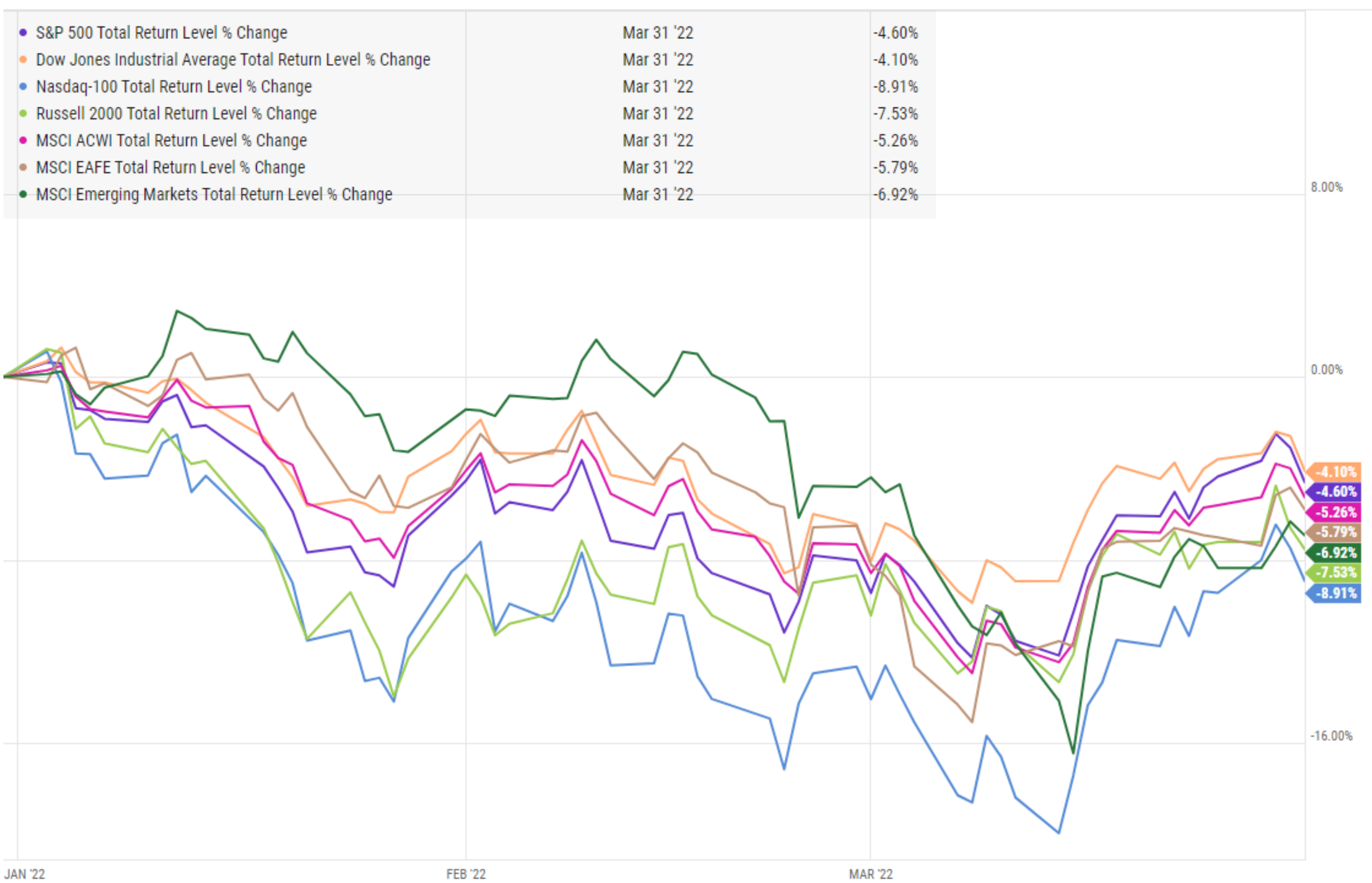
Markets

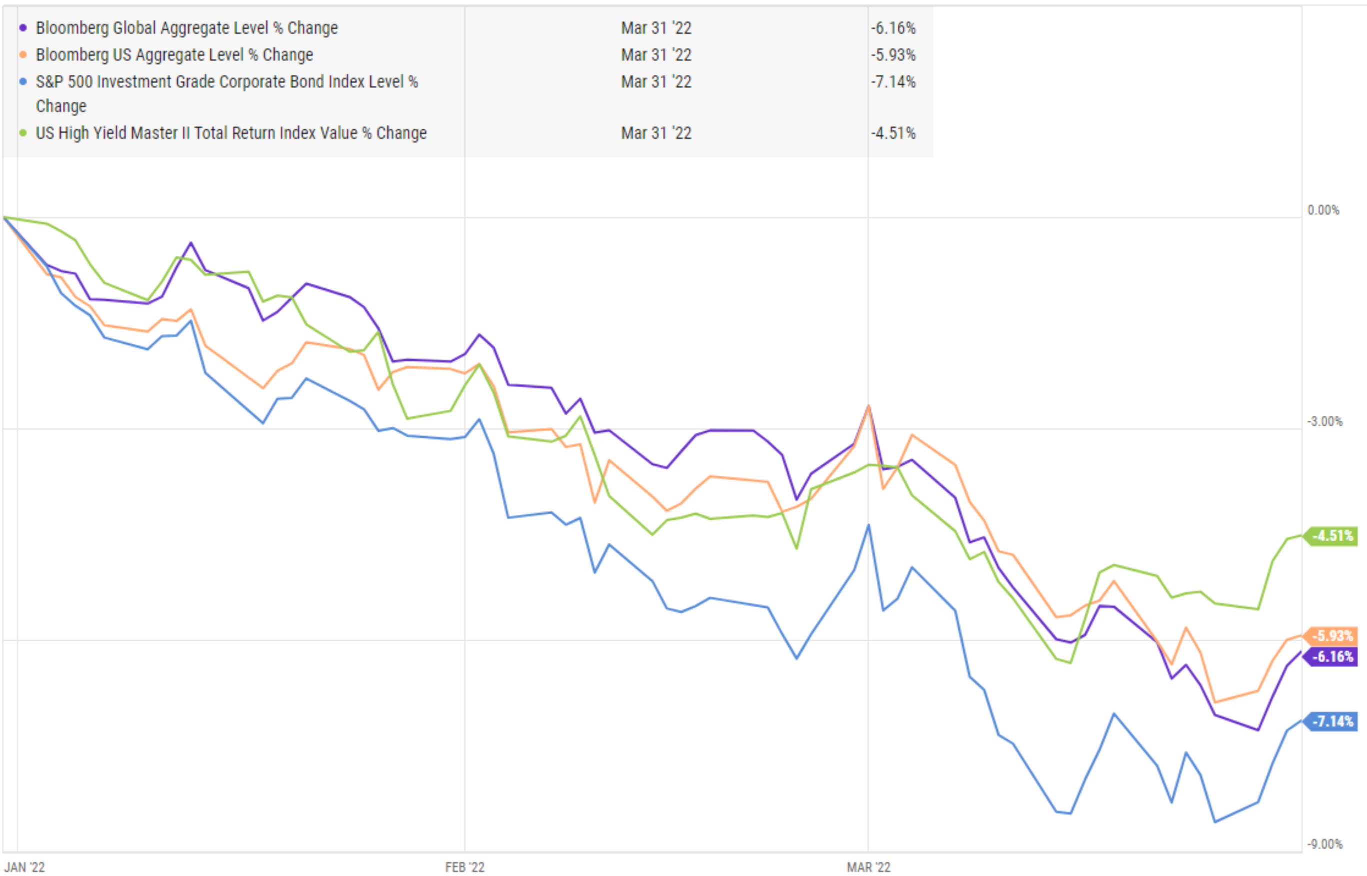
Equity markets closed out the first quarter of 2022 with the worst quarterly performance seen since the initial COVID market sell-off in 1Q 2020. This poor market performance was not caused by an unobservable virus, but rather a tangible and visible rise in both interest rates and geopolitical tensions not seen since the Cuban Missile Crisis, along with an accompanying flurry of negative economic impacts. Despite a resounding comeback during the latter half of March, all observed indices ended the quarter in the red. For the three months ended March 31st, the Dow Jones Industrial Average closed down 4.10% while the S&P 500 closed down 4.60%. Small caps ended further in the red, with the Russell 2000 down 7.53% while the more tech-heavy Nasdaq 100 TR diverged significantly, down 8.91%. Internationally we