JSF FINANCIAL

THE BUMPY PATH TO NORMALIZATION: JANUARY 2022 MARKETS

FEBRUARY 2022

QUICK TAKE

Much of January was a wild ride for stocks, with the S&P 500 posting its biggest January decline since 2009. Some of the turbulence was driven in particular by the Federal Reserve's announcement of its intention to start normalizing monetary policy. While markets took this on the chin, we think this is actually good news given the context: the economic backdrop is strong and the prospects for economic growth remain high.[1] Even if market returns are less impressive than they have been in the last couple years, moderation in inflation and growth leaves room for optimism and opportunity.

Markets had a rocky January, with the S&P 500 Index posting its biggest January decline since 2009.[2] Bond markets were similarly under pressure, with yields starting the year moving sharply higher, resulting in lower prices.[3] It was a sobering start to the year.

However, the month ended on a positive note. As the broad equity indexes surged to close the month,[4] corporate earnings demonstrated continued strength in the face of higher inflation readings and supply chain issues. Already, 33% of S&P 500 stocks have reported fourth quarter earnings, with growth coming in 24% above expectations year-over-year.[5]

Rate Hikes Are Coming

Some of the most significant news of the month came in early January, with the release of the Federal Reserve's December Federal Open Market Committee (FOMC) meeting minutes. This meeting featured a discussion about shrinking the Fed's balance sheet in a process known as quantitative tightening (QT).[6] This would follow the end of the Fed's purchases in the bond markets, removing a layer of liquidity and support for the economy. Some might argue that this move is long overdue: to get a sense of the historical context, the Fed's balance sheet has ballooned from under $1 trillion in 2008 to over $8 trillion today.[7]

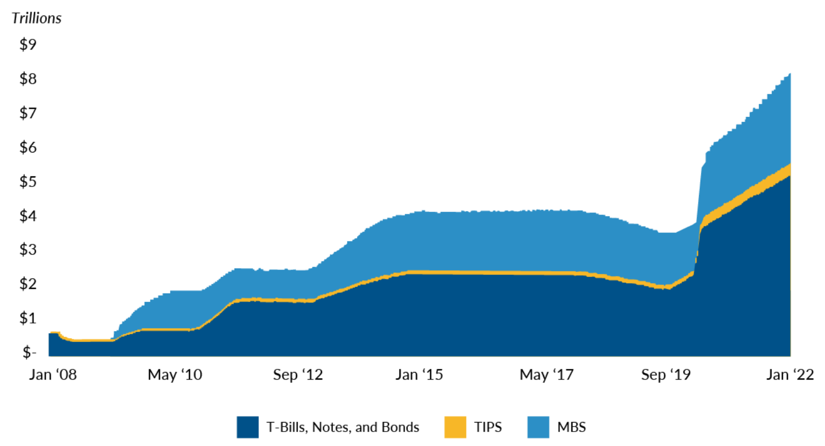
After the meeting in January, U.S. Fed Chair Jerome Powell once again affirmed the Fed's intention to also begin a series of rate hikes, with the first likely to come in March.[8] He stopped short of indicating whether it would be a 50-basis point rate hike, though he also didn't rule this out.[9]

Index Returns
(December 2021 and Year To Date)

Bloomberg Barclays Aggregate Bond Index US investment grade bonds	-0.26% for December*	-1.54% for the year*
S&P 500 Index Large US Equities	4.36% for December*	26.89% for the year*
MSCI World Index Large/mid developed world equities (ex-US, CAN)	4.30% for December*	22.35% for the year*
MSCI Europe Index Large/mid developed european equities	6.61% for December*	16.97% for the year*
MSCI Emerging Markets Index Global emerging market equities	1.92% for December*	-2.22% for the year*

* As of December 31, 2021

The Fed's Balance Sheet Has Ballooned to Over $8 Trillion



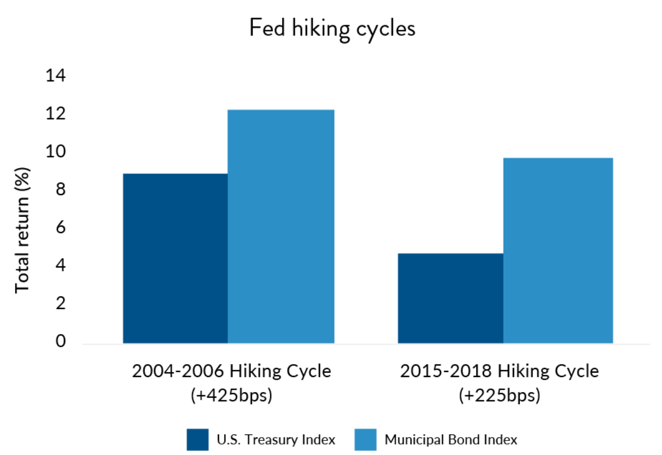
Sources: Source: Bloomberg. Reserve Balance Wednesday Close for Treasury Bills, Treasury Notes, Treasury Bonds, Treasury Inflation Protected Securities (TIPS), and Mortgage-Backed Securities (MBS). Weekly data as of 1/5/2022.

