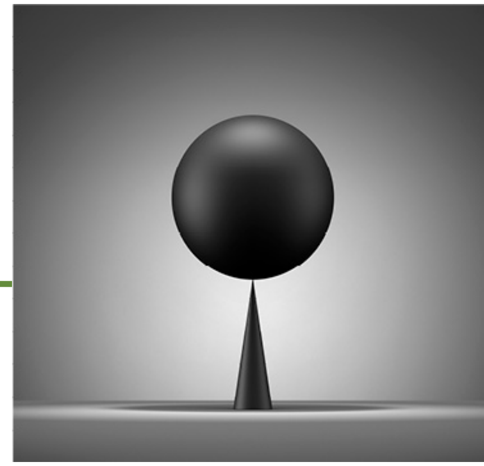
March 18, 2022

MARKET SIGHTLINES



Balancing Acts All Around: Ukraine and Beyond

By Michael O'Keeffe, *Chief Investment Officer*

We started the year publishing **Outlook 2022: Balancing Acts** (report/video/webinar), but we honestly did not anticipate how dramatically 2022 would unfold in this first quarter. Russia invaded Ukraine, inflation continued higher, and the Federal Reserve (Fed) signaled a dramatic hawkish shift in policy. Markets corrected, with the Nasdaq entering bear market territory. So, the balancing acts we identified in our report are in focus. Are we on the right path with the pandemic? Can the Fed hike rates to tame inflation but not push us into recession? Will our federal government enact fiscal and legislative policy that is helpful in this increasingly complex environment? Will Russia, Ukraine, and the West achieve balance to resolve the situation and find peace?

In this week's Sight|Lines, we revisit the concept of balancing acts from our outlook and how it applies to the issues we face in this historic first quarter of 2022.

Finally … a Brief Pandemic Update

Authorities in the U.S. started the year having to balance mandates with keeping case counts, hospitalizations, and deaths at least somewhat under control. Fortunately, while the omicron variant is much more contagious, it has proven to be less severe and seems to have almost run its course here in the U.S. So, the pandemic here may be transitioning to an endemic state, and authorities have been ending mandates as a result.

The Fed Turns Hawkish … Kind Of

The Fed is managing its balancing act by beginning to unwind its supportive policy to help rein in inflation while not pushing the economy into recession. After discontinuing its securities purchases, the Fed this week hiked its benchmark rate 0.25% while also signaling six more rate hikes for the remainder of the year. The Fed acknowledged the risks associated with the war in Ukraine, but Chair Jerome Powell said that the "economy is very strong and well positioned to handle tighter monetary policy" and the probability of a recession is "not particularly elevated." In its latest economic projections, the Fed revised its forecast for PCE inflation for the year to 4.3% from 2.6% while lowering the real GDP forecast to 2.8% from 4.0%. Chair Powell recognized the "need to be nimble in responding to incoming data and the evolving outlook" and didn't rule out a 50-bps hike at future meetings.

Businesses and Consumers Balance … Higher Inflation

While the Fed works to get inflation down, businesses and consumers face the reality of current, higher inflation. Consumers are in a balancing act to decide how much these higher prices may impact their demand. And so far, we see retail sales, not adjusted for inflation, rising by 0.3% in February, as gasoline sales rose 5.3% (retail sales rose 17.9% from a year ago). On the business side, companies are dealing with higher costs. The most recent NFIB Small Business Optimism Index report indicates that 68% of businesses raised selling prices and listed higher inflation as a key issue. So, companies must decide whether to increase prices to maintain profit margin and earnings or let higher costs erode margins and earnings. Consensus earnings growth for the S&P 500 for 2022 sits at 9.1%, which is essentially unchanged from the start of the year.

A D.C. Update … Complexity

The balancing acts faced by our political leaders are complex, to say the least. Congress and the Biden administration are shifting focus from fiscal spending packages to agency legislation while at the same time trying to advance elements of the Build Back Better (BBB) initiative. President Biden didn't mention BBB in his State of the Union address, but he referenced several parts of it. Stifel's Chief Washington Policy Strategist, Brian Gardner, views the chance of passing a revised bill as low. The Infrastructure Investment and Jobs Act passed late last year, which means they have to decide what to implement and when. Of course, the war in Ukraine has driven energy prices higher, adding further to inflationary pressure. And each representative has to decide where they stand on the U.S. response to Russia's invasion of Ukraine. All of this complicates the calculus of the upcoming midterm elections when voters will experience their own balancing act on who to vote for and why.

Glimpses of Future Peace in Ukraine?

We focused on geopolitical tensions in our outlook, with an update on the U.S.-China rivalry while discussing a possible "New Cold War," or the idea that U.S.-China and U.S.-Russia strategic competition may be evolving into hostile actions. But we didn't anticipate a full-scale Russian invasion of Ukraine. There has been significant injury and loss of life, billions of dollars of damage to buildings and infrastructure, a wave of migration out of Ukraine, and real disruption and damage to the lives of Ukrainian citizens. We are seeing glimpses of progress in the ongoing peace talks, with Ukraine signaling its willingness to abandon joining NATO in return for security guarantees. Click here for our work on the Ukraine.

Economic and Market Implications

While inflation and the impact of the Ukraine war represent headwinds, in our base-case scenario, we remain positive on the economy and markets even through this period of volatility, as we believe we are still in the first half of a new economic cycle. Earnings and economic growth are forecasted to continue into 2022 as COVID restrictions ease, supply chain issues resolve, consumer spending remains strong, and we see peace in Ukraine become more possible. We see this next stage of the market cycle being driven by the quality of earnings rather than multiple expansion. So, we are focusing further on quality in our portfolios.

Conclusion

When we published Outlook 2022: Balancing Acts (report/video/webinar), we shared the idea that a lot of what we expected to happen this year would be tricky. We did not fully anticipate just how dramatic events would be in the first quarter. Despite all of the balancing acts we are seeing, we remain constructive about the economy and markets looking forward.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
Follow on LinkedIn

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com

0322.4561007.1