Markets in Transition

January 21, 2022

Larry Adam, CFA, CIMA®, CFP®, Chief Investment Officer

In our Ten Themes for 2022, we acknowledged that there was the potential for a significant increase in volatility this year after the historically subdued levels of last year. But, we emphasized that this was a return to normal volatility and a dynamic that investors needed to prepare for in advance to avoid any knee-jerk reactions. Thus far, the S&P 500 is down ~8.3% from its recent highs (the largest pullback in the current bull market) and is on pace to post the worst start to a year since 2016. The reasons we stressed that volatility was likely to increase include:

◊ **Accommodation Withdrawal:** Historically, in the three months prior to the beginning of the tightening cycle, the equity market experiences at least one 5%+ pullback.

◊ **History:** The S&P 500 tends to exhibit three to four pullbacks of 5%+ during a normal year, which averages, one per quarter. These pullbacks have also tended to happen during the early part of the year when the preceding year, like last year, was up more than 25%.

◊ **Correction Territory:** The S&P 500 averages at least one 10%+ pullback per year. In fact, that type of pullback occurs, on average, every 222 trading days. This bull market has not had one since it started—over 450 trading days—so it may be due for a bigger retreat in the near term.

While is it difficult to anticipate the tops and bottoms of the equity market, we remain confident in our 5,053 year-end target which, from today's levels, suggests a good buying opportunity as it represents ~15% upside. The reason we remain confident is that many of the 'headline' excuses for the decline are priced-in and possibly exaggerated. Below is our take on a few key headlines.

Headlines in the Market	Our Take
The **Fed tightening cycle** is going to be aggressive as the Fed is behind the 'inflation curve.' In fact, many participants have increased their expectations of an initial 50 basis point increase (as early as next week), a terminal fed funds rate well north of 3%, and a quicker and more substantial reduction of the Fed's Balance Sheet.	It would be out of character for the Fed to 'surprise' the market and raise interest rates by 50 basis points. Yes, we believe the economy could absorb three to four interest rate hikes this year. But given the interest rate sensitivity of the economy and the already narrow yield curve (between the 10-year and 2-year Treasury), we think it will be a challenge to get the fed funds rate well beyond the 2% level. Given the recent volatility in the market, there is a growing probability the Fed could provide a market positive 'dovish surprise' next week that would calm down some of the volatility. Importantly, for long-term investors, the start of the tightening cycle typically has not led to a halt in the bull market, as the S&P 500 has typically rallied an additional four years by a magnitude of 100% on average.

Headlines in the Market	Our Take
The **10-year Treasury yield** rising (recent peak of 1.87%) and oil prices surging (recent WTI peak $85.80) are going to slow the economy and lead to more prolonged inflation. In other words, an environment of stagflation.	Clearly, if yields sustainably rise well north of 2% and oil prices surge to levels above $100, that would be a risk to the economy and financial markets. However, given our year end 10-year Treasury yield forecast of 1.90% and $80/barrel oil target, we do not think there is much upside to current yields and oil prices.
Earnings season has not been as robust as the previous six earnings seasons, as the percentage of companies beating, the average beat, and the magnitude of earnings continue to trend lower. In particular, margins appear to be under pressure because of higher commodity, labor and input prices.	Earnings are in a transition period as this is the last quarter of easy earnings comparisons. So logically, the level of beats and earnings is in the process of normalizing. But the bottom line is that a still elevated 71% of companies are beating earnings, the magnitude of earnings beats are above the historical average at 6.1%, and earnings are still north of 20%. Next week will be the biggest week of earnings as major technology, industrial and consumer discretionary companies report. These reports and guidance will hopefully reinforce our expectation of above-consensus earnings growth (S&P 500: $235 vs Consensus $222). One point to emphasize is that earnings matter. That is why we continue to emphasize cyclical sectors that have strong earnings growth and positive cash flow.
Investor sentiment has gotten too aggressive and led to the equity market trading at extremely high valuations with investors paying little attention to potential risks.	Yes, complacency has been a concern we have been monitoring. It is one reason why we believe a pullback of 10% or more could temporarily result. The reason: there is whole generation of investors that have ratcheted up their risk profiles without really experiencing a significant pullback. As the pullback grows beyond 7-8%, these are the investors that could capitulate and 'throw in the towel' leading to a further decline. To us, that capitulation would be a buying opportunity, as we believe the long-term fundamentals remain healthy. Investments that have been driven by flows and uber-sentiment could be hit the hardest and that is why the focus on fundamentals is imperative.

