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Market Thoughts on Russian Invasion of Ukraine - 2/24/2022

In a January research piece, we highlighted that the market was already vulnerable due to the Fed's likely lift-off of a tightening cycle. In the article, we illustrate how the development of other negative headlines influences the degree of weakness inflicted on the already suspect market. For example, the build-up of troops at the Ukraine border was already one of the "other negative headlines”- the invasion moves it up the scale in importance (negative).

Declines due to geopolitical conflict are more often a good buying opportunity:

Stocks will remain under pressure as long as the conflict drags on. Equities tend to overshoot (up and down) during the most uncertain times. The uncertainties regarding this event are numerous. Given the negative impact higher energy prices will have on the global economy, the response of Western leaders with sanctions is one uncertainty. Any adjustment in output from OPEC to counter the increase in energy prices and actions from central bankers will be significant for financial markets. How far Russia pushes and how long the conflict lasts are other unknowns. Finally, the debate and commentary regarding what Europe will look like politically on the other side only add to the uncertainty. Given the degree of uncertainty, stocks are likely to overshoot the downside in the coming days, weeks, or months. When equities overshoot the downside, positive gain ensues on the other side. Historically, **geopolitical conflicts produce good buying opportunities**. Although the current period is different from others in history, past geopolitical conflicts are helpful to review to understand how this may play out. For example, in 1990, the invasion of Kuwait by Iraq and the ensuing Gulf War contributed (a recession occurred as well) to a 20% equity market decline over 3-months. Stocks recovered to a new price high in just 4-months. In 1962, a near Russia/US nuclear conflict during the Cuban Missile Crisis led to a 22% decline for stocks in just 3-months. However, over the following 12-months, stocks rallied to a new all-time high. Although the current situation is troubling, it is far less disturbing than these two examples.

Inflation, Economic Growth, and Central Banks' response remain the key market influences over the next 12-months:

Outside of the near-term, shock-factor implications on the equity market, the most significant risk from the current situation is the upside pressure it will add to already elevated inflation. As a reminder, stocks typically trade at lower valuations in periods of sustained high inflation. As of now, investors anticipate the current period of high inflation to moderate with the 10-year inflation expectation of 2.60% below the 5-year expectation of 3.26% and well below the most recent Core CPI reading of 6%. Although 10-year inflation expectations are not troubling, the rapid rise in the 5-year (it was ~2.7% in late December) is note-worthy over the near term for equity investors. As long as it trends higher, stocks are likely to struggle as valuation adjusts. The second risk is the global economic impact. Military conflict dents confidence and thus has a negative feedback loop on the economy. In the EU, the economic impact will be more dramatic and raise the likelihood of a recession. The threat is much less for the US and other parts of the world. However, higher energy prices, economic weakness with trading partners, and lower confidence will lower GDP growth. Despite potential slower growth, the risk of recession remains low. The US economy was estimated to grow above the long-term trend of 2% before the conflict.

The combination of higher inflation and slower growth puts the central bankers in a difficult position. Therefore, the risk of policy error will increase in the eyes of investors.

Valuation may come under pressure in such an environment as investors compensate for uncertainty. Fortunately, valuation has already declined over the past year. The price-earnings ratio of 20x is down from a peak of 28x and is now back to the 5-year average of 20.9x. Despite the decline, if inflation expectations, as measured by the break-evens, continue higher, we see additional pressure on the multiple.

Equities were already deeply oversold before the latest escalation.

