Market Strategy
by STRATEGAS A BAIRD COMPANY

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Addressing Market Volatility

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It's no secret that we've had a volatile start to 2022—in the financial markets and in the real world. Strategas Chairman and CEO Jason Trennert discusses recent geopolitical volatility, what it means for inflation and the Fed, and his outlook for equities for the rest of year.

Jason Trennert, Strategas
Chairman and CEO

How is Strategas thinking about the Ukraine-Russia situation? There's no question the situation is a risk-off development for the market, so we want to focus on high quality companies. This will prove especially prudent if the increase in inflation forces the Federal Reserve to raise rates aggressively (highly-levered, lower quality firms have benefited from very low interest rates). We also think we could see, to a certain extent, an end of the globalization trend of the last 30 years, which will influence investors to stay closer to home. We think the US should be able to avoid a recession, but Europe may not be so lucky.

At a higher level, how should investors think about geopolitical uncertainty moving forward? This is always a difficult question because we're not geopolitical experts. We make it easier on ourselves by focusing on what the markets are telling us over what an expert might be saying. We're watching credit spreads and the US dollar carefully, and while you can see stress developing, it looks manageable at the moment. The best advice is to focus on the facts—the observable and measurable—as opposed to the latest soundbite. It's been said that the first casualty of war is the truth, and I believe that.

How does this affect your outlook for inflation and for the Federal Reserve? Inflationary pressures will increase for a variety of reasons. **1.)** geopolitical volatility impacts the price of oil (which is already moving higher) because, as I believe, we've been limiting supply unnecessarily. **2.)** I think you'll see an increase in defense spending globally (especially in Europe and Japan), and government spending tends to be inflationary. **3.)** To a certain extent we may see an end to the globalization trend of the last 30 years, causing companies to focus more of their production at home and keep supply chains tighter—both of which come at a cost. While the geopolitical turmoil may pressure global growth, we don't believe it will change the Federal Reserve's calculus on the need to tighten. As it stands today, we continue to think the Fed will raise interest rates five times this year.

With all of this in mind, what is your outlook for stocks for the remainder of 2022? It looks like profits for the S&P 500 will be up about 8% this year, which is solid. However, I think the prospects for higher interest rates and inflation mean that investors will be willing to pay a lower multiple on earnings than they would otherwise. I hope I'm wrong, but I think single-digit returns are pretty likely in 2022, and perhaps beyond. So again, I want to focus on quality and on companies that provide earnings and cash flows. As an expression of that view, we currently have a bias toward Value-oriented sectors in the United States. Higher level, interest rates are still low, so equities will continue to be one of the better asset classes to be invested in. But I think some of the returns that we've become accustomed to over the last several years are unlikely to continue both because of inflation and because of the prospects for higher interest rates.

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