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Financial Markets Review

After back-to-back months of negative returns to start the year, the S&P 500 found its footing in mid-March following a shaky start to the month. Over a nine-trading day span, the S&P 500 advanced by 11%, which paled in comparison to the Nasdaq's 16% rip higher. The late-month recovery has driven the S&P 500 back to within 5% of its all-time high, which was set in the early days of this year. And even after the impressive late-month rallies, the Nasdaq and Russell 2000 remain 12% and 15%, respectively, below their all-time highs.

It is still too early to tell if the lows are in for the year and equity markets are now off to the races again, or if this recent melt-up is simply a "bear-market" rally. As we mentioned in our last edition of Observations, the equity market was ripe for a recovery.

"In the short run, any reprieve in the Russia/Ukraine headlines or backing down by Putin would certainly be applauded by markets. Investor sentiment, as measured by the CNN Fear & Greed Index, is flashing an "extreme fear" reading. And bears are currently outpacing bulls in the most recent Investors Intelligence survey. As investors brace for more downside, any positive development on the geopolitical front could usher in a massive relief rally in equities. However, this type of rally in equity prices would likely be short-lived as it wouldn't alter the path of monetary and fiscal policy." – Observations, March 2022

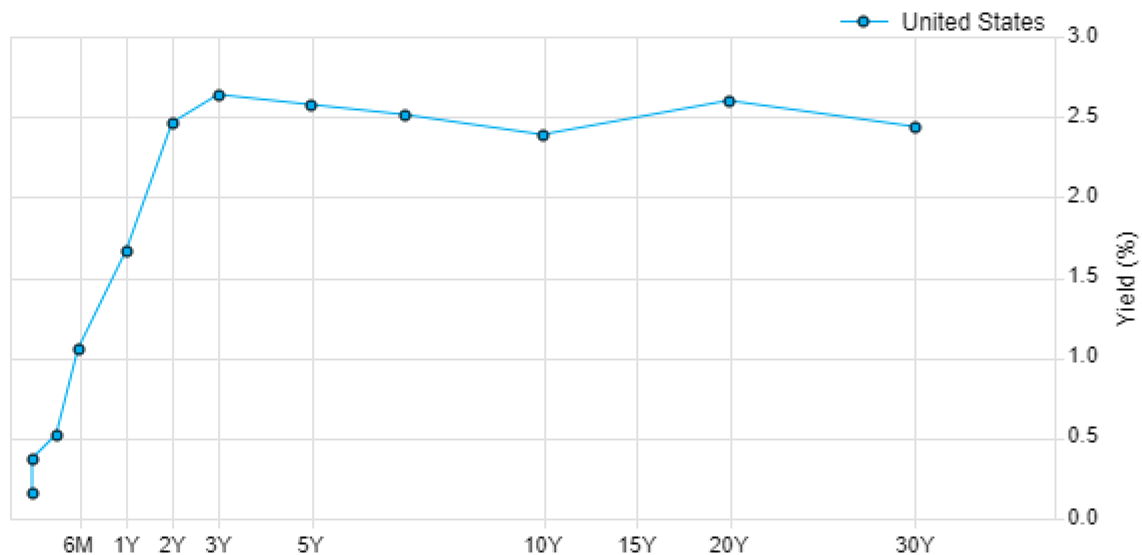
Early on in March, investors were downright fearful. Equity markets from China to Germany were crashing, while the volatility in commodity markets was threatening to upend the global financial system. Rumors of contagion between traders not being able to meet margin calls and the exposure to banks was beginning to make the rounds. At the same time, there was a run on iodine and potassium iodide pills as Putin began hinting toward the use of nuclear weapons.

Eventually, international markets stopped going down. Commodities stopped going up. And Russia's advance into Ukraine has seemingly stalled. The Russia/Ukraine War is by no means in a good place, but it is slightly less bad than when it started. All the market needed was news to be incrementally better for the extreme bearish positioning to be unwound and equities to slingshot higher. However, we should not get ahead of ourselves, as two of the top three best performing sectors in March are considered more defensive in nature – Utilities and REITs. These two sectors are also historically the most interest rate sensitive,

which makes the market recovery a bit suspect given the sharp rise in interest rates this past month. And it is the rise in interest rates and shape of the yield curve that have dominated news headlines over the past couple of weeks.

