—New Albany—
Investment Management

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Harsh Reality Settling In

The stock market continues to struggle, extending a three-week rout of declines, as investors come to terms with a far higher inflation, a far greater hawkish Federal Reserve, and a far longer, brutal war. The fierce but brief rally of over +10% in mid-March has now almost completely dissolved. As of this writing, the S&P is back into correction territory, down over -10% and the Nasdaq is back into bear market, down -20%. But that's only half the story. With inflation at 40-year highs, up +8.5%, interest rates have rocketed higher, causing Bond prices to endure the sharpest year-to-date decline in decades, down -9.4%! The harsh reality of bringing inflation under control has finally begun to settle upon the entire market.

The **good news is the Portfolio strategy is working very well**. The bad news is there is likely more volatility and lower prices to come in the near term. But of course, this can all change in an instant.

Outlook: Much will depend on how quickly inflation can be brought under control. Given the huge gap between inflation (very high) and interest rates (still very low), large swings in the market will continue as the market assess the likelihood of a recession. To close this gap, interest rates still need to rise, and this will continue to put downward pressure on bond prices and high growth areas of the stock market.

How high do rates need to rise? According to history, **A LOT!** The Fed's favorite inflation gauge is the Personal Consumption Expenditure (PCE) index which is currently at 6.4% and up from 4.9% in February and well above the Fed's 2.5% target. History has shown when inflation is above this target, the Fed Funds rate (which the Fed controls) is ABOVE the PCE rate. Today, **the Fed Funds rate is only 0.38%, and would have to rise to over 6% to meet the current inflation rate.** The Fed does expect inflation to fall, perhaps back down to *only* 4.5% by year end. Even with an improvement, the market still has a long way to go.

Implications of rising rates: Interest rates are also rising across all borrowing sectors with Corporate bonds and mortgage borrowing costs rising over 2% points since Janaury! Again another record pace. The speed and magnitude of the rate hikes will definitely cool demand, put downward pressure on earnngs, and could push the economy into a recession at some point over the next twelve months.

How we are navigating these challenging markets: Since the beginning of this year, we have made three deliberate moves to reduce risk and mitigate the rapid decline in both bond and stock prices.

- The first week of January, stock exposure was re-allocated to lower beta (risk) areas of the market. Specifically, risk was moved from 'Growth sectors' (which have been hit hard due to rising rates), to 'Value sectors'. The year-to-date performance spread is remarkable:
  Large Growth = -19%   Large Value = -4.5%
- In anticipation of more aggressive Fed moves, the already short-term bond duration was reduced even further. The year-to-date performance spread between short term, intermediate, and long bonds is remarkable: Short Term: -2.6%   Intermediate: -10.1%   Long Term: -18.7%
- Diversified risk by adding a new 'Long/Short' sector to the portfolio strategy that capitalizes on trends (both up and down) in Commodities, Currencies, Interest Rates, and Stock prices. This position has proven effective as a hedge against falling prices elsewhere in the portfolio.

In sum, the portfolios are weathering the bear market quite well. In these highly volatile times, it is important not to try to time the market, keep exposure diversified and defensive, and stay alert to key changes in economic & political fundamentals that could change the speed and course of the markets. In addition, it is important to remember the long-term time horizon for Investing.

As always, please contact me with questions or concerns. These are my thoughts. Your feedback is always appreciated.

Barbara

Barbara HS Huff, CEO
New Albany Investment Management
614-216-6139
bhuff@newalbanyinvestment.com