Market Perspective from the Investment Advisory Group

Assessing the risk/reward after the drop & subsequent rebound

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Highlights

- The S&P 500 has rebounded forcefully from the lower end of our expected near-term trading range of 4100 to 4600.
- Part of the market's resiliency is due to investors already discounting some of the known challenges.
- The market also took the Fed's first rate hike in stride. Still, the Fed is in a precarious position. Historically, when the Fed has raised short-term rates for the first time, the average unemployment rate has been above 6% vs.sub-4% today and inflation has averaged 2.4% vs. 7.9% today.
- Our base case remains that what we have seen this year is a correction within an ongoing bull market. However, we also acknowledge the range of outcomes is unusually wide.
- Compared to the early part of the cycle, where the risk/reward and our positioning was heavily skewed to the positive side, our current view is that investors should maintain an equity overweight, but at a notch lower relative to the past two years.

What happened

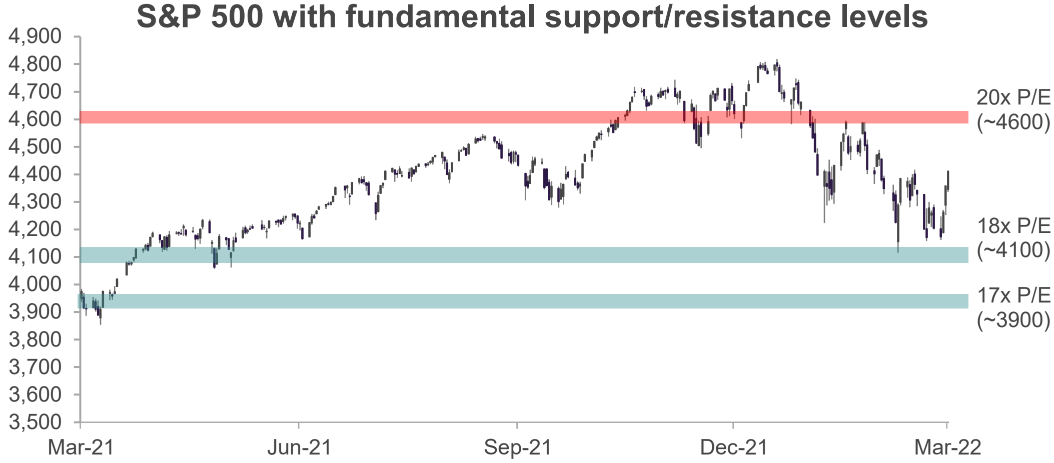
Markets have remained choppy but resilient over recent weeks in the face of uncertainty stemming from the Russia-Ukraine conflict, sharp shifts in the commodity markets, and spiking COVID-19 trends in China. The S&P 500 has popped 6% from its low earlier this week, even as the Federal Reserve (Fed) raised short-term interest rates for the first time in more than three years and Chair Powell took on a decidedly more hawkish tone.

Our take

Markets have rebounded forcefully from an oversold condition and the lower end of our expected near-term trading range of 4100 to 4600 for the S&P 500.

Indeed, buyers stepped in to support the market once again near an 18x forward P/E, which we have highlighted as the first key fundamental support level. Notably, February 24, the day of the Russian invasion, still marks the current low of this recent market correction. With the S&P 500 now trading just above 4400, we still expect the 4600 area, near a 20x forward P/E, to provide stiff near-term resistance.

S&P 500 with fundamental support/resistance levels



Data Source: Truist IAG, FactSet. Past performance does not guarantee future results.