saw much of the same story as the MSCI All Country Would Index (ACWI) was down 5.26% and the MSCI Europe, Australasia and Far East (EAFE) closed down 5.79%. The developing portion of the world continued to bear the brunt of the international sell-off, closing down 6.92%.



Source: YCharts

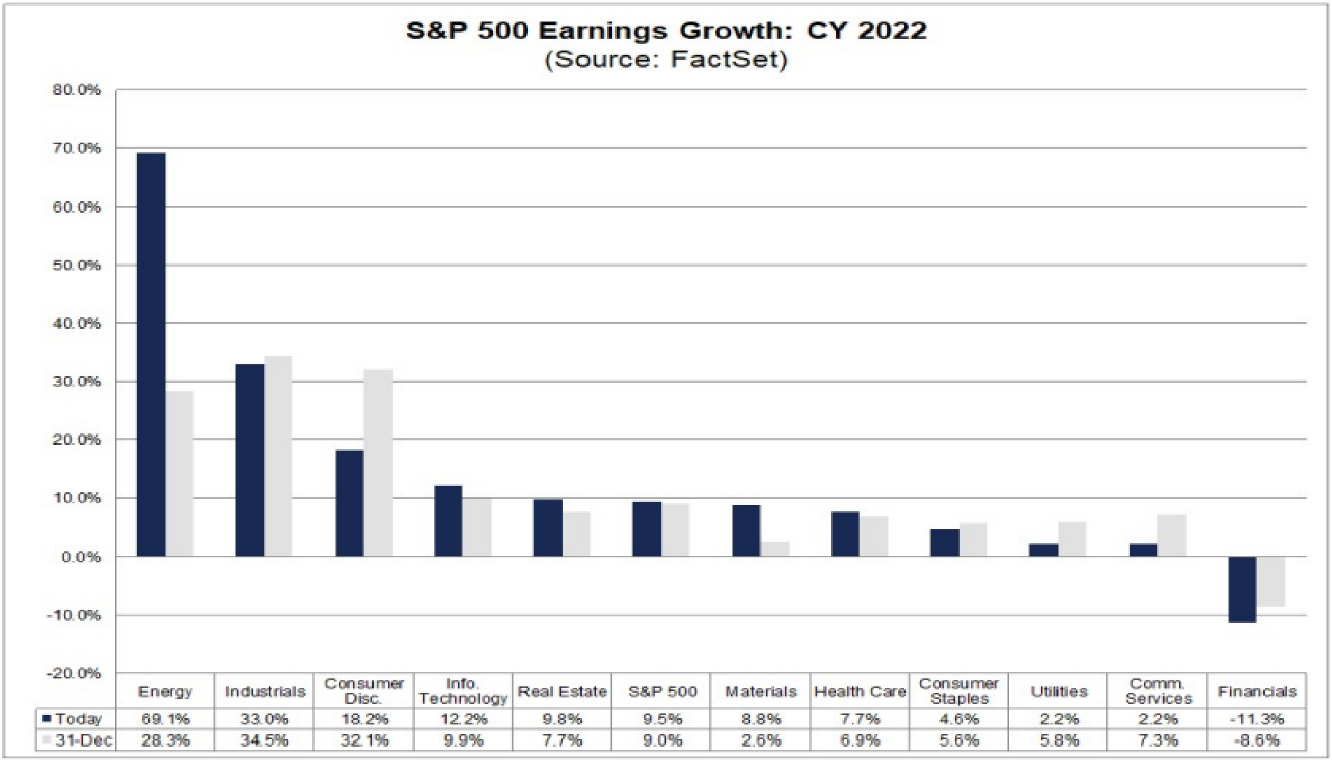
Turning to the fixed income, the treasury curve, as measured by the 2 year to 10 year spread, flattened significantly, with the yield on the 2-year Treasury note beginning the quarter at 0.78% before ending the quarter significantly higher at 2.28%. The longer-dated portion of the curve rose as well, as the yield on the US 10-Year began the quarter yielding 1.63%, before ending at 2.32%. In total, the spreads between the two instruments flattened from an 85 basis point differential at the beginning of the quarter to just a 4 basis point differential by March 31st.

