CONWAY• JARVIS LLC
Investment Outlook

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Event Risk Adds to Inflation's Weight on the Global Economy

In our December Investment Outlook we addressed the need for investors to adapt their finances to challenges we saw arising for the economy and its markets in 2022. We measured the known risks. In our opinion, none were judged to be more than just "Moderate", likely to do nothing more than slow the current global expansion. All were considered to be *cyclical*, solvable, and likely to be resolved over time. Today, we find the markets mired in the extreme uncertainty of *event risk*, dealing with the unexpected, and confronted by factors that threaten to do more than just slow the expansion. The Russian invasion of the Ukraine holds the *potential* to not only disrupt the recovery, but end the expansion and spark a recession. Like COVID, this event could trigger dire consequences for the investor community. Unlike COVID, it's not treatable by a vaccine and its effect on the global economy may persist in the long term.

The Known Risks

Last year, we saw the return of inflation at a level not seen since the 80's. Investors worried that the Fed's response to it could disrupt the economy and its markets. Those risks were the natural consequences of the post-COVID recovery that began in Q2 of 2020. As the expansion has matured, the Fed has had to adjust its policies to address a resurgence of demand amidst a hangover from the pandemic in the form of a disrupted supply chain. The resulting inflation that has persisted creates the *possibility* of a policy misstep by the Fed that could result in a hard landing for the economy. Raising rates too fast or too far could bring about a recession or create an environment that feels like one to consumers and investors.

The market has been pricing in these known risks for the past several quarters. Add to the list a change in the political landscape that portends of a shift in fiscal policy and you have headwinds emerging for the markets that will likely require a change of course for investors lacking diversification in their portfolios. Our view heading into the New Year included a forecast of only modest positive returns for '22, based on expectations for a slowing of GDP growth and the same for earnings while the Fed fights inflation. That's a far cry from the recession that TV folks tout to keep you viewing through the next commercial. Despite the noise from the media, the Fed has demonstrated a transparent and strategic approach to arresting inflation, instilling confidence in investors and stability in the markets. The events of late February changed that.

Addressing Event Risk

The war in Europe wasn't factored into market analysis until early in Q1 as Russian troops massed at the Ukraine border. The actual incursion took place on February 24th and an orderly correction for segments of the market escalated to one that encompassed all the indexes, briefly pushing the NASDAQ into bear market territory. Thankfully, investors remain discriminating as they gravitate toward quality and stable earnings growth. This has kept the S&P 500 out of bear market territory and we've seen the indexes rebound from their year-to-date lows. Whether that serves as a plateau for an advance in the second half of the year hinges on the unknown. One can only speculate as to Russia's objective and its resolve to pursue it over time.

A month into the conflict, we find the Russian military stalled in what was thought to be an engagement measured in days rather than weeks. Severe economic sanctions have been brought to bear and military support from NATO appears to be forthcoming in some measure. A stalemate in the Ukraine could prompt

Putin to either negotiate or redouble his efforts to take the country using methods previously viewed as unthinkable. That prospect currently overhangs the global economy and its markets. Europe's recovery has been derailed. The synchronous expansion of the developed world has been halted. The Fed has made its initial rate hike of 25 basis points this month and short-term treasury rates have risen to flatten the yield curve. The only good news is that these events could do much of the Fed's work by lowering consumer demand, thereby cooling inflation.

Preparing for the Unexpected

In our view, "Prepared" means that a precipitous decline in the markets due to an event leaves your budget and your life *unaffected*. In our view, prudent debt management, proper financial asset allocation, and having sufficient liquidity to cover living expenses for at least eighteen months defines a prepared investor. A common refrain we heard last year was "I'm holding too much cash." We haven't heard that one this year. In response, we advised frequent assessment of liquidity needs, taking into account the prospect of a new car, home improvement or purchase, education funding, travel, etc. With the recent market history over the past half decade, we encouraged clients to let the market pay for those. The only caveat was the tax liability embedded in highly appreciated portfolios that many would like to forget but are being reminded of this time of year.

Investors who viewed this year as a period of late cycle recovery were likely already "prepared" for recent events by having highly diversified portfolios and rebalancing in anticipation of changes in monetary and fiscal policy. That meant allocating capital toward rationally-priced issues in lagging sectors while returning to average weightings in the mega-cap Growth issues that are still producing earnings gains. We expected the P/E multiple contraction we've seen in last year's market leadership. It explains the lagging performance of the NASDAQ relative to the more sector-diversified S&P 500. Investors who were prepared for the *known* cyclical risks have, so far, been only minimally affected by the events in Europe. There is still time to prepare for the unknown by weighing liquidity needs for the period ahead.

Update on our list of Risks to Recovery and Economic Expansion

Conflict in Europe: Too many unknowns. This makes its first appearance on our list and is deserving of a **"High"** risk rating.
COVID: The Omicron variant subsides as the seasonal surge wanes. The reopening gains momentum. Decreased to **Low.**
The Fed: Executing a well-telegraphed change in policy by ending QE and beginning to tighten. Remains **Low**
Trade War: China's economy weakens further. Markets soften on accounting standards issue. Trend toward globalization begins to fade. Remains **Low**
Global Economy: US alone leads the recovery. Europe stalls due to conflict and rising energy concerns. Risk remains **Moderate**
Policy Formation: The shift in monetary policy is fully engaged. Treasury and mortgage rates rise. Still awaiting fiscal policy currently stalled in Congress as attention turns to European conflict. Risk remains **Moderate**

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