## More volatility ahead: Your key questions answered

***Please see important information at the end of this program. Recorded on 5/9/2022.***

Hello, everyone and thanks for watching. I'm Chris Hyzy, Chief Investment Officer for Merrill and Bank of America Private Bank.

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On today's program we're going to explore some of the key drivers of today's market volatility and why, in our view, it will continue for some time.

I'll also address some of the key questions that we have been hearing from clients and provide some thoughts you can consider to help reduce the level of risk in your portfolio and smooth the effects of volatility.

Let's get started.

This past week the S&P 500 had its fifth straight weekly drop, which is the longest losing streak since June 2011. In some of the higher growth areas of the equity markets it started much earlier and the decline has been much more pronounced.

In fact, there have been pockets of so-called bear markets in a variety of areas within global equities, sectors and market capitalizations rolling through since late last year. Add to this the fact that longer dated bond yields have risen and pressured bond prices and now the two largest asset classes have created a very challenging portfolio environment.

Uncertainty is at one of highest levels we have experienced since the beginning of the pandemic period in 2020 and perhaps in the last decade.

The capital markets have been pressured by a multitude of events including:

**[GRAPHIC CARD]**
**What's pressuring the markets**

- Crisis in Ukraine
- Central bank tightening
- Lockdowns in China
- Recession worries in Europe
- U.S. midterm elections
- Supply chain disruptions
- Weakness in the Japanese Yen

- Multi-decade high inflation
- High energy and food prices

An extended crisis in Ukraine; a pivot toward sharp central bank tightening and historic balance sheet contraction plans; lockdowns in China; worries over recession in Europe and the UK; upcoming midterm elections in the U.S.; continued supply chain disruptions; extraordinary weakness in the Japanese Yen; still multi-decade highs in inflation and very high energy prices, and not to mention rising food prices as well.

Much of this has been converging together for a good part of this year and recently a confluence of central bank events this past week have led to sharp volatility in both the equity and bond markets.

We believe the capital markets are trying to come to grips with not only the headlines and events of each week but a clash of competing forces: high inflation and slowing growth. Some suggest this is an environment akin to stagflation cycles of the past. To a certain extent we agree.

The individual rotation within the equity markets and the continuous adjustments in the yield curve are signaling a number of structural shifts in our opinion. Markets are attempting to price in higher short-term rates, above average inflation, slowing growth, and whether or not the economy ultimately falls into a recession - which is estimated to be about a 25% probability in 2023 and rising, according to various economic and capital market gauges.

Competing forces that clash tend to send mixed economic signals create saw-tooth or very choppy markets in which rallies are often sold and weakness gathers momentum due to lack of new and positive catalysts. These types of environments tend to be the most difficult on investor psychology, given the high velocity in the markets as the more cyclical areas weaken while the defensive areas rise - and the fact that economic data still shows some solid trends.

Today, this is the case with jobs growth, consumer spending, corporate capital investment, durable goods purchases - and free cash flow overall in corporate America is still healthy. This is backed up by the action in the credit markets in which credit spreads have not widened out like they normally would when recession risk is rising. To put it simply, the U.S. bond and equity markets together, which have had their worst start to a year perhaps ever, are telling different stories. Another sign of competing forces at work.

From our perspective, the biggest debate in the markets most recently has been more about whether the Federal Reserve should tighten short-term rates more aggressively. In other words, 75 basis point increases per meeting versus the 50-basis point increase in the next few meetings. This has dominated short-term speculators thinking and pressured the highest valued sections of the markets.

We, however, think the more important debate should be centered on four primary questions. The answers to these questions can help us better determine if economies are headed more for a hard landing or a growth recession - and does the Fed ultimately have to back off its tightening campaign earlier than expected.

Let's go through the four questions:

Now first: ***Has inflation peaked already?***

**[GRAPHIC CARD]**
**4 key questions**

1. Has inflation already peaked?

We will find out in the coming weeks as data is released. The bond market is doing some of the heavy lifting already here and so are the sharp increases in mortgage rates. Also, balance sheet contraction scheduled to start in June should bring down the money supply, helping to cool some inflation.

It's quite likely inflation has already peaked but it will take considerable time to settle down closer to the Fed's average target rate of some two to two and a half percent.

We believe that a defined peak in inflation, even if elevated for some time, is a catalyst that could stabilize the markets and relief rallies could ensue. With investor sentiment at extraordinarily low levels across the board an expected positive catalyst, such as a peak in inflation, would catch the markets by surprise, in our opinion.