The Bloomberg U.S. Aggregate and Global Aggregate traded relatively in-line with each other, as the Global Aggregate ended the quarter down 6.16% while the US Aggregate ended down 5.93%. On the corporate side, high-yield bonds continued to “outpace”(i.e. sold off less) their investment grade counterparts as S&P 500 Investment Grade Corporate Bond Index ended the period down 7.14% while the US High Yield Master II Index was down 4.51%.



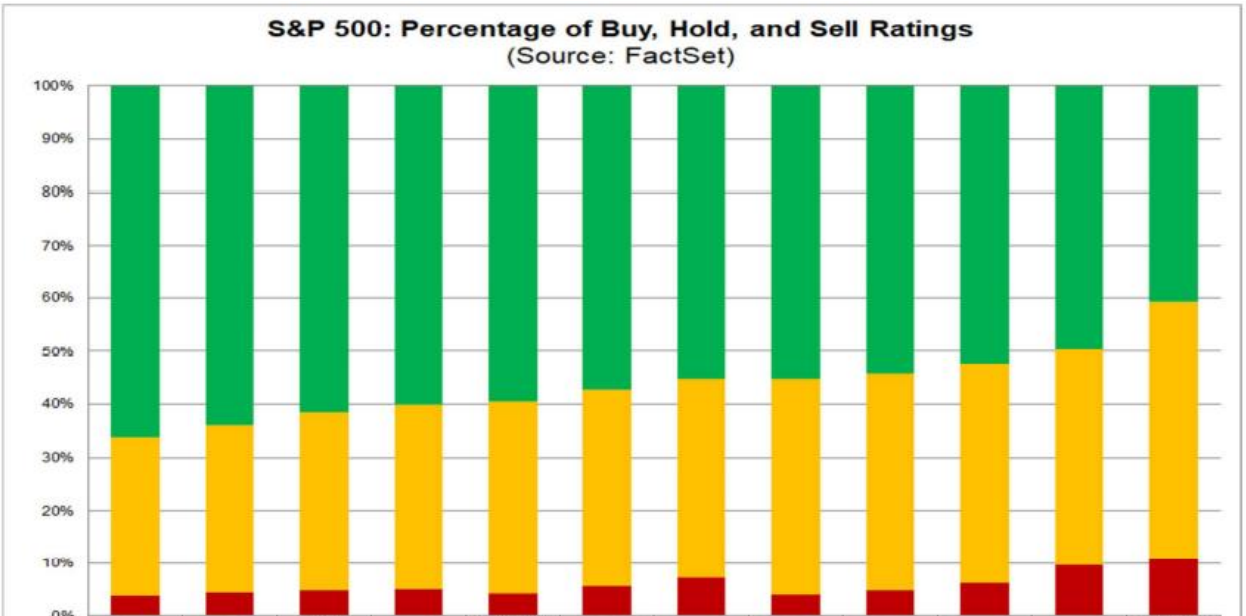
Source: YCharts

Such a turbulent market and economic environment seems to be taking its toll on company operations as well, with analysts decreasing their bottom-up 1Q2022 earnings per shares (EPS) estimates by 0.7% to an estimated earnings growth rate of 4.7% for the index. This downwards revision marks the first such occurrence since 2Q2020 when the US economy was experiencing widespread economic lockdowns. Thus far, of the 96 companies that have issued 1Q earnings guidance, 70% of that guidance is negative, which is above the 5-year average of 60%. However, what is interesting to note is that while the bottom-up EPS estimate for 1Q2022 decreased, the CY 2022 and CY 2023 earnings estimates for the index increased, all while the actual price level of the S&P 500 decreased. With prices falling and earnings estimates rising, the forward 12-month price-to-earnings (P/E) ratio for the index declined from 21.3 to 19.5, which is still above the 5- (18.6) and 10-year (16.8) averages. In total, the CY 2022 EPS estimates increased 2.0% while CY 2023 estimates increased by 1.9%. On a sector level, 5 of the 11 sectors experienced upwards revisions to CY 2022 earnings estimates since the beginning of the year, while the other 6 experienced downwards revisions.



	Energy	Industrials	Consumer Disc.	Info. Technology	Real Estate	S&P 500	Materials	Health Care	Consumer Staples	Utilities	Comm. Services	Financials
Today	69.1%	33.0%	18.2%	12.2%	9.8%	9.5%	8.8%	7.7%	4.6%	2.2%	2.2%	-11.3%
31-Dec	28.3%	34.5%	32.1%	9.9%	7.7%	9.0%	2.6%	6.9%	5.6%	5.8%	7.3%	-8.6%

In conclusion, despite all the noise surrounding the outbreak of war in Ukraine and the continual march of inflation, analysts remain bullish on the intermediate- and long-term prospects of the equity market. As of March 28th, industry analysts in aggregate predict the S&P 500 will see a price increase of 16.8% over the next 12 months. On a sector level, the Communications Services, Consumer Discretionary, and Information Technology sectors are expected to see the largest price increases, while the Energy and Utilities sectors are expected to see the smallest price increases. Indeed, as Wall Street analysts stare down the barrel of higher inflation, rising interest rates, military conflict, and a resurgence of COVID-19 in China, their response, more often than not, is to "Buy." On March 31st, there were 10,821 total ratings on stocks in the S&P 500. Of these, 57% were Buy ratings, 37% were hold ratings, and 6% were sell ratings. This means that, despite the headwinds faced by global economies, analysts have the most "Buy" ratings on the index since at least 2010. A truly remarkable show of investor confidence.



