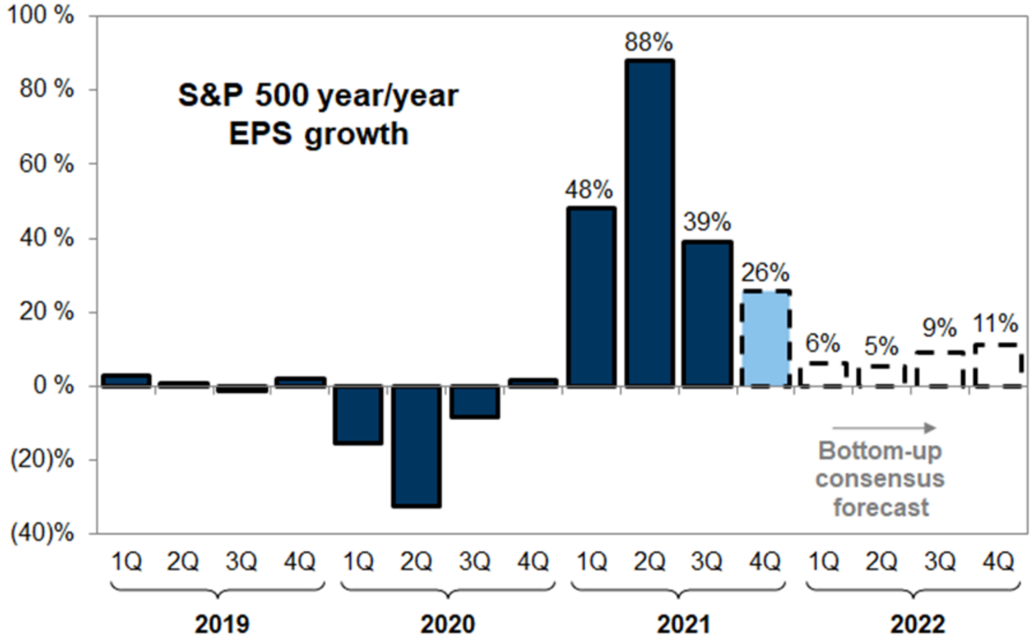
Week in Review

Friday, February 18th, 2022

1. Latest Earnings Season Metrics Overall Positive but Slower Growth Ahead

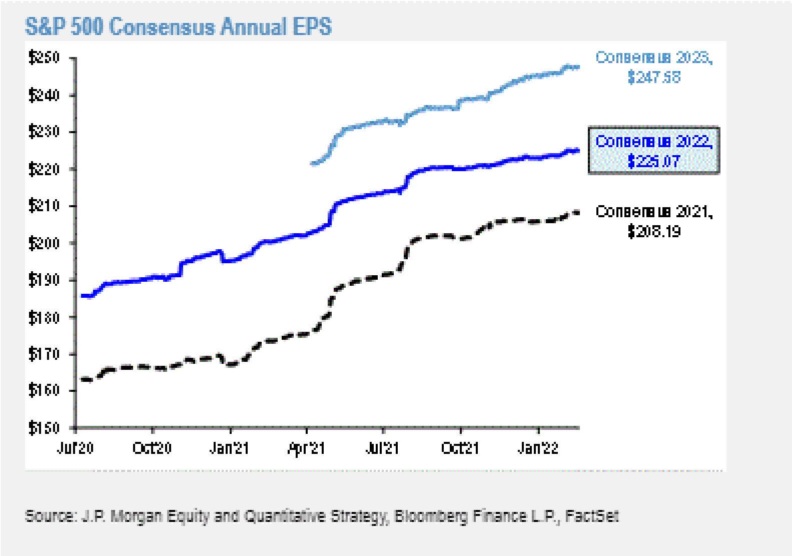
Earnings reporting season for the 4th quarter of 2021 has largely concluded and logs another quarter of strong earnings growth at 26%, which was above expectations for 20% growth.



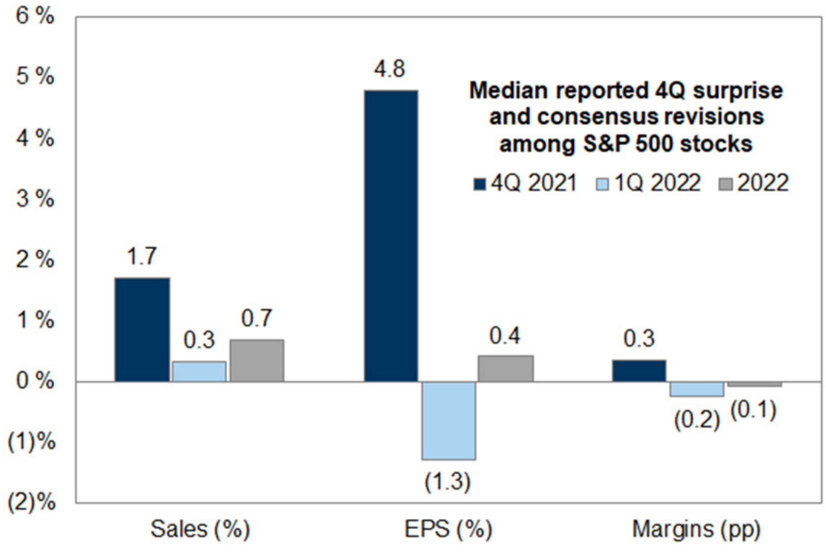
Source: FactSet, Goldman Sachs Global Investment Research

