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*In this week's recap: Powell favors quick movement on rising interest rates.*

# Weekly Economic Update

*Presented by Ed Papier, April 25, 2022*

## THE WEEK ON WALL STREET

Hawkish comments from Fed Chair Jerome Powell overshadowed many largely positive earnings results, sending stocks lower for the week.

The Dow Jones Industrial Average declined 1.86%, while the Standard & Poor's 500 dropped 2.75%. The Nasdaq Composite index fell 3.83% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, advanced 0.50%. [1,2,3]

## FOCUS COMES OFF EARNINGS

With the inflation report in the rearview mirror and a Fed meeting two weeks away, many may have expected corporate earnings to be in focus last week. Comments by Jerome Powell stole the spotlight. Investors began the week awaiting earnings reports looking for insight into businesses handling the latest inflation, a jittery consumer, tighter monetary policy, and ongoing supply chain issues. Despite one high-profile earnings disappointment, corporate profits appeared better than expected. By the time trading began on Thursday, 17% of S&P 500 companies had reported, and 81% had beaten Wall Street analysts' estimates. Investors responded positively, sending share prices higher until Powell's comments on Thursday afternoon triggered selling into the day's close and accelerated through Friday. [4]

## POWELL UNNERVES MARKETS

On Thursday, at an event hosted by the International Monetary Fund, the Fed Chair offered his view that it may be appropriate to move more quickly on raising interest rates. He indicated that a 50 basis point hike was on the table for the Federal Open Market Committee (FOMC). [5]

His comments also emphasized the need to restore price stability, recalling the successful efforts of former Fed Chair Paul Volker, who used a series of rate hikes to tame the inflation of the 1970s and early 1980s. While some observers anticipated these comments, yields rose, and stocks fell in response.

## THE WEEK AHEAD: KEY ECONOMIC DATA

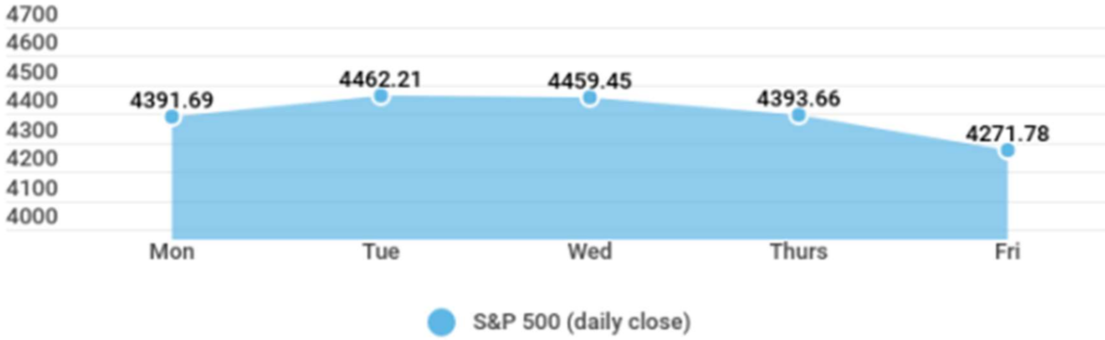
Tuesday: Durable Goods Orders. Consumer Confidence. New Home Sales.
Thursday: Gross Domestic Product (GDP). Jobless Claims.
Friday: Consumer Sentiment.

### QUOTE OF THE WEEK

*"If you're taking flak, you're over the target"*

*A WW II Air Force Pilot*

| Market Index | Close | Week | Y-T-D |
|---|---|---|---|
| DJIA | 33,811.40 | -1.86% | -6.95% |
| NASDAQ | 12,839.29 | -3.83% | -17.93% |
| MSCI-EAFE | 2,126.64 | +0.50% | -8.97% |
| S&P 500 | 4,271.78 | -2.75% | -10.37% |




| | Treasury | Close | Week | Y-T-D |
|---|---|---|---|---|
| | 10-Year Note | 2.90% | +0.07% | +1.38% |

Sources: The Wall Street Journal, April 22, 2022; Treasury.gov, April 22, 2022
Weekly performance for the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite Index is measured from the close of trading on Thursday, April 14, to Friday, April 22, close. Weekly performance for the MSCI-EAFE is measured from Friday, April 15, open to Thursday, April 21, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

## OF NOTE

Let's discuss what diversification is and what it is not. Diversification is a hedge against uncertainty. If one knew with 100% certainty what the best performing investment would be, any rational investor would simply put all their money into that one single investment because owning anything else would detract from performance. The less certainty you have, the more diversification you should seek.

