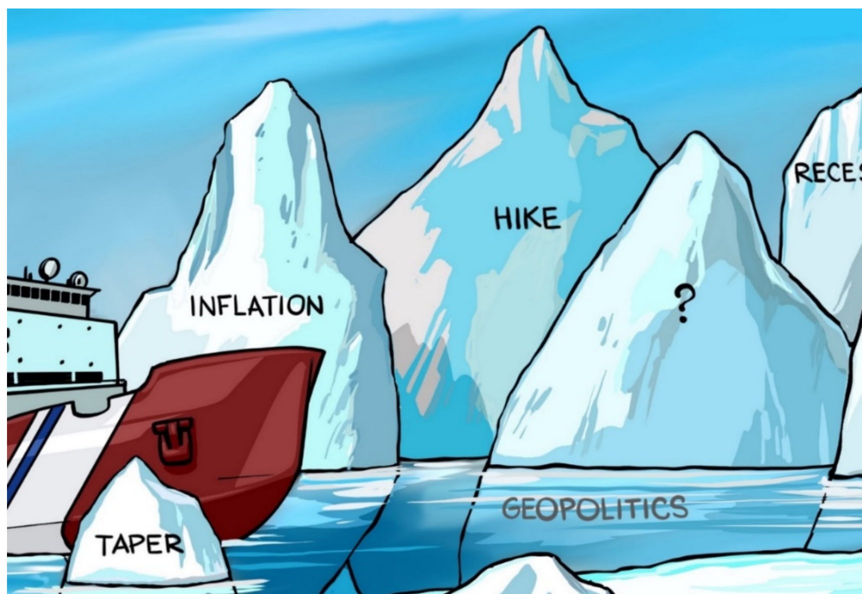
Goldman Sachs

Investment Strategy Group

Sunday Night Insight
February 13, 2022

Still Piloting Through



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Since the publication of our *2022 Outlook: Piloting Through*, the financial markets, especially those of the US, have become much more volatile. US equities–as measured by the S&P 500–have declined by 7.2% on a closing basis since the end of December 2021, and by 12.4% based on intraday pricing from their peak on January 4th to their recent low on January 24th. Volatility–as measured by the CBOE VIX Index–increased from 16% to an intraday peak of 39% on January 24th. The interest rate on the 10-year Treasury bond increased by about 50 basis points year-to-date, from 1.5% to just below 2% (with 2% being the mid-point of our year-end 2022 target) as of the close on Friday, February 11th.

Within the S&P 500, the energy sector has gained 27.1%, while real estate and communication services (includes Facebook, Netflix, and Alphabet) were notable underperformers, declining

12.3% and 12.2%, respectively. Consumer discretionary (including Amazon, and Tesla) and information technology (including Apple, Microsoft, and Nvidia) have also underperformed, declining 11.6% and 11.0%, respectively.

Non-US markets were much less volatile. Non-US developed equity markets–as measured by MSCI EAFE (Europe, Australasia, Far East)–have declined only 2.1% year-to-date, while emerging equity markets–as measured by MSCI EM–have increased by 0.6%, driven by a nearly 10% return in Brazilian equities. Eurozone and UK bonds have slightly underperformed similar-maturity US bonds.

Inevitably, clients are asking whether these price declines foreshadow a bear market in equities. In such a scenario, higher and more persistent inflation leads the Federal Reserve to aggressively tighten monetary policy enough to cause a recession and a corresponding decline in earnings. While such a scenario is possible, we do not think it is likely this year. Our base case posited in our 2022 *Outlook* is that the US economy will pilot through the icebergs of inflation and Federal Reserve policy rate hikes. What we are most uncertain about are the risks emanating from the Russia-Ukraine crisis.

While it is virtually impossible to accurately attribute short-term market movements–let alone erratic ones–to specific data releases or events, we think it is helpful to examine the confluence of four key factors that may account for some of the recent downdrafts.

We also think it is important to note that no one should be overconfident in the forecasts of the path of inflation or the trajectory of Federal Reserve interest rate policy in 2022. One of the key pillars of our investment philosophy is “history is a useful guide.” The last time the world was confronted with a pandemic was over 100 years ago, with a very different economic, financial market, and geopolitical backdrop than today. We do not presume to know the exact impact of a two-year pandemic on employment and on savings and consumption behavior.

