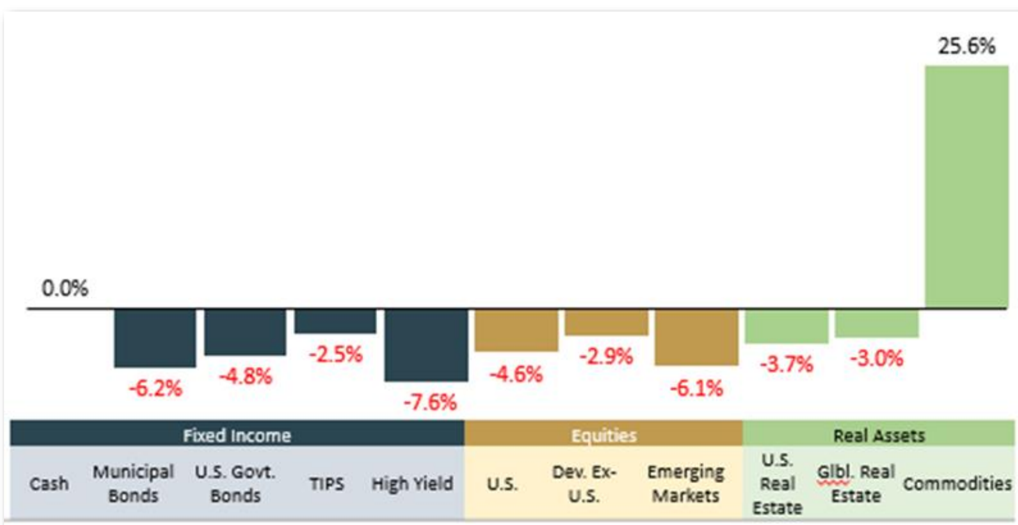
Markets in a Minute:
2022 First Quarter Review & Outlook

If 2021 proved that markets can climb a wall of worry, this year's first quarter demonstrated they can ignore certain risks for only so long.

Even before Russia invaded Ukraine in February, risks that the markets had mostly shrugged off last year — from lofty valuations among growth-oriented stocks to tighter monetary policy – began to weigh on stock and bond prices. The war in Ukraine only added fuel to the proverbial fire, exacerbating inflationary pressures (particularly energy prices) and concerns about the global economic outlook.

Macroeconomic concerns, combined with new geopolitical risk, reignited market volatility in the first quarter. Here's a recap of performance:

Q1 2022 Index Returns



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index. Source: Kestra Investment Management with data from FactSet. Index proxies: Bloomberg Municipal Bond Index, S&P US AGG Bond Index, S&P 500 US TIPS. Dow Jones Corporate Bond Index, S&P 500, MSCI World ex USA, MSCI EM, Dow Jones US Select REIT, Dow Jones Global X US, and Bloomberg Commodity Index. Data as of March 31, 2022.

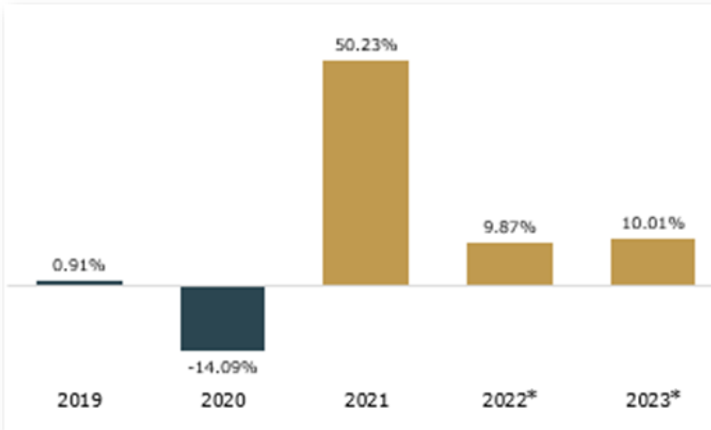
- In a rare occurrence, the broad stock and bond markets fell in tandem, finishing the quarter down roughly 5% and 6%, respectively. Stocks and bond markets tend to move in opposite directions, which helps cushion portfolios during periods of stock-market volatility. In the first quarter, however, bonds were unable to surmount a barrage of news that spelled trouble for fixed income, including the so-called Powell pivot to more-hawkish monetary policy.
- The Energy sector outperformed the broad stock market. The sector gained 39%, buoyed by a continuing rebound in commodity prices that gathered additional steam after the Russian invasion of Ukraine.
- Perhaps not surprisingly, Treasury Inflation-Protected Securities (TIPS) were the best-performing asset class within fixed income for the one-, three- and five-year periods.

