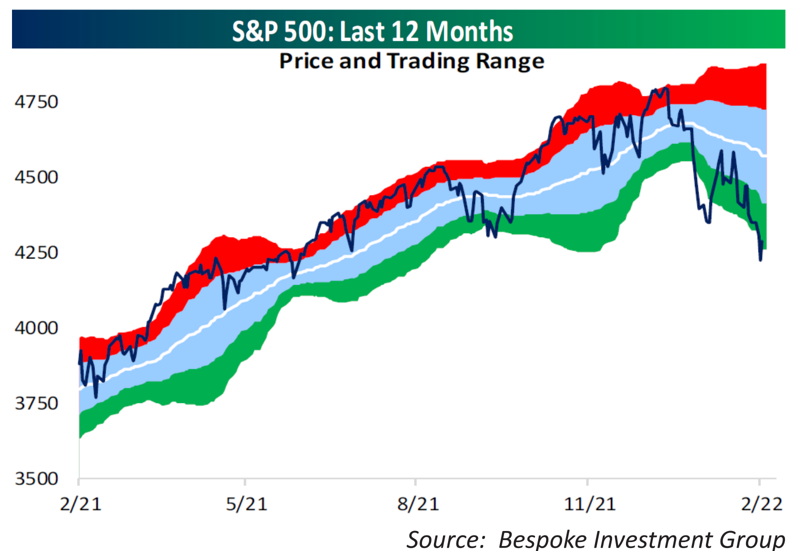
Capital Ideas

03/03/2022

Any recap of current news events will be seriously outdated by the time you receive this letter. So rather than repeat the headlines we will try and discuss the implications for markets and your investments from the invasion of Ukraine. The two most obvious are intensifying cost pressures driving inflation and the increasing uncertainties weakening upside market momentum.



Source: Bespoke Investment Group

The Ukraine, specifically Odessa, is a major port for the export of Urals oil. The country is also the southern crossroads for oil and gas pipelines carrying Russian petroleum exports. As we are writing this the price of West Texas Intermediate crude is trading above $105 per barrel. The disruption in petroleum markets is not the only difficulty facing commodity markets. Ukrainian corn is 16% of world exports and Russian and Ukrainian production of wheat account for 29% of world consumption. With ports on the Black Sea closed no grain or petroleum exports are moving. And longer-term spring crops may not be planted extending grain shortages into the foreseeable future. Additionally markets as disparate as metals and fertilizer are being disrupted. Russia is a major producer of aluminum and palladium, and it remains the world's largest exporter of potash, a major ingredient in fertilizer.

One positive consequence of the conflict is dollar strength. The US dollar is viewed as the ultimate safe-haven currency and intense demand for it is sharply lowering domestic interest rates. Those lower rates may help slow the rapidly decelerating growth of domestic GDP evident in the Atlanta Fed's estimates of first quarter GDP. Currently they believe economic growth will be less

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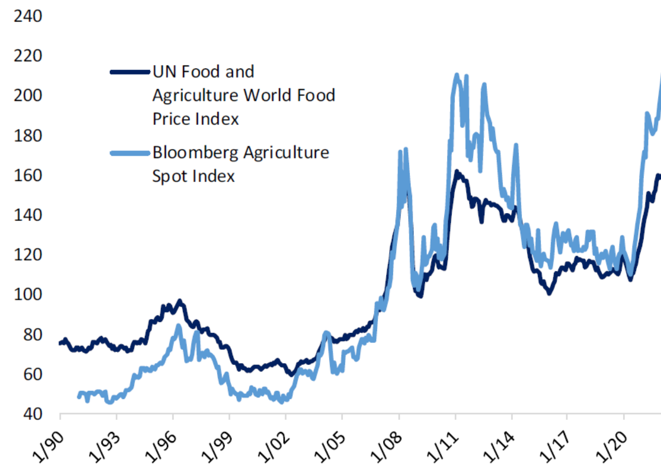
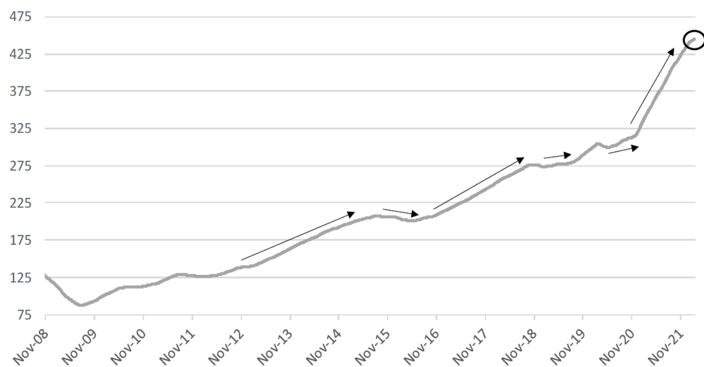
than 1% compared with 7% growth in the fourth quarter of 2021. According to Jay Powell uncertainty created by the conflict has slowed growth of the economy enough to temper the Fed's plans to rapidly increase interest rates this year. In our opinion this expected economic weakness combined with the uncertain situation in Ukraine has been the primary reason for the stock markets loss of upside momentum over the last two months. Jay Powell's statements in Congressional testimony pertaining to the Fed's policy shift may be the catalyst that reinvigorates the markets rally.

