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Wealth Advisory Market Update

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Market Update

World markets have been in a constant state of motion over the last few weeks. Volatility is usually driven by uncertainty, and we have a lot of uncertainty at the moment. The world is watching the conflict between Ukraine and Russia unfold in real time causing large swings to both the upside and downside. Although it is no longer an unknown if there is going to be an invasion, the main cause of concern going forward are the effects this will have over the long-term. Sanctions being imposed by the West will have major ripple effects across the globe. Yes, the major impact will be on the Russian/Ukraine economies, the latter not from sanctions but from occupation by Russia, but European countries will also see a major economic impact. Currently, most EU nations rely heavily on Russian and Ukraine energy/commodities. If this energy/commodity source is cut-off or sanctioned, it will cause prices to spike with the most pain, outside of Russia/Ukraine, being felt in the EU. Because of this, we could again see supply chain disruptions on a macro scale but in our opinion, it will pale in comparison to what we witnessed during the Covid-19 lockdowns. As a result, the recent pivot by Central Banks to a more hawkish stance could be undone. If this happens, we expect inflation to continue to run rampant throughout Europe and the rest of the globe, placing a heavy burden on average citizens savings.

Because of the current state of affairs, we wanted to draw on historical precedence and see how markets reacted during times of war over the last 100 years. The chart below gives historical context that we can draw upon, showing how different markets have reacted during a period of war.[1]

Capital Market Performance During Times of War

	Large-Cap Stocks	Small-Cap Stocks	Long-Term Bonds	Five-Year Notes	Long-Term Credit	Cash	Inflation
1926-2013							
Return	10.0%	11.6%	5.6%	5.3%	5.9%	3.5%	3.0%
Risk	19.0%	27.2%	8.4%	4.4%	7.6%	0.9%	
All Wars							
Return	11.4%	13.8%	2.2%	3.7%	2.8%	3.3%	4.4%
Risk	12.8%	20.1%	6.4%	3.5%	5.5%	0.7%	
World War II							
Return	16.9%	32.8%	3.2%	1.8%	3.0%	0.3%	5.2%
Risk	13.8%	21.0%	1.9%	0.8%	1.1%	0.0%	
Korean War							
Return	18.7%	15.4%	-1.1%	0.7%	0.3%	1.5%	3.8%
Risk	11.1%	12.7%	3.0%	1.7%	3.2%	0.1%	
Vietnam War							
Return	6.4%	7.3%	1.9%	4.7%	2.7%	4.9%	4.1%
Risk	12.1%	21.1%	8.1%	4.4%	6.9%	0.3%	
Gulf War							
Return	11.7%	-1.2%	12.5%	12.5%	12.1%	7.0%	4.7%
Risk	19.4%	27.5%	8.4%	3.8%	6.7%	0.2%	

As you can see above, war does not necessarily mean negative equity returns. When looking at all wars, equity returns are actually higher than the average S&P 500 returns and had less risk to achieve those returns. Bonds usually underperform during times of war because of the increased borrowing and higher-than-average inflation, both of which drive interest rates higher. Even though we are not currently in a war-time scenario and hope to remain that way, taking a look at historical data is a helpful guide to what might take place should things change.

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[1] *Sources: Mark Armbruster, CFA®. The indices used for each asset class are as follows: the S&P 500 Index for large-Cap stocks; CRSP Deciles 6-10 for small-cap stocks; long-term US government bonds for long-term bonds; five-year US Treasury notes for five-year notes; long-term US corporate bonds for long-term credit; one-month Treasury bills for cash; and the Consumer Price Index for inflation. All index returns are total returns for that index. Returns for a war-time period are calculated as the returns of the index four months before the war and during the entire war itself. Returns for "All Wars" are the annualized geometric return of the index over all "war-time periods." Risk is the annualized standard deviation of the index over the given period. Past performance is not indicative of future results.*

We are also looking at market performance during and after major geopolitical events (so far, more similar to the Russia-Ukraine situation than "times of war"). The chart below shows different geopolitical events over the last eighty years. It will surprise many to see that 75% of these time periods ended with positive equity returns over the following 12-months. The only instances where negative returns occurred are when the United States experienced a recession during the concurrent 12-month time period.

