TAKE 5 VIEWS

Keeping cool on a rocky road

Kenneth T. Kozlowski, CFP, CLU, ChFC
Chief Investment Officer
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2022 has been off to a rocky start - with a war, Omicron, inflation, and the markets dropping significantly - the S&P 500 down 12.9% through the end of April. Below we share insights from some of our subadvisors on the challenges facing today's markets and suggestions on how to meet these challenges. Our approach to investing has always been to look to the long term and keep emotions out of investment decisions. As Meera Pandit from J.P. Morgan says in the closing article *"The best strategy during volatile times is to maintain composure and stick to your investment plan."*

1 Markets struggle to adjust in the face of Fed uncertainty

Kristina Hooper
Chief Global Market Strategist,
Invesco Distributors, Inc.

Invesco

Key takeaways

- **Market confusion**
  Markets are clearly confused about what the Federal Reserve will do this year and just how aggressive it will get.
- **A global issue**
  This uncertainty also exists for other major central banks – will they be able to tamp down inflation without sending their economies into recession?
- **Historical perspective**
  I think taking a historical perspective is helpful: Rates are likely to still be relatively low once tightening ends.

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I'm so old that I can remember "pre-QE" fixed income markets — the time before quantitative easing when yields were more normal. As newlyweds back in 1996, my husband and I decided to buy a starter home. We met with a lending officer from a local bank (which has long since been acquired by a series of larger banks) who provided us with a plastic mortgage "calculator" – essentially a sliding scale that showed what your mortgage payment would be for every $1,000 you borrowed, depending upon your interest rate. The calculator's scale ran from 6% to 20%, reflecting the range of mortgage rates for the last several decades. While I kept that gadget for posterity, it proved obsolete once monetary policy got very accommodative and mortgage rates fell well below 6%. Of course, just like A-line dresses and bell bottoms tucked away in the backs of closets, I suspect this relic in the back of my desk drawer might be useful once again, at least for my children.

The impact of experimental monetary policy

In my opinion, U.S. mortgage rates are just one example of how experimental monetary policy from major developed central banks created financial repression and re-shaped fixed income markets in much of the world. While many economists and market observers have pined away for a "return to normal" for more than a decade, it really never happened. Yes, the U.S. Federal Reserve – which led the charge on very experimental, accommodative monetary policy in the wake of the Global Financial Crisis – began a tightening cycle back in 2015, but it was as slow as molasses and never got very far before reversing course. And so here we are again, with major Western central banks beginning another tightening process – and for some, a far more aggressive one.

It stands to reason that there is a high level of anxiety in markets. We've all become accustomed to a low yield world after being mired in it for so long. Change can be very difficult, especially when it's coupled with uncertainty about high inflation and confusion about Fed policy. And so the ugly month of April has continued into May, helped along by continued confusion from the Fed. Fed Chair Jay Powell started off sounding very hawkish, addressing the American consumer directly and emphatically declaring that "Inflation is much too high" at his press conference following the May Federal Open Market Committee meeting. (This reminded me of an obscure populist politician in NY whose slogan was "the rent is too damn high" and created a single-issue political party based on it). Powell boldly stated that the Fed has the tools to bring inflation down and that it will use those tools. He reiterated that the Fed is "highly attentive" to inflation risks.

However, in the question-and-answer portion of the press conference (which, of course, is the unscripted portion), Powell got somewhat more dovish. When asked about what he thought the neutral rate was, he answered 2% to 3%. In addition, he said that a 75 basis point rate hike was not a consideration at this point. And that created some confusion and volatility for both equities and fixed income.

Uncertainty abounds for markets

Markets are clearly confused about what the Fed will do this year and just how aggressive it will get. That can be seen in the volatility in expectations for where the fed funds rate will be at the end of 2022, as seen in fed funds futures. And it is reflected in stock market volatility, with the VIX above 30.1

This uncertainty exists for other major central banks – will they be able to thread the needle and tamp down inflation without sending their economies into recession? I believe each central bank will have to be data dependent to have the best chance to achieve a soft landing.

