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CAPITAL MANAGEMENT

BCM 1Q22 Market Commentary:
Investors Question the Role of Fixed Income but It Hasn't Changed

By the BCM Investment Team

Fixed income finished the quarter with losses similar to those in equity markets, and investors are questioning the role of fixed income. But, when markets were at their lowest point, fixed income still provided substantial relative outperformance.

The yield curve inversion affirmed the market's concerns about economic growth going forward. However, inverted yield curves, which often coincide with Fed hiking cycles, have historically preceded particularly strong fixed income markets.

Housing, a crucial driver of economic activity, face a historic price shock not seen since the late-70's/ early-80's. This begs the all-important question—can the economy stomach substantially higher interest rates?

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As we reflect on another quarter, it's astounding how rapidly the prevailing narrative changes. Last quarter we were cautiously optimistic that Omicron would push the world towards a "living with Covid" reality, yet that story already seems far from mind. As time continues to pass, it seems more and more unlikely that we will return to the "normalcy" of the pre-Covid world. Any comfort from declining case counts in the U.S. was short lived, and now the world watches as a nuclear power conducts a large-scale military invasion of its neighbor. While Russia's invasion of Ukraine has and will continue to have economic implications, it is predominantly a human crisis—and our thoughts are with those in or since ousted from Ukraine.

While many economic trends that have been at the forefront remained so in the quarter, investors shifted their focus forward to the potential impact of an inflationary environment and a more aggressive Federal Reserve. The Russian invasion of Ukraine spurred oil prices that haven't been seen in over a decade, fueling an 8.5% year-over-year increase in the Consumer Price Index (CPI).[1] Last quarter we wrote about the considerable damage in equity markets—hidden by the broad indices. This quarter the damage spread further from the most speculative areas to nearly all economically sensitive segments of the market.

The 5 Best and Worst Changes in Sub Sector Valuations in Q1 2022

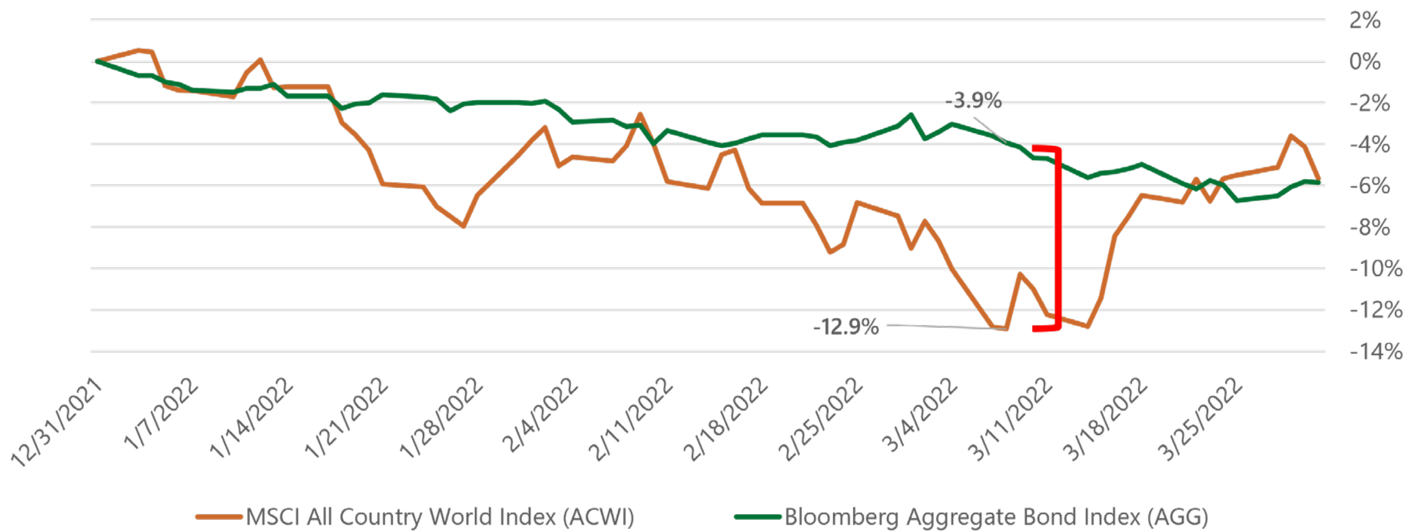
	P/E Ratio 4/11/2022	P/E Ratio 12/31/2022	% Change
Utilities	21.4	20.3	5.1%
Insurance	14.0	13.5	3.6%
Food & Staples Retailing	24.6	23.8	3.4%
Energy	10.8	10.5	3.0%
Food, Beverage & Tobacco	19.4	19.0	2.3%
Total Market	19.4	22.2	-12.3%
Media & Entertainment	19.6	23.5	-16.6%
Software & Services	30.1	36.5	-17.6%
Automobiles & Components	31.9	39.7	-19.7%
Semiconductors & Semiconductor Equipment	17.5	24.2	-27.8%
Consumer Durables & Apparel	11.0	15.5	-29.0%

Source: Bloomberg, GICS Industry Level Classification, Beaumont Capital Management (BCM).

