



The stock market's first quarter decline could be attributed to a number of factors—Omicron, the war in Ukraine, the highest year over year consumer price inflation in 40 years, labor shortages, and/or continued supply chain disruption. Yet its root cause might be best attributed to “Poor Peter Powell finally had to Pay the Piper!” Naturally, “Peter” is Fed Chairman Jerome Powell who indulged in the fantasy that MMT (Modern Monetary Theory) offered a free lunch—meaning no amount of Federal Reserve Board money supply growth to fund the federal government's massive deficit spending spree, while suppressing of yields via its Zero Interest Rate Policy (ZIRP), would put upward pressure on consumer and industrial prices. After wishing and forecasting for months that price inflation would prove to be transitory, Powell finally acknowledged the Fed was behind the curve. The Piper now has to be paid with many more Fed Fund rate hikes than would likely have been necessary had he ended the Fed's extraordinary monetary ease and ZIRP in June of 2021.

It's just a little too late to do the right thing now.

Even with its change of heart, the Fed only ended its monthly Treasury bond purchase program in March, the week before the Federal Funds rate was raised off its 0% interest floor by just 25 basis points. Financial markets understand the Fed's dilemma—it needs to raise short-term interest rates by 25 basis points at least another six times by year end to regain its inflation-fighting credibility and even further in 2023, but not so fast that it kills the economic recovery.

The bond market quickly discounted this outcome, and the yield curve raced higher and by the end of the quarter was virtually near flat at 2.4% for 2-year T-Notes all the way to 30-year T-Bonds. This is likely just the beginning phase of an increase in Treasury yields.

For years now, growth-stock indexes feasted on low interest rates that justified high price/earnings ratios. Not surprisingly, the rise in discount rates this year punished these stocks the most. Even with price recovery in March, the NASDAQ plunged -8.9% for the first quarter as a whole, the Russell 1000 Growth -9%, the S&P 500 dropped -4.6%, and even value benchmarks declined modestly for the S&P 500 Value (-0.2%) and Russell 1000 Value (-0.7%). Given the shellacking the 30-year T-bond took, with a return of -11%, T-bonds looked a lot like growth stocks and offered no protection against the weak equity market returns.

In light of these pressures, it is a pleasure to report that most SKBA equity portfolios produced positive returns in the quarter and most SKBA bond portfolios declined less than their market benchmarks.

It is important to note that the booming economic recovery was well underway, producing real growth from pent up demand at the same time price inflation was gaining upside momentum. All of the factors necessary to create today's problems were in place before the Fed realized its error and changed policy, before the wave of Omicron infections peaked and then dropped sharply in January, and before Russia launched its war against Ukraine. With the Omicron wave receding rapidly (except in China), the economic reopening story was revived once again.

With the Fed asleep at the switch, however, consumer and commodity prices surged higher. Furthermore, the pandemic's acceleration in revenue growth in products and services that were boosted by shelter in place policies is now waning, with the potential for negative growth rate surprises having pulled forward revenues from the future years into 2020 and 2021. The opposite is likely to be the case for economically sensitive companies and commodity producers that took a beating with plunging earnings during the pandemic shutdown.

While the supply chain disruptions have eased somewhat, the inherent problems in believing price inflation will be easily conquered are two-fold regarding the shifts in supply and demand curves from Econ 101. For nearly all products and services, our opinion is supply

curves have moved “backward,” meaning at every level of output, suppliers demand higher prices due to their own inability to produce, to rising labor and materials costs, and government regulations. In addition, demand curves have shifted “outward,” meaning at every level of output, users are willing to pay higher prices to secure their supply. Most likely, the “just-in-time” inventory management practices have turned into a “just-in-case” desire to maintain higher levels of inventory to secure their supply. Think semiconductor chip shortages for automakers—will they make the mistake again of having just a few days of inventory on hand under the assumption?

The question on the mind of the markets is: Does the flat yield curve portend a recession? Our answer is no. When yields rebound after years of yield curve suppression by the Fed’s monetary policy, the reversion to normal yields is worse for financial markets than the real economy. Savers are finally getting their just due, and banks will be much happier to lend when net interest margins move higher.

Price inflation itself is the more significant headwind to real economic growth. Where do prices get so high that real demand for goods and services is destroyed? “Stagflation” (slowing real growth while price inflation remains high) appears to be the greater risk than outright recession.

If the human tragedy with Russia’s brutal attack on Ukrainian citizens weren’t enough, the worldwide economic setback is the impact on trade and prices of commodities such as wheat, oil, nickel and other rare earth metals. This is where the impact of Russia’s invasion of Ukraine added to worldwide price inflation that might create demand destruction. Yet pent up demand for products and services continues to exist around the world, and outside of Russia and Ukraine, trade flows continue to recover.

As a result, amidst the volatility of the markets, rising bond market yields appear likely to hurt both interest-sensitive and growth sectors of the market the most. Our view is that this is likely to continue during the next few years.

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