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FROM THE DESK OF DARRELL L. CRONK

State of the Markets

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Putin, Powell, and Prices

"In preparing for battle, I have always found that plans are useless, but planning is indispensable." — Dwight D. Eisenhower

When you provide market outlooks and forecasts for a living, you can be known as an optimist or a pessimist. We were optimistic on March 23, 2020, when markets hit bottom in the throes of a new global health pandemic. We placed our trust in the human spirit and in science. In recent days, some have asked for an optimistic note. Some have asked for the same serving of guidance that we have often delivered when markets experience a garden-variety correction — they want the all-clear signal to buy the dips or to rush back into risk assets. This is fine when most of the unknowns are known, or at least when risk factors can be measured and historical precedents abound.

This may surprise regular readers, but I do not think of myself as an optimist or a pessimist. Rather, I think of myself as a pragmatist and a realist. So today's offering will involve candor and caution — and that is because there are still considerable unknowns about the three P's: Russian President Vladimir **Putin**, Fed Chair Jerome **Powell**, and the **prices** we will now pay for many daily living expenses.

Putin

We can create market forecasts. We can track economic trends. We can even develop a base case with great conviction about geopolitical events like elections and trade disruptions and negotiations between super-powers. What we cannot do is predict the behaviors of a political leader initiating a war of choice bent on destruction and now effectively exiled from the global community.

When we map out potential scenarios in Eastern Europe, the most far-reaching tail risk event possibilities remain on the table — threats to use nuclear weapons, military incursions that extend deeper into Eastern Europe, the shutdown of much of the energy flow to Europe, and an escalation of military intervention by NATO. To be clear, we do not expect these things to happen, nor do we want these things to happen, but none can be dismissed from our scenario planning just yet. Putin's actions, with no easy or clear off-ramp to de-escalate, are one unknown for markets.

Another unknown is the potential unintended consequences of economic sanctions, including cutting off Russia from The Society for Worldwide Interbank Financial Telecommunication (SWIFT) system and seizing central bank reserves held abroad. Weaponizing financial systems by using banks and not tanks at this scale is relatively unprecedented. I am not saying these severe economic sanctions are bad, but they are new. Game theory teaches us that when you change the rules of the game, the players change how they play. We do not yet fully know the ramifications of these actions, and the world, along with financial markets, need adjustment time to adapt.

Powell

The risk of a Federal Reserve (Fed) policy error was already high long before geopolitics factored into the calculus. Now the risk is significantly higher, complicated by both an economic and territorial war — both difficult to accurately predict. The path for Chair Powell and the Fed to remove the oxygen from rising inflation without snuffing out economic growth has narrowed considerably.

All eyes were on Fed Chair Powell last week as he testified before the House Financial Services Committee and the U.S. Senate Committee on Banking, Housing, and Urban Affairs. All eyes will be on Powell when he takes the podium on March 16 and announces, as he's foreshadowed, that the Fed will begin hiking rates, normalizing policy, and taking the fight to inflation. Powell's battle against inflation, in our view, is one in which he has no choice.

The Fed and other global central banks find themselves locked in battle with their own mortal enemy — inflation. The transitory inflation of last year became the persistently high inflation of this year, and we believe many central banks find themselves behind the curve — both needing to raise rates to fight inflation and needing to test how aggressive they can be during a global disruption. There is little doubt among market observers, however, that the Fed needs to begin its policy tightening now and likely has some distance to travel to combat broadening and rising inflation.

Prices

While Putin wages a war of choice, and Powell a battle with no choice, we think it will be difficult consumer choices that ultimately determine the trajectory of economic growth. We have often pointed out that consumer spending drives 70% of U.S. gross domestic product (GDP) growth. As consumers feel the bite of inflation in their grocery bills and at the gas tank, as prospective homebuyers think twice when they see rising mortgage rates, as consumers spend more to heat and cool their homes, and as travelers weigh whether to head back to airports, there is likely to be some increased hesitation to spend on discretionary purchases.

More under the radar are the risks of significant supply disruptions many don't see each day. For example, metals like platinum and palladium, key inputs into catalytic converters for auto production, are key exports for Russia. Similarly, neon gas is a major export of Russia and a key input into semiconductor production. Both of these sectors (autos and semiconductors) were hit hard last year with bottlenecks from the pandemic supply chain disruptions. While existing supplies today are sufficient to last for several months, if disruptions persist, we expect that prices will undoubtedly rise, even assuming companies can obtain the raw commodity inputs.

Overall, the impact of a commodity supply shock reveals itself through a rise in prices and its resulting feedback to economic activity. For economic growth, it is important to note that whether the physical supply shock actually occurs or whether prices rise owing to higher risk premiums is immaterial. The damage to purchasing power remains the same. The duration and stickiness of this shock on prices will ultimately determine the materiality of price resets and the denting impacts to growth.

Bottom line, investors can afford to exercise some patience and discipline today. We believe selling into a selloff simply to raise cash is generally a harmful idea unless you believe the next recession is imminent, which we do not. Specific to equities, most U.S. and global indexes have broken through key support levels and continue to set lower highs and lower lows. Therefore, if your time horizon is long, then averaging into markets in correction territory has often proven long-term beneficial. If, however, you were looking for the bottom of this latest retreat, most signs would still point to the fact that we have found a low, but may not have found the low for this correction quite yet.

Important tenets during any period of uncertainly that apply once again today include: working with an investment professional to assess your portfolio (we favor sticking with quality, large-cap stocks with strong balance sheets); be defensive with fixed-income investments in what we believe will be a rising-rate environment; fully allocate to commodities based on investment objectives; and consider using alternative assets to buffer risk.

Just as Eisenhower's plan for the D-Day invasion in Normandy changed — in fact, it was originally planned for May 1944, then for June 5, and then finally moved to the June 6 date we remember each year — your investment plan may very well change. Do the planning anyway. Have the planning conversation with a trusted advisor anyway. Do the work now, so that when conditions on the ground change and more of the unknowns become knowns, you are ready to adapt your plan to new realities.

Addendum

Most days, our job is to take quantitative facts, data, and models and provide guidance on what is happening with markets and economies. It is a humbling job fraught with complexity in an attempt to predict the future through forecasts. However, we would be remiss if we did not acknowledge the human tragedy unfolding in Eastern Europe currently.

I concede that our words are not equal to the gravity of the moment as we attempt to make sense of the senseless. Lives, families, cities, and even countries are disrupted and lost with immense pain and suffering inflicted on so many. History is littered with examples of tyrants attempting to conquer, divide, and rule over people and geographies. History also provides a multitude of instances where human strength and resolve have shaped turning points in an unrelenting search for freedom and human decency. Ultimately, leadership is about defining reality and giving hope. Let us hope for the people of Eastern Europe that one of these turning points lies in the very near future.

Risk Considerations

Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

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