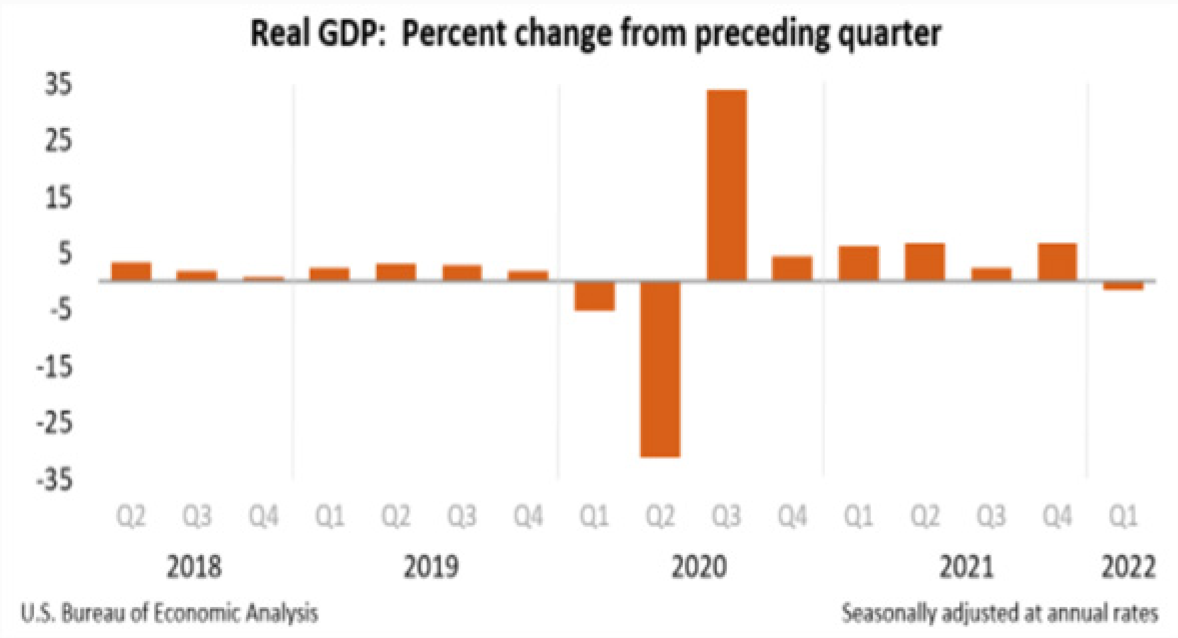
Week in Review

Friday, April 29th, 2022

1. Real GDP Growth

The U.S. economy has downshifted into a lower gear following the Covid-19 recovery in 2021. In terms of data, real GDP for the first quarter of 2022 was reported this week and declined 1.4% annualized in the first quarter.



However, focusing on the headline negative number is likely misleading due to some peculiarities about the first quarter 2022 GDP report that might mean it won't repeat. Peeling back the headline number, there are a number of factors that show underlying strength.

- Private-sector domestic demand was actually robust in the quarter -- growing at a +3.7% annualized pace.
- The hurdle for 'real' growth was very high. The GDP price index rose by +8.0% quarter over quarter. So a real GDP contraction of 1.4% was still a nominal GDP EXPANSION of over 6%
- The switch to services from goods was significant. Services spending grew at a solid 4.3% pace while spending on goods declined slightly by 0.1%.
- Government spending contracted by 2.7%.
- A surge of imports negatively impacted GDP by 2.5% as companies may have been pulling forward import orders during the quarter in the wake of the Russia-Ukraine conflict.

