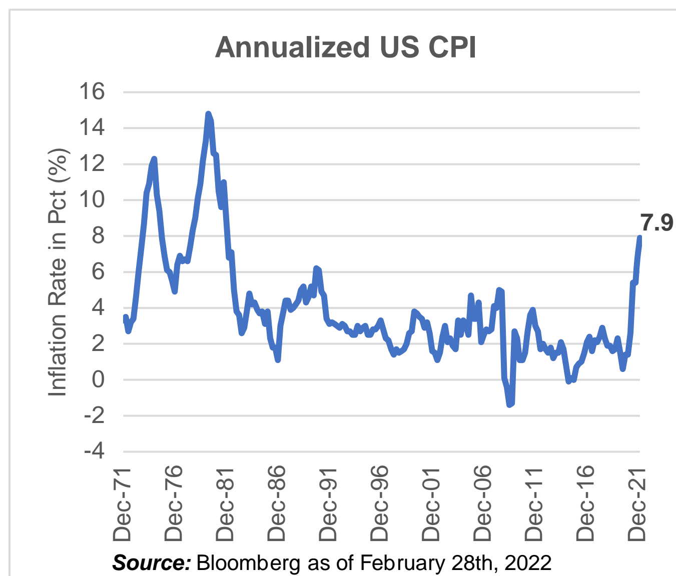
AndCo's Monthly Market Update

Mar 2022

THE ECONOMY

Just as it seemed the pandemic was receding and life was beginning to return to normal, a different kind of crisis emerged as Russia invaded Ukraine on February 24th.[1] This developing situation remains fluid and it will be some time before the full impact of the humanitarian crisis it has created can be assessed. From an economic perspective, the Russia's decision to invade Ukraine, while not directly impactful from a global GDP perspective, is significant in the new uncertainties it has created regarding the pace of future economic growth, the trajectory of global inflation, and the potential monetary policy shifts by the Federal Reserve Bank (the Fed). While we will have to wait for future economic reports to provide us with datapoints, consumers are already feeling the impacts of these events at gas stations and grocery stores.

In terms of US growth, the economy was already showing signs of slowing prior to the invasion of Ukraine. For context, US GDP grew by 7.0% in the fourth quarter of 2021, and estimates for the first quarter of 2022 range between 0.5% and 3.0%.[2, 3] Some of the slowdown can reasonably be attributed to the continuing challenges faced with global supply chains and the ending of monetary stimulus by the Fed and other central banks. However, inflation factors such as rising energy and food costs have also weighed on consumers which has contributed to lower consumption of non-discretionary items such as electronics and travel and leisure.



Source: Bloomberg as of February 28th, 2022

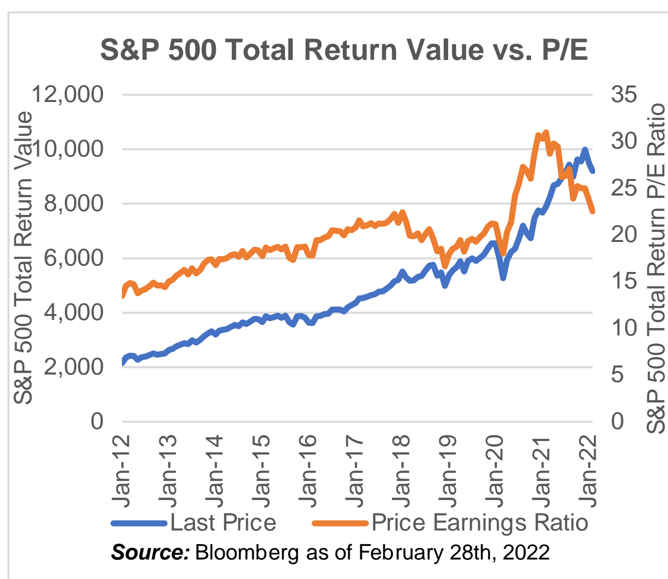
Annual inflation in the US as measured by the Consumer Price Index (CPI) rose to 7.9% during the month of February, up from 7.5% in January. This marks the highest rate of inflation since January of 1982.[4] Digging deeper, the energy component of February's CPI reading climbed by 25.6% over the trailing 12-months.[5] Importantly, this datapoint was prior to the full impact of the conflict being reflected in the number. During the same

period, gasoline prices have climbed by 38.0% with the average cost of a gallon exceeding $4.31 nationally according to AAA.[6, 7] The concern here is that continued price increases will likely act as a headwind to economic activity moving forward.

In terms of monetary policy, the "fog of war" may have clouded the Fed's ability to move aggressively against rising inflation. Prior to the conflict, there were several estimates that the Fed would move to raise interest rates by 0.5% at the upcoming March meeting, followed by as many as seven 0.25% rate hikes by the end of the year.[8] In anticipation of these rate increases, US interest rates began moving markedly higher with the US 10-Year Treasury Bond trading above 2.0%.[9] However, during his recent testimony to Congress, Fed Chairman Powell indicated that interest rates would likely rise by 0.25% at the March meeting with additional hikes to follow.[10] During the discussion, Powell also acknowledged that inflation remained well above the Fed's 2.0% average target.[11] From our perspective, the Fed is in a real quandary as to what comes next. Without aggressive action, inflation in the US will likely remain well above the Fed's stated target. However, with the economy slowing and additional potential shocks likely hitting the system due to the conflict in the Ukraine, the Fed runs the risk of tipping the US economy into recession if the pace of rate hikes is too fast. Given this tenuous uncertainty, it is likely that any action taken by the Fed could result in a bad outcome.

