FIRST QUARTER 2022 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

April 12, 2022

PORTFOLIO THEMES

- We continue to favor larger, high-quality companies given our assessment that we remain in a late bull market cycle in global equities.
- We remain constructive on global equities and believe the relative strength in cyclical and defensive categories will likely reverse as we move past the market correction.
- Economic growth and inflation expectations likely continue to moderate as supply and labor constraints subside, supporting our preference for growth equities.

MARKET OUTLOOK

- **Early Year Volatility Appears to be a Classic Correction:** Geopolitical uncertainty drove a sharp, early year decline in global markets. Despite the humanitarian tragedy, the scope of the conflict seems unlikely to derail the global economy or global equity markets.
- **Increased Investor Pessimism:** Depressed sentiment, driven primarily by Russia's invasion of Ukraine and concerns on inflation, has significantly lowered investor expectations increasing the likelihood that markets realize a better-than-expected outcome.
- **Global Markets Typically Reward US Political Gridlock:** The incumbent party routinely loses power during the midterm year, reducing political uncertainty and the likelihood of extreme legislation. Increased gridlock likely acts as a tailwind for global markets in the back half of the year.

After hitting a January 4 high, global markets fell into this bull market's first correction as investors feared rising interest rates, inflation and Vladimir Putin's vile Ukrainian invasion. At its March 8 low, the MSCI ACWI Index was down -13.4% before rallying to put full-quarter returns at -5.4%[i]. Despite the volatility, we still believe 2022 should be good for equities, with Tech and growth leading.

This turbulent start to the year unnerved many, especially with the tragic Ukraine invasion. Yet this appears to be a classic correction. Like typical corrections, this decline was a steep drop off a market high with big scare stories that headlines quickly extrapolated into worst-case scenarios. Excluding 2020's lockdown-driven (and correction-like) downturn, bear markets usually start much more gradually, with investors much more complacent—even dismissive. The central cause typically expands unnoticed, getting scant attention until far later in the downturn. By contrast, corrections strike and recover quickly, although neither happen in straight lines. Equities usually move on to material up moves afterwards.

i Source: FactSet, as of 04/01/2022. MSCI ACWI Index returns with net dividends, 01/04/2022 – 03/08/2022 and 12/31/2021 – 03/31/2022.

When 2022 began, we forecast a nicely positive but back-end-loaded year, with early volatility. We still believe this is most likely, hard as it may be to fathom after this difficult quarter. All those suffering from the war have our deepest sympathies. Yet neither Russia's invasion nor sanctions' fallout changes our market outlook. While the human toll will last for years—with the damage to so many irreparable—for equities, this too shall pass. There is a very long history of regional wars and corrections. Corrections often end with a V-shaped bottom, and perhaps we are on the right side of that now. Or, perhaps this will have a W-shaped bottom, delaying the rebound briefly with another brief down spurt ahead.

While we didn't forecast the invasion, we wouldn't expect to. Nor have we ever tried predicting corrections or other short-term swings. Yet we did think the first half would likely be volatile—the correction fits with this, similar to other midterm-year corrections. The war simply adds to this uncertainty in the near term. The economic response, particularly sanctions, extends some of the dislocations weighing on sentiment and triggering inflation. Yet these issues aren't insurmountable for equities. The MSCI ACWI and S&P 500 are both nicely positive since February 24, the day Russian forces invaded Ukraine.

Always remember: Equities don't need perfection. Objectively negative realities aren't always negative for equities, especially if they don't go as badly as feared. Due to high oil and gas prices stemming from the war, inflation likely peaks higher and stays elevated longer than we initially expected. Objectively, this is bad, creating hardship and forcing people into tough choices. Yet the economy has already proven strong enough to absorb the hit. Many businesses' gross operating profit margins remain fat, particularly large growth equities.