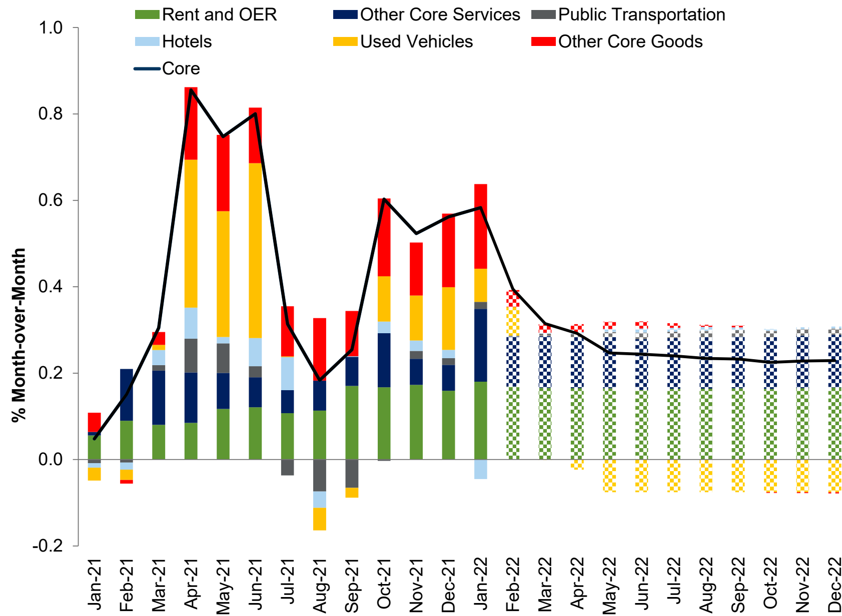
The four key factors that, in all likelihood, account for the recent downdrafts are:

- Recent inflation and employment data and their implications for Federal Reserve tightening policy.
- Commentary by Federal Reserve board members.
- Mixed earnings from the FANGMANT (Facebook/Meta, Apple, Netflix, Google/Alphabet, Microsoft, Amazon, Nvidia, and Tesla) stocks.
- Increased escalation of Russia-Ukrainian tensions.

Inflation and Employment Data

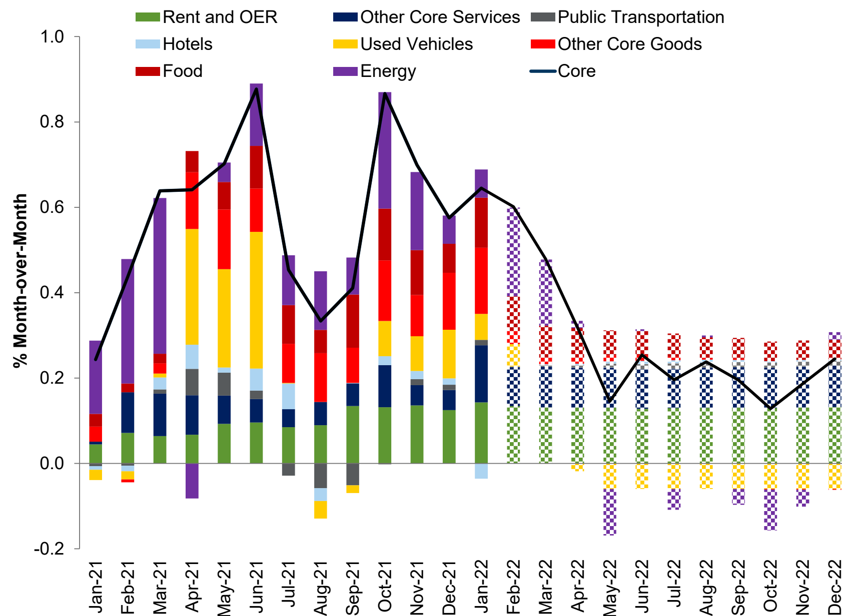
Inflation: As shown in Exhibits 1 and 2, after a significant increase in core and headline inflation, driven primarily by used vehicles in April, May, and June of 2021, monthly inflation dropped to nearly a third of the prior three months’ levels. The reprieve was short lived, as both core and headline inflation steadily increased after October. The January 2022 core and headline year-on-year inflation readings released last week stood at 6.0% and 7.5%, respectively, the highest inflation levels observed since the early 1980s.

1. Month-over-Month Core CPI Decomposition (January 2021 to January 2022) and ISG Forecast (Through December 2022)



Source: Investment Strategy Group, Haver.
Note: Forecasts are estimated, are based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved.

