Market Commentary - March 2022

“The Landslide Brought Me Down”

I took my love, I took it down
I climbed a mountain and I turned around
And I saw my reflection in the snow-covered hills
‘Till the landslide brought me down

“Landslide” – by Stevie Nicks & Fleetwood Mac
https://www.youtube.com/watch?v=eK2HAfb3rC0

February certainly felt like a landslide. After summiting market peaks at year-end (up 28% on S&P 500 for 2021), we’ve been buffeted again and again by a barrage of negative news culminating in last week’s Russian invasion of Ukraine. We started the year battling the fast spreading Omicron variant of Covid, then soaring inflation and looming Fed tightening, and now the geopolitical black swan of a ground war in Europe. To quote another famous Russian Vladimir, ***“There are decades where nothing happens; and there are weeks where decades happen.***” – Vladimir Lenin.

Amid all this uncertainty, the S&P 500 has slid into correction territory down about 12% year-to-date, while the tech heavy Nasdaq Composite has flirted with bear market territory down about 20% ytd. Even safe longer-dated Treasuries are down nearly 8%.

In this environment it is totally normal to be a little fearful, totally normal to question your investments and your asset allocation. Fear is a natural reaction to loss and uncertainty, but what is most important is how we react to fear.

When we think of reactions to fear we usually think of Fight or Flight. We can either face the threat head-on and fight, or we can choose to run and live to fight another day. These are the general reactions to an immediate threat, but for a longer-term more abstract threat there is a third choice – don't think about it. Fear is a negative emotion so we seek to avoid it. Humans are extremely good at avoidance, if a risk is out in the future we can refuse to think about it or even convince ourselves that it isn't real.

When it comes to investment portfolios, fear (both near-term and long-term threats) need to be managed. By managed I mean we have to have a portfolio designed to survive these threats as well as surviving our emotions. The "flight" emotion, sell and run away, has never been an appropriate strategy, because even in the rare instance where you might be right the odds of you getting back in to participate in the eventual upside is minute. The "fight" emotion may prove successful, but the risks of making errors during volatile times greatly increases.

True investors need to look at fear differently, instead of avoiding threats we need to recognize that they are simply a cost of playing the game and therefore we need to learn to live with them. We need to manage our emotions and take advantage of increased volatility when it presents opportunities.

The table below shows how the stock market reacts around major geopolitical shocks. What jumps out at me is that since markets tend to be forward looking they have generally sold-off prior to the event and then gone higher after the event. So far our current "shock" has followed historic precedent.

