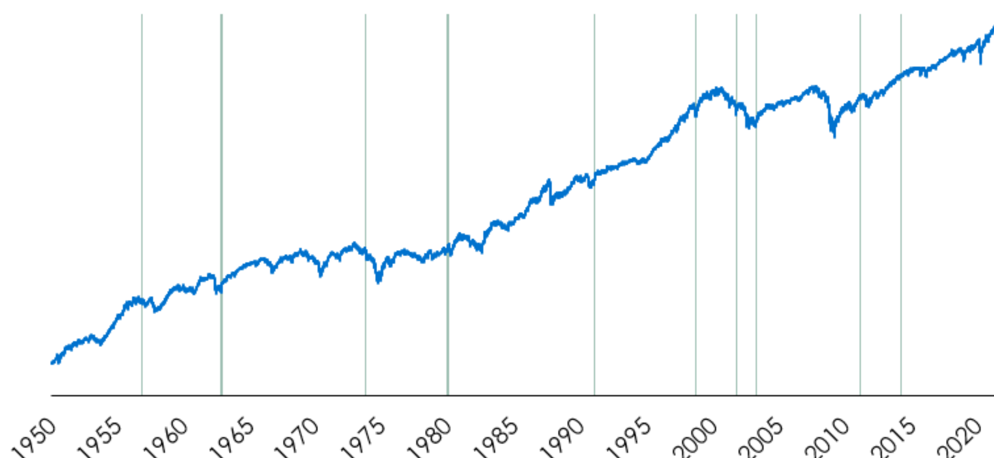
Market Trend Unlikely To Change

With the world understandably focused on the horrors occurring in Ukraine, it almost seems inappropriate to take time to discuss the direction of the stock market. But that's our job, so we'll do our best to provide some perspective in these unnerving times.

In looking back at previous geopolitical shocks, one lesson that stands out to us is that the general trend that was in place *before* the event usually continued *after* the event.

Trends Tend to Persist Through Global Crises

S&P 500 Index



Oct 1956: Suez Canal Crisis
Oct 1962: Cuban Missle Crisis
Oct 1973: Arab Oil Embargo
Dec 1979: USSR in Afghanistan
Jan 1991: Gulf War
Aug 1998: Russian Default
Sep 2001: 9/11 Attacks
Mar 2003: Iraq War
Jan 2011: Arab Spring
Feb 2014: Annexation of Crimea
Feb 2022: Russia Invades Ukraine

Source: Yellow Cardinal Research, Strategas

Heightened uncertainty and market volatility usually accompany the onset of a global crisis. However, as you can see in the chart above, major geopolitical events did little to change the broader market trend. If the market was headed higher before the crisis, it usually resumed its climb once the crisis passed. If the market was in a decline, it continued its decline. The only potential exception to this would be the Iraq War in March of 2003, which commenced within weeks of a re-test of the post-Tech Bubble lows in October 2002.

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We don't expect this crisis to change the overall market trend, either. We expect the equity markets to continue their current "correction" phase. The Tech & "growth" heavy NASDAQ 100 peaked in late November, and the S&P 500 hit its high-water mark on January 3. Since then, markets have been in decline due to several factors that we identified last year:

- Inflation that is proving more persistent than was widely anticipated
- Anticipation of tighter monetary policy
- Rising interest rates
- Slowing corporate profit growth
- Leadership shift from "growth" to "value"

In recent months we've written about the potential for heightened market volatility in 2022. One of the biggest reasons underpinning this view is stubbornly high inflation. What started out as supply-chain related inflation has now picked up more steam due to a burgeoning wage-price spiral, as well as rising commodity prices (most notably, oil).

Inflationary pressures are likely to linger, and the Russia / Ukraine conflict could stoke further inflation. Ukraine is one of the world's largest grain exporters, and this supply will undoubtedly be interrupted for the foreseeable future. In fact, wheat prices have already spiked higher and these increases should soon flow through to food prices.

The pandemic-driven movement towards de-globalization will likely be hastened due to Russia's aggression. More of Corporate America sounds willing to trade lower production costs for supply chain security by bringing more of the production cycle home to the USA. While unlikely to cause a jump in inflation, bringing production back home will likely mean that higher prices are here to stay.

Higher and stickier inflation will force the Federal Reserve to tighten monetary policy, first by raising the benchmark Fed Funds rate and then potentially by actively selling off the securities held on its balance sheet. While the market has largely priced in 150-175 basis points (1.50%-1.75%) of tightening through early next year, there is a distinct possibility that Chairman Powell may have to become more hawkish if inflation remains stubbornly high.

Tighter monetary policy usually translates into higher interest rates. Over the past few months, the yield on the 10-year Treasury bond has risen from 1.2% in August to nearly 2.0%. As a key factor in valuing "growth" companies whose current value is based on earnings far off into the future, higher interest rates can have a big negative impact on the price-earnings multiples for these stocks. After leading the market higher for the past few years, rising rates have been cited as the cause for the relative underperformance of "growth" stocks since late November. While many of these issues have already fallen 20% or more, there is still plenty of room to

the downside. Rising rates are just one reason that we believe that "value" stocks – which have underperformed "growth" to a greater degree than during the Tech Bubble of the late-90's – will assert market leadership in 2022.

Slowing earnings growth rates will also be a likely contributor to market volatility. Coming off the trough earnings experienced during the Great Lockdown, simple math almost guarantees that earnings growth rates will be slow (yet still positive). Research shows that equity returns usually moderate during the deceleration phase of the earnings cycle, with more defensive areas of the market performing better than others. This further supports the idea of "value" leadership over "growth".

Last, but not least, is the fact that 2022 is a mid-term election year. Typically market volatility increases during mid-term election years, and we see this year as being no different.

We continue to believe that the macroeconomic picture is one of robust – yet moderating – growth and inflation. As such, we will continue to focus on "value" and "quality" as this economic cycle matures. Throughout the past year, we have trimmed "riskier" assets in client portfolios (stocks and alternatives) in order to maintain a relative balance with lower volatility securities, like fixed income and hedges against market volatility.

We have become more neutrally positioned across equity classes, though we continue to favor "value" and "quality" within the large-cap domestic market. We've also taken steps to become slightly more defensive in terms of our sector weightings in our individual equity portfolios.

In the fixed income area, we remain focused on more credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates.

Within the alternative market segments, we have maintained an emphasis on "real assets" (think commodities and, to a lesser extent, real estate) as a hedge against the potential for continued inflation. We have recently increased our exposure to the diversified alternative sector as a hedge against market volatility.

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