GREAT OAK
INVESTMENT MANAGEMENT
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Unwelcomed but Expected

After a difficult two years, the start of 2022 hasn't given us a breather. In our 2022 outlook, we discussed the potential concerns for the upcoming year. However, we didn't suspect two of those concerns to appear in the first month. Our first concern was the valuations of speculative assets. In the first few months, we saw stocks such as PayPal, Netflix, Meta and Zoom sell off more than 35%. In addition to the selloff of speculative stocks, we were concerned with the impacts of elevated inflation. These inflation concerns have only been amplified with the Russian/Ukraine conflict, leading to a more hawkish Federal Reserve and potentially cooling down of the economy and markets. We were a bit surprised with how quickly the Fed pivoted in their language and guidance. They have nearly abandoned any dovish tones over the first three months of the year and now appear to act as boldly as needed to fight inflation.

In the first 3 months of the year broad markets suffered the first quarterly decline since Q1 of 2020. The S&P 500 was down 4.95% but traded as low as 12.26% on March 8th. Value oriented stocks outperformed growth stocks, as investors looked for fundamentals rather than growth prospects. The Nasdaq, an index of 53.45% technology stocks, hit correction territory (down 20%) on March 14th. Large capitalization stocks outperformed small capitalization stocks as investors looked for perceived safety. Domestic stocks outperformed international stocks as investors were concerned with the global impacts of the Russian/Ukraine conflict. For example, we saw the German DAX index fall 20% on Match 7th and the Hang Seng Index fall even further. As NATO and EU countries showed solidarity in their condemnation of Russia's unprovoked invasion of Ukraine; the coordination around sanctions proved more difficult, especially around energy. With many countries dependent on Russian oil and gas imports, navigating these sanctions has proved challenging. Leading to a rippling effect of volatility for global energy prices. This was apparent with the increase in gas prices. Consequently, the shining light in equity markets was in the energy sector, returning 37.66% in Q1.

As predicted, fixed income assets had a difficult start as markets began to price in a surprisingly more hawkish Federal Reserve. The 5-year treasury moved from 1.37% to 2.34%. Even more interesting, was the move in the 1-year treasury from .39% to 1.63%. Municipals weren't a place to hide as total return was down -4.57%. Most fixed income indices had their worst quarter since the early 1980's when the Fed was trying to control inflation with its aggressive interest rate policy. More recently, we have seen moments of inversion in the yield curve, where short term rates have been higher than the longer-term rates. Historically, an inverted yield curve has been seen as a harbinger of an economic recession, but it may be too early to determine those prospects. The Federal Reserve's window is narrowing to execute a soft landing with its economic policies.

Fortunately, both equity and fixed income philosophies performed well relative to their well-known indexes during the first quarter. Holding quality names with solid cash flows and balance sheets tend to bode well during periods of uncertainty. Fixed income ladder strategies provided investors consistent cash flow, allowing them to reinvest bonds during rising interest rate environments.

Moving forward, we are starting to see cracks in economic fundamentals. A moderating and slowing LEI (Leading Economic Indicators) index is just the start. As always, we need to focus on the consumer, as they are the engine that moves this economy forward. Personal Saving rates have fallen back to pre-pandemic levels. This means consumers have less money in their pockets and are feeling the effects of higher food and energy prices.

The higher goods and energy costs are a direct result of higher inflation, which has risen to the top of concerns for the Federal Reserve. The Federal Reserve now sees the need to elevate interest rates at a faster pace in an effort to tame inflation. Higher interest rates, lead to higher borrowing costs creating less disposable income for consumers and businesses. For example, higher mortgage rates (resulting in higher mortgage payments) put more strain on consumer's ability to buy goods and services. If mortgage rates continue to rise, they may begin to have a chilling effect on what has been a hot real estate market. (As of 4-11-22 the 30-year mortgage is 5.08%)

We are also focusing on the fall of real personal income, i.e., a person's inflation adjusted income, which has fallen for the 10th time in 11 months. This means US households are taking home less money relative to the inflation rate. With the lower saving rates and falling real personal income, US households are starting to show signs of fatigue. We continue to focus on consumer sentiment to understand the current mindset of US Households.

With the potential of a weakening consumer, how should investors be positioned? Equity investors should look for companies who can weather difficult economic times. These companies should have solid business prospects and experienced management teams. Furthermore, it's important for investors to value cash flow and balance sheet durability.

Fixed income investors should look to take advantage of higher rates throughout the curve. We would also encourage investors holding large cash positions without liquidity needs, to evaluate attractive yields on the shorter end of the curve. Finally, laddering bonds over various maturities can be a way to help mitigate the concerns of higher inflation and interest rates.

We encourage investors to evaluate rebalancing portfolios. Equity markets over the last few years have been strong, potentially creating an over allocation to stocks. Investors should evaluate the risk dynamics of their portfolio confirming they are comfortable with their asset allocation.

Thank you for entrusting us with your hard-earned capital.

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