GRAPPLING WITH VOLATILITY: THOUGHTS ON THE EQUITY MARKETS — JUNE 2022

Turbulence is Inevitably Part of the Process

Investors and businesses alike crave stability if not certainty, and a lack of such clarity often leads to market volatility. That has certainly been the case in 2022 with the S&P 500 off to one of its worst starts in years, having declined for 7 consecutive weeks during April and May and briefly trading into bear market territory (>20% decline). Setting aside the understandable anxiety associated with periods of market weakness, the S&P 500 has produced an astounding +815% return from its market bottom of March 2009 to the all-time high set in January 2022. Yet, as is never the case, such performance has not come in a straight line. During these past twelve bull market years, the S&P 500 incurred nine declines of more than 10%, and four periods marked by > 20% downturns.

Stepping back from the news of the moment, it bears emphasizing just how powerful equity performance can be over the long run. Since 1928, the S&P 500 has delivered an annualized total return of roughly +10%, a compound growth rate that would double an investor's assets every 7 years. The risk premium afforded equity investors relative to other asset classes comes with a price though, as one must be willing to navigate economic and market uncertainties and navigate periodic drawdowns. As we move towards the second half of 2022, we feel several factors are likely to drive the US equity markets.

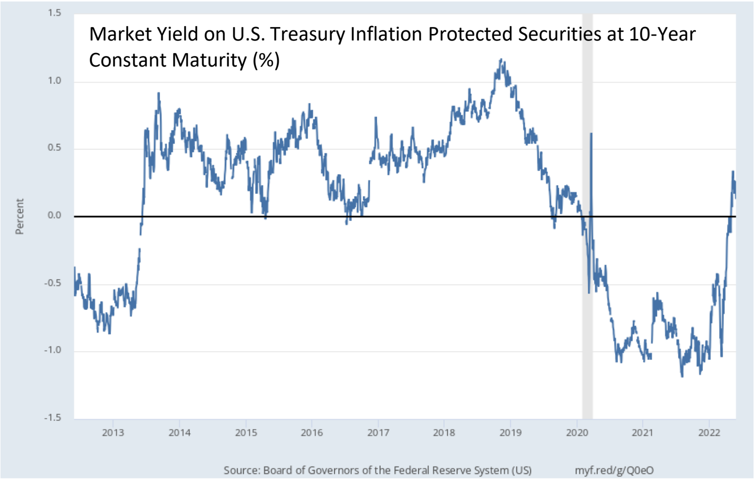
Inflation, Interest Rates, and Monetary Policy

The Federal Reserve's determination to dampen inflation has been made abundantly clear. Inflation has been significantly elevated for a sustained period due largely to the effects of lingering global supply chain constraints, massive Covid-related fiscal stimulus, and the Russian invasion of Ukraine. Given an inability of supply to catch up with demand, the Fed is attempting to fight price pressures by slowing growth.

To do so, the Fed is engaged in monetary policy tightening, a policy response that many economists feel is overdue. The Fed Funds rate has already increased 75 bps with market consensus calling for additional 50 bps hikes in June and July. The Fed is simultaneously steadily reducing the size of its ~$9 trillion balance sheet, a process that has dialed back the central bank's longstanding accommodative stance.

This rapid and significant shift in monetary policy has caused real interest rates to rise thus putting pressure on risk assets such as equities. This dynamic can be seen through Treasury Inflation Protected Securities ("TIPS"), a measure of real interest rates. 10-year TIP yields increased from -1.04% at year-end 2021 to 0.13% as of 5/26. Ironically, the Fed's objective of reducing inflationary pressures by tightening financial conditions is actively being supported by market repricing, with interest rates moving up, the USD rising, credit spreads widening, and risk assets under pressure. Ultimately, how persistent inflation proves to be will likely drive the length and intensity of the Fed's monetary policy tightening cycle. That is why more optimistic inflation data such as was revealed ahead of Memorial Day at least temporarily triggered an equity rally into the holiday weekend.

Rise in Real Yields Pressures Risk Assets



China's Zero COVID Policy

In an attempt to contain the spread of COVID, China has locked down tens of millions of people in several cities including Shanghai and Beijing. These lockdowns have produced a twofold hit on the global economy, disrupting manufacturing and constraining global supply chains. How far China will go in this regard is unknown, yet their actions have clearly hampered global economic growth and elevated inflationary pressures.

