HELM INVESTMENT MANAGEMENT

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Headwinds

Anyone who has ridden a bicycle, played tennis or golf, sailed or motor boated knows that headwinds are a pain. The invisible enemy to rapid progress. Headwinds demand that we make adjustments – tack frequently, hit a line-drive golf shot, or find other bike riders to huddle behind. Tailwinds are often more fun (but not always – it's no fun landing a small plane with a tailwind).

The financial markets are facing strong headwinds at the moment. Inflation. The Federal Reserve's response to inflation. War in Ukraine. China locking down huge cities to fight Covid.

As a result, stocks are much more volatile this year than last year. The S&P 500 index is down more than 18% from its record high close (hit on January 3 this year). The NASDAQ index of mostly high technology stocks is down 29% from its peak – well into bear market territory (defined by drops of more than 20%). The bond market, usually a safe haven when stocks fall, is having its worst year in decades. The total return for the Bloomberg aggregate index of US bonds is a negative 10% so far this year. That's because when rates rise, bond prices fall.

Inflation and the prospect for rising interest rates are the biggest culprits behind the drop in stock and bond prices. After a number of years of very low inflation, inflation suddenly jumped to its highest level in more than 20 years. The Federal Reserve started to raise short-term interest rates in March and promises a series of rate increases at least through this year. The idea is to increase the cost of borrowing and cool off demand for big-ticket items like houses, cars and trucks. Higher interest rates also raise the cost of capital for corporations, real estate developers and investors in more speculative asset classes like venture capital and crypto currencies.

The bond market listened when various Federal Reserve governors made it clear they intend to raise short-term rates from near 0% to 2.5%-to-3%, or possibly higher depending on how inflation behaves. The yield of the 10-year Treasury bond jumped from less than 1.2% in August to more than 3.1% in May. As a result, rates for a 30-year mortgage jumped from about 3.0% last year to more than 5.5% now. Banks' prime rate, to which most home equity loans are tied, has moved from 3.25% to 4.0% and will rise with each Fed rate increase, likely to above 5% this summer.

For the stock market, higher interest rates do not necessarily lead to bear markets. However, higher interest rates lead to higher discount rates in formulas used to judge the value of a company's future earnings. For companies with little or no current earnings but prospects of potentially high earnings several years from now, the higher discount rate can lead to dramatic drops in theoretical fair value. Consider that the price of Rivian, an electronic vehicle startup, has dropped 86% from its peak, or that the meme stock Gamestop (a one-time favorite of swarms of online individual traders) is now 81% below its peak. Robinhood, an app aimed at making stock trading easier for individual investors, has dropped 90% from its highs last year.

Investors are hunting instead for stocks of companies with solid cash flows, good balance sheets and a history of paying and raising dividends. That's why value-oriented stock index exchange-traded funds (ETFs) such as the iShares Core Dividend Growth ETF (DGRO) have performed relatively well during this slump – down a bit more than 13% from its peak vs. a drop of almost 19% for the S&P 500 index and a fall of more than 26% for the S&P 500 growth index. Some individual dividend-paying equities like Dow Chemical, Chevron and Kraft Heinz are for the year.

There also are international headwinds. The biggest is Russia's invasion of Ukraine, which has caused the deaths of thousands of people and a wave of millions of refugees. The war has led to a spike in the price of oil, wheat and some other commodities generally exported by Russia and Ukraine. Oil, for example, jumped from about $65 a barrel late last year to briefly top $120 a barrel and settling in for now at about $105 a barrel. That has driven up the price of gasoline and made the Fed's inflation fight more complicated. Though the war has gone worse than Russian leader Vladimir Putin expected, there is no clear sign yet of how it might end.

Speaking of international autocrats with trouble on their hand, Chinese President Xi Jinping has been sticking with his "Zero Covid" policy this year, locking down both Shenzhen and Shanghai – cities of 18 million and 26 million, respectively. That has put a dent in Chinese exports, leaving supply chains for some companies snarled. It also has decimated consumer spending in China, hurting sales there for companies such as Tesla and Apple.

Given the trifecta of headwinds – inflation, war and slow growth in China – there is every chance the stock market will remain volatile for a while. The current deep correction in stocks does not need to fall much more to dip into a bear market. A lot of care is needed to make fixed income investments successful.

If the recession and bear market caused so suddenly two years ago by the pandemic has taught us anything, it's that people and companies can be incredibly inventive and adaptable to big challenges. Headwinds don't have to stop progress. Savvy investors spot bear markets as a time to rebalance their accounts and ensure they are sticking to their asset allocation plan.

Corrections and bear markets don't last forever. In fact, the average bear market lasts about 10 months. The long-term average total return for U.S. stocks of more than 10% per year includes all the bear markets (including a few during the Great Depression) since 1926. Finally, it's good to remember that most companies tend to keep paying their dividends throughout market cycles, and dividends account for a significant portion of long-term stock returns. It's a particularly good time to add to position in stocks of companies that have strong balance sheets (so they won't need to refinance at higher borrowing rates), good quality of earnings and have a history of paying and increasing their dividends.

As for the bond market and its big headwind of rising rates, even there the long-term outlook has some good signs for investors. After years of getting paltry returns of a fraction of 1% on bonds, it's possible now to get more than 3% on even government-guaranteed fixed income. By the time the Fed has made progress on its plan to raise interest rates and slay inflation, investors should be able to find fixed income yields that will once again be greater than expected inflation. As a result, Helm is hunting for good deals in fixed income markets, including government-guaranteed bonds and CDs but also municipal bonds.

It's indeed challenging to command a craft, win the crit, or hit the perfect shot when winds are gusting. We strive to stay the course and follow our time-tested plan of action amidst these headwinds. Eventually these gusts will subside, and many should turn in to tailwinds and bring us back on course to positive returns.