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Damage Assessment

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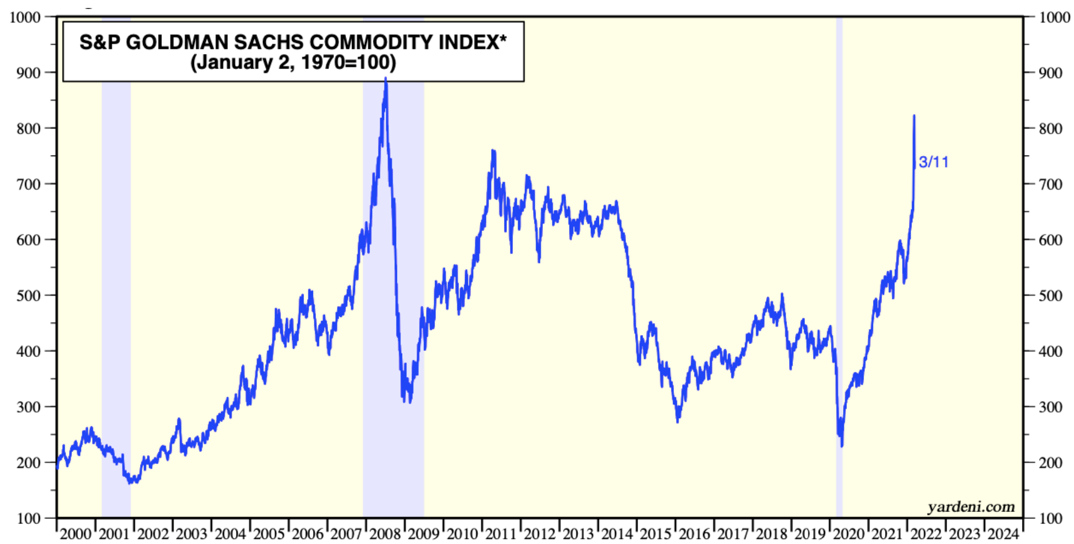
We are three weeks into a war that many military experts predicted would only last a few days. It's becoming increasingly likely that there will not be a definitive end to this war anytime soon, perhaps ever. All of us will collectively watch needless death and destruction and be dumbfounded. It will never make sense to us. We acknowledge that's irrelevant. Our job is to understand the economic impact of the war.

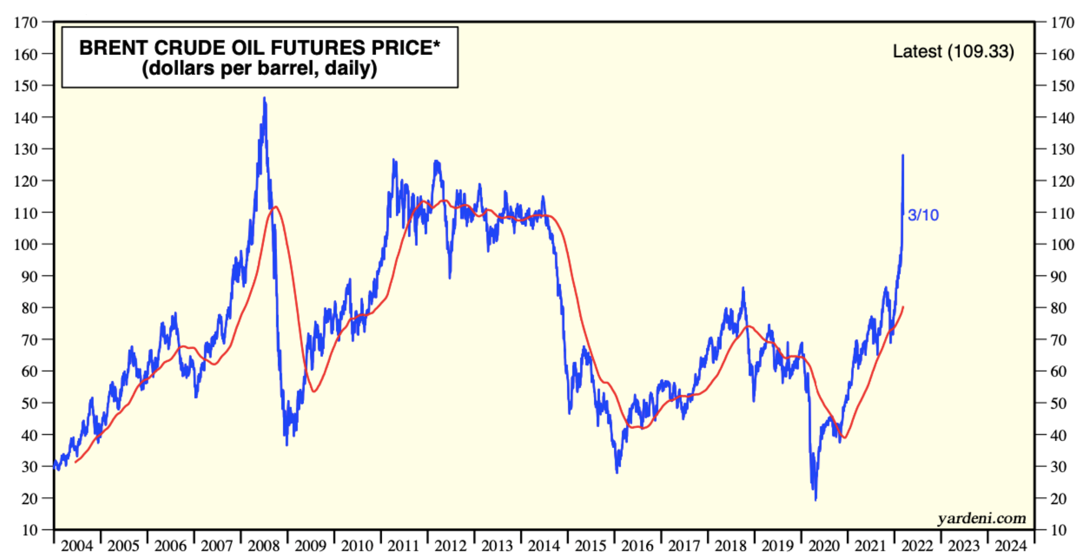
Big Picture – Our expectations now relative to our expectations at the start of the year; global economic growth will be slower, inflation higher, commodity prices, in particular energy, significantly higher, corporate earnings growth lower, bond yields higher, credit spreads wider, stock markets lower.

