Key Questions

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Why Are Financial Assets Falling?

George Mateyo, Chief Investment Officer, KeyBank Investment Center

Stocks and bonds are both decidedly in the red this year. But while volatility is likely to persist, short-term volatility usually leads to longer-term prosperity.

As hard as it is to believe, one-third of 2022 has already passed. Our kids are nearly done with school, the days are longer, and spring is upon us. Despite these cheerful indicators, the financial markets have been under pressure for much of the year. Large-cap US equities have fallen nearly 13% through the end of April. International stocks are down by roughly the same amount. Energy stocks – reflecting the surge in oil and gas – have spiked nearly 40% year-to-date (YTD). But almost all other market sectors are in the red, including, and most notably, the technology sector, which is in bear market territory, falling 20% this year. Many individual stocks are down considerably more.

Typically, at least in the past two decades, when stocks suffered as much as they have this year, bonds would serve as a useful shock absorber and rally in price as bond yields fell. But 2022 is not a typical year as bond prices (as measured by widely accepted benchmarks) have fallen by 10%. Corporate bonds have fared even worse and are down nearly 15%; longer-term bonds had sunk 20% as of April 29.

[For more thoughts about this evolving relationship between stocks and bonds and how investors might better position their portfolio amid this new regime, please refer to our recent Key Questions article: "What Do Investors Need to Know When Historical Patterns Change?"]

Investors Seek to Understand Why

Against this backdrop, many investors seek to understand why financial assets are falling. Interestingly, the first quarter estimate for US Gross Domestic Product (the broadest measure of the economy) was recently reported. The estimate revealed that consumer spending, the economy's main driver, increased at an annual rate of 2.7%, a healthy pace. Business spending was even stronger, rising more than 9%. Another report shows that US employment is nearing an all-time high and that salaries and wages have increased at their fastest year-over-year rate in almost four decades, which bodes well for future spending.

So again, if the economy is doing so well, why are financial assets doing so poorly?

The answer rests with inflation and the possible actions the Federal Reserve (the Fed) will have to undertake to bring inflation back to more desirable levels. At its meeting in March, the Fed took a small step and raised interest rates by 25 basis points, or 0.25%.

Many market participants believe the Fed will have to raise interest rates another 200-300 basis points (2-3%) to fully address the inflation situation.

A fundamental truth of investing is that the stock market tries to anticipate where the economy is going versus reacting to past events. With that truth in mind, financial markets are expecting that the Fed, through the measures it is contemplating, will cause the economy to significantly slow in the latter half of 2022 and possibly fall into a recession in 2023.

China is also exacerbating the inflation situation, putting more pressure on the Fed to raise interest rates. The Chinese economy is facing considerable pressures in light of "Zero COVID" restrictions imposed by the government to limit the spread of the coronavirus. As evidence, China's air traffic last month dropped to the level last seen in February 2020. In short, the pressure on supply chains has intensified even more. Simultaneously, many parts of Europe are under considerable strain as a result of the energy crisis brought on by Russia's invasion of Ukraine, and the rhetoric involving Russia is worsening as this humanitarian tragedy lingers on.

Reasons for Hope

However, there are reasons to be hopeful moving forward. First, the post-COVID recovery remains in place in the US. Based on recent reports by the Transportation Security Administration, the number of passengers passing through checkpoints is back to pre-COVID levels. This data should bode well for continued economic momentum. Secondly, the ability of individuals and companies to innovate remains robust and will be an enduring positive driver of long-term productivity and profitability.

More immediately, with the decline in both stocks and bonds, valuations on most assets are now less demanding, although some may still not consider them "cheap."

Elsewhere, visible signs of concerns within certain stock market signals may have become so bad, that they are good.

In a survey of the attitudes of investors toward stocks, for instance, fewer than 20% expressed optimism. Since 1998, when such a signal fell below this threshold, stocks were higher 97% of the time one year later. That's why we recently stated: "When stocks are unloved, the only thing we may have to cheer is fear itself."

By themselves, valuations and sentiment are not direct catalysts for sustainable recoveries. But they should be noted, nevertheless.

Key Takeaways

Ultimately, the path of stock and bond prices will be determined by inflation, its impact on corporate earnings, and its impact on future policy maneuvers enacted by the Fed.

It's frustrating that the outlook for inflation is immensely uncertain, but based on what we know now, we believe that inflation will modestly improve in the months ahead; nascent signs of such are apparent. With that said, we also believe that it will take additional time for inflation to return to the Fed's "comfort zone" – approximately 2.0-2.5%.

For this reason, we advise maintaining a "Neutral to Risk" position with modest amounts of dry powder to be deployed opportunistically. Financial assets may fall further, but short-term volatility usually leads to longer-term prosperity.

For more information, please contact your advisor.

See page 3 for important disclosures

About the Author

As Chief Investment Officer, George Mateyo is responsible for establishing sound investment strategies for private and institutional clients, expanding internal and external research capabilities, and managing the delivery of solid risk-adjusted investment performance.

In previous roles, George spent more than 15 years in investment management and investment consulting, where he acquired firsthand knowledge and insights into the capital markets and the stewardship of investment portfolios for institutional and high net-worth investors.

George received his MBA from the Weatherhead School of Management at Case Western Reserve University and completed additional studies at the London School of Economics.

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