In particular, the energy and wider commodity shock is a much greater challenge for the Eurozone and United Kingdom than it is for the U.S.. In the UK, Bank of England (BoE) Governor Andrew Bailey has more or less signaled a high risk of recession, almost signaling a limit to the extent of tightening. The BoE has thus gone from being the most hawkish of the large central banks to being much further behind in the pack. In the Eurozone, asset purchases are likely to be wound down, but balance sheet reduction seems unlikely. And though rate hikes seem increasingly likely to start after mid-year, the hikes are likely to be smaller and slower than in the U.S.

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In conclusion, change is difficult – especially when it is accompanied by confusion and uncertainty. I think it's worth noting that, despite a lot of volatility last week, the S&P 500 Index was essentially flat.1 One friend of mine, who is a high-net-worth financial advisor, told me she's not getting calls from clients asking to sell securities, but she is getting calls from clients asking to switch from monthly statements to quarterly statements so they can avoid seeing volatility – and therefore avoiding getting rattled. I think taking a historical perspective is helpful: Rates are likely to still be relatively low once tightening ends — I don't think we'll need to consult anything other than the very low end of my old plastic mortgage calculator anytime soon. And while I don't expect this period of volatility and sell-offs to end immediately, as it's likely to take more time for markets to digest a new monetary policy world, I'm confident markets will adjust to this change. For long-term investors, I believe this digestion period can present buying opportunities in equities, fixed income and alternatives.

2 Managing Challenges in U.S. Equity and Fixed Income Markets Today

FRANKLIN TEMPLETON

Edward D. Perks, CFA, Chief Investment Officer,
Franklin Templeton Investment Solutions

Key Points:

- The U.S. equity and fixed income markets are facing challenges due to a slowing U.S. economy along with a significant pivot in monetary policy toward a more hawkish stance.
- Combating inflation has become a priority, and investor focus has shifted toward the uncertain impact of rising interest rates on the economy and markets.
- Despite challenges, U.S. corporations are faring well so far in 2022, and the strength of the U.S. labor market could delay or prevent a U.S. recession.

Equity and Fixed Income Markets Facing Challenges

Looking back to the latter part of 2021, the U.S. market environment was robust for equities, with strong economic growth that led to stock valuations that appeared appropriate to us. At the same time, the U.S. Federal Reserve's (Fed's) accommodative environment—put in place during the pandemic—impacted fixed income markets.

So far this year, market performance has been challenging across a broad range of asset classes. U.S. equities, as measured by the S&P 500 Index, are down 14.04% through May 6, 2022.[1] Growth-oriented stocks, as measured by the NASDAQ Composite, declined even more than the S&P 500. The broader bond markets, as measured by the Bloomberg U.S. Aggregate Bond Index, have also declined this year. Investment-grade and noninvestment-grade bonds within the aggregate index have also fallen, reflecting the broader rise in yields and some weakness in corporate credit spreads.

Entering 2022 Investors expected that U.S. gross domestic product growth would decelerate, but we still believe growth is likely to be above long-term trends. In our opinion, it was inevitable that U.S. year-over-year growth would slow following robust growth in 2021 as economies reopened. Also, the fading monetary and fiscal stimulus contributed to the U.S. economy slowing. Economies worldwide are also moderating, with Canada doing better than other places due to the commodity-oriented nature of its economy.[2]

1 Source: Year-to-date through May 6, 2022. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator of future results.
2 Source: Bloomberg, as of March 31, 2022.