EQUITIES

Given the uncertainty surrounding the crisis in Ukraine and the subsequent spike higher in volatility, it should come as no surprise that stocks, outside of the energy section, were broadly lower in February. For the month, the bell-weather S&P 500 Index was down roughly -3.0%.[12] Year-to-date, the benchmark is now down nearly -8.3%.[13] For the month of February, the Energy sector was the only positive performer, returning 7.1%.[14] Looking across market capitalizations, large cap stocks underperformed small and mid-cap stocks primarily due to the exposure of many of the large multi-national companies to foreign markets, particularly Europe. From a style perspective, growth-oriented stocks continued to underperform value-oriented companies during the month across all market capitalizations primarily due to rising interest rates which act as a headwind to growth stocks.[15]



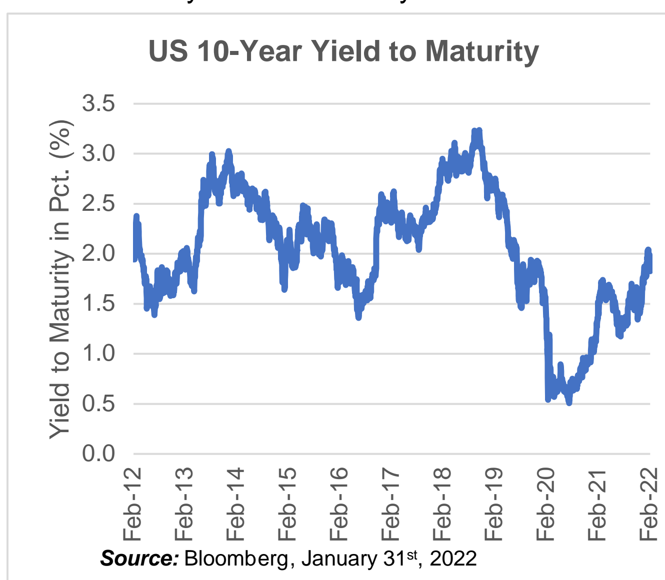
Source: Bloomberg as of February 28th, 2022

As expected, international developed and emerging equity markets declined with the MSCI EAFE Index falling roughly -1.8%, while the MSCI Emerging Markets Index declining by roughly

-3.0%.[16] Near-term economic growth in Europe will likely be challenged given the current geopolitical climate. Importantly, the rash of sanctions imposed on Russian energy imports will likely result in significantly higher food and energy prices, which could also result in higher inflation over the near-term. Moving forward, the concern will be whether economic growth will return or if Europe will succumb to a stagflationary environment. In emerging markets, the big news was related to Russia's removal from the MSCI Emerging Markets benchmark.[17] Prior to the removal from the index, Russia compromised roughly 1.6% of the index.[18] Moving forward, emerging markets could potentially perform well given many of these countries are commodities exporters and, as a result of rising prices, should benefit relative to developed market countries.

FIXED INCOME

While stock market volatility grabbed the headlines, bonds also declined in February as interest rates rose. During the month, the benchmark US Treasury 10-Year Bond yield closed at 1.83%, up roughly 6 basis points for the month, but off the high of 2.04%.[19] The US Treasury yield curve continued to flatten during the month as short-term rates increased faster than long-term rates. The rise in US interest rates was likely in anticipation of the Fed beginning the process of raising interest rates. While not yet inverted, the narrowing of the spread between the Treasury 2-Year and 10-Year bond yield, down to 37 basis points from 62 basis points in January, is a sign that investors believe that economic growth is slowing, and a recession could occur.[20]



Source: Bloomberg, January 31st, 2022

Performance across most sectors and geographies was broadly negative during the month. The higher quality Bloomberg US Aggregate Bond Index fell by roughly -1.1% in February.[21] Performance of investment grade corporate bonds and lower quality high yield bonds were down roughly -2.0% and -1.0%, respectively.[22] Despite the increase in market volatility, corporate investment grade credit spreads moved wider by only 20 basis points.[23] High yield bonds outperformed investment grade bonds primarily due to their overall shorter duration profile as rising interest rates acted as a headwind to performance. Finally, the number of corporate defaults has remained near recent lows. That said, we are watching closely for signs that, because of rising inflation, corporate gross margins will be negatively impacted, making it harder for companies to service their debt. In addition, certain asset-backed sectors like credit cards, auto loans and mortgages could also see rising delinquencies as consumers' wages fail to keep pace with rising prices.

APPENDIX

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21. Morningstar, February 28th, 2022
22. Bloomberg, February 28th, 2022
23. Bloomberg, February 28th, 2022

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