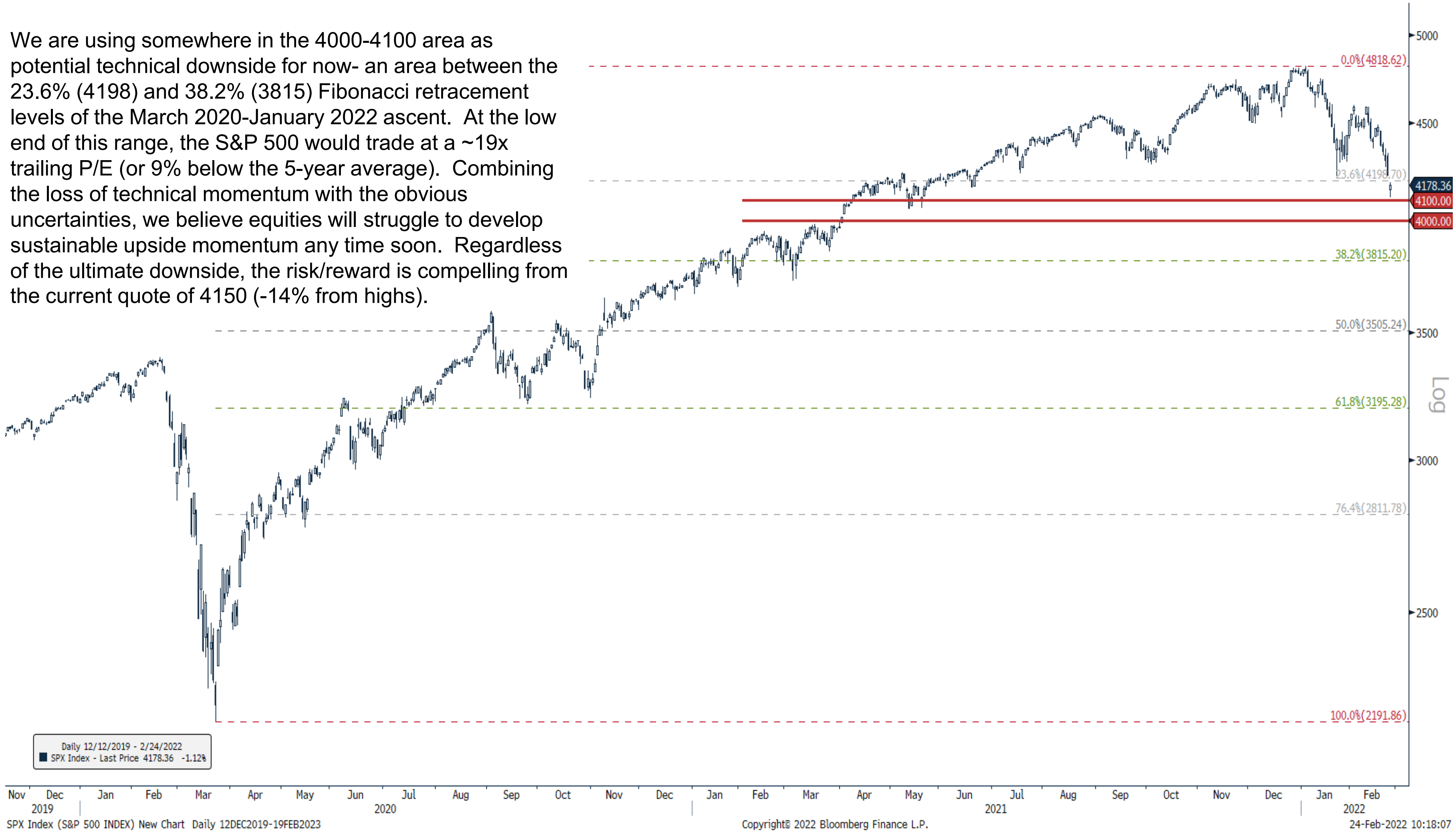
Despite the apparent headwinds, we believe equities will register gains over the next 12-months. The already decline of 14% discounts much of the uncertainty. Energy is a component of inflation, but other factors, including the supply chain and labor, have room to improve. Before the conflict, our base case had inflation moderating over the next twelve months as labor market participation improves and the supply-chain backup improves. Our base case remains for moderating inflation ahead. When combining this with the belief that the US economy is not at risk of slipping into contraction, higher equity prices over the next 12-months are likely. Furthermore, stocks screen favorably versus bonds with a current excess return of 3% (utilizing the S&P 500 earnings yield of 4.9% vs. the 10-year treasury yield of 1.9%). Since 1962, an earnings yield in the 2.5-3% range coincided with an 8.3% compounded annual return on average over the following 3-years.

Technically, the upside momentum created as the market glided higher in 2021 is broken, for now. Combining the loss of technical momentum with the obvious uncertainties, we believe equities will struggle to develop sustainable upside momentum anytime soon. For now, we are using somewhere in the 4000-4100 area as a potential technical downside. If inflation proves more problematic and economic conditions become challenging, the market's downside will increase.