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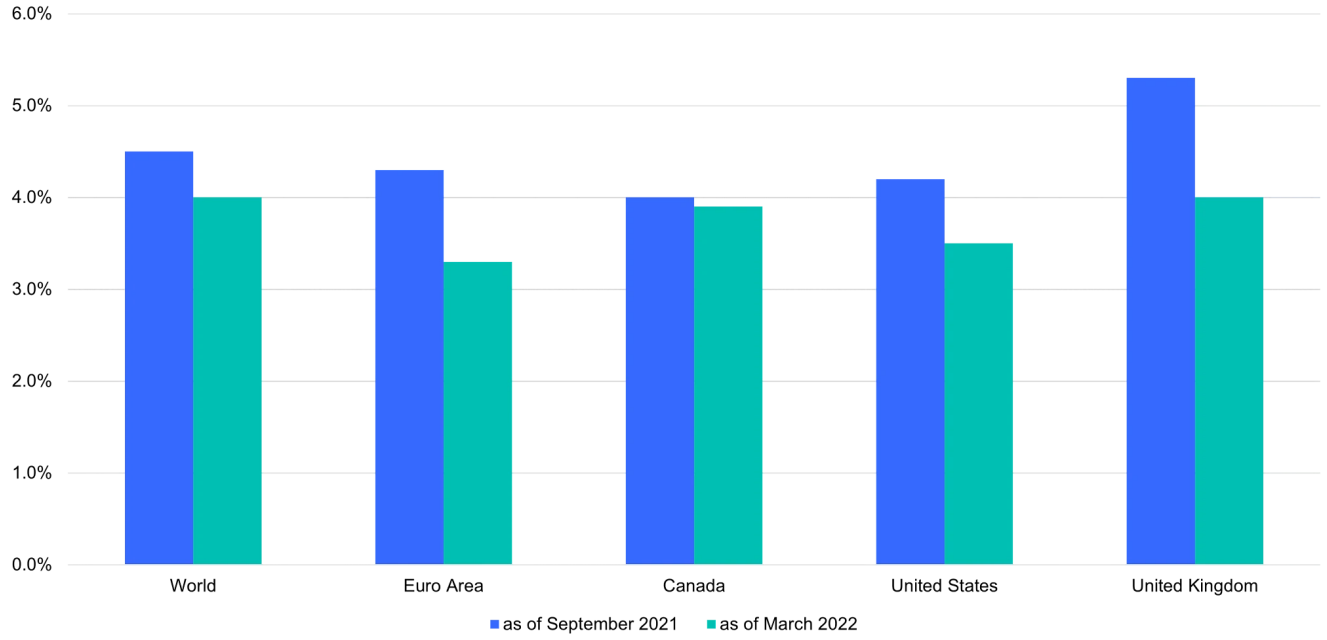
Similar to Global Regions, U.S. GDP growth Expected to Moderate in 2022

2022 GDP Growth Estimates



Sources: Bloomberg, U.S. Department of Labor; Bloomberg, The Federal Reserve Bank of St. Louis. There is no assurance that any projection, estimate or forecast will be realized.

Inflation Concerns Have Become Top Priority

While economic activity in the United States has been normalizing as it gets past the pandemic, a lot of inflationary pressures have been more pronounced and are rotating through different parts of the economy. This scenario is what is leading the Fed to raise the federal funds rate, and the market has baked in more frequent rate hikes for this year. These likely increases have rippled across the Treasury yield curve in general, which is what we believe is driving the challenging performance in fixed income markets. Thus, the backdrop remains highly uncertain in terms of the kind of tightening that is possible as the economy decelerates. In addition, there are other risks for investors—mainly geopolitical risks. These include of course the Russian-Ukraine war, which could further dampen economic activity in certain regions, particularly in the eurozone.

Consequently, rising inflation and its impact on the economy has become the primary focus. One of the bigger questions the market has right now is whether or not the Fed can successfully engineer a soft landing, or if a hard landing is more likely, given the pace of rate hikes and quantitative tightening starting up in June. With the Fed starting to make aggressive rate hikes and reducing its balance sheet, it is a dynamic time for the markets. Challenges are likely to stick around for quite some time. Thus, we believe that being nimble in finding opportunities will be critical.

