Should I Be Concerned About the Markets?

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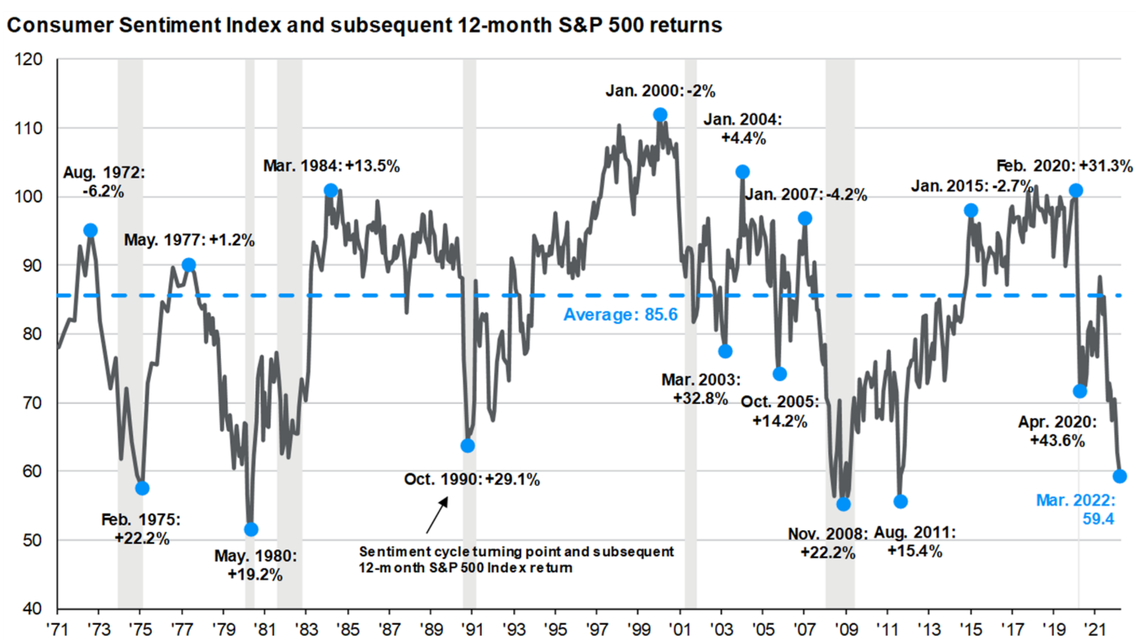
By Brian Luster

With consumer sentiment approaching historical lows on concerns of the Federal Reserve "front-loading" their interest rate hike in May, stickier than expected inflation, geopolitical uncertainty, continued supply chain challenges, and the maintenance of a zero-COVID policy in China, it is surprising to see that market apprehension hasn't been an even larger topic of conversation during our recent communications with investors.

While we suspect this is a result of many of you having experienced several market corrections in the past, it's worth reiterating an important lesson about investment discipline. When investors are worried about the outlook for markets, their natural tendency is to sell risk assets in general and stocks in particular. However, history suggests that trying to time markets in this way is a mistake. The chart below shows the University of Michigan index of Consumer Sentiment stretching back over the past 50 years. As you can see, there have been eight distinct peaks and troughs noted by the blue dots. We also show the performance of the S&P 500 in the 12 months following those peaks or troughs. On average, buying at a confidence peak provided investors with a 4.4% return, while buying at a confidence trough generated a 24.5% return.



Source: FactSet, Standard & Poor's, University of Michigan, J.P. Morgan Asset Management. Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month S&P 500 returns are price returns only, which excludes dividends. Past performance is not a reliable indicator of current and future results. U.S. Data are as of April 5, 2022.

While we would not believe it is reasonable to expect a 24.5% return in the coming year, we would recognize that the world has experienced significantly worse macroeconomic and geopolitical backdrops over the past 50 years, and during those times, being a patient equity investor has proven to be quite profitable.

What Allocation Changes Have We Made?
Given the uncertainties plaguing markets, we recommended several asset allocation changes in the second half of last year and first quarter of this year that have been very helpful in blunting negative market performance.

First, we shifted approximately one half of our core sub-asset class allocations in domestic Large Cap and Small Cap equities toward a value/quality tilt. This has been particularly helpful in blunting the negative returns from US Large Cap and US Small Cap stocks, as value has been outperforming growth year to date. Second, we reduced our Mid Cap allocation by half, and reallocated the proceeds toward Global Real Estate, again reducing losses from this sub-asset class. Finally, we reduced our core intermediate fixed income allocation by one half and reinvested the proceeds into ultra-short-term bonds. The combined effect, while very helpful in reducing value destruction, has not been enough to avoid portfolio losses.

Where Does this Leave Us Now?
We are now left with a portfolio that is taking somewhat of a barbell approach to the market, with half of domestic equities exposed to their benchmark indices, and the other half tilted toward value/quality and real estate. Meanwhile, our Core Fixed Income portfolio retains a one-half allocation to intermediate term bonds and one-half in ultra-short-term bonds.

We feel very confident in this approach, as fixed income yields have improved drastically over the past few months, and we believe there are opportunities for appreciation in intermediate-term bonds, as the market has priced in a very aggressive interest rate pathway that may not be attainable should the Fed make a policy error. In that situation, longer-term bonds could see substantial upside potential from a marginally less aggressive Federal Reserve.

We continue to believe that slowing economic growth and a resolution of supply chain issues will cause inflation to moderate. Additionally, the decline in trade union membership will place downward pressure on wage inflation, the impact of technology on the consumer's ability to secure the lowest price for goods and services will cause downward pressure on price inflation, and the waning of pandemic assistance will cause a slowdown in consumer demand. Together, these factors will naturally cause inflation to erode, without the necessity of going into economic recession. As a result, we believe it is very reasonable that the Federal Reserve will front-load their interest rate policy yet slow the pace of rate increase as we approach year-end to a final figure below that which the market currently expects, creating opportunities for longer duration fixed income investors.

For equity investors, we continue to expect value to outperform growth, and small cap to outperform large cap during this economic cycle as interest rates rise and the gap in relative valuations closes. We continue to expect international equities to outperform domestic equities in the intermediate and long-term over the course of this economic cycle. Still, we continuously monitor changes in economic data, and are prepared to make allocation shifts when appropriate. At present, we do not feel the current market sentiment warrants significant concern and remain optimistic about the path of returns and current allocations for the years ahead.

ABOUT THE AUTHOR

BRIAN LUSTER is a Principal and Chief Investment Officer of Collective Family Office located in York, Pennsylvania. With over 20 years of Wealth Management experience, Mr. Luster has previously served as Founder and CEO of a boutique Multi Family Office in New York City, as the Managing Member and Portfolio Manager of a long/short US event-driven value-oriented hedge fund in New York, and as a Senior Wealth Manager for BNY Mellon Wealth Management in Central Pennsylvania.

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