ecf Insights

ECF Endowment Management | First Quarter 2022

The Other Side of the Mountain in 2022

It has been nearly two years since the onset of the pandemic that rocked the world. During this time, the world entered into a synchronized recession, the deepest recession since WWII, when production, demand, and mobility came to a grinding halt.

And almost as quickly as the stop occurred, the re-start during the second half of 2020 and into 2021 led to strong economic growth (US GDP: 5.7% Y/Y in 2021, BEA). Buoyed by massive monetary and fiscal stimulus and limited spending during the 2020 closures, consumers found themselves flush with savings. In 2021, consumers, aching for products (including big ticket items), dining out, and vacations, came out in droves overwhelming supply chains that couldn't keep up with demand. And by the end of the year, labor shortages, and supply chain bottlenecks across every sector led to rising inflation.

FROM TAILWINDS IN 2021

- Stimulus
- Vaccine
- Low Interest Rate
- Consumer Strength

TO HEADWINDS IN 2022

- Stimulus Ending
- Higher Inflation
- Rising Interest Rate
- Lower Consumer Savings
- Geopolitical tensions
- Mid-term Elections

The economic growth in the US is still expected to be positive in 2022 (4.0%, IMF estimate) and exceed the 10 year average of 2.1% Y/Y. However, the *slowing* growth rate (from 5.7% in 2021 to 4.0% in 2022) represents a shift in momentum. In addition, the US is entering 2022 on a much weaker footing than in 2021. Emerging headwinds include:

Stimulus – We can expect both monetary and fiscal stimulus to end this year. During the last two years, these worked in tandem. The government was injecting money to boost economic activity while the Fed added liquid-

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Endowment Tip

Is it time to adjust your endowment spending rate?

Prudent spending to preserve purchasing power over time is based on the expected total return of your investments in the *future* rather than what they have returned in the past. This standard is included in the law that applies to permanent endowment funds. It also helps an organization maintain steady spending in times of economic downturn or economic strength.

Recently, expected returns have fallen as predictions of future economic growth have slowed, inflation has increased, and investors expect interest rates to rise. A chart from State Street Global Advisors comparing projected returns in various asset classes in 2017 and 2021.

Active/Passive 70/30 Portfolio:

	Projected Return as of 12/31/17	Projected Return as of 12/31/21	*Difference*
US Large Cap	6.0%	5.3%	*-0.7%*
US Small Cap	6.6%	5.8%	*-0.8%*
Int'l Developed	6.3%	5.2%	*-1.1%*
US Investment Gr	3.0%	1.1%	*-1.9%*
US High Yield	4.7%	3.0%	*-1.7%*

We encourage investment committees to set aside time at an upcoming meeting to ensure spending aligns with up-to-date expected returns as well as church or organizational guidelines and applicable law. Please let us know if we can provide information for your portfolio.

ity. Fiscal stimulus totaled approximately $5.6 Trillion. And the Federal Reserve bond purchases were roughly $5 Trillion.

Inflation – Higher inflation may continue longer term driven in part by a labor shortage leading to higher wages. A near-record number of job openings was caused, in part, by baby boomers' early retirement during the last two years. In turn, employers had little choice but to increase wages to lure workers. In addition, the supply chain disruptions may linger deeper into 2022 than anticipated.

Consumers – Consumer spending contributes to approximately 70% of the US GDP growth. With persistent inflation and falling levels of savings, spending has begun to weaken.

Interest rates – In 2022, geopolitical tensions could loom and mid-term elections could result in a pullback in government spending. But perhaps the biggest immediate risk to the financial markets are the Federal Reserve actions, including interest rate hikes.