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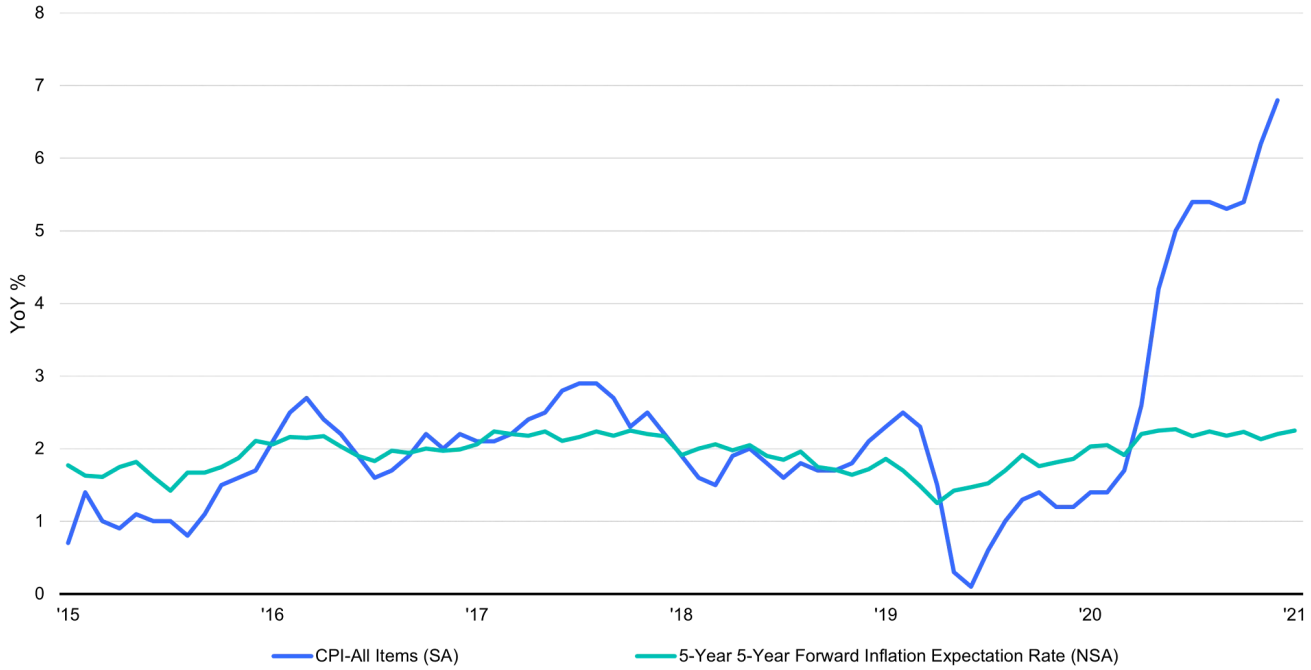
Elevated U.S. Inflation is Starting to Drive Policy Shifts

U.S. Inflation: Actual vs. Expected (5-year, 5-year forward)
December 2015 - December 2021



Sources: Bloomberg, U.S. Department of Labor; Bloomberg, The Federal Reserve Bank of St. Louis. There is no assurance that any projection, estimate or forecast will be realized.

Previous U.S. rate hike cycles, specifically the last time the Fed raised rates in 2015–2018, played out over a long period of time as the economy generally slowed without elevating inflation. This time, it is radically different, with inflation at a very high level at the same time economic growth is decelerating. The United States has not experienced this type of inflation outlook in more than four decades, leading to newer challenges and uncertainties impacting current market performance.

Corporations Starting 2022 on a Positive Note

Historically, earnings expectations for companies tend to start the year on an optimistic note, and then decline over the course of the year.[1] An exception was 2021, which started with a high degree of uncertainty around the level of earnings coming out of corporate America, but then surprised on the upside as companies managed supply challenges and other logistical issues.

