

JANUARY 23, 2022

# Investment Strategy Commentary: Market Pullback

Spurred by rate hike concerns, geopolitical tensions and more, markets saw a 10% correction intra-day today – find out how that impacts our outlook.



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Our outlook for 2022 was focused on the transitions the economy and markets were facing — including fading fiscal stimulus, reversal of monetary accommodation and a maturation of the

COVID pandemic. Our constructive outlook on risk taking was, and remains, based on a constructive outlook for corporate earnings and interest rates.

The recent sell-off has put us into another 5% correction — something that has historically happened every 10 weeks (see Exhibit 1). Today markets almost closed in 10% correction territory — something that has historically happened every 34 weeks, and of which we are well overdue (current stretch is 94 weeks). Weakness can be attributed to a combination of concerns about rate hikes, economic growth and corporate earnings. There is also the unquantifiable risk surrounding Russia's intentions toward Ukraine.

The concern about interest rates seems overblown. Market expectations for the Fed funds rate at the December 2022 meeting have only increased by 25 basis points over the last month and the 10-year Treasury yield is right in the middle of our 1.5%—2.0% forecasted range.<sup>1</sup> We think the Fed will manage its balance sheet with a strong aversion to inverting the yield curve. Moreover, some further upward move in long-rates, if driven by the real component versus inflation, is unlikely to spell the end of the bull market or expansion.

#### EXHIBIT 1: CORRECTIONS

5% corrections have historically happened every 10 weeks, and we are long overdue for a 10% correction.

##### S&P 500 CORRECTIONS SINCE 2019



Source: Northern Trust Asset Management, Bloomberg. X% correction (X being 5, 10, 20 and 30) on the S&P 500 is defined as a decline of X% from recent peak. A correction of X% is still occurring until the market increases X% from the trough. Data through 1/21/2022.

We think concerns about economic growth are inflated. Omicron is peaking in key parts of the U.S., so the weakness in high frequency data should start to reverse. Consumers have \$2 trillion of excess savings, and corporate inventories are near historic lows — both of which should underpin growth. The start of earnings season has seen some high profile companies warn about their outlooks (banks on costs, pandemic winners on future demand). We don't yet think these are valid read-throughs to the broad markets, and don't expect material negative revisions. We think the strong demand outlook should help offset cost pressures from areas like wages.

We assess the outlook for geopolitical risks like the current Russia/Ukraine situation through evaluating the sustaining risks toward global growth and/or inflation. Geopolitical risks tend to not have lasting impacts on asset prices. In fact, over the last twenty years only one geopolitical risk became concrete enough that it became a formal risk case for us. Maybe coincidentally, it was when Russia annexed Crimea and we were concerned about the security of energy supplies and further geographic expansion. As developments quickly settled down,

this risk case also quickly disappeared. As there is no way to confidently forecast what will happen among Russia, Ukraine and the West, we will just have to “monitor the situation” (as much as we dislike that phrase). The current risk cases to our positive outlook are: 1) Persistent inflation that justifies a more hawkish Fed; and 2) China growth disruption from their economic policies and zero-tolerance COVID policy.

### IMPACT OF RECENT SELL-OFF ON SELECT ASSET CLASSES

As depicted in Exhibit 2, the recent sell-off has hit growth stocks hardest. While the first stage of this underperformance has been attributed mostly to rising interest rates, the recent weakness is also attributable to some high-profile earnings misses. Financial markets have shown moderate weakness since January 3, likely driven primarily by the increased odds of Fed rate hikes (possibly as early as its March 15-16 meeting) and the resulting impact on the yield curve and corporate profits. U.S. equities were most hit (down 8.8%) — driven by the fact that it is the Fed raising rates (hometown central bank) and the impact higher interest rates can have on “longer duration” equities (the stocks of those companies with higher growth rates such that a larger percentage of aggregate cash flows come in future years). For those companies, higher interest rates mean a higher discount rate for those future cash flows and a bigger resulting impact on the stock’s present value and current price. To wit, U.S. value stocks (“shorter duration” equities) have managed this drawdown better. The Russell 1000 Value Index is down 4.1% in comparison to the Russell 1000 Growth Index being down 12.9%.