Conclusion: Transitions are never easy and the markets are in a transition period in regard to monetary policy, fiscal policy, and earnings. From our vantage point, increased volatility after last year was inevitable. And while the pain of a pullback could linger, we believe that equities at current levels represent a good opportunity given a robust economic backdrop (3.5% estimated GDP), strong earnings (above consensus forecast), record cash on corporate balance sheets (leads to increased dividends, buybacks, M&A) and attractive equity valuations.

Tracey Manzi, CFA, Senior Investment Strategist, Investment Strategy

The bond market is off to its worst start of the year since 1992, with the 10-year Treasury yield rising, at one point, over 30 basis points since the start of the year. The sharp upward move in rates has been driven by the Fed's hawkish pivot late last year, where it signaled an acceleration in the pace of tapering, while pulling forward its tightening cycle and introducing a new twist—a possible balance sheet reduction later this year. While the Fed typically likes to telegraph its intentions to the market, its sense of urgency seems to have caught the markets by surprise. This has led to another upward shift in rate hike expectations, with the market now pricing in four rate hikes this year, and an additional two to three rate hikes in 2023. This is a dramatic shift since last September when the market wasn't expecting the tightening cycle to begin until sometime in 2023.

This begs the question, where are rates headed next? While it's true we are in the midst of an inflationary surge that is lasting longer than most, including the Fed would have expected, we do expect growth to moderate this year as the big reopening of the economy is now firmly in the rear-view mirror and the effects of the past fiscal stimulus continue to fade. In addition, household spending and purchasing power is likely to be dented with inflation and interest rates up sharply in recent months. This should go a long way toward moderating demand and easing some of the inflationary pressures we've been seeing, which should ultimately keep a lid on rates.

Also, from a technical perspective we think the recent moves are overdone for two key reasons. First, bond bearishness has ramped up considerably, with short bets on 10-year Treasurys at their highest levels since the Fed was at the end of its previous tightening cycle. While it's hard to know if we're at an extreme, when investor positioning starts to get very one-sided, the market could be setting up for sharp reversal if, and when, sentiment does shift. Also notable is the fact that the 14-day Relative Strength Index has moved into oversold territory for the first time since early 2000. Historically when this has occurred, it has led to positive performance over the next three, six and twelve months.

J. Michael Gibbs, Managing Director, Equity Portfolio & Technical Strategy and **Joey Madere, CFA** Senior Portfolio Analyst, Equity Portfolio & Technical Strategy

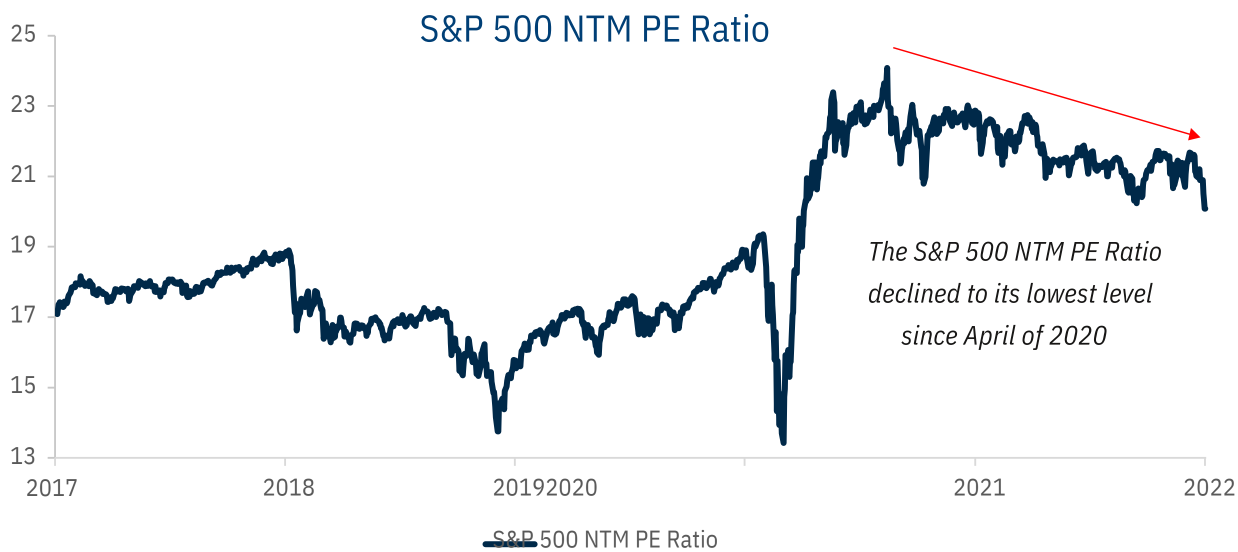
Volatility and market weakness around a Fed tightening cycle is not unusual. Historically, the weakest period occurred three months after the Fed tightening process began. This time we feel the three months before lift-off will present the most weakness with the Fed telegraphing intentions today versus being mysterious in the past. With market expectations for lift-off in March, market volatility may persist over the near term. However, a bounce is likely with stocks oversold in the near term.

