Our Latest Thoughts on the Market

As 2022 unfolds, we have seen a host of familiar and some new issues pushed to the periphery as geopolitics takes center stage. The Russian invasion of Ukraine has had a profound impact on markets, with far-reaching implications for commodity prices (notably Energy, Wheat, and Nickel) and the outlook for growth. Investors headed into the current maelstrom positioned for business as usual, despite a line of sight towards significantly lower economic growth in the middle part of the year and an increasingly hawkish Federal Reserve. In the paragraphs below, we outline some of the major issues buffeting the market along with the opportunity set. Specifically, we provide our thoughts on the market and the conflict in Ukraine, fully acknowledging that we are not foreign policy experts. We also discuss our more cautious stance on equities over the next few quarters – driven by slowing growth, stubbornly high inflation readings, and a Federal Reserve determined (at long last) to "normalize" Fed policy.

The Conflict in Ukraine

Heading into the new year, equity indices hovered at or near historic highs, owing to a combination of heightened complacency, declining COVID cases, and a view that the Federal Reserve would continue to proceed with caution as growth slowed to still solid levels. These "*known unknowns"* have now been called into question, as Russia crossed the border into Ukraine. Greed has turned to fear, and most major indices are down double digits from their 52-week highs. The conflict in Ukraine has reverberated throughout global markets and will undoubtedly have long-lasting humanitarian and geopolitical consequences. For now, the West's primary response has been economic sanctions, which spurs questions about global trade during a period already fraught with supply chain shortages. The surge in commodity measures looks like a classic supply shock, leading to discussions about stagflation. However, we are reminded of the old adage about commodity markets: "The cure for high prices is…high prices."

"What's Next?" That's the question without an answer right now, given Putin's determination and limited ability to "save face." This is a scenario markets don't like and is reflected in volatility measures, which have spiked to multi-year highs. Investors are trying to parse every news story, Instagram post, and press conference to discern how long and how systemic the conflict will be. The war is less than one month old, and it remains to be seen whether it will drag on indefinitely, whether it will intensify, and whether it begins to overwhelm the global economy.

On the Energy and Commodity front, its presence has already been felt. Higher commodity prices will undoubtedly propel inflation higher in the near term. At the same time, tighter financial conditions will likely serve as a countervailing force, placing downward pressure on inflation over the medium term.

Together with the effect of higher natural gas prices on utilities costs, they could easily lift our 3.6% baseline forecast for headline consumer price inflation (CPI) above 4%. Higher prices for other commodities also pose upside risks. Crops like wheat and corn have risen substantially given Russia's and Ukraine's shares of world production.

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Milton, MA 02186	N.W. Washington, DC 20037	East Longmeadow, MA 01028	Worcester, MA 01606	Farmington, CT 06032

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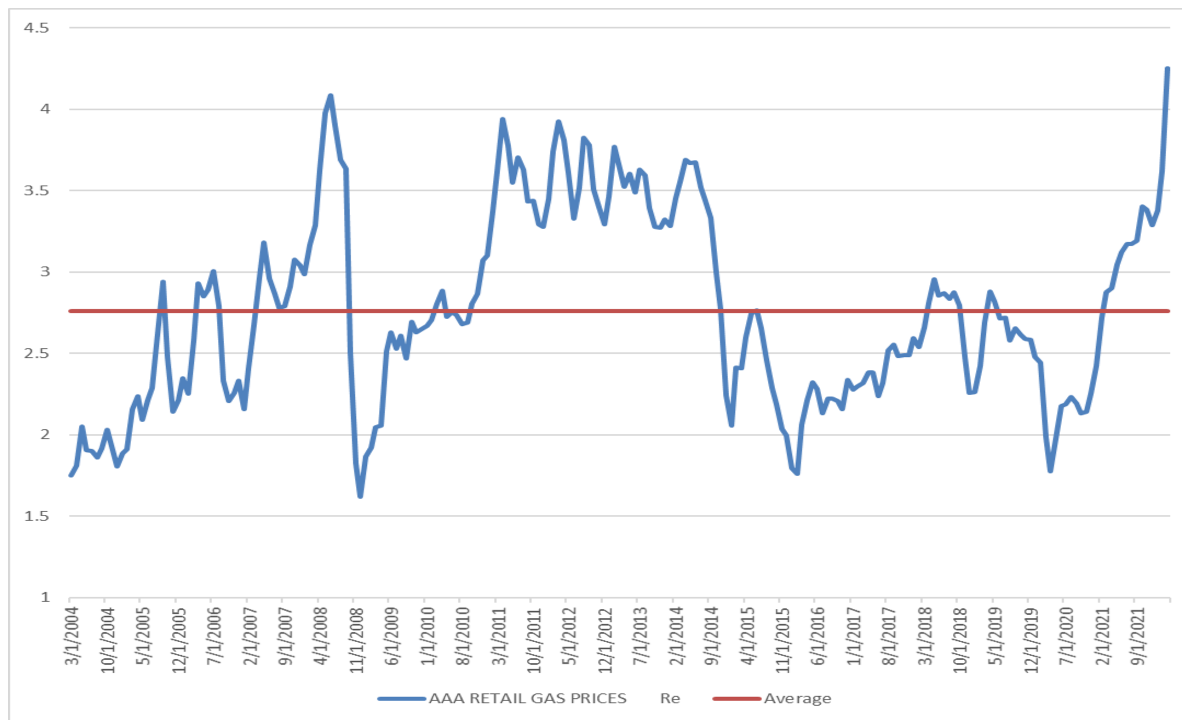
Our work suggests that higher gasoline and natural gas prices have the potential to throw budgets into disarray, as the increase in prices if sustained for a year would cost approximately $200 billion on an annualized basis. That's roughly $1,579 per household based on 2019 consumption pattern and comes on the heels of two years of significant household inflows (approximately $7500 per household). This will undoubtedly slow consumption. Expenditures on energy (natural gas and gasoline) range from 1.7% of disposable personal income for the highest income group to 7.7% for the lowest.