2. Month-over-Month Headline CPI Decomposition (January 2021 to January 2022) and ISG Forecast (Through December 2022)

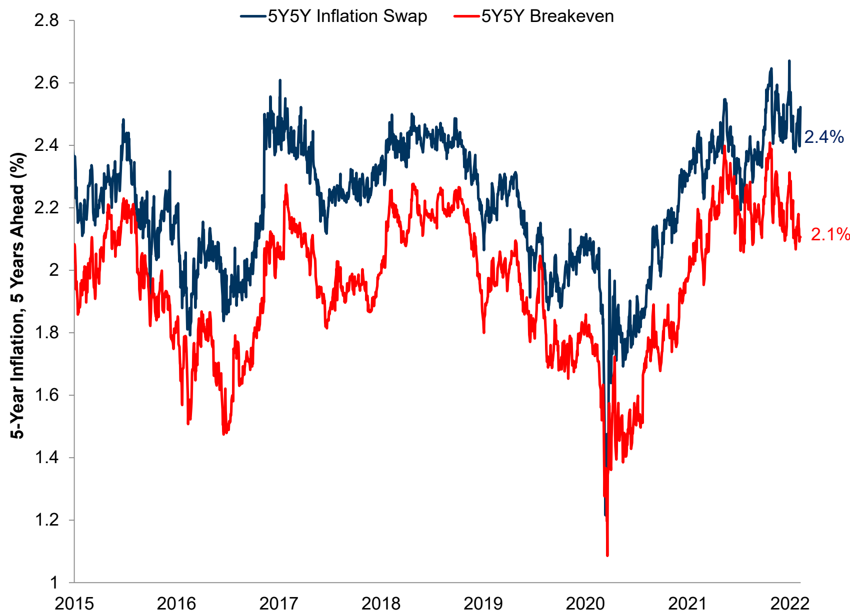


Source: Investment Strategy Group, Haver.
Note: Forecasts are estimated, are based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved.

The greatest concern in the inflation data was the breadth of price increases across all sectors based on year-on-year data: energy prices were up 27%, used vehicles were up 40%, core goods and food were up 7%, and rent and owner's equivalent rent (32% of the Consumer Price Index weight) and other core services were up just under 4%.

While equity investors are concerned that inflation expectations could become unanchored as a result of such price increases, long-run inflation expectations remain well anchored at just over 2%, as shown in Exhibit 3.

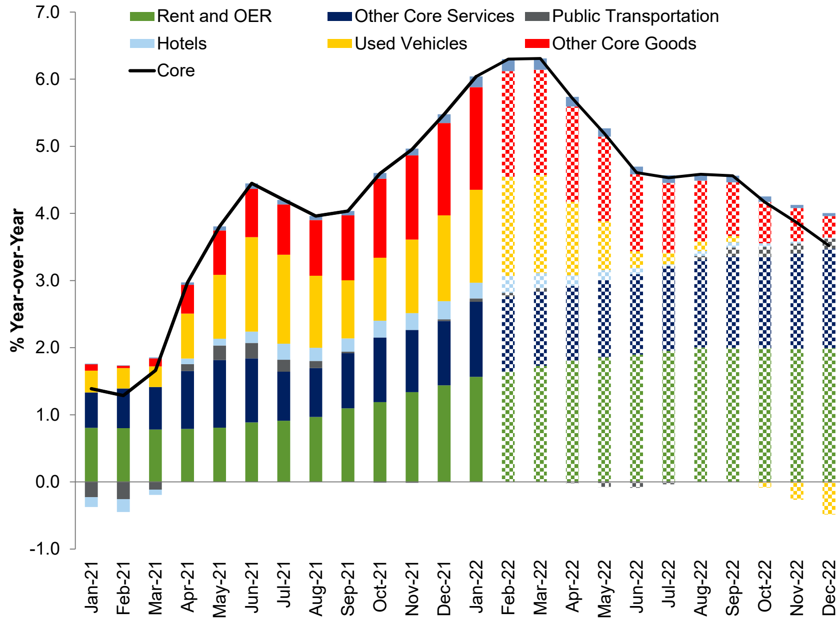
3. Long Run Market-Based Inflation Expectations



Source: Investment Strategy Group, Bloomberg.

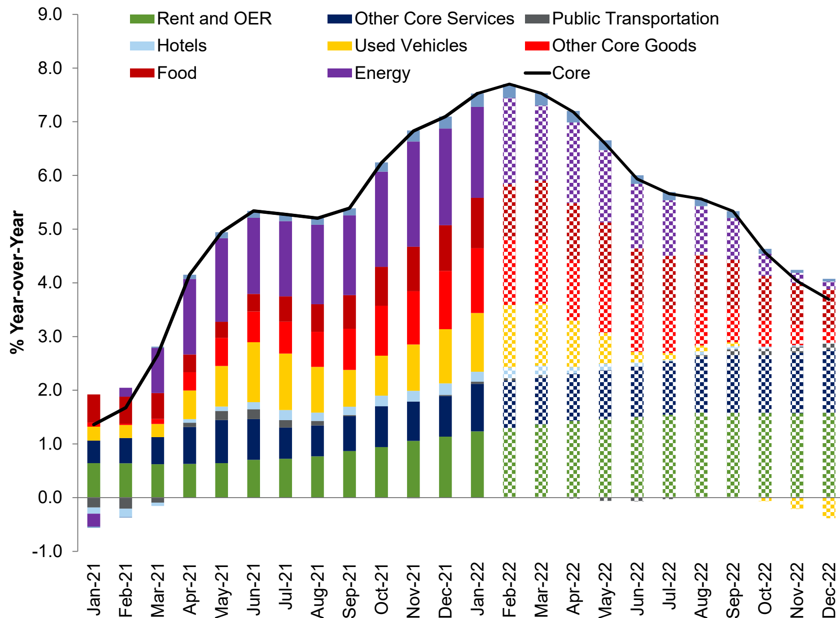
We expect inflation to gradually abate from its current high levels to 3.5% for core inflation and 3.7% for headline inflation by the end of this year (see Exhibits 4 and 5). While there is a risk that inflation remains elevated over the next several months, we expect declining Covid-19 infections such as seen in the US, Europe, and the UK (see Exhibits 6, 7, and 8), the gradual easing of supply bottlenecks and a return to normalcy in most economies to put downward pressure on the pace of inflation.

