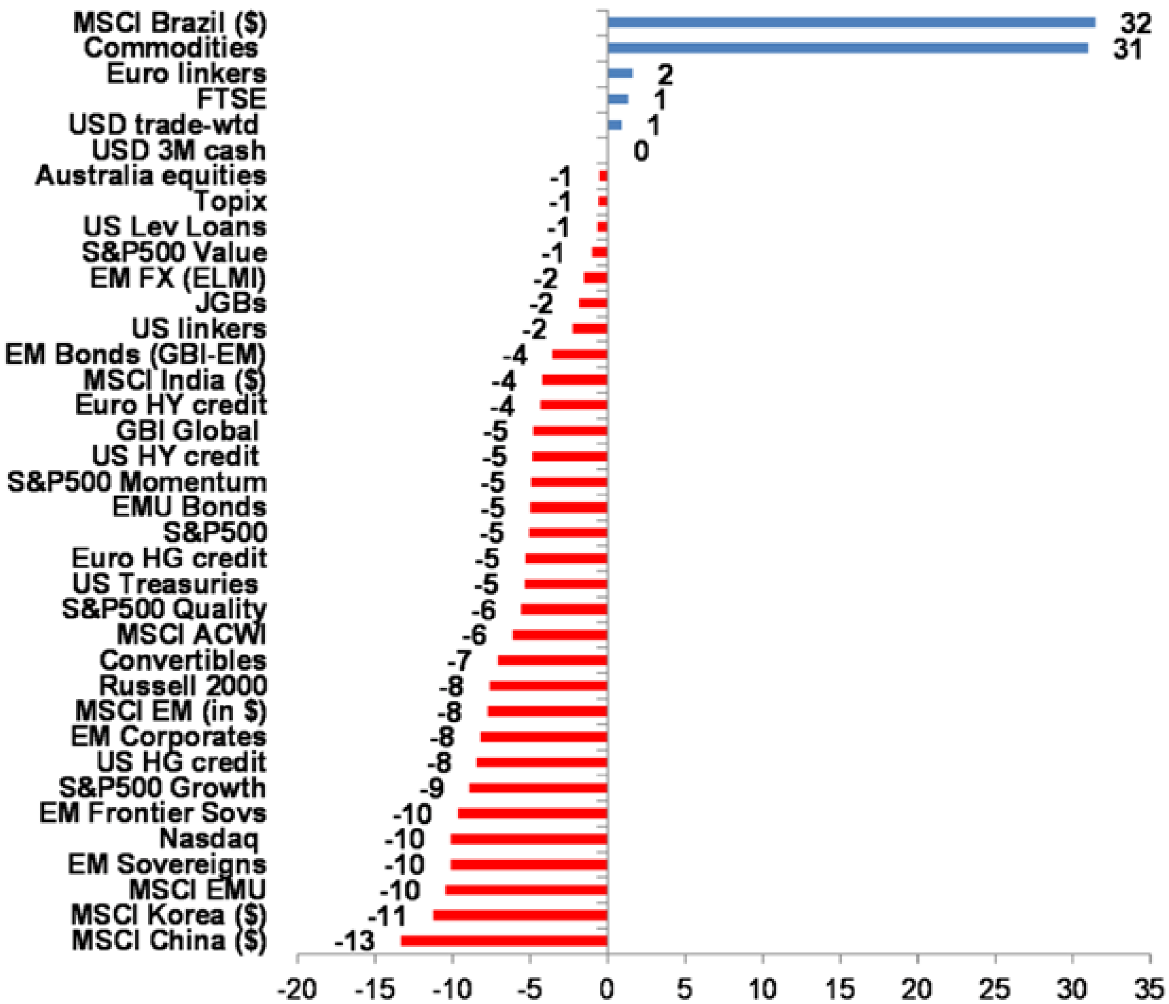
Week in Review

Friday, April 1st, 2022

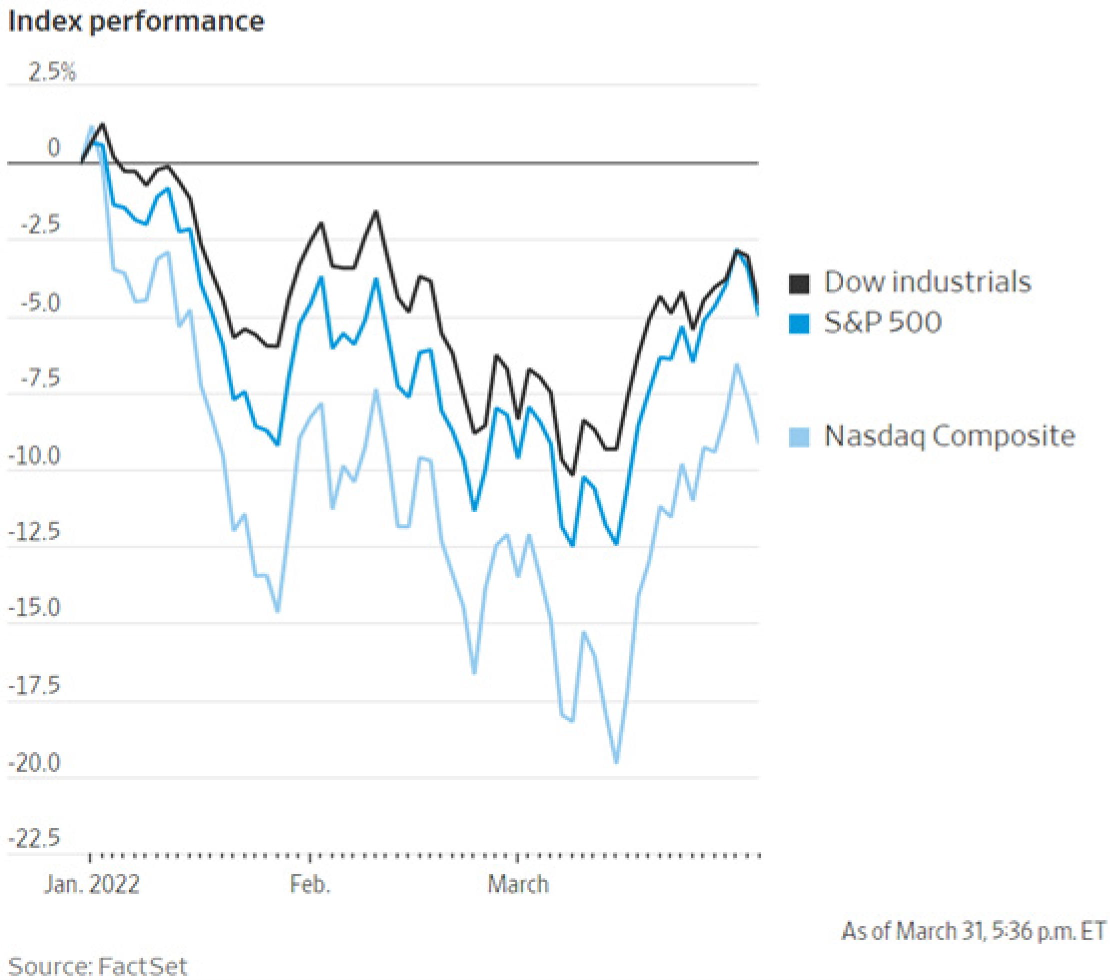
1. First Quarter Returns were Tough for Both Equities and Bonds

The first quarter of 2022 is now in the history books. War, inflation, and ongoing impacts from the global pandemic contributed to it being a historically difficult period for stock and bond investors. Across equity and fixed-income markets broadly, the least-bad performance among U.S. assets was a decline of 4.9% in the S&P 500 and high yield credit. They were followed by a 5.6% fall in Treasuries and a 7.8% slide in investment grade. Global markets, for the most part, faced even greater headwinds in the first quarter as Europe is seen as more negatively impacted by the Ukrainian War, and China continues to see changing government policy impacting their markets. The only major asset that is booming is commodities. From oil to copper to wheat, the prices of basic materials have surged as a supply crunch was exacerbated by Russia's invasion of Ukraine.

