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March 23, 2022

Threat Assessment

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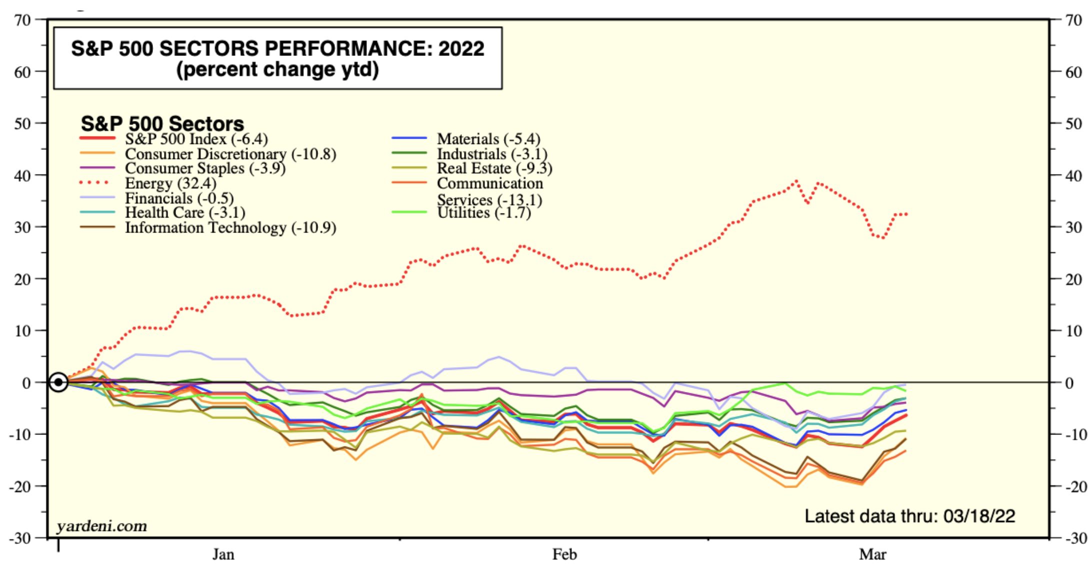
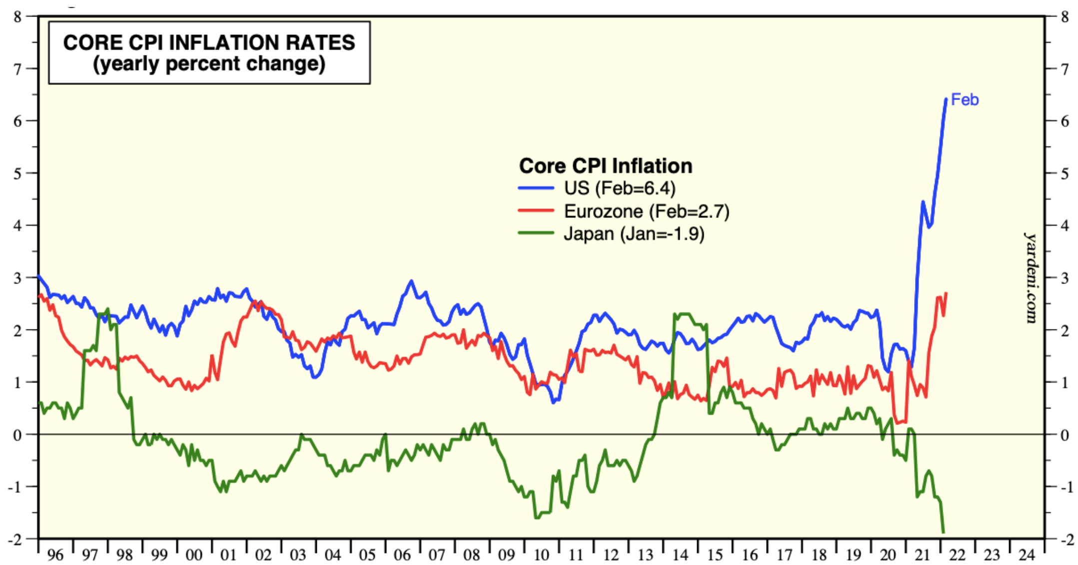
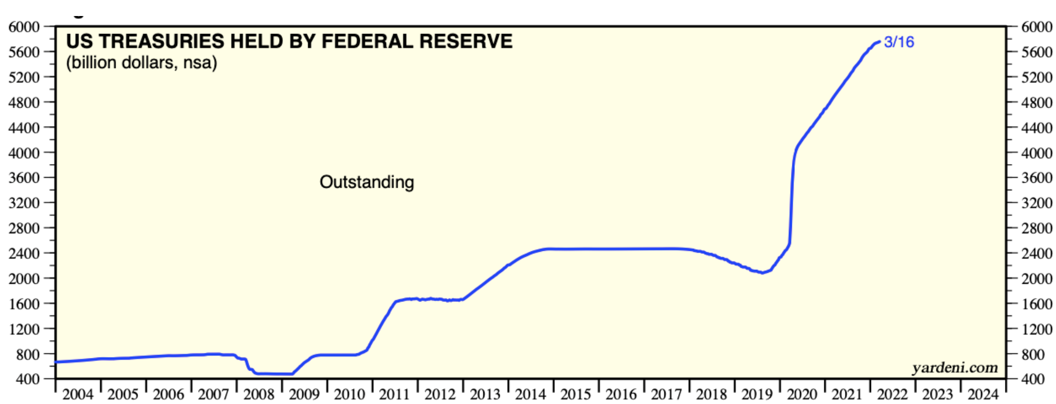
Last week we opined on the financial and economic damage resulting from the Russian invasion of Ukraine. Our expectations were that markets would adjust lower, eventually form a bottom, then spend the next year trying to grind back to even. The market adjustment lower was in recognition of consensus forward earnings expectations being adjusted lower. The S&P 500 dropped 10.8% from its record high close on January 3rd, may or may not have formed a bottom on March 14th, then bounced 5% to currently stand at -6.4% YTD. Currently, all sectors have lost value with the notable exception of energy stocks.



