Key Questions

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Should You Sell Your Stocks Now?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

The economic landscape is in transition. And while we encourage investors to revisit their risk appetite and recalibrate if necessary, equities are favored for their appreciation potential over the long run.

In the first three weeks of the year, equity investors have had to endure a very bumpy ride. Since the year began, the bellwether S&P 500 Index has fallen nearly 8%. Smaller companies (as measured by the Russell 2000 Index) have shed 12% of their collective value, and while these declines may be unnerving to some, many individual stocks are down considerably more. (Returns are through January 21, 2022.)

The proximate cause for this sell-off is a change in tone from the Federal Reserve (the Fed), which recently signaled that it might raise interest rates later this year to curtail inflation which, by many measures, has spiked to levels not seen in four decades. In addition, the Fed is also planning on draining the liquidity it injected into the economy in March 2020 to offset pressures triggered by economic restrictions imposed in an attempt to limit the spread of COVID-19.

This dynamic – rising interest rates and reducing liquidity (commonly referred to as Quantitative Tightening or "QT") – are headwinds for risk assets such as stocks because as the cost of capital rises, the valuation multiple applied to companies' earnings declines. Also, companies face added pressures from inflation in the form of higher wages which can eat into corporate earnings.

This leaves the Fed in a challenging situation: if it decides that inflation must be addressed by aggressively withdrawing liquidity and raising interest rates, equity investors could likely face continued stress.

In October 2017, the Fed attempted to engineer a similar maneuver; interest rates had already begun to rise as they withdrew liquidity. Initially, despite several bouts of volatility, the stock market was relatively well behaved until late 2018, when equity investors decided they had enough and ultimately sent the S&P 500 Index down 20% in December of that year. Soon thereafter, however, the Fed announced it was ending QT, which caused the market to stabilize and resume its upward trend after that.

In our 2022 Outlook which we penned in early December, we coined the phrase: "Hot inflation combined with crowded markets augurs for flat returns."

Here, we suggested that above-trend inflation, coupled with markets that have become more concentrated and more sensitive to interest rates, would result in stocks trading sideways with heightened levels of volatility. A recession, we thought, would be avoided as the economy appears poised to generate above-trend growth this year. But the wild card, again, we thought was the Fed: How aggressively they tighten monetary conditions is the key question investors must grapple with today, and the pace of inflation will determine the Fed's course.

In our view, inflation will likely remain elevated in the near term because of three factors: higher wages, booming home prices, and higher energy prices. This suggests that the Fed will go forward with its plan as the year unfolds. At the same time, however, some of these inflationary pressures should eventually subside, and thus it is possible that the Fed may not need to be as aggressive as feared. Time will tell, but as evidenced by the continued slide in stocks, many market participants are seemingly adopting a "Fire, Ready, Aim" strategy and choosing to reduce risk ahead of any official pronouncements from the Fed.

Such pre-emptive selling may prove correct in the short run. But in our view, equities offer the best potential for long-term appreciation and should not be sold in response to short-term gyrations. That said, with impressive gains achieved since the pandemic began, many US stock market indexes are still up considerably. Thus, it is always worth revisiting one's portfolio exposure to risk and recalibrating if necessary.

Long-term investors, however, will be rewarded by staying disciplined and staying invested with equities. In addition, active managers' opportunities should expand amid heightened volatility levels as not all stocks are moving in lockstep. Value stocks, for instance, have outperformed their growth peers thus far in 2022, and certain international stocks are faring better as well.

In sum, the economy is undergoing a transition: inflation has risen, and the Federal Reserve is likely to respond by lifting interest rates and removing liquidity. But the Fed is in a difficult position: do too much to address inflation, and the stock market may face additional near-term risk. Do too little to manage inflation, and the economy overheats, making inflation an even more complicated problem to contain later.

As of this moment, investors are confined to a vacuum waiting for the Fed to show its hand later this week, and the one indisputable truth is that markets abhor uncertainty. Such uncertainty inevitably resolves itself, and the inflation, as mentioned earlier, should moderate later this year which would also provide further clarity regarding the Fed.

In the meantime, we recommend investors fasten their seat belts. Investors should recalibrate, but only if needed, remain committed to owning high-quality assets, and remain committed to their long-term plan. We remain committed to our process of placing a premium on adhering to one's policy and not succumbing to moments of panic.

For more information, please contact your advisor.

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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