

IN BRIEF: Thoughts on Market Volatility

With the S&P 500 down about 6% for the year and valuations still remain at the high end of their historic averages, investors are increasingly nervous. Their unease is understandable given the litany of risks, including slowing global growth at a time of soaring inflation, less accommodative monetary policy, rapidly rising interest rates, dwindling odds of additional fiscal spending and lingering uncertainty about the path of COVID.

Against this uncertain backdrop, we think it is important to keep the following observations in mind:

- **Slowing Growth is not a Recession:** While global growth is set to slow this year, we should not equate that with the onset of a recession. In fact, we expect most major economies to experience well above-trend growth in 2022 - and accordingly place very low odds on a global recession.
- **Less Accommodative Policy is not Restrictive Policy:** Although policy rates in the U.S. are expected to rise this year, real policy rates here and around the world remain deeply in negative territory. Moreover, the total balance sheet of the major central banks is still expected to expand this year, even as asset purchase programs are being pared back.
- **Not Every Hiking Cycle Leads to a Recession:** Most market pundits expect the Federal Reserve to begin hiking interest rates in March. While investors are concerned this could lead to a recession, note that 6 (or 40%) of the past 15 tightening cycles in the post-WWII period did not lead to a recession. Market participants have also already priced in 4 hikes for this year, setting a high hurdle for the Federal Reserve to exceed market expectations and default to a hawkish stance.
- **Even Hiking Cycles That Led to a Recession Took Time:** For the 9 hiking cycles that ultimately led to a recession, it took about 30 months from the first hike to the onset of a recession and 24 months until the peak of the S&P 500, according to Ned Davis Research. Taken literally, these statistics would imply a peak in the equity market in early 2024 in anticipation of a recession starting in late 2024. We would not recommend underweighting equities today in response to that time table, as the average total return from the first hike to the peak of the market was 36%.
- **Earnings Remain Supportive:** We expect earnings to grow about 10-12% this year, a material slowdown from last year's almost 50% earnings growth. While this has fostered concerns about peak earnings growth, we note that about 75% of the time market peaks occurred more than two years after the peak in earnings growth. Additionally, these earnings are fueling record stock buybacks, which are estimated to approach \$900B this year. Finally, we think the growth in earnings will more than offset the decline in P/E ratios we expect this year in response to rising interest rates, supporting our expectation of mid-single-digit equity gains. Our bias toward relatively low P/E investing should provide a margin of safety, should our market forecast be too ambitious.

- **Prices ≠ Fundamentals:** Although market prices reflect fundamental developments, they are also subject to short-term distortions arising from technical factors and the behavioral biases of market participants. In the current environment, we think several of these factors are exacerbating price movements. Corporate buybacks are currently in their blackout period ahead of Q4 earnings, reducing a key source of equity demand. At the same time, the ability to transact large volumes of S&P 500 futures without moving prices is near its worst levels in years, according to Bloomberg analytics. Dealer hedging activity is also magnifying price movements according to Goldman Sachs Research as rising demand for downside hedges from worried investors—and the expiration of a large number of out-of-the-money call options on January 21st—is forcing dealers to sell into price weakness to hedge their exposure. Although active managers would typically buy into an equity pullback, their own problematic/poor year-to-date performance and resulting redemption pressure is instead necessitating further reductions in exposure into already vulnerable markets. In summary, recent market action might be overstating the degree of fundamental deterioration.
- **Sentiment is Bearish, a Contrary Positive according to Goldman Sachs:** Their proprietary sentiment indicators measure equity positioning across retail, institutional and foreign investors relative to the past 12 months. According to their research, it currently stands 1.4 standard deviations below the mean, the lowest reading in nearly 90 weeks. Such extremely depressed sentiment has historically been followed by favorable equity returns, with the S&P 500 generating returns higher than the average in the subsequent twelve months. Several other measures echo this poor investor sentiment. Consider that bullish respondents to the American Association of Individual Investors (AAII) survey have only been lower 8% of the time since 1987, and inflows into “negative” ETFs—which profit when stocks decline—reached a record high on January 14th.
- **The Rationale to Rebalance into Stocks:** We also see built-up potential for investors to further rebalance into equities, given the \$3.4 trillion difference between sizable cash/bond inflows and relatively small equity inflows since the end of 2018.
- **Odds Favor Remaining Invested in Expansions:** We continue to believe that a recession over the next year is unlikely. As we often highlight, investors enjoy an estimated 88% likely odds (according to our calculations) of a positive return and low risk of large losses when the U.S. economy is expanding. Past economic expansions have always been associated with sizable cumulative equity gains - which implies further upside despite the impressive gains from the pandemic lows.
- **Market Pullbacks Are Inevitable:** Equities most certainly can be a volatile asset class, which makes a periodic 5-10% drawdown statistically unavoidable. In fact, the odds of a 5% pullback in a given year are almost 100% during past periods with similar valuations (excluding 2017), while a 10% pullback occurred 79% of the time. As we have seen in recent years, however, the inevitability of pullbacks is not a good reason to exit the market since these pullbacks often occur from higher price levels and tend to be short-lived.

In Summary:

The above arguments put forth don't necessarily preclude continued year-to-date lows in major market indexes. But ultimately, there have been far more growth scares than actual recessions - and subsequent equity returns have tended to be quite strong as long as recession fears proved misguided. Our read of the current and prospective fundamentals is not consistent with a recession unfolding in the next 12 months, and hence we continue to recommend that clients remain invested.

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