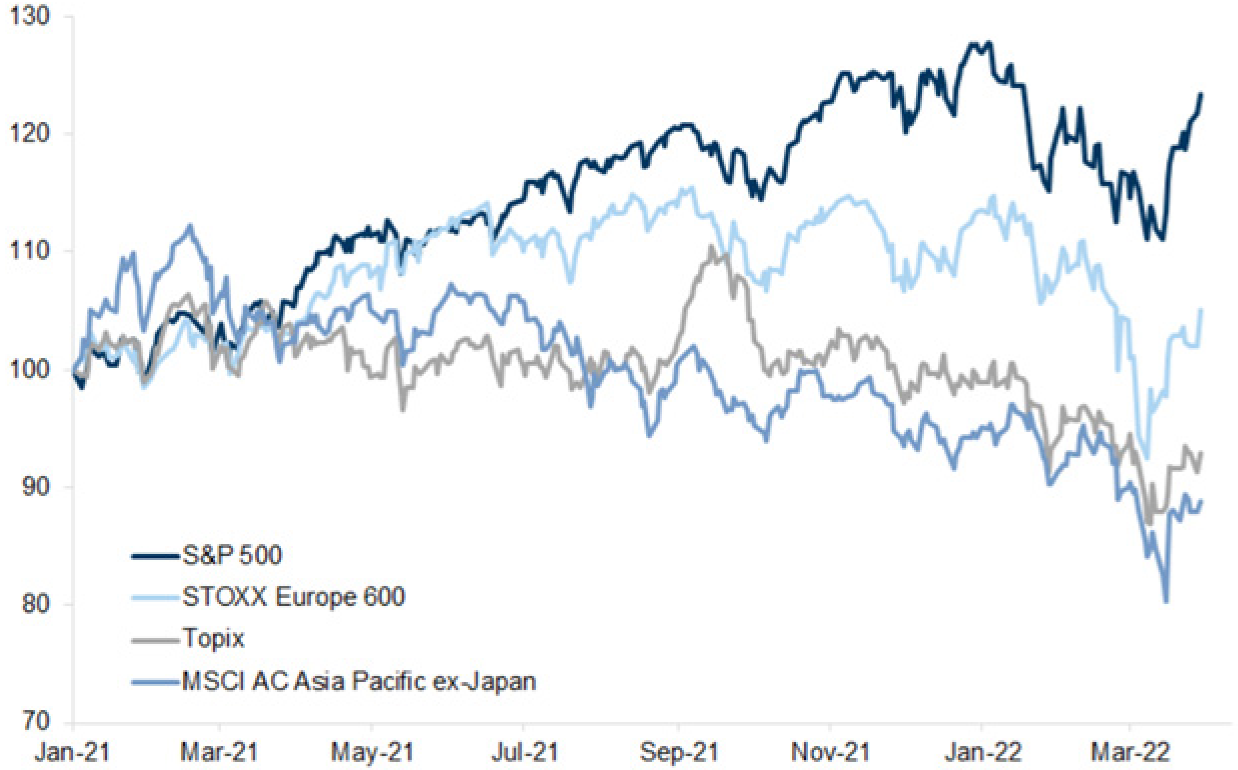


Source: J.P Morgan

In the U.S., underpinning the uncertainty that permeated the first quarter was the Federal Reserve's growing commitment to raise rates to combat high inflation. In terms of stocks, the impact was felt most significantly in more speculative segments of the market and among higher valuation stocks, perceived to be more sensitive to rising rates and the removal of stimulus of the past two years. The S&P 500 suffered a peak-to-trough slide of 13% at its worst, while the tech-heavy Nasdaq 100 and the Russell 2000 of small-caps each entered a bear-market decline of 20%. The market bounced back in the last two weeks as it digested the impact of the Ukrainian War and rate hikes amidst the ongoing underlying strength in the U.S. economy.



