FREE

THE CLIENT LETTER

MONTHLY NEWSLETTER

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April – No Place to Hide

May, 2022

In 1986 I was sitting in finance class at Belmont studying the relationship of interest rates to asset prices such as homes, stocks, bonds and the like. A student today could save themselves the hassle and just observe what's happened so far this year in markets.

When interest rates rise, it causes a decrease, at least initially in the value of investment assets. In this year's case, it has affected both stocks as well as bonds such that a normally diversified portfolio really had very few places to hide during this initial drop. This has resulted in the worst 4-month start to the year in the stock market since 1937. I did a double take when I read that statistic, but the selloff this year has indeed been swift, and I will caution that ***April statements are not for the faint of heart***. But as always, statement values are simply a snapshot of that day only – not a predictor of long-term potential – and any knee-jerk reaction to such single day values is usually too late ***and*** likely not the best decision financially. I have decades of anecdotal evidence to support that. With that disclaimer out of the way, now back to the show:

With the Fed committed to raising rates rapidly, they are attempting to slow the economy and bring down inflation while at the same time hopefully avoiding a recession. Can they do it? Only time will tell. Historically they're success rate is, well, "iffy". And because of this, financial markets have been adjusting downward as a way to price in the risk that the economy may slow at some point.

However, in typical fashion, I expect that markets will overreact on the front end as they generally do. Markets don't usually wait on the end result but rather try to predict what may happen in the future. And right now, they are predicting the possibility of perhaps a mild recession in my opinion. And to those that think they can time or outguess the market's reaction to recessions, good luck.

But a recession is not the end of the world. After all, the business cycle is still alive and well and we will have a recession at some point. Since I began my career in late 1989, I have been through 4 1/2 recessions (I call 2015 a half recession because we almost got there as GDP stalled). Yet when I got in the business, the Dow Jones industrial average was 5,500. It is now around 34,000. Recessions are normal and simply part of doing business for the long-term investor.

I will say this year reminds me of a combination of 1994 as well as the period 2000-2002.

In 1994, the Federal Reserve aggressively began raising interest rates because of a hot economy. GDP growth was 5.9% and the Fed Funds rate was hiked from 3.25% to 5.5%. This caused an initial jolt to the stock market and a big punch in the nose to the bond market as well. interestingly though, 1994 ended with the stock market basically flat but bonds were down nearly 3%. However, during the year there was much volatility and stock and bond prices were much lower mid-year than where they finished. I could see this year providing a similar roller coaster ride. And while 1994 was somewhat of a throwaway year for investors, it set the stage for very good performance in 1995-1999 as both stocks and bonds recovered nicely.

The similarity to 2000-2002 period in my opinion has to do with a shift in the types of stocks investors might favor going forward. Prior to 2001, highflying tech stocks related to the dot.com era were all the rage and values had risen to unsustainable levels for companies that didn't even have earnings at the time. After that bubble burst, investors favored old line, stodgy companies that paid dividends and had reasonable valuations. While tech stock valuations are not necessarily at the crazy levels they were in the late 90s, I do feel there is a bit of a sea change taking place under the surface of the market. I would not be surprised to see the focus shift to lower valuation, blue-chip dividend paying companies rather than overvalued growth stocks with only a possibility or "promise" of earnings in the future.

Of course, a declining market can throw nuance aside and take a machete to everything across the board initially, as it did so far this year. It is often said that stocks "take the stairs up and the elevator down". Folks, there may be more pain to come in the market short term, but I think it will happen quickly. And even if there is a recession at some point on the horizon, current metrics do not necessarily suggest it is eminent. Consider the following:

1. The unemployment rate is 3.2%, everyone that wants a job has one.

2. Consumer's bank accounts are at the highest level on record according to Brian Moynihan at Bank of America.

3. Corporate balance sheets remain in good shape and companies are finally increasing capital expenditures for the first time in a while.

4. Consumer spending on travel and leisure have been reported to be the best in years. United Airlines recently noted that demand for air travel is the highest in 30 years.

5. And yes, while overall debt has risen, actual debt service ratios are quite healthy. (That is, the amount consumers and businesses actually pay to service the debt they have)

So yes, the federal reserve may have to raise interest rates enough to slow this economy and possibly tip it into recession, but the above data points certainly don't suggest a fragile or unhealthy economy, at least not just yet. But when a recession inevitably comes, markets may have already factored it in far in advance – and this is the important part. You see, markets tend to react 6-12 months before the actual economic events unfold so it would not be uncommon for the market to actually be recovering or rebounding ***even while economic data is still weakening or suggesting recession***. This is what makes timing the market so difficult.

Harry Katica, a market strategist whom I read weekly even suggests the economy will experience a quick, mild "recession" and recovery beginning as soon as November of this year. His rational: The Fed will get three 50 basis point rate hikes out of the way by summer, the economy will start to slow, and the Fed will declare victory over inflation by the mid-term elections and be able to take their foot off the brakes by the 4th quarter. Is he right – who knows? But if that is the case, I would fully expect the markets are in the process of pricing it in now. ***Thus, by the time an investor sees the declines, it may be too late to make any significant changes that would have any meaningful effect other than missing some part of an eventual recovery.***

<u>Lastly, a note to retirees or anyone living off their portfolio</u>: It can certainly be nerve racking to see markets fall and portfolio values decline if you are relying on these assets to supplement your retirement income. However, it has been my experience that the best way to handle market declines while living on one's assets is the following:

1. Have a well-diversified portfolio, with proper mix of stocks, bonds, cash,etc. So far this year, diversification has not provided quite the buffer that is has in the past, but that is an anomaly in my opinion. Over time, diversification in various types of assets should have the effect of reducing overall volatility.

2. Have realistic return and withdrawal assumptions. We generally advise clients to stick to a 4% withdrawal rate. That is, the annual amount withdrawn for living expenses should not be much more than 4% of the overall value of the portfolio. While history is no guarantee of the future, this level of withdrawal has been generally sustainable over long periods of time while enduring economic downturns and market corrections. Again, I have decades of anecdotal evidence to support this and I believe it to be a sound practice.

Bottom line: The Fed has likely waited too long to raise interest rates and thus inflation is the genie that's tough to get back in the bottle. I am confident they can do it, just not necessarily without slowing the economy first. Folks, that's called the "business cycle" and it hasn't changed since I was a sophomore at Belmont sitting in Professor Wynn's Finance class. I guess that tough old bird knew what he was teaching after all.

Edie's Corner

A couple of housekeeping items: Just a reminder that when making checks to invest or add to your accounts, they should be made payable to "**Raymond James**" only. Our affiliation with Pinnacle and other Raymond James subsidiaries can make it confusing – but "Raymond James" is the proper payee.

Also, as many of you know, Cole Ellett, CFP joined our team last year. If you haven't had a chance to meet him, hopefully you will soon. Below is contact info for all of us as we are always happy to help you with any issues:

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As always, we thank you for your business, your friendship and the trust you place in us. Feel free to share this letter with anyone you feel may benefit. Edie, Cole and I are happy to answer any questions you may have. Until then, wishing you health and happiness.

Regards,

B. S. J.

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