

WEEK IN REVIEW

FRIDAY, FEBRUARY 25TH, 2022

1. RUSSIA'S ATTACK OF UKRAINE FUELS MARKET VOLATILITY

Russia's attack on Ukraine is fueling market volatility and higher commodity prices. The CBOE Volatility Index captures the market expectations for volatility over the coming 30 days and elevated readings reflect increased levels of risk, fear, and stress in the market. While the index had been increasing with the growing concerns of the Ukraine conflict, the index spiked on the actual invasion.

CBOE Volatility Index



Source: Yahoo Finance

The economic impact of the invasion is linked primarily to sanctions which are expected to have the greatest impact on commodity prices. Notably, Russia supplies 37% of the energy used in Western Europe and disruption of this supply is pushing up global prices. Rising energy costs are feeding through to the potential for higher inflation concerns as well as slower global growth.

Crude Oil Price



Source: Yahoo Finance

The spike in volatility and rising energy prices are a rational near-term response to the Ukraine invasion. To a degree, the markets had already anticipated this potential outcome with increases in both volatility and energy prices preceding the actual event. Volatility is likely to subside post the realization of the event, while oil price direction may still depend on evolving sanctions and alternative sources for supply. Short term, oil prices have seen a pull-back after bumping through \$100 as extending sanctions on oil were not initially draconian.

2. EQUITY MARKETS ARE IN CORRECTION MODE

Prior to the actual Russian invasion into Ukraine, the markets had already been in a correction defined as a greater than 10% pull back from the most recent market highs. The invasion itself initially further weighed on the market, although a recovery occurred later in the day.

However, market corrections, while uncomfortable, are not an uncommon event in the markets. In fact, a market correction on average happens approximately once a year. The markets have not seen a correction since February/ March 2020 at the beginning of the Covid pandemic suggesting we were perhaps due.

Correction in DJIA Back to 1896

DJIA After Closing in Correction Territory							
DJIA	One Week	Two Weeks	Three Weeks	One Month	Three Months	Six Months	One Year
Average	2.7%	2.7%	2.8%	3.3%	4.5%	5.2%	8.7%
Median	0.7%	0.6%	1.2%	1.0%	1.2%	4.0%	6.6%
% Positive	57.8%	56.3%	56.3%	57.8%	52.6%	58.5%	62.2%

Source: Dow Jones Market Data

DOW JONES MARKET DATA

Source: Marketwatch

Last 20 Corrections in the DJIA

DJIA After Closing in Correction Territory							
Entered Correction	One Week	Two Weeks	Three Weeks	One Month	Three Months	Six Months	One Year
10/15/1999	4.5%	7.1%	6.8%	7.4%	17.0%	2.9%	1.7%
2/11/2000	-2.0%	-5.4%	-0.6%	-4.8%	1.2%	5.8%	3.4%
10/12/2000	1.1%	3.4%	8.4%	5.7%	4.9%	0.9%	-6.9%
3/16/2001	-3.2%	0.6%	-0.3%	3.4%	8.1%	-2.2%	8.0%
7/10/2001	4.2%	0.6%	3.4%	2.4%	-9.2%	-1.1%	-13.4%
6/11/2002	2.0%	-4.1%	-5.4%	-7.5%	-9.8%	-9.8%	-3.5%
9/19/2002	0.7%	-2.8%	-5.1%	4.8%	5.3%	4.1%	21.4%
1/27/2003	1.5%	-0.9%	-1.0%	-1.3%	4.0%	16.2%	32.8%
11/26/2007	4.5%	7.7%	3.3%	6.3%	-0.5%	-2.1%	-31.5%
6/26/2008	-1.4%	-2.0%	-0.1%	-0.7%	-2.7%	-25.7%	-26.3%
10/24/2008	11.3%	6.7%	1.4%	0.8%	-3.6%	-3.6%	19.0%
11/12/2008	-3.4%	5.4%	3.7%	4.2%	-4.2%	2.3%	23.1%
1/20/2009	2.8%	1.6%	-0.8%	-7.3%	-1.4%	11.3%	33.4%
5/20/2010	1.9%	1.9%	1.0%	3.8%	1.4%	11.3%	24.3%
8/4/2011	-2.1%	-3.5%	-2.1%	-1.3%	5.3%	13.0%	15.0%
8/21/2015	1.1%	-2.2%	-0.2%	0.3%	8.3%	-0.4%	12.7%
1/15/2016	0.7%	3.0%	1.4%	-0.1%	11.9%	15.8%	24.4%
2/8/2018	5.6%	4.6%	3.1%	4.3%	2.1%	7.2%	5.2%
12/14/2018	-6.9%	-4.3%	-2.8%	-0.8%	6.7%	8.3%	16.7%
2/27/2020	1.4%	-17.7%	-22.0%	-16.0%	-0.8%	10.6%	20.0%

