

## *Marketline March 2022*

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### *Stocks:*

The market took a breather from the downward direction last month, rising 2.3% on the Dow, 3.6% on the S&P 500 and about 3.4% on the Nasdaq. These indices are still down year to date however. Overseas, Canada mimicked the US market, but Mexico performed quite well, up almost 6%. Mexico, as an oil producer and beneficiary of ‘near shoring’ – moving production facilities away from Asia and onto the North American continent – may perform better than other emerging markets, and some developed markets as well, in the near term. In Europe, the war in its eastern flank has damaged confidence and set up a scramble for resources. We expect returns to be scarce in this segment of the world.

The big question is, was this small rally the beginning of a better outlook for stocks, or just a bounce inside a longer downward trend? For answers, we turned to other rate hike cycles. Unfortunately, historical precedent is divided into one very inflationary period such as the current environment, and several low inflation periods. The one very inflationary environment we have to work with is the 1970s and early 80s. During that period of time, there were *seven* rate hike cycles extending from 1971 through the first part of 1980. During these torturous times, stock returns were volatile with some outstanding years interspersed with two extremely poor years (1973 and 1974, a nasty bear market) and a couple of minorly negative years. The decade of the 1970s produced a low annual return on stocks of just 5.87%. These results are a warning for the upcoming Fed scenario.

Other rate hike periods shared a beneficial inflation environment and are not comparable to today’s situation. These started in the mid 1990s and resulted in good stock market returns during the actual rise in rates. But recessions and bear markets followed several of these cycles, including 2000-2002, 2008-2009 and 2020. All of these instances were preceded by an inverted yield curve, which is developing today.

While many pundits are claiming that the economy is strong and can withstand higher rates, we see matters differently. The economy may in fact be strong, but trends in some indicators are pointing down. Even if we are able to make it past a Fed error and escape a recession, it is likely that the peak in earnings is either upon us, or nearing. The double threats of higher rates and diminishing earnings growth can be difficult to surmount. We always have a choice regarding exactly when we jettison expensive stocks. This year, we have made those sales more aggressively, all year long, to raise cash and where warranted, shift to cheaper stocks, or in order to buy bonds. In many cases, all we are doing is rebalancing away from the high side of stock exposure in clients’ policy statements – basically getting down to ‘normal or below normal’ stock weights.

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### *Bonds:*

Yields took a significant leap upwards last month, causing losses in bond values. The long Treasury rose to 2.44% and today as we write the long bond stands near 2.6%. Short term interest rates rose as well: the one year note closed at about 1.6%, far higher than February’s 1%. While rates are rising in most maturities, the action is uneven. Generally, long maturity rates are rising less, and the curve is inverting. Today, three year notes yield more than the thirty year bond. But as rates increase, we are switching from inversion to flattening on a daily basis, like an out of control slinky.

The Fed is employing three tools to tighten policy – talking, which influences rates in and of itself; raising short term rates; and allowing its own bond portfolio to run off. This latter activity is somewhat new, having been employed only once before. Basically the Fed has taken to managing the economy by buying or selling bonds for its own portfolio, with the buying occurring in crisis times and the run-off or sales supposedly occurring when the danger passes. This time around, the size of the Fed’s portfolio is almost \$9 trillion, versus about \$2 trillion in the last crisis period of ‘08-’09. This manipulation of our economy is unprecedented, and no one really knows what’s going to happen if it is unwound. However, last time there was a runoff in the Fed’s bond holdings, rates rose about 50 basis points across the curve, then re established a trading range. In mid 2019, as the runoff proceeded, rates dropped precipitously until the balance sheet expanded again in late 2019, implying an economy too weak to stand on its own.

While rising rates hurt existing bond prices, cash flow from existing bonds does not change. Furthermore, higher rates gives us the opportunity to reallocate from stocks occasionally to capture better cash flow (see above). Consequently, this is a bad news/good news story, hurting values while rates rise, but allowing for higher income down the road.

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