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INVESTMENT PERSPECTIVES

>>FIRST QUARTER 2022

Diversified portfolios protect investors in uncertain times

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The U.S. stock market has been impressively resilient since the bottom marked during the pandemic-induced lockdowns of March 2020. Since that time, the market has marched steadily upward, with surprisingly little volatility. This year may feel different: While there are many catalysts for further gains, a slew of challenges could slow or ruin progress. These include supply chain disruptions, inflation, elevated valuations, Covid-19 trends, and Federal Reserve policy. Amid these economic cross currents, 2022 could witness heightened volatility in financial markets.

Investors can protect themselves in a highly uncertain and volatile environment. The age-old practice of diversifying financial assets remains the best protection: Allocating to different asset classes and to different sectors within an asset class provides for better risk-adjusted returns, i.e., higher returns for the risk taken. Conversely, concentrated portfolios (with respect to individual holdings, asset classes, or sector exposures) create outsized idiosyncratic risk.

In a well-diversified portfolio, individual holdings will perform differently as market conditions change or company-specific events occur. While some holdings may fall on a souring economic outlook or poor execution by a corporate management team, other assets will move higher, helping to mitigate the impact. The key is managing correlation of returns.

If a portfolio is entirely invested in stocks, adding some fixed income will reduce volatility by far more than it will trim long-term returns, because the assets behave differently and thereby dampen the impact of each other. Similarly, a fixed income portfolio that adds a little equity exposure will enjoy far better returns but be subjected to only slightly more risk. Ultimately, both scenarios yield better risk-adjusted returns. The optimal combination — known as the efficient frontier — has the highest expected return for a defined amount of risk. This can only be achieved through diversification across and within asset classes.

Investors are grappling with many uncertainties, both good and bad, which is widening the potential range of outcomes. Diversification is the paramount step to reduce risk and build confidence in uncertain times. As the highly regarded Nobel Prize-winning economist Harry Markowitz noted, “Diversification is the only free lunch in investing.”

>> PERSPECTIVES ON THE ECONOMY

Today’s inflation is different, and so is the Fed’s response

By Ananya Pierce
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Since the Bretton Woods monetary system was launched in 1944, there have been six episodes in which inflation was higher than 5%. The first, immediately after World War II ended, was caused by the elimination of wartime price controls. Subsequent Korean war inflation was a result of a surge in consumer hoarding due to fear of rationing. The Federal Reserve had minimal power to intervene, as price controls and rationing were under the Treasury’s influence.

Later, however, the Fed gained more power through the Treasury-Federal Reserve Accord, paving the way to the modern Fed. In the 1960s, inflation was a function of excessive government stimulus, designed to propel the economy toward full employment; the Fed was reluctant to act against President Johnson’s Great Society push. Inflation soared through the 1970s after two oil shocks, forcing the Fed to act aggressively and resulting in two recessions in the early 1980s.

The Gulf War caused oil prices to spike again, bringing on broader inflation. This time, the Fed decided not to raise rates; it correctly foresaw the success of Desert Storm protecting the oil-producing facilities in the Middle East. Rising oil prices also spurred inflation in 2008, but the financial crisis hit soon thereafter, leaving the Fed to deal with the recession instead.

Inflation today isn’t exactly like any of those episodes, but there are echoes: We do have supply shortages and pent-up demand following pandemic shutdowns, and the effects of massive fiscal stimulus and sharply higher oil prices. The Fed’s direction is clear, but the number of rate hikes could depend on how the economy responds to new virus strains and other factors.

U.S. CONSUMER PRICE INDEX

Inflation topped 5% six times since World War II.

Source: Bureau of Labor Statistics

>> FOCUS ON EQUITIES

Taking the long view: Can stocks sustain their momentum?

