CROSSMARK
GLOBAL INVESTMENTS

April 4, 2022
Issue 2.13

DOLL'S DELIBERATIONS

QUARTERLY EDITION

War and Inflation Cause A Tough First Quarter: Quick Reversals Unlikely

The S&P suffered its first quarterly decline since the depths of the pandemic in Q1 of 2020 (-5.0%). Growth (-8.6%) meaningfully lagged value (-0.6%). The biggest development in Q1 was the dramatic repricing of the Fed rate hike path and expectations for an earlier start to and more aggressive balance sheet runoff phase. Late in the quarter, markets priced in a ~80% probability of a 50bp rate hike in May and ~200 bp in cumulative hikes by the end of 2022 following the 25 bp liftoff at the March meeting. This shift was driven by concerns about elevated and persistent inflation pressures. A 40-year high in the CPI highlighted such concerns. The hawkish Fed policy shift drove a big backup in bond yields, and Treasuries suffered one of their worst quarters on record. Curve inversion drove worries about potential recession and a Fed policy mistake. Q4 earnings season marked a fourth straight quarter of 20+% earnings growth.
Geopolitical tensions became a much bigger issue for the market as the quarter witnessed Russia's invasion of Ukraine. Energy stocks surged nearly 40%, its biggest rally on record. Treasuries sold off sharply, with 2-year yields up over 150 bp to 2.30% and 10-year yields up over 80 bp to 2.33%. WTI crude rallied more than 30%.

Investor attention has pivoted over the past few weeks from the war in Ukraine back to the accelerated unwinding of global monetary accommodation. While the war could still pose further threats to economic growth, global bond markets have struggled as central bank policy rate expectations move higher. As the war settles into an apparent stalemate accompanied by improving odds of a ceasefire agreement, rallying risk assets suggest that underlying global growth conditions are much better than a flat yield curve forecasts. Evidence exists that some investors have been selling bonds and buying stocks.

It remains to be seen whether equities can sustain recent advances against a backdrop of high and rising bond market volatility. During the last economic expansion, equities benefitted from low inflation and central banks' prompt policy support whenever investor confidence sagged. Central banks have no such latitude today and now face the uncomfortable prospect of having to engineer slower growth to tame inflation. The Fed is far behind the curve that both growth and core inflation will likely increase in the year ahead if it does not push interest rates higher. Markets are now discounting 200 bps of additional Fed rate hikes by early next year. However, the real rate will still be negative at that point, implying continued monetary accommodation and ineffective inflation policy.

Engineering a soft landing is a difficult maneuver to achieve. The Fed must tighten quickly enough to keep long-dated inflation expectations anchored; on the other hand, the Fed wants to avoid tightening so quickly that it causes a recession. The commodity price shock and the additional impact on the global supply chain will clearly create additional price pressure in the months ahead relative to what would have otherwise been the case.

We believe there is a low probability of a U.S. recession developing in 2022. Despite high inflation, U.S. consumer spending should remain strong in the year ahead, buttressed by a strong job market, healthy balance sheets, and the reopening of the service sector as COVID headwinds fade. The outlook for investment spending is also solid, given robust corporate profits, a still-low cost of debt, and the ongoing need to upgrade technology and modify supply chains. Worries about Fed rate hikes killing the expansion anytime soon are misplaced. The real Fed funds rate is deeply negative, and the nominal rate is far below the consensus estimate of nominal potential GDP growth for the next several years. The yield curve is an important indicator of a recession that briefly flashed a warning signal in late March. Fed Chair Powell recently downplayed the 2-10 yield curve (we prefer the 90-day/10-year curve) as a recessionary indicator, instead pointing investors to the market-implied change in the fed funds rate over the coming 18 months.

We expect volatility to remain a feature of capital markets. As a result, we continue to recommend a neutral weighting in stocks, underweight in bonds (notwithstanding our view of a positive short-term trade), and overweight in cash.

Fixed Income:

Short-term, we believe bonds are oversold, and a further pullback in yields is likely in the near term. However, our baseline scenario of an ongoing economic expansion and sticky headline and core inflation imply that bond yields are certain to have other waves higher on a 6–12-month horizon. Real bond yields across the maturity spectrum remain unsustainably negative. In other words, the bond bear market has further to run. We expect investment grade and high yield spreads to remain tight by historical standards on a 6–12-month horizon, allowing corporate credit to outperform similar-duration government bonds.

Equities:

The outlook for equities has deteriorated since the beginning of the year. Despite this, we still recommend an overweight position in stocks over bonds. Our S&P 500 target of S&P 500 4550 established when we released our 10 Predictions in December is unchanged. A decision to downgrade stocks in favor of cash would require expectations of a significant further decline in U.S. equities. The risk of such an outcome has increased. While we expect that investors will experience a recession scare at some point over the coming 6-12 months, we do not expect a recession.

The ongoing economic expansion will be a tailwind ("earnings tailwinds") for stocks over the next 6-12 months but offset by underlying upward pressure on bond yields ("valuation headwinds"), and all of this is accompanied by above average volatility. The earnings outlook remains broadly supportive if the economic expansion continues, as we expect, although the pace of growth will moderate further. Earnings estimates for most markets have held up well in Q1.

Value stocks still have more upside versus growth stocks, although much of the value advantage has been realized in Q1. Financials remain our favorite sector given their earnings leverage to improving credit growth and rising interest rates, combined with appealing relative valuations.

Commodities and Currencies:

Higher commodity prices (especially oil) will likely displace some spending on goods and services. The good news is that energy goods and services spending as a percentage of income is much lower today than in the past, so recessionary concerns stemming from higher gas prices alone are overblown. However, the war in Ukraine has raised energy prices and increased food and industrial metals prices. Commodity prices and the U.S. dollar will likely be positive in the near term. Still, risks are to the downside for both assuming a likely settlement between Ukraine and Russia and the ongoing reopening of the global economy.

Conclusion:

1. 90-day/10-year yield curve is more helpful currently than 2-year/10-year. (Suggesting economy is still growing.)
2. Inflation likely (and hopefully) peaks in Q2.
3. Fed is between a rock and a hard place as it remains woefully behind the inflation curve.
4. Near-term, bonds are oversold and likely to rally.
5. However, the bond bear market is not over.
6. Corporate America's ability to pass on cost increases is key to sustaining the earnings story.
7. Stocks to remain in volatile sideways pattern (therefore, buy dips/trim rallies).
8. Year-end 4550 S&P 500 target is unchanged.
9. At least half the value over growth advantage has been realized.
10. Look for dollar weakness and international stock outperformance if the war ends.

Source: BCA Research, MRB Partners, FactSet