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COMMENTARY

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As we cautioned in our 2021 year-end letter to clients, the new year has started with a bumpy ride in markets. After hitting an all-time high on January 3, the first trading day of the new year, the bellwether S&P 500 fell nearly 12% by February 23. The declines have been significantly more severe in certain pockets of the market. For example, the technology dominated NASDAQ was down slightly more than 20% peak to trough, the classic definition of a bear market, from the highs of November until the lows of February. The ARK Innovation ETF, which we have previously used as an illustrative example of the hyper-growth area of the equity market, was down more than 35% at its lows since the beginning of the year, a staggering decline on top of its decline of 24% in 2021. This painful transition period began with worries about inflation and the Federal Reserve's reaction to it, and more recently, by the Russian invasion of Ukraine.

For much of 2021, the Federal Reserve consistently used the framing of "transitory" to describe the increase in inflation seen across the economy, a topic we touched on multiple times in 2021 Commentaries and quarterly letters. This characterization has changed dramatically since the late fall, as a continuous run of high inflation reports have increasingly pushed the Fed into a hawkish position. The Fed, in an effort to prepare the market for coming action, has had its top voting officials begin to "leak" out their opinions on the pace of rate hikes. This deliberate messaging has not been missed by the bond market, with the 2 year Treasury rate, an important market indicator of how quickly the Fed will raise rates in the coming years, rising from ~0.7% to a peak of 1.6% in little more than a month. This aggressive re-pricing of interest rates has been a significant catalyst for the equity declines experienced thus far in 2022.

Just as markets became wobbly due to Fed worries, Russia made the stunning decision to invade Ukraine, the largest conventional military attack in Europe since the Second World War. The conflict has been a devastating tragedy for the people of Ukraine, and our thoughts and prayers go out to all of those affected by this unprovoked war. In response to the invasion, the Western democracies have responded with humanitarian and weapons aid to the Ukrainians, and increasingly severe economic sanctions directed towards Russia. The latest sanctions include banning Russia's central bank from making any dollar transactions and limiting the countries access to SWIFT, an international payments system. These actions are being taken to inflict pain on the Russian economy, harming Russia's financial capacity to wage war, and increasing unrest amongst the Russian people to pressure the government to change course. The financial consequences have been severe: the Russian Ruble has lost 29% of its value against the US dollar and the Russian stock market has plunged over 50%. As of this writing, Russian leadership remains undeterred, and the long term ramifications of the unprecedented actions taken thus far by both Russia and the West remain uncertain.

The US equity markets have rallied since hitting a recent invasion fear low, but in all likelihood the turbulence is not over. The crisis in Ukraine remains unresolved, and at this point in time, it is hard to see an off-ramp to the hostilities. The situation has reduced market expectations for a 0.5% increase in the Fed Funds rate in March from close to 100% to less than 5%, but the market still expects 4 or more rate hikes in 2022. In the very near term, the conflict in Europe may increase inflation at a point when the Fed has become determined to fight it. Both Russia and Ukraine are large exporters of commodities: Russia in the energy markets and Ukraine in agricultural commodities such as wheat. Disruptions to these markets will cause prices to rise. Global growth expectations have dropped dramatically, as a financial crisis in the 12th largest economy in the world will have wide reverberations. This leaves the Federal Reserve in a box: determined to fight inflation, but now increasingly wary of tightening monetary policy during an international geopolitical and economic crisis. Despite all of the negative headlines, we must remember that markets are forward looking. It is possible that max-hawkishness from the Fed has been priced in, with any reduction in rate hike expectations becoming a tailwind for equity markets. Historically, volatility increases as equities begin to price in a rate hiking cycle, but have positive forward returns from the time of the first hike, as can be seen in the above chart.

S&P 500 Index Performance After The First Fed Rate Hike

		S&P 500 Index Future Returns		
Date Of First Hike	Size Of First Hike	Next Three Months	Next Six Months	Next Twelve Months
8/8/1983	0.50%	2.0%	-0.7%	2.1%
4/1/1987	0.25%	3.6%	10.1%	-11.7%
5/11/1988	0.50%	3.4%	8.6%	20.7%
2/4/1994	0.25%	-5.9%	-2.5%	2.4%
3/25/1997	0.25%	13.6%	20.6%	39.6%
6/30/1999	0.25%	-7.6%	6.6%	6.0%
6/30/2004	0.25%	-2.3%	6.4%	5.2%
12/16/2015	0.25%	-1.1%	0.1%	9.1%
Average		0.7%	6.1%	9.2%
Median		0.5%	6.5%	5.6%
% Positive		50.0%	75.0%	87.5%

Source: LPL Research, Bloomberg 01/10/2022

With all of this in mind, from a valuation perspective, it appears that much of the excess exuberance of 2020 and 2021 has been wrung out of markets over the last two months. The forward P/E of the S&P 500 has fallen to about 18x from a peak of greater than 23x in August, driven by both growing earnings and recently falling prices. While not historically cheap, it is the first time since the initial COVID crash that equities are trading at a discount to their 5 year average, and much closer to historically average levels. Given the uncertainty, we expect volatility to remain elevated until there is more clarity on Fed policy and a resolution to the situation in Ukraine.