S&P 500 Historical Performance Around Major Geopolitical Shocks

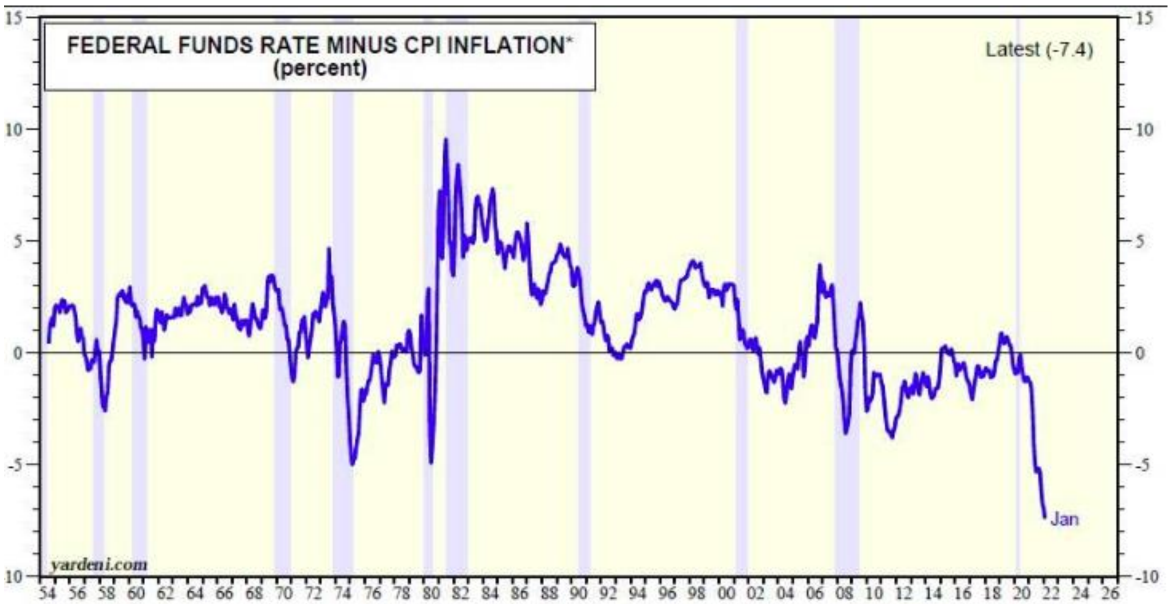
6 mos prior	3 mos prior	Date	Select geopolitical/military events	1 month later	3 mos later	6 mos later	12 mos later
-10.3%	**-14.5%**	**12/7/1941**	**Pearl Harbor**	**-3.4%**	**-12.7%**	**-9.1%**	**0.4%**
-3.8%	**-5.2%**	**10/31/1956**	**Suez Canal**	**-2.8%**	**-3.8%**	**-0.1%**	**-11.5%**
-17.5%	**-1.4%**	**10/20/1962**	**Cuban Missile Crisis**	**8.7%**	**17.7%**	**25.1%**	**32.0%**
-0.5%	**3.8%**	**10/17/1973**	**Arab Oil Embargo**	**-7.0%**	**-13.2%**	**-14.4%**	**-36.2%**
4.0%	**-3.5%**	**11/3/1979**	**Iranian Hostage Crisis**	**4.2%**	**11.6%**	**3.8%**	**24.3%**
6.0%	**-0.7%**	**12/25/1979**	**U.S.S.R in Afghanistan**	**5.6%**	**-7.9%**	**6.9%**	**25.7%**
0.1%	**-5.6%**	**8/3/1990**	**Iraq Invades Kuwait**	**-8.2%**	**-13.5%**	**-2.1%**	**10.1%**
-9.6%	**6.0%**	**1/17/1991**	**Gulf War**	**15.2%**	**23.5%**	**20.6%**	**33.1%**
7.5%	**3.0%**	**8/17/1991**	**Gorbachev Coup**	**0.0%**	**3.0%**	**7.0%**	**8.9%**
5.7%	**4.5%**	**2/26/1993**	**World Trade Center Bombing**	**1.2%**	**2.5%**	**4.0%**	**6.4%**
-11.9%	**-15.7%**	**9/11/2001**	**9/11 Attack**	**-0.2%**	**2.5%**	**6.7%**	**-18.4%**
-2.4%	**-5.8%**	**3/20/2003**	**Iraq War**	**2.2%**	**15.6%**	**17.4%**	**28.4%**
-2.7%	**-2.9%**		**Average**	**1.3%**	**2.1%**	**5.5%**	**8.6%**
42%	**33%**		**% Positive**	**50%**	**58%**	**67%**	**75%**
-3.9%	**-6.3%**	**2/23/2022**	**Russia Invades Ukraine**				

The market has been under pressure for the last several months for a variety of reasons, but at least some of the recent sell-off is attributable to the Russian troop buildup around Ukraine. Now that the invasion has happened that's one less fear to worry about. Of course we don't know the outcome or long-term consequences of Putin's invasion, but temporarily at least we have a relief rally.

