

The Global Financial Market Ecosystem

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The equity market has faced bouts of volatility since the year began, and the sell-off over the last several days has brought the S&P 500 back into correction territory (down ~10% from the January 3 record high). For US investors, it may be difficult to understand why equities have struggled given the resiliency of the US economy (e.g., Leading Economic Indicators index at a peak level, strong job creation, unprecedented savings) and with 1Q22 earnings season off to a strong start. However, given the integration and globalization of world economies and markets, investors cannot ignore what is going on beyond our borders—because that is what is having an overriding impact on our markets. Below we discuss how international dynamics are weighing on our markets.

1) Russia-Ukraine Crisis Continues As Peace Talks Collapse

The Russia-Ukraine conflict is extending into the third month. As we have noted, the longer the conflict lasts, the worse the potential negative impact could be for the global economy and financial markets. For instance, Russia contributes 40% of the world's palladium supply, 17% of natural gas, and 11% of oil – it is no wonder the prices for these commodities have skyrocketed. If the European Union formalizes an embargo of Russian oil, that will only further pressure oil prices in that region. And, higher commodity prices may further cramp economic growth as the German central bank (Bundesbank) warns that a Russian gas embargo would cost Germany 5% in lost output this year. As a result, this conflict has and will continue to worsen the inflation outlook and dampen global growth—both negatives for the equity market.

Could the potential conflict end on Russia's 77th Victory Day on May 9? It is possible, but it will ultimately depend on the trajectory of the war. While Russia has ramped up its attacks, Ukraine, with the help of the West, continues to fight back. The unwillingness of Ukraine to give up any land to Russia will prolong the conflict. The only thing predictable about President Putin's path has been unpredictability, therefore the financial markets may be weighing the odds of Victory Day being an off-ramp for the conflict, or a day of escalation.

2) China's COVID Contagion

One of the major headwinds to the Chinese market has been the upward trend in COVID-19 cases, knowing that the zero-tolerance policies would soon follow. As expected, the lockdowns across China are increasing, particularly in some of its largest cities – such as Shenzhen and Shanghai. Part of the problem has been the seeming ineffectiveness of Chinese vaccines. With no improvement in Shanghai's case trajectory, the government has imposed even stricter lockdowns for its residents. In fact, Chinese officials suggest that only ~30% of the workforce is eligible to return to work. Even though Shanghai only accounts for 3.8% of China's GDP, it is home to the world's busiest port and third-busiest cargo airport.

Chinese authorities do not seem willing to deviate from their zero-COVID policy, going so far as to install metal barriers around cities to close off streets as it enters its fourth week of reinstated lockdowns. In fact, vehicle freight flows in Shanghai have already declined over 80% this month! The city has over 500 vessels (~20% of all vessels globally) waiting outside its port. These vessels now account for ~28% of the global economy's stagnant ships – a figure that has doubled since the COVID outbreak began in February. Therefore, the cost of shipping a container, which is already five times the pre-pandemic rate, is likely to remain elevated for longer. Until the supply chain tangles stemming from China are resolved, the global economy's inflation outlook can only improve so much.

3) Central Bank Conundrums

It is well known that central banks around the world are attempting to fight inflation by raising interest rates. The problem is that raising rates does not end the drivers of these inflationary pressures—supply chain disruptions, war and pandemics. As a result, raising interest rates too fast, too far could inadvertently slow economic growth and potentially cause a recession. While the US economy is likely able to absorb several interest rate hikes this year (because of its healthy economic growth backdrop), other parts of the

world are less fortunate. In particular, there has also been a sea change in sentiment from the European Central Bank, where the market is now anticipating that policymakers will raise rates above zero for the first time since 2012, regardless of growth concerns. Rising concerns of a recession in Europe and its potential impact on US corporate earnings is weighing on US equities.