The War in Ukraine Drags On

The fighting in Ukraine has gone on for more than 3 months, a war that has produced widespread human suffering and considerable geopolitical risk. The ripple effects on global markets have also been significant, particularly in the commodities markets given the shock to energy and agriculture prices. A recession in Europe appears likely, while US and other global consumers are also feeling the effects. History has demonstrated that times of war are inflationary, and severe economic dislocation has factored into a delay in what many hoped would be a Q1 peak in inflation.

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Deceleration Sparks Recession Fears

With the Fed in tightening mode, there is growing concern about the economy's ability to avoid a recession. In fact, over the past eight Fed hiking cycles, the economy ultimately went into recession six times. Although the Fed clearly has their work cut out for them, we believe the odds of a recession in 2022 currently remain low. The labor market is still extremely strong with millions of job openings and low unemployment, while consumer ~~balances~~ sheets remain quite strong. Historically, recessions do not occur with those two factors in place. However, economic conditions are clearly changing with a white-hot housing market showing signs of cooling amid rising mortgage rates, and consumers facing spiking food and energy prices. The ultimate question is whether the Fed can navigate a "soft-landing," successfully fighting inflation without tipping the economy into recession. The runway to do so is narrowing, although with equity markets at least partially pricing in a mild recession there may be upside should one be avoided.

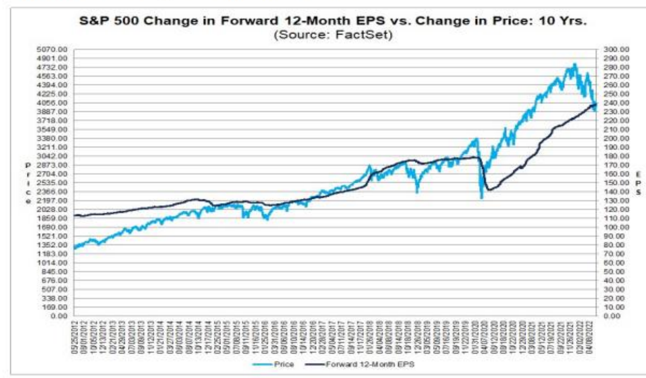
Corporate Earnings Are Holding Up Well

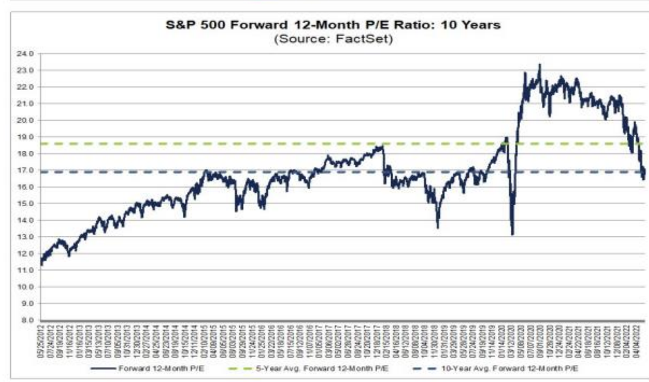
Q1 earnings season recently wrapped up and aggregate results were solid. S&P 500 earnings grew at +9% for the quarter on an annualized basis and profit margin growth was strong at over +12%. What this demonstrates is the resiliency of corporate America in the face of a more challenging economic environment. Wall Street estimates call for average annualized forward earnings growth of roughly 10% in 2022 and 9.5% in 2023, a pace that would offer a healthy backdrop for equities.

Over the long-run, stock prices tend to follow earnings growth, although over shorter-term periods the price investors are willing to pay for future earnings fluctuates. Downside pressure on stock prices experienced over recent months has generally not been a function of falling corporate bottom lines, rather reduced valuations in a rising rate and inflationary environment. In fact, the 12-month forward multiple on the S&P 500 has fallen from 21x to about 16.4x. With multiples already down significantly, we will be watching corporate earnings estimates carefully, including the extent to which rising wages and materials costs put a dent in the bottom line. Should corporate earnings growth be maintained, equity investors could be rewarded over time.

Stock Valuations Coming Down on Uncertainties

Forward 12M P/E Ratio: 10-Years





Source: FactSet

Searching for a Bottom

The question clients often ask is whether recent market declines have sufficiently priced in economic and monetary policy concerns. In short, can we safely say that equity markets are near a cyclical bottom? We think the signs are mixed as certain technical indicators such as relative strength, % of stocks above the 10- and 50-day moving averages, and TRIN readings that measure advance/decline issues relative to advance/decline volume have hit levels typically associated with a forthcoming bounce. Perhaps positive momentum into the Memorial Day weekend was such a sign. Time will tell.

