O'Brien WEALTH PARTNERS
ADVISORS | ANALYSTS | ADVOCATES

April 14, 2022

Dear O'Brien Client,

The past several months have seen a volatile pullback in most asset markets, largely driven by the Federal Reserve (Fed) tightening cycle and the war in Ukraine. The war in Ukraine has been a humanitarian catastrophe, and we continue to wish for the safety and peace for everyone that has been impacted. But probably the biggest contributor to market volatility has been the ambiguity around the outlook for the Fed.

Typically, when discussing portfolios we focus on the tradeoffs between return and risk – and specifically the concept of risk aversion, or investor preference for less uncertain outcomes. Investments with more uncertain outcomes – such as stocks – generally need to offer higher returns than those with less uncertain – such as bonds – outcomes for investors to be interested in them.

But the broadness of this current market pullback suggests it is less driven by a re-evaluation of returns and risks than by a behavioral finance concept called ambiguity aversion. Ambiguity aversion differs from risk aversion in that investors struggle to both identify the potential outcomes and the probability of those outcomes occurring. These dynamics adversely impact an investor's ability to value assets and risks, and therefore their willingness to construct portfolios and participate in markets.[1]

In 2020, the Fed shifted from targeting a constant 2% inflation rate to targeting an average 2% inflation rate over an *undefined* period of time. This shift created ambiguity around how much – and how rapid – tightening will need to be for them to achieve this new, and less well-defined, target.

Entering 2022, investors anticipated 75 basis points of rate hikes during 2022. By the end of the quarter, investors anticipated 225 basis points of rate hikes to occur. And throughout this adjustment in market expectations, Fed rhetoric has become even more hawkish – leaving that ambiguity in place.

The result has been a surge in interest rates (and corresponding drop in bond prices) and a drop in stock prices as investors try to understand the potential opportunities and risks created by the Fed's intentions. As shown below, the one safe-haven from the selloff has been commodities, which have benefitted from continued supply-chain constraints that have been exacerbated by the outbreak of war in Ukraine.

[1] Li, Wenhui and Christian Wilde (2021), "Separating the effects of beliefs and attitudes on pricing under ambiguity", SAFE Working Paper No. 311.

	1Q 2022	2021		1Q 2022	2021
Commodities	25.5%	27.1%	Treasuries	-5.6%	-2.3%
Gold	6.6%	-4.3%	U.S. Mid Cap Stocks	-5.7%	22.6%
High Yield Bonds	-4.5%	5.3%	Non-U.S. Developed Market	-5.9%	11.3%
U.S. Large Cap Stocks	-4.6%	28.7%	**U.S. Aggregate Bond Index**	**-5.9%**	**-1.5%**
Mortgage-Backed Bonds	-5.0%	-1.0%	Municipal Bonds	-6.2%	1.5%
Real Estate Stocks	-5.3%	41.3%	Emerging Market Stocks	-7.0%	-2.5%
Global Stocks	**-5.4%**	**18.5%**	Investment Grade Bonds	-7.4%	-1.1%
Non-U.S. Stocks	-5.4%	7.8%	U.S. Small Cap Stocks	-7.5%	14.8%

Past performance is no guarantee of future returns. You cannot invest in an index.
Source: Morningstar Direct, O'Brien Wealth Partners, as of 3/31/22.

Historically, the start of a Fed tightening cycle brings a rise in interest rates that has temporarily weighed down interest-rate-sensitive bond market returns. But that tightening usually occurs against strong economic backdrops, meaning that risk assets, such as stocks, have tended to offset those losses for diversified investors.

The decline in both stocks and bonds the past several months therefore represents a notable breakdown in diversification. This was only the seventh quarter in the past 23 years where both global stocks and the U.S. investment-grade bonds fell simultaneously. Moreover, this was the first of those seven instances where bonds fell more than stocks.

So where does all of this leave us entering the second quarter?