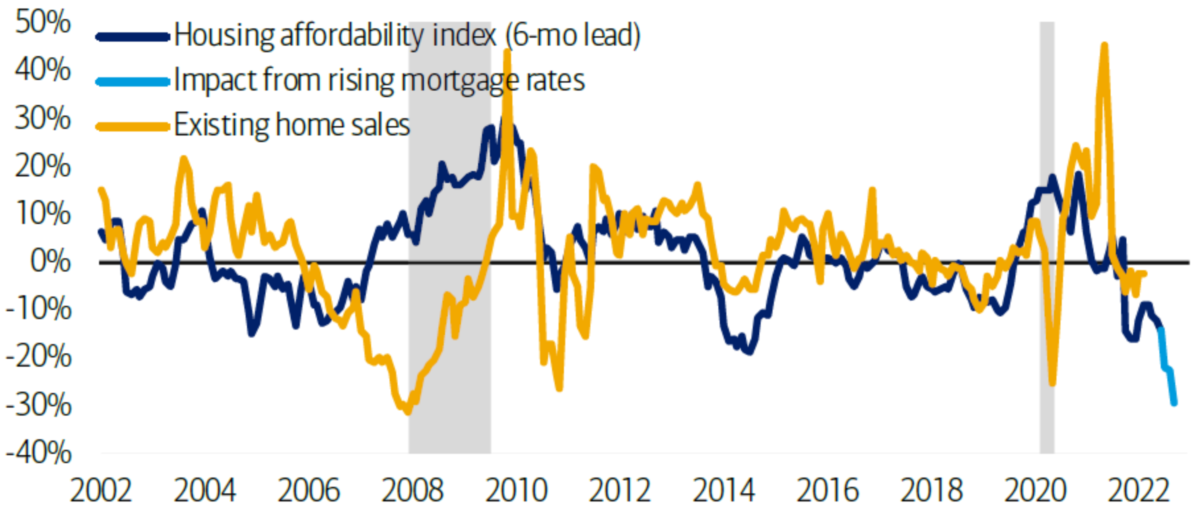
	Energy	Info. Tech.	Comm. Services	Health Care	Consumer Disc.	S&P 500	Industrials	Real Estate	Materials	Financials	Utilities	Consumer Staples
Buy	66%	64%	62%	60%	60%	57%	55%	55%	54%	52%	49%	41%
Hold	30%	32%	34%	35%	36%	37%	38%	41%	41%	42%	41%	48%
Sell	4%	4%	5%	5%	4%	6%	7%	4%	5%	6%	10%	11%

US Economy

Looking at US Purchasing Manager's Index (PMI) data, we get a sense of two key takeaways. Firstly, we see that previous supply chain related issues are continuing to ease as the flash estimate from the S&P Global Composite PMI pointed to the fastest pace of expansion in the US private sector in 8 months. Supported largely by pent up demand stemming from the easing of COVID-19 lockdowns, activity also experienced significant tailwinds from what the report described as "less severe supply chain disruptions and job creation," which allowed the private sector to step up production and capture new customers. Interestingly, demand for services is growing so fast that companies are struggling to keep pace with new orders, leading to the largest rise in backlogs of work recorded since the survey began in 2009. While this is good news in that companies will have a healthy book of orders to sustain such strong output in the coming months, the bad news comes with the implication this has on prices. As demand continues to outstrip supply, price pressures remain significant as costs increased at one of the fastest rates on record, driven by further price hikes in raw material, fuel and energy.

Until recently, the US mortgage market enjoyed historically low 30-year fixed rates as low as 2.50%, but the first quarter of 2022 saw an end to this "easy-money" environment as the 30-year fixed rate increased 1.60% since the beginning of the year to 4.67%, the highest level since November 2018. When this steep climb in borrowing rates is combined with the seemingly unstoppable climb in national housing prices, which according to the Case-Shiller index rose 19.2% YoY in January, we see housing affordability decline at the fastest rate on record. According to Bank of America and The National Association of Realtors Housing affordability index, affordability levels now look to be declining close to 30% YoY, a move which would bring the level of affordability to the lowest since 2007, when the housing bubble was bursting.