4. Year-over-Year Core CPI Decomposition (January 2021 to January 2022) and ISG Forecast (Through December 2022)



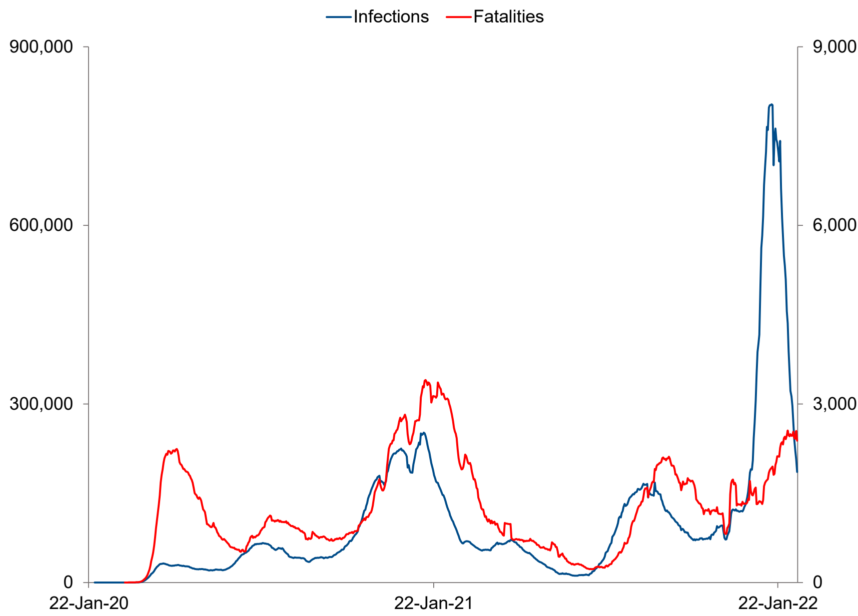
Source: Investment Strategy Group, Haver.
Note: Forecasts are estimated, are based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved.

5. Year-over-Year Headline CPI Decomposition (January 2021 to January 2022) and ISG Forecast (Through December 2022)



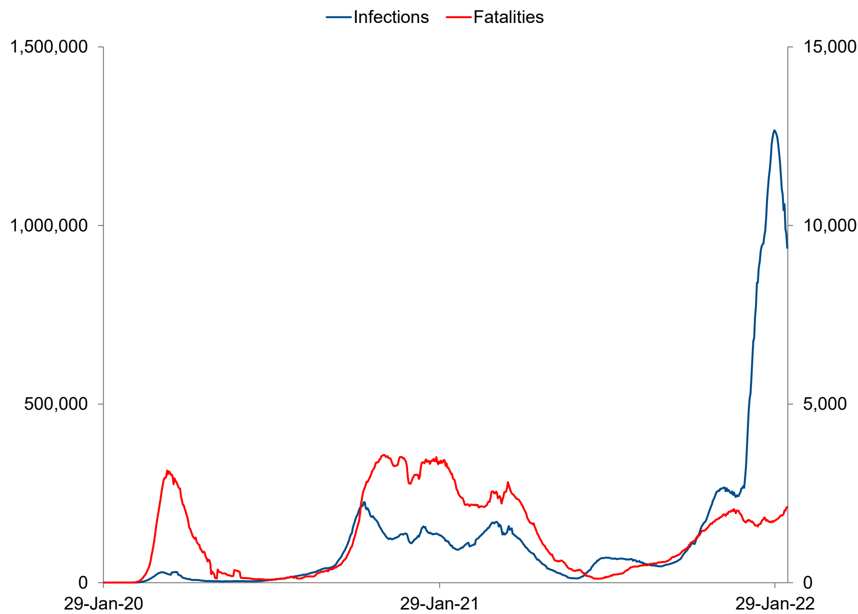
Source: Investment Strategy Group, Haver.
Note: Forecasts are estimated, are based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved.