While delivering the first negative quarter of returns out of the past seven quarters, the U.S. equity markets have remained strong on an absolute and relative basis since the beginning of 2021.

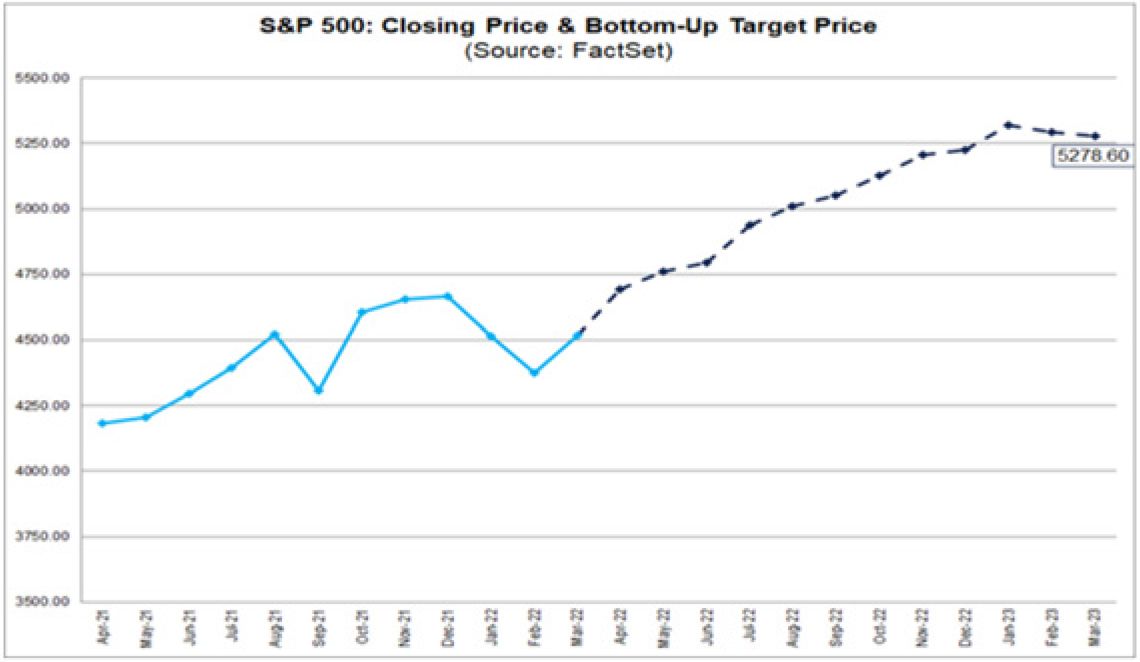


Source: Datastream, STOXX, Goldman Sachs Global Investment Research

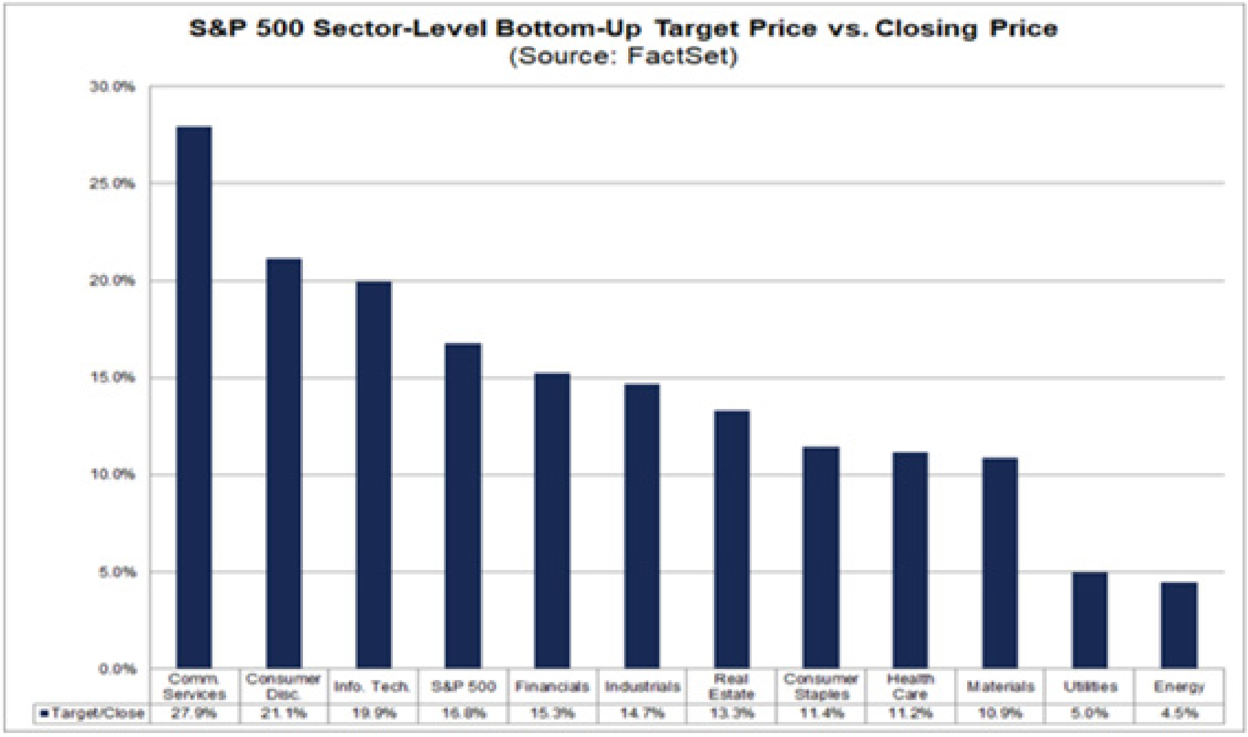
Company outlooks for the rest of 2022 and discussion of the recent drivers of growth and margins will likely be a key driver of U.S. markets in the coming months.

2. Bottom-Up Analysis is Still Optimistic About Longer-Term U.S. Equity Returns

Analysis by Factset suggests that equity analysts are positive on the prospects for the market based on forward-looking price targets for the companies comprising the S&P 500. Based on data from March 24, the bottom-up derived price target for the S&P 500 suggested a 16.8% increase over the next 12 months.