Now the second question is this:

**[GRAPHIC CARD]**
**4 key questions**

1. Has inflation already peaked?
2. What's the appropriate valuation for equities?

***What is the appropriate valuation for equities in this new business cycle, this new market cycle?***

Is it closer to long-term averages around 16 to 17 times earnings per share? We believe so. If this is the case, then we are more than likely closer to the end of this cyclical downdraft than many believe. In other words, this could be the entry point longer-term investors in the asset management community have been waiting for. We expect rebalancing by long-term investors to start around these levels.

Now there are various time frames for cyclical equity market downdrafts to keep in mind. Most downdrafts end before the growth data heads higher. This usually is due to clues in the bond market that begin to suggest that monetary policy tightening has gone too far and growth is slowing too much. Rates are then eventually cut but equities have already started to move higher generally.

Today, with higher inflation and the Fed just beginning its tightening campaign and balance sheet contraction plans, we think a majority of the equity market has already fast tracked the rising probability of recession, given that more than 50% of the S&P 500 is down more than 20% from its 52-week high and more than 60% are down 20% or more from their all-time high.

In the Nasdaq 100, the percentages are much larger at more than 60% and 70% of stocks are down 20% or more from their 52-week and all-time highs respectively.

The third question:

**[GRAPHIC CARD]**
**4 key questions**

1. Has inflation already peaked?
2. What's the appropriate valuation for equities?
3. How strong is the consumer and corporate sector?

***How strong is the consumer and corporate sector, all things considered?***

The consumer still has excess savings coming out of the pandemic in aggregate. This is why the high prices of certain goods and services are still elevated. And job growth and household balance sheets are strong. Unemployment rate has held steady just above a 50-year low and there is still a job opening to labor supply gap. Consumer confidence is at post-pandemic low due to high inflation but spending is still healthy. Corporate spending is also strong particularly in technology-driven productivity areas. We will watch these areas closely for any signs of change in the coming quarters.

Now the final question:

**[GRAPHIC CARD]**
**4 key questions**

1. Has inflation already peaked?
2. What's the appropriate valuation for equities?
3. How strong is the consumer and corporate sector?
4. What's the ultimate impact of slowing growth and higher input prices on corporate profits?

***What is the ultimate impact of slowing growth and higher input prices on corporate profits?***

This helps us determine the magnitude of a slowdown and potentially a market level range where stocks can stabilize.

Higher rates and input costs are expected to weigh on margins in subsequent quarters. This is known. Productivity should help some but with margins coming off decade highs there is still some cushion relative to last cycles similar to this, in our view. Overall, we expect good but slowing earnings growth this year and still slightly positive earnings growth for next year, at this time.

In our conversation with clients in the last few months we've been asked, "What's different this time? What's different with this cycle?" Stepping back and taking a deeper view is important.

This is an entirely new business cycle that is transitioning from a long road of secular stagnation after the global financial crisis that began around 2008. That era was dominated year in and year out by dis-inflation or deflationary forces, low real and low nominal economic growth, record low rates and outperformance of long duration growth stocks for a very long time. This leadership position has changed.

With higher rates and an inflationary cycle, the higher growth areas with high valuations struggling to produce the near-term profits investors want is what we're seeing. This section of the equity market is in a major workout while the areas of higher quality, less earnings variability, higher free cash flow and solid dividends have taken the baton and are the new leaders. We expect this to continue through and to the end of this cycle.

Central banks are now collectively trying to bring inflation down and have signaled they are likely to continue this path well into 2023. On the flip side, there are signs that the economy is already slowing - another element of competing forces. In recent business cycles, the Fed hiked rates when inflation was increasing but still well below the 2% implied target. If growth slowed too much at that point, they could just cut rates, which is what they did multiple times, before rates even got too high.

So where do we stand and what is our view on how to invest through this new cycle? As we said earlier, new cycle, new positioning is needed.

But first what doesn't change is our thinking that investing is about a portfolio strategy over time, ***not*** at a point in time. In other words, market timing has not been a successful strategy in our opinion.

We want to consider using weaker periods in the markets as rebalancing opportunities in areas that over-correct; and in some cases when asset prices get overextended to the upside, rebalancing back to your asset allocation targets also make sense.

