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MARKET SIGHT LINES

Learnings From My Colleagues: Making Sense of This Environment

By Michael O'Keeffe, *Chief Investment Officer*

We're in the second half of May 2022, and this highly volatile year is passing quickly. Last year, stock market volatility was muted by historic standards, with the S&P 500 moving up or down 2% or more only 7 times. In 2022, so far this has happened 18 times, and the S&P 500 is down about 18% this year, close to bear market territory. The VIX Index, a popular measure of stock market volatility, has jumped this year, and the MOVE Index, a popular measure of interest rate volatility, is also higher in 2022. With both stocks and bonds lower, the traditional "60/40" portfolio has come under pressure, and we've been more actively engaged with clients this year. I've had more in-person meetings than is typical, and just this week I hosted a client webinar with two of my colleagues, Dr. Lindsey Piegza, Stifel's Chief Economist, and Brian Gardner, Stifel's Chief Washington Policy Strategist, to help make sense of this unusual economic, political, and market environment. In this week's Sight|Lines, I share some insights from this meaningful session, including our views looking forward.

NEGATIVE FIRST-QUARTER GDP GROWTH…AND INFLATION

Lindsey discussed the first-quarter U.S. GDP decline of 1.4%. The weakness stemmed from a growing trade deficit and slower growth in inventories. But she also highlighted the bright spots, such as the continued strength of the consumer and business investment. In fact, when we look at real final sales to domestic purchasers (which excludes inventories and net exports), this segment of the economy grew 2.6% in the first quarter. Of course, this is against the backdrop of what has been sustained, higher inflation. Lindsey pointed out that renewed supply chain disruptions and the war in Ukraine could lead to inflation remaining elevated for a period of time. When we look to market forecasts, both consensus estimates and implied break-even measures put 2023 inflation at about 3%, still above the Federal Reserve (Fed)'s target rate of 2%, but well below current levels.

GEOPOLITICS AFFECT ECONOMIES AND MARKETS

We discussed the war in Ukraine and the tragic loss of life and destruction happening there. But we also discussed the effect this disruption, with Russia effectively isolating itself from the world, is having on the global economy and markets. For example, oil and gas prices are higher as Europe and the U.S. seek to bid for other energy sources around the world.

Brian discussed that some believe the tariffs on China are contributing to inflation, essentially increasing costs of cross-border goods and services that companies obtain from China. He explained that the 2018 tariffs are scheduled to expire later this year, and the U.S. Trade Representative (USTR) wants to extend them to serve as a point of leverage in future negotiations.

FED POLICY AND INCREASED RISK OF RECESSION

Lindsey shared a summary of the Fed's hawkish policy, explaining its goal to rein in inflation while managing a "soft landing" in the economy. We should expect more rate hikes, at least some of which being 0.5% hikes, with a Fed that remains "data dependent" and set on bringing inflation down in a "clear and convincing way." She pointed out that the Fed will monitor the health of the consumer and that the ongoing positive spending activity reinforces the Fed's notion that the economy can withstand further rate hikes.

WHAT TO EXPECT FROM THE MIDTERMS

Brian shared an update on the midterms. He pointed out that national sentiment has shifted somewhat in favor of Republicans given worries about inflation and a weakening economy. While recent events like the leak of a draft Supreme Court opinion to overturn Roe v. Wade or the pending January 6 committee hearings will be in focus, he does not think these events will change the minds of voters too much. He expects Republicans to gain the majority in the House, with the possibility of doing the same in the Senate.

OUR VIEWS LOOKING FORWARD

We expect market volatility to continue this year, but potentially fall later in the year as investors gauge the effectiveness of Fed policy shifts and gain a better handle on who will next be in charge in DC. While we're seeing some glimpses of negative data on the economy, we expect 2022 economic growth to be above trend and a recession to occur no earlier than the second half of 2023. Despite some challenges companies face, we see positive earnings growth this year and next, both likely above our long-term assumption of 6%. Despite continued equity volatility, we believe stock market levels will be higher a year from now. So, for many, this market weakness represents a buying opportunity. Those looking to invest more in equities should do so but in a planned, disciplined fashion. We guide long-term investors to stay the course, since "time in the market is better than timing the market." Finally, while we continue to have confidence in balanced portfolios like the popular "60/40" strategy, this is a good time to work with your Stifel Financial Advisor to explore ways to further diversify your portfolio.

CONCLUSION

We're in an environment of heightened volatility and amplified uncertainty in 2022, creating challenges and opportunities for investors. At Stifel, I am blessed to face these challenges with such capable colleagues as Lindsey Piegza and Brian Gardner. We hope you find our recent webinar helpful as you work with your Stifel Financial Advisor to meet these challenges and explore the opportunities.

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