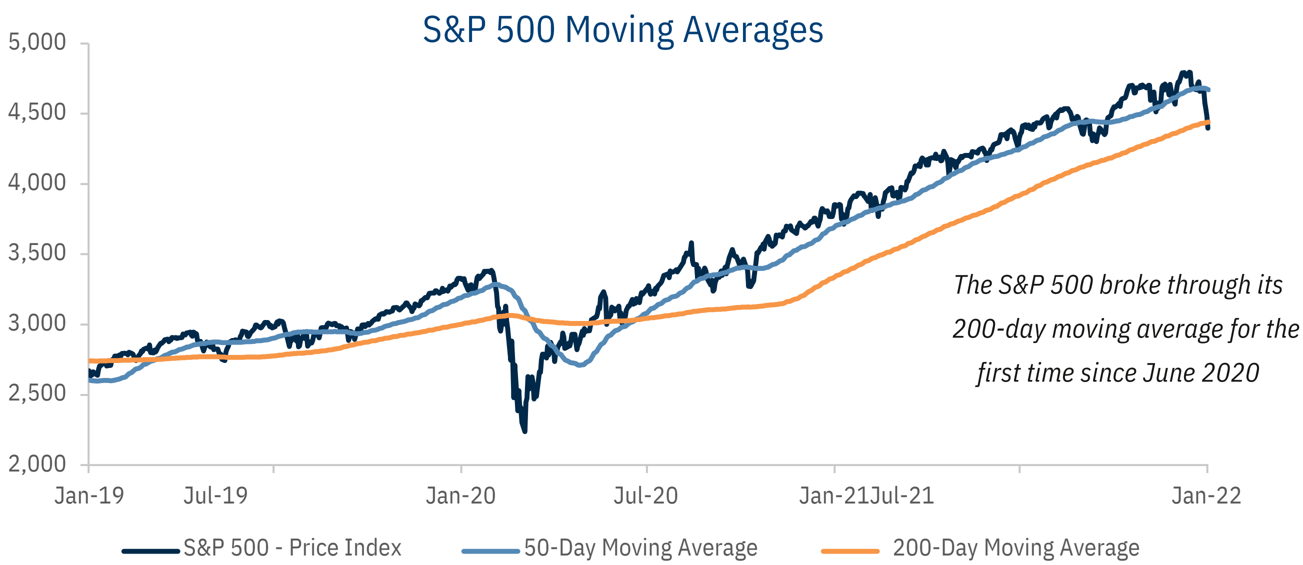
The shift in the Fed's position changed the market's tone from the ultra-bullish conditions seen late last year to a more cautious stance. During cautious periods additional items of concern, such as Russia/Ukraine, influence weakness more than they would otherwise. Any further decline inflicted on the market allows for additional gains when the equity market regains confidence, which we expect it will.

