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Markets in Transition

Maintaining the Long-term Focus While Taking Advantage of Opportunities

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Markets in transition most often are volatile, never knowing what the day may bring. Headlines, which there is no shortage, may cause the most devoted investor to question their long-term conviction. Knowing the cause of the transition, may provide insight into the long-term direction even though there may be short-term pain.

Here is a selection of the current headlines: CoVID 19 and the newest variant; market volatility; price of gasoline; possible recession, Federal Reserve increasing the Fed Funds rate; Russia's unprovoked attack on Ukraine; Putin's unknown responses to the aid provided to Ukraine; upcoming mid-term elections; inflation; and the supply chain just to name a few.

While most headlines are truthful, without some exaggeration many readers would never take a second look. Headlines generally depict what is happening this month, this week, or today. Investors should be looking five, ten, or more **years** into the future. Periods of transitions are good in the sense they provide opportunities not normally seen. Clearly the variety of headlines indicate there are many current issues, but the ones most likely to cause markets to be in transition is the Federal Reserve increasing the Federal Funds interest rate and inflation.

In short, we are managing through this volatility and will take advantage of opportunities as they are presented. If appropriate, we will adjust allocations to strengthen the portfolio's ability to recover when the markets return to positive moves. Please call us if you have questions. The following provides a more technical view of the markets today and what we anticipate.

The two charts included depict the value of the Fed Fund rate for the last 62 years and a closer look during the last 20 years. The vertical gray areas reflect recessions our economy has experienced during these periods. Since the early 1980s, the long-term trend has been a decreasing Fed Funds rate. The 21st century brought two short periods of increasing interest rates both of which were followed by near zero rates. The first followed the 2001 recession and lasted approximately two years reaching 5.24% before being adjusted lower due to the great recession of 2008-2009. The second increasing interest rate period started about six years ago, in January 2016 and peaked April 2019 at 2.44%. The most recent start by Chairman Powell is the Board's attempt to raise the Fed Funds rate to reach a more 'normal' rate and to impact inflation levels. Depending upon the size of each move, this could take more than a year to reach two percent. The Board will monitor economic data which could impact the timing and size of each interest rate adjustment. Most investors are aware the purpose of the Federal Reserve increasing funds rate is to reduce demand by increasing financing costs. If projects or acquisitions cost more due to the higher interest rate, many may be delayed or canceled thereby reducing de-

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mand. If successful, this reduction in demand may also impact inflation causing it to wane, eventually bringing it back in line with the target range of the Federal Reserve, which is two percent. It seems contradictory to combat increasing costs and inflation, by increasing interest rates to increase the cost of financing. But this is the primary tool of the Federal Reserve which is used to impact the rate at which our economy grows.

Inflation, when in the moderate range of two to three percent, is beneficial to the economy. But, when it is running hot, like it is now, costs and assets are rising at rates damaging to the economy and harms particularly lower and fixed income groups. Early in 2021, Chairman Powell acknowledged inflation was running hotter than desired but believed the lack of supply was a greater influence than high demand. There were hundreds of container ships waiting outside U.S. ports to dock and offload thousands of containers. Due to the lack of truck drivers at the time, many of those containers once off loaded sat in storage not for days, but weeks or longer. Around the globe there were many factories shutdown or running below capacity experiencing shortages of raw materials or healthy workers. Both were contributing to shortages. Impacting the demand side in my opinion was the trillions spent by the U.S. government through three rounds of stimulus payments, business expense reimbursements and forgivable loans to businesses. The government also allowed millions to delay mortgage, rent, and student loan payments or the stoppage of foreclosures and evictions. While many needed the assistance, others may have used the opportunity to pay down debt, spend money elsewhere, or bank part of the cash thus enhancing the demand. The extra cash created by the all the government support combined with the shortages created by the supply chain, and prices were bound to increase. Chairman Powell is no longer using the term ‘transitory’ as he describes inflation since higher prices appear more intrenched in our economy.