The word "temporary" has become a popular adjective to describe the economic impact of this war. We understand why, but also see this word as misleading. Global economies do eventually adjust to the economic disruptions of war, however, the impact of these temporary disruptions is permanent. Consensus forward corporate earnings estimates for the next four quarters have been lowered in response to the war. Analysts don't expect corporate earnings to start *GROWING* until later this year. The earnings *hit* is being referred to as temporary. Fair enough. However, the impact on stock market valuation is permanent. Companies have earned less money than they expected to, and therefore their worth is lower. Here's an analogy; you have a job, and you get paid a salary for that job. If your employer cuts your pay for the next two quarters while also promising to reinstate your full wage after that, your wage decrease is temporary, but the impact on your net worth is permanent. You made less, and therefore you are worth less.

Stocks have adjusted lower to reflect lower earnings expectations over the next several quarters. It is likely stocks will start recovering when corporate earnings start recovering. Our expectation is consistent with the consensus expectation of earnings analysts which likely won't start happening until the 3rd or more likely 4th quarter of 2022. There are several headwinds facing corporate earnings but the headwind most directly attributable to the war is higher energy prices due to disruptions in global trade. Higher energy and commodity prices decrease the disposable income of consumers while increasing the cost of production for corporations.

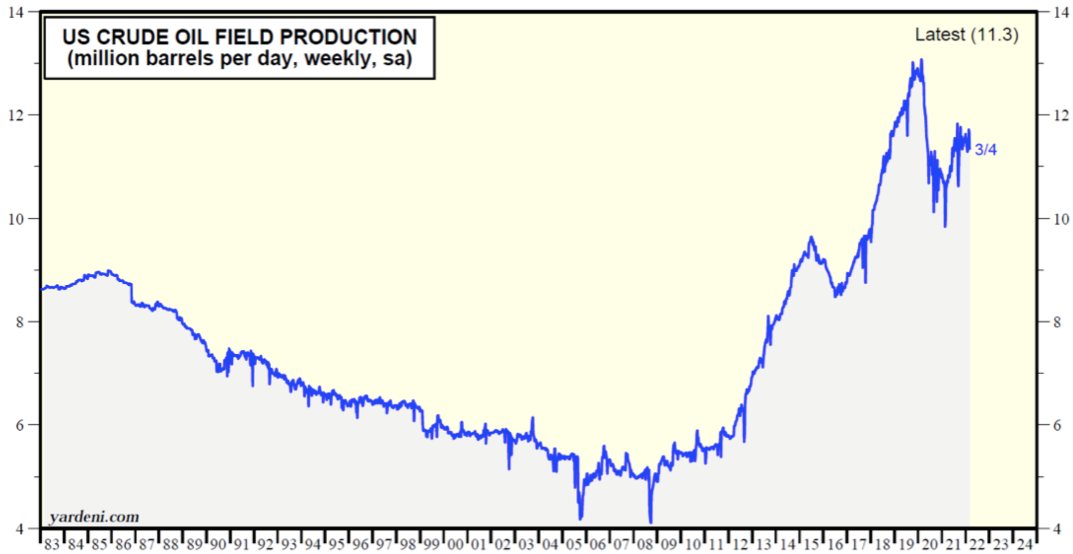


We've often observed that the cure for high commodity prices is high commodity prices. That's why commodities have been a lousy long-term investment. Higher prices lower demand and give producers the incentive to produce more. Increases in supply coupled with lower demand drive high commodity prices lower. Despite our observation regarding commodity prices, it's become somewhat of a tradition during energy price spikes that an energy analyst at a major investment bank forecasts $200 a barrel oil. Bank of America just did so, Goldman Sachs is still waiting for their 2007 forecast to pan out. Here's our reasoning why $200 a barrel for oil is unlikely.