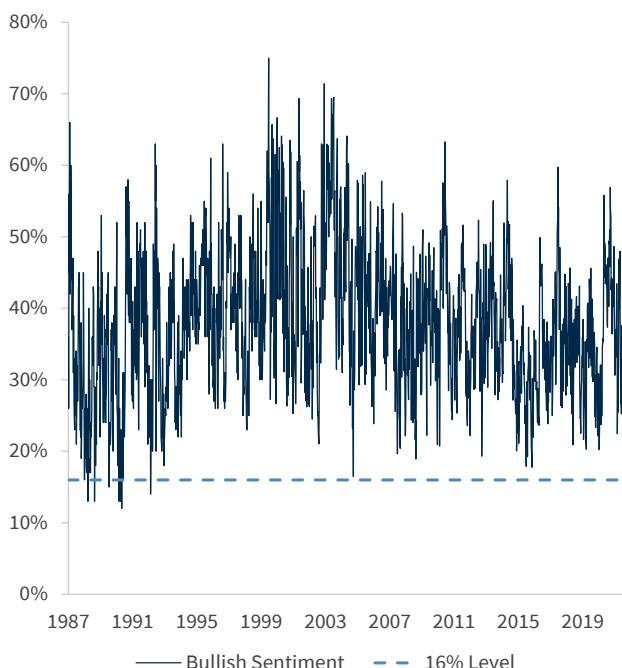
Bottom Line | This Environment May Be A Buying Opportunity

The uncertainty surrounding these three developments will continue to induce elevated volatility, but at this point, much of this negativity has been priced into the market. With our expectation that the equity market will remain range bound in the near term (between 4,200 and 4,600) before moving higher by year end (S&P 500 2022 year-end target: 4,725), we would opportunistically use weakness at the lower end of the range as a buying opportunity.

We remain constructive on the equity market for several reasons:

- **Overly Pessimistic Sentiment** — The percentage of bullish investors in the latest AAI Investor Intelligence survey recently declined to the lowest level since 1992, suggesting that much of the bad news has been priced into the market. Depressed bullish levels (levels below 20%) have historically been a contrarian indicator, as the market has been up 17% in the following 12 months on average.

Bullish Investors Decline to 1992 Lows



Source: FactSet 4/25/2022

- **Forward Looking Lens** — We are not sure exactly when we will have peak inflation, peak hawkishness by the Federal Reserve (Fed), or peak long-term rates, but believe we are close to these peaks now which means by year end they could be a distant memory. By the way, when looking at the NY Fed's global supply chain index, we are seeing peak supply chain disruptions (regardless of recent China lockdowns) easing. A further easing in supply chain issues should lead to a moderation in inflation. We will get an update on inflation later this week, as PCE (the Fed's preferred inflation measure) for March will be released on Friday. It is worth noting that it is expected that core inflation rose on a MoM basis at the slowest pace (+0.3% MoM) in six months and is expected to moderate on a YoY basis (from +5.4% to +5.3%) for the first time since February 2021.

- **Healthy Corporate Earnings Growth** — Admittedly, there have been a few high profile companies that have disappointed with their earnings. But they have one thing in common—they were all beneficiaries of the stay-at-home dynamic during the pandemic. More important, 1Q22 earnings have been very solid with strong revenue growth, strong beats, and favorable forward guidance. In fact, forward S&P 500 earnings for all of 2022 and 2023 have moved higher to \$228 (from \$226 at the start of the month) and \$250 (from \$248), respectively. This suggests that earnings should remain healthy going forward. The next two weeks will be important, as ~60% of the S&P 500 including many bellwethers are set to report. Positive reports by these companies will hopefully, at a minimum, stabilize the equity market or more likely, provide additional evidence that corporate America is resilient despite the ongoing aforementioned international dynamics.

- **Strong Corporate Activity** — With nearly record cash on corporate balance sheets (almost \$2 trillion), corporations continue to enact shareholder-friendly actions. Quarterly S&P 500 buybacks rose to a record high (\$259 billion) last quarter, and are likely to remain elevated as corporations announce buyback plans during this reporting season. Dividends also remain robust, as S&P 500 dividends are expected to rise 8% YoY for full-year 2022.

- **Limited Risk of Recession** — The recent inversion of the yield curve, combined with a more aggressive Federal Reserve tightening cycle has brought concerns regarding the prospect of a US recession. We view these concerns as overblown, as a healthy labor market, combined with elevated levels of consumer spending and corporate capital expenditures continue to support a healthy fundamental backdrop for the US economy. We expect the US economy to grow ~2% in 2022 with limited risk of recession over the next 12 months.

