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Investment Management Perspective

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The events unfolding between Russia and Ukraine have been unsettling and alarming to say the least. Headlines with words such as “war” and “invasion” invoke uncertainty and often prompt investors to seek safe havens.

As a result of the latest market volatility, the S&P 500 index has officially entered “correction territory”—commonly defined as a decline of more than 10% from its high. In this piece, we share Barrett’s latest macro thinking and how investors should navigate through this complexity and volatile landscape.

Throughout decades of stock market history, geopolitical events have periodically stress-tested the markets. In our view, the invasion of Ukraine adds greater urgency to problems we were already facing in the U.S.—namely, high inflation. Prior to Russia’s attacks, U.S. investors were already convinced that inflation is not “transitory”, and the Federal Reserve Bank must promptly raise interest rates to control the price surge in final goods and services. However, the recent conflict has complicated the situation, as we now expect additional supply chain issues and shortages. Put simply, inflation is likely to persist—higher for longer—or even trend higher in the months ahead. At the same time, investors have been seeking safe assets, such as U.S. Treasuries, which has in turn suppressed the longer part of the yield curve. A flatter yield curve implies the Central Bank will have less flexibility to raise short term rates since any sudden shifts on the front end could create an “inverted” yield curve, a flashing signal that the U.S. could slip into a recession.

The above unknown variables have clearly induced more questions than answers. If U.S. stock history is any guide, we expect the stock market to eventually recover from this Russian-led energy crisis. However, the recovery will be uneven and accompanied by many bouts of heightened volatility, as we have experienced recently. Looking forward, we will continue to closely monitor Russia’s next moves and Ukraine‘s reaction. It will be critical to also watch how the West continues to apply sanctions towards Russia and Vladimir Putin. The restrictions thus far have proven somewhat effective, but not strong enough to result in a ceasefire.

The implications from the current crisis can be viewed from a short- and longer-term lens. In the coming weeks and months, we expect many dynamics to remain elevated, including inflation (due to energy prices spiking), stock market volatility and overall investor anxiety. As the Fed stands committed to raising interest rates, it will be important to watch how monetary policy can help rebalance the supply and demand equation. It will likely take a few interest rate hikes before the economy feels any impact. Ironically, higher energy prices will also naturally curb demand for goods and services since there will be fewer discretionary dollars to allocate elsewhere.

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Our priority is to help clients best protect their portfolios through market turmoil. Currently, investors are trying to make sense of a fluid situation and with that we are seeing many stakeholders adopt a "get me out at any price" attitude. It is critical to distinguish noise from a change in fundamentals. This is a time for discipline, and we recommend clients stay the course although recognize that risks have moved higher.

To this point, the odds of a U.S. recession have increased, but as of this writing our base case is still to expect U.S. economic growth to slow but not contract. Our rationale is multi-fold:

1) U.S. companies remain in good shape, with ample cash on their balance sheets.
2) U.S. households are also healthy as supported by excess savings from the pandemic and wage inflation growth currently at 5%.
3) Retail spending has proven more resilient than anticipated throughout the pandemic. We expect U.S. consumers to continue this trend although higher gasoline prices will be a notable headwind. If the price for crude oil tops $150 per barrel for a sustained period, then demand destruction should begin to take hold.
4) The Fed will continue to be nimble and take a measured approach to reduce the chances of a U.S. recession. There may be fewer rate hikes depending on how persistent higher energy prices will be. The Fed could also plan to sell assets from its balance sheet to control the shape of the yield curve.
5) According to the Energy Information Administration (EIA), the U.S. imported about 8% of its oil from Russia in 2021. With the government now banning Russian oil, the impact on our economy will be challenging but manageable, overall. Of course, our European counterparts may suffer more given their higher dependence on Russian energy. It will be critical to watch for any contagion effects.

In today's sea of uncertainty, the importance of knowing what one owns is paramount. We continue to prefer companies that will benefit from secular shifts, or "mega trends," including digitization, urbanization, and sustainability. We are also keen on owning companies that can operate in a higher inflationary environment. To this point, many of our companies have flexed their "pricing power" muscle as a reaction to higher input costs over the past year. Additionally, our investments tend to be asset-light operators—meaning they should thrive on innovation versus traditional manufacturing.

We remain vigilant in rebalancing our portfolios, on an as needed and tax efficient basis, to ensure the highest quality of investments for our clients.

Former hedge fund manager Whitney Tilson once said, "Imagine you're on a ship being tossed around in a storm. If you focus on each wave, you'll get seasick in no time ... so instead, fix your eyes on the horizon." Today's storm is clearly challenging on many levels. We agree with Tilson and reinforce the notion that volatility is a normal part of investing, which may sound odd considering how calm markets have been during the past 18-months.

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History tells us that in any calendar year, one can expect the market to experience a significant correction. Some years are more severe than others and for the S&P 500 that average decline has been 14% since 1980.

It is not always a smooth journey but investors who choose to stay the course will benefit from their patience more often than not.

Your entire team here at Barrett is available to you. Please let us know if you have questions or concerns that we can discuss with you.

Amy Kong, CFA
Chief Investment Officer

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