1 Source: Bloomberg, S&P Dow Jones Indices, as of December 31, 2021, and March 31, 2022.

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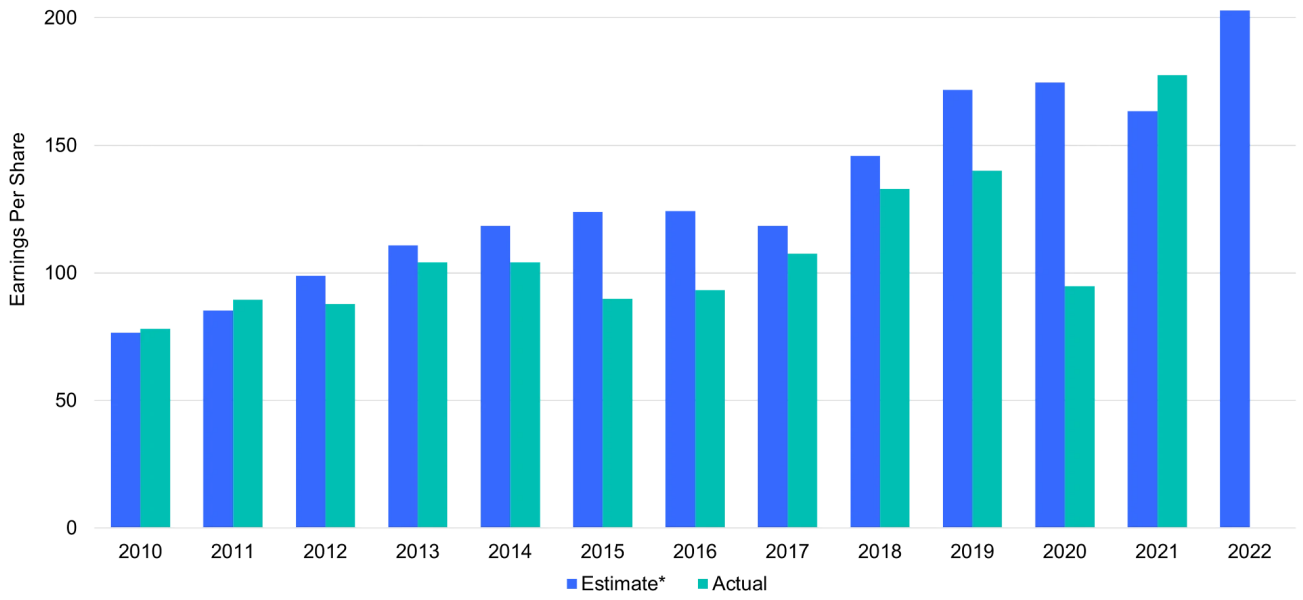
Equity Earnings Have Rarely Exceeded Analyst Expectations

S&P 500 Index's Earnings Per Share: Expectations vs. Actuals
2010–2022



*Estimate at the beginning of the year. There is no assurance that any projection, estimate or forecast will be realized. Source: Bloomberg, S&P Dow Jones Indices.

As for the outlook for 2022, companies are generally performing well in terms of meeting first-quarter expectations.[1] For the remainder of 2022, expectations are starting to come down as companies will likely vary in how they navigate the changing macroeconomic environment. Demand is still very strong, and challenges with logistics still exist; COVID-19 lockdowns are still occurring in China and may ripple through the United States and the world.

Meanwhile, the U.S. labor market is nearing record low levels of unemployment, with elevated numbers of job openings. Employee sentiment is still high, and while tempered by market declines and higher inflation, household wealth and wages remain robust. The challenge for consumers is how to maintain purchasing power. In our analysis, the resilience of the U.S. labor market—as well as how monetary policy transitions impact the economic outlook—could delay or prevent a U.S. recession.

1 Source: Bloomberg, as of April 21, 2022.

PIMCO

3 Fed Outlook: Expeditious but Nimble

Allison Boxer, Economist, PIMCO

On May 5, 2020 the Fed hikes policy rate 50 basis points, while remaining flexible in fighting inflation.

Swift monetary tightening will likely continue through the summer following the Federal Reserve's first 50 basis point (bp) hike in the fed funds rate since 2000. The Fed also announced a plan for balance sheet runoff. Ongoing inflation risks prompted the May meeting's notable policy moves: The Fed's favored U.S. inflation measure exceeded 5% in the first quarter, and Fed officials continue to see risks to the upside. So it's no surprise Fed policy appears squarely focused on taming inflation, and the officials excluded any mention of downside risks to growth from the May statement. We expect a rapid reversal of pandemic-era rate cuts through the summer Fed meetings, including another 50 bp hike in June, consistent with Fed Chair Jerome Powell's comments in the press conference.

How hawkish?

However, despite the large rate hike and clear resolve to continue to fight inflation, the details of May's meeting and press conference were not as hawkish as many market participants had expected, and the bond market reacted accordingly. Powell downplayed the need for 75 bp rate hikes, and emphasized that the Fed will need to be "nimble" to react to the ongoing evolution of economic data. This was consistent with PIMCO's expectation that the rapid pace of tightening this summer will be followed in the fall and winter by continued, but less aggressive, rate increases.