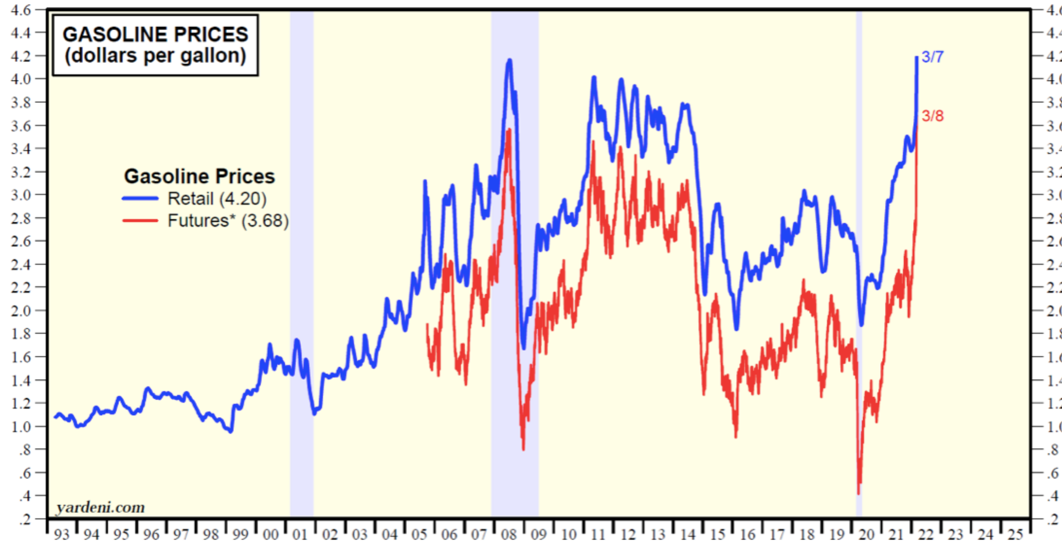


The U.S. was importing about 500,000 barrels of oil a day from Russia. Replacing this supply won't be immediate. (It should be noted that the U.S. is self-sufficient in natural gas production. Europe was importing 2.5mm barrels of oil a day from Russia and 30% of its natural gas supply).

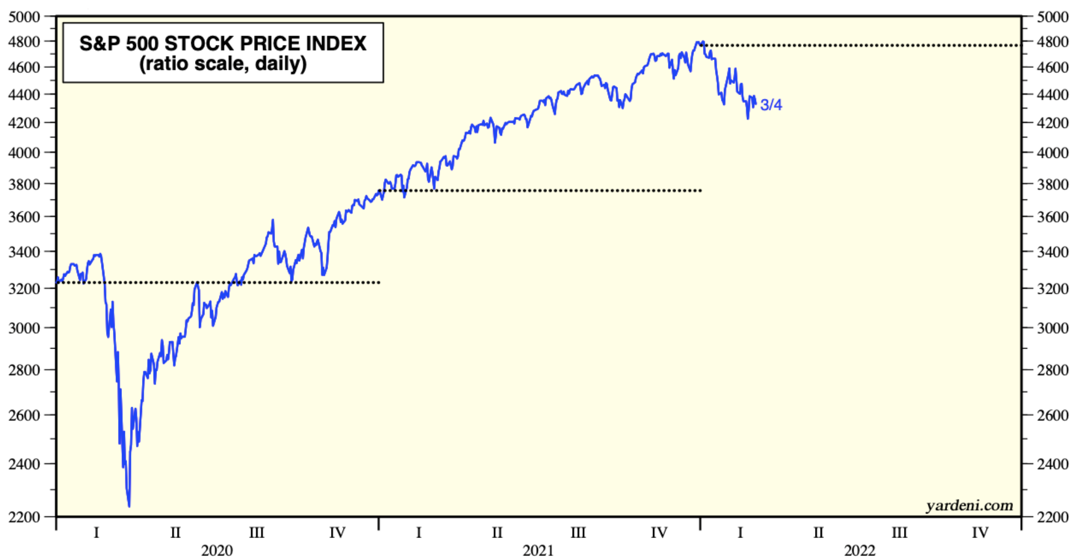
It appears relatively easy for the U.S. to boost production and replace its crude imports from Russia. US crude production is currently 11.3 million barrels per day (mbd), well below the 13mbd it produced just prior to the pandemic.



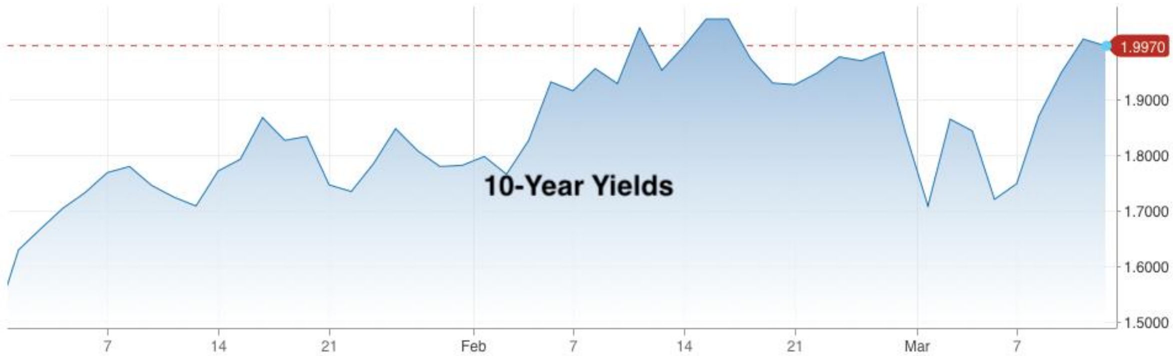
Although energy companies might prefer limiting supply in favor of larger profit margins, explaining to Americans that $7-gallon gasoline is increasing shareholder returns would not be our recommended corporate relations strategy. Pioneer Energy recently acknowledged, "Shale regions such as western Texas could increase output by about 700,000 barrels per day this year…..and could double to 1.4mn in 2023 and 2024". This is not the 1970s, we have the capacity to solve high oil prices.