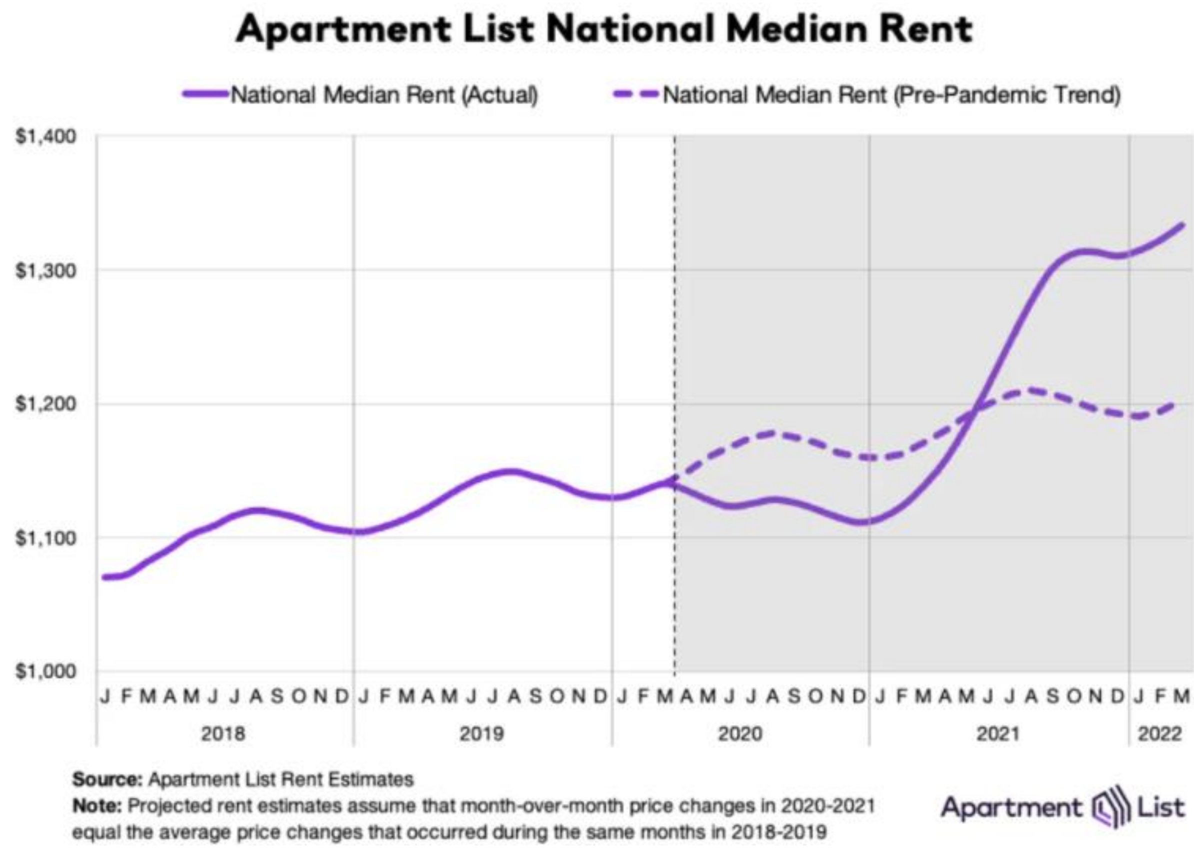
Exhibit 1: Affordability index and existing home sales (% yoy)
Housing affordability tends to lead existing home sales



Source: BofA Global Research, National Association of Realtors

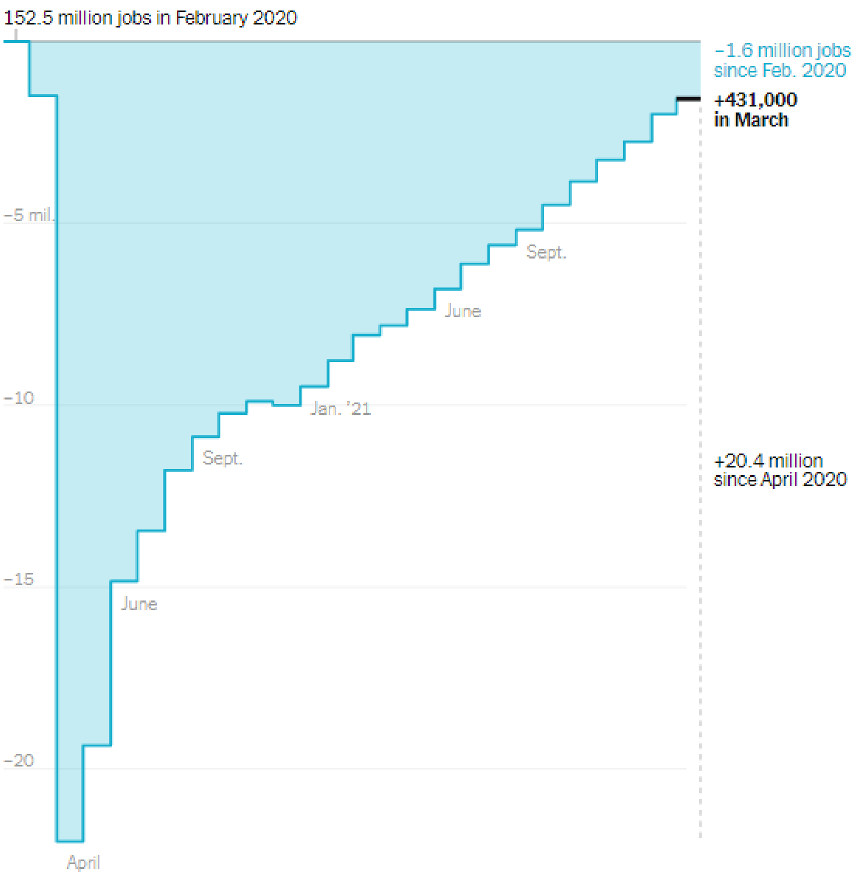
BofA GLOBAL RESEARCH

Even looking at the rental market, it appears that there is no place to shelter from the rising shelter prices as fresh rental data from Apartment List points to a resumption of price increases following a brief winter slowdown. While thus far in the year it appears rents are growing more slowly than they did in 2021, the YoY rent growth in the national index reaching an unprecedented 17.1% in February points to another year of above-trend rental growth for the nation. For comparison, YoY rent growth in March of 2019 averaged just 2.5%. What is important to note, however, is the driving factors behind such rental growth. The pandemic threw the rental market into a period of historic tightness, with the Apartment List National Vacancy Index reaching a historic low of 3.8% in August 2021, nearly 3% lower than the pre-pandemic average. These tight renter conditions have gradually eased by 0.1% a month, rising for 7 consecutive months to 4.6% in March 2022. As the market continues to ease into pre-pandemic levels of vacancies, rental prices should lose some of the momentum behind them as the market enters the busy summer season.