We agree that the Fed will have to navigate nimbly in the coming months as it tries to tame high inflation without breaking the U.S. economy. While the economy is starting from a position of strength, including stable household and business balance sheets, we see downside risks to growth amid a faster monetary tightening cycle, withdrawal of fiscal support, elevated geopolitical uncertainty, lockdowns in China, and depressed confidence levels, which will make the Fed's desired soft landing difficult to achieve. The 1.4% contraction in real U.S. GDP in the first quarter was a reminder that reopening and rebalancing the economy will be a bumpy process. As growth slows, we expect the Fed will inject smaller moves and/or pauses into an otherwise rapid tightening cycle.

May meeting details: 50 bps, not 75

The Fed managed to deliver the largest rate hike since 2000 while at the same time surprising market participants somewhat on the dovish side. Powell suggested another 50 bp hike would be considered at the June and July meetings, and further tightening this year, but he pushed back on the 75 bp hikes market participants had begun to consider.

The Fed also unveiled its plan for running down the balance sheet, which was in line with details published in the March meeting minutes. The pace of the runoff will be nearly twice as fast as in the previous cycle (2017–2019), with a $60 billion monthly cap for reinvesting principal in U.S. Treasuries and a $35 billion cap for mortgage-backed securities (MBS). The caps will be phased in from June through September at 50% of the final pace (versus 12 months phasing in last cycle). In months where Treasury coupon maturities don't reach the monthly cap, the Fed will fill that cap by allowing Treasury bills to mature. However, there was no mention of the fact that MBS paydowns are also not expected to reach the caps, consistent with the guidance that Fed officials likely won't revisit this issue until the balance sheet runoff is "well under way."

4 Central Banks Face the Growth-Inflation Dilemma

Eric Winograd| Director—Developed Market Economic Research, AllianceBernstein

On May 5, 2020 the Bank of England (BOE) raised its benchmark interest rate by 25 basis points to 1.0%. That move was widely expected, but what happens next is up in the air. As with most of the world's economies, the UK economy is being pulled in different directions, with inflation soaring and growth slowing.

What's a central bank to do when faced with this dilemma? Unfortunately, there are no good answers. Raising interest rates to attack high inflation will exacerbate the growth slowdown; easing monetary policy conditions to shore up growth also means letting inflation run too hot for too long.

Growth-Inflation Dilemma Is Most Intense in the UK

That dilemma is more intense in the UK than in Europe or the U.S., with inflation running hotter—and more likely to stay that way. A big reason is that regulated energy prices in the UK are reset in both April and October. April's increase was more than 50%, and another large reset is likely in October. The BOE's forecasts reflect that trajectory—they now have inflation peaking at more than 10% in the fourth quarter—later and higher than we expect in other major economies.

At the same time, the growth slowdown is more apparent in the UK, which is also reflected in BOE forecasts. The central bank now expects the UK economy to contract in 2023 and expand only slightly in 2024. As with the inflation forecast, UK-specific elements in the growth forecast make the coming downturn more extreme than is likely elsewhere. Brexit, for example, will continue to weigh on UK trade, pulling growth down.

Policymaking Bodies Likely to See More Division

But the UK isn't alone in facing this challenge—even if it faces the most pronounced version. Our forecasts for the U.S. and the euro area show growth slowing during 2022 even as inflation remains well above target. This will make the BOE's response an interesting case study for what may happen elsewhere in coming quarters.

It's unclear what that response will be. Of the nine Monetary Policy Committee members at the BOE, three wanted to raise rates by 50 basis points last week, while two wanted to eliminate language from the statement suggesting that future rate hikes are likely. Such deep divisions within the policy-setting body of a central bank are unusual, but that may be a preview of things to come elsewhere.