In the near term, volatility will likely remain elevated and equity market weakness may persist as investors grapple with the potential peaks in inflation, bearish sentiment, expectations for central banks, and geopolitical tensions. But based on our assumptions (e.g., limited risk of recession, supply chains easing, a flexible and agile Fed), much of the downside risk has already been priced into the market. Therefore, investors with a long-term approach may consider the current environment, particularly as we sit toward the bottom-end of the expected trading range, as a buying opportunity.

Scott Brown, Ph.D., Chief Economist, Investment Strategy

The Consumer Price Index rose 8.5% over the 12 months ending in March, the highest in 40 years, reflecting significant imbalances between supply and demand. Inflationary pressures remain elevated following Russia's invasion of Ukraine and the COVID-19 lockdowns in China. Federal Reserve (Fed) Chair Powell has continued to stress the importance of price stability, which the Fed defines as a long-term inflation rate of 2%. The central bank cannot do much about supply, but it can tighten credit to dampen demand. Powell has admitted that, knowing what it knows now, the Fed should have been raising short-term interest rates earlier – and with a neutral federal funds rate target of 2.25-2.50% (vs. the current 0.25-0.50%), the Fed has a long way to go. Looking ahead, Powell indicated that rate hikes should be front-loaded, meaning larger rate increases in the near term. The federal funds futures are pricing in 175 basis points in rate increases over the next three policy meetings (May 4, June 15, and July 26). Fed officials are confident that they can achieve a soft landing, slowing growth to a more sustainable pace with low inflation and a strong job market.

Michael Gibbs, Managing Director of Equity Portfolio & Technical Strategy

Equities remain under pressure as investors digest the reality of what will likely be a much more aggressive Federal Reserve effort to combat current inflationary pressures than believed just a few months ago. The consensus expects a 50 basis point rate hike at the upcoming four FOMC meetings, with an outside possibility of a 75 basis point hike at the May 3-4 meeting. Early in the tightening cycle, such as now, is historically the most volatile time for equities. And, with inflation at levels not seen in decades, there are risks that inflation will force policymakers to accept a recession as they attempt to cool the economy to bring inflation under control. Therefore, the weakness is no surprise.

Price action last week reflects the uncertainty as, after a meek attempt to rally from oversold levels, the S&P 500 rolled over and ended the week 2.75% lower. We expect the index to test or slightly undercut the March low at 4,157 in the days or weeks ahead as investors continue to weigh the path ahead.

Despite the understanding that equities are vulnerable in the coming weeks and months, we continue to feel equities will post gains over the next 12 months. That position is due to our expectation of above-trend earnings growth and a belief in easing inflationary pressures due to improving labor participation gain, improvement in the supply chain, and easy comparisons versus the elevated readings over the past 12 months. Additionally, at our forecast of \$225 for S&P 500 earnings, profits will be 41% above the year-end 2019 earnings of ~\$159 versus the S&P 500 price at just 24% above the pre-pandemic peak. If inflation does begin to trend in the right direction, investors will once again focus on profits, and valuation can adjust modestly higher. With this in mind, as equities continue in their choppy trend, we would look to accumulate favored stocks on the downdrafts. The risk to our positive outlook over the next 12 months will be if inflation proves more sticky, forcing the Fed to induce economic contraction. Until additional data transpires, such an outcome is not entirely out of the question.

Tracey Manzi, CFA Senior Investment Strategist, Investment Strategy

Bond market sentiment has been universally bearish, driven by the hawkish shifts from the global Central Banks amid rising inflation pressures. Expectations for an accelerated pace of tightening have driven US and European bond yields to their highest levels since 2018 and 2015, respectively. While market performance has been dismal in the fixed income markets this year, the outright level of yields across the fixed income complex has improved significantly for fixed income investors. We think much of the front-loaded move in the global rates market is overdone and do not expect rates to move substantially higher from here given the current economic backdrop. With the inflation scare expected to recede in the coming months, 10-year Treasury yields should start to stabilize and grind lower as we head through the remainder of the year. Credit spreads have also started to widen again as the market contends with fund outflows, increased supply and concerns about a policy-led global economic slowdown. While the tug of war between the growth and inflation narrative is likely to weigh on credit spreads, we think US growth and corporate health remain solid, which should support the markets once Treasury rates stabilize.

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