April Investment Outlook 2022

KLINGENSTEIN FIELDS
ADVISORS

Gregory W. Golinski, CFA
Director of Analytics
Partner

Current Market Conditions

The geopolitical environment remains in flux

The war in Ukraine has created human tragedy, and a dangerous geopolitical situation. Russia's armed forces appear bogged down in Ukraine and seem significantly less formidable than previously perceived. Despite the shortcomings of its conventional military forces, Russia maintains a significant numerical advantage and a deadly nuclear arsenal. Sanctions continue to bite, though Russia is trying to blunt the effects by courting powers like India and China. The situation remains fluid, and as we have noted in the past, national leaders with territorial or other aggressive inclinations are carefully watching and positioning themselves.

Inflation expectations continue to rise

Over the last several weeks, measures of inflation expectations have continued to rise. While oil prices have retreated from recent highs, prices remain elevated relative to history. In addition, pricing pressures persist in other commodities globally due to supply chain bottlenecks, tight labor conditions, regional Covid-19 flare-ups, and the war in Ukraine. While corporations and governments are adjusting their business models and policies to compensate for supply chain challenges, the solutions will take time to implement and are unlikely to provide near-term relief.

Despite risks and fears, equity markets have rallied

After a rough start to the year, equity markets experienced a "risk on" rally over the last two weeks of March, with the S&P 500 up 8.6% and the NASDAQ 100 up 14.1%. This rally has reduced losses in the index, and year to date through March 31st the S&P 500 is down -4.6% and the NASDAQ 100 down -8.7%. Trading at a valuation of approximately 20x

continued on page 2

the forward earnings estimates, the price to earnings multiple on the S&P 500 has bounced off its recent lows, but is still below last year's average of around 22x. Despite the decline in the S&P 500 year to date, government bonds have experienced even larger losses in some cases; an index of U.S. Treasury bonds with 7-10 years to maturity is down 6.6% on average (including interest). It is tempting to attribute the equity market rally to a better investing environment, but the recent moves are more likely reflective of heightened volatility in the markets, a situation we expect to persist in both directions.

More significant rate increases are now expected

Due to inflationary pressures, the Federal Reserve Board (Fed) will likely have to move more aggressively to tame inflation. The current expectation is that the overnight federal funds rate will end the year at approximately 2.5%, up more than 1% from the views of just a month ago. There is even mounting concern in some circles that the Fed might not respond quickly or strongly enough to tamp down inflation. Looking at historical periods, however, we see that the short-term impact of the Fed rate increases have not prevented the market from continuing to go up for a time, as shown in the chart below.

What Happens After the First Fed Rate Hike?

S&P 500 Index Future Returns

Date of First Hike	Next 3 Months	Next 6 Months	Next 12 Months
8/8/83	2.0%	-0.7%	2.1%
4/1/87	19.1	20.9	1.5
5/11/88	3.4	8.6	20.7
2/4/94	-5.9	-2.5	2.4
3/25/97	13.6	20.6	39.6
6/30/99	-7.6	6.6	6.0
6/30/04	-2.3	6.4	5.2
12/16/15	-1.1	0.1	9.1
Average	2.7	7.5	10.8
Median	0.5	6.5	5.6
% Positive	50.0	75.0	100.0

Source: LPL Research, Bloomberg

continued on page 3

Economic activity is still encouraging

The economy faces headwinds in the form of inflation, ongoing geopolitical risks, and uncertain monetary and fiscal policies. However, estimates for Gross Domestic Product (GDP) and corporate profit growth remain strong. Global GDP forecasts project 4.0% growth in 2022, which is above the historical average. Manufacturing surveys reflect strength, and corporate profits for the S&P 500 are anticipated to be up 9% in 2022. Labor markets are tight, which can pressure inflation with higher wages. In the current environment, workers can easily find employment, which can lead to increased spending and higher corporate profits. With the exception of China, countries are gradually easing COVID-19 restrictions, allowing restless consumers to travel more safely. The investing environment provides more challenges given all of the uncertainties, but historically, fiscal and monetary policies have adjusted rapidly to provide stabilization, should the economic environment deteriorate radically.

Investment Approach and Strategy

Although the markets have rallied recently, we expect volatility to continue. The geopolitical outlook and the duration of elevated inflationary pressures remain uncertain. Despite the increase in interest rates due to these factors, yields on bonds are still relatively low and remain unattractive; therefore, significant policy change to the portfolios is not warranted.We expect that equity markets will remain volatile and news flow related to inflation and global stability will at times drive market rallies and likewise result in pullbacks. While there are several negative factors weighing on capital markets, we still believe that global economic growth is strong enough to support investments in risk assets.

Things we are watching

Recent increases in inflation continue to bear close watching, as does the degree to which monetary and fiscal policies keep pace with the dynamic economic situation. While in the short-term, such an environment can remain constructive for equities on a relative basis, over the longer term, inflation damages economic activity and can lead to a recession. In addition to fiscal policies and increases in the federal fund rate, we are closely watching for additional details on how the Fed intends to reduce their balance sheet of securities. These securities were purchased over the last several years to help support the economy though COVID-19 and other challenges. How the Fed successfully decreases these securities will be very important to watch. When the Fed purchased bonds, they created excess liquidity in the market, which in turn helped support capital markets. By reversing this strategy, liquidity will be withdrawn from the financial markets, potentially increasing volatility and pressuring capital markets. Lastly, while Russia's military appears to be less formidable than feared, they possess dangerous unconventional weapons. Russia remains a very serious threat to global geopolitical security, calling for close scrutiny.