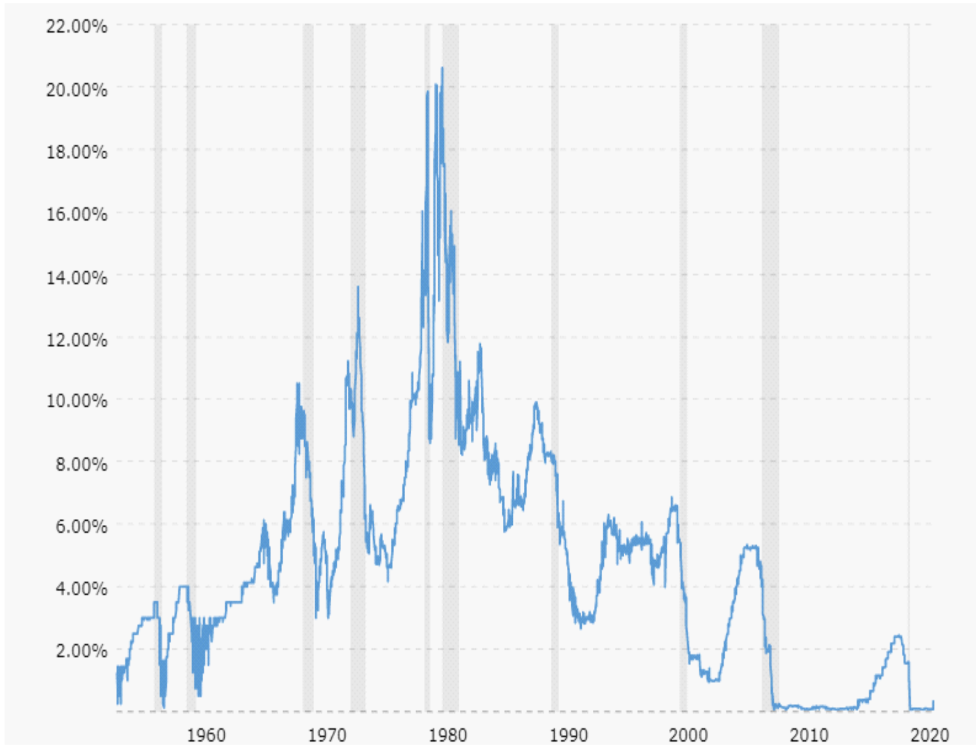

Chart 1: Federal Funds Rate 62 Year History

There are any number of investment managers and economists who believe the Federal Reserve is still behind the curve on increasing interest rates. In addition to controlling the Fed rate, the Reserve kept market rates lower by expanding their balance sheet. In 2021, through the purchase of over 2 trillion dollars of treasury and Mortgage Backed bonds this added demand allowed market rates to remain low. Now they are shrinking the balance sheet by letting maturing bonds payoff and not using the cash received to reinvest in more bonds. This and the Board’s transparency on increasing Fed Fund rates allowed the ten-year treasury yields to

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increase significantly. The Fed Funds rate was increased in March a quarter point or 25 basis points, but the market using guidance and expectation moved the ten-year treasuries higher by 110 basis points from 1.75% to 2.85%. Along with the rise in the ten-year treasuries is the increase in mortgage rates from the low three percent to now five percent range. These increases by the market in general is already having a small impact on the economy, however, historically it takes six to nine months to see results in the data from a change in Fed Funds rate. There are indications housing sales and refinancing are slowing due to higher mortgage rates. While interest rates impact the economy, they are not the only thing that can impact the economy and inflation.