Finishing the domestic recap with the labor market, the pace of job gains has increased as compared with 4Q2021, with the economy adding nearly 1.58 million jobs during the first 3 months of 2022, as compared with an increase close to 1.1 million in the final quarter of 2021. In total, the unemployment rate fell from 4.0% to 3.6% with an unemployed population of 6.0 million. Remarkably, these levels are now nearly equal to their pre-pandemic levels last seen just over 2 years ago in February 2020, where unemployment was 3.5% with a total unemployed population of 5.7 million. Importantly, the number of workers voluntarily leaving their jobs and job openings remain near historic levels, with the quit rate ticking back up to 2.9% while the number of job vacancies for every unemployed American rose back to 1.8 – showing demand for workers remains at the highest level in decades according to the Job Opening and Labor Turnover Statistics (JOLTS) data.

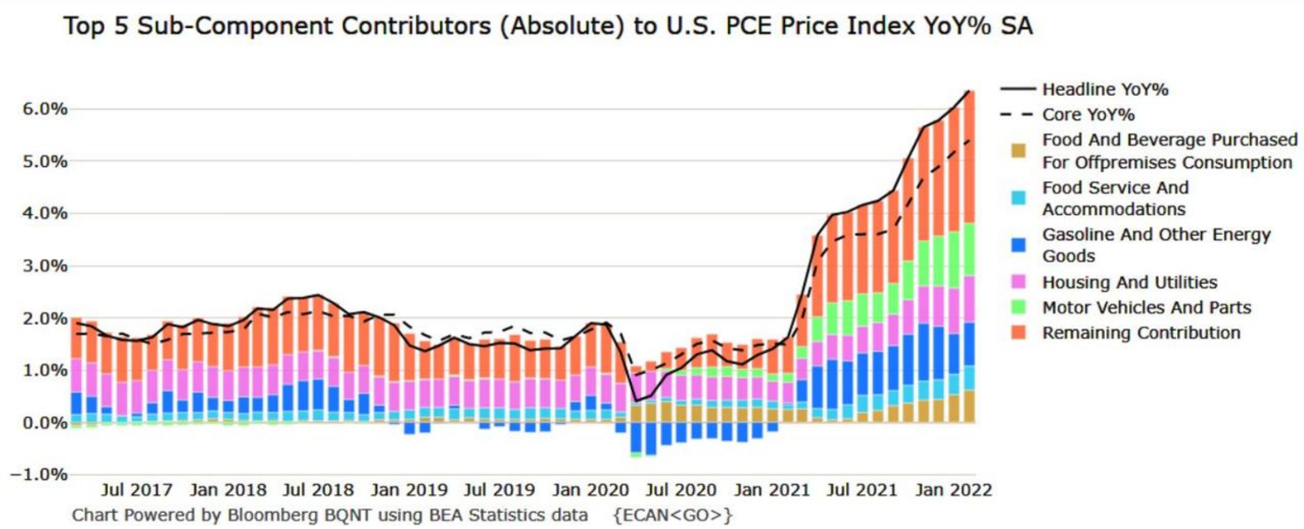
Cumulative change in jobs since before the pandemic



Data is seasonally adjusted. • Source: Labor Department • By Ella Koeze

This strong labor market and historically high demand for laborers has led to sizeable wage gains according to the March jobs report from the Bureau of Labor Statistics, with average hourly earnings increasing 5.6% YoY. However, considering rapidly increasing price levels and transfers, this cheery picture quickly begins to cloud. Personal income data over the past 2 years has been particularly distorted by lockdown policies which caused massive layoffs and government stimulus programs that sent transfer payments skyrocketing. According to data from Refinitiv Datastream, as these distortions continue to fade, personal income is returning to recent trend growth around 4.5% in nominal terms. After adjusting for inflation, personal income excluding transfer payments is up 2.2% YoY, about 0.2% below the average trend line for the metric. This data is supported by the still-falling personal savings rate, which is now hovering at its lowest level since 2013 at 6.3%.

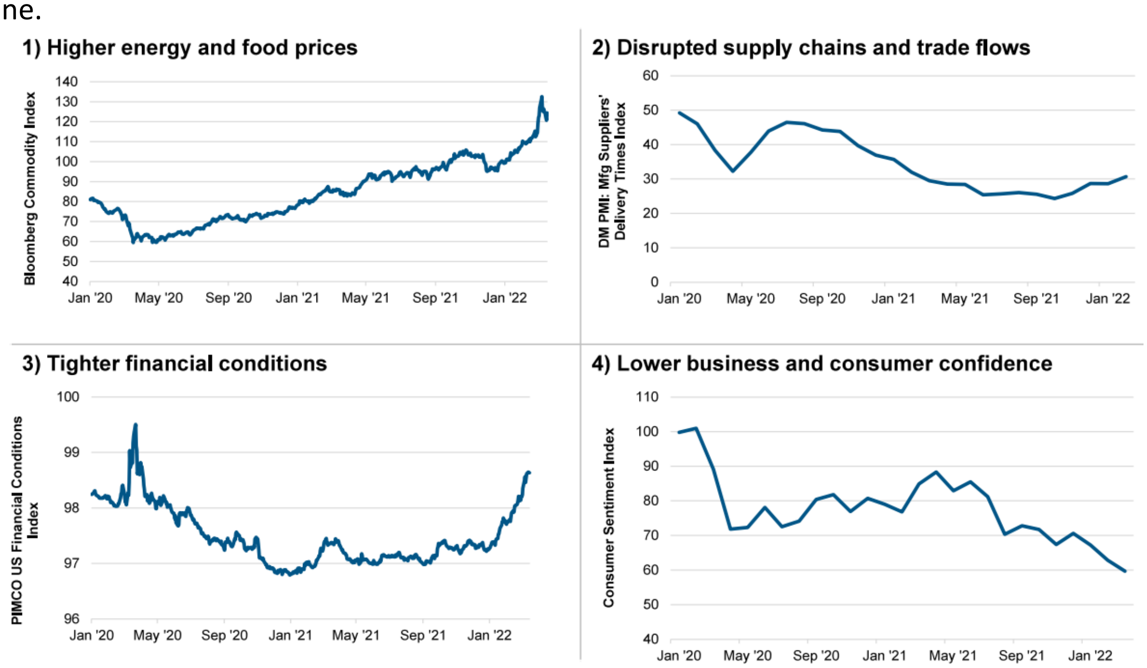
Such drastically different conclusions when discussing real or nominal gains should come of no surprise when considering the level of inflation workers, consumers, and businesses are all currently facing. According to the March Bureau of Economic Analysis (BEA) report, February 2022 saw the personal consumption expenditure (PCE) price index rising 6.4% YoY, the highest level since 1982, reflecting increases in both goods and services. Importantly, economists expected this index to rise 5.5% in February, showing still accelerating price pressures. Key contributors to the spike in PCE include motor vehicles and parts, housing, and gasoline and other energy goods – all experienced *before* the war in Ukraine.



