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Dear Client:

We noted in our last monthly comment that while war brings about human suffering on a massive scale, such events historically haven't been that meaningful to the fundamentals that drive financials markets, and the immediate reaction to conflict tends not to affect equity valuations over the long term. This observation aged well in this short period as the S&P500, which was down -11% YTD when the invasion commenced (2/24), barely budged, and then jumped +9% from the March 8 low to finish the month firmly in positive territory. This was a remarkable recovery considering the atrocities in Ukrainian, a more hawkish Fed, an inverting yield curve, a new Covid strain, and what appears to be stagflationary economic data.

The fact is, while the above is unsettling, it hasn't deterred advances in the stock market because investors to remain fixated on monetary policy. That's not to say that the war has had no impact, as commodity prices spiral significantly. Higher gasoline and food prices will act as a huge tax on discretionary spending which will impact the entire economy, and shift spending from what people want to what they need. But for the market in aggregate, thus far, short term rates remain near historic lows, liquidity remains ample, and so the stock market has looked the other way despite this meaningful disturbance. For the market, rates are the primary concern, and the overarching question is whether inflationary pressures will force the Fed's hand to overtighten.

What is a continuing concern for market fundamentals is that, more than two years after the world was first introduced to COVID, supply chains are still experiencing severe complications. Prolonged public health interventions, repeatedly loosened and then tightened with each subsequent variant of the virus, continues to disrupt the movement of goods and materials, seriously hampering manufacturing. As we have discussed, corporate bosses expected supply-chain disruptions to abate in the coming months. But that was before the fallout from the war in Ukraine, and a massive coronavirus outbreak in China produced fresh kinks in global supply chains and adding to the inflationary pressures caused by already-existing supply-chain disruptions.

We have fretted about the impact of global fertilizer shortages on agricultural production. A March 20 Wall Street Journal article reported that "with wheat already in the ground, and only a few weeks left to plant corn, farmers in Ukraine can't get needed fertilizers and chemicals. They are low on fuel for tractors and other farm equipment. Workers are quitting to join the fight or to leave the country, leaving farms short-handed." According to the U.S. Department of Agriculture (USDA), Ukraine accounts for 10% of global wheat exports, 14% of corn exports, and about half of the world's sunflower oil. Ukraine is the world's fourth-largest exporter of corn, and fifth-largest for wheat; and 85% of its crop exports travel by sea -- and all their ports are closed.

Combined, these headwinds suggest that market volatility -- spurred on by what we expect to be earnings-outlook volatility -- will likely play a growing role as rising rates and commodity prices eat into consumer demand and corporate margins. The main takeaway is that not only do we expect consumers to shift spending preferences towards necessities and away from discretionary items (wants vs needs) but, given the likely persistence of this current food and energy price shock, the reallocation of household budgets to be even more pronounced than past episodes. We do not time the market, but this environment should allow the down-market portfolio allocation to continue to outperform, dampen volatility, and preserve relative capital.

Regards,

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Chief Investment Officer
U.S. Large Cap Equity Strategy