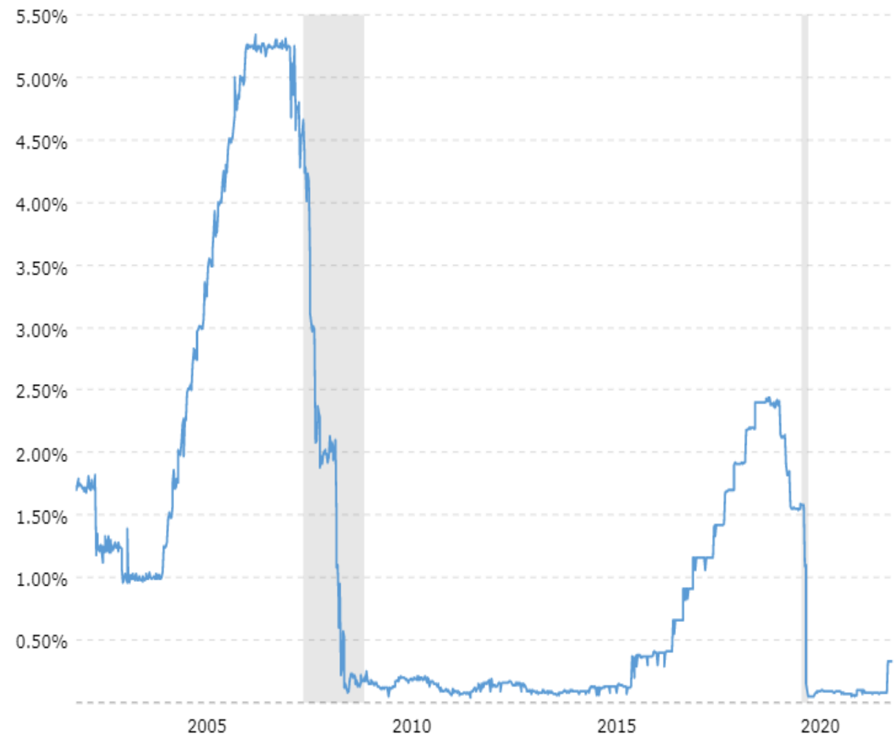

Chart 2: Federal Funds Rate 20 Year History

Higher interest costs impact those who need to borrow funds or have variable rate loans. Higher energy costs though impact every individual, family, and business. In 2000, oil prices were on the rise along with interest rates. It is my belief the two increasing in tandem had a greater impact than expected and contributed to the 2001 recession. Like in 2000, oil prices have been increasing. Except for the severe drop at the start of the pandemic, the price recovered by the end of 2020 and continued to rise. The price of oil moved from the high $50's to the high $70's by the end of 2021 and is now near $100. While rising oil prices may have contributed to inflation, it can also be a factor in a slowing economy and waning inflation. For all of 2021, the GDP growth rate was strong with the lowest quarterly rate being 2.3% and the others above 6%. Last week the first 2022 quarter GDP rate was announced and was an unexpected contraction, rather than the anticipated growth of 1.1%. The economy declined by 1.4%. Part of this decline may have been caused by the war in Ukraine, but most likely it was the rise in oil prices finally working its way through the economy.

There are some good points to consider as well. The unemployment rate and initial jobless claims are both low indicating the economy still has some strength. It seems the supply chain issues may be improving as many of the companies when reporting quarterly profit results were commenting on improving conditions. With the first quarter GDP coming in lower than expected and oil prices remaining high, the urgency for higher rates also may lessen as data continues to be evaluated. Several catalyst may occur from positive news on the war, to lower CPI and PPI rates as well as later this year, the mid-term election.

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This is an opportunity to continue to elevate the quality of holdings. There are many companies who have strong management, products in high demand, positive outlooks, and yet their stock value is off recent highs by ten, fifteen percent or more. The roller coaster ride in the markets may be contributed to nervous investors, concern about the Federal Reserve raising rates too high, rather than disappointing economic conditions, indicating this may be short lived. The annual meeting of Berkshire Hathaway occurred this past weekend which provided an opportunity to hear Warren Buffett respond to questions from a variety of investors. The most important takeaways were 'patience' and having cash ready to take advantage of opportunities when presented. We are heeding Mr. Buffett's recommendations and seeking quality opportunities.

Citations:

Charts 1 and 2: Macrotrends.net