Risk vs. reward compelling: At the low end of the above range, the market would trade at ~19x trailing earnings or 9% below the 5-year average. Consider our scenario outlined above regarding the economy, earnings growth, and moderating inflation comes to fruition. In that case, we envision the S&P 500 in a range between the old high of 4800 to a level near 5000. Regardless of the ultimate downside, the risk-reward is compelling from the current quote of 4150 (-14% from highs).

TECHNICAL: S&P 500

We are using somewhere in the 4000-4100 area as potential technical downside for now- an area between the 23.6% (4198) and 38.2% (3815) Fibonacci retracement levels of the March 2020-January 2022 ascent. At the low end of this range, the S&P 500 would trade at a ~19x trailing P/E (or 9% below the 5-year average). Combining the loss of technical momentum with the obvious uncertainties, we believe equities will struggle to develop sustainable upside momentum any time soon. Regardless of the ultimate downside, the risk/reward is compelling from the current quote of 4150 (-14% from highs).



Source: FactSet, Raymond James Equity Portfolio & Technical Strategy

HISTORICALLY, GEOPOLITICAL CONFLICT PRODUCES GOOD BUYING OPPORTUNITIES

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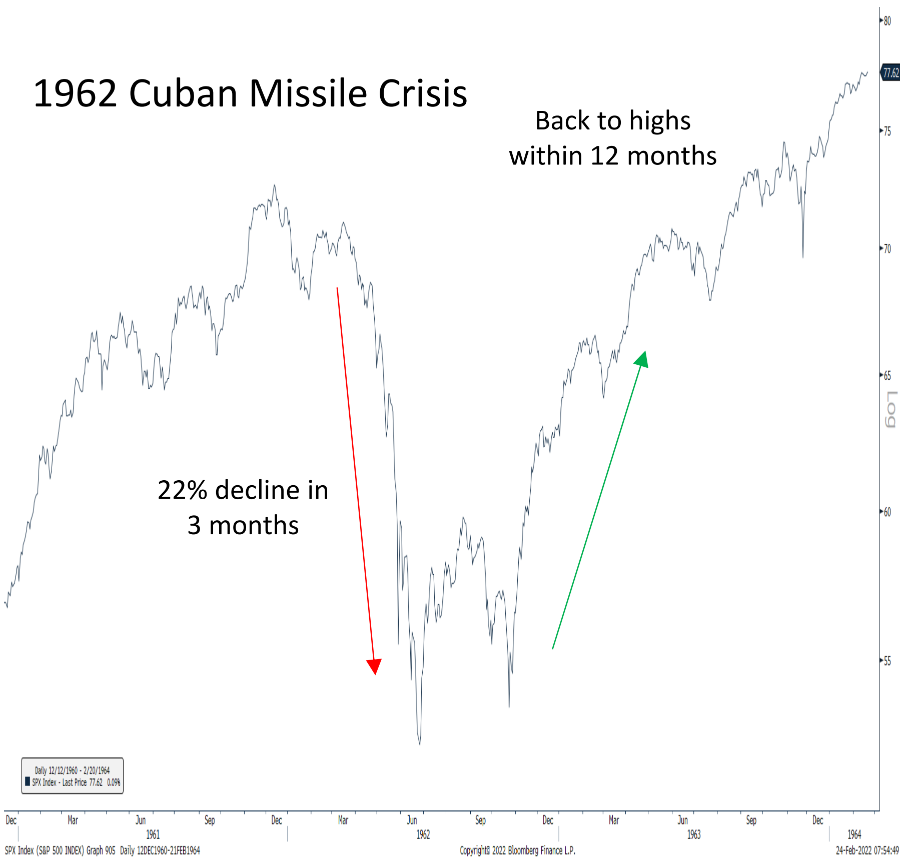

