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Allocation Change – Volatility Storm

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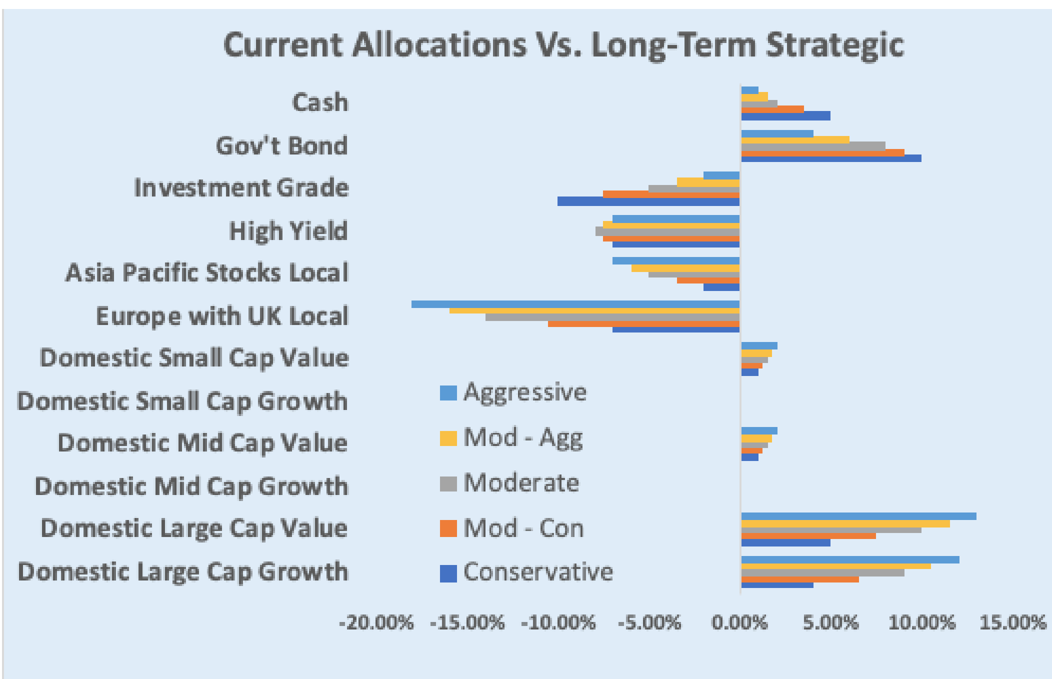
Good afternoon, Investors,

As you are likely aware, stock markets have officially "corrected" as of this morning's sell-off. This means the S&P 500 has dropped more than 10% from its highs. We are re-allocating your portfolios today. We are doing some modest loss harvesting, but our primary objective is to add equity and decrease cash and bond holdings. More specifically, we are adding Small and Mid Cap Value stocks. The obvious implication being we see this latest market sell-off as an opportunity and not the start of a longer-term bear market.



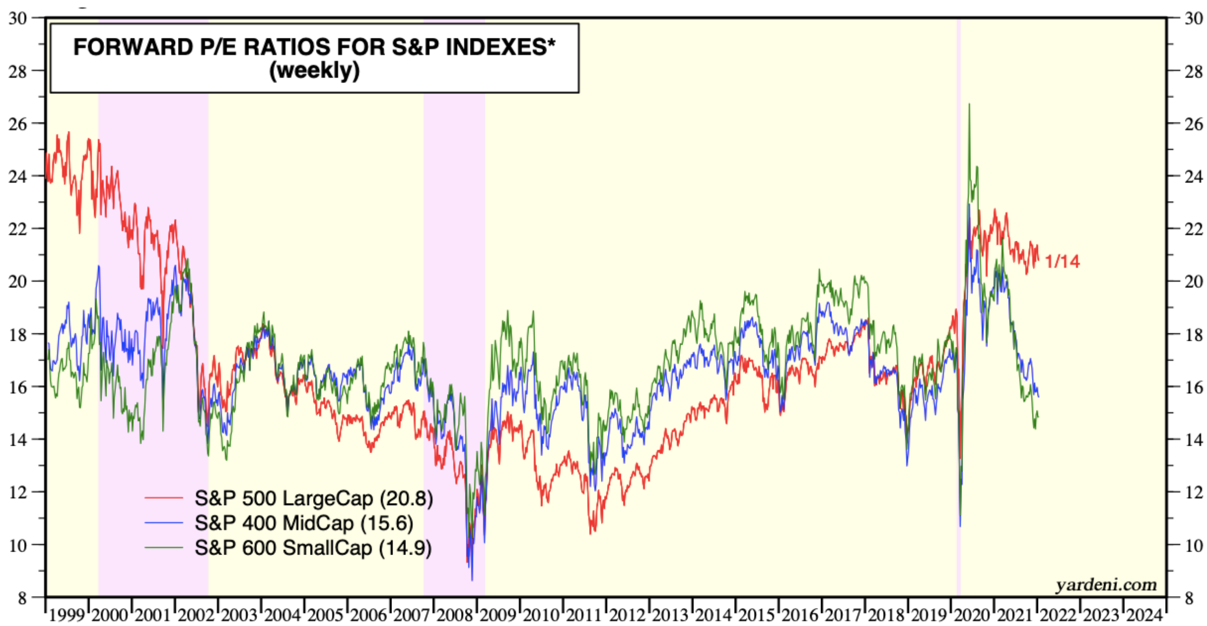
Stock markets peaked during the first week of January and then started selling off when the Federal Reserve voiced a more hawkish view on inflation. Investors viewed this as the likelihood that the Fed would tighten (taper) monetary policy quicker than originally anticipated. The first move lower in stocks was widely viewed as a taper tantrum, similar to several others over the last several years. The next leg down started Friday. It seems to be somewhat related to Jeremy Grantham's declaration that we are in the fourth super-bubble of the last century. Here is the article, it is a worthwhile read.

