April 2022

Quarterly Market Strategy Report

Stagflation or Recession?

To date, 2022 has been a rough year for equity investors. After seven consecutive quarters of solid price gains, the first quarter of the year ended with a loss of 4.9% in the S&P 500 index, a fall of 4.6% in the Dow Jones Industrial Average and a larger 9.1% decline in the Nasdaq Composite index. These were the first 3-month declines in the indices in exactly two years, or since early 2020, when the COVID-19 global shutdown triggered a global recession.

Still, considering the alarming invasion and bombing of Ukraine by Russia in late February, we believe the decline in stocks has been remarkably orderly. Particularly since this attack has catapulted the world economic and geopolitical environments into turmoil. In addition, February's inflation benchmarks revealed that consumer prices were soaring 7.9% year-over-year – a forty year high -- and Russia's conflict with Ukraine is expected to exacerbate prices in fuel, grain, and fertilizer for the foreseeable future.

Last, but far from least, in mid-March the long awaited, yet decisive shift from a monetary policy of extreme ease to tightening began. This shift by the Fed reverses the historic liquidity boost that has been supporting stock prices for the last 24 months. In addition, following the FOMC meeting, Chairman Jerome Powell indicated there will be many more interest rate increased before year-end and the consensus is now forecasting rate hikes in each of the next six FOMC meetings this year. There is no doubt that a shift in monetary policy will impact the US economy. The only question is how much. Will the Federal Reserve be able to manage a soft landing for the economy? Or will the shift trigger stagflation or a recession? The next few months should be telling.

Changing Landscape for Investors

In short, the environment for equities has changed and the Fed's shift to a tightening policy will be pivotal. Expectations of multiple rate hikes have

Summary

Given the geopolitical and economic uncertainties we see in coming months, we would not be surprised if stocks trade within a broad trading range for much of 2022. Holding a core portfolio tilted toward value stocks is advised, but there will be trading opportunities in 2022, particularly in the technology sector, for those willing to assume the risk.

"Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man."

– Ronald Reagan

Wellington Shields & Co. LLC
140 Broadway, 44th Floor
New York, NY 10005
212.320.3000
wellingtonshields.com

triggered fears of an inverted yield curve and a recession. While we believe this fear is real, we also believe it is premature. First, inverted yield curves can be measured in many ways, but in our opinion, a truly inverted yield curve requires the 3-month Treasury bill yield to exceed the yield on the 10-year Treasury note yield. Given the present level of short-term rates, all things being equal, it would take eight 25 basis point rate hikes by the Fed to invert the yield curve. This is unlikely to materialize in coming months.

A truly inverted yield curve requires the 3-month Treasury bill yield to exceed the yield on the 10-year Treasury note yield. This is not in place and is unlikely to appear in coming months.

Second, history shows that markets usually rally following early rate hikes and begin to weaken only after four consecutive rate hikes take place within a twelve-month period. This implies the actual risk associated with inverted yield curve will appear later in the year.

In our view, the 10-year Treasury note market is a huge global market, is not under the Fed's control, and due to its global reach, can be an excellent predictor of future economic strength. Yields often fall, sometimes precipitously once investors expect rising interest rates will significantly damage economic activity. We would remain alert to this possibility, but do not expect it soon. And remember, the curve usually inverts six to twelve months prior to the start of a recession.

Earnings will be the key to investments

Whether the Russia-Ukraine conflict increases or diminishes, whether inflation grows or weakens, earnings growth, or the lack thereof, is the true foundation of any market trend. With this in mind, the upcoming first quarter earnings season will be important since it will indicate how well, or how poorly, companies have weathered the various difficulties of supply constraints, inflation, and rising interest rates, of the first quarter. First quarter earnings season begins this month, and it could become a market moving event.

Balanced portfolios should include stocks with a predictable earnings stream shielded from inflation, price earnings multiples at or below the S&P 500 average and dividend yields greater than 1.5%.

Beneficiaries of inflation such as energy, food, and staples are expected to do best and outperform this year. The Russian invasion has been the catalyst for many Western countries to increase their defense budgets and this increase in spending will benefit defense stocks and the industrial sector. Cybersecurity is another sector that is likely to see more capital investment and rising demand from consumers. Conversely, we will be watching company statements from housing and auto companies to see how corporate leaders respond to the prospect of rising interest rates and waning demand.

Investing in a new environment

In an era of rising inflation and higher interest rates, equites can still perform well but portfolios need to adjust. The best insulation today would

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Wellington Shields & Co. LLC
140 Broadway, 44th Floor
New York, NY 10005
212.320.3000
wellingtonshields.com

a balanced portfolio that include stocks with earnings shielded from the pressures of inflation, price earnings multiples at or below the S&P 500 average, and stocks with dividend yields greater than 1.5%.

However, given the geopolitical and policy uncertainties in the current environment; we would not be surprised if equity indices trade within a broad trading range for most of 2022. If so, holding a core portfolio tilted toward value stocks is still advised. But for those willing to be nimble, we expect a trading opportunity may appear in the technology sector in coming months.

Gail M. Dudack
Gail M. Dudack is the Chief Market Strategist both at Wellington Shields and its Dudack Research Group division, an independent institutional research firm, she founded, that provides economic, fundamental, quantitative, and technical strategy and tools to mutual funds, hedge funds, and private money managers.

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