PCM Insights: Special Market Update

June 2022

"The only real security that a man will have in this world is
a reserve of knowledge, experience, and ability."
– Henry Ford

While we have experienced a few downturns in the past decade, the start to 2022 has certainly been an unsettling period for investors. In moments of market stress, it is always important to refocus on things that we can control and take advantage of any market mispricing.

As for the markets, they have been roiled by a succession of blows this year – higher bond yields, lingering post-pandemic supply chain imbalances, a commodity price shock exaggerated by the war in Ukraine, and lockdowns across most major cities in China. Although none of these are trivial, markets have been able to brush off similarly worrying events in recent years because policymakers, particularly the Federal Reserve, have been quick to step in with support, typically in the form of lower interest rates, quantitative easing, or both. But markets currently have a new threat, one that has not been experienced in several decades – stubbornly high inflation.

Not only is inflation high, but it is jarringly so. As such, it is front-and-center for consumers and policymakers alike, and the fear of it has surpassed worries of an economic slowdown. In April, the University of Michigan Index of Consumer Sentiment hit 65.2, one of its lowest readings in four decades. From the accompanying press release:

> *"The downward slide in confidence represents the impact of uncertainty, which began with the pandemic and was reinforced by cross-currents, including the negative impact of inflation and higher interest rates."*[1]

It is this fear – of the hardship inflation and tighter monetary policy could cause – that has driven market returns in recent weeks. In addition to eroding purchasing power and investment returns, inflation also undermines the current value of financial assets, including stocks and bonds. This dynamic can become self-reinforcing if elevated inflation persists and consumers lose the incentive to defer much-needed current income for the prospects of potential future gains.

Persistently high inflation has pushed the U.S. consumer and the overall economy to an inflection point. As we look forward, we will continue to focus our efforts on how consumers and policymakers respond to incoming inflation data.

Unless inflation moderates meaningfully, the Fed faces an agonizing dilemma, albeit one of its own making. Because it waited so long to address inflation, it now must abruptly slow economic growth and risk a recession in the process. The alternative is equally unattractive. If it fails to do enough,

[1] UofM: http://www.sca.isr.umich.edu/

inflation could persist/continue, allowing stagflation to take hold and further eroding what is left of the Fed's already waning credibility.

Our view is that the path of least resistance is the former option – the Fed will attempt to address inflation now, even if that means sacrificing economic growth and markets. We believe this will be their focus until inflation materially declines or until the pain from the resulting slowdown exceeds the pain of inflation.

While this environment could continue to be challenging for risky assets, we are more optimistic than we have been for some time about the prospects of active managers and allocators navigating markets that appear to be placing more emphasis on the fundamental earnings capabilities of asset classes, sectors, and specific investments. In addition, stock market valuations have come down to more reasonable levels and bond yields look more attractive with treasury yields back to 3%.

So, with that, one might be asking either: (a) "What have you been doing?"; or (b) "What should we be doing?"

- *Tax loss harvesting*: You have probably been noticing a larger number of trades this year. Given the market volatility in both stocks and bonds, we have been diligently tax loss harvesting while swapping to a similar ETF or mutual fund. By realizing the paper losses, we can increase your future after-tax returns without altering your current portfolio positioning.

- *Rebalancing*: We have been investing cash and rebalancing portfolios, as both stocks and bonds are looking more attractive given the pullback in valuations.

- *Roth Conversions*: For those with large IRAs and in a low tax-bracket, we continue to strongly encourage Roth Conversions in periods of market stress. By taking a tactical view and converting when the market is low, we can grow the tax-free account for future use.

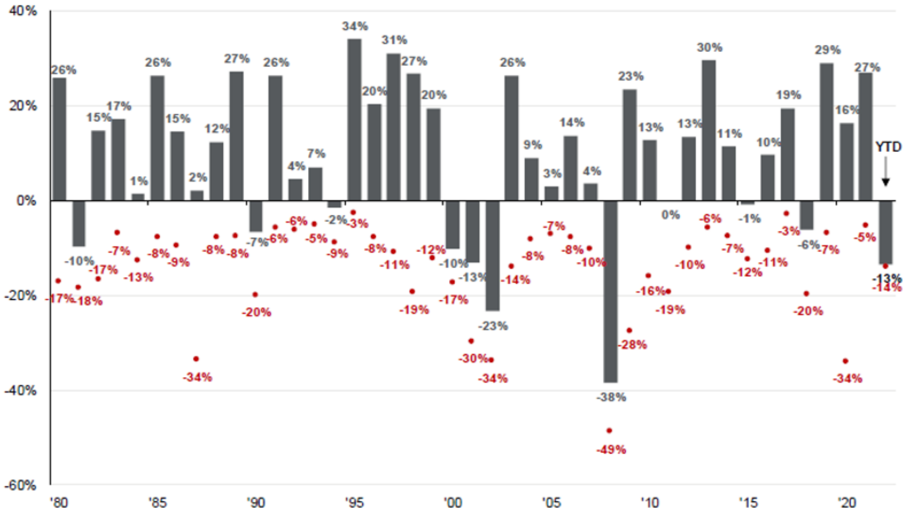
- *Financial planning goal planning*: Has anything changed over the last year in which you are planning for? If so, please reach out as we should discuss how best to prepare for the pending change. Otherwise, stay disciplined!

- *Cash flow review & savings goals*: Given the increased cost of goods and services, it is important to watch your cash flow and look to save a little extra this year. In addition, if you can make additional portfolio contributions, your financial plan will be rewarded in the long run with future portfolio growth.

- *Manager search*: We are currently completing a manager search to identify additional ways to hedge portfolios. Given the economic backdrop, we need to prepare for a wide range of outcomes and position portfolios with high quality, defensive exposures which can complement a traditional stock/bond portfolio.

- *Expect and accept volatility*: Remember market volatility is normal. Rather than trying to time the market, focus on time in the market. Being disciplined to your asset allocation has historically rewarded investors over time.

S&P intra-year declines vs. calendar year returns
Despite average intra-year drops of 14.0%, annual returns were positive in 32 of 42 years



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2021, over which time period the average annual return was 9.4%. *Guide to the Markets – U.S.* Data are as of May 10, 2022.

As always, please reach out to your advisor if you have any questions or would like to discuss your portfolio or financial plans.

Sincerely,
The Private Capital Management Team