Together, these indicators show that the Fed sees very little reason to further delay normalizing policy. Since inflation is running hot at 7% and unemployment is low at 3.9%, this does make sense.[10] However, the idea of combining rate hikes and quantitative tightening roiled bond markets, especially in comparison to how slowly the Fed embarked on quantitative tightening following the 2008 financial crisis.

During the last cycle, the Fed waited a full 2 years after hiking rates to end quantitative easing.[11] Clearly, the economic backdrop has changed significantly, and the economy is in a much stronger place. As such, even though the Fed started discussing an acceleration of rate hikes last year, the markets finally acknowledged and brought forward rate hike expectations, resulting in the repricing of treasury bonds.

As a result, U.S. 10 treasury yields jumped to 1.9%, a new high in the post-Covid world.[12]

Munis historically do well when rates are rising



Source: Federal Reserve, Bloomberg Indices, BlackRock, as of 12/31/2021

Bright Spot Among Bond Markets in Munis

When it comes to bonds, however, a common question we hear from clients is about the stability and safety of municipal bonds—especially in a changing economic environment. Investors might use municipal bonds as a core component of their fixed income portfolio, as they generally offer stable income with tax benefits and typically low default rates.

The year 2021 was positive for municipal bonds, as demand continued to be strong, and even in a higher interest rate environment, BlackRock expects low-single-digits returns for investment grade (a low risk of a credit default) municipal bonds.[13]

Overall returns may moderate this year, though municipal bonds tend to do well when interest rates are on an upward swing.[14] We wrote about municipal bonds in more detail in a recent white paper, which we invite you to read on our website.

Click here to read now!

Our recent whitepaper on municipal bonds provides more in-depth information and analysis about this asset class.

The Path Forward

So, where do we go from here? There are three main variables that we are watching. The first is inflation, the second is the labor market, and the third is geopolitical tension between Russia and Ukraine.

Inflation will likely settle at levels higher than they were pre-Covid.[15] While supply chains issues could work themselves out pretty soon, it may still take some time to work through these imbalances. However, there are other pressures on inflation, and we believe that we're likely to see those persist.

The other mandate the Fed has is employment. Even though markets were surprised by the Fed's recent rate hikes and monetary tightening announcements, there is a silver lining. The Fed feels comfortable moving rate hikes forward because the economy seems close to full employment. That's good news after the massive pandemic job losses we saw in 2020, even though there are still 3.8 million fewer people working now than before the pandemic.

As far as Russia and Ukraine, we hope that cooler heads will prevail, but the potential conflict is contributing to the rise in oil costs.

In other words, the economic backdrop is strong, and economists generally expect above trend growth in this phase of the recovery, despite perennial geopolitical concerns.[16] Even if market returns are less impressive than they have been in the last couple years, moderation in inflation and growth leaves room for optimism and opportunity.

As always, if there is anything we can do to answer your questions, please don't hesitate to ask. We are here as your partner to help you navigate through uncertainty and the wobbles and volatility of markets.

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Asset Allocation and Diversification do not guarantee a profit or protect against a loss.

The Bloomberg Barclays U.S. Aggregate Bond Index measures the investment-grade U.S. dollar-denominated, fixed-rate taxable bond market and includes Treasury securities, government-related and corporate securities, mortgage-backed securities, asset-backed securities and commercial mortgage-backed securities.

The S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market.

The MSCI World Index is a broad global equity index that represents large and mid-cap equity performance across 23 developed markets countries and covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Europe Index captures large and mid-cap representation across 15 developed markets countries in Europe and covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe.

The MSCI Emerging Markets Index captures large and mid-cap representation across 26 emerging markets countries and covers approximately 85% of the free float-adjusted market capitalization in each country.

Gross domestic product (GDP) is a monetary measure of the market value of all the final goods and services produced in a specific time period. GDP is the most commonly used measure of economic activity.

SOURCES

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MSCI: https://www.msci.com/end-of-day-data-search