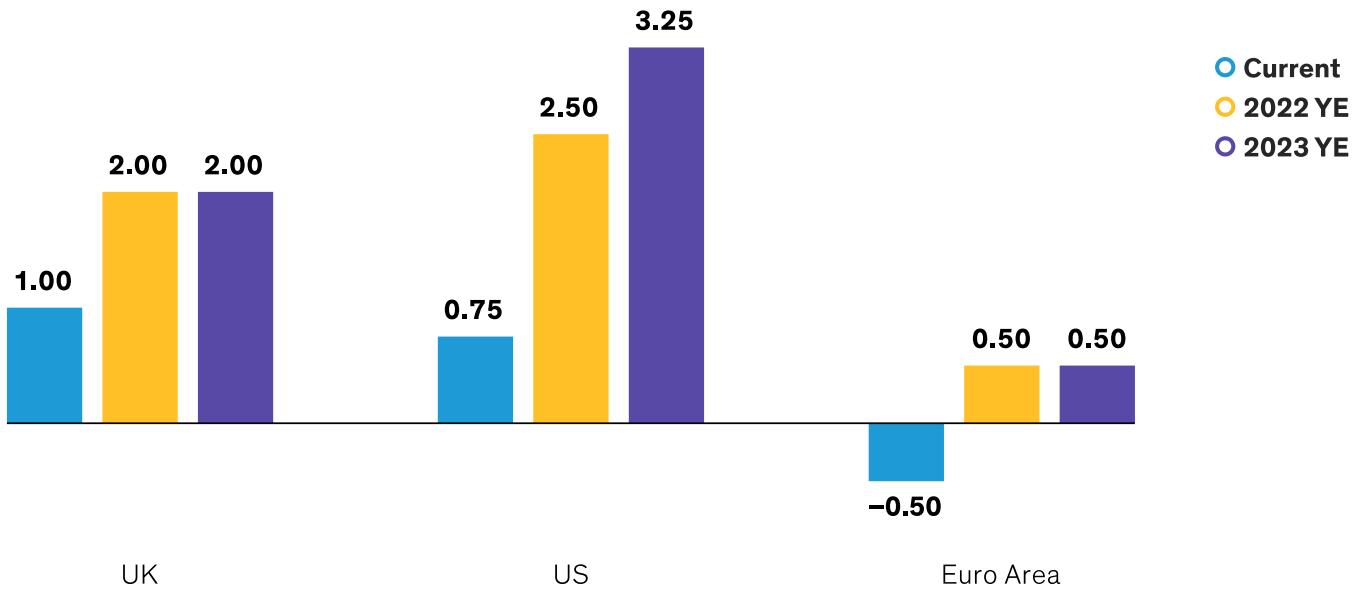
For now, the U.S. Federal Open Market Committee (FOMC) is unanimous in expecting policy tightening, but we expect that consensus to fray later this year as evidence of slowing growth mounts. The more hawkish members will want rates to keep rising until inflation has fallen significantly, while more dovish members will be quicker to respond to slower growth. The same is true for the European Central Bank (ECB): several members seem eager to hike as soon as July, while others are much more cautious. That gap will widen as the year progresses.

Splitting the Difference: Growth and Inflation

We expect all three central banks to try and split the difference when setting policy in such a challenging period. The BOE is likely to hike further—it's simply too much to ask a central bank to keep rates this low with inflation close to 10%. We see UK rates peaking at 2.0%.

Central Bank Policy Rates Are Headed Up

Policy Rate Forecasts (Percent)



Current forecasts do not guarantee future results.
As of May 10, 2022
Source: AllianceBernstein (AB)

The ECB seems likely to move rates at least into positive territory, but lower inflation makes the need for higher rates less intense; 0.50% is a likely ceiling this year. U.S. growth momentum is much stronger than in either European economy, so we expect the Fed to be more aggressive. We do think the pace of hikes will slow during 2022, leaving the policy rate at roughly 2.5% by year end.

The BOE's overarching message is that volatile economic conditions will likely necessitate flexible policymaking. In an environment that presents no good answers to the growth-inflation challenge, central banks have to be nimble—and so do investors.

5 How do investors navigate market volatility?

J.P.Morgan ASSET MANAGEMENT

Meera Pandit, Global Market Strategist, J.P. Morgan Asset Management

After a peaceful 2021, volatility has picked up meaningfully in 2022, with corrections across major indices. The S&P 500 is down -18% from its January 3rd peak, while a brutal sell-off in tech has sent the NASDAQ down -29% from its November 19th high. Compounding the pain in equity markets is the nearly -10% drop in U.S. aggregate bonds.