6. Daily US COVID-19 Infections and Fatalities – 7-Day Moving Average



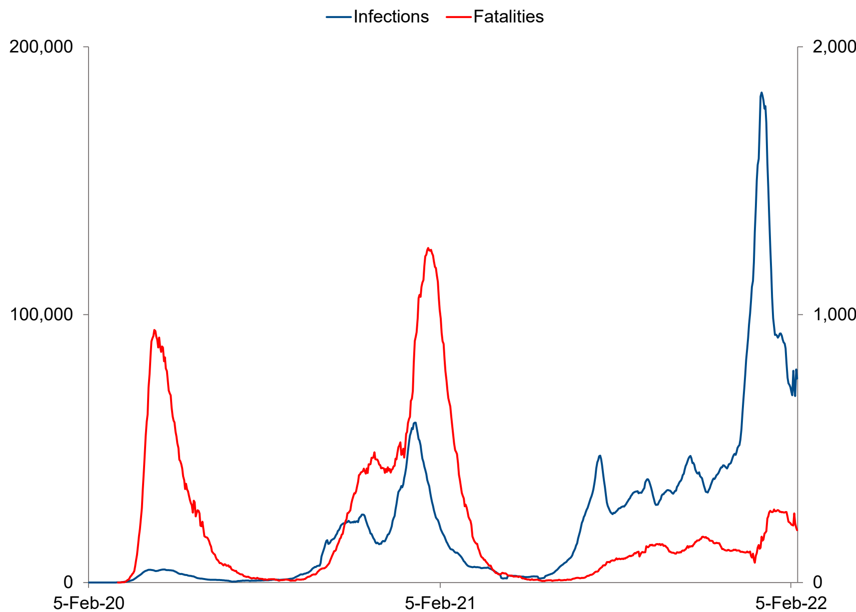
Source: Investment Strategy Group, John Hopkins University.

7. Daily European Union COVID-19 Infections and Fatalities – 7-Day Moving Average



Source: Investment Strategy Group, Our World in Data.

8. Daily UK COVID-19 Infections and Fatalities – 7-Day Moving Average



Source: Investment Strategy Group, Our World in Data.

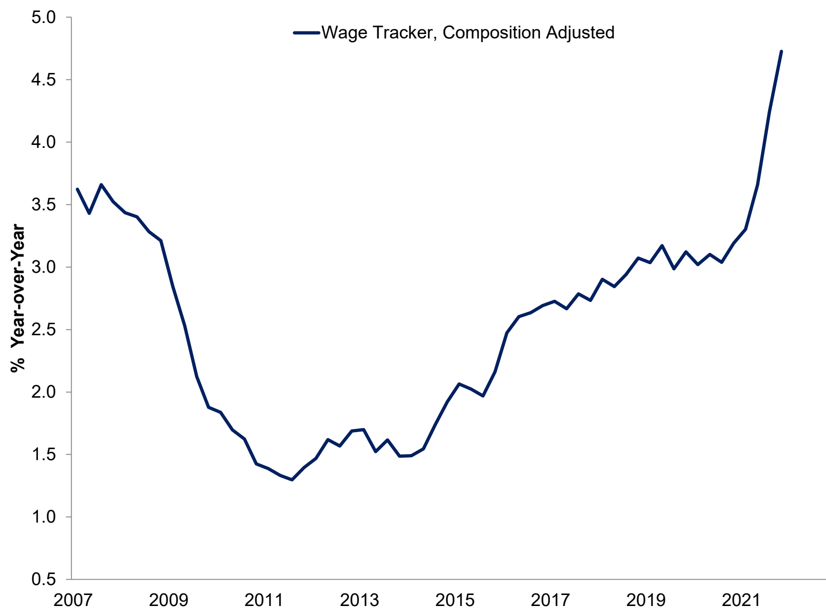
Employment: The employment data released on February 4th further confirmed upward pressure on inflation. Average hourly earnings increased 0.7% from the prior month and 5.7% from a year earlier. The annualized rate for the last three months is even higher at 6.9%. All these readings point to a tight labor market.

The actual employment numbers that were reported are somewhat distorted due to two changes. The Bureau of Labor Statistics changed the seasonal factors that they use to adjust every employment report for higher-than-average hiring in the private sector in the Spring and early Summer and sharply lower numbers in January.

They also changed what is referred to as population controls based on updated 2020 census data. For example, an increase in household employment of 1,199k people was actually a decline of 272k after accounting for the population control changes.

Therefore, the key takeaway from the employment report is that the labor market is tight and wage inflation will persist for the time being (see Exhibit 9).

9. Goldman Sachs Global Investment Research Wage Tracker



Source: Investment Strategy Group, Goldman Sachs Global Investment Research.

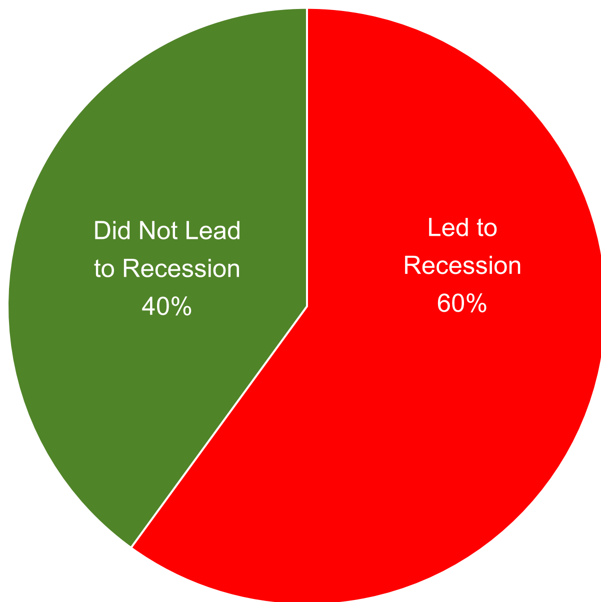
Commentary by Federal Reserve Board Members