The Fed Takes a Front Seat

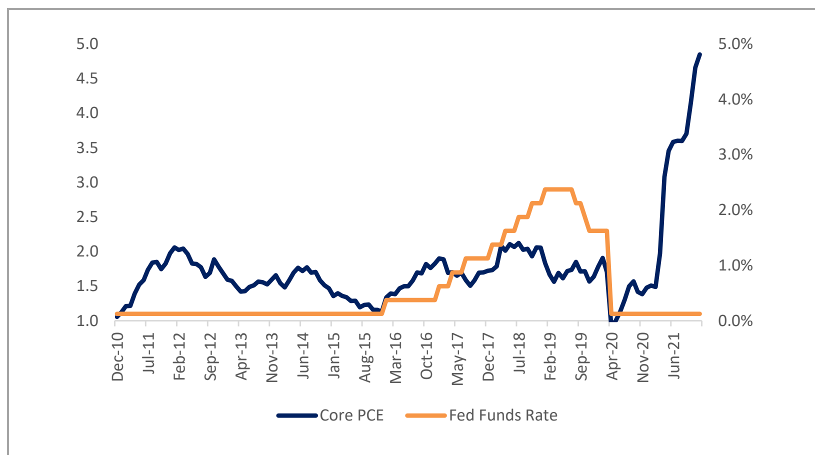
Monetary policy has been front and center in 2022. Central banks globally were extraordinarily accommodative to support the global economy through the deepest recession this generation has seen. But as we dig out the of the pandemic, Central Banks including the Federal Reserve have suggested normalization (bringing the Fed balance sheet and interest rates back to average) would occur in 2022 and into 2023. These actions include:

Tapering – As a stimulus measure to encourage more spending, the Fed purchased $120B of Treasury and Mortgage Backed Securities each month. Tapering (or slow down) of bond purchases is the first step toward moving policy away from an emergency setting. And in November, the Fed tapered its purchases by reducing the pace of purchases by $15B per month. In December, the Fed announced an acceleration of tapering – doubling the pace of the pullback, from $15B to $30B per month.

Interest rates hikes – The Federal Reserve lowered its benchmark policy rate from 1.50%-1.75% in December 2019 to 0.00-0.25% in March 2020 to support an economy weakened by the pandemic. Rates had been unchanged at near-zero since then. With the economy on a growth trajectory, the Fed's goal is to raise rates to be in line with inflation.

In the U.S., in addition to normalizing interest rates and its balance sheet, the recent bout with inflation has pressured the Fed to prioritize its fight against inflation by accelerating the pace of interest rate hikes (see Chart 1). In December the FOMC Dots (a tally of voting member's view on the target rate) suggested a possible three interest rate hikes during 2022, up from the late 2021 prediction of two hikes. More recent expectation has suggested rates could be raised as many as 5-7 times (CME FedWatch) in 2022 including at least one 0.50% hike to combat lingering inflationary pressures.

Chart 1: Core Personal Consumption Expenditure Y/Y (%) & the Fed Policy Rate



Source: Refinitiv, St. Louis FRED, Federal Reserve, as of December 2021

At the same time, the Federal Reserve began to taper its purchases of assets beginning in November and is expected to begin reducing the size of its nearly $9 trillion balance sheet as early as mid-year.

Financial Market Implications

The Federal Reserve actions led to a turbulent start to 2022. Fears of more aggressive Fed moves, including the quicker pace of interest rate hikes, spooked the markets. While there could be some sector rotation and overall market price adjustments, rising interest rates isn't all bad news for markets in the longer term.

Fixed income securities, such as bonds, are sensitive to interest rates. Bond prices have an inverse relationship with interest rates – when interest rates go up, bond

