HANOVER
ADVISORS

Market Commentary
First Quarter 2022

Our Outlook

After a strong 2021, the first quarter of 2022 has been difficult for the markets. Russia's invasion of Ukraine has roiled the global economy, but even prior to the invasion, uncertainty was on the rise as central banks around the world began to tighten monetary policy to combat rampant inflation. This increased uncertainty has led to increased volatility and big swings in the market. Both the NASDAQ and Russell 2000 entered bear markets during the quarter, and the S&P 500 fell into correction territory. The markets did stage an impressive rebound in late-March, but much of the rally was driven by the closing of puts and other hedging options rather than a rebound of optimism. Despite the rebound, the S&P 500 closed the quarter down nearly 5% from the beginning of the year. The bond market has fared even worse, with the Bloomberg Aggregate Bond index down more than 6% this year, marking the worst quarterly performance since 1980.

As we enter the second quarter and beyond, uncertainty will remain elevated throughout the global economy. With much of the world cut off from Russia's vast energy resources, crude oil prices have spiked, climbing to more than $120 per barrel, and though prices have retreated somewhat, they are up 33% from the start of the year and will remain volatile until the conflict is resolved. Surging energy prices will hit Europe hardest, where consumers and businesses were already facing historic energy price increases prior to the invasion. As of February, European gas prices were up 55% from the start of the year, and the bulk of that data came from before Russia's invasion. Europe sources about 40% of gas imports and about 27% of oil imports from Russia, and higher energy prices are likely to be a major economic drag on the region. Aside from energy, Russia and Ukraine account for roughly 30% of the world's wheat exports, and Russia's natural gas exports are key to fertilizer production. As the war and sanctions drag on, American consumers will likely see prices in the grocery store continue to climb.

Even as destabilizing as Russia's invasion has been, a swift resolution will not do much to settle investors, who remain focused on surging inflation and the actions that central banks around the world are taking to combat it. After insisting for the last year that surging inflation would be "transitory," the Federal Reserve finally acknowledged the reality of the situation by raising interest rates for the first time since 2018. The 25-basis point increase brings the new target range to 0.25%-0.50%, which is still extremely low on a historical basis, and though this is only the first of what we expect to be 5 or 6 more rate increases this year, it is likely that the Fed will have to be more aggressive than many expect to truly combat inflation.

The Fed's latest economic and interest rate forecasts show growth slowing to 2.8% this year and core inflation running more than double the Fed's 2% target. The forecast also shows that inflation is expected to run above that target through 2023 and into 2024, meaning that rate increases will likely continue well into next year. The general consensus from the forecast is that the rate increases will stop at a rate of 2.75%. The Fed considers a rate as high as 2.4% to be "neutral," so raising the rate to 2.75% in late 2023 will do little to address the current inflation surge. To truly address inflation, rates may need to climb as high as 4%-5%.

Fed Chairman Jerome Powell has acknowledged the need to act aggressively, leaving open the possibility for a larger 50 basis point increase at the Fed's next meeting. He has also indicated that as long as the labor market remains tight, he may be willing to allow a downturn in the stock market, and with valuation so high, the downturn could be quite sizable. The Fed abandoned its plans for further interest rate hikes in 2018 after the initial increase triggered a massive selloff, bringing the S&P 500 down nearly 14% in the fourth quarter. However, with inflation surging, it is unlikely that Powell will pivot away from his hawkish stance, even if it roils the market. Of course, by waiting so long to address inflation, the Fed is now tightening monetary policy on a slowing economy, meaning they may not be able to act aggressively without triggering a recession, and the added uncertainty of the situation in Ukraine makes the path forward even murkier.

There are growing concerns that the economy is heading for a recession. Surging oil prices have historically been an indicator of a looming recession, as is an inversion of the 2-year and 10-year Treasury yield curve, meaning that 2-year Treasuries are offering a higher yield than a longer-term 10-year one. Such an inversion has preceded every recession since the 1970s, so many analysts have taken the recent inversion as a sign of an impending recession. It is important to keep in mind, however, that an inverted yield curve is not the cause of a recession, and that the factors driving the current inversion are different than in recent recessions. Currently, short-term rates are higher because inflation expectations are at an all-time high, so investors are demanding higher yields for short-term fixed income. Investors also see inflation fading, eventually, so they are demanding less of a premium to hold long-term fixed income. Some analysts have also posited that factors like the Fed's massive balance sheet and low overseas bond yields have skewed the predictive power of the 2- and 10-year yield curve. Moreover, on average, a recession follows a yield curve inversion by 18 months, and in one case, the recession did not arrive for 33 months. Though we are in a recessionary window, based on other market conditions like swap spreads and real yields, we do not expect to see a recession in the near future.