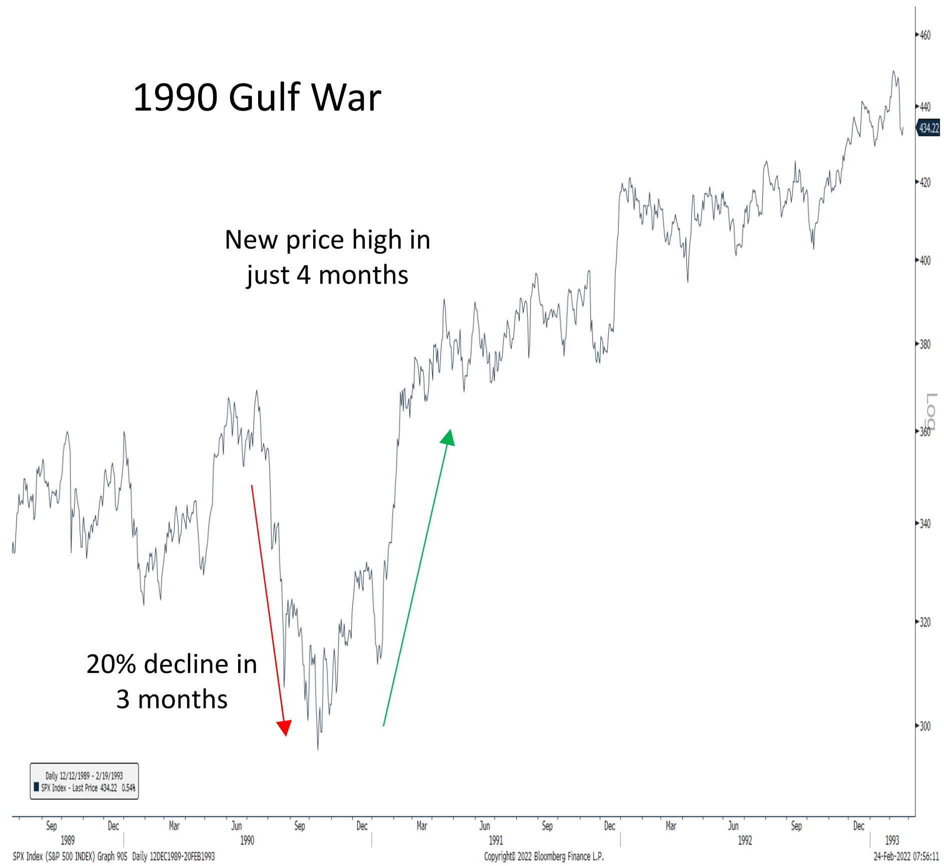

Source: FactSet, Raymond James Equity Portfolio & Technical Strategy (M22-4370232)

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Index Definitions

The **S&P 500** is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market.

The **Dow Jones Industrial Average (DJIA)** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The **NASDAQ Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market.

The **MSCI World All Cap Index** captures large, mid, small and micro-cap representation across 23 Developed Markets (DM) countries. With 11,732 constituents, the index is comprehensive, covering approximately 99% of the free float-adjusted market capitalization in each country.

The **MSCI EAFE (Europe, Australasia, and Far East)** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the United States & Canada. The EAFE consists of the country indices of 21 developed nations.

The **MSCI Emerging Markets Index** is designed to measure equity market performance in 23 emerging market countries. The index's three largest industries are materials, energy, and banks.

The **Russell 2000** index is an index measuring the performance of approximately 2,000 smallest-cap American companies in the Russell 3000 Index, which is made up of 3,000 of the largest U.S. stocks.

The **NYSE Alerian MLP** is the leading gauge of energy infrastructure Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

The **Barclays Intermediate Government/Credit Bond** index measures the performance of U.S. Dollar denominated U.S. Treasuries, government-related and investment grade U.S. corporate securities that have a remaining maturity of greater than one year and less than ten years.

The **Euro Stoxx 50 Index** is a market capitalization weighted stock index of 50 large, blue-chip European companies operating within Eurozone nations. Components are selected from the Euro STOXX Index which includes large-, mid- and small-cap stocks in the Eurozone.

The **China CSI 300** is a capitalization-weighted stock market index designed to replicate the performance of top 300 stocks traded in the Shanghai and Shenzhen stock exchanges. It had a sub-indexes CSI 100 Index and CSI 200 Index.

The **S&P 500 Futures** is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **DJIA Futures** is a stock market index futures contract traded on the Chicago Mercantile Exchange`s Globex electronic trading platform. Dow Futures is based off the Dow 30 stock index.

The **Nasdaq 100 Futures** is a modified capitalization-weighted index of the 100 largest and most active non-financial domestic and international companies listed on the NASDAQ.

Europe: DAX (Deutscher Aktienindex (German stock index)) is a blue chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

Asia: Nikkei is short for Japan's Nikkei 225 Stock Average, the leading and most-respected index of Japanese stocks. It is a price-weighted index composed of Japan's top 225 blue-chip companies traded on the Tokyo Stock Exchange.

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