January was the cruelest month (with apologies to T.S. Elliot who said that April was the cruelest month). Stock markets posted the worst performance since the start of the pandemic in March of 2020. Large cap growth stocks led the decline, falling more than 14% by January 27 before reclaiming some of those losses by month-end. Small-cap stocks were close behind, while the Dow Jones Industrial Average and value stocks also declined, but by lesser amounts.

Corrections are a healthy fact of life, with stocks typically falling by 10% or more at least once per year. The last time stocks declined by at least 10% was September of 2020, so perhaps we were overdue.

This recent sell-off, in particular, seemed to be fueled by further uncertainty regarding interest rates and the potential unwinding of policies the Fed put in place to prevent a health care crisis from becoming a financial crisis. Not only did the Fed lower its target rate to virtually zero, but it has also been adding significant liquidity to the financial system through the purchase of bonds. These purchases helped keep all interest rates low, and helped provide liquidity to companies, many of whom saw their revenues drop to zero in a matter of days or weeks. (Think airlines for example.)

The Fed now predictably and unavoidably finds itself in a problem of its own making. As the economy began to fully recover, the Fed argued that much of the higher inflation was “transitory.” Certainly some inflation pressures will prove to be temporary, but inflation has proved to be more stubborn than initially believed. The Fed has now had to backpedal, and their statements suggest that policy interest rates will likely increase several times this year. Further, the Fed will fully stop buying bonds by March, and may actually start letting its inventory of bonds expire - draining more liquidity from the system.

Even worse is the reality that higher interest rates will do nothing to help relieve supply chain shortages. In fact, to the extent that higher interest rates prevent companies from expanding production by making capital expenditures more expensive, higher interest rates could actually exacerbate inflationary pressures as demand continues to exceed supply.

The Fed, feeling compelled to fight inflation, has announced that it will raise interest rates and take other actions to prevent inflation from becoming even more entrenched. This is a big change in policy from the central bank, and these actions have given the market a reason to be nervous.

While Omicron reigned in growth in January, the economy remains remarkably strong, growing at 6.9% in the fourth quarter of 2021. This, in spite of continued product shortages, and the many industries still wallowing in pandemic slow-downs - hospitality and international travel come to mind. Imagine how strong the economy will be when even more businesses return to normal.

Strong economic growth will lead to corporate earnings growth, and that is usually a good environment for stocks. How much of that growth is already priced in is a key question, adding to the recent volatility. Still, it is important to focus on the types of stocks that will do well in a rising interest rate environment. This suggests that portfolios must be restructured to have greater focus on industrials, materials, and financial companies. These changes are being incorporated into our managed portfolios as I write, and should position portfolios for the environment we expect.

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