Additionally, inflation-adjusted spending remains firm. Business surveys globally show strong activity, with higher input costs hitting sentiment more than output. This is true even in Europe, which is the most vulnerable major region to the war and sanctions' economic dislocations. If the war's fallout were to drive a global recession, Europe would show it first. But data suggest Europe is faring better economically than most assumed. If Europe doesn't contract, the chances of Ukraine driving a global recession are low. Slower growth is almost certain but that doesn't stop equities. We have long expected growth to slow after the initial COVID reopening surge.

Emerging Markets (EM) were down slightly more than developed in Q1 falling -7.0%.[ii] Yet with careful analysis, EM's volatility is a tale of divergence between China and the rest of the emerging world. Seventeen of the MSCI EM Index's now 24 constituent countries have had positive year-to-date returns, many of them in the high double digits. Chinese equities meanwhile fell -14.2% over the quarter.[iii] Yet there is some encouraging news, as the MSCI China was down -24.9% month-to-date in mid-March, before a 22.5% rally in the month's second half.[iv] The early decline stemmed first from a sentiment reaction to US officials putting a few small, US-listed Chinese firms on delisting watch—sparking fears that bigger companies would follow—and the COVID outbreak and lockdown in Shenzhen. Yet in the early morning US time on March 16, Chinese officials announced several measures aimed at calming markets. Additionally, Chinese officials signaled a forthcoming end to Tech regulatory uncertainty, a heightened focus on backstopping troubled property developers, and continued accommodative fiscal and monetary policy. While we don't think any of these issues had much fundamental power moving forward, they have weighed heavy on sentiment and therefore returns, making China's announcement a beneficial confidence boost.

ii Ibid. MSCI EM returns in USD with net dividends, 12/31/2021 – 03/31/2022.

iii Ibid. MSCI China returns in USD with net dividends, 12/31/2021 – 03/31/2022.

iv Ibid. MSCI China returns in USD with net dividends, 02/28/2022 – 03/15/2022 and 03/15/2022 – 03/31/2022.

Many forecasters now fear the eurozone will enter recession this year as the war's fallout sends energy and food prices higher and hurts consumer confidence. It is possible eurozone GDP contracts, though the latest business surveys suggest eurozone businesses continue to expand despite the geopolitical related uncertainty. Additionally, we don't think the energy supply issues are as dire as projected. Sanctions haven't prevented Russia from selling oil to India and China, which has freed up other producers to sell to Europe. Moreover, big global producers (e.g., the US) are set to raise output this year, adding to global supply. Like other commodities, oil supply and demand are likely to be in better balance than many appreciate.

Long-term interest rates' rise is the other big fear—frequently cited as negative, especially for growth equities. Yet reality suggests otherwise. One, growth equities have a long history of rallying alongside higher long rates, as the full Review will detail. Two, higher long rates steepened the yield curve—a positive economic signal.[v] If a recession were nigh, we would expect an inverted yield curve, with 3-month rates exceeding 10-year. As we will detail, while many fret inversions at other less-important segments of the yield curve, like the commonly touted 2-year to 10-year spread, the most meaningful spread is wider today than at 2022's outset. Amazingly, this remains largely unnoticed.

How long war-intensified disruptions will last is unknowable. Eventually, though, they should fade alongside rising US political clarity from the midterms. The US elections will likely create traditional interparty gridlock—bringing benefits that have a long reality of positively surprising almost everyone as they induce political calmness. This usually generates a late-year rally, and maybe this correction accelerates the rally's arrival. Regardless, whether it comes immediately or later this year, we think patient investors will be rewarded. Of course, we are monitoring risks to this outlook, and could change course if we saw a huge enough negative shock to have us believe a bear market was underway. But, for now, we see nothing with the size and surprise for that.

v Source: FactSet, as of 04/04/2022. Statement based on comparison of 10-year Treasury and 3-month Treasury constant maturity yields.

Should you have any questions about any of the information in the First Quarter 2022 Review and Outlook, please contact us at (800) 851-8845 or FisherInstitutional@fi.com.

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