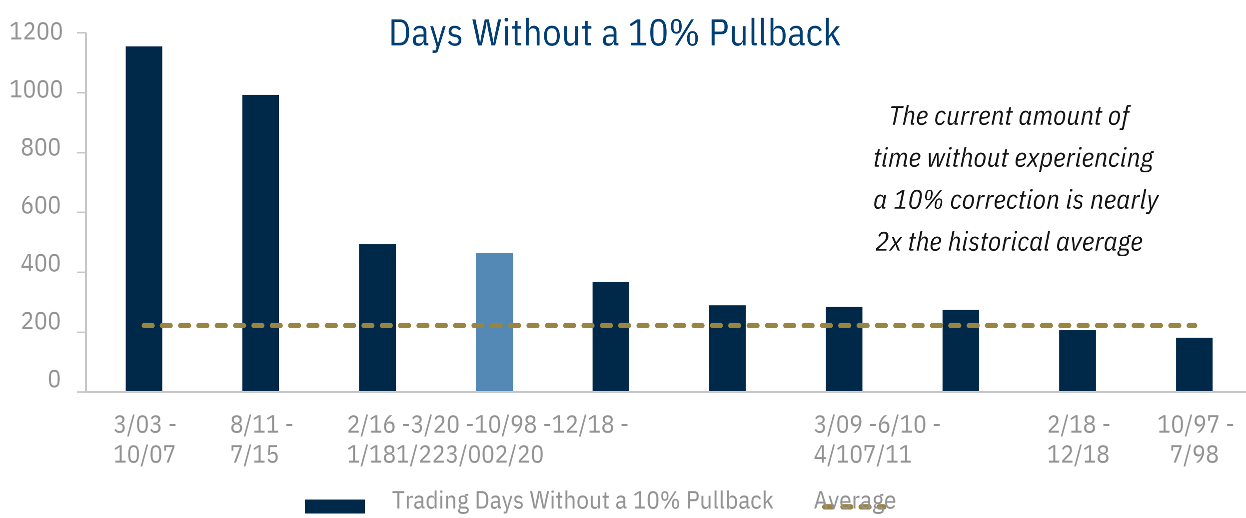
We encourage investors to avoid the urge to time the market to pick a bottom; it is simply too challenging to do and involves more luck than skill. Moreover, we believe that the bull market is not ending, given expectations for above average economic and earnings growth for 2022. In such an environment, the equity market is likely to reach levels above the current quote over the next 12 months. Accordingly, we maintain our 5,053 year-end price target for the S&P 500. Based on our outlook, purchases at the current market quote have elevated odds for gains over the next 12 months regardless of the absolute low price seen during any weakness developing in the coming days or weeks.

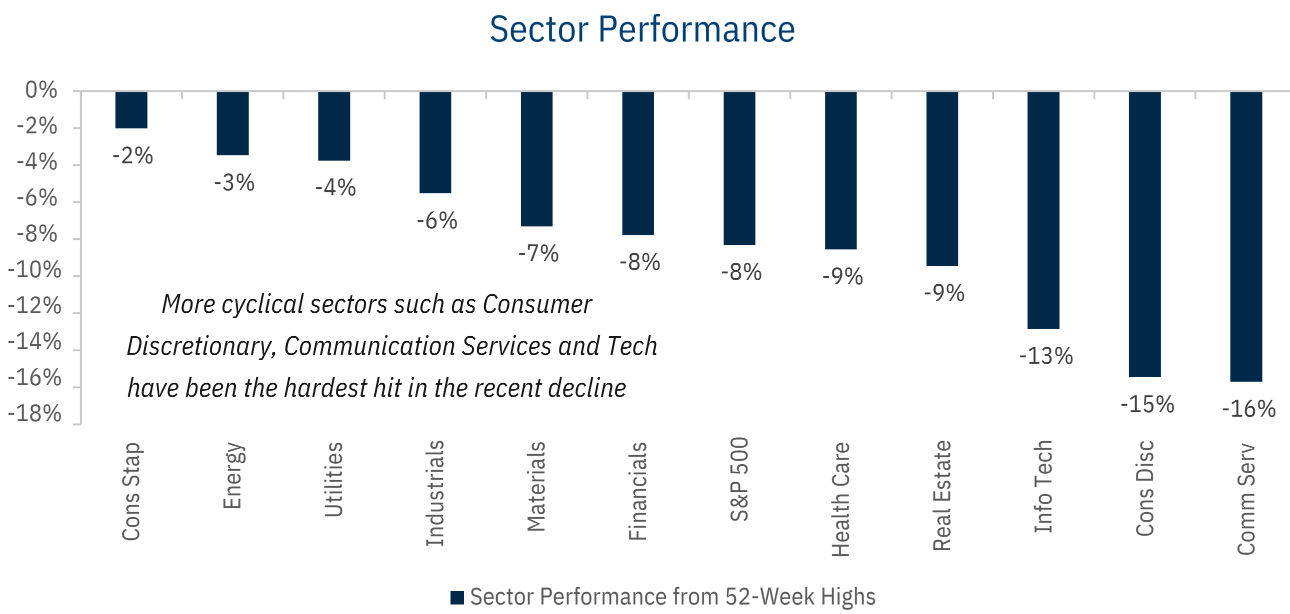
Pavel Molchanov, Energy Analyst, Equity Research