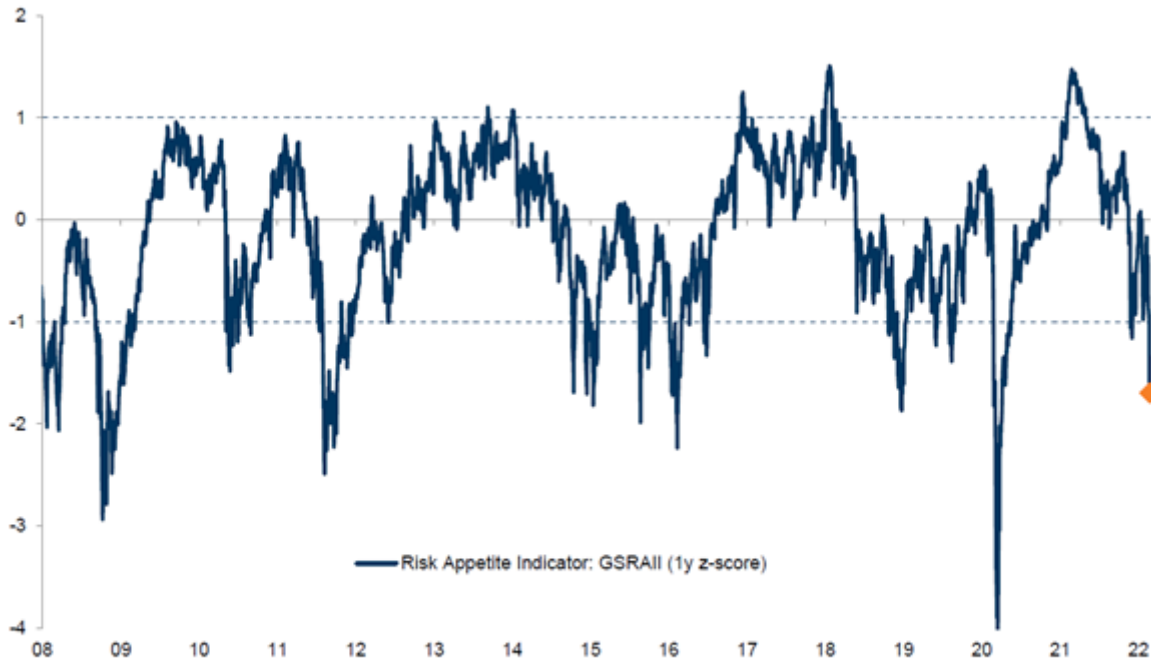
Source: Dow Jones Market Data

Source: Marketwatch

In certain instances, the recovery has taken longer than one year. Notably, this occurred during the dot.com bubble which rippled through the markets from late 2000 through 2002. The delay in recovery was principally caused by the preceding “irrational exuberance” as noted by Federal Chairman Alan Greenspan. Another instance was the unwinding of the financial crisis from 2007 through early 2009 as credit metrics became overextended and very risky. While speculation has existed during the past two years, the primary driver of stocks has been earnings recovery with many of the largest market constituents also generating strong free cash flow. In addition, credit metrics have been relatively conservative with few concerns about defaults. The current period does not appear to be as exposed to the same causes of the previously extended corrections of the recent past.

Another factor associated with historical corrections is the level of risk aversion. Goldman Sachs has tracked risk aversion over time via their Risk Appetite Indicator. The current indicator is currently notably negative at a level of -1.6.

RISK Appetite Indicator (GSRAll)



Source: Goldman Sachs Global Investment Research

Based on history, the current Risk Appetite Indicator level has seen markets turn positive two-thirds of the time within one month and 80% of the time within one year.

Risk Appetite Indicator

RAI below...	S&P 500 avg ret. In the next				Hit ratio in the next			
	1m	3m	6m	12m	1m	3m	6m	12m
-0.6	1.5%	3.6%	5.9%	9.9%	70%	75%	74%	77%
-0.8	1.5%	4.3%	7.0%	10.1%	69%	75%	74%	74%
-1.0	1.5%	4.6%	8.1%	11.1%	68%	75%	75%	74%
-1.2	1.6%	4.4%	8.9%	11.6%	67%	73%	75%	75%
-1.4	1.8%	4.8%	10.4%	15.0%	67%	72%	78%	80%
-1.6	2.0%	4.4%	11.3%	18.3%	66%	66%	77%	83%
-1.8	2.8%	4.7%	13.0%	23.7%	67%	62%	80%	89%
-2.0	4.1%	6.1%	14.1%	28.5%	68%	60%	74%	93%
Uncond.	0.8%	2.4%	4.7%	9.7%	64%	70%	75%	80%

Source: Bloomberg, Goldman Sachs Global Investment Research

Market corrections can be catalyzed by unique circumstances. The current correction is driven by inflation, tightening Fed policy, and global geopolitical events. The combination of these factors results in contracting valuation multiples and lower or at least uncertainty for corporate earnings growth outlooks broadly. History would suggest that markets demonstrate significant resiliency and profitable business with growth prospects are particularly rewarded over time.

3. U.S. FUNDAMENTALS REMAIN POSITIVE

Hidden by the headlines about Ukraine, US GDP was revised upward for the 4th quarter of 2021, and claims for unemployment continue to hit post-pandemic lows. GDP came in at 7% for the final quarter of 2021 as businesses restocked their inventories and private investment increased.

The latest unemployment claims fell to 230,000 for the week ended February 19. Continuing claims, the number of people already collecting jobless benefits, decreased to 1.476 million below the forecast for 1.583 million. This is the lowest level for insured unemployment since 1970.

In terms of GDP, economists are expecting a deceleration of growth in the first quarter, primarily due to lower expectations for inventory growth. Russia's invasion of Ukraine is also presenting a risk to growth as it has the potential to push inflation higher and weigh on consumer sentiment. On the positive side, the US economy is at least entering this period of uncertainty with strength.

THINKING AHEAD

The Russian invasion of Ukraine accelerated volatility and near-term pressure on the markets. The response is rational as factors such as the impact on inflation and global growth are reassessed. However, with the overall backdrop for the economy showing strength and further recovery from the pandemic expected, a significant negative economic shock is not expected. Based on history, the probability of recovery from market corrections is favorable given time. Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.

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