PORTFOLIO REVIEW

June 2022

Rodney Sullivan, CFA, CAIA

In March of this year, I attended a CFA luncheon featuring Tom Barkin, President of the Federal Reserve Bank of Richmond featuring his outlook for the US economy. During Q&A, I asked if he could share his view as to whether or not he believed the Fed might be behind the curve in raising rates given that inflation was already clearly present in the data (see Figure 1).[1] He replied that he felt that the Fed was on track but then added that the Fed, in hindsight, may not have needed as much Fed quantitative easing (QE) during the pandemic. I'm biased of course, but his reply seemed to me to be a diplomatic way of saying that the Fed had in fact eased too much and was too slow in unwinding the unprecedented easy money unleashed during the pandemic. I then followed up by asking for his view on the likelihood of U.S. stagflation (a period of low economic growth and high inflation) in the coming year(s). He shared that inflation, in his view, would soon moderate and that economic growth was in fact currently strong, not weak, and so stagflation seemed unlikely.

Figure 1: CPI Inflation is Running Hot

Source: Federal Reserve Bank of St Luis, https://fred.stlouisfed.org/series/CPALTT01USQ659N).

[1] The Fed had undertaken unprecedented monetary easing during the pandemic, however as of March of 2022 the Fed had only just begun to tighten (to a still very low 0.25%-0.50%) while inflation was already 7.1% annualized, much higher than the Fed's stated 2% inflation target.

This all matters because Fed policy is very important to the economy and markets. As readers of my commentaries are already aware, the Fed in my view, has been far too slow in anticipating and then in responding to the high inflation. The Fed's loose policy, combined with the unprecedented fiscal stimulus in 2020-2021, along with the decision by the current Administration and Congress to dampen US fossil fuel energy production, have all combined to bring a form of both cost-push and demand-pull inflation.[2] This type of inflation was never going to be transitory as promised. Investors have more recently awoken to the facts on the ground and both stocks and bonds have sold off rather dramatically in the first half of the year.

Fast forward to now, and what lies ahead from here is much less clear, akin to seeing through a thick fog. The resulting consequences of high inflation, slowing global growth, and geopolitical stress will be highly important to both markets and the economy in the year ahead. My own, not widely shared, view is that a meaningful economic slowdown (a period of stagflation) is already underway being driven by tighter money, inflation, a winding down of fiscal stimulus, and supply constraints.

Perhaps most important among these is Fed policy. It seems that the Fed feels that it must now, after being behind for so long, play catch up and raise rates rapidly before inflation becomes "entrenched" and thus difficult to rein in. As evidence, consider the Fed's surprise June 75bps hike in short-term interest rates (to 1.5%-1.75%) instead of the 50 bps increase as expected (and as initially guided by the Fed). The Fed for now is guiding a continued aggressive hiking campaign throughout 2022 while the fiscal stimulus is also ending. These will eventually tame inflation, but will also undoubtedly also slow the economy, likely leading (if not already underway) to a recession in both the global economy and corporate profitability.

These factors are already leading to declines in consumer spending and business investment. Once the weakness becomes clear, the Fed will most likely reverse its current rate hiking policy and begin to move in the opposite direction to lower rates. If this forecast (yes, a big "if") bears out, the result would be a bond market rally, further declines in stock prices, and a drop in commodity prices after a strong start to the year. So yes, it's quite possible that the market bottom is not yet in, meaning potentially even more pain ahead for risk assets.

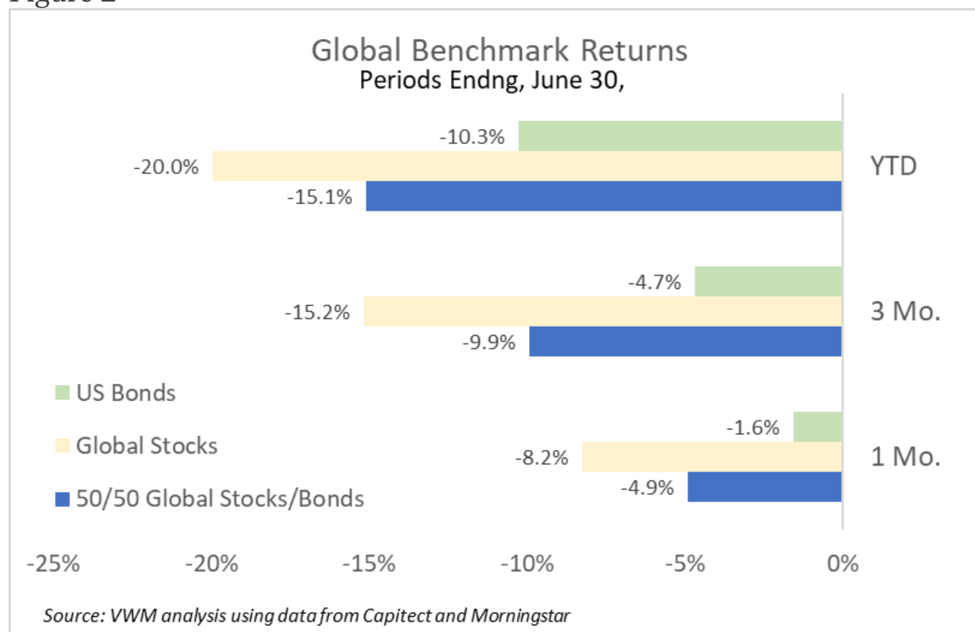
VESTEER PORTFOLIOS

So, what does all this mean for Vesteer portfolio strategy? Most importantly, the current period of market volatility reinforces the importance of being globally diversified across an array of asset classes. As readers already are aware, at Vesteer, we work to aggressively diversify our portfolios across global stocks, bonds, and inflation hedging assets. We've also taken steps to position portfolios more defensively late last year by tilting portfolios towards lower risk, higher quality, and commodity assets (while also shortening our bond duration considerably to protect against rising rates). As our research, and investment theory, suggests here, here and here, the combination of broad diversification and being more defensive has historically been a helpful combination in providing a measure of portfolio protection during market downturns.