The initial damage has been done. We don't expect stocks to bounce back as rapidly as they did post-pandemic. Depending on the daily news flow, day-to-day market movements will continue to be volatile. We may dip a few more percent before forming market lows, or we may have already formed them. We are currently 58 days removed from all-time market highs. We expect it will take the rest of his year, perhaps into 2023, to repair the damage and once again visit the previous highs. We are tempted to add equity exposure at this time but have decided against it. Although we are reasonably confident this trade would eventually prove profitable, increasing portfolio risk at this point isn't prudent. There are too many uncertainties.



Bonds are fighting two strong but opposing forces. Inflation is rising which is pushing rates higher, and the world is becoming less stable, which is pushing rates lower. Our expectation is for geopolitical fears to subside but for inflation to remain persistent. The forces pushing rates higher will be more powerful than the forces pushing rates lower. We used the recent dip in rates to further decrease interest rate exposure, we expect those rates to be the lowest we see for quite some time.



European stocks are a disaster and Emerging Market stocks are even more so. We plan to keep stock exposure domestic and tilted towards a Value orientation for quite some time. It's reasonable to question why we didn’t more aggressively to lower equity exposure as Russian troops gathered on the Ukrainian border. The answer is the same answer we’ve given during previous geopolitical crises. Hindsight bias makes geopolitical events appear far more predictable than they are. Reacting to the headlines has cost investors far more money than it has saved them. Here is a reminder of headlines creating material sell-offs over the last 5 years that didn't pan out.

Headline
Ukraine crisis
Omicron
Evergrande (Chinese real estate bubble)
Election jitters
Covid19
Trump threatens new tariffs on China
North Korea crisis
Trump impeachment scare
FBI flags Hillary

We are not side-stepping the question. This event is different. It's causing an actual economic impact. Investor portfolios would have benefitted from a further decrease in stock allocations as Russian troops gathered on the Ukrainian border. That said, trying to guess which crisis will or won’t materialize is a difficult and costly game to play. Deciding when to re-enter a market can be an even more difficult and costly. We believe allocating portfolios consistent with longer-term economic variables is still the best way to accumulate wealth. We also understand we need to incur shorter-term periods that are uncomfortable. This is why an investor’s time horizons are the most critical component we use in determining the proper risk profile for investors. Barring any further escalations, we expect economies will adjust and stocks will recover over the next year. At the start of this year, we expected mid-single-digit returns for domestic stocks. Our current expectations are that domestic stocks will end the year higher than their current levels but will likely post modest negative returns for the year. We don't expect stocks to make new highs again until 2023.

We will remain diligent in the management of your portfolios. We will continue to adjust your allocations as economic conditions change and will always update you regarding our reasoning. Both absolute and relative longer-term portfolios returns remain strong, and our expectation is for this to continue. A greatly simplified summary of what we see as the portfolio impact of this war is that it will cost investors about one year of returns.

Please reach out to us anytime, we are always available.

The Mommaerts Mahaney Team

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J. Matthew Tuccini, CFP®: Matt has over 17 years of experience working in the financial services industry with vast experience in retirement planning, tax strategies, and financial planning.

Robert Kea, CFA: Bob has over 30 years of experience in portfolio management. He was a founding member and Co-Head on Putnam's Asset Allocation Group, which managed $12Bn in both retail and institutional assets.

Jason Rolling, Financial Advisor: Jason has been in the financial services industry for the past 15 years. His financial experience includes retail banking, consumer & commercial lending, bank management at the local, regional and SVP level, wealth management, and financial planning.

Mommaerts Mahaney Financial Services, Inc. provides advisory services through ERTS Wealth Advisors, LLC, a registered investment advisor.
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