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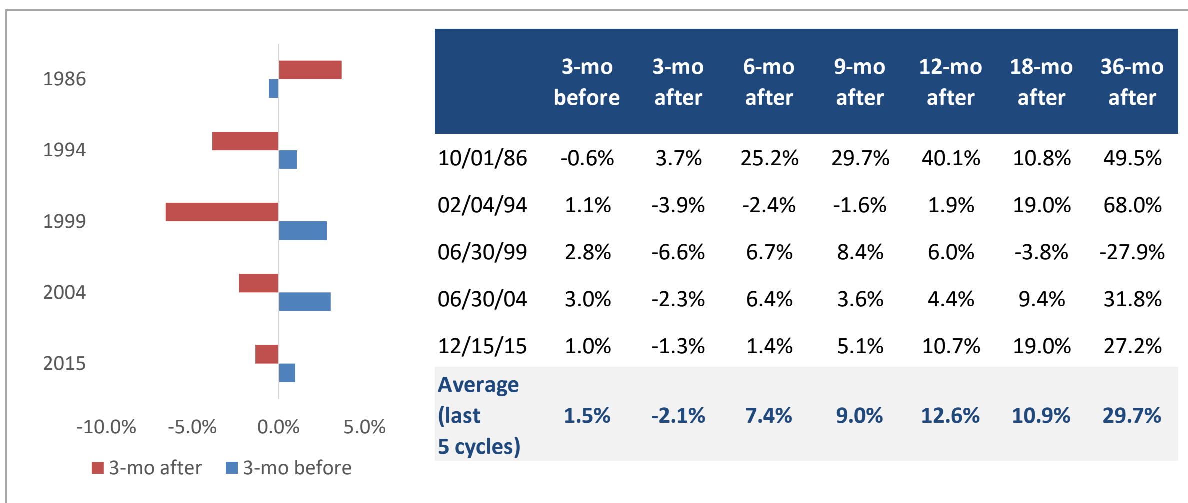
prices go down and vice versa. Bond prices reflect the yield (or the income) they carry. And if interest rates rise, newer bonds deliver a higher yield (income), making older bonds less valuable. This is interest rate risk. During periods of rising interest rates, interest rate risk is high and bond prices could fall.

However, rising interest rates and higher rates are not the same. Although the route to a higher interest rate often involves falling bond prices, the value of a bond, at some point, will become attractive – delivering both lower pricing and higher yield. Bonds issued with higher rates can generate more income on an ongoing basis – supporting a larger portion of an endowment's spend rate.

Equities can be volatile but can still deliver positive performance longer term. History suggests equity markets could still bring positive returns during periods of interest rate hikes when the economy is still growing. Nonetheless, the performance around the first rate hike historically has been volatile. During each of the last 5 cycles, the S&P 500 performance 3 months prior to the first rate hike reversed course during the 3-months following the first rate hike (See Chart 2).

However, longer term the S&P 500, on average, resumed its positive momentum during the first 6 months after the first rate hike, returning 7.4% and 12.6% just 12 months after the initial hike (see Chart 2).

Chart 2: S&P 500 performance 3 months prior and post first interest rate hike, last 5 cycles *[left]*
Average S&P 500 Performance 3-mo to 36-mo after initial rate hike, last 5 cycles *[right]*



	3-mo before	3-mo after	6-mo after	9-mo after	12-mo after	18-mo after	36-mo after
10/01/86	-0.6%	3.7%	25.2%	29.7%	40.1%	10.8%	49.5%
02/04/94	1.1%	-3.9%	-2.4%	-1.6%	1.9%	19.0%	68.0%
06/30/99	2.8%	-6.6%	6.7%	8.4%	6.0%	-3.8%	-27.9%
06/30/04	3.0%	-2.3%	6.4%	3.6%	4.4%	9.4%	31.8%
12/15/15	1.0%	-1.3%	1.4%	5.1%	10.7%	19.0%	27.2%
Average (last 5 cycles)	**1.5%**	**-2.1%**	**7.4%**	**9.0%**	**12.6%**	**10.9%**	**29.7%**

Source: Refinitiv, January 2022

This is a pivot point. While U.S. economic growth could still remain in positive territory during 2022, moderating growth and higher interest rates represents a pivot from where we've been during the last 2 years. Equity markets may continue to grind higher but at a slower rate than the average 10 year return of 14%. In addition, investors can also expect more challenging returns for the fixed income markets as interest rates climb during the next 1-2 years. And finally, overall projected portfolio returns may reflect this shift in momentum.

***NEW* Quarterly Call**

On Tuesday February 1, ECF & State Street hosted the first in a series of regular **Quarterly Calls.** A replay is available at: https://bit.ly/3ANbyOd

Please join us in late April for the Q1 2022 quarterly call.

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