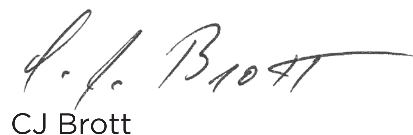




Source: Bespoke Investment Group

On a humanitarian basis we hope for a peaceful resolution of the Ukrainian conflict in the very near term. But we believe the effect of this war will extend beyond the cessation of hostilities. The the chart of the S&P's 200 day moving average indicates an upcoming period of sideways market movement in the intermediate term. With the current economic indicators signifying a slowdown in growth coupled with higher commodity inflation we believe a bifurcated approach to portfolio construction will yield the optimal investment results. Therefore, while retaining your allocation to growth investments we have increased your portfolios investment in inflation sensitive securities. We did this by adding the SPDR Metals and Mining ETF (XME) to your Invesco Commodity ETF (DBC). We believe this balance between your growth-oriented securities and inflation sensitive equities should enhance your returns in this uncertain investment environment.

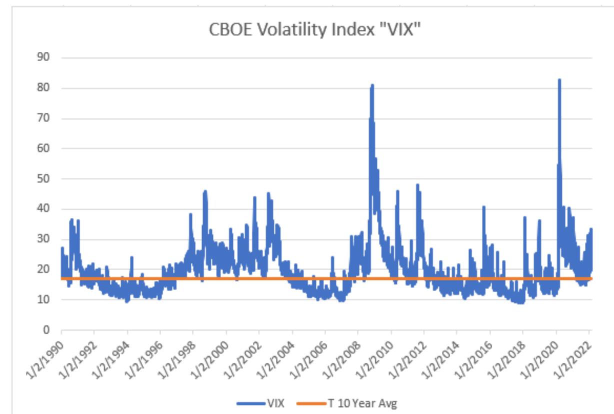
Sincerely,



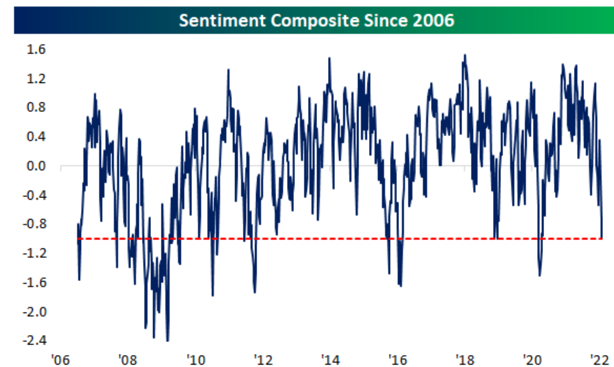
CJ Brott

Karen Burns

February was another challenging month for investors – the S&P 500 posted a return of -3.1% bringing the year-to-date return to -8.2% through the first two months of 2022. Volatility remains elevated – the CBOE Volatility Index (the “VIX”) ended the month at 30.15 compared to 17.22 at the end of 2021.



While the macro events driving elevated volatility (Russia/Ukraine conflict, inflation, Fed policy concerns, etc.) dominate the headlines on a daily basis, as investors we must assess both the current and long-term health of the economic environment and corporate earnings prospects. And the question facing investors right now – is a further pullback across markets likely or should this be viewed as an attractive entry point?



** Average of z-scores of AAII bulls, Investors Intelligence Bulls, and NAAIM Exposure Index.*

S&P 500 After Extreme Bearish Sentiment

	Sentiment	S&P 500 Performance (%)				
Date	Composite	Week	Month	3 Month	6 Month	Year
7/6/2006	-1.07	-2.50	0.49	4.85	11.32	20.23
8/30/2007	-1.38	-0.28	4.74	-3.46	-8.71	-11.99
1/10/2008	-1.11	-6.13	-6.27	-3.86	-11.75	-37.31
7/1/2010	-1.02	4.92	7.23	11.17	22.62	28.55
6/16/2011	-1.04	1.25	3.83	-8.31	-3.31	5.93
9/24/2015	-1.02	-0.44	6.22	3.79	5.37	12.03
1/14/2016	-1.47	-0.78	-2.97	7.28	12.59	18.36
12/20/2018	-1.00	0.74	6.71	14.46	19.58	30.55
3/12/2020	-1.27	-2.87	12.46	30.30	37.02	58.96
1/27/2022	-1.01	?	?	?	?	?
	Average	-0.67	3.60	6.25	9.41	13.92
	Median	-0.44	4.74	4.85	11.32	18.36
	% Positive	33.3	77.8	66.7	66.7	77.8
	All Periods					
	Average	0.17	0.71	2.17	4.74	9.88
	Median	0.33	1.10	2.95	5.48	11.27