We would be remiss in not emphasizing that other market indicators suggest we may not be out of the woods quite yet. Confirmation of a sustainable bottom has not been seen through market volatility measures such as the VIX, put/call ratios, or fund flows. When such sentiment is extremely negative it often suggests a bottom may be near. It is important to watch how investors behave, and an absence of panic selling out of mutual funds and ETFs may imply that stocks need to move lower before this year's cyclical weakness is behind us.

Reasons for Optimism

The risk of recession has increased, although by no means is one a foregone conclusion. Recessions are typically preceded by weakening labor conditions and falling corporate profits. Neither condition is currently in place as the outlook for the labor market and consumer balance sheets remain healthy. Corporate earnings should continue to grow as they are closely aligned with nominal GDP growth.

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As previously noted, higher interest rates resulting from a hawkish Fed have pressured stock valuations, leaving the market trading at multiples well below pre-pandemic levels and its 25-year average. Should inflation cool in the coming months, the Fed would likely pause given the accompanying slowdown in economic growth and tighter financial conditions. This could translate into a leveling off of interest rate hikes at a pace short of market expectations, a dynamic that would likely give stocks and bonds a lift.

A positive aspect of recent bout of equity volatility is that we have seen a stabilization in bond yields. The flagship 10Yr Treasury has retreated from a recent multiyear high of 3.14% to a current level of about 2.74% as investors flee to quality in a slower growth environment.

Investor and consumer sentiment in the face of inflation and recessionary talk also appears despondent based on surveys such as the American Association of Individual Investors (AAII) and Investors Intelligence (II), a somewhat counterintuitive but potentially positive contrarian indicator. Weak sentiment levels such as are evident today have often been associated with strong equity performance over the following 12 months as positive surprises can trigger a resurgence in equity buying momentum.

Expect Choppy Waters to Persist

We believe market volatility will continue for the time being as the market grapples with economic expectations and monetary policy response. Economic and corporate profit growth is likely to slow but remain positive in 2022 and 2023, and we do not expect a near-term recession. Market timing is next to impossible and not a productive investment strategy, thus we recommend that long-term investors stay the course. History tells us that patient investors are far more often rewarded than not.

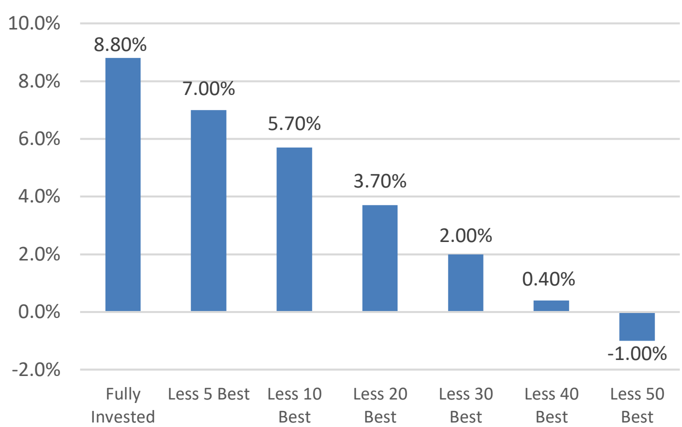
Volatility introduces anxiety and challenges but let us not forget that it also produces rewarding opportunities. Over the past 20 years, half of the S&P 500 best days have occurred during bear markets, while another third took place during the first 2 months of new bull markets that were too early to be evident at the time. Those selling out during times of stress often miss out on those extremely positive days. Making overly short-term reallocation decisions is typically problematic, particularly so in an environment such as we are currently experiencing with 1 in 6 trading days so far in 2022 resulting in a +/- 2% move in the S&P 500.

In an uncertain world, what we know for sure is that equity valuations have already declined considerably. Over twelve post-WWII recessions Goldman Sachs reports that the S&P 500's median pullback was ~-24%, suggesting that much of the pain may already be priced in. Suffice it to say, our advice remains the same . . . asset allocation strategy should be driven by personal needs and circumstances, as well as individual risk tolerance. Should you have questions about your portfolio or overall asset allocation strategy, please reach out to your Portfolio Manager.

Time In the Market Beats Timing the Market

S&P 500 Compound Annual Growth Rate

(January 1, 1995 - March 31, 2022)



Source: Strategas

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