#### EXHIBIT 2: RETURNS OF KEY ASSET CLASSES SINCE MARKET HIGH

The sell-off in growth began first — the Russell 1000 Growth Index is down over 12% this year.

RETURNS SINCE 1/3/2022 (%)



Source: Northern Trust Asset Management, Bloomberg. Total returns from 1/3/2022 through 1/21/2022.

Similarly, Developed ex-U.S. Equities — more value-oriented than the U.S. given its sector mix (with a much lower weight in Technology, for example) — has only lost 1.8%. Meanwhile, Emerging Market Equities have actually gained during this period — likely a result of the pain experienced in that asset class for much of 2021, much more attractive valuations and the fact that the catalyst here is mostly the Fed and not further exacerbation of the issues hitting Emerging Market Equities hardest — namely COVID (less vaccine efficacy and more willingness to shut down the economy — notably in China) and broader regulatory concerns (again,



mostly focused in China). Other asset classes of note include High Yield, which has provided more downside protection than it normally does (its 1.5% drawdown is 17% of the U.S. equity drawdown, which is lower than the ~35% drawdown historically). Also, noteworthy has been the performance of Natural Resources — an asset class that usually suffers more than broad equities during downturns. This time it has put up some fairly robust positive returns at 4.3%. Interestingly, it has not been unusual for Natural Resources to perform well at the start of a rate hiking campaign — its average 12-month return after the first rate hike of the past 4 cycles has equaled 25%.<sup>1</sup>

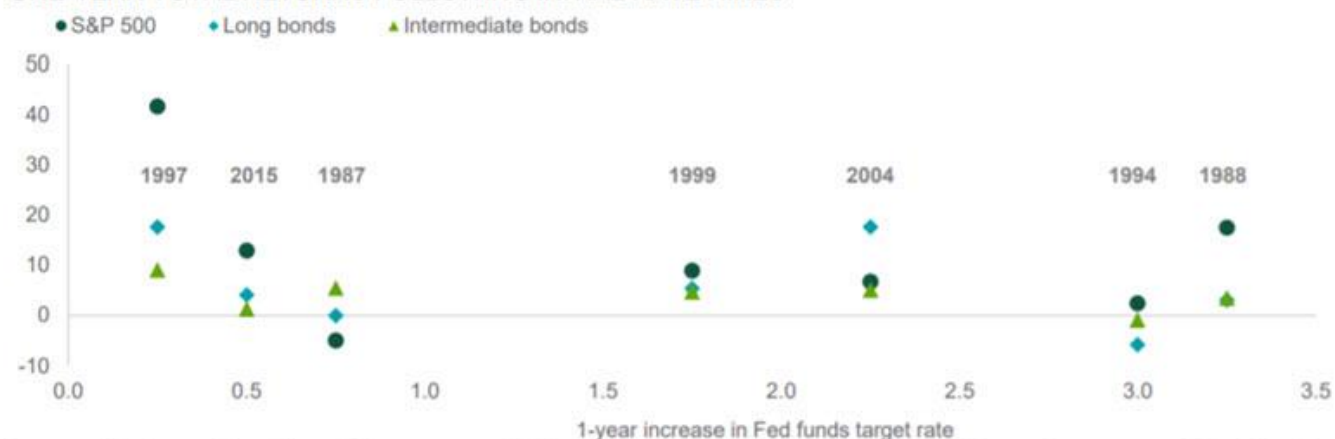
## IMPACT OF RATE HIKES ON STOCKS AND BONDS

Exhibit 3 shows the returns of select asset classes from the date of the first Fed rate hike. Stocks have generally produced fine results during rate hike cycles. What we need to worry about is a Fed that loses sight of its impact on the equity and bond markets — and charges ahead with rate hikes that invert the yield curve. We think a materially flattening yield curve will temper the Fed's actions.