International Economy

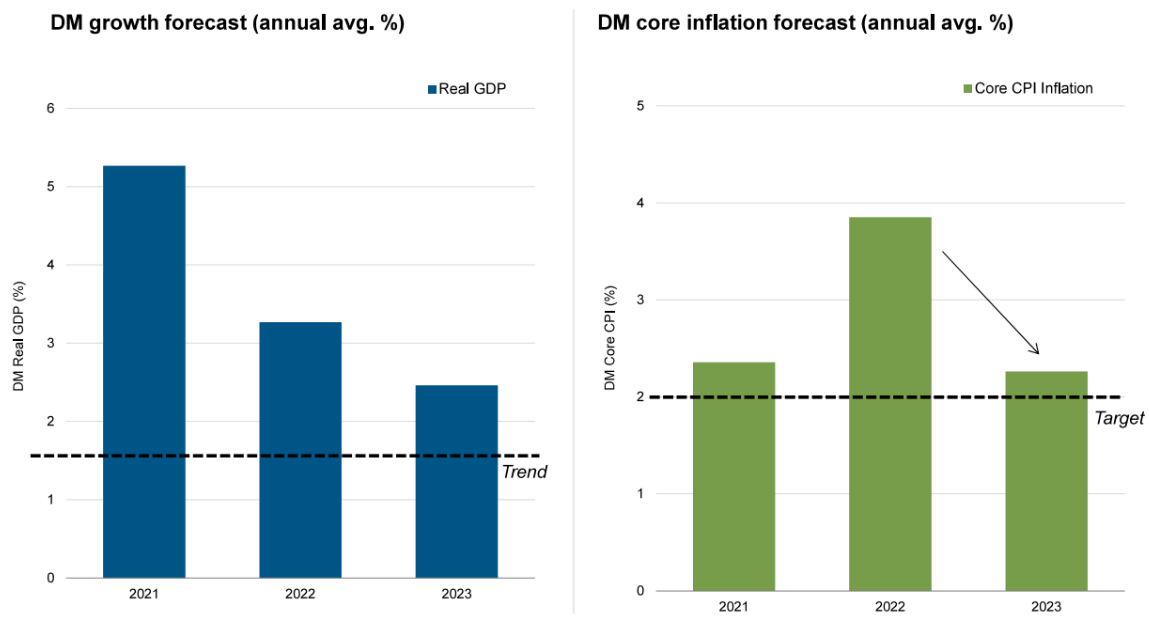
Beginning the international section with a brief snapshot of the European equity market, reality continues to defy expectations. Looking back at 4Q2021, with more than 95% of companies in the STOXX Europe 600 having reported their results, earnings momentum is strong according to FactSet. Back in September 2021, analysts were expecting earnings growth of 35% for the quarter. With the earnings season all but wrapped up, that number came in nearly twice as large at an impressive 68% growth rate for the quarter, larger than the US market which saw 31% growth in 4Q. In all, 10 of the 11 sectors beat expectations with Energy exceeding expectations by over 200% with a 642% earnings growth rate. Utilities, as seen in the US as well, was the laggard with earnings results coming in below expectations. Looking forward, despite the conflict in Ukraine, growth is anticipated to increase as CY 2022 earnings growth estimates have risen from 5% to 11% for the index.

Turning to the broader global economy, PIMCO's recently released cyclical outlook shows the balancing act domestic and international economies are currently facing between inflation running too hot and growth turning too cold. During a period where declining growth and rising inflation are front and center, the group focuses on the possibility of stagflation, and the channels in which this can become a reality. Stagflation, a relatively rare economic condition, refers to an economy that is experiencing a simultaneous increase in inflation and stagnation of economic output. While it has occurred sporadically in developing nations, the most notable example was seen in the US in the 1970s. To start, PIMCO looks at 4 possible channels of transmission – higher energy and food prices, disrupted supply chains and trade flows, tighter financial conditions, and lower business and consumer confidence. With all 4 of these channels gradually becoming more conducive to an environment in which stagflation could occur, as shown below, the group revisits their macroeconomic outlooks considering the outbreak of war in Ukraine.



As of March 16, 2022. Source: Bloomberg, Haver.