Furthermore, analysts estimate that these higher prices could crowd out other spending, as Energy as a share of income could increase by 75%. Our rule of thumb for the effects of oil on overall gross domestic product (GDP) is that a 10% increase in oil prices is worth about a tenth of a percentage point of GDP growth. However, there are crosscurrents to consider. The US has a roughly even balance of trade for oil—a considerable change from a decade ago—which indicates that the terms of trade and investment effects from higher oil prices can act as counterbalances.

AAA Average Retail Gasoline Price (2004 to Present)



Source: Bloomberg, AAA, and Seeley Howard Private Wealth, Inc.

The conflict in Ukraine is no doubt being watched closely by other leaders around the world with nation-building aspirations—notably, China's long-standing desire to bring Taiwan into its fold. The Chinese leadership have been careful

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not to criticize Russia for its actions, leaving many to wonder whether the outcome in the Ukraine could ultimately be used as a justification for a more aggressive stance towards Taiwan.

Out of the Frying Pan; Into the Fire?

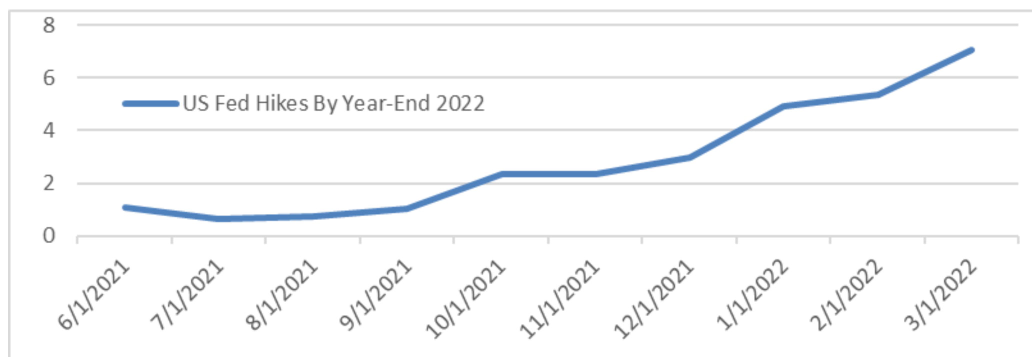
If clarity on the geopolitical front were reached in the next few weeks (or if the market felt that the situation in the Ukraine were manageable), it might be tempting to flash the all-clear sign and resume business as usual. However, we see risks to that strategy, given meaningfully slower growth, stubbornly high inflation, and a more hawkish Federal Reserve. The sharp rally from the March 14th lows will soon tell us whether the all-clear has been sounded. We aren't so sure.

Fed Policy

To us, most of the key questions about the future pace of the economy and the market can be answered if they know where inflation is headed. It ties into nearly everything that has an impact on GDP growth – the job market, supply chain issues, and of course Fed Policy. Stubbornly high inflation readings have persisted for long enough that even Fed Chairman Powell ditched the word, "transitory," and that was more than two months before the invasion of the Ukraine.

The path of the market and the economy will likely be determined by a handful of key decisions taken by policymakers around the globe. Their challenging job has been made more difficult by the recent Russia-driven commodity price spike. On an ex-post basis, it is clear that the Fed's "dual" (growth and inflation) mandate has really been more of a one-trick pony over the past four decades: Focus on Growth. This is due to structural disinflation: For the first time in many investors' professional lives, the Fed needs to balance the growth and inflation equation at a time when growth has already begun to slow meaningfully.