With Brent crude up more than 10% year-to-date, and approaching a seven-year high of $90/Bbl earlier this week, the impact of rising fuel prices is particularly problematic in the context of the pre-existing inflationary backdrop. In other words, the oil price spike would be less impactful had it not been for the overarching inflation problem. To state the obvious, high fuel prices lead to higher costs in every supply chain, since all products must be shipped by road (diesel / gasoline), rail (diesel), sea (bunker fuel), and/or aviation (jet fuel). Moreover, high fuel prices raise the cost of living for consumers. This is true even in countries such as the US and Brazil that are largely sufficient in petroleum. However, the macroeconomic hit is magnified in countries that are highly dependent on imports, such as India, Japan, and most of Europe. In the long run, consumers and businesses will be able to make changes, whether it is swapping conventional cars for electric ones, or developing more efficient travel routes. But for now, there is no avoiding the reality of having to pay up for fuel, and this is compounding the market's fears that inflation will be higher for longer, with corresponding pressure on central banks to raise interest rates.


S&P 500 NTM PE Ratio
25
23
21
19
17
15
13
2017
2018
2019
2020
2021
2022
The S&P 500 NTM PE Ratio declined to its lowest level since April of 2020
S&P 500 NTM PE Ratio


S&P 500 Moving Averages
5,000
4,500
4,000
3,500
3,000
2,500
2,000
Jan-19
Jul-19
Jan-20
Jul-20
Jan-21
Jul-21
Jan-22
The S&P 500 broke through its 200-day moving average for the first time since June 2020
S&P 500 - Price Index
50-Day Moving Average
200-Day Moving Average


Days Without a 10% Pullback
1200
1000
800
600
400
200
0
3/03 - 10/07
8/11 - 7/15
2/16 - 1/18
3/20 - 1/22
10/98 - 3/00
12/18 - 2/20
3/09 - 4/10
6/10 - 7/11
2/18 - 12/18
10/97 - 7/98
The current amount of time without experiencing a 10% correction is nearly 2x the historical average
Trading Days Without a 10% Pullback
Average


Sector Performance
0%
-2%
-4%
-6%
-8%
-10%
-12%
-14%
-16%
-18%
-2%
-3%
-4%
-6%
-7%
-8%
-8%
-9%
-9%
-13%
-15%
-16%
More cyclical sectors such as Consumer Discretionary, Communication Services and Tech have been the hardest hit in the recent decline
Cons Stap
Energy
Utilities
Industrials
Materials
Financials
S&P 500
Health Care
Real Estate
Info Tech
Cons Disc
Comm Serv
Sector Performance from 52-Week Highs

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Fixed-income securities (or "bonds") are exposed to various risks including but not limited to credit (risk of default or principal and interest payments), market and liquidity, interest rate, reinvestment, legislative (changes to the tax code), and call risks. There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices generally rise. U.S. Treasury securities are guaranteed by the U.S. government and, if held to maturity, generally offer a fixed rate of return and guaranteed principal value.

Source: FactSet, as of 01/21/2022

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