DANN ASSET ADVISORS, LLC

Interim Update
Falling Markets
May 9, 2022

As of Friday's close, the stock market as measured by the S&P 500 was 14.4% off its early January high. In addition, the iShares Core US Aggregate Bond exchange traded fund (a proxy for the U.S. investment grade bond market) had generated a negative return of 10.4%[1], one of the worst returns generated by bonds over a short timeframe ever according to a recent Wall Street Journal column[2]. We don't have the data but believe that year-to-date 2022 has been one of the worst periods for combined stock/fixed income portfolios since at least the early 1980s.

The only places to be in 2022 have been a few sectors of the stock market (energy (+49.7%) and utilities and consumer staples stocks (both about flat)), select commodities, and gold. Communications (-24.6%), consumer discretionary (-23.1%), and technology (-20.7%) have been among the worst performers[3], with high growth, money losing stocks faring especially poorly. As an example of the last, the Ark Innovation exchange traded fund (ETF) was down 51.8% through Friday's close[4].

Tight labor markets, supply chain issues (including the availability of key components like semiconductors), high commodity prices (energy, but also others), rising interest rates, and increasingly restrictive Fed policies are fueling market weakness. Each of these factors contributes to inflation, which we continue to view as the key issue for the economy and markets over the near to intermediate term.

In our April 11 update, we noted the Fed's difficult task of trying to bring down inflation without tipping the economy into a recession. We believe this task has gotten more difficult. The pace and magnitude of interest rate increases has surprised us, and mortgage rates are now back to 2009 levels. Higher energy and food costs are likely to cause consumers to allocate more dollars to those items and away from more discretionary purchases that typically fuel economic growth. And lastly, international economies seem to be slowing; Europe due to a relatively greater impact from higher energy prices and China due to rolling Covid-induced lockdowns. These factors combined with a Fed that seems committed to reducing inflation are making a recession increasingly likely, in our opinion.

We believe that the stock market is forward looking, often correctly anticipating where the economy will be in six to 12 months. The market's decline is saying the economy – and corporate earnings – will be weaker. And beneath the market's surface, sector performance is indicating a consumer that will be under pressure – through Friday, indexed ETFs for retail, consumer discretionary, and homebuilder stocks were down 23.0%, 23.1%, and 28.3%[5], respectively, considerably worse than the S&P 500 index's 13.1% year-to-date decline. The U.S. economy usually has a tough time growing when consumers are under pressure.

With respect to client portfolios, we've not made any changes in fixed income since the end of the first quarter. We've owned an intermediate-term, investment grade municipal bond fund for a handful of clients for years, and we may add this for additional clients. Until very recently, this fund had been closed to new investors as the managers weren't finding good values in the municipals market. If we move forward with the purchase, funds likely will come from intermediate term mutual funds already owned by those specific clients. Doing this would enable realizing some modest losses, in addition to upgrading intermediate term exposure (which overall remains small).

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On equities, in April we sold the remainder of a mid-cap growth mutual fund that had been owned by most clients. We continue to like the fund and performance relative to mid-cap growth indices has been respectable. However, we have more confidence in our two other funds in the small-mid cap area, and likely will add to one or both of these.

More generally on client equity portfolios, we're focused on higher quality for clients' sector focused exposures (technology, healthcare, industrials, and for some clients, aerospace and defense) and actively managed mutual funds. We want to own businesses that have strong balance sheets to survive higher interest rates and take advantage of opportunities that often arise when the economy slows. And we also want businesses with pricing power to alleviate the margin pressure that comes with inflation.

After many years of outperformance, technology stocks have had a poor stretch. In retrospect, it's clear that valuations were stretched. But we still believe in the sector – while technology can have negative impacts it's likely to be part of the longer-term solution for many problems. We note that energy is the one sector that truly has shone over the past 12 months. We've considered adding exposure here, but our experience is that adding exposure to commodity stocks when the underlying commodities are near record levels rarely works. Although we haven't owned commodity focused stocks in a long time, we track them as indicators of economic strength. The fact that Alcoa (aluminum) and Freeport-McMoRan (copper) have declined 35% to 40% in the past seven weeks may be a further sign of upcoming economic weakness.

Finally, we want to mention the possibility of stagflation – high inflation and a weak economy, last an issue during the 1970s. Generally speaking, the 1970s was a tough period for investing, other than for energy (Arab oil embargo in 1973) and some other commodity focused industries. Listening to Fed Chair Pro Tempore Powell speak about inflation, including references to Paul Volker's efforts to break inflation, we're taking the Fed at their word that reducing inflation is the number one priority. Accordingly, we're assuming the next six to 24 months will play out as a normal cycle, with the economy slowing, inflation moderating, and the Fed eventually becoming more accommodative with monetary policy.

(1) Morningstar.
(2) The Wall Street Journal, The Intelligent Investor, Jason Zweig, May 6, 2022
(3) Vanguard, based on returns of Vanguard sector ETFs.
(4) Morningstar.
(5) Retail and homebuilding sector returns from Morningstar, using SPDR sector ETFs.

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