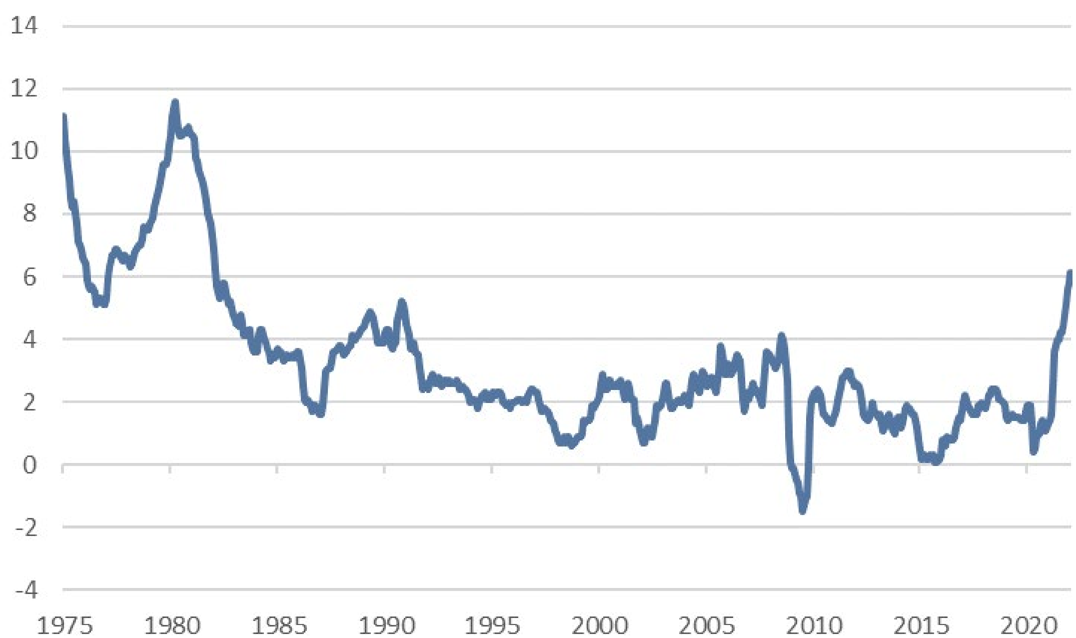
MILL CREEK
Our values appreciate yours

MARCH MARKET UPDATE
February 28, 2022

MARKET COMMENTARY

Fig. 1: One of the Fed's preferred inflation measures has reached levels not seen since 1982. Personal Consumption Expenditures Price Deflator, year-over-year percentage change.



Sources: Bloomberg, Mill Creek.

Financial markets have been pressured recently by **(1) hawkish "Fed speak"** and **(2) geopolitical risk coming from Russia's invasion of Ukraine.** While we are careful not to minimize the human toll of war, monetary policy, not geopolitical risk, has been the primary driver of the recent market correction. That might change over the coming days and weeks.

Western sanctions aimed at Russia have had an immediate impact, but it has been mostly contained within Russia. The Ruble declined by 30% against the US dollar, there are reports of bank runs within the country, and the Russian Central Bank raised its policy rate to 20% to stem further currency depreciation. The sanctions, which included removing certain Russian Banks from the SWIFT international payments system, have not shown signs of systemic contagion - yet.

However, we are operating in **unknown unknown** territory. Many investors forget that the US equity market traded up the week after Lehman bankruptcy. It took time for fragility in the system to show up, which could very possibly be true for Russian sanctions as well. However, unlike in 2008, global central banks are prepared to offer whatever liquidity is necessary to facilitate the functioning of financial institutions and markets.

Bottom line – Absent further escalation, neither monetary policy nor the Ukraine invasion should affect US corporate profits (except the energy sector) in any significant way this year. The current decline is likely a buying opportunity for investors looking to take money off the sidelines, but all investors should expect volatility.

Economic and Geopolitical Review

- Economic activity continues to recover from an Omicron-led slowdown at the start of the year.
- The US job market remains very tight. Job openings are at all-time highs and the unemployment rate is 4%.
- Inflation remains too high. The Consumer Price Index increased 7.5% year-over-year in February and the rate of increase accelerated on a month-over-month basis.
- The Federal Reserve struck a particularly hawkish tone in February. The market has priced in 150-175bps of rate hikes this year.
- The long-telegraphed Russian invasion of Ukraine started on Thursday, February 24. The market reaction has been volatile but muted, particularly for USD assets.

Market Review

- Global equity markets are close to correction territory. At the end of last week, US equities, international developed equities, and emerging market equities have declined -8.2%, -6.6%, and -4.8%, respectively, year-to-date.
- Fixed income portfolios have also struggled. Taxable bonds and municipal bonds are down -4% and -2.6%, respectively, year-to-date.
- Interest rates rose overall in February, but the Russia/Ukraine geopolitical pressures led to some moderation in rates last week.
- Commodity prices continue to surge, increasing 6.5% month-to-date in February and 16% year-to-date.

Our Perspective

- Inflation remains the primary risk to financial markets and —eventually — economic growth. Inflationary pressures are not subsiding, and higher energy prices will exacerbate the monetary policy challenge.
- For example, household incomes (total dollars taken home by households in the US) grew at a 10.2% year-over-year pace in January. Our economy cannot produce real growth of 10%, so income (i.e. spending) growth of 10% will inevitably lead to inflation of 6-8%. Firms are also finding that consumers are not pushing back on price increases and inflationary pressures are increasingly broad-based.
- In addition to the clear risks emanating from Russia and Ukraine, we're also worried about escalating geopolitical conflict emanating from other actors – Iran, North Korea, China, etc. — that may try to take advantage of the global focus on Russia and Ukraine.
- Prudent asset allocation remains the best way to address geopolitical risk. Investors with cash on the sidelines should consider using the current sell-off as an opportunity to accelerate dollar-cost-averaging plans.
- Against the backdrop of elevated inflation and above-trend growth, we continue to overweight US equities within global equities and allocate to private debt and absolute return hedge funds out of high-quality bonds.

QUICK LINKS

- "If you hear missiles flying..."
- The "Hurry Up" is over
- 2022 Monitor Risk: Equity Valuations
- 2022 Monitor Risk: Rising Interest Rates
- Q1 2022 Outlook
- Year Ahead 2022: Hurry Up and Wait

Contributor: *Michael Crook, CAIA*