

# EQUITY MARKET UPDATE

As of 03/31/22 | Volume 11, Issue 3 | FFTAM.com

Stocks rose in March despite continued worries about persistent inflation and the war in Ukraine. A wave of COVID-19 infections led to lockdowns in major cities throughout China that threaten to further strain global supply chains. The Federal Reserve increased interest rates for the first time since 2018, and they signaled many more rate hikes are on the horizon. The bond market responded by inverting numerous parts of the yield curve—historically a bad sign for future economic activity. Overall market volatility remained high.

## **US Stocks Rose Despite a Hawkish Fed Meeting**

The S&P 500 increased 3.58% in March. Over 50% of the gain was attributable to six stocks—Tesla, Apple, Microsoft, Amazon, NVIDIA, and Berkshire Hathaway. Buying was broad-based as every sector rose except financials. For the quarter, energy and utilities were the only sectors to post a positive return. The advance in energy was impressive with the sector beating the S&P 500 by over 43%! In 2022, the S&P 500 is down 4.60%.

The Dow Jones Industrial Average returned 2.32% for the month. A higher allocation to financials, along with less technology exposure, hurt results versus the S&P 500. Year-to-date, the Dow is down 4.10%.

The NASDAQ jumped 3.41% in March. The index was aided by large gains in Tesla and Apple. Year-to-date, the NASDAQ is down 9.10% as investors shy away from high valuation companies as interest rates rise. The index has also been hurt by large declines in Meta Platforms, Netflix, and PayPal.

Middle-to-small-sized companies underperformed large cap indexes last month with the S&P 400 Mid Cap Index gaining 1.21%, while the S&P 600 Small Cap Index rose 0.18%. Higher allocations to consumer services and banks cost these indexes. So far in 2022, this area has slightly trailed its large cap peers with the S&P 400 Mid Cap Index falling 5.22%, while the S&P 600 Small Cap Index is down 5.93%.

## **International Markets Underperform on Russian Invasion and China COVID Scare**

The war in Ukraine continues to be a focus for investors. The United States, along with its European allies, applied numerous financial sanctions against the Russian government, its leaders, its state-owned companies, and its banking system. With few signs of peace, President Biden banned the purchase of Russian oil. Europe responded by procuring desperately needed LNG

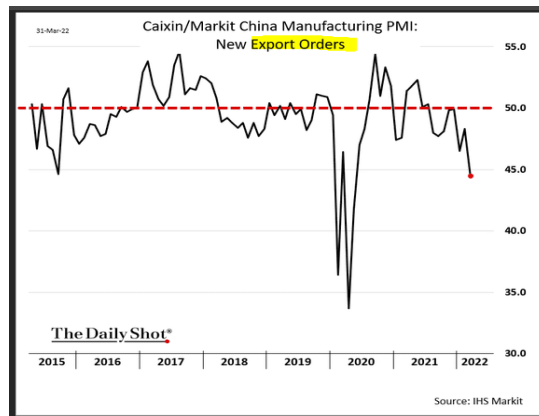
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supplies from the US, Qatar, and the UAE. The European Union gets 35% of its energy from Russia. There is not enough excess capacity of LNG currently available, so it will take several years for Europe to wean itself off Russian energy. In the meantime, the Eurozone continues to be plagued by record high levels of inflation. In Germany, the producer price index (PPI) surged 25.9% from the previous year! Much of the jump was due to higher energy prices. The country's economic minister announced the government is looking into activating an emergency law that will ration gasoline consumption. Austria is taking similar steps. Recent waves of COVID-19, the war in Ukraine, and record high inflation are weighing on consumer confidence. Several economists have downgraded their growth forecasts for Europe.

Omicron arrived in China and began to quickly spread. The Chinese government has a "zero-COVID" policy, so they responded with lockdowns of major population centers including Shenzhen and Shanghai. These regions are home to major factories for many global companies so further disruptions to the supply chain are likely. Chinese Manufacturing PMI dropped to 48.1 after four months of gains. More importantly, new export orders fell further into contractionary territory. The People's Bank of China loosened monetary policy to aid the economy. Finance Premier Li Keqiang reiterated GDP growth of 5.5% and CPI of 3% for 2022 even though most analysts believe those targets will be difficult to achieve. His comments could open the door to further stimulus measures from the Chinese government.