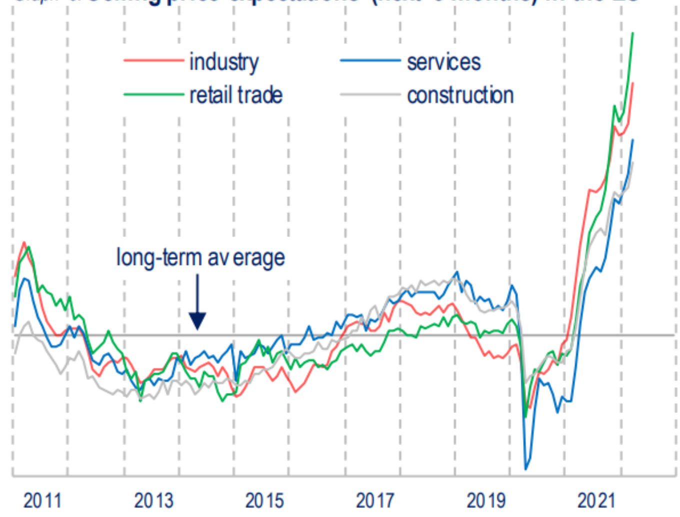
Considering these rocky conditions, PIMCO revised their baseline forecast for developed markets growth down about 1% compared to pre-war forecasts, with inflation forecasts increasing from 2% to 5%. Specifically, supply chain disruptions were already widespread due to COVID-19, and Russia's incursion into Ukraine and the global sanction regime developed in response has led to further disruptions just as some of the pandemic-related bottlenecks began to ease. Two key takeaways from these new complications are that there are recent COVID lockdowns in China which have the potential to create new bottlenecks independent of the war in Eastern Europe, and that even after a conclusion to the war is reached, sanctions would likely remain in place for some time.



As of 16 March 2022. Source: PIMCO calculations, Haver.
DM = US, Canada, EA, UK, Japan

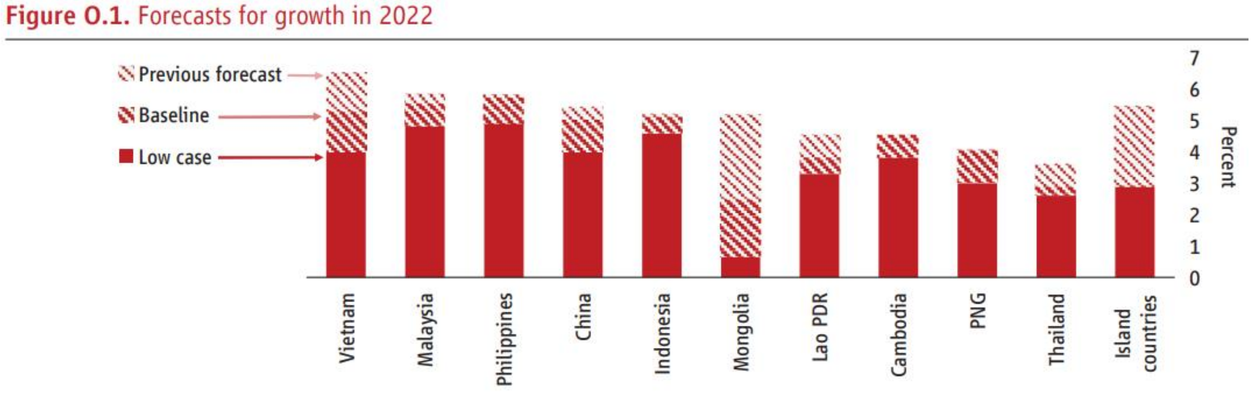
With respect to the average European consumer, we see much of the same story that is playing out in the US: rising inflation. The most recent flash estimate for Euro Area inflation released from Eurostat showed inflation growing to another historic high of 7.5% YoY in March, up from 5.9% in February and now nearly quadruple the European Central Bank's (ECB) 2% price stability target. Looking at the main components, as anticipated, the largest contributor was energy which rose 44.7% YoY as the industry is continually impacted by the war in Ukraine. The momentum is unlikely to end soon as leading price indicators continue to point towards further price increases in the coming months. For example, the European Commission Economic Sentiment Indicator (ESI) reported that selling-price expectations for the next 3 months rose to unprecedented levels in all surveyed business sectors. Furthermore, the S&P Global Eurozone Composite PMI showed that amid the rising energy, fuel, and commodity prices in the region, input cost inflation accelerated to a survey high in March, which led to prices charged for eurozone goods and services being raised to the quickest extent on record.

Graph 6: **Selling price expectations (next 3 months) in the EU**[2]



Ending the international coverage with the World Bank's recently released East Asia and Pacific (EAP) Economic Update, we see that the war in Ukraine has consequences far outside the realm of Europe and its allies. The report states that as the war comes on top of not just the lingering pandemic, but also the economic distress caused by financial tightening in the US and slower economic growth in China, the EAP region will undoubtedly experience lower growth and higher inflation. Specifically, the region is now projected to grow by 5% in 2022, down from the 5.4% projected in October 2021, with a warning that growth could foreseeably slow to 4% if global conditions worsen and national policy responses are weaker than anticipated. This is especially important as the organization notes that government capacity to assist has narrowed significantly due to pandemic spending. Growing debt levels among the emerging economies will limit the capacity to provide fiscal support while rising inflation and tightening global financial conditions will shrink the opportunity for monetary easing. What is interesting to note is that because real interest rates are relatively high and core inflation is relatively low in the EAP region as compared to the West, monetary policy makers at present can continue to support recovery in ways the West largely cannot. On a national basis, the largest economy in the region, China, is forecasted to expand 5% while the rest of the region is expected to grow 4.8%.

Figure O.1. Forecasts for growth in 2022



Source: World Bank staff estimates.
Notes: PNG stands for Papua New Guinea.

In summation, as we survey the global economic and earnings landscapes, there are certainly potential headwinds to asset returns—rising inflation costs, increasing geopolitical tensions, and the uncertainty that comes with central bank tightening. That said, we are still optimistic on the direction of markets and believe asset prices have reasons to climb higher from current levels, despite a volatile first quarter. Underlying economic trends are positive, labor markets are strong, and consumers are generally in good shape. Both domestic and international corporations could see input costs eat into profitability, but overall we believe corporations will be able to navigate the difficult environment and deliver positive earnings growth.

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