Last Thursday, when the President of the St. Louis Federal Reserve Bank, James Bullard, called for a tightening of 100 basis points by July 1 and implied he was open to a 50 basis point increase in the Federal Fund rate at the upcoming FOMC meeting in March, the equity market sold off sharply. On the other hand, as summarized by our colleague David Mericle, Chief US Economist in Global Investment Research, Thomas Barkin, Mary Daly, Loretta Mester, Patrick Harker, Raphael Bostic, and Christopher Waller have all pushed back against a 50 basis point hike in March.[1]

Joseph Stiglitz, Nobel laureate in economics, former chief economist at the World Bank and Chair of the Council of Economic Advisers from 1995-97, recently wrote that a "large across-the-board increase in interest rates is a cure worse than the disease," and that "we haven't been through something like this before" so policy has to be more incremental.[2]

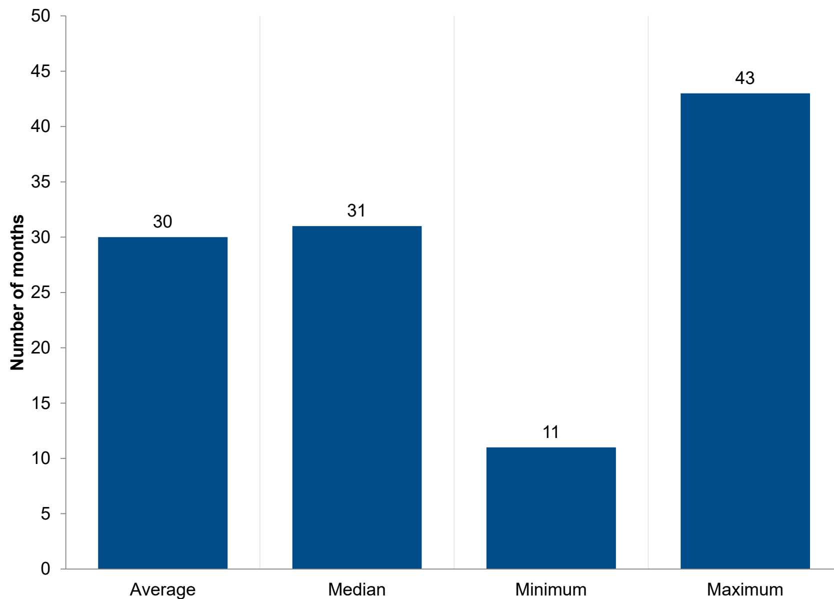
Federal Reserve Tightening: The most important question following the inflation and employment reports is whether the Federal Reserve will tighten policy so aggressively that a recession becomes inevitable in 2022. We think a recession remains unlikely this year. While the probabilities increase in 2023, we think they remain below 30%. As shown in Exhibit 10, not every tightening cycle leads to a recession. Furthermore, as shown in Exhibit 11, the average number of months from the start of Federal Reserve tightening to the start of recession is 30 months, the median is 31, the shortest period was 11 months in 1980, and the two longest ones were 42 and 43 months, respectively.

10. Percentages of Fed Tightening Cycles that Led to or Did Not Lead to a Recession



Source: Investment Strategy Group, Bloomberg, Haver.

11. Number of Months Until Recession from Start of Hiking Cycle



Source: Investment Strategy Group, Global Financial Data, Haver, NBER.

If the Federal Reserve is incremental in tightening policy and accepts higher inflation than its stated target of 2%, then a recession is far from inevitable in the next two years. Trying to forecast beyond that is a futile exercise, in our opinion.

Earnings from the FANGMANT stocks

The disappointing earnings or forward guidance of two of the FANGMANT stocks (Facebook/Meta and Netflix) seems to have overshadowed the positive earnings reports of other FANGMANT stocks—such as Apple, Amazon, Google/Alphabet, and Microsoft—as well as that of the rest of the S&P 500 in the fourth quarter of 2021.

Of the 72% of companies in the S&P 500 that have reported fourth quarter earnings so far, 77% have exceeded consensus expectations for earnings per share and revenue growth. S&P 500 earnings have exceeded consensus estimates by 9% and provide very strong momentum for earnings growth in 2022.

Russia-Ukraine Crisis

The amassing of Russian troops in and around Ukraine and the uncertainty around Moscow's intentions have been another factor contributing to the recent market downdraft.