Market Implied Moves by the Fed by Year-End



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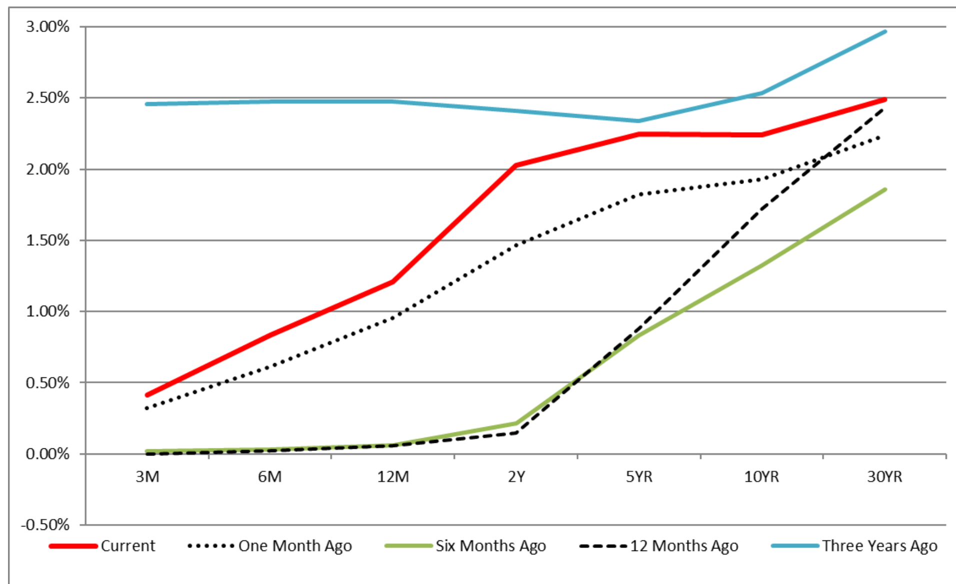
Forecasting the correct path of the economy in 2022 won't necessarily be a cheat code for figuring out the market. While "base effects" (exceptionally strong activity last year) will make growth acceleration nearly impossible in the middle of the year, we still expect reasonable GDP growth over the next three quarters. This creates an interesting quandary: The market typically focuses less on the absolute level of growth and is more sensitive to the rate of change (acceleration and deceleration). Keep in mind, growth this year will likely still bounce around the familiar 2% rate that we have seen on average since the Global Financial Crisis.

U.S. Treasury Yield Curve Over Time (as of March 21, 2022)



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Earnings & Valuation

We are keenly focused on earnings and valuations for the market, though we acknowledge that valuations matter more over the long term and come into keen focus during periods of slowing or declining growth. When economic growth is accelerating and "animal spirits" are on the rise, we like to say that people eschew cash flows in favor of concepts. Long-term, however, earnings – and the price you pay for a company's shares – matter. Indeed, over the past century, the market has followed the path of earnings quite closely.

We see a strong likelihood that investors will be left wanting this year after the stellar growth of 2021. Earnings growth approached 50% year-over-year in 2021 but are expected to slow meaningfully to the single digits this year.

