LEWIS
WEALTH MANAGEMENT

Newsletter

April 14, 2022

Market Data as of March 31, 2022

		1st Qtr 2022
US Equities	S&P 500 ETF	-4.62%
International Equities	MSCI EAFE ETF	-6.77%
Emerging Markets Equities	MSCI Emg Mkts ETF	-7.79%
US Bond Market	iShares US Core Bond ETF	-5.86%
US Bond Short Duration	iShares US 1-3 Year ETF	-2.49%
Commodities	S&P GSCI Comm ETF	32.68%
Real Estate	iShares US Real Estate ETF	-6.58%

Executive Summary

There are four interrelated issues causing current market volatility: 1) inflation, 2) rising interest rates, 3) the war in Ukraine, and 4) the pandemic.

Inflation is being caused by supply and demand issues, supply chain problems, and our fiscal and monetary policy response to the pandemic.

The Fed is raising short-term interest rates to combat inflation, but this increases the chance for a recession.

It is difficult to forecast what might happen in the war in Ukraine. It is hard to read what Putin might do next.

The pandemic is still with us, and recent lockdowns in China will exacerbate supply chain issues in China.

Recommendations include rebalancing, favoring stocks with reliable cash flows, keeping bonds short in duration and high in quality, and harvesting losses. Prepare for more volatility. Stay focused and patient.

Lewis Wealth Management
(855) 353-3800
www.LewisWM.com

A Very Difficult Quarter

Investors suffered through a very difficult quarter. The stock market was down 4.62%.[1] The bond market was down 5.86%, its worst quarter in 40 years.[2]

Particularly hard hit were high-flying growth stocks. They were down 9.02% for the quarter.[3] Also hard hit were long-term government bonds. They were down 10.63%.[4] Commodities were a bright spot, but prices are already coming down rapidly.

Four Interrelated Risks

The markets are struggling with four risks that are all interrelated: 1) inflation, 2) rising interest rates, 3) the war in Ukraine, and 4) the pandemic. All four of these risks increase the likelihood of a recession in the coming months. Let’s discuss.

Inflation

Of the four risks, inflation is the most serious one for investors. The current Consumer Price Index surged 8.5% from 12 months ago. We have not seen this level of inflation since the early ’80s.

[1] As measured by the S&P 500 ETF (SPY).
[2] As measured by the Barclays Aggregate Bond Index ETF (AGG).
[3] As measured by the iShares Russell 1000 Growth ETF (IWF).
[4] As measured by the iShares 20+ Year Treasury Bond ETF (TLT).

There are two primary causes of inflation.

First, the pandemic caused massive disruptions in the supply chain and global economy. Consider airline tickets, for example. During the initial phase of the pandemic, no one flew anywhere. Airports were completely empty. Ticket sales were essentially zero, and prices were rock bottom. Now, everyone is ready to take a vacation. Planes are overbooked. Airlines are understaffed. Ticket prices have soared. This is only one example. This type of dynamic has rippled through the entire global economy.

Second, in response to the pandemic, the federal government passed massive fiscal relief packages to help families get through the initial phases of the pandemic. Additionally, the Federal Reserve continued to expand the money supply and kept short-term interest rates near zero. As a result, there was a lot of cash sloshing around the economy. Too many dollars chasing too few goods is a recipe for inflation.

These issues are currently sorting themselves out, but it may take a while. Supply chains are unwinding themselves, and supply imbalances are improving. There are no more rounds of fiscal stimulus planned, and the Federal Reserve is raising short-term interest rates to tighten the money supply. ***Some analysts believe inflation already peaked in March.***

Rising Interest Rates

The Federal Reserve is raising short-term interest rates to combat inflation. This will increase borrowing costs, and that will slow down the economy. The 30-year mortgage rate has already risen to 4.7%, which may start to slow the red-hot housing market. Corporate borrowing costs have increased, and that has hit the stock prices of highly leveraged tech companies.

But the biggest impact of rising rates has been on the bond market. ***The bond market had its worst quarter in 40 years.*** Why? When the Fed is raising rates, investors expect new bonds to come out with higher, more attractive interest rates. While this is good news for future investments, it is not good for the price of existing bonds that have lower interest rates.

If you own one of these bonds and want to sell it to another investor, you must sweeten the deal by lowering the price to make up for the lower interest payments. Hence, the price of existing bonds comes down when interest rates go up. Nervous investors have been selling bonds since the beginning of the year.

