ALTMAN
INVESTMENT MANAGEMENT

BRIEF INSIGHTS

FEBRUARY, 2022

IN BRIEF: The Tug-of-War in Normalizing Economic Policies

The financial markets, especially those of the U.S., have become much more volatile. U.S. equities, as measured by the S&P 500, have declined by 7.2% on a closing basis since the end of December 2021 - and by 12.4% based on intraday pricing from their peak on January 4th to their recent low on January 24th. Volatility – as measured by the CBOE VIX Index – increased from 16% to an intraday peak of 39% on January 24th. The interest rate on the 10-year Treasury bond increased by about 50 basis points YTD, from 1.5% to just below 2% (with 2% being the mid-point of our year-end 2022 target) as of the close on Friday, February 11th.

Within the S&P 500, the Energy sector has gained 27.1%, while Real Estate and Communication Services (including Facebook, Netflix, and Alphabet) were all significant underperformers, declining 12.3% and 12.2%, respectively. Consumer Discretionary (including Amazon, and Tesla) and Information Technology (including Apple, Microsoft, and Nvidia) have also underperformed, declining 11.6% and 11.0%, respectively. Non-U.S. markets were much less volatile. Non-U.S. developed equity markets – as measured by MSCI EAFE (Europe, Australasia, Far East) – have declined only 2.1% YTD, while emerging equity markets have increased only slightly by 0.6%, driven by a double-digit return coming from Brazilian equities. Eurozone bonds have slightly underperformed similar-maturity U.S. bonds.

Do these price declines foreshadow a bear market in equities?

In such a scenario, higher and more persistent inflation leads the Federal Reserve to aggressively tighten monetary policy enough to cause a recession and a corresponding decline in earnings. While such a scenario is possible, we do not conclude that this is the likely outcome. Our current positioning of portfolios is that the U.S. economy will be able to navigate through the coincident inflation prints and a seemingly more hawkish Federal Reserve policy anticipating an acceleration in rate hikes. And of immediate concern is the uncertainty of the Russia-Ukraine military buildup on their borders. While it is virtually impossible to accurately attribute short-term market movements, let alone erratic ones, to specific data releases or events, we think it is helpful to examine the confluence of key factors that may account for some of the recent declines in overall equity prices.

We will cover recent inflation and employment trends and their implications for Federal Reserve tightening policy, as well as the mixed earnings reports coming out of the largest market capitalized companies, referenced in past commentaries as the FANGMAT stocks. (Facebook/Meta, Apple, Netflix, Google/Alphabet, Microsoft, Amazon, and Tesla). Lastly, the geopolitical tension between Russia and Ukraine.

Historical Perspective:

Although it is important to note that we are certainly not overly confident in the forecasting the path of inflation or the trajectory of Federal Reserve interest rate policy in 2022, we lean on a time-tested investment philosophy that history can be a useful guide. The last time the world was confronted with a pandemic was over 100 years ago, with a very different economy, financial market, and geopolitical backdrop than today. The challenge we are faced with is not knowing the exact impact of a two-year pandemic on employment, as well as on savings and consumption behavior.

Inflation and Employment:

After a significant increase in core and headline inflation since October, the January 2022 core and headline year-on-year inflation readings released last week stood at 6.0% and 7.5%, respectively. This reflected the highest inflation levels observed since the early 1980s. The greatest concern in the inflation data was the breadth of price increases across all sectors based on year-on-year data: energy prices were up 27%, used vehicles were up 40%, core goods and food were up 7%. Rent and owner's equivalent rent which is some 32% of the Consumer Price Index were up just under 4%. While equity investors are concerned that inflation expectations could become unhinged as a result of such price increases, long-term inflation expectations remain at just over 2%.

However, we are expecting inflation to gradually come down from its current high levels to settle in at ~3.5% for core inflation, and slightly higher for headline inflation by the end of this year. While there is a risk that inflation remains elevated over the next several months, we expect declining Covid-19 infections and see a gradual easing of supply bottlenecks. This should result in a return to normalcy in most economies around the world and put further downward pressure on the pace of inflation.

The employment data released in February certainly confirmed the upward pressure on inflation. Average hourly earnings increased 0.7% from the prior month and 5.7% from a year earlier. The annualized rate for the last three months was even higher at 6.9% according to the BLS. All these readings point to a tight labor market. Adding to the confusion of these reports was the distortion associated with changes in seasonal factors that are used to adjust employment reports for higher-than-average hiring in the spring and early summer versus the sharply lower numbers in the winter. There are also changes associated with population controls based on updated 2020 census data. The key takeaway from the employment report is that the labor market is tight and wage inflation may persist in the near term.

The Federal Reserve Board Members have changed their tune. The President of the St. Louis Federal Reserve Bank, James Bullard, called for a tightening of 100 basis points by the summer - and implied a 50-basis point increase in the Federal Fund rate maybe on the table at the upcoming FOMC meeting in March. The equity market responded by selling off sharply. On the other hand, several Nobel laureates in Economics disagree, along with the former chief economist at the World Bank and Chair of the Council of Economic Advisers, James D. Wolfensohn, who recently wrote that a "large across-the-board increase in interest rates is a cure worse than the disease". The most important question following the inflation and employment reports is whether the Federal Reserve will tighten policy so aggressively that a recession becomes inevitable in 2022. We think a recession remains unlikely this year. While the probabilities may increase in 2023, we still think they remain low and that when examining history not every tightening cycle leads to a recession. In addition, the average number of months from the start of Federal Reserve tightening to the start of recession is well over 30 months with the longest period approaching 45 months. If the Federal Reserve implements an incremental tightening policy, and is willing to accept slightly higher inflation than its stated target of 2%, then a recession is far from inevitable in the next two years.