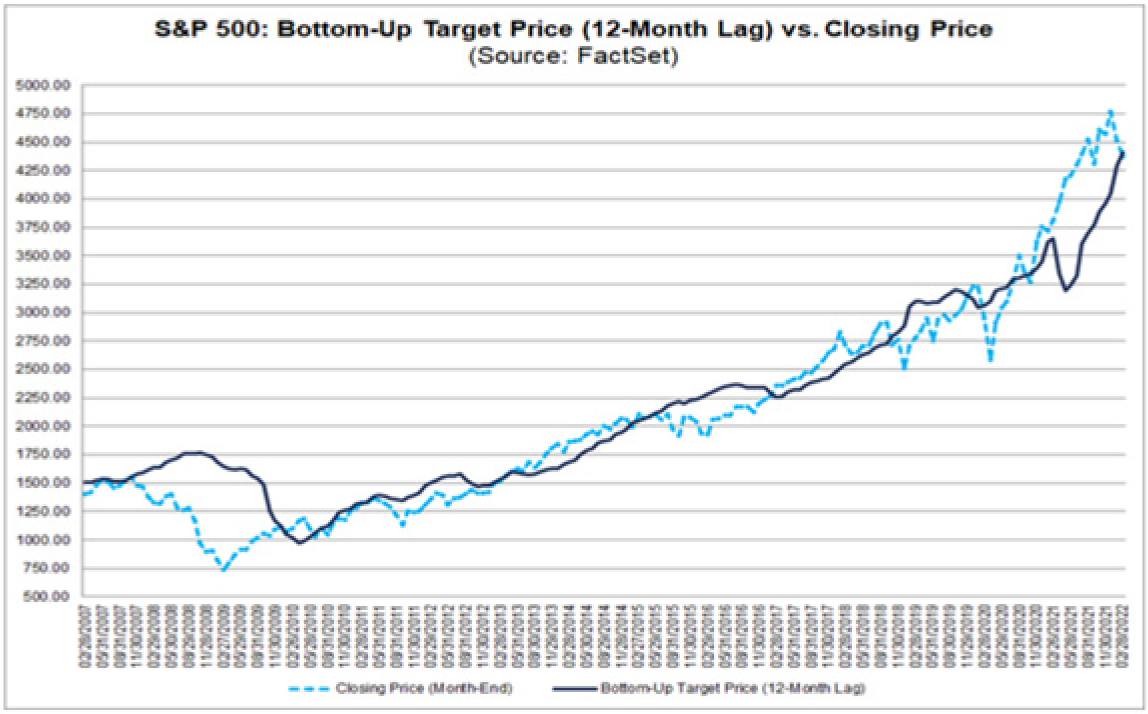


Of note, the bottom-up analysis suggests that the upside drivers of the market will be generated by a reversal in the relative performance year-to-date as underperforming sectors such as consumer discretionary, technology, and communication services would lead the markets higher, while the top-performing sectors year-to-date of energy and utilities would lag on a relative basis.



Source: Factset

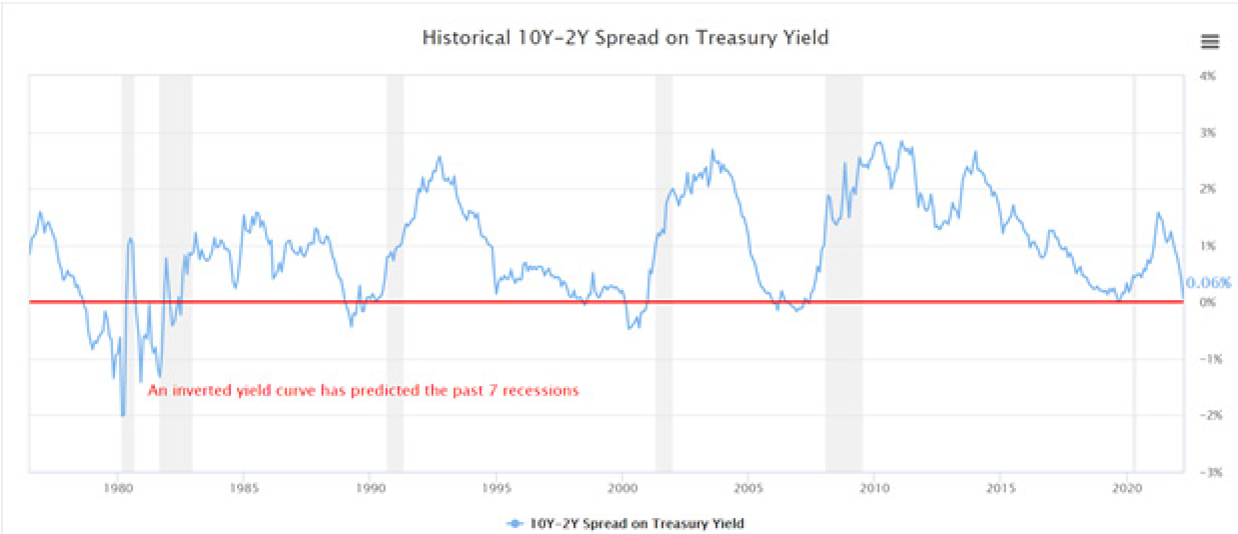
In terms of the predictive capability of this analysis, over the past 10 years, industry analysts have underestimated the price of the index by 0.1% on average. However, there have been periods when analysts have been too optimistic. Notably, this has occurred due to an unexpected major event, such as the financial crisis of 2008, that resulted in a major adjustment to corporate earnings expectations for the coming year.



