Musings on the Market

Observations amid the developing situation in Ukraine

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Given the alarming developments in Ukraine, we want to offer some perspective on how geopolitical events have historically impacted markets, as well as provide our current market observations and views on key drivers of the market's path forward.

Geopolitical Disruptions Over Time

Consider the table below, which highlights total returns of the S&P 500® following major geopolitical disruptions back to the 1960's. While events like these can create volatility in the short run, markets appear unaffected in the longer run, with the exception of the OPEC oil embargo in 1973 and Iraq's invasion of Kuwait in 1990. Increased volatility is a pattern during these types of disruptions, as is the impact on energy prices and markets, which typically includes price spikes and acute supply disruptions. We believe a similar pattern may hold true this time around, but it is too early to draw firm conclusions.

Current Market Observations

With the S&P 500 officially entering correction territory on February 23, 2022, the technical backdrop has weakened even further relative to the sharp reset we experienced in January as the market repriced the dramatic shift in the Federal Reserve's (Fed's) monetary policy stance. The market has been in a high-volatility regime since the start of the pandemic, but it has been several months since investors have wrestled with a sharp downdraft. Last year, the biggest drawdown for the S&P 500 was only 5%!

- The CBOE Volatility Index (VIX) has spiked again and a large portion of the futures curve is now inverted, meaning the market is pricing current contracts for more volatility than future-dated contracts. This is not a healthy-shaped VIX futures curve, but it makes sense given the March 16 Fed meeting is less than a month away and we have additional uncertainty from the Russia-Ukraine conflict.
- Volatility is not isolated to equity markets as the MOVE Index — the bond market's equivalent of the VIX — is sitting at March 2020 levels. In our view, this is not surprising given the prospect of shifting monetary policy combined with how volatile the path for market-driven interest rates has been.

S&P 500 Total Returns Following Dates of Geopolitical Disruptions

Event	Date	1-Day	5-Day	60-Day
Cuban Missile Crisis	10/23/1962	-2.67%	1.38%	13.97%
Oil Embargo	10/16/1973	0.13%	-0.27%	-14.70%
Iraq Invades Kuwait	8/2/1990	-1.12%	-4.22%	-9.69%
September 11th	9/11/2001	-4.89%	-8.12%	2.78%
Iraq War Begins	3/20/2003	0.19%	-0.61%	5.32%
Russia Invades Crimea	2/20/2014	0.62%	1.47%	2.38%
Houthis Attack Saudi Infrastructure	9/15/2019	-0.31%	-0.49%	3.26%

Source: Bloomberg, L.P.

- Intra-index stock correlations for the S&P 500 have increased modestly to 0.57. While it is the second-highest level in the last 12 months (the one-year average is approximately 0.30), it does not reflect a market environment where all stocks are moving in concert. Remarkably, the volatility has been somewhat orderly and rational in that stocks with the highest valuations and non-earners have tended to get hit the hardest.
- Market breadth (the percentage of companies above their 200-day moving average) fell from 46% the week of February 14–18 to 37% on February 23. This is a low figure relative to history as the 20-year average is 65%, but we have been in a narrowly led market environment since the onset of the pandemic. Couple this dynamic with still being in fourth quarter earnings season and it translates to a market where there is a notable distinction between winners and losers, not a rising-tide-lifts-all-boats situation, which is a typical experience in a slowing expansion phase of the business cycle.

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Despite recent market volatility, in our view the plumbing of the financial system is not showing any signs of stress. Here are some of our observations:

- The 10-year U.S. Treasury (UST) yield was 1.99% as of February 23, representing only a 3 basis point (bp) decline from the day before. We do not believe this indicates a dramatic flight to safety, which would normally translate into aggressively falling bond yields. Yields are up year to date, but the move was already well underway — catalyzed by the Fed — before the Russia-Ukraine conflict.
- The spread between 2-year and 10-year USTs is still flattening, now at just 38 bps. This does not leave the Fed much headroom in the short run to aggressively raise rates without inverting the yield curve. The short end of the curve has risen quite a bit in anticipation of the Fed raising rates in March, but the long end is not moving up as fast. In our view, the bond market is signaling a slower growth outlook and acting as a market-based cap on longer-term rates.

FINANCIAL CONDITIONS REMAIN IN SUPPORTIVE TERRITORY FOR MARKETS AND THE ECONOMY.

- Overnight repurchase agreements, 1-month T-bills, and other securities at the shortest end of the curve are not showing any signs of the type of stress we saw in March 2020 at the onset of the pandemic.
- High yield credit spreads have widened by approximately 100 bps from the record lows of last summer; however, this is nearly in line with the 10-year average.
- Financial conditions have tightened lately, but remain below 12-month highs and are still in supportive territory for markets and the economy.

The Path Forward

While we will continue to closely monitor the events playing out in Ukraine, and the conflict will likely influence certain areas of the market, we do not believe this conflict will be the primary driver of the market's path forward. However, the longer the Russia – Ukraine conflict continues, the more likely it may influence each of our top-four investor themes for this year: (1) Supply chains, (2) Inflation, (3) Monetary policy, and (4) Earnings growth. With regard to inflation, it is already running at more than 7.5% year-over-year growth, and if oil prices rise meaningfully from here, it could potentially

IF THE CONFLICT CONTINUES, IT MAY INFLUENCE KEY INVESTOR THEMES:

1. **Supply chains**
2. **Inflation**
3. **Monetary policy**
4. **Earnings growth**

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force the Fed to act even more aggressively to tame inflation. Alternatively, the Fed could decide to gauge the impact of the Russia – Ukraine conflict before implementing policy changes. Given the absence of clarity, we expect the high-volatility regime to dominate.

Our base case for the market entering 2022 assumed we were passing the peak in terms of increasing inflation. Also, we expected as year-over-year comparisons got tougher and supply chains normalized, it would help take some of the inflationary fire out of the backdrop. While it would not eliminate the need for the Fed to take action, it could allow for a more orderly increase in policy rates versus a potential six rate hikes the market is now expecting based on fed funds futures. After all, our PNC Economics team expects core PCE to hit 3% by year-end, well above the Fed's 2% target, but also well below where it currently stands at 4.9%. Supply chains may take longer to normalize given the ripple effects from sanctions on Russia and rising cost pressures from potential energy supply disruptions. On a positive note, earnings growth continues to be quite solid for this year — still tracking at 8%-plus growth for the S&P 500 — and earnings revisions have turned up again after stagnating toward the end of 2021. At some point we may start to see building headwinds from the complex, shifting macro backdrop, but importantly, the fundamental backdrop is still very much intact in our view.

While it is difficult to argue public markets are "cheap," even with the valuation multiple compression we have seen year to date, pockets of relative attractiveness still exist (see our 2022 Outlook across the multiasset class universe). We have a high degree of certainty that volatility will persist, and the path forward is unlikely to be a straight line higher, but we believe there is still growth left in this cycle.

For more information, please contact your PNC advisor.