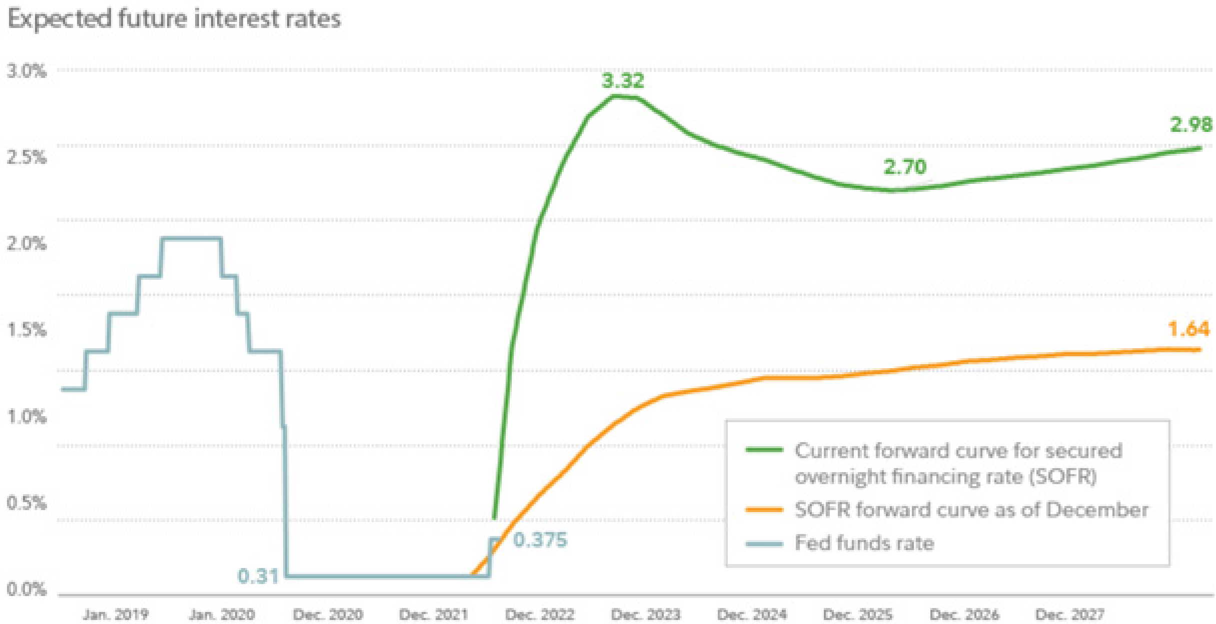
In addition to these points, consumer spending for March was released on Friday and showed a sharp rise and continues to support underlying strength in the U.S. economy. However, while consumer spending has been supported by strong job and wage growth, inflation has also contributed to the rise as the price of goods and services has risen.

Overall, the economy remains in good shape for now despite the negative headline GDP print.

2. Market Focus Remains on Inflation and Interest Rates

Inflation remains a key risk to the economy. As companies and people expect increasingly higher prices in the future, higher prices and wages are demanded which becomes the very process that can create spiraling inflation. The Fed knows this, which is why it is intent on raising interest rates so that people and businesses buy fewer goods and services. Slowing demand will hopefully slow inflation.

The ongoing elevated levels of inflation have escalated the Fed's hawkish outlook resulting in a much higher level of investor expectations for interest rates. The chart on expected forward interest rates illustrates the large increase in expectations as of 6 months ago compared to last week.



Secured overnight financing rate (SOFR) is the interest rate charged for borrowing cash overnight collateralized by Treasury securities. Source: Bloomberg, FMRCo.

Source: Fidelity Management

The market is now pricing in 10 more 0.25 percentage-point hikes this year, with only 8 more months left in the year. So, it seems reasonable to expect several successive 0.50 percentage-point hikes, starting with the May Federal Open Market Committee meeting this coming week.

The bond market has already largely priced in the Fed's expected moves for this year. The risk or opportunity for the bond market is where rates may go beyond this year. If the Fed succeeds in slowing inflation, it is likely that the pressure to raise rates will be removed and bonds could see stabilization or even a recovery.

For equities, stock valuations have already contracted significantly, but concerns exist that both earnings may be under pressure prospectively as well as further room for valuation compression may exist. The positive news is that even after a volatile week of earnings reports, corporate earnings are still expected to grow near 10% this year, and above estimates coming into the year.

All in all, the hope for the equity market is that earnings continue to show overall strength and resiliency, thereby offsetting most of the valuation decline. Of equal or greater focus though is hope for a reduction in the pace of current and expected inflation. Tempering the number of rate hikes necessary would take tremendous pressure off of equity valuations with positive implications for the bond market as well.

3. Risks of Timing the Market

While exposure to market risk, and in this case interest rate risk, affects all investments, investments based on sound fundamentals and future growth should ultimately recover from short-term fluctuations. This is the basis for staying invested in the market and resisting the urge to time the market.

The case for staying invested even during periods of market draw drawdowns is that it has proven difficult to time market recoveries. Illustrating this case was the 20-year period commencing in January 2001 (prior to the dot.com meltdown) and through December 2020 (prior to the Covid pandemic). During this period being fully invested in the S&P 500 produced an annualized return of 7.47%. A key risk to returns during this 20-year period was missing the best days.

Fully Invested 1/2001 – 12/2020	7.47%
Missed 10 Best Days	3.35%
Missed 20 Best Days	0.69
Missed 30 Best Days	-1.49%

Past performance is no indication of future results

During the 20-year period there were approximately 5,000 days the market was open and missing just 10 resulted in the return being cut by more than half. Missing 30 resulted in a material negative return.

It is painful to experience a market correction, but with a long-term horizon and focus on maintaining exposure to sound investments, it has proven a winning strategy to not try and time the bottom of a market correction as the tendency to remain on the sidelines too long can materially impact the benefits of the eventual recovery.

Thinking Ahead

This past week saw significant volatility as financial markets continue to grapple with slowing growth, continuing consumer spending strength, corporate earnings, and anticipation of hawkish Federal Reserve policy. As the market adjusts, it is important to remain focused on long-term goals and the benefit of weathering volatility versus attempting to time the markets. Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.