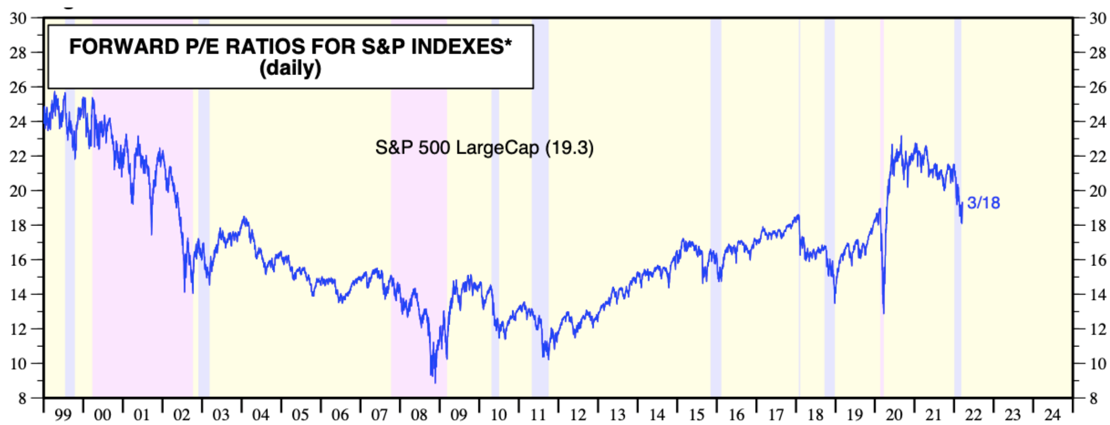
Most pundits credit the slower than expected advancement of Russian troops and hope for a sooner than expected cease-fire for the market bounce. They lowered their geopolitical threat assessment. We would agree that is the primary reason for the sooner than expected bounce back in stocks. Going forward, we believe inflation is a greater threat to the economy and markets than geopolitical events. The Federal Reserve is woefully behind the inflation curve and will need to aggressively tighten monetary policy in order to control inflation. Way too much liquidity was injected into the economy and now it's time to pay the piper. The chart below shows U.S. Core Inflation, which excludes sky-high energy prices. Inflation is real, and it's spectacular!