Thus far in 2022, the market has rewarded the most defensive sectors (as well as Oil) while harshly punishing those that are cyclical or have higher discretionary demand—all while the treasury yield curve inverted, affirming the market's concerns about economic growth going forward. Despite this obvious risk-off backdrop, the most cautious investors were not rewarded for their prudence as rates rose precipitously. Remarkably, fixed income ultimately finished the quarter with losses similar to those in equity markets.

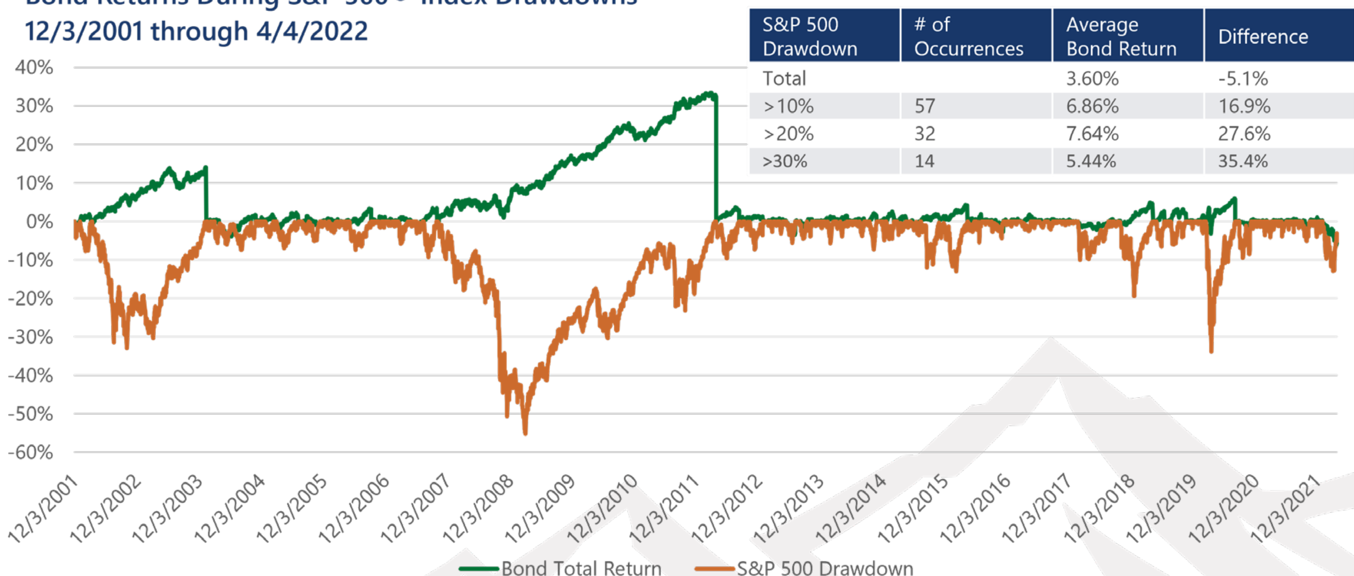
After a quarter where equities experienced a double-digit drawdown, and fixed income seemingly didn't blunt any of the losses, many investors have begun to question the role of fixed income within their portfolios. Why own any at all? While we agree the lack of "defense" provided from the defensive portion of a portfolio has been frustrating, we firmly believe the role of fixed income has not changed.

Although both fixed income and equity markets ultimately declined in the quarter, when markets were at their lowest point fixed income provided substantial relative outperformance and protection.



Source: Bloomberg. Data for the period is 12/31/2021 through 3/31/2022.