What's driving this market volatility? The war in Ukraine is causing surging commodity prices, COVID lockdowns in China are exacerbating strained supply chains, and 40-year-high inflation has prompted the Fed to aggressively tighten monetary policy. Together these dynamics are also creating uncertainty about future growth. However, it is important to highlight that the U.S. consumer has been resilient, the labor market is strong, profits are still growing, and now valuations have reset.

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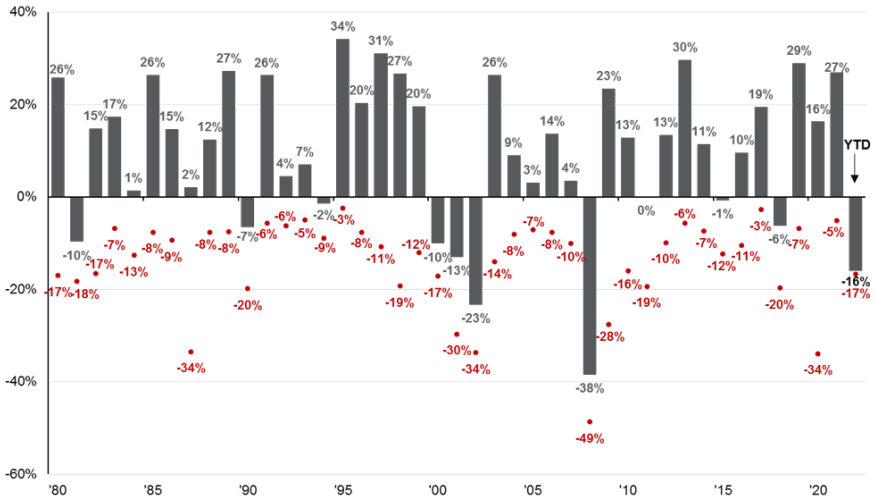
Given that, how do investors navigate this market volatility? As we highlight in "Investing with Composure", here are several key principles to bear in mind:

- **Volatility is normal** – A booming consumer, robust profits, and ample fiscal and monetary accommodation drove a 27% gain in the S&P 500 in 2021 with only a -5% drawdown during the year. Yet the S&P 500 falls -14% on average each year, so 2021 was far from normal while this year is in line with historical drawdowns. Ultimately, annual returns have been positive in 32 out of the last 42 years, underscoring the need for patience.
- **Diversification supports portfolios through market downturns.** If you had invested in the equity market at its October 2007 peak, it would have taken you until March 2012 to recover your initial investment. However, if you had invested in a 60/40 stock/bond portfolio instead, your portfolio would have recovered in October 2010 – a year and a half earlier. Diversification captures returns on the upside and protects on the downside to deliver better risk-adjusted returns.
- **It's about time *in* the markets...** Being invested in the equity market for any one calendar year since 1950 could have yielded a 47% return or a -39% return. However, over longer time horizons the range of outcomes is compressed significantly and overwhelmingly skews positive, particularly if diversified with bond exposure. A 50/50 diversified stock/bond portfolio did not experience a period of negative returns over the rolling 5, 10, or 20-year calendar periods since 1950.
- **...not *timing* the markets**. Investors are often tempted get out when markets get choppy. However, if an investor were to miss the 10 best days in the market rather than staying fully invested, they would have cut their return in half from 9.5% to 5.3% annualized over the last 20 years. What is the chance of missing the 10 best days? Seven of the 10 best days occurred within two weeks of the 10 worst days, often immediately following the worst days. Exiting on a bad day means potentially missing the rebound.
- **Stay invested when you feel the worst** – Sentiment is not a great guide for investor behavior. Looking at the peaks and troughs of consumer sentiment since 1970, average one-year equity returns following peaks in consumer sentiment were 4.1%, but average returns following the *bottoms* in sentiment were 24.9%.

One more crucial point: through multiple wars, recessions, pandemics, and crises, the S&P 500 has never failed to regain a prior peak— and then surpass it. The best strategy during volatile times is to maintain composure and stick to your investment plan.

S&P 500 intra-year declines vs. calendar year returns



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2021, over which time period the average annual return was 9.4%. *Guide to the Markets – U.S.* Data are as of May 10, 2022.

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