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Maryland Capital Advisors

INVESTMENT COMMENT

June 13, 2022

Perspective on Recent Global Stock and Bond Market Performance

Stock and bond markets started the week with a decent sell off. Indeed, in just the past few trading days the S&P 500 Index has fallen -8.9%, which is the most significant 3-day drop year-to-date. The big story is the bond market where yields have jumped incredibly. For perspective, the yield on US Treasury 2-year note has increased 0.58% in the past three days. That magnitude of yield change was typical during the early 1980's, but market yields at that time were over 10% rather than today's 3.35%[1].

So what's going on? First, as we all know, during the past 15 months, consumers have experienced substantial cost-of-living increases. During 2020, we had price inflation running between zero and 2%, before lifting-off to our current 8+% year-over-year rate. Economists have parsed the data and had expected that inflation would peak around now. Last Friday's Consumer Price Index (CPI) release was the catalyst for some (not all) analysts to declare that we have not yet seen a peak in inflation.

Selected Asset Classes As of June 13, 2022	**2022 Q2**	**2022 Q1**	**2022 YTD**
PORTFOLIO **RISK** SEGMENTS			
US Large Cap	-17.7%	-5.4%	-22.1%
US Large Cap Value	-10.4%	+1.0%	-9.5%
US Small Cap	-16.5%	-5.7%	-21.3%
US Small Cap Value	-13.1%	-1.3%	-14.2%
International Large Cap	-13.3%	-5.8%	-18.3%
International Large Cap Value	-9.3%	-0.3%	-9.6%
International Small Cap	-15.6%	-9.2%	-23.4%
International Small Cap Value	-12.6%	-6.5%	-18.2%
Emerging Markets	-10.3%	-6.5%	-16.1%
Emerging Markets Value	-10.8%	-1.6%	-12.3%
Emerging Markets Small Cap	-11.7%	-4.5%	-15.6%
US Real Estate Investment Trusts	-18.8%	-6.1%	-23.7%
International Real Estate	-15.7%	-3.7%	-18.9%
SELECTED PORTFOLIO **LOW-RISK** SEGMENTS			
US Treasury 1-3yr Notes	-1.3%	-2.5%	-3.8%
US Treasury 7-10yr Notes	-7.6%	-6.4%	-13.5%
US Treasury 20-30yr Notes	-16.1%	-10.6%	-25.1%
US Treasury Inflation-Protected	-5.2%	-3.1%	-8.1%
Inv Grade Short Duration	-2.3%	-3.1%	-5.4%
Inv Grade Intermediate Duration	-7.8%	-7.1%	-14.3%
Inv Grade Long Duration	-14.4%	-11.2%	-24.0%
Mortgage-Backed Securities	-6.6%	-4.9%	-11.2%
Municipal Bonds	-3.6%	-5.9%	-9.2%
International Bonds (US$ hedged)	-7.4%	-4.8%	-11.8%
EQUITY INDICES			
MSCI All-Country World Index	-15.5%	-5.2%	-20.0%
S&P 500 Index	-17.0%	-4.6%	-20.8%
Bloomberg US 1-5yr Bond Index	-2.9%	-3.4%	-6.4%
BALANCED PORTFOLIOS			
Vanguard 60/40 Fund	-13.4%	-5.6%	-18.2%
DFA 60/40 Fund	-10.2%	-4.4%	-14.1%
DFA 25/75 Fund	-5.6%	-3.4%	-8.8%
OTHER NOTABLE MARKET DATA			
Crude Oil Futures	+24.8%	+33.1%	+66.2%
Gold ETF	-5.9%	+5.7%	-0.6%
US Dollar (Trade-Weighted)	+7.0%	+2.8%	+10.0%
High Yield Bond ETF	-10.8%	-4.9%	-15.1%

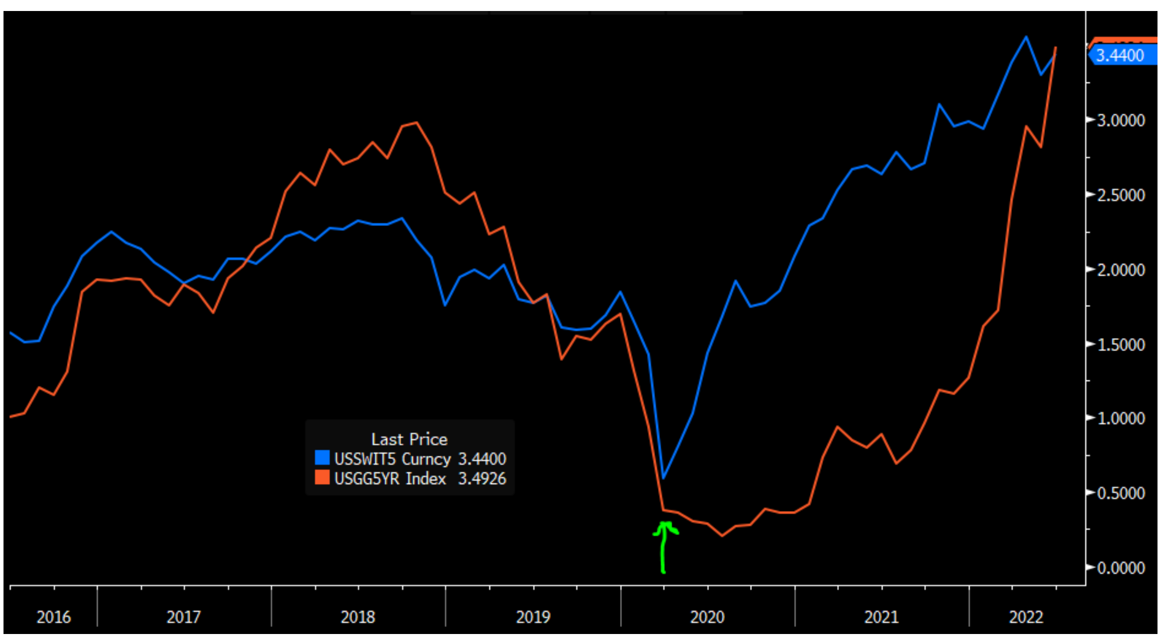
Source: Bloomberg, Maryland Capital

Note: Returns include reinvested dividends

[1] Side note: I was curious and checked the data – today's 3-day change in 2-year Treasury yields exceeds any similar period during my Wall Street bond trading career back in the 90's.

