The Cobblestone Advisor
Investment Brief
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COBBLESTONE
CAPITAL ADVISORS

Bad Company

The first quarter was one of the worst on record for traditional asset class investors. The only times that a 60/40 stock/bond portfolio has experienced a worse start to the year was during the COVID-19 pandemic, Global Financial Crisis, dot-com bubble, and Volcker era (when Fed Chair Paul Volcker raised the federal funds rate to 20% to curb a 14.8% inflation rate). Bad company, indeed.

Within equities, despite an intra-quarter decline of -13%, the S&P 500 managed to retrace some of its losses, ending the period down -4.6%. US small caps were more challenged (-7.5%), as were international developed (-5.9%) and emerging market stocks (-7.0%).

Generally, when riskier asset classes—such as stocks—experience heightened volatility and negative returns, investors expect bonds to act as a ballast, dampening portfolio volatility and offsetting some of their equity losses.

During the first quarter, however, volatility in fixed income markets rose to levels not seen since the onset of the pandemic. Rates spiked, and bonds faltered, going on to underperform stocks by 1.3 percentage points for the period.

US Treasuries had their worst quarter on record (-5.6%) and broad US fixed income markets experienced a -5.9% return in the midst of their largest drawdown (-8.7%) since 1981 and third largest in history (we note one silver lining—the recent rise in bond yields portends higher future bond returns).

Several developments led to the difficult quarter: investor concern over the persistence of inflation, the resulting potential for quicker than previously expected Fed rate hikes, how unfolding monetary policy may impact economic growth, and the exogeneous shock of Russia invading Ukraine. These developments culminated in a perfect storm, leading investors to shed equity risk and sending bond yields sharply higher (and bond prices sharply lower).

While recent market dynamics may elicit feelings of consternation among investors, it is important to consider the weakness within a broader context. As of March, stocks had returned +99% since the pandemic trough, marking the best two-year price performance for the S&P 500 in at least 75 years. And bond investors have been fortunate to enjoy +8% annualized returns over a nearly 40-year run—the greatest bond bull market in history. Capital markets have been very rewarding to investors that have stayed the course.

Though we do not anticipate a repeat of the heady performance seen in recent years, we believe that there may be reasons for cautious optimism looking ahead. Although growth has modestly softened, overall economic conditions generally remain healthy, and both consumers and corporations remain fundamentally supportive of continued growth, having shored up their balance sheets over the last few years.

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Total Return (%), Ending 3/31/2022				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	-4.60	-4.60	15.65	18.92	15.99	14.64
Russell 2000 (Small-Cap Stocks)	-7.53	-7.53	-5.79	11.74	9.74	11.04
MSCI EAFE (International Stocks)	-5.91	-5.91	1.16	7.78	6.72	6.27
MSCI EM (Emerging Markets)	-6.98	-6.98	-11.37	4.94	5.98	3.36
Bloomberg Barclays US Aggregate Bond Index	-5.93	-5.93	-4.15	1.69	2.14	2.24
Dow Jones US Select REIT	-3.71	-3.71	27.73	9.87	8.87	9.16
Consumer Price Index (% Chg over Period; One-Month Lag)	2.08	1.76	7.87	3.92	3.10	2.27

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This fundamentally healthy backdrop is an especially important characteristic in today's environment, as it provides adequate cushion while Fed policymakers embark on their campaign to raise interest rates. It will be a delicate balancing act as policymakers seek to stamp out inflation while at the same time exercising caution so as not to tip the US economy into recession. The general health of the consumer and corporate sectors makes attainment of this goal less challenging, even if only slightly.

As we enter what is likely to be a cycle of Fed policy tightening, the below analysis of equity returns over each of the eight tightening cycles since 1970 should provide investors some solace. Fed rate hike cycles have historically been punctuated by bouts of volatility as investors digest the shifting economic landscape, similar to what markets have experienced this year. Equity markets have, however, generally performed well over the cycle, with the S&P 500 delivering positive returns over each of the eight cycles and generating an average annualized return of +7.2%.

