Email Body 4-5-2022

**Where is the Economy Headed?**

As always there is a lot happening here and abroad. Hopefully, you have been able to avoid the news and focus on life here in America’s greatest city. Spring is upon us with warmer temperatures and the opportunity to engage in local favorite pastimes more thoroughly. I encourage you to get out and enjoy what San Diego has to offer.

COVID-19 UPDATE

Covid has devolved into the endemic phase and is not a significant issue economically here in the U.S. Globally, there are some hotspots of Omicron variant spikes that have shut down some economic activity, but it has been minimal.

GEOPOLITICS AND THE ECONOMY

We started the year with the Federal Reserve actively removing support from the bond markets in the form of reduced money creation and bond buying. Last month the Federal Reserve added the beginning of interest rate hikes to its inflation-fighting toolkit. Combine that with a Russian invasion of Ukraine, the world’s largest exporter of wheat and largest supplier of neon (i.e., 45%-50% of world market), and you have market volatility. In case you were not aware, neon is a critical component used by lasers to make microchips. As if we did not have enough of a microchip manufacturing problem.

The equity markets reacted by contracting and bottoming out in mid-February (e.g., at about negative 13% for major indexes) and have been slowly retracing back up since then. The low interest rate, low inflation environment of the last ten years was great for growth-oriented stocks whose earnings and cash flows are valued several years into the future. Moving forward into a higher interest rate, higher inflation environment will favor value-oriented stocks whose earnings and cash flow potential is more front-loaded into the near future. The market correction in January and early February reflects this change of leadership as market participants reduce growth-oriented holdings (i.e., tech, energy, pharmaceutical, e-commerce, retail, etc.) and increased value-oriented holdings (i.e., banks, insurance, real estate, auto, communication, etc.). Also, greater than 10% market corrections typically happen every 1.7 years. Not counting the self-induced covid bear market of 2020, the last 10%+ correction we have had was in 2018 or over three years ago. We have been long overdue for such a correction.

Higher inflation and higher interest rates are not fun, especially as it is reflected at the gas pumps and grocery stores. Consumer sentiment is stalling but still in positive territory. Further supporting my case that a recession in the next 6-12 months is not likely is strong real corporate profits growth, low and falling unemployment, and strong corporate and household balance sheets (i.e., cash levels). The main risks to my base case of no recession in the near future are the Federal Reserves ability to achieve the vaunted “soft landing” through measured rate hikes and any unforeseen events, geopolitical or otherwise that may occur and upend expectations.

One of the reasons I started writing my own analyses is because I wanted you to have a source of information to better explain what mass media presents only in headlines and clickbait. Recently, much has been made of the occurrence of a “yield-curve inversion” which some theorize predicts a recession. When you graph interest rates versus maturities you normally see a line moving up and to the right. This reflects lower rates for shorter maturities and higher rates for longer maturities. Recent articles made much of the fact that the rates on 10-year treasury bonds dropped below the rates for 2-year treasury bonds, thus an inversion.

First, yield curve inversions have historically predicted about 60% of recessions. Second, when the inversion correctly predicted the recession, it was between several months and two years before the recession began. Only a couple of parts of the yield curve have inverted recently and only temporarily. Further, the most accurately predicting yield-curve inversion is the comparison of the 3-month T-bill rate (e.g., 0.65%) to the 10-year treasury bond rate (2.54%). As you can see, an inversion here is nowhere in sight for the near future. The last 3mo/10yr inversion occurred in 2005 or over two years before the recession began in October 2007.

Finally, I would like to invite you to listen in on a recent call featuring Brad MacMillan discussing the impact of inflation and the Ukraine invasion on the economy and financial markets. It is about thirty minutes long. Brad is managing principal and chief investment officer at Commonwealth Financial Network®, where he chairs the Investment committee and is the primary spokesperson for the firm’s investment divisions. Check out <https://onlinexperiences.com/scripts/Server.nxp> or see the attachment to this email.

I am always available to you via phone, zoom conference or in person. I look forward to talking with you over the next few weeks. If you have any questions or if we can be of any help, please do not hesitate to contact Linda or me.

*Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results.*

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