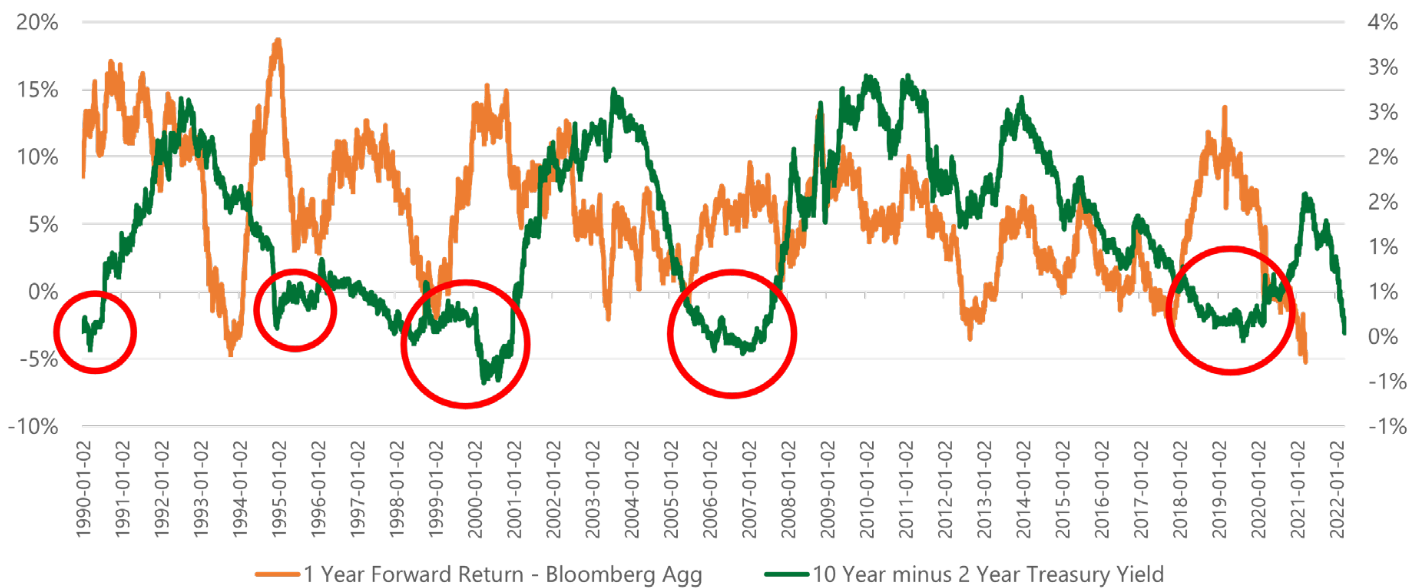
We believe disregarding the defensive characteristics of fixed income would be disregarding an extremely consistent historical relationship in times of duress.



S&P 500 Drawdown	# of Occurrences	Average Bond Return	Difference
Total		3.60%	-5.1%
>10%	57	6.86%	16.9%
>20%	32	7.64%	27.6%
>30%	14	5.44%	35.4%

Source: Bloomberg, Beaumont Capital Management (BCM). Data for the period 12/3/2001 through 4/4/2022. Bond returns represented by the total return of the Bloomberg Aggregate Bond Index. S&P 500 returns represented by the total return of the S&P 500 Index.

Most individual investors concede their inability to time equity markets, but any bet on a change in longer-term interest rates is an exercise in market timing. While the Federal Reserve will raise rates multiple times this year, they can only manipulate the shortest of lending rates. Interest rates further out on the yield curve are set by the market and incorporate the increased Federal Funds rate well before the Fed acts. Therefore, imminent increases in the Federal Funds rate doesn't necessitate continued negative returns in broad fixed income markets. Historically speaking, inverted yield curves, which often coincide with Fed hiking cycles, have preceded particularly strong fixed income markets. The average 1-year forward return of the Bloomberg Aggregate Bond Index was 9.02% following a yield curve inversion between 1990 and 2022, compared to a 5.68% 1-year forward return when the yield curve was not inverted.



