War, inflation and hawkish policy pressure the financial markets

The world and markets continuously change, but over the first three months of 2022 there have been shocking shifts in the landscape and asset prices. Russia's invasion of Ukraine caught many off-guard. Beyond the terrible hardships this war has already caused for those directly involved, the distressing circumstances have cast a dark shadow of uncertainty over Europe and exacerbated existing risks. Geopolitical tensions between the West and the rest are as strained as they have been in decades. Stresses have been felt most acutely in the energy arena, as Russia produces about 10% of global oil and provides Europe with more than 40% of its natural gas. This disruption makes it more difficult for policy makers to quell inflation, which the Federal Reserve now admits is not transitory. Even stripping out food and energy, core CPI and personal consumption expenditures (PCE) are up 6.4% and 5.4% year-over-year (YoY), respectively. Labor markets are extremely tight: job openings now exceed estimates of unemployed workers by nearly 2:1 (Figure 1). As a result, the Fed has set a more hawkish tone in recent communications and left investors wondering how aggressive it will be.

The situation has not been favorable for stocks. Except for Latin America, a commodity-centric region, most major markets sold off during the quarter. In the United States, larger-capitalization, more value-oriented stocks outperformed smaller, growth-oriented stocks. Overseas, countries most exposed to the war, either geographically or economically, struggled. What made this a particularly painful period, however, was the lack of safety generally offered by bonds. The move-up in yields was astounding, not only for the size of the move — the 157 basis point increase in the two-year U.S. Treasury yield was a five-standard-deviation move — but also for the speed at which it occurred. Rising rates, along with wider yield spreads across the quality and product spectrum, caused core bonds to underperform stocks during a risk-off period, which is highly unusual.

Tactical indicators

Economic growth (positive)

U.S. real GDP growth was 6.9% in 4Q21. We expect it will slow in 2022, with full-year GDP growing about 3%

Fundamentals (positive)

U.S. earnings appear most resilient to rising prices and economic instability, but their pace of growth is likely to slow from past quarters and current expectations

Valuations (negative)

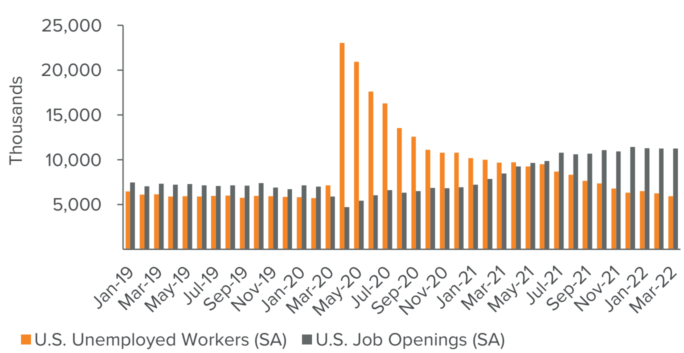
Stocks still look more attractively valued than bonds, but the spread has narrowed and is less appealing with each successive interest rate hike

Sentiment (neutral)

Market sentiment is mixed but generally bearish. Consumer sentiment is highly negative

Figure 1. U.S. job openings exceed the estimate of unemployed workers by nearly 2:1

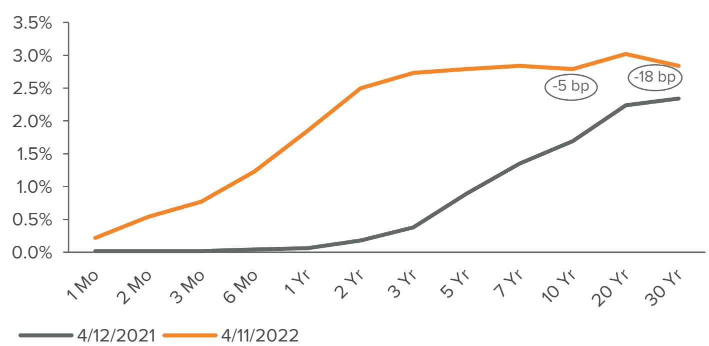
Unemployment versus job openings



Source: Bloomberg, as of 3/31/22.

Figure 2. The long end of the yield curve has slightly inverted. The short end is still steep, but expected to flatten

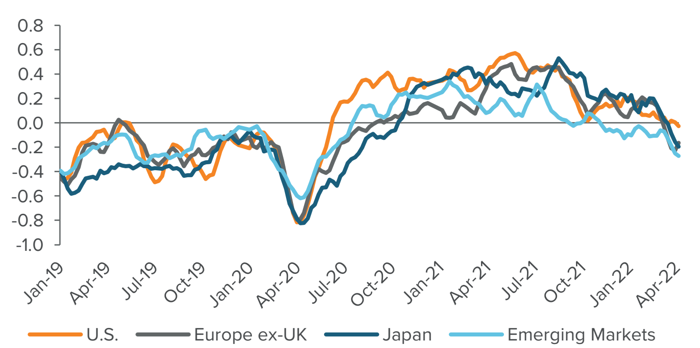
U.S. Treasury par yield curve rates



Source: U.S. Department of the Treasury, Voya Investment Management, as of 4/11/22.

