MARKET OBSERVATIONS
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INVESTMENT COUNSEL

Relationships

Relationships in the physical world tend to be immutable, e.g., water freezes at 32°F and boils at 212°F. Relationships in the economic and financial world can be more variable. Financial mathematical relationships are immutable, e.g., $1 invested at 7.2% per year will double in 10 years. However, both the nominal and real (after-inflation) returns from all types of investments have varied widely. Varied as well have been rates of change for important variables such as overall economic growth and inflation. Recent unexpected events including pandemic and war have impacted economic and market relationships. A review of some key relationships can provide perspective for investing ahead.

PERSPECTIVE

The most recent quarterly report of economic activity showed a divergent outcome with real growth negative and inflation accelerating. As shown in Chart I, such an outcome has occurred in only 13% of all quarters since World War II. Outcomes have been clustered with 83% of all quarters showing positive rates for both growth and inflation. The first quarter of 2022 was a bit of an outlier. Inflation at a rate of 8% or more has occurred in only 19 quarters in the past 75 years. Declining real growth has occurred in only 16% of all quarters. Certainly, investor concern has risen with both the current high inflation and the potential for an outright recession. The latter usually occurs with declining growth in two or more consecutive quarters. Such an outcome is not the consensus forecast at this time.

Bonds and stocks are asset cornerstones in most investment portfolios. They serve different purposes, more income from the former and more growth from the latter. An additional portfolio benefit stems from the relationship between the two. Chart II shows concurrent, rolling 12-month rates of return over the past 54 years. 69% of the time, both assets have provided positive returns together. For another 21% of these observations, bonds provided a gain while stocks posted a loss. In only 1% of the total periods did bonds and stocks record losses together. The twelve months just ended was one of those outlier periods. Concerns for lower growth with higher inflation weigh on both assets at this time.

Higher inflation prompts interest in assets that might benefit in such an environment. Gold is one such asset. Chart III shows the relationship between rates of inflation and gold price changes for rolling 12-month periods over the past 54 years. Inflation rates were positive 98% of the time. Gold performed well at periods of inflation extremes. In the most recent twelve-months of outlier inflation, gold was an effective hedge. For 60% of all periods, gold did appreciate; but in the other 40%, gold prices fell. Other factors that enter into the price movement of gold and its relationship with inflation must be assessed.

INVESTMENT IMPLICATIONS

Relationships among asset returns and the factors that determine them can vary widely. And such variances can result in outlier outcomes, especially in times of unusual and unexpected developments. More immutable at all times is the relationship between appropriate portfolio structure and its key determinants – goals, time horizons, risk tolerance. Certainly, these determinants can shift over time, triggering a portfolio review and potential adjustments. Discipline in this relationship can reduce the potential for adverse outlier outcomes.

CHART I

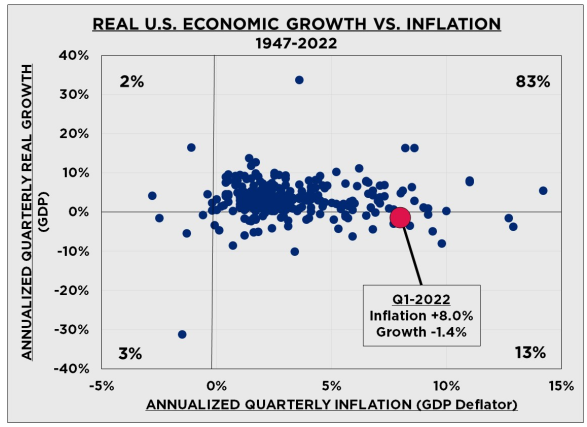

CHART II

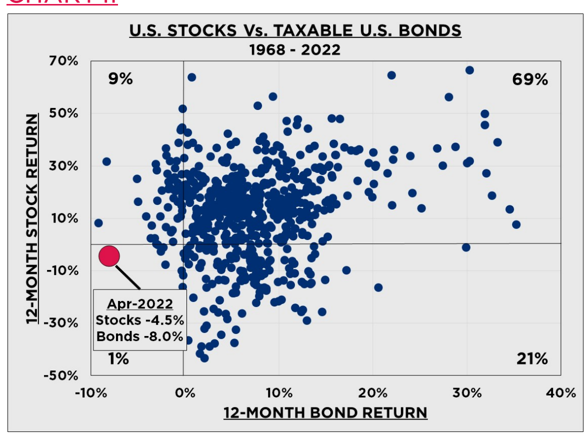

CHART III