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REVIEW & COMMENTARY

PETER W. TUZ, CFA, CFP®
PRESIDENT & PORTFOLIO MANAGER

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Peter W. Tuz, CFA, CFP®
President & Portfolio Manager

“Markets were, and remain, bedeviled by three “I’s” in the quarter: Inflation, interest rates and invasion.”

It Could Have Been Worse

Five words probably best sum up equity market results in the United States at least in Q122: “It could have been worse!”

After a strong 2021, markets fell sharply in January and February, but recovered strongly in March. The recovery was not strong enough to offset the earlier drops so the S&P 500 Index ended down 4.60% in Q122 while the Dow Jones Industrial Index fell 4.10%. Within markets, there were significant changes, the most dramatic of which was the outperformance of “value” stocks versus “growth” stocks. The Russell 1000® Value Index fell 0.74% compared to a 9.04% drop in the Russell 1000® Growth Index.

First quarter results for the S&P 500’s 11 sectors were overwhelmingly negative with only two sectors having positive performance. The energy sector rose 39.03% while the utility sector rose 4.77%. Every other sector fell with the worst performance being the 11.92% drop in the communications services sector, and the 9.03% drop in the consumer discretionary sector.

Markets were, and remain, bedeviled by three “I’s” in the quarter: Inflation, interest rates and invasion.

As anyone who has visited a gas station or grocery store can attest, inflation is now rampant. The recent CPI (consumer price index) figure for February was up 7.9% from a year earlier, the highest figure since early 1982. Inflation’s effects on consumer spending and corporate earnings are only beginning. Consumer spending had been strong lately because of pent-up demand and high savings due to Covid. This could change quickly. The impact on corporate earnings will be easier to see. First quarter earnings season begins next week, and inflation should be a topic in many earnings releases and calls.

Largely because of inflation, the second “I” – interest rates - are rising. Federal Reserve bankers raised short-term rates in March and are likely to do so several more times as the year progresses. Two-year interest rates have risen from 0.73% at year-end, to roughly 2.50% today. With 10-year U.S. Treasury rates at the same levels, we have been in and out of “inverted yield curve” situations several times recently. Inverted yield curves (a condition where short-term interest rates are higher than long-term rates) have preceded recessions frequently, but not always, in the past. Meanwhile, higher mortgage rates have begun to have a negative impact on the housing industry in the U.S.

The last “I” of course is invasion – the Russian invasion of Ukraine that occurred in February, but which began to impact markets earlier. Apart from the human tragedy, the sanctions imposed on Russia by much of the rest of the world have further caused energy prices to rise in addition to the prices for many agricultural products and inputs such as grains and fertilizers.

The result of all this is a vicious circle with the invasion pushing up inflation and inflation pushing up interest rates. (over)

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The hope among Fed bankers is that higher rates slow down economic activity and result in lower inflation - but still some economic growth. This is called a "soft landing." The fear among some investors is that higher rates coupled with inflation lead either to an outright recession or to a situation of "stagflation," a condition of low growth and high inflation.

It is easy to paint a scenario good for markets – the Ukraine war ends, commodity prices (and inflation) drop, the rise in interest rates is tempered. Of course, the opposite scenario could occur as well – a long war, higher commodity prices, and higher interest rates. Time will tell which scenario prevails.