The Yield Curve

If you have not heard yet, the much watched and hyper-scrutinized 2-year to 10-year Treasury spread has officially inverted. We have been highlighting the flattening of the curve for months, so it should not come as much of a surprise. The long end of the curve inverted last fall and it was only a matter of time before other durations followed suit. Below is a chart of the U.S. Treasury curve.



With February's CPI print coming in at 7.9%, expectations are ramping up for even tighter monetary policy. The expected acceleration of Fed rate hikes and a winding down of their balance sheet is coming at the same time that some macroeconomic data points are beginning to weaken. Rising inflation in the face of slowing economic growth is stoking fears of stagflation and thus the inversion of the yield curve is an expression of those concerns.

Over the past several days, the debate over the yield curve's signaling of a recession has intensified. One side argues that an inverted 2-year to 10-year spread is reason enough to believe we are on the precipice of an economic recession, and you might want to leave the party now. And the other side points to the steepness of the 3-month to 10-year curve and states we are nowhere near a recession, and you should not only stay at the party, but you should also refill your drink. So, let's see if we can dissect the signals to come to some sort of conclusion.

For starters, the yield curve is one of just many signals that help guide future expectations of the economy and corporate earnings. At no point in time does a bell ring and a recession commences with financial assets tumbling in value. An inverted yield curve does not ring that

bell and no other single indicator rings that bell. Rather, an economy's move toward a recession is a process. And part of that process has historically included an inverted yield curve. As the Fed raises interest rates to fend off inflation, short-term rates rise, and long-term rates fall or remain steady on fears of growth slowing. Since banks borrow on the short end and lend on the long end, their profitability on new loans declines and their willingness to lend disappears. The lack of loan creation and a reduction in liquidity ultimately slows the economy into a recession. The Fed then cuts interest rates, the curve steepens, banks make loans and economic growth resumes. Rinse and repeat.

Today, the negative 2-year to 10-year spread is signaling that future economic growth expectations are waning. The economic growth trajectory is slowing, but not declining. Corporate earnings growth is also slowing, but not declining. The positive 3-month to 10-year spread is signaling that banks can still make profitable loans. So again, the economy may be shifting down, but the conditions are not there for it to retract in the immediate future. With all of that being said, it is likely not a question of if the 3-month and 10-year yield inverts, but rather when it inverts. The 3-month yield tends to track the Fed Funds Rate. Given the Fed just increased rates for the first time in this cycle to a range of 0.25% to 0.50%, one would expect the 3-month yield to be right where it currently trades, which is 0.50%. However, as we progress through the year and the Fed continues to hike interest rates, the 3-month yield will increase and get ever closer to inverting with the long-end of the curve. Assuming the 10-year remains at its current yield of 2.4%, based on the market's expectation for future rate hikes, there is a 66% probability that the 3-month yields 2%-3% at the September 21st FOMC meeting. And there is a 95% probability of the 3-month yield trading in the 2%-3% range at the November 2nd FOMC meeting.

In the meantime, until the Fed has officially choked off growth by raising short-term rates too much, the economy will plod forward, albeit at a slower pace than we've experienced over the past year. Markets will search for direction amidst higher volatility. And opportunities to strategically both purchase and sell stocks will be aplenty. Up until a couple of weeks ago, the opportunities in equities were heavily skewed to the buy side. If the market continues its current trend higher, then the opportunities will likely switch to the sell side. Regardless, the key is to stay nimble and disciplined amidst the noise. If the endless discussion over the past week regarding the initial inversion of the yield curve is any sign, the noise has only begun.

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Billy Little is a shareholder, Vice President and Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Little began his career in the investment industry in 2004, as a Financial Advisor with Ameriprise Financial in Baltimore, Maryland. Mr. Little joined Tandem in 2006. Mr. Little oversees Tandem's corporate financials, including business planning, budgeting, and vendor negotiations. Mr. Little also directs Tandem's quantitative and fundamental research. He is a regular member of the CFA Institute and past President of the CFA Society South Carolina. Mr. Little graduated from the College of Charleston with a Bachelor of Arts in Business Administration with a concentration in Finance.

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