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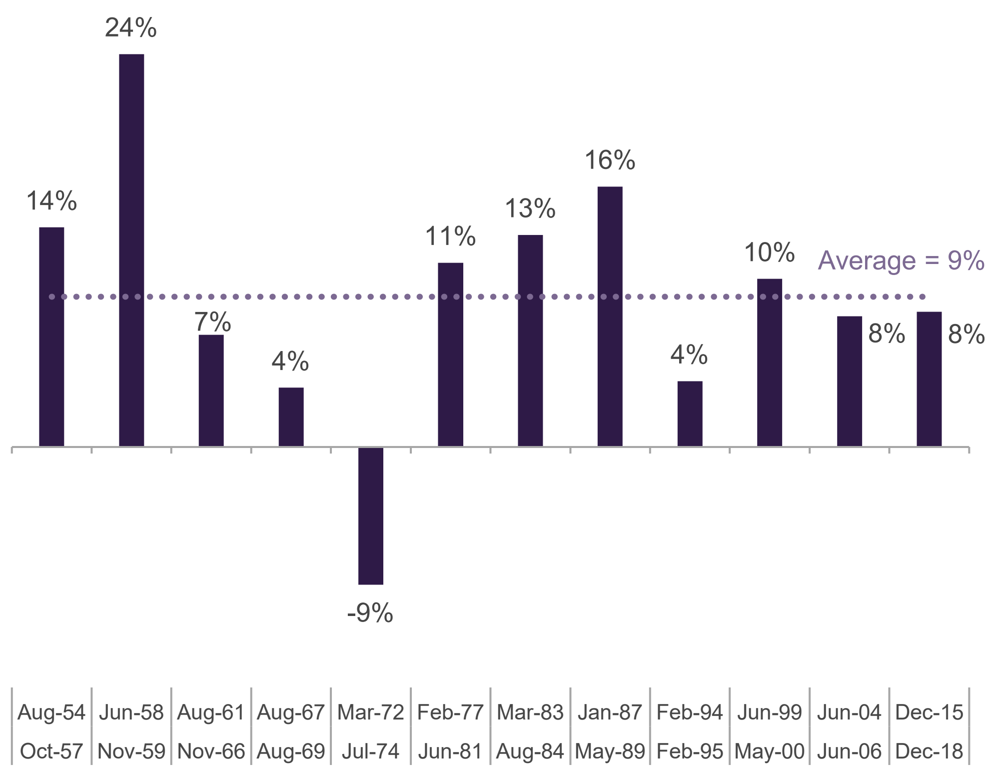
Part of the market's resilience can be attributed to depressed investor expectations, which suggests **markets are already braced for and discounting some of the known challenges**.

Over the past 10 weeks, the percentage of individual investors who consider themselves bullish has averaged just 23.9%, according to a survey from the American Association of Individual Investors (AAII). This is the lowest average level of bullishness since the June 2016 Brexit referendum and one of the least optimistic readings since the survey's inception in 1987. Historically, this has been followed by consistent and positive returns on a six to 12-month basis for the S&P 500.

Markets have also taken the recent shift in Fed policy in stride given investors were already pricing in an aggressive rate path. Historically, **the first rate hike tends to inject volatility, but it does not typically end a bull market.**

The S&P 500 has risen at an average annualized rate of 9.4% during the 12 Fed rate hike cycles since the 1950s and showed positive returns in 11 of those instances. The one exception was the 1972-1974 period, which coincided with the 1973-1975 recession. While we expect growth to be slower this year, our baseline view is that U.S. recession risk remains relatively low near term.

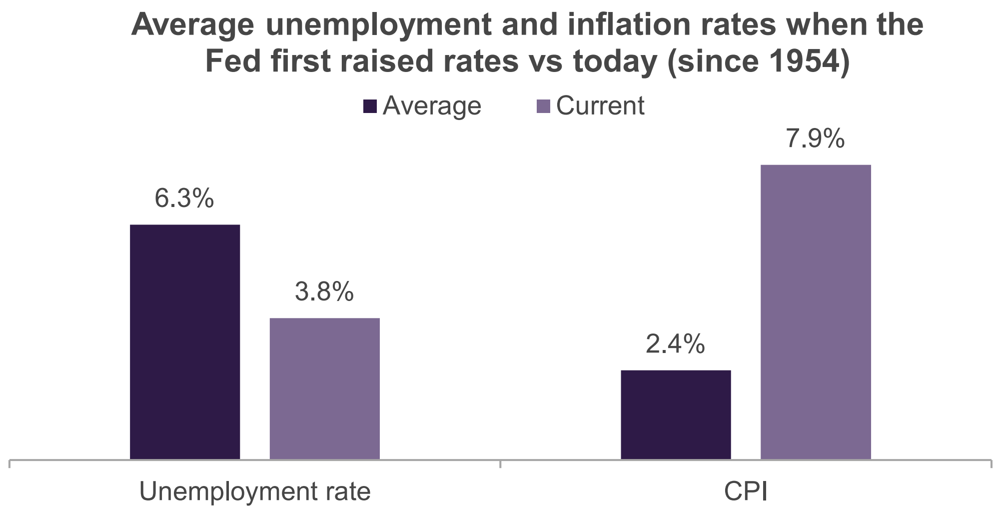
S&P 500 annualized total return during Fed rate hike cycles



Data Source: Truist IAG Morningstar, Haver. U.S. Rising Fed rate periods constructed using the Federal funds effective monthly average rate from 1954 – 1981; thereafter, the Fed funds target. Past performance does not guarantee future results.