At the current moment, markets are digesting war, inflation, and higher interest rates as well as the ongoing pandemic recovery. Despite all these issues, corporate earnings at an aggregate level have yet to be adjusted in a manner consistent with a historical shock that has meaningfully impacted forward market expectations.

3. The Yield Curve Inverts

The 2-year and 10-year Treasury yields inverted for the first time since 2019 on Thursday, sending a possible warning signal that a recession (2 quarters of consecutive negative GDP growth) could be on the horizon. This bond market phenomenon means the rate of the 2-year note is now higher than the 10-year note yield. The yield on the 10-year Treasury fell to 2.331%, while the yield on the 2-year Treasury was at 2.337% at one point in late trading Thursday.



Source: Gurufocus

While there has been a high correlation to a recession following such an inversion, stocks have historically performed quite well following the onset of the inversion and the actual realization of a recession. Since 1978, the S&P 500 was up an average of 1.6% a month after the inversions but was up an average of 13.3% a year later.

Another consideration is that an inversion has not typically seen a recession occur right away. For example, the yield curve inverted 422 days ahead of the 2001 recession, 571 days ahead of the 2007-to-2009 recession and 163 days before the 2020 recession – which was caused by Covid, unknown at the time of the inversion. The long-time lag suggests there needs to be corroborating evidence before investors need to fear a recession is around the corner. Some of those other signals could include a slowdown in hiring and a sudden increase in unemployment, or early warnings in ISM and other data that manufacturing activity could be slowing. The yield curve's inversion could also reverse should there be a resolution to the war in Ukraine or the Federal Reserve pauses in its rate-hiking cycle.

Some analysts do not believe the yield curve inversion is as reliable a recession predictor as it once was because the Federal Reserve has become such a big player in the market. The Fed's nearly $9 trillion balance sheet holds many Treasuries, and strategists believe it has suppressed interest rates at the long end, meaning the yields of the 10-year note and the 30-year bond should be higher. In fact, Richard Bernstein Associates notes that if the Fed had never engaged in quantitative easing, the 10-year yield could be closer to 3.7%. Were it not for the central bank's bond-buying program, the yield curve for the 2-year and the 10-year would then be more like 100 basis points apart, instead of inverted.

Goldman Sachs has done a multivariable model analysis of the probability of recession and concludes there is 0% probability in the near term and a 38% probability, thereafter.

	Current Probability of Recession within....			
	6m	12m	1y1y	2y
3m vs. 2y instantaneous forward rate	0%	0%	7%	7%
2y vs. 10y curve	12%	31%	27%	49%
3m vs. 10y curve	1%	1%	11%	12%
2y5y instantaneous forward curve	24%	64%	53%	83%
Excess bond premium	4%	10%	12%	21%
SPX 6m return	4%	12%	13%	24%
VIX	10%	18%	10%	26%
Combined model (see text for details)	0%	0%	38%	38%

While probabilities of a recession are rising, it is neither a foregone conclusion nor an indicator to panic about negative market returns. Given the current high levels of inflation, a mild recession might even be seen as a longer-term positive in resolving excesses and bottlenecks that have built up in the economy.

Thinking Ahead

The first quarter of 2022 saw a pullback in financial returns across both the equities and fixed income markets. While the underlying conditions that have contributed to the environment still exist, a shock to the economy has yet to manifest. This has resulted in a generally positive view of longer-term equity prospects, and perhaps less downward pressure on fixed income returns. The historical bond market indicator for slowing growth prospects, an inverted yield curve, has materialized, but in of itself does not represent an imminent threat to markets longer term.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.