Even if a recession is avoided this year, economic growth in the U.S. is expected to moderate. Personal consumption was already expected to slow this year as the impact of federal stimulus fades, and as households grapple with the fastest inflation in 40 years. As consumers spend more on energy and food, they may spend less on other goods and services. As of February, real, inflation-adjusted wages had declined 2.6% from the previous year, and consumers are feeling the pressure. Consumer confidence in March fell to 67.8, the lowest level since 2009. Personal consumption accounts for nearly 70% of U.S. GDP, so a marked slowdown in consumer activity would be a major drag on the economy.

Stocks

There is a great deal of risk in the U.S stock market. With so much uncertainty around inflation and economic growth, the markets remain vulnerable to a sizable correction. Valuations are extremely high on a historical basis, meaning that if we do see a major correction, the downside could be much larger than many analysts expect.

Market leadership has flip-flopped between growth and value stocks, and rather than try to predict the course of the economy and time the markets, we believe the best stance is to maintain balanced exposure to both. Value stocks will be a good hedge if inflation continues to surge, and growth stocks will be poised to perform better if we do see an economic downturn. Our preference remains for large-cap stocks, which will perform better during an economic downturn and perform well even if economic growth keeps a steady pace. With so much geopolitical tension, we prefer U.S. stocks. The U.S. dollar shows its strength during periods of geopolitical uncertainty. The dollar climbed 2.8% this quarter, and a stronger dollar hurts the profits of international companies, while currency conversions can diminish the returns of foreign investments.

Bonds

As mentioned, this has been one of the worst quarters for bonds in recent memory. Yields have climbed, sending prices much lower. The bond market is at an inflection point between surging inflation and a global economic slowdown. With so much uncertainty, we prefer bonds with short or intermediate maturities, though if we do see a sustained slowdown, we will be investing in bonds with longer maturities. With inflation continuing to surge, Treasury Inflation-Protected Security (TIPS) remain attractive, and we will continue investing in them where it makes sense.

With recessionary risk elevated, quality is key, so we prefer high quality U.S. corporate bonds. Yields have been climbing for these bonds, but they are also attractive as a hedge against an economic downturn. We remain concerned about the massive amount of corporate debt with a BBB rating, which is the lowest rating before a bond loses its "investment grade" status. An economic downturn could trigger a wave of credit downgrades that would roil the market, so credit rating remains paramount.

Commodities

Russia's invasion sent global commodities prices skyrocketing. The Bloomberg Commodity Spot Index had its strongest quarter since 1990, and the third-best on record, relative to the S&P 500. Despite the recent surge in prices, commodities remain attractive as a way to hedge against volatility. We prefer exposure through commodity stocks and ETFs, though for investors with tax-sheltered accounts, we will invest in direct ownership of precious metals like gold and silver where it makes sense.

International

Europe is a huge importer of oil and natural gas from Russia, which makes the area highly vulnerable to the Russia-Ukraine conflict. The risk of a recession is much higher in Europe than in the U.S., and a prolonged period of high energy prices could severely slow the region's economy. However, such a slowdown could also be mitigated by the high excess savings accumulated during lockdowns, healthy labor markets and fiscal stimulus.

The European Central Bank has maintained a more accommodating stance than many other central banks, but recently began the tapering of its asset purchase program, with the expectation that it will end in September. President Christine Lagarde has stated that an interest rate hike will come "some time" after the end of asset purchases, but traders have become increasingly convinced that we will see a rate increase later this year. However, by waiting so long to act on inflation, the ECB faces the prospect of tightening policy as growth is already slowing, lowering the odds that they will be able to rein in inflation without tipping the economic bloc into a recession.

The first quarter was a difficult one for the Chinese markets, as Chinese companies listed in both Hong Kong and the United States suffered their worst single-day sell-offs since the global financial crisis. China faces widespread uncertainty about the strength of its economy amid a resurgent pandemic, a draconian crackdown on the nation's tech companies, and its ambiguous position in the Russia-Ukraine conflict. Chinese officials have responded with economic stimulus measures and Chinese President Xi Jinping appears to have stalled his plans for an ambitious reform agenda that prioritized tackling inequality and fostering sustainability above economic growth. This has settled investors somewhat, but it remains unclear if the nation will meet its optimistic growth projections, especially as China's maintenance of normal economic ties with Russia could further alienate the nation from significant trading partners in the west.

Summary

The remainder of 2022 is likely to be a tumultuous period for the markets. We have already seen a major downturn followed by an impressive rally and, volatility is likely to remain elevated. The war in Ukraine has captured headlines and added more uncertainty, but the Fed's tightening cycle will be the primary driving factor of the economy and the markets. Economic growth is expected to slow, and the risk of a recession is elevated. In times like these, it is important that investors remain focused on their long-term investment goals. Hanover's approach will be to maintain a balanced and diversified approach to portfolio management and ensure that client holdings are compatible with their personal level of risk tolerance. The markets are a risky proposition, but much of this risk and volatility are already priced in. Uncertainty will remain elevated, but over the next 6 to 9 months, the direction of the global economy will become clearer and the markets will stabilize.

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