Quite simply, no one knows how this tightening cycle will unroll and conclude. So, we should instead focus on what we think we know today and see if that frame of reference could help clarify the potential opportunities and risks that lie ahead.

From a secular (think long-term) standpoint, economic growth – on average – is expected to slow because population growth is slowing. This dynamic may result in reduced return potential. And while there are significant questions about inflation today, long-term the Fed probably remains credible and inflation cools.

From a cyclical (think next several years) standpoint, the drivers of the economy are becoming more mixed. Yield curve inversion is a front-and-center topic, as it has been a consistent early warning sign for recessions. But it is also not the only dynamic that matters for the economic cycle (or else there would be a consistent lead time between inversions and the starts of recessions).

Labor markets, for example, also play a consistent role in cycles, and those dynamics remain more constructive. The number of job openings per unemployed worker is the highest it has been in decades, translating into a multi-decade high increase in compensation for workers (albeit one that is still lagging inflation).

Consumers have also saved an estimated $2.5 trillion from stimulus checks during COVID that they are now tapping into to help offset higher prices. Home price gains since the Global Financial Crisis have also created an estimated $10 trillion in "tappable" home equity, which consumers are only just recently beginning to access. Consumer spending – which accounts for roughly 70% of the economy – remains healthy as a result.

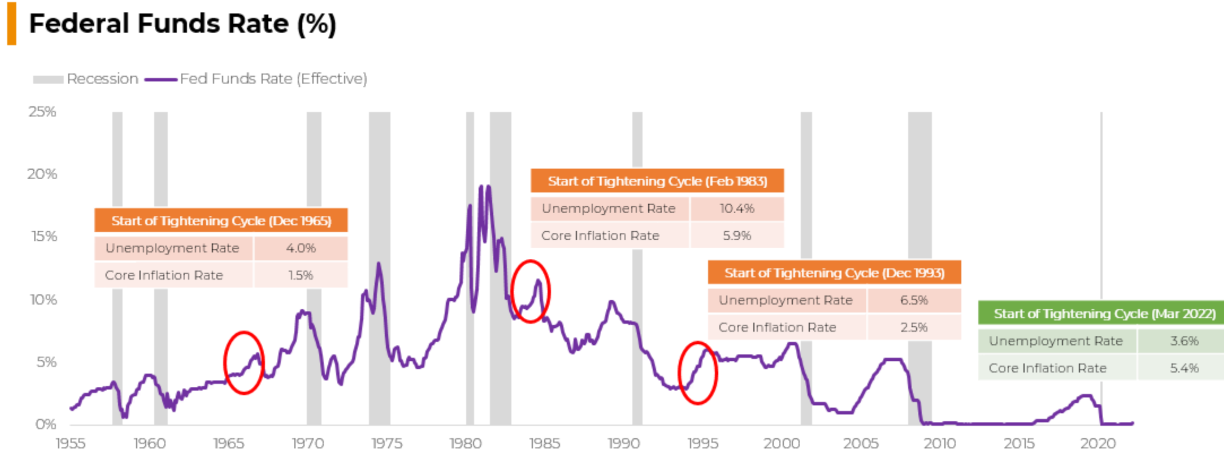
In sum, the economy is slowing from the rapid pace of growth since reopening began, but slowdowns are not synonymous with recessions. And to us, the odds of imminent recession remain low.

177 Huntington Avenue, Suite 2010, Boston, MA 02115 **P** 617.547.6717 **F** 617.547.9516 **www.obrienwp.com**

Yet inflation has surged and could move even higher. On the positive side, a faster pace of Fed tightening will slow demand and likely lead to an inflation rate peak over the next few months. On the downside, there has been a shift of inflation-drivers toward less price-sensitive markets, such as shelter, recreation, and medical care (see chart below). This demand shift increases the odds that inflation may stay elevated versus recent history and require potential tightening beyond current expectations.