While beating forecasts for the latest quarter, earnings guidance for 2022 and the first half of the year, in particular, are seeing a significant deceleration to the mid to high single digit levels. The deceleration should be expected as the next few quarters will be lapping very tough growth comparisons in the first half of last year which were coincident with the rollout of vaccines and the reopening of the economy.

While decelerating growth rates can be concerning, the trend for S&P 500 earnings is still soundly positive, growing off a recovered post-pandemic base, and indicative of the ongoing strength in the economy.

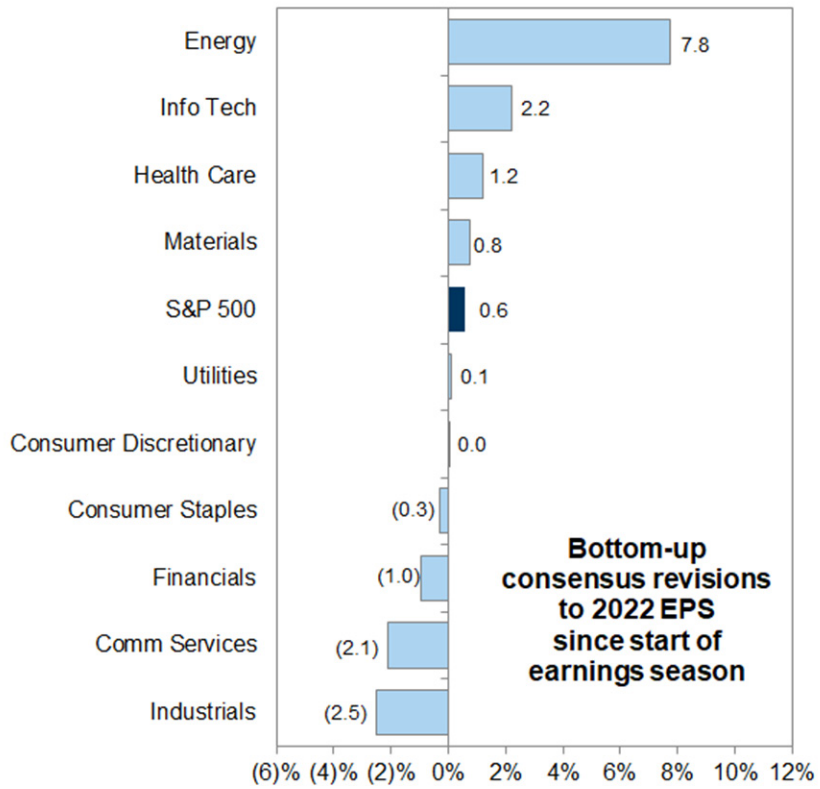


In comparison to the past year, the opportunity to surpass expectations on a forward-looking basis has been reigned in. Near term expectations for the current quarter have risen only slightly for sales but dropped slightly for earnings. The culprit is margins which are seeing pressure due to higher input costs and supply chain constraints. These headwinds are expected to lessen in the second half of the year leading to a slight increase in earnings expectations for the full year.



Source: FactSet, Goldman Sachs Global Investment Research

Drilling down further, earnings revisions for 2022 are varying by industry with the strongest revisions within the energy sector and the weakest revisions within the industrials sector.



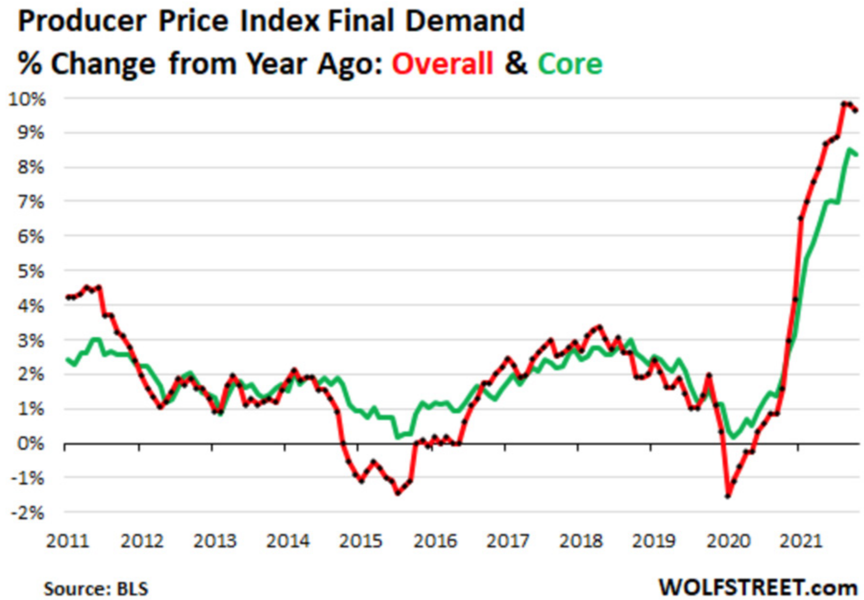
Source: FactSet, Goldman Sachs Global Investment Research

Energy revisions being driven by higher oil prices associated with the current tight inventory levels and concerns about disruption to supplies from a Russian-Ukranian conflict. Industrials on the otherhand are seeing the brunt of on-going supply chain disruption and inflationary pressures.