### EXHIBIT 3: STOCKS CAN HANDLE INITIAL RATE HIKES WELL

Stocks can handle initial rate hikes well. Substantial rate hikes have had a more adverse impact.

#### ONE-YEAR TOTAL RETURNS FOLLOWING INITIAL RATE HIKES



Source: Northern Trust Asset Management, Bloomberg (BBG). Long bonds: BBG Long Government/Credit Index; Intermediate bonds: BBG Intermediate Government/Credit Index. It is not possible to invest directly in any index.

## UPDATE ON TECHNOLOGY AND CORPORATE EARNINGS

Since pre-pandemic (12/31/2019), the S&P technology sector and the Nasdaq 100 have seen their year-forward earnings estimates improve 50% and 54%, respectively, versus 35% for the S&P 500. Over the same time, the forward P/E ratio of the technology sector has expanded 12% versus 1% for the S&P 500 (see Exhibit 4). So, most of technology's outperformance has come from fundamentals, not valuation. Moreover, the relative forward P/E ratio between technology and the broader market doesn't indicate that there is a big tech bubble that needs to continue to deflate in the large cap space.

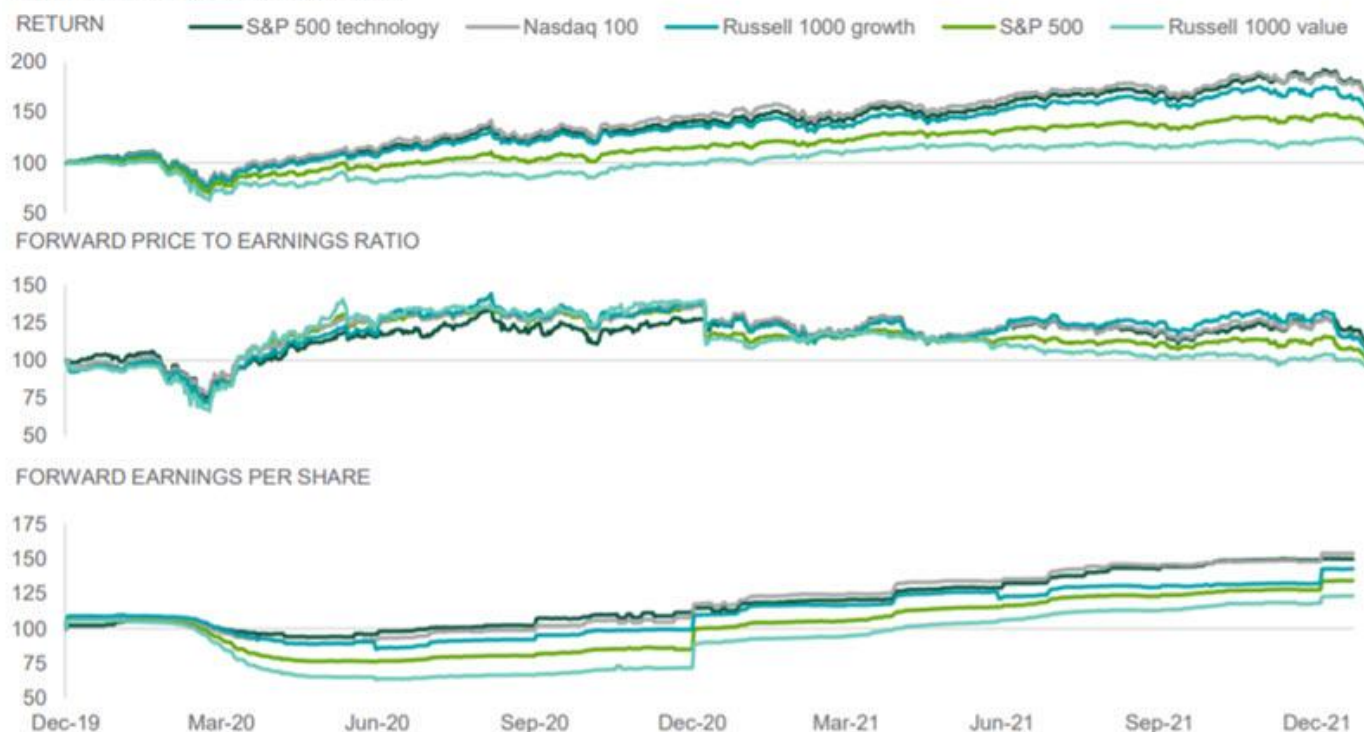
It is still very early in the fourth quarter 2021 earnings season (~13% of companies have reported), but aggregate sales and earnings are tracking above expectations. However, for a market looking for negatives to justify shifting sentiment, there have been some validating data points. Several banks disappointed with respect to expense guidance, though not a great

