Legacy Trust

Investment Perspectives

Volatile Start to the New Year

January 2022

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2021 proved to be another great year for stock market investors. Global equities ended the year with a strong 18.5% return while U.S. large caps led with a 28.7% gain, and downside volatility was minimal throughout the year. However, the beginning of 2022 has seen a resurgence of volatility as rising interest rates and geopolitical risks weighed on investors.

Key Takeaways

- Following a robust year for stock market gains, equities sold off in January as volatility spiked
- Investor fears surrounding heightened inflation, Federal Reserve actions and rising geopolitical risks led to selloffs in risk assets
- Volatility began to calm in late January following the Fed's meeting as a faster pace of interest rate hikes is now priced into the markets
- Equities continue to look attractive based on the forward outlook for economic and earnings growth

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Equities ended 2021 on a high note despite the threats presented by the latest Omicron variant of the Covid-19 virus. Fortunately, the initial scare over Omicron quickly faded as data showed that the variant, while more contagious, did not appear to produce a surge in severe outcomes for those that became infected. Hospitalization rates have remained within range of peaks seen during previous surges despite a record number of new cases. As a result, most countries did not impose major new restrictions, and there is growing consensus that we are nearing the endemic stage of the virus where it will have less and less of a negative effect on overall public health and on the state of the economy going forward.

However, as the calendar turned over into the new year, investors found new potential causes for concern. Inflation as measured by the Consumer Price Index (CPI) jumped 7.1% in 2021, the highest gain in forty years, and in response the Federal Reserve has been signaling a more aggressive tightening path for 2022 than was originally expected. Geopolitical risks also spiked in January due to rising tensions between many Western countries and Russia over the military buildup along the border with Ukraine.

In response to these fears, investors sold off risk assets including equities. The S&P 500 fell 9.8% from its record close at 4796.56 on January 3rd to a closing price of 4326.51 on January 27th. Volatility peaked in the days leading up to the Fed's January meeting press release on the 26th and began to stabilize as the FOMC statement confirmed the trajectory that most investors had anticipated. The Fed is expected to begin interest rate hikes at their next meeting in March, with several additional increases throughout the year as economic conditions dictate.

It should be noted that a major source of higher inflation in the near-term continues to be strong demand from American consumers, coupled with supply chains that have struggled to keep up given ongoing challenges from the pandemic. We continue to expect these supply chain roadblocks to unwind as the year progresses and we expect the supply-demand imbalances to gradually improve, which should bring inflation down to a more reasonable level, albeit higher than it was pre-pandemic. Further, while it is understandable that investors are concerned about the Fed's ability to navigate an inflationary environment for the first time in decades, interest rates have been at zero for nearly two years now and there is room for several hikes before rates would be at a level that would have the potential to derail the U.S. economic expansion.

In addition, we believe there are other fundamental reasons to remain optimistic about equity investments in 2022. Most major world economies including the U.S. are expected to show above-trend GDP growth of 4-5% this year and, with the pandemic's effect on the economy waning, the risk of recession appears low. Corporate earnings are expected to grow this year by 10% – down from the significant earnings recovery we saw in 2021 off the pandemic lows of the prior year, but still a year of solid growth which will help to support stock valuations and which leaves room for further price appreciation.

Finally, January's stock market rollercoaster is a good reminder that equity markets are volatile by nature. Pullbacks of 10% or more are common even during bull markets and do not necessarily signal a fundamental shift in the narrative. We believe conditions are supportive for 2022 to be another growth year for equities, albeit at a lower level than 2021, and we encourage investors to view near-term market volatility as an investment opportunity as the year progresses.

S&P 500 Price Movement – January 1, 2021 – January 31, 2022

Source: FactSet Research Systems

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