Additionally, by raising short-term interest rates, the Fed briefly inverted the yield curve a couple of weeks ago. This means that short-term interest rates were slightly higher than long-term rates. This occurs when the Fed pushes up short-term rates and long-term rates do not also rise. ***Unfortunately, in the past, when the yield curve has inverted, it has been a good (although certainly not perfect) indicator of an upcoming recession.***

The Fed has a difficult job. Trying to get inflation under control is a top priority, but raising interest rates too rapidly can tip the economy into a recession. This happened in 1981 when Paul Volcker aggressively raised interest rates to finally put an end to an inflationary cycle that started during the Arab oil embargo in 1973. Volcker made a difficult choice in 1981, but it had to be done. Certainly, the economic conditions of that time were more extreme than today's conditions. Back then, unemployment exceeded 10% and mortgage interest rates exceeded 15%. Today, unemployment and mortgage rates are below 5%.

The War in Ukraine

The war in Ukraine has complicated the inflation outlook. Ukraine is a major supplier of wheat to the global economy. If that harvest is interrupted this summer, food prices may go up. Also, Russia is a major supplier of oil and gas, especially to Europe. If Europe stops buying Russian energy, it will need to seek other suppliers. This may cause energy prices to increase.

No one knows where this war is going or how it might end. Here are a few thoughts.

Based on his rhetoric, Putin views this war through a distorted, nationalistic lens that hearkens back to WWII. There is a lot of history here. Ukraine has been fought over many times. Russia was forced to give up Ukraine to Germany in WWI, but the Soviet Union recaptured it in WWII.

Of particular importance to Putin was the cataclysmic struggle for survival faced by the Soviet Union in WWII. Ukraine and the surrounding area were of central importance in the Eastern Front. It was a struggle for resources and territory. It was also an ethnic war.

The war was fought with a level of voraciousness and destruction not seen on the Western Front. Military and civilian casualties were in the millions. Eventually, the Soviet Union prevailed over Germany and survived.

When the Soviet Union dissolved in 1991, Ukraine gained its independence. This never sat well with Putin, a former KGB agent for the Soviet Union. He believes Ukraine should be part of Russia (along with other former Soviet states). He wants to restore the former glory of the Soviet Union.

Putin has been waging wars of expansion for years. He went to war in Chechnya in 1999 and established direct Russian rule after a brutal 10-year conflict. He invaded Georgia in 2008 and gained control over several separatist regions. He invaded and annexed Crimea from Ukraine in 2014.

In the current war in Ukraine, Russia's brutal battlefield tactics are a throwback to WWII. No one really knows the end game, but if the past is any guide, Putin may seek a "peace" settlement only after he achieves his military objectives on the battlefield. Now that a quick takeover of Ukraine looks difficult, he may seek to achieve more limited objectives in the south and east and then sit down and negotiate. That may end the current war.

It is very difficult to know what Putin is thinking. In the meantime, we watch as the people of Ukraine suffer.

The Pandemic

Here in the US, the pandemic is slowly morphing into an endemic. There is currently another surge brought on by another variant, but hospitalizations are low (so far). Herd immunity may finally be emerging as an asset. Hopefully, we are on the downside of this pandemic. It's not clear.

That is not the case in other parts of the world. In China, the government is pursuing a zero-tolerance approach to COVID-19. China is currently experiencing a surge of cases in Shanghai, and the government has responded with strict lockdowns. People are confined to their homes while local authorities try to deliver food and medicine. During these lockdowns, Chinese factories lie idle, and goods are not being manufactured and shipped. ***These lockdowns are not going to help global supply chains and could further exacerbate inflation risks.***

The pandemic is a momentous global event. It has changed so many things so rapidly. We will be feeling its effects for years to come.

The Increased Risk of Recession

With inflation on the rise and the Fed raising short-term interest rates to combat it, the risk of recession has increased.

The last time the Fed aggressively raised interest rates to combat inflation was in 1979, when Fed Chairman Volcker raised short-term interest rates from 11% to 20% over two years, even though unemployment was at 10%. While many believe this triggered a recession from 1980 to 1982, Volcker did break the back of a "stagflation" problem that began during the Arab oil embargo in 1973. All that said, most economists believe our current inflation problem is less serious and our general economic condition stronger.

If we do tip into a recession in the next year or so, this is what I have learned as an investor.

First, you don't know you are in a recession until it is almost over. This is because a recession is not official until there are two consecutive quarters of GDP decline. GDP is a lagging economic indicator, and sometimes it takes months for economists to confirm that a recession has occurred.