The evidence is overwhelming that recessions cause bear markets. More specifically, when the Fed tightens, they cause a credit contraction, which in turn creates an economic contraction. We don't think we are near that point. We'd argue the latest market moves are another taper tantrum, not the start of the next bear market. Consensus forecasts are for the Fed Funds Rate to reach 1% at the end of this year and 1.5%-2% by the end of 2023. These levels would not cause the type of credit contraction that would crash the economy. For what it's worth, consensus forecasts have had the Fed rate at these levels for the last several years and rates have remained at zero.

Sticking to the recession theme, none of the LEI (Leading Economic Indicators) are showing any signs of a recession. Consumer spending is still outpacing demand. We are in an economic situation where businesses can sell as much product as they are able to produce and ship. That's not recessionary. Recessionary economies are created when consumer demand dries up.

Jeremy Grantham’s points about speculative excesses are interesting but inconsistent. We are somewhat sympathetic to his stock argument, at least in Large Cap Growth, but have a hard time understanding his commodity argument. Commodity prices are generally lower than they were 20 years ago. When adjusted for inflation, they are much lower. Where is the excess? Commodity prices are higher because demand is higher. The same could be said for housing. Demand for housing is higher than the supply for housing. We haven't been building much over the last many years and it's starting to catch up to us. People aren't buying houses on spec, they are buying houses to live in. You know our thoughts on the bond market, Yes, yields are too low given traditional measures. However, U.S. yields are still attractive given that the only other options are zero and negative yields in the global marketplace.

Lastly, it's a fair observation that stock valuations are high. That said, they aren't anywhere near the bubble levels we have seen in the past. This recent selloff dropped the S&P 500 multiple from 21.5X to 20.8X. As of this morning's allocation change, the S&P 500 dropped to 19X earnings. The reason why the S&P 500 valuation is still a little high is primarily due to the handful of tech stocks (AMZN, APPL, etc) that are carrying very high valuations. (They continue to justify those very high valuations with very high earnings growth). Mid Cap is currently 15.6X and Small Cap is 14.9X. There is certainly no bubble there. These valuations are cheap relative to history. (This is also the basis for our allocation shift.)



Our suspicion is this will eventually turn out to be another volatility storm that passes. It may take several months, but we believe, *this too shall pass*. The most important argument here is that the Fed does not, and almost certainly won't, need to raise rates aggressively. Despite the recent headline inflation numbers, most of the inflation we see should self-correct as base effects and supply chains catch up.

We will send out a more detailed note regarding the reasoning of our allocation shift. Given the real-time volatility and our allocation change we thought it made sense to send a quick note and let you know where our heads, and your portfolios, are at. (Please forgive any grammatical misgivings, this note was not subjected to our usual reviews.) Also, please reach out to us if you would like to discuss markets or your portfolios in more detail.

Thank you,

The Mommaerts Mahaney Team

<u>Jon C Mommaerts, CFP®</u>: Jon is a Principal of Mommaerts Mahaney Financial Services, Inc. He has over 30 years of experience working with professionals and those about to retire. He is a member of the Financial Planning Association, as well as a member of the Preferred Financial Advisors.

<u>J. Matthew Tuccini, CFP®</u>: Matt has over 17 years of experience working in the financial services industry with vast experience in retirement planning, tax strategies, and financial planning.

<u>Robert Kea, CFA</u>: Bob has over 30 years of experience in portfolio management. He was a founding member and Co-Head on Putnam's Asset Allocation Group, which managed $12Bn in both retail and institutional assets.

<u>Jason Rolling, Financial Advisor</u>: Jason has been in the financial services industry for the past 15 years. His financial experience includes retail banking, consumer & commercial lending, bank management at the local, regional and SVP level, wealth management, and financial planning.

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Mommaerts Mahaney Financial Services, Inc. provides advisory services through ERTS Wealth Advisors, LLC, a registered investment advisor.
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