February 28, 2021

Weekly Viewpoint

Inflation Deflates the Markets

Performance for Week Ending 2.15.2022

The Dow Jones Industrial Average (Dow) finished down 0.03%, the Wilshire 5000 Total Market Index[SM] (Wilshire 5000[SM]) added 0.90%, the Standard & Poor's 500 Index (S&P 500) gained 0.82% and the Nasdaq Composite Index (NASDAQ) tacked on 1.08%. Sector breadth was positive with 8 of the 11 S&P sector groups closing higher. The Healthcare sector (+2.71%) was the best performer followed by Real Estate (+2.69%) and Utilities (+2.03%). On the downside, Consumer Discretionary (-2.16%) was the worst performer.

Index*	Closing Price 2/25/2022	Percentage Change for Week Ending 2/25/2022	Year-to-Date Percentage Change Through 2/25/2022
Dow	34058.75	-0.03%	-6.27%
Wilshire 5000	44260.11	+0.90%	-8.67%
S&P 500	4384.65	+0.82%	-8.00%
Nasdaq	13694.62	+1.08%	-12.47%

Market Observations: 2/21/22–2/25/22

The major market indices finished the week mostly higher, in very volatile trading, as investors weighed the impact of Russia's invasion into Ukraine and how it may affect the global economy and interest rates. A prolonged conflict could deliver a major blow to global markets and slow the normalization of central bank policy that's expected over the course of this year. At the same time, disruptions of energy and food could stoke already-high prices and increase pressure on central banks to act faster to curb inflation. Russia is a commodity powerhouse and Ukraine is a major grain exporter. Markets seemed to take some solace following comments from President Biden who made it clear that the U.S. wasn't currently looking to sanction the Russian energy sector — the country's strongest tie to the global economy.

Situation Still Very Fluid: Despite the late-week (sigh of) relief rally, the situation remains very fluid, therefore making it difficult to handicap the ultimate impact on the global economy and equity markets. Markets did seem to find comfort on news that Russia is sending a delegation to Minsk for talks with Ukrainian leadership, suggesting the potential for a quick resolution, however, the details were unclear as of late-Friday. While the visibility on the situation remains low, what we do know is that historically, geopolitical events tend to be short lived with a median drawdown of 5.7%. The average event lasts approximately 3 weeks and then it takes another three weeks to fully recover.

For the US markets, the concern really isn't what happens with Russia or the Ukraine as they are minimal in terms of their contribution to the global economy. In addition, the S&P 500 derives only a tiny fraction of its sales from Russia. Instead, the concern is whether this invasion leads to sustainably higher energy and commodity prices and how they may impact already high levels of inflation. Russia is the third largest producer of oil and the number one producer of wheat. A studying of recessions over the past 50 years shows that almost every recession in the US was preceded by a surge in oil prices. That may be the message that the yield curve is sending as the spread between the 10-year and 2-year Treasuries finished the week as at only 38 basis points – lowest level since early 2020. However, that doesn't mean a recession in imminent, according to research partner Strategas. Their work shows that historically, when the 10/2 spread falls below 50 basis points, it has taken, an average of 16 months before the curve inverts, an event that almost always foreshadows recessions.

The potential for higher energy to translate into higher levels of inflation, could complicate the Fed's effort to tighten policy. While the Fed is still likely to hike by 25 basis point at the upcoming FOMC meeting, the Russia/Ukraine uncertainty seems to have reduced the odds of a more aggressive move, at least for the immediate future. Bloomberg's World Interest Rate Probability tool shows the odds of a 50bps hike at the March FOMC meeting have fallen to about 28% (from over 80% two weeks ago). For the year, the market is now discounting 6 hikes, down from nearly 7 two weeks ago. Fed Chair Powell is set to testify to Congress this week so we could get some clarity on the path higher. It still seems like there is too much hawkishness built into the markets and therefore we could see Powell try to tamp this down a bit.

Any Good News Out There? I Think So: The US economy remains in good shape and it is generally isolated from any fallout in the Russian economy. Hard data reports (Durable Goods Orders, Retail Sales, Industrial Production) have been very strong relative to the survey and sentiment data (which are likely being impacted by inflation worries). Covid cases have plunged and many areas around the country are dropping Covid related mandates. Supply chain issues are starting to ease. The earnings environment remains solid with high single digit growth expect this year and next. The recent market weakness has pushed valuation levels lower with the S&P selling for just over 17x the 2023 estimate and just over 15x the 2024 estimates. In addition – from a contrarian POV, the number of bearish investors relative to bullish investors – as measured by the AAII data is 2.3. That's one of the highest readings we've seen for at least the past few years. Large asset managers have also derisked over the past couple weeks according to the National Association of Active Investment Managers who tracks investment advisers from 125 different firms. According to their data average equity exposure has fallen to just 44% down from the mid 60% area two weeks ago. Historically when exposure falls to these levels, it has almost always led to a buying opportunity.

The Week Ahead: The focal point this week will be Fed Chair Powell's semi-annual testimony before the House Financial Services Committee on Wednesday and the Senate Banking Committee on Thursday. His appearance comes ahead of the Fed's much-anticipated meeting just 2 weeks later, at which time they're widely expected to raise the federal funds rate for the first time since the pandemic. Investors will be listening for clues on the path higher and any updated thoughts on inflation in light of the Russia/Ukraine situation. It will be a busy week on the data front with the February payroll report taking the spotlight. According to Bloomberg, Friday's report is expected to show nonfarm payrolls growing by 400K and for the unemployment rate to dip to 3.9% from 4.0% in January. Other reports of interest include; The ISM Manufacturing data for February, the February Chicago PMI report, the February ISM Services Index, January Factory Orders and the weekly initial jobless claims report. On the Fed front, the will release the Beige Book report which will be used as the playbook for the March 15/16 FOMC meeting. On Tuesday evening President Biden will speak to the nation in his State of the Union address.

Definitions

The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally defined as the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

Wilshire 5000 Total Market IndexSM represents the broadest index for the U.S. equity market, measuring the performance of all U.S. equity securities with readily available price data. The index is comprised of virtually every stock that: the firm's headquarters are based in the U.S.; the stock is actively traded on a U.S. exchange; the stock has widely available pricing information (this disqualifies bulletin board or over-the-counter stocks). The index is market cap weighted, meaning that the firms with the highest market value account for a larger portion of the index.

Standard and Poor's 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Nasdaq Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. The index was developed with a base level of 100 as of February 5, 1971.

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