Why is elevated inflation bad for bond markets? Traditionally, bond investors incorporate future inflation expectations in their analysis when deciding at what yield they are willing to purchase a bond. When evaluating a fixed-rate bond, investors will not want to buy (and may decide to sell) if they perceive a risk of heighted inflation which would erode their "real" (after-inflation) yield. Back in the 80's an analyst coined the term "bond vigilantes" to explain overall bond market behavior – this natural aversion to inflation meant that higher inflation expectations drove bond prices lower (market yields higher) and vice versa. Academics later studied this market dynamic and concluded that "By issuing debt that is not protected by inflation, the government creates a powerful political group opposed to inflation, and ends up choosing less inflation than it would otherwise."[2]

This natural bond market discipline "feature" to demand higher yields in the face of higher inflation expectations has recently been suppressed, intentionally, by global central banks – particularly the US Federal Reserve – through use of a monetary policy "tool" called Quantitative Easing (QE) during certain times of crisis. This is simply a fancy way of saying the Federal Reserve became a participant (buyer) of longer-term bonds displacing bond market participants (vigilantes) that would otherwise demand higher yields. Through the most recent QE program invoked by the Fed during the 2020 pandemic, bond market yields were kept low despite increasing inflation expectations. In the below graph, we show the market's expectation for inflation of the next 5-years (blue line) plotted against the 5-year US Treasury note (red line). The green arrow denotes when the Fed launched QE4 – a substantial program of monthly bond purchases. *Note this program appears to have been quite successful in keeping interest rates well below rising 5-year inflation expectations.*



Source: Bloomberg, Maryland Capital Advisors

[2] Federal Reserve Bank of San Francisco Working Paper 2015-09

This year's sharp move higher in yields coincides with the Fed's March 2022 announcement to wind down their bond buying program and begin a process of raising short-term interest rates – ***bond market participants that care about inflation are back in the driver's seat and have reset bond yields in line with inflation expectations.***

While bond markets have repriced lower (higher yields), stock markets have grappled with uncertainty arising from higher interest-rates, supply-chain complications, higher costs, and – most recently – a fear of possible Fed-induced recession as it seeks to slow demand and inflation. Some companies and industries have performed well during this tumult, while others have not.

Perspective on Portfolio Returns

We encourage you to review your portfolio performance using your Maryland Capital Client Portal or mobile app and we are available to discuss any questions or concerns you may have. Despite significant challenges during 2022, note that markets have been functioning normally. There is no imminent financial or economic crisis and, despite some forecasters now raising the possibility of a recession, keep in mind that markets are forward looking and have now priced in quite a bit of uncertainty. Overall, there have been some important portfolio investment themes to note during 2022.

Risk Assets

Note that US Large Cap Value (-9.5%) and International Large Cap Value (-9.6%) have held up much better than other Risk Asset segments – particularly growth (tech) company stocks. Recall that our portfolio models seek to overweight Value, so in a tough year-to-date our Risk exposures are at least performing better than reference indexes.

What have we been doing in Risk Assets? In portfolios that have drifted significantly below our targeted Risk exposures, we have done some modest buying. Our primary activity this year, where possible, has been tax-driven activity to take advantage of lower prices by "harvesting" unrealized losses while maintaining the portfolio's overall investment strategy.

Low Risk Assets

Although Low Risk asset returns have also generated negative returns across the board, notice that US Treasury 1-3yr Notes (-3.8%) and Investment Grade Short Duration (-5.4%) have performed much better than longer-term bonds. This is simply due to the math of interest-rate sensitivity: For a given change in yield, a 30-year bond will change in value by approximately 9-times as much as a 2-year bond. This is the reason that our portfolios maintain average interest-rate sensitivities equivalent to 1-5 year bonds.

Lower bond prices have created tax-loss harvesting opportunities in portfolios and we have been busy taking advantage, where possible. Recently, we have also been able to purchase some bonds at relatively attractive interest rates. Remember that bond returns may be negative as interest rates rise, but higher yields are a positive force on future total return – this is the "silver lining" of bond holdings during periods of rising rates.

It is worth noting that bank deposit rates are slow to rise as market interest rates move higher, so we would advise cash reserves held in deposit accounts should be moved to brokerage accounts where we can purchase short-term US Treasury Bills.

Bottom Line

Since March this year, the Fed has started the process of ending the QE bond-buying program and start increasing short-term interest rates. Tomorrow is the next leg in this rate-rising process and markets expect they will raise rates by at least 0.50%. We are early in this process with upcoming Fed rate announcements July 25, September21, November 2, and December 14. **What is priced into the markets?** Markets are braced for the Fed to raise their benchmark short-term rate by 2.75% by year end.

We do not have a forecast of near-term market moves and we may, indeed, have some continued choppiness as markets find equilibrium, but our investment discipline remains the same. Trading activity is simply dictated by each portfolio's exposure to Risk Assets and its deviation from our agreed-upon target.