Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Quarterly Market Update

First Quarter, 2022

RECESSION WATCH, VOLATILITY, INFLATION, AND THE FED

We believe investors are facing one inescapable question today—Can the Federal Reserve get control of inflation without inducing a recession? The March rally in Growth stocks suggested that a slowdown may be more likely than a recession. Investors should favor Growth stocks, the thinking goes, because economic growth will be scarce. Adding to the argument against a recession in 2022 are healthy employment numbers, job openings, corporate and personal savings, and still-accommodative monetary policy. Still, the odds of a recession in 2023 are increasing as the Fed seems to be indicating that it will tighten until significant progress is made on inflation, say 3.0% core PCE, the Fed's preferred measure of inflation. Core PCE, which excludes more-volatile food and energy prices hit 5.4% in its latest reading. Putting all this together, the equity market can expect little support from the Fed in the near-term.

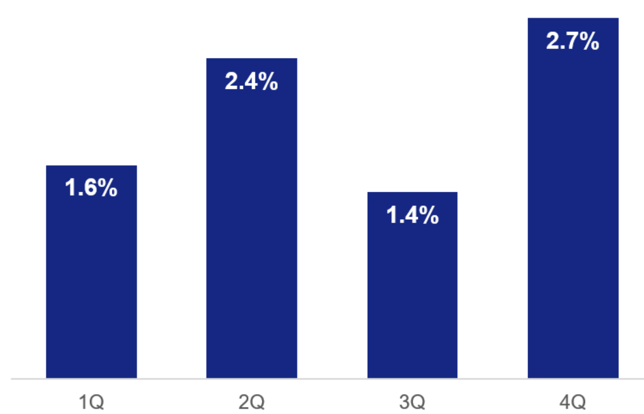
Although the major indices rallied into the end of the quarter, we believe that increased market volatility is likely to continue. No one knows how long the war in Ukraine will last but sanctions on Russia are likely to extend well into the future. Globalization is now in reverse. And although earnings are likely to rise due to the impact of the "money illusion" (the human inclination to feel like you have more money based on dollar amount, even as inflation keeps your money from going as far), we suspect that guidance from corporate management teams will be less than enthusiastic. Earnings may rise but the price multiple investors are willing to pay for those earnings is at risk of falling.

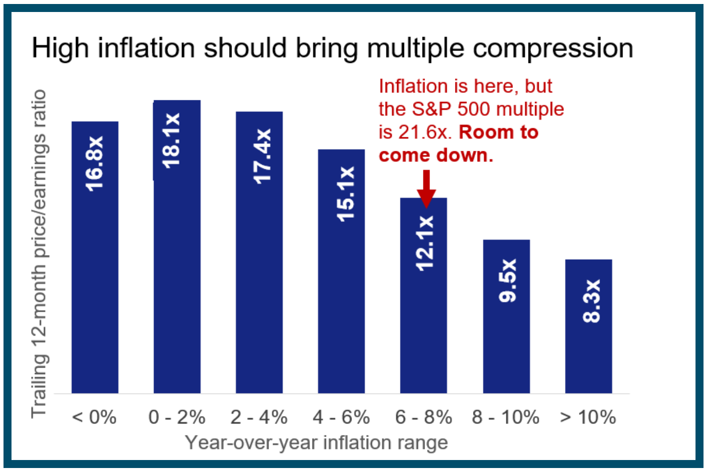
Finally, it seems likely that a corporate tax hike will be included in the Biden administration's budget. Such an increase could mean that inflation remains elevated even as the economy slows—especially taking into account rents, wages, and policy choices that appear to be creating a shortage of fossil fuels and heightened demand for industrial commodities related to electric vehicles (e.g. copper).

The still-large gap between the S&P 500's earnings yield (profits / price) and the 10-year Treasury yield suggests that the equity market is at little risk of a collapse. Still, it is important to remember that the Fed has only just begun to tighten monetary policy. Until recently, perpetually negative real rates meant that virtually all stocks, regardless of valuation, were better options than bonds for those seeking higher absolute returns. That dynamic is now changing as long-term rates head higher. Going forward, we believe the better alternative to bonds will be relatively "short-duration" equities that have the cash flow to return capital to shareholders (by paying dividends and buying back stock). It's wise to remember Wall Street legend Marty Zweig's advice—"Don't fight the Fed"—but we believe the idea that stocks will do well as an asset class because "there is no alternative" (the TINA theory) is beginning to change.

