Legacy Trust

Investment Perspectives

Market Downturn and Investment Implications

May 18, 2022

Global markets continue to experience significant volatility, as tightening financial conditions and a higher risk of recession have weighed on investor sentiment. As of Friday's market close, the S&P 500 was down more than 15% year-to-date while the tech-heavy Nasdaq has experienced losses of more than 24%. Bonds, typically a haven in times of equity market trouble, provided no support as a sharp spike in interest rates has pulled the Barclays U.S. Aggregate Bond Index down nearly 10% year-to-date. Amidst this more challenging investment environment, we wanted to share some key considerations for investors as we look ahead:

- It is notable that **the stock market decline has been driven by investor sentiment rather than an underlying problem with company earnings. Q1 company results actually came in stronger than expected** and the companies making up the S&P 500 are expected to see earnings growth of 8-10% for the full 2022 calendar year. The P/E ratio on the S&P 500 has fallen down to the levels we experienced in March 2020 despite a much stronger economic backdrop today, and valuations on some companies currently look very attractive by historical standards.

- While uncertainty about the future has increased, **the current fundamental economic backdrop in the U.S. remains supportive.** Personal and corporate balance sheets are strong, with a lot of cash held on the sidelines, and consumer activity largely remains robust at this time.

- We continue to watch inflation readings for indications that consumer spending is being adversely impacted, which we expect to see to some degree going forward. While we believe capital goods inflation may be at or near a peak as pandemic-related supply chain issues subside, service prices are still under pressure and we expect that inflation readings will remain elevated for some time. **Consumer demand is likely to slow, but our base case continues to be that the U.S. economy has enough cushion to stay in expansionary territory for the foreseeable future.**

- The bond market has effectively already priced in the Fed's anticipated future path of higher rates despite the fact that only two rate hikes have officially been announced at this point. The 10-Year Treasury bond yield has doubled since the beginning of the year, rising above 3% at one point before dropping back to 2.93% as of Friday's close. This rapid climb of market rates is responsible for bond price declines year-to-date. While further volatility is possible given the continued uncertainty about our economic path, **we believe the majority of interest rate moves have already been priced in and we do not anticipate further meaningful price declines in bonds going forward**.

- Futures markets are pricing in a near-certain probability that the Fed will continue to raise the overnight rate from its current level of 0.75% - 1.00% to 2.75% - 3.00% by the end of 2022. We believe that this significant of an upward move over this short of a time frame would almost certainly suppress consumer demand to such an extent that it would, in fact, 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**; however, this remains a key 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 last six weeks 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.

- We have been and will continue to **be active during this period of market disruption to implement portfolio adjustments that make sense given the economic outlook**. Within our equity portfolios we are adding to beaten-up growth and small-cap stocks that are trading at historically attractive valuations and are looking to add holdings in premium companies with strong fundamentals at a discounted price. Within our fixed income portfolios, we have begun to shift our duration toward intermediate-term bonds, as this area of the yield curve is now paying decent rates of income and we believe the prospect of further price declines is minimal. We had previously focused more on short-duration bonds in anticipation of rate hikes, but now that this move has been priced into the fixed income markets, we believe it is advantageous to shift further down the curve.

- While we are looking out for tactical opportunities, **we strongly encourage investors to stay the course with their long-term asset allocation plans that will have already accounted for the next few years of anticipated cash flow needs**, avoiding the need to make significant and costly portfolio adjustments during periods of market volatility. Remember that your investment plan was set with these types of scenarios in mind and that your equity allocation was designed to ride through periods of heightened risk and uncertainty.

We will continue to monitor conditions closely and will share our thoughts with you as things progress. We know that it can be challenging to ride through these periods and we're here to help. Please don't hesitate to reach out to the Legacy Trust team with any questions.

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