Hiding in Plain Sight

<u>The Real Bear Market Risk:</u>

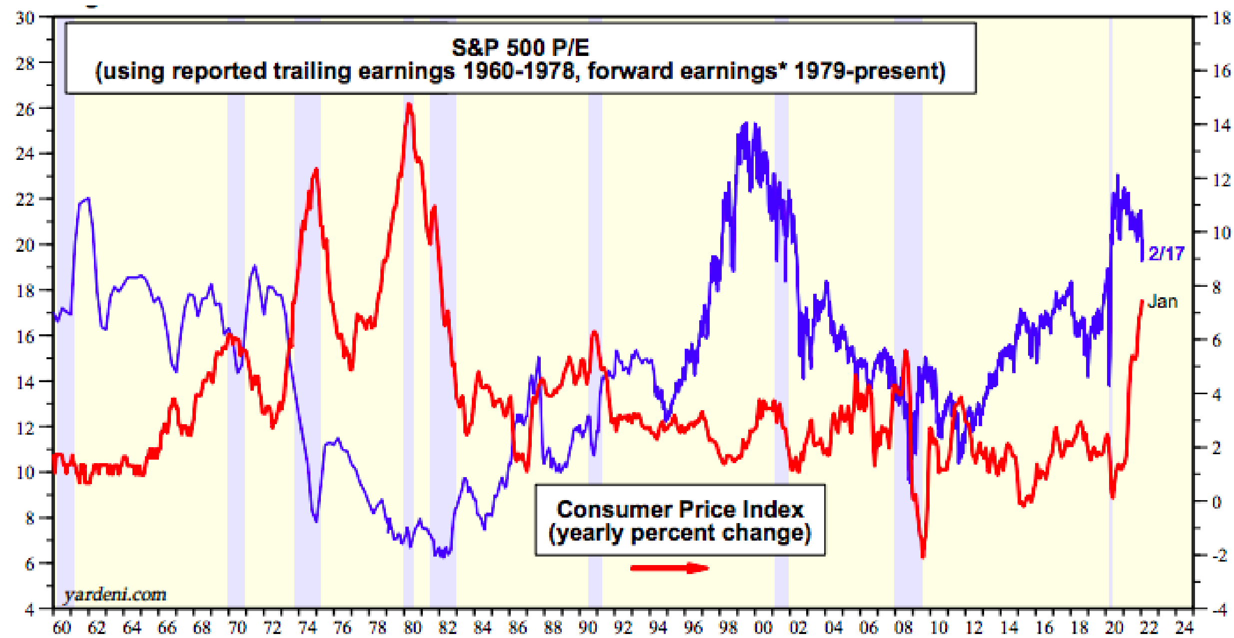
Other than the geopolitical shock of Russia invading Ukraine, the real threat to our markets is surging inflation causing the Fed to tighten and valuations of risk assets to reset.



* Yearly percent change in CPI.
Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: Board of Governors of the Federal Reserve System and Bureau of Labor Statistics.

As everyone is keenly aware inflation has been soaring with conservative estimates showing it running above 7%. High single digit inflation with a Fed Funds rate of 0.25%, and continuing quantitative easing in the form of Fed bond purchases, makes absolutely **zero** sense! The Fed finally recognizes this and has said that the bond purchases will end this month and that rates will start to rise. The question now is how big and how fast will the tightening be? Will it be enough to slow the economy and make inflation decline? Will they be able to navigate this tightening without sending the economy into a recession?

No one really knows how this will play out. The market has been readjusting/resetting valuations lower. We've seen the forward P/E ratio on the S&P 500 decline from about 23x to a current 19.5x (Earnings have risen and Prices have fallen). The last time inflation was this high (1981) we were in the throes of a brutal recession, interest rates were in the high teens and the P/E ratio plummeted to 7x.



* Time-weighted average of consensus estimates of S&P 500 operating earnings per share for current year and next year. Monthly from January 1979 through April 1994, then weekly.
Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: I/B/E/S data by Refinitiv and Standard & Poor's.

