WASATCH
CAPITAL MANAGEMENT OF
RAYMOND JAMES®

"The stock market is like a roller coaster, except I never throw up my hands and go wheeeeeeeeeeeeeee!"

February 2022

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Winds of Change -Article by Mark Lazar

There is no risk-free path for monetary policy. **Jerome Powell**

Item	YTD Change
Dow Jones Ind Avg	-3.32%
S&P 500 Index	-5.26%
EAFE Foreign Index	-4.86%
Emerging Market Index	-1.93%
Barclays Agg Bond Index	-2.15%
10-Year Inflation Forecast	2.43%
Unemployment Rate	4.0%

**Market index data as of 1/31/2021*

Baby Boomers, like myself, painfully recall the 70s and early 80s, when many of us purchased our first home, financed a car, and possibly carried credit card balances (guilty) at interest rates that would make a loan shark blush. Due to imprudent monetary and fiscal policies, which began during Nixon and were exacerbated by the Carter Administration, the federal funds rate peaked in 1981 at 22.36%, as did mortgage rates at 18.53%. To put this into perspective, the fed funds rate today is .08% and the 30-year mortgage rate is 3.55%.

With rare exception (e.g., supply shocks), inflation is simply the product of too much money chasing too few goods. Logically, the solution would be to either boost output via supply-side policies that increase production, or reduce the money supply. But Fed policymakers believe they're smarter than the rest of us, so instead rely on complex (and flawed) econometric models and questionable policy tools (monetary chicanery) to manage inflation.

For the first time in four decades, inflation is clearly on the march, and surged to 7% in 2021, or 5% over the Fed's target inflation rate. Both Jerome Powell and Janet Yellen proclaimed for over a year that inflation was transitory. Oops. Of course, Fed policymakers said the same thing during the early to mid-70s. They seem to forget that every period of secular inflation is always preceded by a period that's initially deemed transitory.

Inflation is an implicit tax on savers. Extraordinary monetary stimulus (i.e., low interest rates, bloated money supply, targeted asset purchase, etc.) intended to offset government-imposed COVID lockdowns was a boon to stock and real estate investors. However, it was devastating to savers who remained in cash, bank CDs, and government bonds, where the rate of interest was nearly zero. Ultimately, inflation erased roughly 7% of their purchasing power this past year.

The federal funds rate is currently reported as .25%, but it's not actually a rate but, rather, a range. That range is currently 0–.25%, and the FOMC manages the rate via asset purchases/sales to be somewhere in the middle. The market is presently forecasting four to five quarter point (.25%) interest rate hikes this year, which would put the fed funds rate roughly 1–1¼ points higher twelve months from now.

The federal funds rate is an interbank lending rate, or the rate which commercial banks charge one another for overnight lending. Thus, unlike prime or the now deceased LIBOR, it isn't a retail rate that directly affects consumers. So why do we care? Because the Fed's key interest rate both signals the market as to the Fed's monetary policy direction (looser/tighter) and influences commercial lending, retail, and mortgage rates.

To appreciate why the stock market has been getting anxious recently it's important to understand the relationship between interest rates and asset values. In a nutshell, falling interest rates make the net present value of a series of cash-flows (e.g., interest, dividends, rental income, sales proceeds, etc.) more valuable. Conversely, rising rates do the very opposite. To illustrate, let's look at how a 1% rate increase would affect the value of different assets and liabilities.

Loan/Asset/Bond	Rate	Payment/Value	Post 1% Increase	$ Change	% Change
Mortgage Payment ($1M)	3.55%	$4,518	$5,097	$579	12.82%
Rental Property	5.00%	$1,000,000	$833,333	($166,667)	-16.67%
10-Yr Treasury Note	1.92%	$1,000,000	$931,900	($68,100)	-6.81%

**Rental property value is based on cap rate, whereas the Treasury note is based on a duration of 6.81*

In the example above, a 1% hike in the 30-year mortgage rate would increase the payment on a $1M loan by nearly 13%. Viewed another way, a borrower who qualified for a $4,518 payment (P&I) would now only be able to borrow $886,000 rather than $1,000,000, or ~11% less. Likewise, a 1% increase in the capitalization rate—a metric real estate investors commonly use to value income property—might reduce the market value of a $1M property by nearly 17%.

Bonds are inversely correlated with interest rates, meaning bond prices rise when interest rates fall and vice versa. Since 1981, when the 10-year Treasury note peaked at over 15%, bond investors have enjoyed a 40-year bull market. However, with the 10-year note currently yielding ~2% and inflation trending north of 7%, interest rates across the board need to move higher if inflation is to be constrained. As my father use to say, this makes a tough row to hoe for bond investors.

Like all risk assets, stock prices are similarly affected by changes in interest rates, as evidenced by the recent spike in market volatility. But unlike bonds, which have nowhere to go but down in a rising interest rate environment, stocks are inherently inflation-adjusted. When input costs (e.g., materials, labor, energy, etc.) increase, companies simply raise their prices.

The primary factors which drive stock prices are earnings and interest rates. While corporate earnings are projected to surpass all-time highs this year, rising interest rates do the opposite, compressing PE ratios, or the multiple of earnings an investor is willing to pay for a stock. For example, the S&P 500 Index is currently ~4,500, with earnings forecast at $225. This translates into a forward PE ratio of 20, or 20-times earnings. Over the past forty years the forward PE ratio of the S&P 500 is 18.9, or ~5% less than the current multiple. However, interest rates were significantly higher in the past, particularly between 1982–2000. If market pundits are right, even post-Fed rate hikes, interest rates will still be far below the long-term average, and, thus supports a higher-than-normal PE ratio. The moral of story, in spite of higher inflation and rising interest rates, stocks fundamentals appear sound and stocks have the potential to reward investors who filter out the noise and focus on the fundamentals.

But it’s not all rainbows and sunshine. The bad news is that while stocks can and oftentimes do increase during times of rising rates (albeit with less enthusiasm), bonds do not. The Fed clearly has its work cut out for it, attempting to curtail inflation while simultaneously engineering a soft landing. Regardless of the outcome, bond investors are feeling the winds of change and are likely in for a rough ride for the foreseeable future.

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Wasatch Team Updates

Mark

Mark & Savina in Chichen Ista, Mexico

Stan

Stan and family in Cabo over President's Day

Rees

Rees & daughter Rachel at Deer Valley

John

John and friends in Napa Valley this month!

Nicola

Nicola with 3 of her 4 kids!

Matt

Matt and Sam skiing!

Jon

Jon refereeing a Rugby game !

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