[2] Consider that energy prices rose from around $50/bbl at beginning of 2021 to nearly $100/bbl one year later. Following the invasion of Ukraine, oil has risen even further to now around $120/bbl.

However, as we've stressed in the past, every market environment is different and this year has obviously been uniquely challenging for investors. As Figure 2 shows, total returns are negative for both stocks and bonds for all 2022 periods (June, Q2, and YTD). In fact, all of the major global asset classes, with the one exception being commodities, report negative year-to-date returns with the most-risky asset classes being down the most (for those interested, an appendix reports returns for an array of asset classes across various periods).

Figure 2



The portfolios shown are hypothetical portfolios and do not necessarily represent any actual Vesteer portfolio or strategy. The results are hypothetical and are not an indicator of future results and do not represent returns that any investor might actually achieve. Indexes are unmanaged, do not reflect management or trading fees, and one cannot invest directly in an index. Purchases are subject to suitability. This requires a review of an investor's objective, risk tolerance, and time horizons. Investing always involves risk, whenever you invest you are at risk of loss of principal as the market fluctuates. Past performance is not indicative of future results.

In terms of Vesteer portfolios, while also in negative territory through the first half of the year, our portfolios have held up relatively well versus our usual market benchmarks. More specifically, Vesteer portfolios (after subtracting advisory fees and fund expenses) are besting their respective benchmarks by about +3.0% YTD and by about +1.5% for the 2nd Quarter. On an absolute basis, Vesteer portfolios (net of fees and expenses) have declined YTD between -12.1% and -13.4% depending on the risk profile, while our usual benchmarks are down between -15.1% (50/50 stock/bond mix) and -17.0% (70/30 stock/bond mix).

Altogether, while it's certainly nice to see that the theory and our research have "worked," it has still been a challenging environment to preserve wealth. It's never fun to witness negative absolute performance.

During my career, I've seen many market downturns, a reality of investing too often forgotten by our industry, especially during the course of a long bull run. This leads advisors to create portfolios with too much concentrated equity risk for a client's given circumstances, especially for those nearing or already in retirement. For us, in addition to being more broadly diversified and defensively positioned, Vesteer's strategic client portfolio profiles (how much risk each client takes in total) tend to be more conservative versus our peers. This varies of course from

client to client depending on circumstances, but in general this has been our experience. Our overall approach tends to better enable our clients to stick with their chosen portfolio mix when times get tough while at also hopefully allowing the portfolio to grow when times are good (2021 for example).

Whatever your chosen portfolio strategy, it is important to stay invested. Research shows that as a group, investors tend to underperform the market due to their "chasing" returns, or buying after the market has gone up and selling after it has gone down. The result of the poor "market timing" behavior (buying at the top and selling at the bottom), investors underperform the market by a whopping *3.7% per year* over the long term.[3] Definitely not what you want to do. In short, timing the market is hard and should be done only modestly. Success over the long haul requires one to be invested through the good times and the bad.

All this is to say we hope that our clients will stick with their Vesteer strategies through these tough times. We take seriously our responsibility to help our clients grow and preserve their wealth over the long term and continuously seek opportunities to improve our approach to portfolio construction. For now, we are maintaining our defensive posture in the face of continued economic uncertainty. Our view is that eventually we will hit a bottom (hopefully this year!) and things will then finally begin to improve. In the meantime, our approach will hopefully continue to provide some downside protection until markets eventually turn in the other direction.

Vesteer Wealth Management, LLC
Rodney.sullivan@vesteerwealth.com
(434) 282-1215

[3] See John C. Bogle, "The Relentless Rules of Humble Arithmetic", *Financial Analysts Journal*, Nov 2005 Volume 61 Issue 6

To learn more, please contact us:
web: www.Vesteerwealth.com
email: vesteer@vesteerwealth.com

(434) 282-1215 (O)
(203) 898-3422 (M)
Charlottesville, VA

Advisory services are offered through Vesteer Wealth Management, LLC a Registered Investment Advisor in the State of Virginia. The information contained herein should in no way be construed or interpreted as a solicitation to sell or offer to sell advisory services to any residents of any State other than the State of Virginia or where otherwise legally permitted. All written content is for information purposes only. It is not intended to provide any tax or legal advice or provide the basis for any financial decisions. The information contained in this material has been derived from sources believed to be reliable, but is not guaranteed as to accuracy and completeness and does not purport to be a complete analysis of the materials discussed. Whenever you invest, you are at risk of loss of principal as the market fluctuates. Past performance is not indicative of future results. Purchases are subject to suitability. This requires a review of an investor's objective, risk tolerance, and time horizons. Investing always involves risk and possible loss of capital.