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THE TEMPO VANTAGE

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Straw Off an Inflation Camel's Back?

As a Vantage reader, you may know that I have been expecting inflation to pick up for a long time and have been positioning portfolios with this in mind.

For years I wondered why inflation was so tame given the plethora of inflationary pressures which included foreign tariffs, reductions in immigration, low unemployment, supply chain disruptions, and money pouring into the economy due to the CARES Act, the Paycheck Protection Program, the American Rescue Plan, and the Infrastructure Bill.

None of the above stoked inflation.

Then oil prices increased due to the war in Ukraine.

Rates rose some at first, but the rise really accelerated in the second quarter. In the past few months, the yield on the 10-year Treasury went from 1.8% to 3.4% before falling back to 3% as of this writing. What happened in the second quarter?

My theory is there was a shift in the consensus view on inflation. Inflation that was once viewed as transitory is now viewed as having more staying power. The increase in oil prices combined with this shift in perspective were the proverbial straws that broke the inflation camel's back.

As you would expect, the rise in interest rates not only caused a decline in the bond market, but the stock market as well.

For the quarter the S&P 500 was down 16.1%. The NASDAQ fell 22.3%. International stocks sank 14.5%.

Most sectors were down very close to the S&P 500. The outliers were technology (-24%), healthcare (-11.8%), infrastructure (-9%) and utilities (-6%).

In the bond market the BarCap Agg Bond Index was down 4.7%. As with the stock market, most bond segments lost a similar amount. The outliers were long-term bonds (-11.5%), high-yield bonds (-9%), emerging-market bonds (-10%), and muni bonds (-3%).

Whenever there is a significant market decline, I always try to determine if the magnitude of the decline is warranted or if there was, perhaps, an overreaction (very common).

In this case, I believe the drop was warranted. My (very crude) discounted cash flow stock valuation tool tells me that, all else being equal, stocks should drop by about 25% when the yield on the 10-year treasury rises from 1.8% to 3.0%.

That is very close to what happened.

Of course, the problem with a simple model, any model for that matter, is that you can never take every factor into account. Plus, all else is never equal!!!

The real question is: where do we go from here?

If you think rates will go to 4% you might expect another 10% to 15% drop in stocks… all else equal!

It is also a bit of a concern that the yield curve between two-year and 10-year treasuries is quite flat (both at 2.82% as of July 5th). Not yet flashing recession, but close.

On the other hand, what if we can take one or two straws off the camel's back?

Remember that after peaking at 3.4% on June 14th, the 10-year yield fell to as low as to 2.8% and is currently at about 3%.

While infrastructure spending will continue through 2026, the special government programs to assist with COVID have all ended.

Supply chain issues have been improving, but there is still a way to go.

The war in Ukraine will not go on forever.

As you may know, I am a bit of a contrarian, or at least I try to be.

When was the last time you ready anything good about the economy, the stock market or the bond market?

Can't recall? Me neither.

It is rare to have overall sentiment so heavily tilted to pessimism. In fact, consumer sentiment is at an all-time low. This great news!

Recall that consumer sentiment is negatively correlated to stock market returns. Low sentiment readings generally correlate to higher market returns and vice versa.

While you could certainly argue that interest rates will continue to rise and stocks to fall, it wouldn't take that much to ease worries and send stocks higher, either.

What should you do?

The same thing we always do: Invest in a portfolio that is right for you, knowing there will be both bull markets and bear markets and not knowing when they will occur.

Of course, we will try as best we can to tilt the risk-reward scales in our favor!

Tempo Financial Advisors' 2nd Quarter Investment Performance

Speaking of tipping the risk-reward scales in our favor, that is exactly what Tempo has done thus far in 2022.

Let's start with the **Tempo Dynamic Growth Program**. Tempo's second quarter and year-to-date (YTD) returns of -5.8% and -4.4%, respectively, compare quite favorably to the benchmark returns of -10% and -13.6%.

Dynamic Growth outperformed by 4% in the second quarter and by over 9% YTD. I'd say that is tipping the scales in our favor!

Thus far in 2022, our model correctly limited equity exposure to the minimum required (40%) and allocated to sectors of the bond and alternative markets that have performed better than generic bonds.

Portfolios have been rebalanced for the third quarter. Not only do we remain at our low equity allocation, but the specific positions have also taken a turn to the conservative, shifting from small cap value and financial to utilities and a covered-call writing fund (call me if you want to understand what this is).

Should the markets continue down or even flatten, Dynamic Growth will likely continue to outperform. If the markets turn to the positive, Dynamic Growth will likely lag. Of course, since it only lost 4.4% YTD, it also has a lot less ground to cover to get back to break even.

Second quarter and YTD returns were -2.9% and -5.7% for **Tempo Dynamic Income** and -3.9% and -5.0% for **Tempo Diversified Income.** This compares to returns for the BarCap Bond index of -4.7% and -10.3%.

Our Income Programs outperformed by 1% to 2% in the second quarter and 4% to 5% YTD.

While the Dynamic Income and Diversified Income strategies differ, both strategies have the ability to look beyond the BarCap for value, which has been the key to their success in 2022.

As is usual in extreme down markets like this, among Tempo's four investment strategies, **Tempo Lifestyle** accounts took the worst of it. (They also get the best of it in up markets.)

With stocks (S&P 500) and bonds (BarCap Index) down 16% and 5% for the second quarter and 20% and 10% YTD, you won't be surprised to hear that all Tempo Lifestyle accounts were down in the second quarter and YTD as well.

Conservative Lifestyle accounts lost about 9% for the quarter and 12% YTD. Moderate accounts lost 11.5% for the quarter and 15% YTD. Aggressive accounts lost 12.3% for the quarter and 16% YTD.

Here's the good news. These returns are all between 1.5% and 2.5% ahead of benchmarks.

A small factor in our success is our specific equity overweights which include healthcare and infrastructure.

A larger factor is our use of alternatives in place of what would traditionally be bonds. Our basket of alternatives was down about 0.5% in the second quarter as opposed to the 4.7% loss for the BarCap Index.

There are a lot of factors that go into long-term success as an investor. Keeping up as best as you can during bull markets is part of that. Equally important is to minimize losses when they inevitably occur.

While no one (at least no one I know!) likes to lose money, it is periods of outperformance such as this that will serve us well in the long run.

Reminder

Please contact us if there has been a change in your financial circumstances that would warrant a fresh perspective on your portfolio.

Daniel J. Traub