International markets underperformed the US in March with the MSCI EAFE Index gaining 0.12%, while the MSCI Emerging Markets Index dropped 2.52%. Year-to-date, the two indexes are down 6.61% and 7.32%, respectively.

## **COVID-19 Spreads Across China, New Variant Appears, and FDA Approved Second Booster**

Infection numbers continue to improve after a surge from Omicron. The United States has seen average daily infections drop to less than 30,000 cases. This is far below the 800,000 new daily cases seen in January. Hospitalization and death rates are also rapidly declining. This is different than China where Omicron has begun to spread. In Europe, scientists identified a new variant called BA.2. It is milder than Omicron, but it spreads more rapidly. The variant is already in the US, and it currently accounts for 50% of all new cases. The FDA approved a second booster shot for people older than 65 or immunocompromised patients above 50. The shot is to be taken at least four months after the first booster shot.

## **US Economy Grows, Inflation Worsens, Fed Raises Interest Rates**

March was another strong month for employment with the economy creating 431,000 jobs. We have seen 11 straight months of over 400,000 job gains, the longest stretch since 1939. Hiring was broad based with all major industries adding new employees. Unemployment fell to 3.6%. Labor force participation barely budged. We have stated for months the effect retirements have had on the size of the labor pool. Wages grew 5.6% from one year ago. Plentiful employment and wage gains fueled consumer spending. Total expenditures grew 0.5%, and retail sales gained 0.3%. Both readings were below analyst expectations and less than the previous month. Service expenditures continued to grow, while consumers cut back on physical goods. Personal income grew 0.5%, but inflation rose more quickly. Income after taxes, adjusted for inflation, has fallen for seven straight months. Consumers continue to tap savings to maintain their brisk pace of spending. The savings rate, which measures income left over after paying for expenses, has fallen to 6.3%, the lowest reading in nine years. The data paints a

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picture of an economy growing from strong employment and rising wages, but those benefits are being eroded by rising inflation.

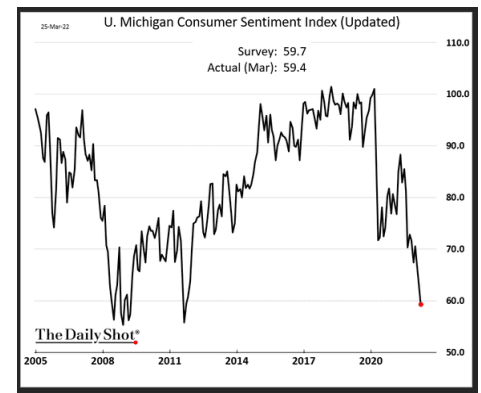
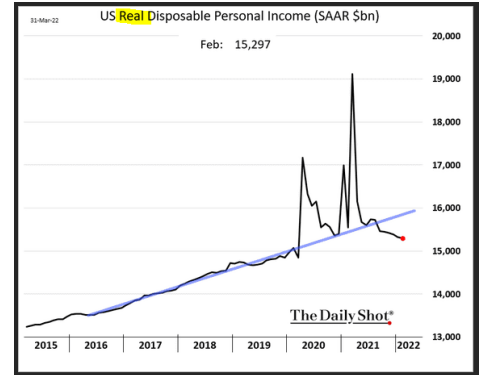
Inflationary pressures continue to plague the economy with consumer prices jumping 7.9% from one year ago. That was the hottest reading since January 1982. The price hikes were widespread. Core CPI, which strips out the volatile components of food and energy, climbed 6.4%. Grocery prices rose 8.6%, the sharpest rise since 1980, and energy surged 38%. We continue to see sharp increases in rent, which accounts for one-third of the CPI calculation. Even though rent is up double digits in many US cities from last year, the rental vacancy rate dropped to the lowest level since the early 1980s. This means housing expenses could continue to rise at an above average pace given the limited inventory, although it will be difficult to replicate the gains of the past two years as the 30-year mortgage rate nears 5%. The personal consumption expenditures (PCE) index, the Fed's preferred measure of inflation was also hotter than expected. It advanced 6.4%. The core reading that strips out food and energy costs rose 5.4%, its sharpest increase in 39 years. These reports serve as another reminder of the ills coming from supply chain constraints, tight labor markets, and strong consumer spending. The Labor Department said higher prices are adding \$250 a month to living expenses.