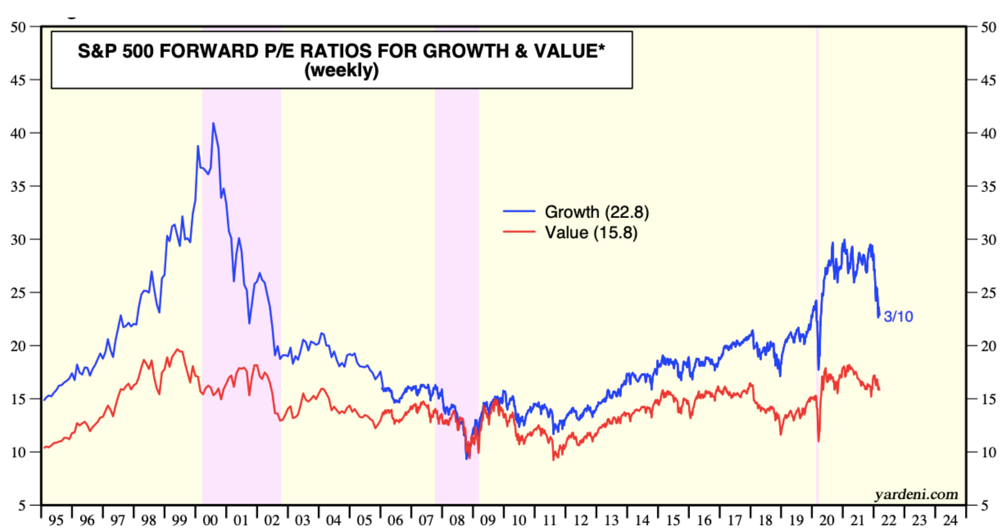
In our commentary, [The Road Goes on Forever and the Party Never Ends](), we reference Robert Earl Keen's signature song. It's an anthem within the Outlaw Country genre that tells the love story of Sonny and Sherry and their delinquent behavior. They live life in the fast lane with no worries about tomorrow or the consequences today's behavior may bring. Just like Bonnie and Clyde, they keep escaping the consequences and start believing they are invincible. Sonny and Sherry eventually find out, just like Bonnie and Clyde, not only does the party end, but it ends violently. We've often referred to the U.S. Federal Reserve as our Crazy Uncle Fed and its monetary policy as an out-of-control party. They now have to deal with the consequences of their crazy behavior, and so do we.

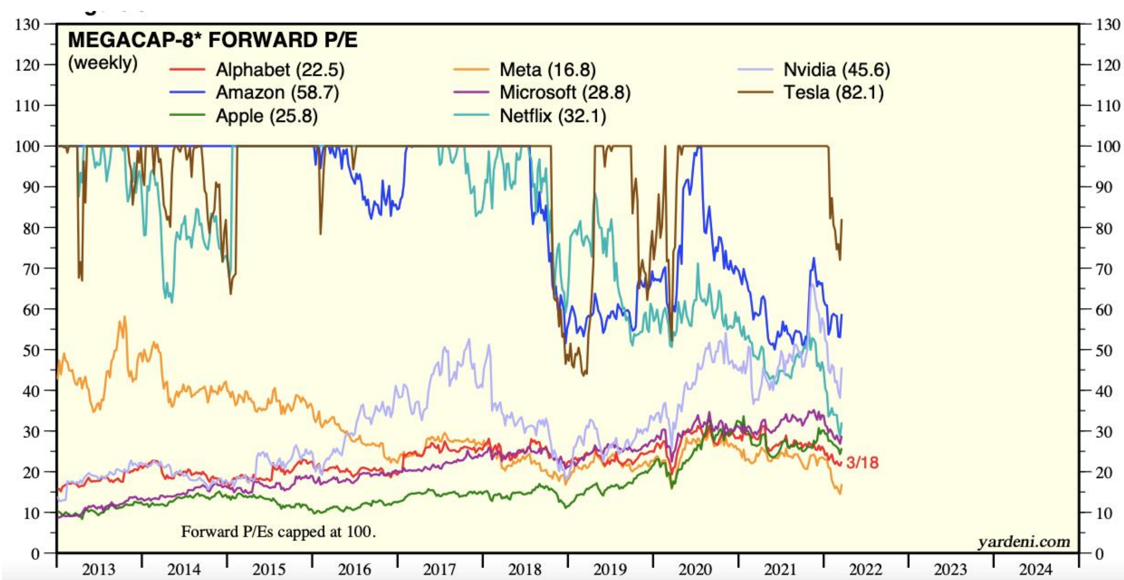


The perma-bears have been yelling about inflated price-to-earnings ratios for more than a decade. We've disagreed that P/Es were too high. We saw higher P/Es as justified. Inflation and interest rates were low, and earnings growth was high. With minimal inflation, there was little erosion in the present value of these anticipated future corporate earnings. A lower discount rate justified higher valuations. The S&P 500 P/E has been hanging out between 21X and 23X over the last few years. After this recent sell-off, it now stands at 19.3X. This is a much more reasonable multiple but it likely is still a little high. We think 18X is a more appropriate level in this new higher inflation and interest rate environment.

