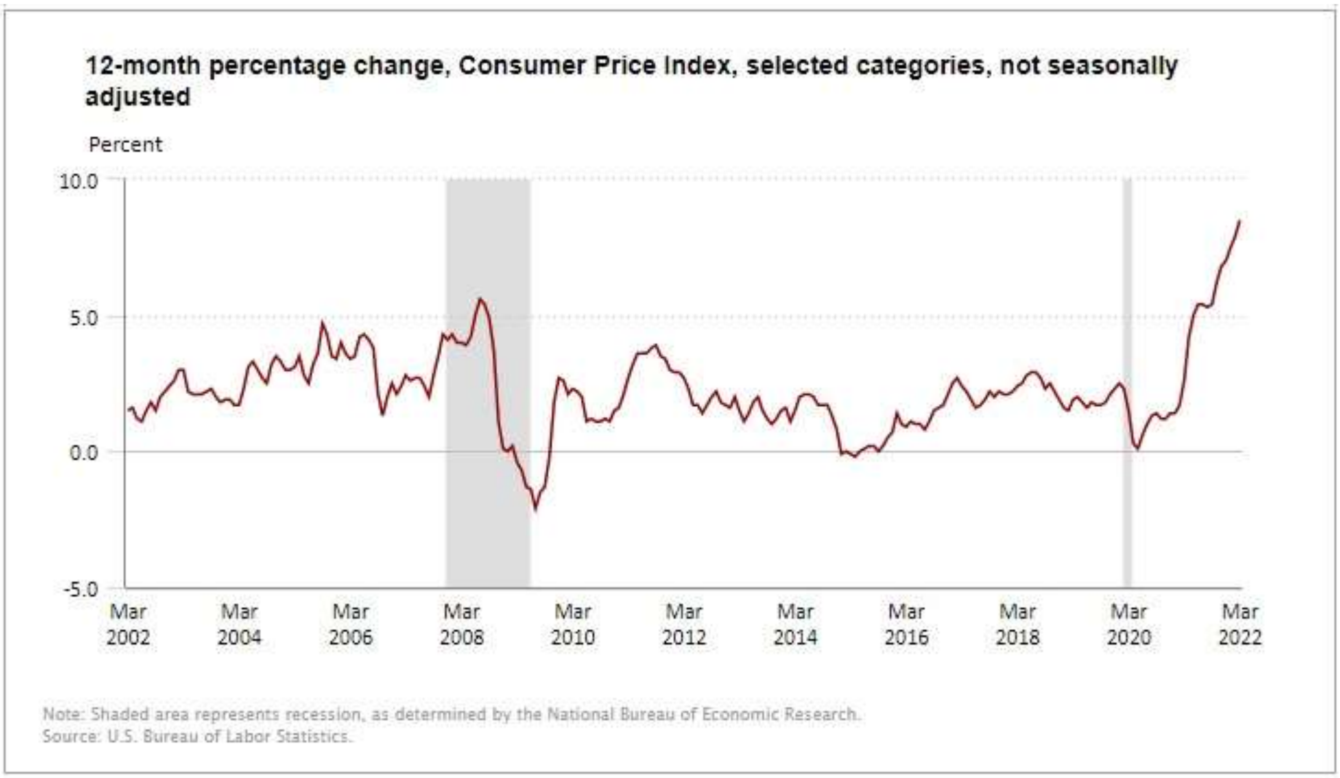
The COVID-19 pandemic presently appears to be under control in the United States and other developing countries. Still, cases have been surging in China amidst widespread lockdowns imposed by its authoritarian government.

Lastly, and most disturbing, is the unprovoked invasion of Ukraine by the brutal Russian military, causing a senseless war, horrific suffering and death tolls upon defenseless civilians, extensive property damage, and economic disruption to both countries. It is estimated that the Ukrainian economic output this year will decline by forty-seven percent. The economic consequences will reverberate worldwide by stimulating inflation and prolonging the supply chain problems, as many of us have experienced if we've tried to buy new-or-used cars or even furniture.



The Markets

Keep in mind that the S&P 500 hit a record high on January 3 this year. Despite all of the Black Swan events that have occurred in the past three months, the global stock markets have proven remarkably resilient, incurring only modest losses year-to-date. So let's explain why we think that is:

- History shows that U.S. stocks typically rise after the Federal Reserve begins raising interest rates. In fact, during the several cycles of interest-rate hikes since 1990, the S&P 500 tumbled shortly after the first rate hike, but typically recouped those losses six months later. After one year, the S&P 500 and NASDAQ Composite were up eighty percent of the time. The key concern is whether the Federal Reserve can engineer a soft landing (i.e., a modest recession), or if a more prolonged and deeper downturn will result.

- The domestic yield curve has inverted recently (the yield on the two-year Treasury rises above the yield on the ten-year Treasury). That has been a reliable and advanced indicator of an upcoming recession. Since 2009, however, this recession predictor has not been dependable, in our opinion. The Federal Reserve has been a significant purchaser of longer-term Treasury debt, artificially forcing the long-term yields down to stimulate the economy. Thus, it has caused long-term yields to diverge from economic fundamentals. The Federal Reserve now owns roughly twenty-five percent of marketable Treasury debt, which is an increase from the previous peak of twenty percent in 2014.
- The U.S. economy currently appears quite healthy, as evidenced by the job market and the lowest unemployment rate since World War II. An exception occured in February 2020 when the unemployment rate hit 3.5 percent. Today, both corporate and consumer financials are strong with accumulated excess cash to assist in weathering this current inflationary bout.
- First-quarter 2022 corporate earnings for U.S. companies are expected to be six percent above last year's first quarter— a respectable and continued improvement in earnings for sure. In addition, U.S. corporations appear to have sustainable pricing power for their goods and services, with estimated first-quarter profit margins at twelve percent. This is higher than the most recent five-year average of eleven percent. Companies will likely continue to retain pricing power during this cycle, which will not result in profit margin compression that typically adversely affects stock prices.
- Finally, companies have consistently announced noteworthy dividend increases and stock buybacks that continue to be widespread use of record-high accumulated corporate cash.

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Final Words

We remain steadfast in our commitment to monitor the evolution and progression of these Black Swan events and their possible outcomes. Eight out of eleven interest-rate increase cycles, occurring over the past seven decades, have resulted in recessions of consequence. However, the global stock markets usually respond to future macroeconomic events up to six months in advance. In other words, once the recession is declared, the global stock markets are already in rally mode. A study of eighteen geopolitical and financial crises since 1940 indicates that after the initial decline, the S&P 500 stabilized reasonably quickly and was higher a year later, the majority of the time.

Finally, we are excited about returning to a more normal monetary policy where fixed-income yields become attractive once again, and excessive risk-taking is no longer required to achieve competitive total returns.

Sources: *The Wall Street Journal, April 11, 2022*