Fed Rate Hike Cycles & Equity Returns

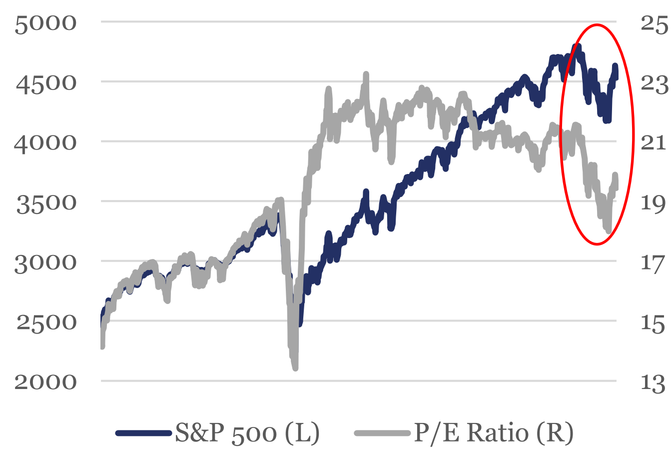
Period	Starting Rate	Ending Rate	S&P 500 Annualized Return
1971 - 1974	3.50%	13.00%	1.6%
1976 - 1981	4.75%	20.00%	10.4%
1983 - 1984	8.50%	11.75%	6.1%
1986 - 1989	5.88%	9.75%	10.6%
1994 - 1995	3.00%	6.00%	0.7%
1999 - 2000	4.75%	6.50%	11.0%
2004 - 2006	1.00%	5.25%	7.8%
2015 - 2018	0.25%	2.50%	9.2%
		Average	***7.2%***

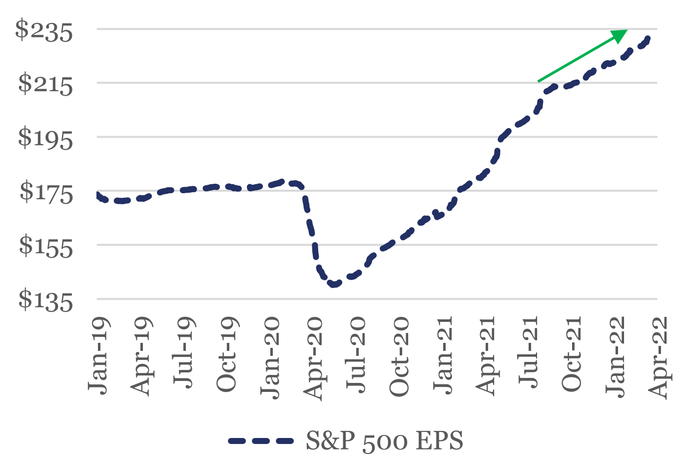
Source: S&P Dow Jones, Federal Reserve, Bloomberg.

Perhaps equally sanguine, the trajectory of the S&P 500 around historical geopolitical events has been characterized by sharp, short-lived selloffs. An analysis of 28 geopolitical events since 1939 shows that the S&P 500 recovered to its pre-event level in 16 trading days (median). Indeed, the index was up +5.8% as of quarter-end since Russia invaded Ukraine.

While historical analogs such as those above can provide helpful frameworks as we consider the range of potential outcomes, the important caveat—of course—is that all environments differ. Elevated inflation and the potential for the Fed to overtighten to combat it exposes both equities and fixed income to unique risks. There is also the potential for markets to come under pressure if signs were to emerge that suggested deteriorating economic conditions.

We will continue to monitor for these signs in the quarters ahead. For now, we believe that while risks have undoubtedly risen, recession risk is not yet at concerning levels. Similar sentiment was echoed by markets, as the decline in US equities was entirely driven by softening valuations, as opposed to a collapse in earnings (below chart). Nonetheless, incorporating uncorrelated sources of return in portfolios—whether that be real assets, private investments, or other alternative asset classes—has helped smooth recent volatility, an outcome we believe will continue to hold true in the years ahead.





Source: S&P Dow Jones, Bloomberg.