By Michael A. Tyler, CFA
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Two consistent themes of American stock markets in the past two decades have been FOMO and its close cousin, TINA. When reluctant investors see stock prices rising relentlessly, they abandon their caution out of *fear of missing out*. And when global financial institutions see negative interest rates abroad and tight credit spreads at home, they conclude that *there is no alternative* to American equities. It's been a potent combination: Money has been gushing into our stock markets, driving prices inexorably higher.

The market's recent performance has been nothing short of amazing. The S&P 500 index dates to 1926, and it can be instructive to parse its performance over time. Over the entire history of the index, the market has risen in about 74% of all years, with an average gain of about 10.4% per year. Since 1981, however, the figures are even more impressive: gains in 83% of all years, averaging about 11.9% per year. More recently still, stocks have been positive in 12 of the past 13 years, during which time they have averaged a 15.9% return. Indeed, we have just completed only the third episode since World War II in which stock prices have doubled in less than three years. Without question, the stock market has been increasingly generous to investors over recent years, almost regardless of the state of the economy, pandemic, or geopolitics.

Old Wall Street wisdom tells us that the trend is your friend — so perhaps we can anticipate more astronomical gains in the next few years. But before we accept Frank Sinatra's offer — *fly me to the moon!* — we may be wiser to heed another adage: Don't fight the Fed.

Perhaps the handsome gains of the past 40 years were fueled by a steady decline in interest rates and long-term bond yields; if so, the even more handsome gains in the past 13 years could be attributed to the Federal Reserve's policy since 2008 of keeping short-term interest rates barely above zero while buying trillions of dollars of long-term bonds. In this reading, the Fed's recent pivot to tapering its bond purchases and raising interest rates would imply rather paltry stock market returns ahead. After four decades of strong tailwinds capped by a spectacular 2019-21 run, we think stock investors should prepare for more modest returns in the years to come.

>> FOCUS ON FIXED INCOME

Bond investors seek protection as the Federal Reserve turns hawkish

By Tom Bussone
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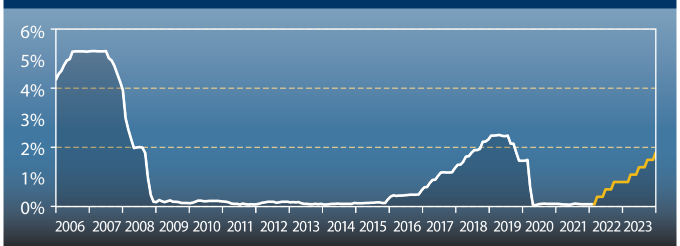
Ever since the Federal Reserve finally acknowledged last December that inflationary pressures have become persistent, bond investors have sought protection from rising interest rates. The Fed announced that it will accelerate the tapering of its bond purchases while forecasting three rate hikes during 2022 in hopes of reining in inflation.

Yet as the Fed abandoned its dovish stance, the spread between the 5-year and 30-year yield declined as money flowed into the long end of the yield curve. Investors are betting that the Fed will slow inflation but at the cost of economic growth. This trend, however, isn't likely to continue. The Fed has pivoted and has indicated that rate hikes are coming, but any potential movement in the federal funds rate isn't set in stone. Fed Chair Jerome Powell has shown on several occasions that the Fed's Open Market Committee is data-dependent, and it will adjust its actions accordingly.

If the Fed isn't on autopilot with future rate hikes, we think Treasury yields may move higher again, most notably on the long end of the curve as investors gain comfort that the Fed won't push the economy into a recession. We have positioned our portfolios to be protected from interest-rate risk by focusing on shorter-dated assets. We have increased our position in the SPDR Blackstone Senior Loan ETF and maintained our weighting in the Shenkman Short Duration High Income Bond Fund, both of which have a duration under one year. As the Fed pulls its support away from the debt markets, it's difficult to forecast that 2022 will be a favorable year for fixed income securities.

FEDERAL FUNDS RATE



The Federal Reserve expects to raise interest rates through 2023.

Source: Federal Reserve, Eastern Bank Wealth Management