Earnings Guidance from the FANGMAT stocks has been a mixed bag. According to Yardeni Research, the disappointing earnings or forward guidance of two of the FANGMAT stocks (Facebook/Meta and Netflix) seems to have overshadowed the positive earnings reports of other FANGMAT stocks - such as Apple, Amazon, Google/Alphabet, and Microsoft - as well as that of the rest of the S&P 500 in the fourth quarter of 2021. Of the 72% of companies in the S&P 500 that have reported fourth quarter earnings so far, 77% have exceeded consensus expectations for earnings per share and revenue growth. S&P 500 earnings have exceeded consensus estimates by 9%, and provide very strong momentum for earnings growth in 2022.

Russia-Ukraine Crisis:

The buildup of Russian troops on the border of Ukraine, and the uncertainty surrounding Moscow's intentions, have been another factor contributing to the recent market downdraft. According to our sources, there is a better than 50% likelihood that a war in the region will occur. While an attack may not be imminent, the timetable of an attack has certainly moved up earlier than originally expected in the second half of this year. Putin may wait for the Beijing Olympics to end, and possibly create a wedge between the U.S. and the UK, on the one hand, and Germany and France, on the other. The attack could come in a number of different forms, such as a full-scale invasion of Ukraine and toppling of the government with severe consequences and loss of human life, entering from the eastern provinces and usurping more territory as was done in 2014. While Russia has made a long list of demands from the U.S. and NATO allies, it is unlikely that these demands would be met, which makes negotiations very difficult. Another option is that there may be some room for negotiations regarding the placement of NATO forces that have been moved eastward towards Russia since 1997, in exchange for Moscow addressing some of its actions that have come in conflict with NATO.

According to M.E. Sarotte, a distinguished Professor at the Hopkins School of Advanced International Studies, while sanctions were used in the past in response to a Russian earlier invasion of Ukraine, the U.S. could also step up its interference with neighboring Ex-Soviet Republics that make things difficult for Russia. Most pundits believe the likelihood of a negotiated solution is hindered by the fact that Putin is attempting to change the fundamental principles that underpin the Atlantic alliance.

Putin's goal of an invasion is to disable the Ukraine and prevent it from acting as an independent country. But we are reminded that Ukraine has a say in this matter and any resolution as a result of "gunboat diplomacy" will not have an acceptable outcome. Of course, Putin is keenly aware that sanctions on Russia imposes disparate results across NATO allies. For instance, Germany's response has been generally pacifist in nature since the second world war, and was outspoken when the Trump administration shifted its policy of American First and altered its leadership role in the international world order.

Keep in mind that the Russia plutocracy could respond to sanctions by withholding natural gas from Europe, which would be counterproductive by introducing a risk premium on its oil and gas exports. Also, the effects of an overreliance of sanctions by the U.S. could threaten the status of the dollar as the reserve currency of the world and exacerbate U.S. interest rates. Then there is the question of how Putin removes himself without damaging his political credibility leaving the region "empty handed". In summary, any military incursion into Ukraine is most likely to be disruptive to the financial markets in the near term and result in continued upward pressure on energy prices.

The Rationale for Staying Invested:

While there are a number of factors that help explain the year-to-date downdraft in equities, we continue to emphasize a fully invested position. As we reviewed in early January, the rationale to underweight equities would be hard to make if the odds of a U.S. recession were low in 2022 with an expectation for earnings to grow at a low double-digit rate this year. The current 2022 earnings consensus of $225 is still unchanged despite the earnings beat, as the fourth quarter of 2021 season comes to a close. According to our research sources, in the last 23 non-recessionary years, calendar-year earnings per share were, on average, 7.1% greater than the annualized EPS from the fourth quarter of the prior year.

It is also important to mention that profit margins continue to be a key driver of earnings upside in the fourth quarter and should persist, as we expect the strong 9-10% sales growth to more than offset rising costs this year. In fact, S&P 500 net profit margins have increased from their year-earlier levels 89% of the time when sales growth was at least 5% and the economy was not in a recession, both of which we expect to be true this year. However, we also acknowledge that risks have increased given higher-than-expected inflation, a faster pace of Federal Reserve tightening and the ratcheting up of Russia-Ukraine tensions. As a result, we have adjusted our thinking to the probability of another correction of greater than 10% from the high is likely. Given our view that inflation is more likely to peak this year and that Fed tightening will be incremental, an upside bias to markets is a reasonable conclusion.

During times of crisis - one can opt to move to the sidelines and wait for uncertainty to pass. The challenge is returning to the equity markets at higher prices. The alternative, to trade the ups and downs of the market, can be disruptive to accomplishing long-term objectives. Or we can choose to remain invested given a favorable economic and earnings growth backdrop.

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.