** Times when the sentiment composite falls below -1.*

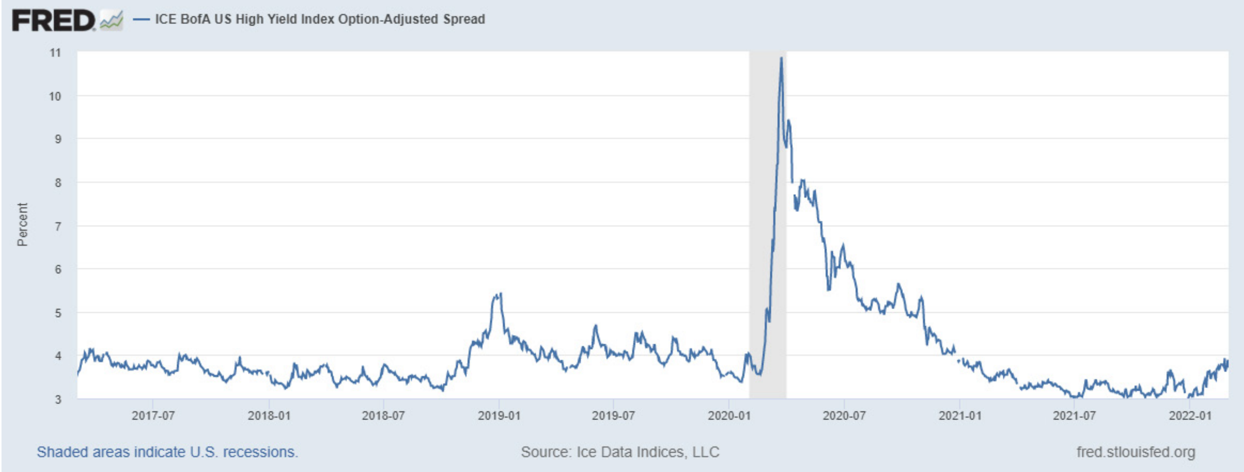
Source: Bespoke Investment Group

While it is difficult to predict the direction of markets in the short-term, investors may find some comfort in the fact that forward returns have historically been strong following a sharply negative shift in investor sentiment (which generally results in a market pullback).

While this may seem counter-intuitive at first glance, it provides support for our view that equity investors tend to over-react to both good and bad news in headline-driven markets (like we are currently experiencing).

Following 2009, investors have turned bearish multiple times despite the overall economic environment remaining generally healthy. Given oil prices have now soared well above $100/barrel, investors may find it somewhat ironic that sentiment shifted well into bearish territory in late 2015-early 2016 due the fact that oil prices had plummeted and there were concerns regarding energy companies’ ability to service their debts.

To be clear, significantly elevated inflation and uncertainty regarding a less accommodative Federal Reserve may ultimately drive a slowdown in economic



growth and a less healthy consumer. That said, it appears that investors are baking in a great deal of negative outcomes based on recent selling behavior. Corporate earnings have generally remained strong while their stock prices, in many cases, have been pummeled after reporting results. While investors are forward-looking, should events play out in a less negative fashion than many are expecting, that could fuel a market rally later in the year.

Last month, we looked at high yield bond spreads (the excess yield investors require on high yield corporate bonds compared to U.S. Treasury bonds of a similar maturity) and noted that, while high yield spreads have modestly increased, they have not widened meaningfully as one would expect during a significant equity market sell-off. The same can be said today – at the end of February, high yield spreads were 3.77% (well inside of the historical average) compared to 3.63% a month ago and 3.10% at the beginning of the year. This may imply that institutional investors have a more favorable view of fundamentals than would be implied by current equity market volatility. While most companies would likely be able to adequately service their debts even if economic growth were to decline, it is unlikely that spreads would remain at current levels if institutional bond investors viewed negative economic growth (a recession) as a likely near-term event.

As always, we thank you for your patronage and encourage you to call us with any questions or concerns.

Sincerely,

Andrew Kerai