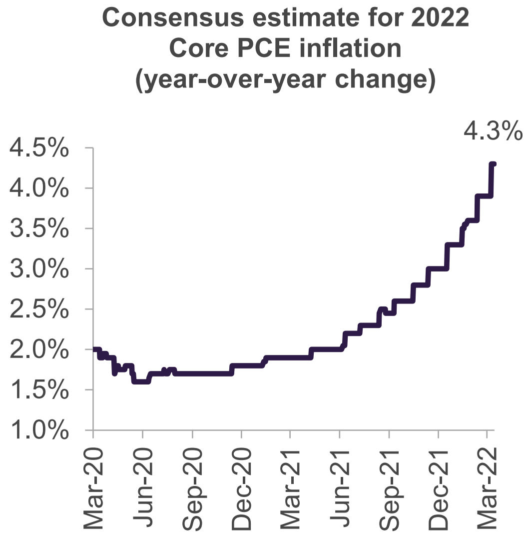
Still, the Fed is in a precarious position. Historically, when the Fed has raised short-term rates for the first time, the average unemployment rate has been above 6% vs.sub-4% today and headline inflation has averaged 2.4% vs. 7.9% today.

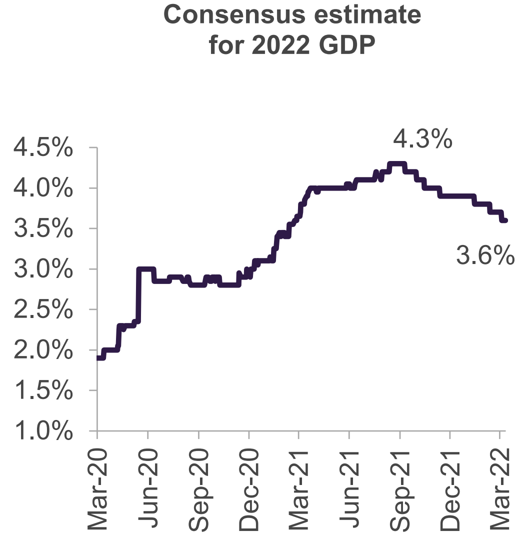
Even though the Fed expects inflation to ease somewhat by the end of the year, this higher starting point is likely why Chair Powell placed such great emphasis on combating inflation in his press conference.



Data Source: Truist IAG, Haver

We are also seeing a steady increase in estimates of core inflation, which excludes food and energy, and is a metric the Fed tends to focus on. At the same time, we are seeing a **steady markdown of economic growth projections** by economists on Wall Street.





Data Source: Truist IAG, Bloomberg

And, yet another wrinkle that the Fed must contend with is the slope of the yield curve, or the difference between short-term and longer-term U.S. Treasury rates.

The yield curve typically has a positive slope, with longer-term yields above those of short-term rates, during an economic expansion. When a curve inverts, meaning short-term rates rise above long-term rates, it is often seen as a recession indicator, albeit with a varying and sometimes long lead time.

As the Fed hiked rates on Wednesday, the spread between the 10-year and the 2-year U.S. Treasury yields closed at 21 basis point vs. an average of 109 basis points at the time of the first-rate hike (since the early 1980s). **Our House View remains that near-term recession risks remain relatively low near-term, especially considering the improvement in COVID-19 trends and a strong labor market,** but we certainly would prefer the curve to remain positive.

Bottom line

Our base case remains that what we have been seeing this year is a correction within an ongoing bull market. Investor sentiment is a positive from a contrarian perspective and relative market valuations remain supportive. However, we also acknowledge today's backdrop is complicated and the range of outcomes is unusually wide. Beyond geopolitical uncertainties and supply chain disruptions that linger, the Fed finds itself in a precarious situation. This backdrop will continue to inject volatility into the markets.

Thus, compared to the early part of the economic and bull market cycle, where the risk/reward and our positioning was heavily skewed to the positive side, our current view is investors should maintain an equity bias, but at a notch lower relative to the past two years.

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