Second, capital markets are forward-looking and are a leading economic indicator. Markets usually go down in advance of a recession and then recover quickly, usually during the middle of it.

Trying to time the markets around a recession is difficult, to say the least. Most of the time, you end up behind the curve and lowering your long-term rate of return.

Should I Make Changes to My Investment Portfolio?

When markets are up, investors are complacent. When they are down, investors are under pressure to do something – anything. The urge can be overwhelming. When investment losses mount, our first instinct is to make those losses stop, even though we understand that markets are down from time to time. This is when we are the most likely to make mistakes.

During market turbulence, you spend more time trying to forecast what may happen. We search for certainty, for signs of where the markets may be going. We read more articles and watch CNBC. ***Unfortunately, economic forecasts are notoriously unreliable, and our own divinations are frequently wrong.***

Making significant changes to your investment strategy in the middle of a volatile market is always risky. You should make sure your objectives and tactics are consistent and understand the cost if you make a mistake. Many investors get this wrong, in my view.

Risk and return are always related – always. If you want to reduce risk, you must be prepared for lower returns. If you want higher returns, you must be prepared to take more risk. If someone tells you otherwise, they are selling you something and you should look for the door.

Currently, here are a few strategies that I see investors considering that warrant caution.

Cryptocurrency

Crypto is an extremely volatile and speculative asset class. By investing in crypto, you are adding risk to your portfolio. That said, you are also adding the potential for high returns. Add crypto when you want to increase the overall risk-return profile of your portfolio. If you go down this road, I suggest a very reliable platform and a very small allocation. ***This is money you should be able to afford to lose.***

Investing in CDs

While CDs might seem like a safe investment, they actually add risk for most investors. Since CDs will not make enough money to keep up with inflation, you are quickly losing purchasing power. When markets recover from the current slump, the money you invest in CDs will not benefit from that recovery. ***You fall behind on your long-term goals.*** If you must, consider a few insured, short-term CDs as a substitute for some of your bond portfolio.

Gold

Many investors believe that gold is a good hedge against inflation and poor monetary policy. But the data does not bear this out. While inflation pressures were building in 2021, gold lost money. It is up this year, but not as much as many expected. The Fed is contracting, not expanding, the money supply. Gold has made almost no return over the past 10 years. Taking delivery of physical gold requires a secure location. If you want to keep it at home, you take on the added stress of worrying about theft. ***Admittedly, it is fun to touch and hold, but it is not the safe haven many think.*** Doomsday articles, newsletters, websites, and commercials are often quietly sponsored by the purveyors of precious metals investments. Buyer beware.

Picking Individual Stocks

This is very difficult to do. In my view, by picking individual stocks, you must believe you can do a better job than the full-time analysts and fund managers out there. Otherwise, you are wasting your precious time – unless it is an enjoyable endeavor for you. According to the Wall Street Journal, about 85% of professional stock fund managers failed to beat the overall stock market index last year.[5] And last year was supposed to be an "easy" year to pick winners and losers. ***If you must scratch this itch, make a small side portfolio for the stocks you think will be winners. Honestly compare your performance to the overall market over time, and evaluate your results to see if this strategy is worth your time and hard-earned money.***

My Recommendations

Rebalance to your target allocation. On the stock side, consider a tilt toward value and dividend stocks with good cash flows that will hold up during a recession. On the bond side, orient your portfolio to bonds that are short in duration and high in quality, and wait while the Fed raises rates. While you are rebalancing, look for opportunities for tax loss harvesting.

I believe that markets will be volatile for some time, but eventually they will recover. The timing of all this is very difficult to forecast. But when markets recover, they do so very quickly. Investors understand that markets are down from time to time. It is how we react, or don't react, that will determine our long-term success.

Keep your focus on the long term, and be extra patient and disciplined during these turbulent times.

---

[5] Baer, Justin, "Stock Pickers Are Struggling to Beat the Market," Wall Street Journal, December 28, 2021.

I hope this newsletter finds you safe and well. Please reach out with your investment questions and concerns.

Thank you.

D. Austin Lewis

This is an educational newsletter expressing opinions only. This newsletter should not be relied upon until your individual situation is taken into consideration by an experienced advisor. This newsletter is not designed or intended to give you individual investment, tax, or legal advice. We strongly recommend that you consult with your own financial/tax advisor and/or legal counsel for information and advice concerning your particular situation. If you are a client, please give us a call. Past performance does not indicate or guarantee future results. Investing involves substantial risks, including loss of principal.