read-through for margins for the broader market. Pandemic winners have suffered significantly as the market reassesses what a steady state business looks like — for example, Netflix, Peloton and dragged down names such as Amazon. There haven't been substantive changes to forward estimates more broadly yet, but we do expect more company guidance this earnings season, which should be biased conservatively. We continue to expect the demand backdrop to offer substantial cushion against potential margin pressure, allowing for earnings to remain durable, and would be surprised by materially negative revisions.

#### EXHIBIT 4: MARKET RETURNS, VALUATIONS AND EARNINGS

The bulk of technology's outperformance has come from fundamentals, not valuation.

INDEXED TO 100 ON 12/31/2019



Source: Northern Trust Asset Management, Bloomberg. Data from 12/31/2019 through 1/21/2022.

#### CONCLUSION: BENEFITS TO STAYING INVESTED

Don't ever agree to a debate with Jeremy Grantham. One of the most uncomfortable professional experiences we have ever had was watching him eviscerate Jeremy Siegel of Wharton (Stocks for the Long Run) in a debate. Jeremy Grantham won the debate, but the performance of stocks has probably resembled more closely the long-term expectations of Jeremy Siegel.

For those who didn't see Jeremy Grantham's press appearances last week, he is predicting that we are at the end of a superbubble in stocks, bonds, real estate and commodities. He asserts that we are facing the largest markdown of wealth in history (likely in nominal terms, not percentages, but the former makes a better headline). This is based on a return of valuations two-thirds of the way back toward norms.

We don't debate his conclusion that there has been bubble-type behavior in markets since the pandemic. But we would describe them as occurring more in sub-asset classes than in the

broad markets. Areas such as money-losing IPOs, meme stocks, cryptocurrencies (e.g., those created as a joke and gaining billion-dollar-plus market caps) and high growth speculative stocks have all inflated and then had rolling deflations. As noted in the equity commentary above, the broad technology sector doesn't appear to be in a bubble. For the broad stock market to be in a bubble that will deflate like Jeremy G. predicts, one or two things will likely need to occur: (1) A crash in the economy; or (2) A big jump in interest rates. We don't see either across the tactical (12-month) or strategic (5-year) horizon. The return of valuations two-thirds of the way back to historical levels must assume a significant jump in interest rates, which we think ignores the global wall of savings that has suppressed rates for years. We do, however, predict subpar equity returns over the next five years due to slowing growth and some valuation compression. But note that we and others had a similar view five years ago only to witness an 18% annualized return out of U.S. equities. Our analysis is that 14% of this annualized return was tied to pre-pandemic conditions, with the additional 4% attributable to the pandemic monetary and fiscal response. While Jeremy Siegel's debating skills didn't carry the day, the benefits of staying fully invested have proven out over time.

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Jim McDonald is an executive vice president and the chief investment strategist for Northern Trust. He is responsible for overseeing the strategic and tactical asset allocation policy for our institutional and wealth management clients globally.