We believe for this cycle, one that has stagflationary characteristics and high uncertainty and one that has been in a long-term secular bull market since the lows of March 2009, clients should consider this:

**[GRAPHIC CARD]**
**Steps to consider from here**

- Increase portfolio diversification
- Maintain a long-term approach
- Focus on total return
- Be measured regarding high growth areas

Increasing portfolio diversification; maintain a longer-term thinking approach; take a total return approach; and be measured regarding your high growth areas.

We should look for opportunities of turning points in inflation and consider adding alternative sources of growth, yield and real assets including real estate and commodities. These areas were not the leaders of phase one of the long-term bull market cycle so they are still under owned and in low supply.

Finally, given the slowing growth outlook consider adding more defensive, higher quality areas. We prefer to do this though sector exposures.

We were also recently asked how we should consider positioning a portfolio that's generally fully invested. We want to consider becoming a little bit more defensive as we discussed before, and consider making subtle adjustments to your mix between equities and fixed income with the back up in rates.

To this point, we recently lowered our overall equity overweight by adjusting our non-U.S. developed market view downward, namely due to Europe, and small capitalization stocks as well.  We increased fixed income and cash slightly to increase diversification and due to our belief that yields have become more competitive again overall.

In addition, we added to our "on guard and balance theme" in sectors by increasing real estate, healthcare and utilities and decreasing tech slightly, industrials, consumer discretionary and communication services. We still have a small equity overweight in terms of our overall view as we work through the latter stages of this market downturn.

Maintaining a preference for equities, albeit in a more defensive tone allows for a more effective total return approach through the cycle, given our medium- and long-term view that the secular bull market should regather momentum once inflation peaks and equity valuation settles down closer to its long-term average.

The long-term bull market optimism for us is predicated on these factors:

**[GRAPHIC CARD]**
**Supporting a long-term bull market:**

- Multi-stage innovation cycle
- U.S. energy independence

- Advances in life sciences
- Technological entrepreneurship
- Wealth transition

The growth prospects of the multi-stage innovation cycle is still just beginning; energy independence of the United States; the advancement in life sciences; the incredible technological entrepreneurship across all sectors; and the powerful wave of wealth transition expected in the coming decade or more.

In the end, this leads to a resumption of a strong profits cycle once we get through this phase of competing forces.

We still expect volatility to remain high into the summer months and now yields are more attractive than at any time in the past two-plus years. The 2-year treasury yield is just about double that of the divided yield of the S&P 500. And although we are still generally supportive of the profit cycle, the wildcard of continued pricing power in the face of slowing growth in the short term is appearing in some corporate results.

So we want to further our theme of higher-quality investments, increased diversification and balance through this cycle.

I'll wrap up with one final thought. During these times of extreme volatility, we are often asked whether it's appropriate to try and make full scale changes to asset allocation and move in and out of the markets.

If we look back, we have all experienced unprecedented periods of volatility over many decades - whether it's the hyper inflationary times of the 1970s, the 1987 market crash, the emerging market currency devaluations of the 1990s, the internet bubble, the leveraged global credit crisis of 2008 and 2009, or the European debt crisis, the downgrade of U.S. debt, global tariff battles and most recently an historic healthcare pandemic and a crisis in Ukraine.

Through this all and more the S&P 500 has managed to re-set and engineer a new uptrend. Economies and the capital markets that ultimately price assets have been resilient time and again.

Here's a statistic that we often cite from BofA Global Research. Going back to the 1930s, if an investor missed the ten best performing days of each decade through mid-April of this year, their potential return was around 49% in total. If that same investor stayed in across all days in each of those decades the potential return was approximately 20,650%.

This doesn't mean don't do anything. We focus on how to invest in the markets over time and through cycles, not trying to time the markets from episode to episode. We believe we are at the late stages of this downdraft and our view for the long-term, secular bull market remains well grounded.

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**Final thoughts to consider**

- Focus on the fundamentals,
  including diversification and rebalancing
- Stay focused on your goals
- Invest through and over time

So in closing, during volatile periods, the best advice I can offer is to stay focused on the fundamentals, like diversification and rebalancing. Stay focused on your goals and above all invest through and over time.

I hope you've found these insights useful. If you work with a financial advisor, I encourage you to follow up to discuss the ideas you've heard here.

Thanks so much for joining us.

**Important Disclosures**

**Opinions are as of the date of this webcast - 5/9/2022 and are subject to change.**

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