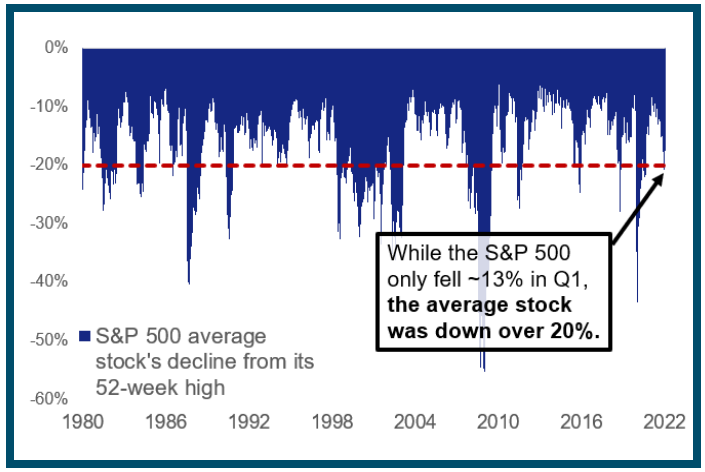
Asset Class	Representative Benchmark	Q1 Return
US Large Cap	S&P 500	-4.6%
US Small Cap	Russell 2000	-7.5%
International	MSCI EAFE	-5.8%
Commodities	Bloomberg Commodity	25.5%
Municipal Bonds	BBgBarc. Municipal Index	-6.2%
Taxable Bonds	BBgBarc. Aggregate	-5.9%
Cash	FTSE 3-Month T-Bills	0.0%

S&P 500 Average Quarterly Return (since 1928)





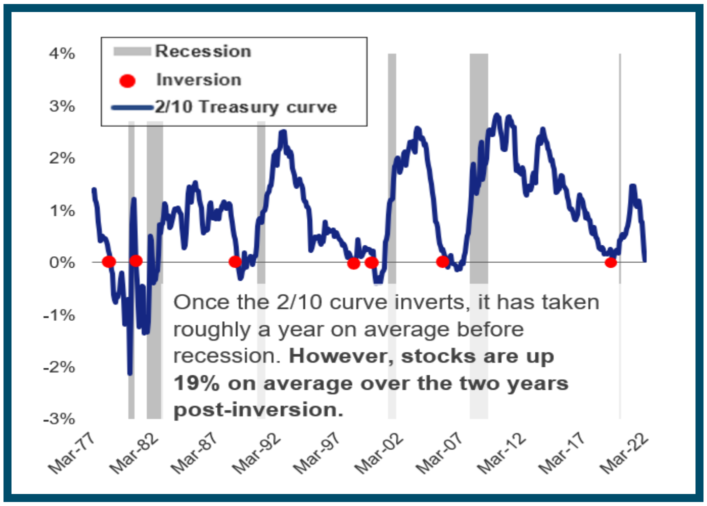
In periods of elevated inflation, the multiple that investors are willing to pay for earnings typically falls. Higher interest rate environments (which are often a result of said inflation) have seen the same. Given the war in Ukraine, continued Covid-related supply chain woes, and the Fed's promise to hike interest rates aggressively, both of these environments could persist near-term. However, profits are still expected to expand in the coming year, so the push-pull between earnings growth and multiple contraction will ultimately determine the path of markets in 2022.



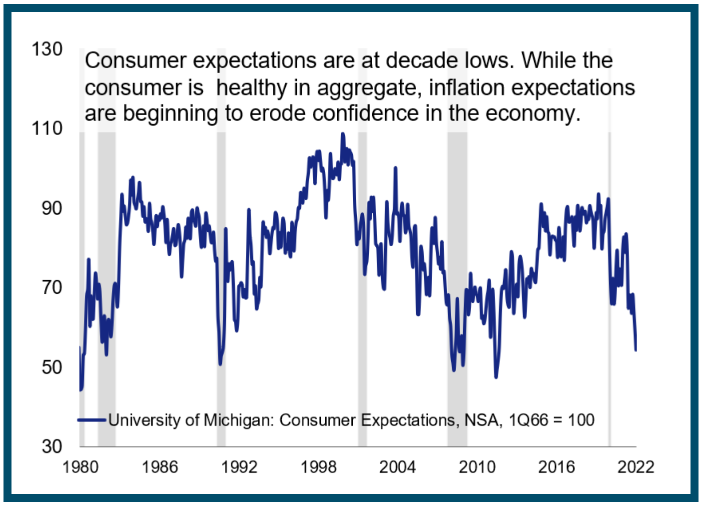
Though the stock market correction in Q1 was the biggest drawdown since the early days of the pandemic, the headline decline (-13%) likely obscured the greater pain beneath the surface, where the average stock was off over 20%. This sort of washout is common during bigger, non-recession selloffs; for example, the -20% level was breached in 2011, 2016, and 2018. At the very least, this chart should be reassuring to those who deemed the -13% correction relatively benign when considering the inflation, geopolitical, and monetary policy backdrop.

The strength in corporate profit margins despite the headwinds of the past two years (labor shortages, wage growth, raw material costs, etc.) is one of the big themes of the 2020s. This strength has held across sector and style. But while the record levels are expected to persist, the growth rate is expected to slow significantly. This is not uncommon in the years following a recession, but it can be a headwind for equity performance. This should push investors to give extra consideration to firms that can protect margins and retain pricing power in this environment.

