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Q1 2022 Newsletter

Economy & Market Valuation

The US stock market as measured by the S&P 500 dropped by around 5.2% in Q1 2022. The US economy is facing multiple headwinds. Top of the list is rising interest rates. The Federal Reserve has started raising interest rates to bring inflation down. They have raised interest rates for the first time since 2018 by 25 basis points (bps) which is 0.25%. But this is only first hike in an expected series of hikes. Analysts are projecting that the Federal Reserve will hike rates by 50 bps at each of the next 2-3 meetings. This is a very fast pace of rate hikes by historical standards. It looks like the Federal Reserve has decided that inflation is getting sticky (as opposed to *transitory*), and it will not come down unless interest rates go substantially higher. This will cause a slowdown in the economy starting with interest rate sensitive sectors. We have already seen mortgage rates increasing to 5% and can even go higher. Interest rates on car loans and corporate loans are also expected to increase. It is all happening at a time when there are supply chain challenges and commodity prices are high due to the Russia-Ukraine war and Covid lockdowns. 40% of China is under Covid lockdown at this moment. Despite all these challenges, economists do not see a recession in 2022. We share the same view. We do see economic slowdown in 2022. The probability of recession in 2023 is much higher at 35-40%.

We have adapted the portfolio to the impending higher interest rates and coming economic slowdown.

2022 investment strategy:

As outlined above, we have made changes in the portfolio due to the changing economic outlook. The first major change has been increased exposure to Energy, Oil and Fertilizer sectors. These sectors are projected to benefit from higher inflation and the shortages caused by Russia-Ukraine war. Russia and Ukraine are the biggest exporters of wheat, oil and fertilizer. It will take some time for the rest of the world to fill the hole created by removal of supply from Russia and Ukraine. As a result, prices are likely to remain high for oil, agricultural products, fertilizers, and other commodities. We have also considerably de-risked the portfolio by reducing high volatility tech names. Finally, we have increased exposure to retailers and discount retailers. These are expected to weather the storm much better during the oncoming economic slowdown. We have increased our cash position in the portfolio due to increased volatility in the market.

We also believe that, after reaching a peak, interest rates will start dropping. That will be the time to increase risk in the portfolio and go aggressive. We cannot predict the time when it will happen. It could be anywhere from 6-18 months. We want to keep the gun powder dry to avail the opportunity whenever it comes up. We want to play it safe till that time.

Enjoy the springtime, as travel, and other social events, are opening up, and stay safe.