ALTMAN
INVESTMENT MANAGEMENT

BRIEF INSIGHTS

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IN BRIEF: Putin or Powell - Who Matters More for the Equity Markets?

The break out of the war in Ukraine, coupled with ongoing supply and demand imbalances as new variants prolong the pandemic are putting upward pressure on prices. In response to rising inflation, the Federal Reserve turned hawkish by accelerating its tapering of bond purchases and raising rates 25 basis points. Now the question on most investors' minds as we enter into the second quarter is: Will Federal Reserve monetary policy be successful in controlling inflation and ultimately avert a recession? The Fed has set expectations for a rate hike at each meeting this year, some with the possibility of a 50-basis point raise. This positions the bar high and leaves room for a positive surprise towards the end of the year should they not hike rates at every meeting. Currently, the Treasury market is pricing a 3% increase in policy rates with Federal Funds reaching around 3.2% by the second quarter of 2023.

Headwinds from inflationary pressures, the Ukraine war, the ongoing pandemic and continued supply disruptions, and China's recent response to covid-19 slowing an expected recovery path, is expected to temper overall global growth. Support from strong labor trends along with the significant wealth effect and built-up liquidity should help offset some of these pressures, moderating growth in the range of 3.0-3.5% this year. On top of all the negative news that has surfaced, we have also witnessed some disappointing news on the earnings front in technology-related stocks. Given this backdrop, U.S. equities have traded in a 10% range since mid-January, reflecting a tug of war between *optimism* about near term economic momentum and earnings growth - and *pessimism* about the need for aggressive Federal Reserve tightening in the face of persistently high inflation.

With March headline inflation at 8.5% and core inflation at 6.5%, the more pessimistic view is that the Federal Reserve has to tighten aggressively to lower inflation to its long-term target and that will, in all likelihood, lead to recession. Although the Federal Reserve may be "significantly behind" the curve according to Bill Dudley, the former President and CEO of the Federal Reserve Bank of New York and former Vice Chairman of the Federal Open Market Committee, the tightening of financial conditions has already done some of the Federal Reserve's leg work. The reason we believe this tightening is relevant is because the Federal Reserve may not be as "far behind", and therefore may not have to tighten beyond what the market is now pricing.

Consumer confidence has been rattled as inflationary fears mount. New orders are waning against expanding inventories while rising wages could outpace productivity. This will likely weigh on corporate profits but some passthrough of higher commodity costs aided by supply/demand imbalances could help offset these pressures. Therefore, our expectations for profit growth this year have moderated towards the mid-single digits, and the probability of a recession in the next 12 months stands at between 15-20%. Keep in mind that not every Federal Reserve tightening leads to a recession. In fact, our research shows that 40% of tightening cycles have not. We estimate that every 100-basis point increase in policy rates lowers U.S. GDP by about 1% and lags about four quarters.

Investment Implications: We believe it is best to stay invested in equities at this time. Our view is supported by a favorable economic backdrop and low risk of imminent recession, the earnings growth expectations, and an already bearish sentiment in the market place, as U.S. and non-U.S. equities have already declined more than 10%. As always, we remain appropriately humble at this time of heightened uncertainty.

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