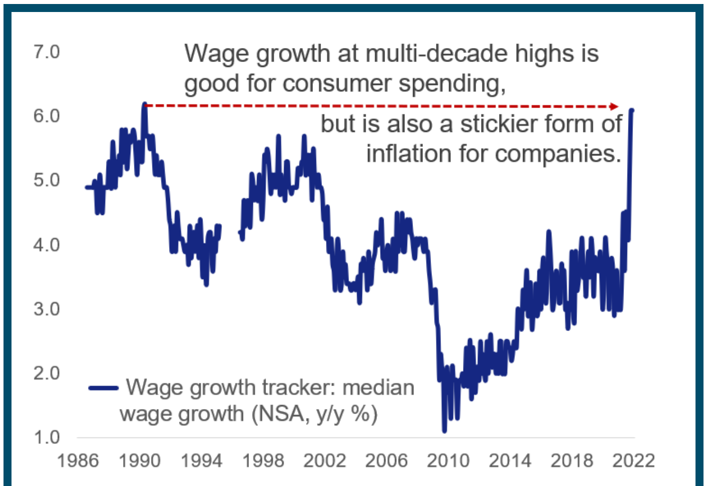
While the inflation story is well-covered, not enough attention has been paid to the impact that higher energy prices will have on the cost of agricultural goods. Natural gas and coal are critical to the production of ammonium nitrate, the most commonly used fertilizer. It has been estimated that Energy accounts for between 20% and 30% of absolute agricultural costs. In poorer countries, expenditures on food make up a significant portion of disposable income. That is why, throughout time, there are few human events more politically destabilizing than inflation.



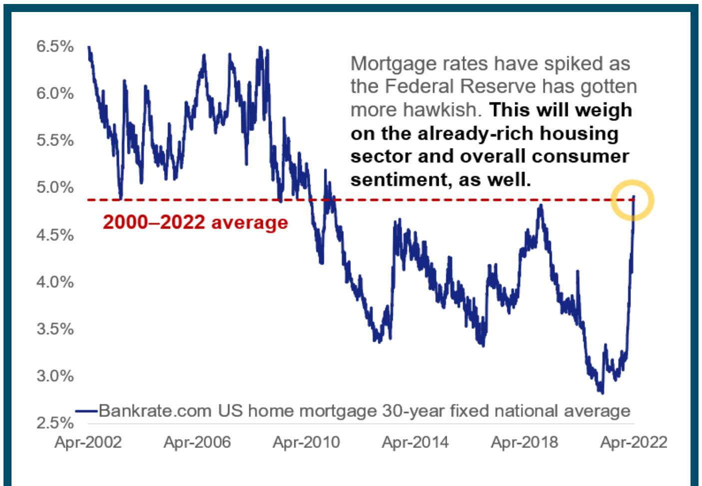
The Treasury yield curve is closely followed in financial circles for its ability to predict near-term recessions when it "inverts." Curve inversion (short-term yielding more than long-term) is a powerful indicator because it is as accurate (the 2yr/10yr curve inversion has predated all six recessions since 1978) as it is uncommon (over the last 40 years, the 2yr/10yr curve has been inverted just 7% of the time). Still, the 12 months post-inversion have actually been quite positive for risk assets like stocks. Generally speaking, the data shows there is still time in the near-term for markets to perform well.



Weaker consumer data in the early stages of a Fed hiking cycle is a challenging combination. If inflation becomes entrenched in consumer expectations, it can become a self-reinforcing mechanism. For example, if demand is strong, firms may raise prices to combat higher input costs. But eventually, a tight labor market means wages (input costs) rise. Then, prices must rise again, and so on. This a classic wage-price spiral and is one of the ways "transitory" inflation can become entrenched. Weaker consumer confidence has also portended a drop in consumer spending in the past.



Based on history, the U.S. doesn't go into recession without labor market weakness. And as of yet, the labor market is robust (bordering on overheating). In 2022, initial claims for unemployment insurance hit a 53-year low, job openings sat above 11 million, and unemployment is near a five-decade low. Of course, the flip side of this labor market strength is wage inflation, which is a serious concern since wages are downward sticky (i.e. hard to reverse). This will pose a challenge to the economy and U.S. businesses.



U.S. housing has been booming for nearly two years. Recent data, however, has turned a bit more mixed, with existing home sales, new home sales, and mortgage applications all declining of late. U.S. housing is an interest-rate sensitive sector and is now firmly in the crosshairs of tighter monetary policy. While historic inflation and a robust U.S. labor market support further rate hikes, the Fed is now likely in a "tighten until something breaks" mode – we're watching housing to see how close we are to that event.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equity of small capitalization.● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990 and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. Bloomberg Commodity Index (Commodities): Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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