

May 3, 2022

Dear Clients,

In an effort to keep you apprised of current market events and potential impacts on the portfolios we manage on your behalf, I am sending along our views on recent market activity and our expectations for the near-term.

April Takeaways

- First quarter earnings reports highlighted continued slowdown across many sectors
- Investors have pivoted from pure inflation concerns to growth concerns
- Continued crosscurrents will lead to continued volatility on both the upside and downside

What We're Watching for in May

- Remaining S&P500 earnings reports – further slowing or light at the end of the tunnel?
- Federal Reserve meeting on May 4 – what will they say about further hikes in June and beyond?
- April jobs report on May 6 – will unemployment remain below 4%?
- Consumer Price Index and Producer Price Index reports on May 11 & 12 – are we at peak inflation yet?

After three years in which the US stock market increased by a cumulative 98% (2019, 2020, and 2021), we entered 2022 expecting that equity returns would be both modest and volatile. This expectation was based on both high starting valuations and the emerging tug-of-war between positive and negative economic dynamics. Indeed, to date, the market has been whipsawing between optimism and pessimism as new data points emerge that alternate between suggesting a more benign economic outlook and a more pessimistic one. Looking at April's 8.8% decline in the S&P500, it is no surprise that April was dominated by pessimistic datapoints.

What did we learn in April? Three things. First, the initial wave of first-quarter earnings reports has highlighted a broad economic slowdown. Second, although inflation continues to be a concern, slower growth (driven in part by lower margins) is proving to be just as much a headwind for stocks. Third, several factors are starting to erode the strong financial position of the US consumer. All these point to continued volatility as we move through the year.

First-quarter earnings results thus far have nicely illustrated the myriad pressures that companies are facing. Low unemployment has led to rising wage pressures, and prices of other inputs remain high, all of which crimp corporate margins. We have seen labor shortages in industries as diverse as railroads, hospitals, and retail. We have also seen lower operating margins in the communications services, consumer, and healthcare sectors. As of this writing, just over half of the S&P500 companies have reported first-quarter earnings, with about two-thirds of companies beating revenue estimates and just over 80% beating earnings estimates. Although top-line reports have been fairly favorable, with revenue growth of about 10%, earnings growth can only be called anemic, averaging under 1%.

Since the beginning of the year, investors' primary concern has shifted from the Federal Reserve (the Fed) raising interest rates to the underlying growth in the economy. Yes, investors still expect the Fed to raise rates, but this is increasingly priced into the futures market – for example, current market expectations are for another two-and-a-half-point increase in short-term interest rates by the December 2022 meeting. We have seen companies that missed or lowered guidance punished quite severely this first-quarter earnings season, highlighting investors' lack of patience for slower growth. In the communications, healthcare, and financials sectors, the average company actually beat earnings expectations, but the stocks declined anyway.

The primary positive underpinning of the US economy today is the consumer. Households still have approximately \$2.5 trillion in “excess” savings, which is more than what the pre-Covid trendline would have predicted. This “excess” savings accounts for 12% of annual consumer spending, so it should in theory buttress at least the average consumer against any slowdown. Unemployment is very low at 3.8%, and nominal wages are rising. However, the negatives for the US economy are stacking up: companies face widespread labor shortages, cost inflation, and supply chain issues; inflation remains high; the Fed will raise interest rates sharply for the rest of the year. These positives and negatives are driving market volatility.

What to do with client portfolios in such an environment? In equities, we are staying nimble, and keeping risks low by increasing quality. We are using market volatility to buy high-quality companies at attractive prices while using strong days to reduce positions in lower-quality companies. We remain diversified across economic sectors and market capitalization, while emphasizing value and large capitalization companies. We remain underweight to Europe and international generally, due to continued impact from Russia’s war on Ukraine. In fixed income, we are reducing credit exposure, and we remain short duration in anticipation of continued interest rate increases. In alternatives, we have even more confidence in our exposure to real assets (infrastructure, real estate, commodities), which have historically performed better in an inflationary environment and are less correlated with equities and fixed income. We are looking to increase commodity exposure and are analyzing other opportunities in the alternatives markets to protect against further interest rate increases.

As we have been discussing for several quarters, markets have a history of being volatile, particularly over short periods of time. This natural volatility is currently being reinforced by the mix of both positive and negative crosscurrents in the US economy. The consumer remains strong, but corporate margins are compressing. Unemployment remains low, but inflation has been high. This combination leads to market swings as investors absorb each new piece of data, positive, then negative, then positive again. The wide variety of indicators we are watching currently suggest that the economy remains healthy yet is slowing. Most asset classes are unlikely to repeat the outstanding performance of the last three years, but opportunities remain.

In this period of volatile markets, we remain focused on our clients’ long-term objectives while pushing to the side the emotional aspects of fluctuating market values. Should you have questions about how our strategy is being applied to your portfolio, or if your objectives have changed, please reach out to your advisory team to discuss.

Sincerely,



Ellen K. Hazen, CFA®
Chief Market Strategist

[Disclosures](#)