Figure 3. Global earnings revisions are rolling over in every region of the world

Citi Earnings Revisions index, four-week moving average



Source: Bloomberg, Voya Investment Management, as of 4/8/22.

Portfolio positioning

Equities	Neutral	
U.S. Large Cap	○–○–●	Larger companies are better situated to absorb high wages, pass inflation through to consumers and maintain margins in an environment where multiples are likely to be pressured.
U.S. Small Cap	●–○–○	Valuation spreads to small caps are wide, which may present opportunities, but we prefer larger U.S. companies for their greater pricing power.
International	○–●–○	Europe is likely to enter recession as it contends with energy supply issues and heightened geopolitical risks.
Emerging Markets	○–●–○	Outlook mixed by region. Covid driven lockdowns across China have disrupted economic activity. They and EM Europe are adversely exposed to Russia–Ukraine conflict.
REITs	●–○–○	Rising rate environment likely to be a headwind for REITs.
Fixed Income	**Underweight**	
U.S. Core	○–●–○	Favor credit given yield pickup over sovereign bonds and generally healthy corporate balance sheets, but expectation for higher rates keeps us underweight the asset class.
Inflation (TIPS)	●–○–○	Break-evens look expensive as inflation has come in at 40-year highs and we believe core inflation is in the process of peaking.
Non-Investment Grade	●–○–○	Tight high-yield spreads imply limited room for compression, especially considering our less sanguine view of the macro environment. We believe risk budget is better deployed through equities.
International	●–○–○	Low relative yields and scope for stronger U.S. dollar keep us favoring U.S. bonds.

Underweight ● Neutral ● Overweight ●

Investment outlook

We know growth is slowing, but is a U.S. recession on the horizon? The probability has risen but we don't think a recession is imminent or inevitable over the next twelve months. As the effects from the pandemic continue to fade, mobility has picked up and formerly left-behind sectors — travel, leisure and lodging — should become recipients of an increased amount of consumer spending in the spring and summer months. Demand for labor remains strong — the unemployment rate fell to 3.6% in March and could go lower. The labor force participation rate has increased recently, and we think higher wages will increase participation more, at some point softening an extremely tight labor market. We do, however, acknowledge our later stage position in the business cycle and are aware that policymakers need to take action to reel in prices. This involves cutting aggregate demand in a manner that results in a soft landing. The war and sanctions on Russia have made that task more difficult; particularly in Europe, which imports significant energy resources from Russia, making it probable Europe will experience a recession. The U.S. is essentially energy independent and thus more insulated against prolonged disruption in Russian oil and gas supplies. What's more, the winding down of Covid will provide inflation relief on consumer prices for autos and shipping costs. We also realize the yield curve has inverted in spots (Figure 2) on several occasions, most notably in the long end, and has a concerning track record of forecasting future recessions. Not all yield curve segments have the same predictive ability, however; the Fed has published research suggesting the short end of the curve is a better indicator. The short end doesn't incorporate a term premium and is currently significantly negative. Moreover, the current level of policy accommodation needs to be considered. A good measure of this is the difference between the real Fed funds rate and the estimate of the neutral rate (R*), which is still clearly negative. In our view, the key to maintaining positive U.S. growth this year will be a transition from accommodative fiscal and monetary policies to a period of increased private sector investment that leads to productivity enhancing technologies such as robotics and automation, the adoption of which already were accelerated by the pandemic.

Despite our view that a U.S. economic contraction is avoidable in the near term, the outlook for equities has deteriorated since the beginning of the year and we think this sour spot is likely to last as monetary policy becomes tighter. If the Fed can anchor long-term inflation expectations, there could be room for equities to outperform, but global earnings revisions reflect the slower growth future and are rolling over in every region of the world — most meaningfully in the emerging markets (Figure 3). There are also several tail risks that appear uncomfortably fat; and in light of a smaller equity risk premium and other not particularly appealing valuation measures, we have reduced our allocation to stocks and now hold a neutral to slight overweight in most portfolios. We continue to prefer U.S. assets over the rest of the world, as its relative geographic and economic insulation provides a layer of defense against some of the most material risks. Within the U.S., large cap stocks remain our favorite asset class. Larger companies are in a better position to absorb high wages, pass through inflation to consumers and maintain margins in an environment where earnings multiples are likely to be pressured. Although earnings growth is coming down, our models forecast mid-teen earnings growth in 2022. This butts against the Fed tightening financial conditions and the likely countervailing force of contracting multiples. Taken together, we think U.S. large caps can deliver positive, albeit modest returns over the balance of 2022.

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Multi-Asset Strategies and Solutions Team

Voya Investment Management's Multi-Asset Strategies and Solutions (MASS) team, led by Chief Investment Officer Paul Zemsky, manages the firm's suite of multi-asset solutions designed to help investors achieve their long term objectives. The team consists of 25 investment professionals who have deep expertise in asset allocation, manager selection and research, quantitative research, portfolio implementation and actuarial sciences. Within MASS, the asset allocation team, led by Barbara Reinhard, is responsible for constructing strategic asset allocations based on their long term views. The team also employs a tactical asset allocation approach, driven by market fundamentals, valuation and sentiment, which is designed to capture market anomalies and/or reduce portfolio risk.

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