S&P 500 performance around select geopolitical/military events

Date	Select geopolitical/ military events	1-month later	3-months later	6-months later	12-months later
12/7/1941	Pearl Harbor	-3.4%	-12.7%	-9.1%	0.4%
10/31/1956	Suez Canal crisis	-2.8%	-3.8%	-0.1%	-11.5%
10/20/1962	Cuban missile crisis	8.7%	17.7%	25.1%	32.0%
10/17/1973	Arab oil embargo	-7.0%	-13.2%	-14.4%	-36.2%
11/3/1979	Iranian hostage crisis	4.2%	11.6%	3.8%	24.3%
12/25/1979	U.S.S.R. in Afghanistan	5.6%	-7.9%	6.9%	25.7%
8/3/1990	Iraq invades Kuwait	-8.2%	-13.5%	-2.1%	10.1%
1/17/1991	Gulf War	15.2%	23.5%	20.6%	33.1%
8/17/1991	Gorbachev coup	0.0%	3.0%	7.0%	8.9%
2/26/1993	World Trade Center bombing	1.2%	2.5%	4.0%	6.4%
9/11/2001	9/11	-0.2%	2.5%	6.7%	-18.4%
3/20/2003	Iraq War	2.2%	15.6%	17.4%	28.4%
	Average	**1.3%**	**2.1%**	**5.5%**	**8.6%**
	% Positive	**50%**	**58%**	**67%**	**75%**

Data Source: Truist IAG, FactSet. Grey shading represents down markets where the economy was in recession at some point during the measurement period. Past performance does not guarantee future results

These data points will surprise most but during times of geopolitical unrest and war, staying invested has been the correct way to position.

While the situation in Ukraine has taken over the headlines, economically at this time, we remain more concerned with inflation in the US, GDP growth, and the Federal Reserve. These issues have a direct impact on longer-run return expectations of the market. Inflation remains rampant in the US, with commodity prices continuing to move higher over the last two years, especially with supply chain bottle necks still unresolved. With the conflict overseas, we expect even more upward pressure on commodity prices, and a bigger escalation could lead to further supply chain disruptions.

The Federal Reserve is going to have a choice to make in the next few weeks. Does it try to stamp-out inflation, even with the geopolitical uncertainties, or does it take a chance on inflation running even hotter due to the economic uncertainty that arising from this conflict? We have stated multiple times our belief that the Fed is behind the curve; if they had started their tightening cycle earlier, they would not be in this predicament. No matter our thoughts on how we got here, we have to make decisions based on the actual environment.

In our view, the amount of tightening that was priced into the market just a few weeks ago will not come to fruition. The futures market was pricing a 50-basis point hike in March along with five to six more hikes this year. We do not think this is likely now because of the uncertainty overseas and the economic impact it could have globally. In our opinion, the economic strain of a hawkish policy would likely push us into a recession later this year. We believe the Fed will start their rate hike cycle but it will be more muted than what was previously expected. The impact, if the Federal Reserve goes in this direction, may be to allow inflation to get out of hand. In that scenario, interest rates move higher, commodity prices continue to increase, which in turn puts major financial strain on the US consumer. This scenario also leads to a slow down or recession. When you hear pundits speak about the Fed being backed into a corner, this is what they mean. Whichever path they choose, the economic stress will be high.

We remain disciplined in our investing style. We will continue to invest in companies that have a steady stream of cash flows, growing or dominant market share, and pricing power. These characteristics will help during either scenario, and so far it has been the recipe for less volatility this year. We remain steadfast in our belief that there is still a speculative bubble in the technology sector even with the major drawdowns of some of the high-fliers. We still favor quality over growth and we don't expect that to change soon.

The recent volatility has not been contained to just the equity markets. Interest rates have seen major moves to both the upside and downside. Fixed income has been a hard asset class to invest in over the last few years. However, with the front end of the yield curve pricing in a more hawkish interest rate policy earlier in the year, short-term bonds have become relatively attractive. Currently, all the risk of rising rates is on the front end and a more dovish Fed could push these rates down. The upward movement on the front-end of the curve allowed us to begin investing more heavily in shorter-term bonds at more attractive yields. As we move forward this positioning may change but currently it offers the best risk/reward profile.

We will continue to monitor these situations from around the globe, and if we deem it necessary, we will make changes that will be dependent on the scenario. We at AMB thank you for your support and for allowing us to partner with you in reaching your financial goals.

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