ICON Insights

Market Commentary - February 2022

By Craig Callahan, DBA | ICON Founder & President

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Equities

The S&P 1500 Index dropped 5.34% in January although it bounced higher the last two trading days of the month. We disagree with the beliefs and assumptions regarding inflation and potential Federal Reserve (Fed) behavior that led to the selling. Inflation did pick up in the second half of 2021 though. Investors selling stocks in January apparently believe the higher inflation can continue. Believing higher inflation will persist leads to the assumption that the Fed will need to implement monetary tightening measures to reduce inflation.

For forty years many observers have been predicting the return of higher inflation and they have been wrong. We believe that tendency is built into some recent inflation predictions. We also believe that some of the predictions are applying a "recency effect" to economic forecasting, projecting whatever occurred recently (inflation) out into the future. We have written that we thought the jolt of inflation was due to supply and demand not being aligned coming out of the pandemic-induced recession. We expect supply and demand to move toward alignment which should reduce the upward pressure on inflation. In other words, we just don't see the ability of the price increases of 2021 to compound.

Bloomberg surveys economists and shows their consensus predictions for inflation. The table has the trailing one-year forecasts (Y-O-Y) quarterly for the Consumer Price Index (CPI) and the Personal Consumption Expenditure Deflator (PCE). The economists are expecting inflation to abate and that we are currently experiencing the peak. Of course, we should note that they can be wrong and that they change their forecasts but for the time being, they are predicting a return to disinflation.

Year-over-Year Inflation Predictions

	Q4'21	Q1'22	Q3'22	Q3'22	Q4'22	Q1'23	Q2'23
CPI	6.7%	6.8%	5.3%	4.3%	3.1%	2.6%	2.5%
PCE	5.5%	5.3%	4.3%	3.4%	2.6%	2.3%	2.3%

The data quoted represents past performance, which is no guarantee of future results. *Source: Bloomberg*

As for the Fed, if these economists are correct, the Fed will not need to adopt extreme monetary tightening. Last year the money supply (M1) grew 15.2%, way above its historic average of near 6%. We expect the Fed to drain reserves, raise its Federal Funds target and slow the growth of M1, but just closer to its historic norm, not enough to risk recession. With a market Value/Price (V/P) of 1.12, we expect the broad market to move higher over the next year. In late January, investors priced stocks for a fairly grim setting of high inflation and severe Fed tightening. With a market V/P of 1.12, we do not need the economy to be perfect for the market to move higher, just better than was priced-in in late January.

Bonds

The yield on the 10-year Treasury note has increased from a short term low of 1.35% in early December to around 1.80% to end January. While the yield has moved higher with the recent jolt of inflation, the yield remains many percentage points below the inflation rate of 2021. We can see the yield inching higher, but we do not fear a rapid spike. We are favoring short term maturities.

Summary

Many analysts who believe inflation will persist and/or get worse state that the Fed is too late, should have tightened sooner, and is "behind the curve," so to speak, regarding inflation. Those commentators seem to be grandstanding to us and we disagree. Our research finds that just a few situations on the supply side contributed to the recent inflation. The Fed does not have any monetary tightening tool that increases the supply of goods and services. We are focused on value and trying to filter out the headline-grabbing commentary regarding inflation.

For more in depth discussions on Inflation and the Federal Reserve, there are chapters in my book with the primary title "Unloved Bull Markets." It is to be released by Wiley February 15, 2022.

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Individual account holdings and composition may vary. Opinions and forecasts regarding sectors, industries, companies, countries and/or themes, and portfolio composition and holdings, are all subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security, industry, or sector.

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The unmanaged Standard & Poor's Composite 1500 (S&P 1500) Index is a broad-based capitalization-weighted index comprising 1,500 stocks of Large-cap, Mid-cap, and Small-cap U.S. companies.

M1 is one measure of the money supply that includes all coins, currency held by the public, traveler's checks, checking account balances, NOW accounts, automatic transfer service accounts, and balances in credit unions.

The Consumer Price Index (CPI) is a measure of the average change in prices over time of goods and services purchased by households. The CPIs are based on prices of food, clothing, shelter, fuels, transportation fares, charges for doctors' and dentists' services, drugs, and other goods and services that people buy for day-to-day living. Personal Consumption Expenditure Deflator (PCE) is a measure of inflation based on changes in personal consumption. It comes out when GDP comes out.

The 10-year yield is the benchmark 10-year yield to maturity reflected by the current issue 10 year U.S. Treasury note.

Sources: Bloomberg

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8480 E Orchard Road, Suite 1200

Greenwood Village, CO 80111

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