



## Market Monitor: May 2022

The stock market had the worst day in two years on May 5, as the benchmark S&P 500 lost 3.6%, the Dow lost 1,063 points, and the technology-focused Nasdaq index was down over 5%. While the causes of market downturns are always different, the results tend to follow a pattern: areas that had the strongest growth in recent years tend to be the areas that are then hurt the most.

Equity markets are likely to continue to be volatile over the coming months as inflation and the actions of the Federal Reserve and the end of economic stimulus from the federal government lead to reduced consumer spending. As we do on an ongoing basis, we will be reviewing asset allocation between equities and fixed income securities, as well as the allocation across the equity market.

### How We Got Here

Since the beginning of the pandemic, governments around the world have taken dramatic action to support their economies. In the United States, the federal government spent approximately \$6 trillion to support the economy (both from direct payments to citizens as well as payments to business owners in the form of forgivable loans) according to the [Committee for a Responsible Budget's COVID Money Tracker](#). On the monetary side, the Federal Reserve committed to over \$7.1 trillion in actions as well, including cutting interest rates to zero and ramping up direct bond purchases, referred to as quantitative easing. To put these numbers in perspective, the total U.S. economy is estimated to be \$25.3 trillion in 2022.

The point of all this spending was to support the economy, but in doing so, the goal was also to increase inflation. Indeed, the Fed got the inflation it wanted and then some. The Personal Consumption Expenditures price index increased 6.6% for the year ended in March, according to the [Bureau of Economic Analysis](#). Inflation as measured by the Consumer Price Index clocked in at 8.5% in April 2022. To combat these moves, the Fed has responded by raising interest rates and reducing the size of its balance sheet. On May 4, the Fed increased the Fed Funds target rate by 0.50% to 1.0%, and it announced it would begin shrinking its balance sheet by \$47.65 billion per month for three months and then by \$95 billion per month thereafter. The planned amount of the reduction in the Fed balance sheet is much larger than the Fed has ever attempted before.

The reduction in the Fed balance sheet is significant, and how the markets will react to it is difficult to predict. We believe that if quantitative easing helped the economy and caused the prices of financial assets to go up, it stands to reason that any shrinking of the Fed's balance sheet will hurt the economy and cause prices of financial assets to go down. This is exactly what we saw when the Fed first began to reduce the size of its balance sheet in 2013 (the so-called "taper tantrum") and again in 2017-2018 when the Fed reduced its balance sheet on a much smaller and more gradual basis.

Equity valuations are in focus considering the planned increase in short-term interest rates and quantitative tightening. When equity markets fell in March 2020, the S&P 500's forward price to earnings ratio (P/E) reached a low of 14.1x. As the monetary and fiscal stimulus took effect, the market's P/E shot up to

over 22x. It has since fallen as higher rates have taken hold, but it is still slightly above its 25-year average on three fronts: forward P/E (17.00x vs. 16.85x), CAPE, or cyclically adjusted price ratio (31.47x vs. 28.01x) and dividend yield (1.65% vs. 1.99%). Most higher valuations are concentrated in large cap growth companies, with growth companies' P/Es at 122% of their 20-year average versus value companies at 101%, and small cap companies' P/Es below their 20-year average.

## Actions We Are Taking

We believe that the Fed will do what it takes to combat inflation. We made a strategic decision in the second half of 2021 to reduce exposure to growth companies and raise our exposure to value companies. This is paying off. As growth company market values adjust, we may actually be in a position where rebalancing activities may cause us to add back exposure there over time. We are also looking at the overall allocation to fixed income, as interest rates have increased quite a bit from their lows and are beginning to look attractive relative to where they have been recently. The goal is not to time markets but strategically lean into areas where we see value and lean away from areas that may not show as much value going forward. As always, understanding your unique situation, including your liquidity needs and risk tolerance are key to making good wealth management decisions.