Fed: Federal Reserve. Shaded areas represent recessions as dated by the National Bureau of Economic Research (NBER). Core "sticky" inflation focuses on goods and services that are less responsive to changes in economic conditions and includes shelter, recreation, food away from home, education, and medical care. Source: Bureau of Labor Statistics, Cleveland Fed, NBER, S&P Global, O'Brien Wealth Partners, as of 2/28/22.

Against this backdrop the Fed is trying to engineer a "soft" landing that slows inflation but does not push the economy into recession. Historically, they have accomplished this in just three of their last 13 tightening cycles (see red circles in the chart below).



Fed: Federal Reserve. Shaded areas represent recessions as dated by the National Bureau of Economic Research (NBER). Source: Bureau of Labor Statistics, Bureau of Economic Analysis, Federal Reserve, NBER, S&P Global, O'Brien Wealth Partners, as of 2/28/22.

Finally, thinking tactically (the next year), markets are also trying to digest the implications from events in Ukraine. Russia is a small portion of the global economy, accounting for less than 2% of GDP, population, and trade activity. But it is much more important in commodity markets, accounting for 11% of oil, 17% of gas, 11% of wheat, and 9% of industrial metal production. The same dynamics are true for Ukraine. Absent a further widening of the conflict, the war in Ukraine is therefore likely more of an inflationary than recessionary risk for the US.

177 Huntington Avenue, Suite 2010, Boston, MA 02115 **P** 617.547.6717 **F** 617.547.9516 **www.obrienwp.com**

We are long-term investors, and as such the secular outlook plays the dominant role in how we build portfolios. The secular outlook above – if accurate – increases the importance of active management in inefficient markets (such as small cap stocks) and finding companies that can consistently grow profits (such as growth- and quality-oriented stocks) to enhance returns. That outlook also implies bonds and stocks can still diversify portfolios. As such, we believe that while bonds are under pressure today, they are not fundamentally broken.

But at the same time, it is unclear whether the Fed's actions in the interim will find that balance of controlling inflation and mitigating recession.

Since COVID began, we have been exploring potential additions to portfolios to help insulate against the risks that would be created by either high inflation persisting or economic recession. We have already implemented some of those ideas to help mitigate recession risks, and will likely begin to incorporate additional findings to help insulate against both risks in the near future.

We hope you are all taking care and staying healthy. If you have questions, or would like to talk, please reach out to your Advisor or any member of our investment team.

Your O'Brien Team

Disclosures:

1. Registration with the SEC should not be construed as an endorsement or an indicator of investment skill, acumen or experience.
2. Investments in securities are not insured, protected or guaranteed and may result in loss of income and/or principal. Diversification does not eliminate the risk of market loss and, long-term investment approach cannot guarantee a profit.
3. This communication may include opinions and forward-looking statements. All statements other than statements of historical fact are opinions and/or forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the beliefs and expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such beliefs and expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements. All expressions of opinion are subject to change. You are cautioned not to place undue reliance on these forward-looking statements. Any dated information is published as of its date only. Dated and forward-looking statements speak only as of the date on which they are made.
4. Investment process, strategies, philosophies, portfolio composition and allocations, security selection criteria and other parameters are current as of the date indicated and are subject to change without prior notice.
5. In general, investment in foreign issuer securities entails additional risks such as limited transparency and accounting overview, varying frequency, availability and quality of financial information, limited enforcement opportunities by US regulators, and limited shareholder rights and/or remedies.
6. Unless stated otherwise, any mention of specific securities or investments is for illustrative purposes only. Adviser's clients may or may not hold the securities discussed in their portfolios. Adviser makes no representations that any of the securities discussed have been or will be profitable.
7. Market or market segment performance is stated for illustrative purposes only and does not reflect performance of actual client accounts. Client performance is affected by advisory fees and transaction costs.

177 Huntington Avenue, Suite 2010, Boston, MA 02115 **P** 617.547.6717 **F** 617.547.9516 **www.obrienwp.com**