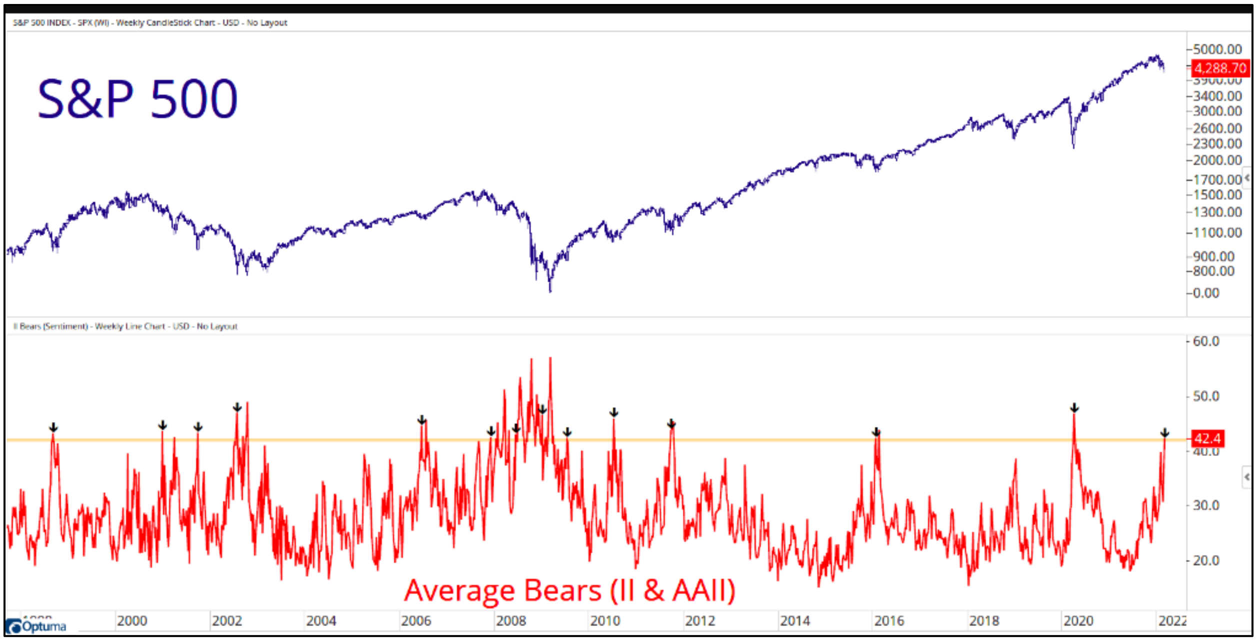
The current 2022 earnings estimate for the S&P 500 is $225 (up 7% from 2021's $210), with the S&P trading at 4,384 that equates to a P/E ratio of 19.5x. The table below shows what type of return you can expect in the S&P 500 under various P/E valuation and earnings scenarios:

S&P 500 Estimated Return Scenarios

		Estimated Forward Earnings S&P 500								
		$ 200	$ 210	$ 215	$ 220	$ 225	$ 230	$ 240	$ 250	$ 260
Estimated P/E Ratio	13	-41%	-38%	-36%	-35%	-33%	-32%	-29%	-26%	-23%
	14	-36%	-33%	-31%	-30%	-28%	-27%	-23%	-20%	-17%
	15	-32%	-28%	-26%	-25%	-23%	-21%	-18%	-15%	-11%
	16	-27%	-23%	-22%	-20%	-18%	-16%	-12%	-9%	-5%
	17	-23%	-19%	-17%	-15%	-13%	-11%	-7%	-3%	1%
	18	-18%	-14%	-12%	-10%	-8%	-6%	-2%	3%	7%
	19	-13%	-9%	-7%	-5%	-3%	0%	4%	8%	13%
	19.5	-11%	-7%	-4%	-2%	0%	2%	7%	11%	16%
	20	-9%	-4%	-2%	0%	3%	5%	9%	14%	19%
	21	-4%	1%	3%	5%	8%	10%	15%	20%	24%
	22	0%	5%	8%	10%	13%	15%	20%	25%	30%
	23	5%	10%	13%	15%	18%	21%	26%	31%	36%

So, if you believe earnings will be better than expected and P/E ratios are done contracting then we could experience a positive single digit return. If, however you believe that multiples may contract some more, or earnings may be weaker than expected, then returns will be negative.

While it may seem that we are under a landslide of negative news, the fact is that a lot of this negativity is probably priced in. The chart below shows nearly record levels of bearishness, and generally this has been an attractive time to buy, not to sell.



Other positives include nearly record low unemployment, increased corporate capital expenditures, and still low borrowing costs. So while we are clearly in a time of uncertainty we are also going to see a lot of opportunities for long-term investing.

Remember what Ukrainian President Zelensky said when faced with the fight-or-flight choice, ***"The fight is here; I need ammunition, not a ride."***

Well, I've been afraid of changin'
'Cause I've built my life around you
But time makes you bolder
Even children get older
And I'm getting older too

Be careful out there,

Chris Wiles, CFA 365111

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