The Investment Strategy Group hosted a client call on Wednesday, February 9th, with two of our expert advisors on geopolitical issues:

- Dr. Ashton Carter, Director of the Belfer Center at the Kennedy School of Government at Harvard University, 25th US Secretary of Defense and a seasoned government official with a long history of involvement with Russia when—as Assistant Secretary of Defense—he was responsible for dismantling nuclear weapons in Russia, Ukraine, Kazakhstan, and Belarus between 1993 and 1996.
- Sir Alex Younger, former Chief of British Secret Intelligence Service, MI6, with a 30-year career in foreign intelligence. He was Knighted in the 2019 Queen's Birthday Honours list for services to national security.

The key takeaways from the call were certainly alarming.

According to Dr. Carter:

- The probability of a military incursion by Russia remains at 50% as he had suggested in our 2022 *Outlook* earlier in the year, noting that 50% for a war is very high.
- While an attack may not be imminent, he has moved the likely timetable earlier than originally expected in the second half of this year. Putin may wait for the Beijing Olympics to end and also see if he can drive a wedge between the US and the UK, on one hand, and Germany and France, on the other.
- The attack could take one of three forms:
  - Full-scale invasion of Ukraine and toppling of the government. Dr. Carter warned that such a war would be a "big fight."
  - Enter the eastern provinces and take some more territory in the same manner as Putin has done with Donetsk and Luhansk.
  - More formally occupy the two eastern provinces.
- While Russia has made a long list of demands from the US and NATO allies, it is unlikely that these demands would be met, which makes negotiations very difficult. There may be some room for negotiations regarding the placement of NATO forces that have been moved eastward towards Russia since 1997, in exchange for Moscow also addressing some of its actions that are troubling to NATO.

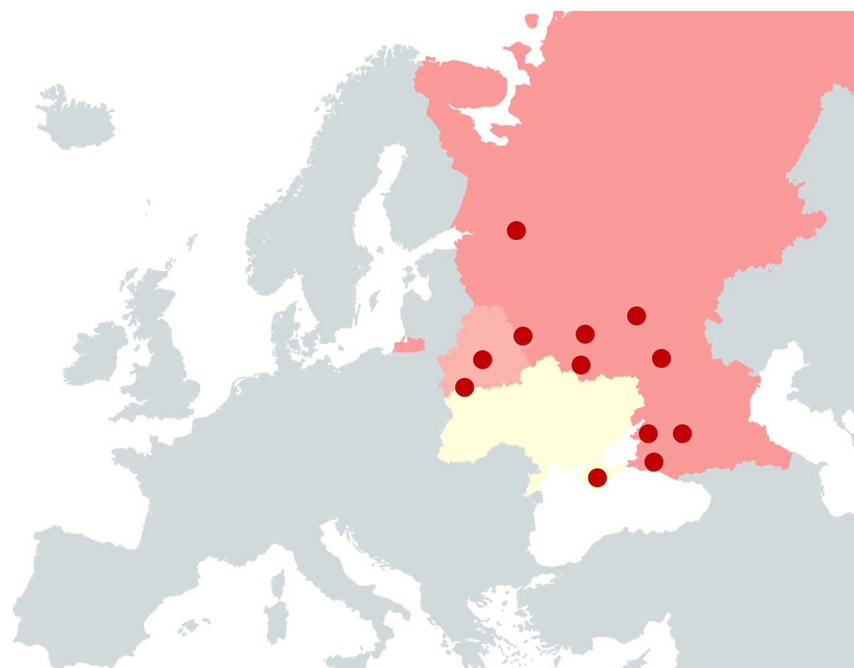
- Dr. Carter also stated that while sanctions were one tool to use in response to a Russian invasion of Ukraine, the US could also make things difficult for Russia in areas like Georgia, Chechnya, Moldova, and Kaliningrad.

Sir Alex Younger shared some of Dr. Carter's views but also offered some additional insights into the Russian and European approaches to the crisis:

- The likelihood of a negotiated solution is low because President Putin is trying to change the fundamental principles that underpin Atlantic security.
- There is a 50% probability that Putin acts militarily with the goal of either disabling Ukraine as an independent country or negotiating something that essentially turns Ukraine into Finland. But he reminded us that Ukraine has a say in the matter and such an arrangement would have been negotiated at the point of a gun.
- Sanctions on Russia impose uneven pain across NATO allies. It is particularly difficult for Germany for the following four reasons:
    - There is a strong pacifist undercurrent in Germany.
    - Germany has a proud history of bringing ideologically hostile groups together, so they believe in dealing with Russia through engagement and dialogue.
    - The Germans were shocked by President Trump's policy of America first.
    - Germany has not yet come to terms with the fact that the American unipolar rules-based international order might have changed.
- Sir Alex also noted that Russia is a petro-autocracy and if it withholds natural gas from Europe, its actions will be counterproductive because it will introduce a risk premium on its oil and gas exports.
- Sir Alex provided an interesting insight that US overreliance on sanctions could threaten the status of the US dollar as the reserve currency of the world.