The overall picture coming out of earnings season is one of continued growth off a more normalized base level of sales and earnings. At this juncture, expectations remain positive for the economy which should be supportive of equities.

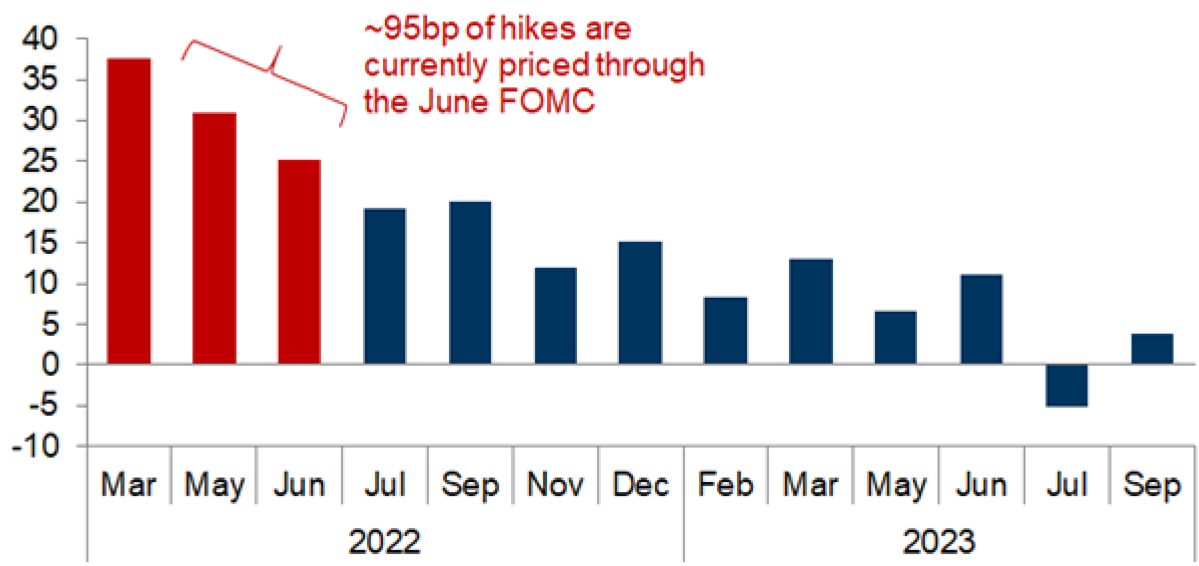
2. Data continues to support Fed Rate Hikes

The latest data released this week indicating the high level of current inflation was the Producer Price Index (PPI). Compared to January last year, the PPI jumped by 9.8%. Excluding food and energy prices the Core PPI was also high at 8.4% growth over a year ago indicating a broad base of price increases for many inputs.



The data supports an expectation for the Federal Reserve to initiate multiple rate hikes over the next year with the potential to front end load the increases to catch up with the current high levels of inflation.

Incremental Fed hikes priced, by Fed meeting



Market pricing as of February 16, 2022.

Source: Goldman Sachs GIR.

The impact on the market in the near term has been a decline in valuation multiples, particularly for longer duration assets which has negatively impacted returns for both equities and fixed income. The front end loaded rate increase expectations have likely added to the pressure.

On the bright side, equity markets have generally seen most of the valuation adjustments prior to rate increases. Historically this has allowed equities to post positive returns in the months after an increase commences if the economy and earnings are stable and growing. This tends not to be the case for fixed income instruments, which do not have the ability to adjust coupons upward.

3. Russian-Ukraine Conflict Heightens Market Volatility

Hopes for a diplomatic end to the Ukraine stand-off appear to be fading. The impact on the markets has been a movement to perceived safe-haven investments. The primary concerns being the potential for an exacerbation of inflation and potentially lower global growth.

While risks exist, history would also suggest that previous conflicts have more often seen bad news priced into markets prior to conflicts and a subsequent recovery. This does not take away from the human impact and suffering that come with conflicts. Also, longer term implications may exist in terms of changing landscape for global trade and relationships.

Thinking Ahead

The markets continued to be pressured this week as several factors including future economic growth, inflation, pace of rate hikes, and the Russian-Ukraine conflict impact sentiment. Stepping back, corporate earnings and forecasts suggest the ability of businesses to adapt to the changing landscape. Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.