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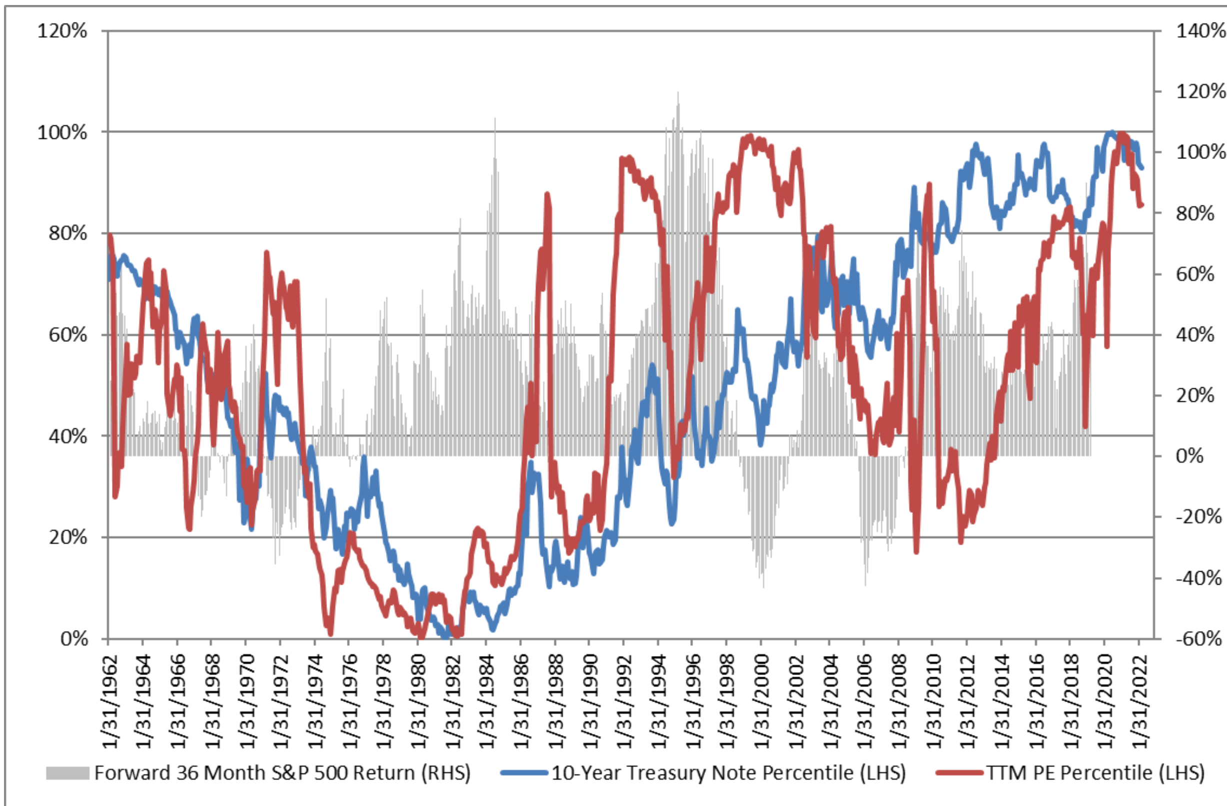
Valuations haven't mattered for most of the past two years. Earnings volatility has made earnings-based valuation challenging, and strong growth has proven flattering to multiples. However, if revisions turn lower, the above-average starting P/E (Price-to-Earnings) ratio could prove quite vulnerable. The forward 12-month P/E ratio stands at just over 18.5, which is in-line with the 5-year average of 18.6x and 10-year average of 16.8x. Beneath the surface, a lot of damage has been done, with the average stock in the Russell 3000 now down more than 33% from its 52-week high. The "megacaps" have generally shielded the major indices from the significant drawdowns of the bulk of the market. The primary risk, in our view, is if those leaders begin to slide, as well.

Asset Valuations: Stocks and Bonds, Percentile Valuation Since 1962



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The Road Ahead

For most of the past two years – against a backdrop of accelerating growth – we have highlighted periods of episodic volatility as opportunities to add to positions. Given the specter of slowing growth and inflation, however, we believe investors may benefit from pivoting towards more defensive areas of the market, like Utilities, REITs, Consumer Staples, and even Treasuries. This is not a call to head for the exits; rather, it is a time for tactical repositioning. We continue to believe high quality equities should remain a core part of the allocation if there are no immediate need to access the funds.

Looking ahead, we see opportunities for investors, though patience and discipline are prerequisites. We continue to believe that a data-dependent process can help navigate challenging periods. Having a roadmap can help discern noise and narrative from real risks that stand in the way of achieving one's long-term investment goals.

Potential Positives for the Market

- COVID case counts continue to show signs of improvement
- Employment trends remain robust
- Financial Conditions remain supportive and growth – while decelerating – remains positive.
- Household net worth remains near a record high for the U.S. boosted by stock market gains and rising house prices
- Interest rates remain low around the world
- Corporate default rates remain low
- Corporate earnings remain robust
- Household balance sheets remain in strong
- Sentiment has gone from complacent to fearful in fairly short order (though positioning remains bullish)
- Beneath the surface, many stocks have fallen meaningfully from their recent highs, making forward return prospects potentially more attractive

Potential Negatives for the Market

- Geopolitical risks abound following Russia's invasion of the Ukraine
- Energy prices have spiked to historic highs following economic sanctions on Russia, a major oil and gas producer
- Questions abound about the ability to maintain growth without outsized help from the Federal Reserve
- The domestic economy looks poised to slow meaningfully given challenging "base effects" and the lapping of significant stimulus payments
- Rising interest rates could dampen loan demand and curtail the current housing boom
- Overall corporate debt levels stand at historic highs
  Record deficits raise questions about financial stability and the need for future growth-dampening austerity

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If you have any questions, don't hesitate to contact Steve or Chris.

Best,

Steve and Chris

Steve Howard
steve@seeleyhoward.com

Chris Seeley
chris@seeleyhoward.com

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