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MARKET SIGHT LINES

What's Driving Volatility? Amplified Uncertainty

By Michael O'Keeffe, *Chief Investment Officer*

As we've discussed many times in the past, market volatility tends to increase with amplified uncertainty. So far, 2022 is turning out to be one such period of uncertainty and increased volatility. The S&P 500 has been down six of the last 10 weeks, and is off 5.3% in April and 9.7% year to date. In this week's Sight|Lines, we describe a number of uncertainties facing investors then offer some perspective looking forward.

UNCERTAINTY #1 – HIGHER INFLATION, GROWTH RISKS, AND FED POLICY

Last week, we wrote about the debate on whether inflation is peaking, summarizing the arguments put forward by both sides and explaining that we believe inflation has peaked. The Federal Reserve's (Fed) hawkish shift and related rate hikes this year are designed to curb inflation, but Russia's war in Ukraine has presented new challenges for the Fed. This week's advance estimate of first quarter GDP showed a contraction (annualized) of 1.4%. The underlying details still show solid contributions from consumer demand and business investment, but a large rise in the trade deficit and slower inventory growth subtracted about 4% from growth. The question remains: Can the Fed help the economy achieve a "soft landing," curbing inflation without causing a recession?

Looking back, of the last eight Fed rate-hike cycles, a recession followed six times. Of course, some of these recessions, like the ones tied to the dot-com bubble and the housing crisis, were triggered by unique problems unrelated to Fed policy. And, in the two instances where the Fed was able to manage a "soft landing" and avoid a recession, inflation was much lower than current levels.

Some investors are worried that the Fed will have to raise rates too aggressively to bring inflation down, which has a real potential of causing a recession.

UNCERTAINTY #2 – RUSSIA-UKRAINE WAR

The fighting in Ukraine has gone on for more than two months despite peace negotiations. In the past week, there's been concern that tensions are set to escalate further, as Russia cut off gas supplies to Poland and Bulgaria, and there's been a growing body of evidence that Russia may expand the war to Moldova's breakaway region of Transnistria. While Poland says it has sufficient gas reserves to limit the impact, some investors are wary that this is the start of a general weaponization of commodities and an attempt by Russia to undermine Europe's unity against the war. European natural gas futures contracts surged 11% on the news. Furthermore, Russia's Foreign Minister Sergei Lavrov made a provocative statement in an interview that "the danger (of a nuclear war) is serious, it is real, it should not be underestimated." While most do not expect Russia to use nuclear weapons, investors will be relieved when Russia backs off of these threats.

UNCERTAINTY #3 – FIRST-QUARTER EARNINGS SEASON/FORWARD GUIDANCE

As of this writing, about 40% of the S&P 500 had reported earnings, with 76% beating analyst expectations. As we learn more about first quarter earnings, the estimated earnings growth rate for the entire S&P 500 is rising. As of March 31, the consensus estimate for growth was 4.7%. This consensus view now sits at 5.5%. While these numbers are positive, analysts are lowering estimates for future earnings, in some cases driven by companies announcing weaker forward guidance. As of March 31, the consensus estimates for 2022 and 2023 earnings growth were 9.4% and 10.0%, respectively. Today they sit at 10.6% for 2022 and 9.6% for 2023. Investors are mindful that elevated inflation, higher rates, and a slowing economy can lead to slower revenue growth, eroding profits, and muted earnings.

UNCERTAINTY #4 – PANDEMIC CHALLENGES CONTINUE

Following the omicron surge here in the U.S., people have begun to actively reengage in activities and business, feeling a sense of relief that the risks and lockdowns of the pandemic may be behind us. But investors are mindful that we've seen a modest uptick in cases recently, even as the illness from the latest strain (BA.2) seems not as severe and less lethal, and as a result, the pace of vaccinations and booster shots has lessened.

But even with relief here in the U.S., China continues to implement a "zero-COVID" policy resulting in renewed lockdowns for millions of people. This has revived worries about supply chain disruptions and the potential spillover effects from a slowdown in the Chinese economy. Oil prices declined this week, despite the Russia-Ukraine war's influence on supply, on the fear of slowing consumer demand from China.

UNCERTAINTY #5 – ARE P/E RATIOS RESETTING TO LOWER LEVELS?

When times are good, rates are low, and there is less uncertainty, markets tend to move higher from both earnings growth and price/earnings (P/E) expansion. So, it is natural to anticipate that P/E ratios will move lower if good times are challenged, rates rise, and we see more uncertainty. For example, history shows us that P/E ratios are lower in periods of higher inflation when compared to periods of lower inflation. If growth is threatened, rates and inflation remain elevated, and uncertainty remains, P/E ratios may fall. But is there a reason for optimism?

REASONS FOR OPTIMISM

Looking at the economy, we can take some solace that recessions are preceded by weakening employment and falling corporate profits. We are not there, at least yet. The outlook for employment is still strong, with 1.7 jobs open for every person looking for work. We still see the forecast for respectable earnings growth and GDP growth, despite lower forecasts. The consumer remains strong, with net worth up 29% compared to fourth quarter 2019 levels. And, as we discussed last week, inflation may be peaking.

We've listed five uncertainties stirring the market, and clarity on any one could lead to a change in investor sentiment and provide a tailwind for the market to find a bottom. We continue to assess the environment and look for signs of an economic downturn but for now, none of the 13 metrics we monitor are signaling a recession.

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

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