Both guest speakers stated that after such a military build-up around the borders of Ukraine, President Putin cannot leave empty handed.

12. Russian Military Build Up in and Around Ukraine



● Russia is reported to have stationed over 100,000 troops in and around Ukraine, including for a snap exercise in Belarus
Source: Investment Strategy Group, BBC, *New York Times*, Map created with Map Chart.

We note that any military incursion into Ukraine is most likely to be disruptive to the financial markets and result in an interim spike in energy prices.

<u>The Rationale for Staying Invested</u>

While these four factors explain the year-to-date downdraft in equities, we maintain our recommendation to stay invested. The hurdle to underweight equities remains high given the still low odds we place on a recession in 2022 and our expectation for earnings to grow by 11-13% this year.

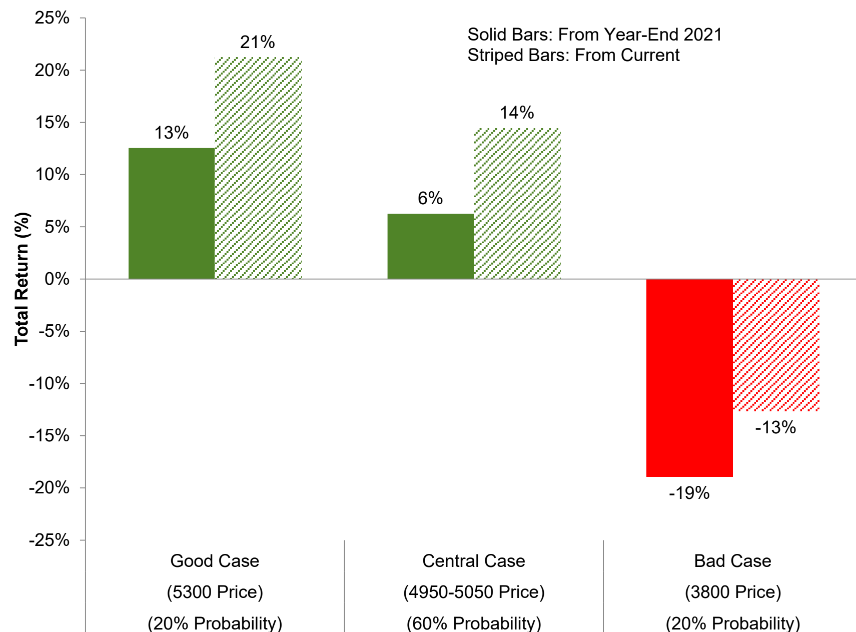
Keep in mind that the current 2022 earnings consensus of $225 is only about 2% higher than the $220 implied by annualizing the earnings in the fourth quarter of 2021. Yet in the last 23 non-recessionary years, calendar-year earnings per share were, on average, 7.1% greater than the annualized EPS from the fourth quarter of the prior year. The growth rate was 8.6% on a median basis. Taken at face value, these growth rates would imply 2022 earnings between $235-239, compared to our range of $230-235.

We also expect the resilient profit margins that were a key driver of earnings upside in the fourth quarter to persist, as strong 9-10% sales growth more than offsets rising costs this year. In fact, S&P 500 net profit margins have increased from their year-earlier levels 89% of the time when sales growth was at least 5% and the economy was not in a recession, both of which we expect to be true this year.

However, we acknowledge that risks have increased given higher-than-expected inflation, a faster pace of Federal Reserve tightening and the ratcheting up of Russia-Ukraine tensions. As a result, we have adjusted the probabilities we assign to our base and downside scenarios.

As shown in Exhibit 13, we have increased the probability of the downside scenario from 15% to 20% by reducing the probability of our base case from 65% to 60%. Importantly, we have not reduced the probability to our upside scenario. Given our view that inflation is more likely to peak this year and that tightening will be incremental, a 20% probability to the upside seems reasonable to us.

13. ISG 2022 S&P 500 Total Return Forecast Scenarios – As of February 11, 2022



Source: Investment Strategy Group, Bloomberg.
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We conclude with a reminder of some sage words from Seth Klarman of Baupost during the Global Financial Crisis which we have referenced in the past. During times of crisis, one can opt to move to the sidelines and wait for uncertainty to pass. One can then return back to the equity market at probably higher prices. Alternatively, one can be a trader and try to get in and out of the market. We, in the Investment Strategy Group, do not believe in the long-term success of that strategy for our clients. Finally, one can be an investor. In the absence of very compelling reasons to go underweight equities, we believe one should remain invested given a favorable economic and earnings growth backdrop.

Endnotes:

(1) David Mericle and Jan Hatzius, "US Daily: Moving to Seven Rate Hikes in 2022," *Goldman Sachs Investment Research*, February 10, 2021.

(2) Joseph Stiglitz, "A Balanced Response to Inflation," *Project Syndicate*, February 7, 2022.

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