Legacy Trust

Investment Perspectives

Inflation and Higher Rates Drive Market Volatility

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Key Takeaways

- Markets have struggled as investors grappled with inflation, higher interest rates and heightened geopolitical risks amid Russia's invasion of Ukraine
- The global economy has continued its post-pandemic recovery, but the outlook for future growth has become more complicated
- The Fed's ability to engineer a so-called "soft landing" continues to be a risk to economic expansion and to market performance in the near-term
- The market dislocations year-to-date have created meaningful active management opportunities and we recommend remaining invested in equities

Markets have begun 2022 with much higher volatility than we experienced last year. The S&P 500 Index has experienced a correction (a 10% drop from peak to trough) and bonds have also turned sharply negative as interest rates surged, now that the Fed has acknowledged that inflation has run up too high and that a more aggressive rate hike path is likely to be necessary.

Stocks struggled in the first quarter as investors grappled with inflation, higher interest rates and heightened geopolitical risks amid Russia's invasion of Ukraine. The S&P 500 finished the quarter with a -4.6% loss, and international equities fared slightly worse, down -5.9%. Much of the market decline has been focused in technology and other growth sectors.

Rising bond yields and increased expectations of Federal Reserve tightening caused asset prices to fall in Q1. Russia's invasion of Ukraine in late February only served to exacerbate these trends, as commodity prices were pushed even higher. High and rising inflation expectations were a challenge for virtually all areas of the market during the first part of the year. A notable exception is commodity markets, which naturally saw a significant short-term jump.

The Fed's shift toward a more aggressive tightening path prompted bond yields to spike along the yield curve. As a result, bond prices dropped in the early months of the year and produced a loss for the U.S. fixed income market. Bonds lost more value than the S&P 500 in Q1 as the U.S. Aggregate Bond Index dropped -5.9%.

The global economy has continued its post-pandemic recovery and expansion, but the outlook for future growth has become more complicated and varies significantly by region. The European Union is directly exposed to the economic fallout from the war in Ukraine, while China's continued pursuit of "zero Covid" has resulted in ongoing strict lockdowns that are impacting their economy's ability to fully recover. Manufacturing activity in China has plummeted due to the lockdowns.

The U.S. remains a relative bright spot as our consumer-driven economy has so far continued to show resiliency. Americans spend far less of their discretionary income on energy than they did in the 1970s, and the combination of a strong job market and record-high household net worth helps to cushion the blow from rising prices.

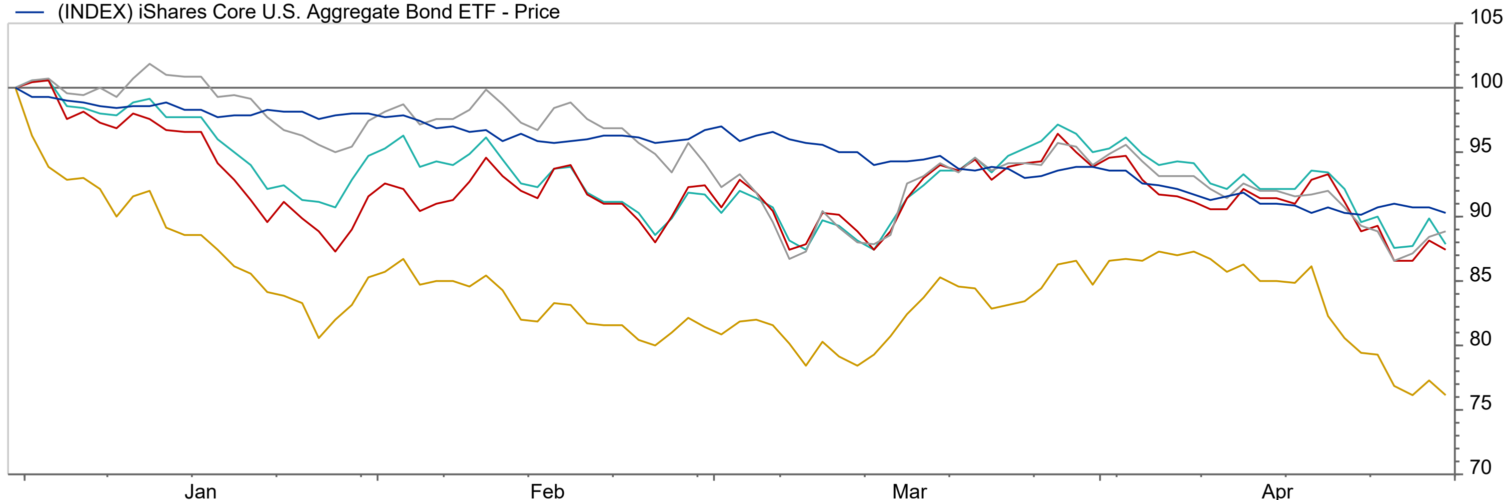
In sum, there are a number of contradictory factors in play in the U.S. economy and capital markets today that are serving to increase uncertainty and exacerbate volatility. Some encouraging signs include:

- Corporate earnings have been coming in stronger than expected, and are projected to be positive for the remainder of the year;
- Corporate stock buybacks are projected to be robust in 2022 and will be a key source of demand for U.S. equities;
- Stock valuations have come down and appear quite attractive today looking forward;
- Private sector finances remain solid, with both households and corporations showing strong balance sheets; and
- Inflation readings are likely at or near a peak as the surge in capital goods prices caused by shortages and rising commodity prices is beginning to moderate.

However, there is no question that risk factors have increased:

- The war in Ukraine that began in late February continues on and, with the Western world uniting against Russia, the risk of escalation remains a concern;
- More persistent high food and energy prices may cause consumers to pull back on spending;

Relative Index Returns – Year-to-Date 2022



Source: FactSet Research Systems

- While household finances overall are healthier than they were prior to the Global Financial Crisis, personal savings have been spent down over the past two years and there is little to no fiscal or monetary stimulus expected going forward to help boost spending; and
- The Fed's rate hike path as currently priced into the bond market today, which would bring the overnight rate from 0.25% to 3% by year-end, would almost certainly suppress demand to such an extent that it would plunge the U.S. economy into recession.

We continue to believe that, with inflation already on a path to head lower even without additional Fed intervention, it is ultimately not likely that the Fed will have to raise rates as aggressively as they have telegraphed. Nevertheless, this remains a key risk, and the uncertainty surrounding the Fed's ability to engineer a so-called "soft landing" continues to be a threat to the economic expansion and to market performance in the near-term.

Despite the ramp-up in downside risk, our recommendation is to remain invested in equities up to long-term strategic neutral target allocations. The market dislocations year-to-date and particularly in the month of April have created meaningful active management opportunities, including buying or adding to companies that are trading at historically attractive valuations as well as looking at short-term tax loss harvesting opportunities.

Equities are historically the best hedge in an inflationary environment. While we believe that inflation is likely at or near a peak, we still expect it to remain higher than it was prior to the pandemic, with persistent wage pressure helping to keep service sector prices higher for longer. Equity investments are the best way to achieve real growth over the long term and history has shown time and again that trying to time rotations in and out of the stock market does more harm than good. We will continue to monitor the investment environment and stand ready to make adjustments if conditions change. For now, we anticipate that volatility is likely here to stay for the foreseeable future and will look to use that volatility to our advantage.