Chart of the Month

January 2022

The Federal Open Market Committee (FOMC) meets next week and is expected to confirm the likelihood of a series of rate increases, starting as early as March as the central bank seeks to reign in inflation, which is running at a 40-year high of 7.0% for the 12 months ended December 31, 2021. The jump in inflation is primarily due to an overly accommodative Fed (maintaining interest rates too low for too long), excessive government stimulus, and an imbalance in the demand vs. supply chain.

The combination of high inflation and the anticipation that the Fed will pivot and raise interest rates soon has caused the yield on the 10-year U.S. Treasury Note to spike from 1.34% on December 3, 2021 to 1.75% as of today. The surge in inflation and bond yields, in turn, has knocked the stock market down from its all-time highs.

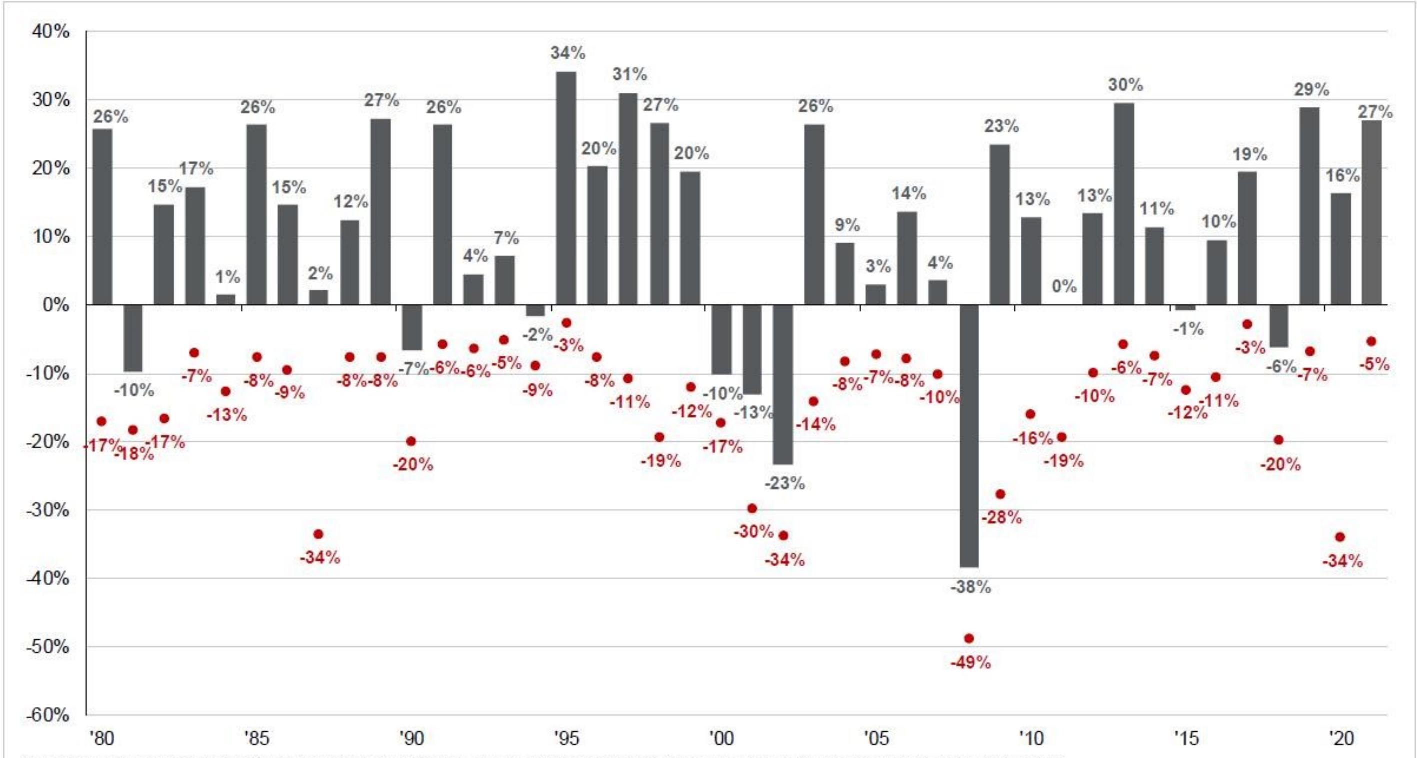
The Dow Jones Industrial Average, S&P 500, and Nasdaq are down 5.7%, 7.7%, and 12.0%, respectively, in the first three weeks of 2021 and have fallen 6.9%, 8.3%, and 14.3% from their peaks late last year and early this year. While easy to forget when the indexes are making new highs month after month (as they did last year), it is important to understand that the stock market has historically averaged three to four pullbacks of 5%-10% each year and corrections of 10% or more roughly once per year, even in the midst of bull markets (including the current one that dates back to early 2009). In other words, they are more commonplace than not.

As shown in the chart below, the S&P 500 was up 29% in 2019, 16% in 2020, and 27% in 2021 for a cumulative return of 90% (plus dividends) in three years. The S&P has produced positive returns in 32 of the 42 years since 1980 with an average annual return of 9.4% (inclusive of average intra-year drawdowns of 14.0%). The index has gone up three out of every four years with about half of the down years limited to single-digit declines and only three years greater than 10%. In conclusion, the market has performed extremely well over the long term, yet it does not go up in a straight line.

As for the current correction, it would be highly unusual for the market to decline 20% or more without an economic recession — and a recession does not appear to be in the cards for the foreseeable future. Nonetheless, in addition to the concerns over inflation and interest rates, there are some uncertainties ahead, including the Omicron variant (and how governments and businesses respond to it), geopolitical risks (Russia/Ukraine and China/Taiwan), and the midterm elections, one or more of which could affect the economy and/or capital markets either positively or negatively.

For what it is worth, according to LPL Financial, the S&P 500 was higher a year later every time after the first rate hike in each of the previous eight cycles. The median return was 5.6% (with a range of 1.5% to 39.6%). If the past is prologue, the market should generate a positive return from March 2022 to March 2023. But it may get a little worse over the next couple of months before it gets better.

S&P 500
Annual Returns and Intra-Year Declines



Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year.
Source: FactSet, Standard & Poor's, J.P. Morgan.

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