Diversification is less about increasing portfolio returns, and more about creating a smoother ride. For example, let's say you have two $100,00 investments that both earn an average return of 8% over a two-year period. Investment no. 1 earns 26% the first year and -10% the second, experiencing high volatility. Investment number 2 years 8% each year, experiencing no volatility. After two years, the value of investment no. 1 is $133,400 and no. 2 is $116,640. Both earn an average 8% over the two-year period but investment no. 2 has a higher value.

The narrow leadership of the past decade has led to high market concentration in those areas that have worked, namely US over international, large caps over small caps, and growth over value. Whether one focuses on single stocks, sectors, regions or styles, the level of concentration in the stock market is at or near record levels.

The very assets most sought after as sources of diversification, such as bonds and alternative investments, tend to have high or rapidly increasing correlations with stocks. Consider the Wilshire Liquid Alternatives Index, which is predominately made up of hedge funds. Both liquid alternatives and the broader hedge fund universe have become extremely correlated with stocks.

We believe we are in a new paradigm of rising interest rates, which suggests that bonds are not likely to provide anything like the type of negative correlations with stocks that investors have come to expect over the past 40 years. Case in point, the first quarter of this year was the first quarter since 1980 — the tail end of the last rising rate regime — where stock markets fell, and bonds were down more than 5%.

In fact, during the entire 30-year period from 1965 through 1995, there were only two instances where stocks fell by over 10% and the yield on 10-year Treasury bonds also declined — i.e. bond prices rose. All of the other 15 stock market corrections saw Treasury yields rise (bond prices fall) by an average of 88bp. It was only in the past two decades of low and declining interest rates where Treasury yields have tended to fall during stock market corrections, but that period may now be over.`

Other areas that investors often look to for diversification are private equity and real estate. However, if the new paradigm results in higher debt financing costs, the returns and valuations of these investments could come down dramatically due to their reliance on low-cost leverage. Additionally, long-duration investments, for which the bulk of the profits are projected to be far into the future, face significant valuation risk from higher interest rates. While this may pertain to some alternative investments such as venture capital or cryptocurrency, this also comes full circle back to the concentrated areas of the stock market. As highlighted in a report by Bank of America Research, the investment recovery period — also known as duration — for the US stock market remains near record levels, which makes it extremely vulnerable to higher interest rates.

To summarize, today's stock markets are more concentrated than they have ever been. The increased concentration is in long-duration equities, which has increased the stock market's sensitivity to interest rates. Investors have flocked to alternative investments hoping to add diversification, but most of these investments have high or increasing correlations with stocks and/or may struggle in a period of secularly rising interest rates. The latter is truer of liquid alternatives than illiquid.

The high degree of market concentration combined with elevated correlations across the investment landscape suggests that passive diversification is extremely low. This is not a desirable situation given the increased likelihood of a new paradigm of higher inflation and higher interest rates and is particularly worrisome against the current fundamental backdrop of slowing corporate profit growth, tightening liquidity and elevated investor sentiment. We think the prudent response to such an environment would be to proactively force diversification into portfolios by reducing concentration and having exposure in areas with lower correlations. [6]

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CITATIONS:

1. The Wall Street Journal, April 22, 2022
2. The Wall Street Journal, April 22, 2022
3. The Wall Street Journal, April 22, 2022
4. CNBC, April 21, 2022
5. CNBC, April 21, 2022
6. advisorperspectives.com/commentaries/2022/04/13/the-biggest-risk-to-portfolios-today?topic=alternative-investments