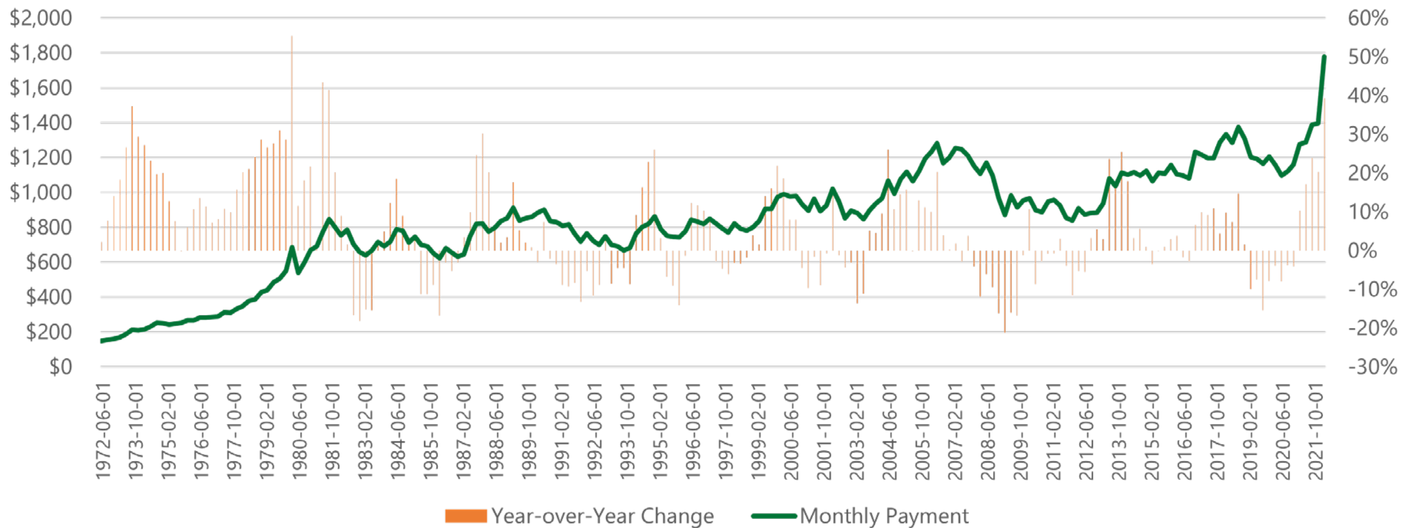
Source: Bloomberg, Beaumont Capital Management (BCM). Data for the period 1/2/1990 through 3/31/2022.

The value of fixed income is grounded in the features of the asset itself. Ignoring potential credit risk via bankruptcy or restructuring, fixed income returns are assured. In some ways the behavior of fixed income is paradoxical—when prices fall and rates rise, fixed income returns have increased going forward. Perhaps ironically, during much of the previous expansion, the chief complaint of fixed income investors was that rates were too low, and as such returns in fixed income simply weren't going to be sufficient. Now that rates have risen, and fixed income is priced relatively more attractively to other asset classes such as equities, investors are worried the losses will continue. This is akin to saying you expect to be able to pay less for something in the future, which is often easier said than done in financial markets.

Looking forward, we believe that caution is merited in today's economic environment. "Overheating" is a very simple description, and one that often coincides with later stages of the economic cycle. In recent years the government has provided ample stimulus, artificially increasing consumers disposable income while their wealth increased at an unprecedented rate. These actions may lead to persistent changes in the economy, but it's at least equally likely that it will prove to be a short-lived boost.

In the short-term we believe the most important question is whether the economy can stomach substantially higher interest rates. Housing is a crucial driver of economic activity, and homebuyers may be the most interest rate sensitive demographic within the economy. New homebuyers are currently facing a historic price shock from the combined effects of higher home prices and the recent surge in mortgage rates. The chart below illustrates a hypothetical mortgage payment at the median home price with a 20% down payment. We

haven't seen a shock this large since the inflationary period of the late-70's/early-80's. From an affordability standpoint, the interest portion of a hypothetical new mortgage represents nearly 30% of average disposable income. That is more than double the same metric from a year ago and a level that approaches the housing bubble in 2007.



Source: FRED, Zillow, Bankrate. Data for the period 6/30/1972 through 3/31/2022.

While we believe continued price shocks amid the pullback of some stimulated consumer spending could put growth at risk, there are still many reasons for optimism. Unemployment is approaching a record lo, wages are rising, and the average household maintains a strong financial position. Whether the higher inflation we see today persists or we revert to lower levels of growth and inflation is still uncertain. One thing that is certain, we are in a unique market environment, one far different than any we've seen in many years. We typically think of our strategies as playing a repetitive game against the market akin to playing poker. Over just a few hands anyone at the table can win, but with enough hands played, the best players end up winning by pressing their edge consistently. We believe our strategies have a consistent edge due to their reliance on probability for decision making and we think the recent dispersion and volatility across markets have likely increased the size of the "pot" for each metaphorical hand. We continue to believe this unique environment offers opportunities for a sophisticated investment system to find value and perhaps will remind investors of the value of a broad opportunity set.

As always, we thank you for your business and trust, and we look forward to navigating these ever-shifting market environments.

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Sources and Disclosures

[1]U.S. Bureau of Labor Statistics, Economic News Release. Consumer Price Index Summary from 4/12/2022.

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