer Staples	-1.37%	-1.42%	1.81%	-1.01%	-1.01%
Financials	0.06%	-1.35%	-0.19%	-1.48%	-1.48%
Industrials	-4.73%	-0.87%	3.38%	-2.36%	-2.36%
Materials	-6.84%	-1.24%	6.11%	-2.37%	-2.37%
Health Care	-6.76%	-1.02%	5.56%	-2.58%	-2.58%
Real Estate	-8.50%	-4.91%	7.79%	-6.22%	-6.22%
Information Technology	-6.89%	-4.90%	3.49%	-8.36%	-8.36%
Consumer Discretionary	-9.68%	-3.99%	4.91%	-9.03%	-9.03%
Communication Services	-6.21%	-6.98%	0.95%	-11.92%	-11.92%

1Q 2022 Index Returns



1Q 2022 Industry Group Returns



Source: FactSet