January 28, 2022

MARKET SIGHT LINES

Equities are lower year to date.
Why, and where do we go from here?

By Michael O'Keeffe, *Chief Investment Officer*

Our Outlook 2022 report and video offered our base case view that equities would end 2022 higher, but with increased volatility. We also offered that a bear or bull scenario might unfold, depending on three critical factors: the path of the pandemic, inflation, and monetary/fiscal policy. January is coming to a close, and this first month of the year is shaping up to be a rough one for stocks. The S&P 500 is down -9.16%, near correction territory. And volatility, as defined by the CBOE's Volatility Index, VIX, has jumped nearly 80% in 2022.

In this week's Sight|Lines, we review the drivers of equity market performance this month and share some thoughts on where stocks are headed from here.

We take a long-term view

Before we dissect what is happening this month, it is good to remind ourselves that stocks are long-term investments that inevitably experience volatility along the way. We forecast stocks to earn a 7% return each year, *on average*, with a range of possible outcomes year to year and month to month. For example, our modeling projects that large cap stocks will post a negative return about every three years, and a return at or below -9.16% every seven years. When we model monthly performance, we expect a negative return every third month, and this experience of -9.16% in January is a one-in-every-74-month event, or expected every six years or so.

So, even as we look to explain what has driven this negative market, we're reminded that we should expect such moves when we invest in stocks.

What's happened this month?

In our view, the drivers of this increased market volatility in January include:

Higher Rates and Elevated Inflation: Prices are up 4.3% to 9.7% in 2021 across various inflation measures, which means companies face challenges of increased costs that may squeeze profits. Higher inflation and the prospect of a more hawkish Federal Reserve (Fed) (which we discuss next) have pushed Treasury rates higher, with the 10-year Treasury yield increasing 0.31% this month to 1.82%, for example. Higher rates increase borrowing costs for companies, a headwind, and higher yields make bonds more attractive than stocks on the margin. These are negative forces for stocks.

A More Hawkish Fed: With inflation elevated, the Fed has quickly shifted to a much more hawkish stance. Heading into this week's meeting, investors were worried about uncertainty around Fed policy. Will the Fed end tapering sooner? Will it hike rates sooner or more this year? Will it accelerate quantitative tightening (QT) to reduce liquidity

in the system to calm inflation? We learned after the meeting that the Fed is on track to end tapering in March, is signaling a good chance of a 0.25% hike then, and is open to three more hikes this year. But officials also signaled they would be measured with these actions and QT, while considering financial conditions, including stock market levels. Investors seemed to calm down some after this meeting.

Geopolitical Tensions: We see geopolitical tensions here in the U.S. and abroad. After bipartisan support for pandemic relief and infrastructure last year, less will probably get done legislatively in 2022. Voters can show what they really think in the midterms later this year, and a divided government is more likely. We know from history that markets are often more volatile heading into, and through, midterm elections. Outside the U.S., the Russian military buildup on the Ukraine border has worried U.S. officials and investors alike. Markets will be more volatile in times of military conflict or war.

The Omicron Effect: This latest coronavirus wave, omicron, has been fast and furious, and we expect it to be short-lived, but reduced economic activity is appearing in the numbers. The IHS Markit flash January composite PMI fell to 50.8 from 57. Chris Williamson, Chief Business Economist at IHS Markit, said, "soaring virus cases have brought the U.S. economy to a near standstill at the start of the year, with businesses disrupted by worsening supply chain delays and staff shortages, with new restrictions to control the spread of omicron adding to firms' headwinds."

Earnings Season: We're well into the earnings season for reporting fourth-quarter 2021 results, and when investors are nervous, for the reasons listed above, any negative news can push prices lower. For example, Netflix reported good 2021 results but signaled a slowdown in subscriber growth, and the stock has fallen -24% since then. Given this stock's weight in the S&P 500, this one move pulled the index down -0.10%.

Fear: Warren Buffett said investors should be "fearful when others are greedy, and greedy when others are fearful." With January's market move, various "fear" gauges are up, signaling that investor fear, and the associated selling pressure it creates, may mean stocks are oversold.

Where do we go from here?

As we shared in our 2022 outlook report and video, a bear market scenario may unfold this year, but we're not there yet. Considering the topics above, here's our take: We see interest rates as range-bound and inflation calming later this year. We got a better sense for the Fed's hawkish shift this week, and less uncertainty helps when it comes to volatility. We see the chance of a Russian invasion of Ukraine as low and expect tensions to ease there. The omicron wave is forecasted to be short-lived, and we should see renewed economic activity in late February or March, which will be a relief to investors. Further downward moves from earnings disappointments or fear will be dampened by the eventual recognition that fundamentals remain strong.

We remain positive on stocks for 2022. But stay ready, we also expect volatility to remain elevated.

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

The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. Indices are unmanaged, do not reflect fees or expenses, and you cannot invest directly in an index.

Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

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

0122.4237580.1