Q1 Market Viewpoints

March 2022

Volatility returned to both the equity and fixed income markets in a dramatic fashion in the first quarter. As a result, the landscape of valuations, interest rates, and inflation shifted quite quickly. In this quarterly piece, Pathstone's Managing Director of Strategy, John Workman, reflects on the **macroeconomic picture and what that means for bottom-up portfolio construction**.

The Macro Picture

Market meteorologists, seeing an unusual culmination of crosswinds including inflation, war, and tighter monetary policy, are beginning to anticipate the probability of a storm forming on the horizon of global financial markets. It is too early to tell whether those conditions culminate in a real storm and when that storm could make landfall. A potential economic storm's damage may well be avoided or mitigated based on the strength of the pillars upon which our economy is built – consumers, businesses, and governments. Notwithstanding heightened consumer and producer prices, we believe that consumers and businesses both have relatively strong balance sheets and the capacity to weather a significant storm. It is unclear whether governments will have that same ability after taking the financial brunt of the impact from COVID-19. Their ability to ease monetary policy and/or distribute additional fiscal support may be more limited than normal.

U.S. Economy Outlook

A strong job market, wage growth, low debt service levels, strong corporate profit margins, and technological innovation continue to propel the U.S. economy. Risks of overheating may be seen in home prices, goods purchases, and financial asset prices. Sustained economic growth will depend on consumer and business sentiment towards spending, given expectations for inflation and interest rates. It is no surprise that both equity and bond prices will face some headwinds as the Fed moves from its emergency 0% interest rate and Quantitative Easing ("QE") policies to address heightened inflation. While financial markets may re-price, the U.S. has the world's most powerful consumer base and a dynamically diverse economy that puts it in a better place relative to other countries. We anticipate that supply chains still have further to recover from the ravages of COVID. We should see a reduction in goods consumption as re-opening should accommodate the pent-up demand for services like travel and dining out. This reduction may help to ease commodity price inflation and bring back more jobs. However, we must pay close attention to sentiment as rising interest rates, falling home prices, a reversal in the job market, or declining wealth may impact consumer demand.

Global (ex-U.S.) Economic Outlook

Developed non-U.S. markets are disproportionately impacted by the Russian invasion of Ukraine as energy prices are multiple times higher than the U.S. The European Central Bank (ECB) and the Bank of Japan (BOJ) are both maintaining easier monetary policy compared to the U.S. (at least for now), as their recoveries seem to be slower in taking off. Tourism, a major economic factor in Europe, has begun to pick up after the Omicron spike. Unemployment rates continue to drop, and corporate profit margins are increasing. The question remains whether the current energy crisis has been sufficiently priced into Developed non-U.S. equities and/or whether it may be more likely to lead to a recession.

Global tensions, energy markets, and restructuring of supply chains are having different impacts across the many countries that make up the emerging markets. As the war in Ukraine continues unabated, countries are being forced to confirm or deny their allegiances which may impact future economic and political outcomes. Energy-producing countries are enjoying a nice economic tailwind as NATO and its partners look to choke off the supply of Russian oil. We are also likely to see a reshuffling of the global supply chain post-pandemic as companies must now consider how to mitigate the previously unforeseen risk. Some companies may follow a "deglobalization" script bringing manufacturing back to their domestic markets, but profit-maximizing instincts may lead them simply to diversify their supply chains more broadly, meaning some countries will lose while others gain. The Chinese economy is at a different part of the economic cycle, having been restrained by its real estate crisis, tighter regulation, and more severe COVID lock-down measures. Global investor sentiment is negative, particularly in the face of China's unwillingness to denounce Russia's actions in Ukraine. Discounted equity prices have resulted, but sentiment and momentum remain negative towards the country.

Tactical Portfolio Positioning

Our expectations to start 2022 were that the global economy would continue to open as the spread of COVID declined and that interest rates would begin to move higher as emergency monetary policy measures were removed. We expected that some part of the inflationary pressures might resolve (supply chain improvements) while demand may remain robust enough to keep inflation well above the Fed's 2% target. In that scenario, we anticipated that global economic growth would remain strong, though milder than the initial post-pandemic jump. Also, investors would begin to rotate their portfolios towards less expensive stocks and those that stood to benefit from further economic activity in services rather than goods.

Economic and Market Impact of Russia's Invasion of Ukraine

The Russian invasion of Ukraine disrupted these expectations in more ways than one. It put more pressure on inflation, particularly related to energy and agricultural commodities worldwide. First, it has put further pressure on central banks to make a strong stand and increase the pace and magnitude to which they expect to act regarding increasing interest rates and decreasing balance sheets. Second, it has impacted sentiment towards Russia and anyone not willing to denounce their actions. Third, it has led to a pick-up in volatility as the risk of a wider war and greater uncertainty in general weighs on investors. Fourth, it has raised questions about deglobalization, which already got a jump start from the pandemic and even prior trade disagreements between China and the U.S., for example. Lastly, it alters risk perspectives around energy, particularly for those that are further from domestic energy independence, such as Europe.

Portfolio Positioning for 2022

How does this change our perspective for the rest of 2022, and how do we think about the bottom-up decisions to be made in portfolios? We believe it further supports the tactical shifts that we have already recommended where appropriate in client portfolios, emphasizing value over growth, short-duration fixed income over intermediate, an overweight to equity risk alternatives to mitigate market risk, allocations to private income which provides high absolute yields and floating rate adjustments. We believe these portfolio tilts still have plenty of support. In addition, we suggested making some modifications to bring other tactical tilts back towards strategic targets. Importantly that includes bringing the liquid real assets allocation within the growth segment of the portfolio back to strategic targets with a specific focus on active management across a diversified portfolio of real estate, infrastructure, and natural resource equities. While commodities have seen significant increases in prices this year, listed real estate and infrastructure have seen more mixed returns and offer potential for inflation protection characteristics and portfolio volatility dampening. For those with tolerance for illiquid investments, opportunities in private real assets like real estate continue to be attractive when positioned with the right manager.

Opportunities in Fixed Income

As we have seen interest rates increase dramatically this year, we want to highlight that investors will find more significant yield differentials between money market funds and short duration bond funds for the first time in multiple years. Therefore, aside from more immediate cash needs (3-6 months), we encourage clients to hold the balance of the short-term liquidity allocation in short-duration fixed income to benefit from the more attractive yields.

Anticipating Future Opportunities

Looking ahead to future opportunities, we are closely monitoring valuations and interest rates, as they will guide us when future opportunities present themselves. In 2022, we have seen non-U.S. market prices dip more than the U.S. despite already having more attractive price-to-earnings multiples to start the year. While this begs the question of whether to overweight international equities or to increase allocations to emerging markets, we remain cautious based on softening momentum and negative sentiment towards those markets. We will also continue to monitor the path and shape of the yield curve, noting that as rates continue to rise there becomes a point where the yield available in intermediate fixed income may begin to justify the risk. We do not believe that point has happened yet, particularly considering the expectations for rate hikes still to come.

If you have any questions or would like to discuss the quarterly market update, please contact us.

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