Businesses are trying to keep up with strong consumer demand; however, supply chain disruptions are wreaking havoc on the availability and price of components with the producer price index (PPI) jumping 10% on a 12-month basis. PMI readings remain strong, although new orders fell briskly.

Elevated inflation is forcing the Federal Reserve to speed-up monetary tightening. The Fed stopped their monthly bond purchases in March. They increased interest rates by 0.25%, their first hike since 2018. More importantly, they signaled six additional rate increases by year-end. Federal Reserve Chairman Jerome Powell told reporters to expect some of the rate hikes to be in half percentage point increments, something the Fed has not done since 2000. The dot plots indicate the Fed wants interest rates to be at 2% by year-end and 2.75% by the end of 2023. If this comes to fruition, it would be the most aggressive rate hiking campaign in 15 years. Mr. Powell said the Fed will reveal the details of shrinking the balance sheet at the May meeting with implementation happening shortly thereafter.

## Market Valuation Remains Above Historical Averages As Earnings Season Approaches

We are on the doorstep of another earnings season. First quarter earnings are forecasted to grow 4.7%. This is a sharp deceleration from the previous quarter when profits grew 31.4%. This indicates that year-over-year comparisons are getting tougher, while profit growth is becoming more elusive in the face of high inflation and geopolitical uncertainty. When digging into the numbers, energy is expected to post the strongest results with earnings growing 245% from this time last year. Industrials, materials, and real estate are also forecasted to report double digit profit growth. For the full year, analysts are forecasting earnings growth of 9.5% with revenues increasing by 9.3%. These estimates are better today compared to the start of the year, and it shows that analysts expect economic conditions to improve in the 2<sup>nd</sup> half of the year, especially regarding inflation.



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The mixture of future earnings growth and the recent market sell-off has the S&P 500 trading at 20.12x 2022 earnings estimates. This is better than the trailing earnings multiple of 23.37x. Stocks currently trade at levels above what we saw pre-COVID (19.4x) on a price-to-earnings (PE) basis, and they remain elevated versus the 5-year average PE of 18.6x and the 10-year average of 16.8x.

The valuation can be justified by low interest rates and the enormous amount of liquidity in the system. However, the Fed and other global central banks have begun to quickly remove stimulus as the global economy reopens and inflation readings remain elevated. This makes stocks ripe for increased volatility, especially among the higher valuation growth names.

## Our Outlook & Strategy

The biggest challenge for stocks in 2022 is central banks navigating how to remove emergency stimulus policies needed during the depths of the pandemic without significantly slowing growth. Russia's invasion of Ukraine complicates matters by pushing energy and food inflation even higher. The prospect of higher interest rates reduces the PE multiples investors are willing to assign to stocks. This places outsized stress on stocks trading at lofty valuations, especially those that cannot clear the earnings growth hurdles investors have forecasted.

Historically, the early innings of Fed rate hikes are positive for stocks in general. The areas that experience the best results are cyclical sectors such as energy, industrials, and financials. This is due to a still growing economy and the low PE ratios assigned to those sectors. We have responded by overweighting both energy and financials. However, we are seeing many signs that this economic cycle is progressing much faster than the past. In fact, recent data indicates we are approaching the late stages of the mid-cycle, a period in which stocks experience above average volatility while producing below average returns. The yield curve has also inverted at all points between 2-10 years in maturity. Given the Fed's forecast for future interest rate hikes, there is a high likelihood of the entire yield curve hovering between 2.50% to 2.75% by year-end. If so, the mixture of less stimulus from the government and the Fed, along with persistent inflation, could weigh on the consumer's ability to maintain spending growth. We have responded by overweighting consumer staples and big pharmaceutical companies.

The best summary I have seen on how to navigate the upcoming environment is from Joe Zidle, Chief Investment Strategist at Blackstone. He said: "The path forward for investors will be more challenging as slower growth, higher inflation, and rising interest rates call for higher quality, greater selectivity, and a sharp focus on duration management for both equity and fixed income investors." This is historically a good environment for First Financial relative to the benchmark given our ownership of higher quality companies—those with consistent cash flows and less leverage. If data continues to trend in the direction of the late stages of the business cycle, you can expect us to tilt the portfolio in a more defensive direction. This would include reducing our cyclical bets in energy and parts of industrials and financials.