Are stock and bond markets signaling an impending recession, or a downshifting from the torrid growth of 2021? We continue to be in the downshifting camp.

The continuing war in Ukraine, rising inflationary pressures and a more-hawkish Federal Reserve represent the largest risks to the economy. Despite these headwinds, most areas of the economy continue to show strength:

- The monthly Institute for Supply Management (ISM) Purchasing Managers Index, which reliably predicts growth across the economy, has retreated from its post-Covid peak, but at levels exceeding 50, is signaling strong growth ahead.
- The labor market remains tight, with the number of unemployed people per job opening hovering a record lows. The tight labor market is beginning to draw older Americans, who quit or retired in droves early in the pandemic, back into the workforce. The growing supply of workers may help ease wage inflation.
- The tight labor market is driving up median wages across income levels, whereas lower-wage workers saw the biggest gains early in the pandemic. Extra money in workers' pockets should help take the sting out of higher prices, but wage inflation also has the potential to pinch corporate profit margins.
- That said, profit margins for S&P 500 companies stood at record levels at the end of 2021, and analysts' earnings estimates have increased for this year and next, according to FactSet. Lower stock prices and higher earnings mean valuations look more attractive.

S&P 500 Earnings Growth Expected to Decelerate, But Remain Strong

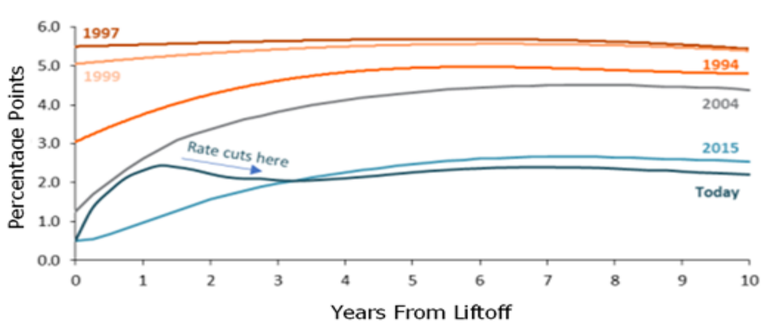


*Estimates. Forward looking estimates may not come to pass. Past performance is no guarantee of future results. Source: Kestra Investment Management, FactSet.

While the Fed fights inflation, we're seeing signs that price pressures could also cool organically. The recent bout of high inflation has been fueled mostly by a huge imbalance between supply and demand for goods. But manufacturing inventory levels are starting to rebound, and shipping costs, which had skyrocketed because of bottlenecks at major ports, are on the decline. Both trends indicate that supply chain disruptions are easing.

What about the risk that the Fed steps on the brakes too hard as it seeks to curb inflation? As inflation has accelerated, Fed-funds futures market expectations for more-aggressive rate hikes have increased dramatically, according to the CME FedWatch Tool. In an unusual twist, the market also now anticipates rate cuts in 2023, which would imply that it raised rates too much this year.

Expected Fed Funds Rate During Previous Tightening Cycles



Forward looking estimates may not come to pass. Source: Piper Sandler.

Conclusion:

The first quarter provided more evidence that this cycle has played out in fast forward, beginning with the economic roller coaster ride that was 2020. Now, the economy appears to be downshifting to slower growth sooner than we might have anticipated — no doubt helped along by the waning of the fiscal and monetary stimulus that helped us get through the pandemic.

During such volatile times, it's important for investors to ensure that their portfolios are aligned with their goals. It's also important to keep in mind that stocks and bonds can provide positive returns amid geopolitical and other risks, as long as the economy remains fundamentally healthy.

Want to learn more? Read previous issues of Markets in a Minute that explore how stocks have performed during previous tightening cycles and past military conflicts; which stock-market sectors have tended to shine when inflation is high; and why bonds continue to play an important role in portfolios.