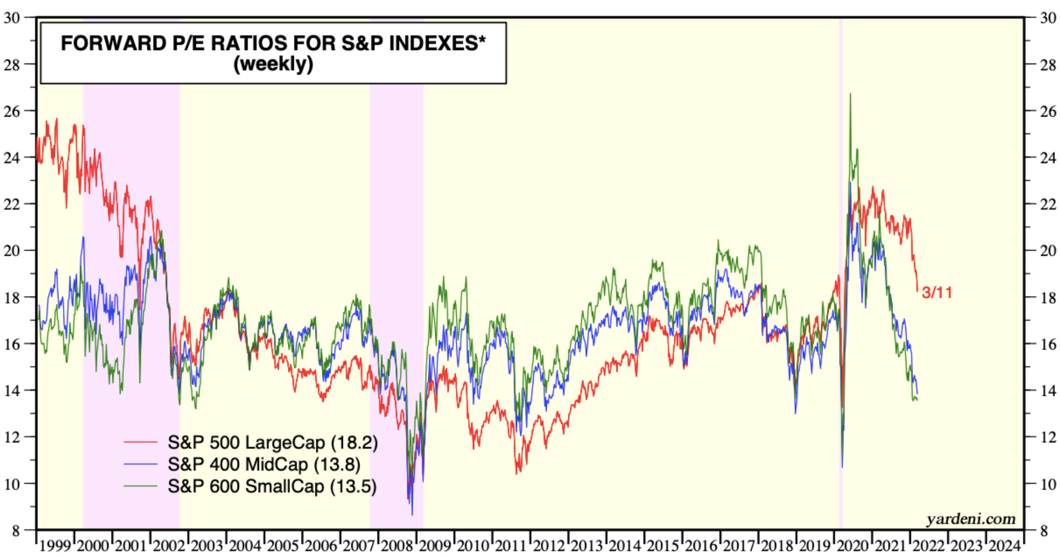


The S&P 500 is a broad market index that encompasses different market caps and different styles. A slightly elevated P/E is not a reason to panic. During a rising inflation and interest rate environment, it is a reason to reallocate assets from higher P/E assets into lower P/E assets, which we have and will continue to do. The primary reason for the S&P 500's elevated P/E ratio is Large Cap Growth stocks, in particular a few big tech names.





During periods of Fed tightening, lower valuation stocks tend to outperform higher valuation stocks. Stock market multiples compress as interest rates rise and stocks with lower multiples are less exposed to this compression. This is why we are continuing to rotate into Mid and Small Cap Value Stocks.



It's reasonable to question why we would hold any Large Cap Growth Stocks. From a pure valuation standpoint, we shouldn't. We must admit to being a bit gun shy. Many investment careers have ended over the last two decades betting against the big tech names. We acknowledge we are subjectively overriding our valuation framework. Simply put, regardless of valuation, we are not betting against Elon Musk, Tim Cook, or Jeff Bezos. It's proven to be a fool's game.

Shifting gears back to the broad equity market, periods of Fed tightening aren't necessarily synonymous with a bear market. More often than not the Fed has been able to orchestrate a soft landing (slow the economy enough to control inflation without crashing the economy). That continues to be the scenario we give the highest probability to. These periods are typified by below-average stock market returns, but not negative returns. These returns are accompanied by considerably higher than average volatility. This is the period we believe we will be in over the next year.

If you have been considering lowering your risk profile, now would likely be a good time. Over the last several years the Core Portfolios have provided returns well above their expected long-term average returns and are only modestly off their all-time highs. We expect the Core Portfolios will continue to provide investors with positive, albeit lower returns, for the next year. Beyond one year out, we will need to continuously reassess the Fed's progress in slowing inflation without overly harming the economy. Bonds tend to be a mixed bag during initial Fed tightenings. Interest rates are almost certain to be higher. Credit spreads typically widen out (which we've already seen) then gradually tighten. Again, the bottom line for portfolio returns is that investors should expect very modest positive returns with lots of volatility for at least the next year. Together, we reaped while the harvest was abundant. We must now power through some more difficult times until there is another bumper crop. That's how we achieve long-term investment success. The only way to avoid the stress is to not be invested, which is far more costly. Other than prudent investing, the most critical component of successful investing is communication. If you haven't recently had a portfolio review, we encourage you to reach out and schedule one.

Optimistically Yours,
The Mommaerts Mahaney Team

Jon C Mommaerts, CFP®: 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.

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

Robert Kea, CFA: 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.

Jason Rolling, Financial Advisor: 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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