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January 2022 Crescent Commentary

Last month, U.S. stocks experienced their worst January since the Financial Crisis in 2009. As a whole, the U.S. stock market decline reached 13% in January from its November high level. While that's not a pleasant thought, speculative assets did far worse, with outcomes ranging from terrible to disastrous. For example, the technology-heavy NASDAQ index fell 19% in January from its November high. Similarly, Bitcoin fell 52% in January from its November high. Even bonds declined, with the iShares long-term bond index falling 10% from its November high[1].

Why did this happen? While corrections occur regularly in financial markets, recent developments could mean that future investment conditions look quite different from the status quo of the past thirteen years. It all started with the emergence of elevated inflation, which our Group first warned about in May of last year. At the time, we saw signs that the U.S. economy had recovered from the covid-19 recession much more quickly than the Federal Reserve had anticipated, yet the Fed continued to stimulate our economy as if we were in the middle of a crisis. Over the following months, as report after report continued to come out showing accelerating inflation, the Fed refused to even publicly acknowledge the possibility that inflation would remain elevated. Then suddenly the world changed last November when the Fed acknowledged their misevaluation of inflation, and publicly stated they would begin to withdraw their economic stimulus at a more rapid rate than originally anticipated[2][3].

Why is it such a big deal if the Fed removes stimulus? Are our financial markets and economy really that addicted to and dependent upon stimulus? Our view is that certain segments of financial markets are indeed inflated as a result of chronic stimulus. This is why the most speculative investments started to fall the most last November when the Fed announced its plan to withdraw stimulus. At the same time as speculative investments were crashing, the consumer staples industry – which provides basic necessities such as food, beverages, and personal and household care products – experienced a 13% increase in its stock market value from the end of November to January. This supports our view that investment markets resemble a seesaw with the most speculative assets high and poised to fall and mundane but sound investments reasonably priced and poised to do fine.

The last time the Fed started to withdraw its interest rate stimulus was in the fall of 2018. Some popular, large U.S. stocks fell more than 30% at that time. The Fed caved in to the pressure of the falling stock market, reversed their course, and actually started increasing stimulus at a time when our economy didn't need it. This certainly intensified financial speculation. The difference today with the Fed reducing its stimulus is that the Fed is being forced to reduce stimulus to fight inflation. As long as high inflation persists, the Fed doesn't have the option of suddenly reversing course on stimulus reduction as it did in 2018[1].

If elevated inflation persists and the Fed must continue to reduce stimulus, we expect the shakeout in risky and popular assets to continue. This would mark a turning point in the investment status quo of the past thirteen years. However, if inflation moderates soon, then the Fed can get away with continuing to stimulate the economy with low interest rates until negative ramifications emerge at some point. In this scenario, investment conditions would more closely resemble the past thirteen years. It's also important to note that even if inflation eventually moderates, by that time the Fed may have withdrawn stimulus enough to still pop the financial bubbles that have developed over the past several years. This happened in 2000 when the technology stock bubble burst, and again in 2007 when the home price bubble burst.

So how should investors position themselves in an uncertain world? Our answer is unchanged. We have positioned our clients in a way that gives them the best chance of succeeding no matter what happens. If the Fed has luck on its side and is able to achieve a "soft landing" where inflation moderates, stimulus stays in place, and the status quo economy of the past thirteen years continues, then investors will benefit from owning investments that provide consumers with the premium products they demand in an economy awash with cash[4].

If on the other hand the Fed's luck runs out and inflation persists, forcing the Fed to reduce stimulus more than expected, and we experience a "hard landing" where bubbles continue to unravel as they started doing last fall, then our clients will benefit from owning reasonably priced assets that provide the basic necessities of life. As we wrote in past commentaries, these types of assets have historically done well during times when past bubbles burst, including the bursting of the 2000 technology bubble and 2007 home price bubble. We expect that to be true if the current bubbles continue to deflate[5].

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<u>Sources:</u>

(1) Yahoo Finance
(2) CNBC
(3) Fortune
(4) Company reports
(5) Richard Bernstein Advisors