

In the Markets Now

Stumbling out of the gates

The market is off to a rough start to begin the new year. Here we take stock of the situation, evaluate what is causing the turmoil, and where to go from here.

PWM Equity & Fixed Income Research

Ross Mayfield, CFA
Investment Strategy Analyst

January 23, 2022

EVALUATING THE STRUGGLING MARKET IN EARLY 2022

2022 is off to a rough start. The S&P 500 is down -7.7%, the worst start to a year since 2016. It also just wrapped its worst week since March 2020 and is in its biggest drawdown since pre-vaccine. The FAANG stocks (Facebook, Apple, Amazon, Microsoft, Google), which make up ~25% of the S&P 500, are all underperforming the index. Small-cap and Growth indexes are down more than 10% in just 14 days, while other more speculative corners of the financial world are in full-on bear markets.

Things aren't much better in fixed income. The swift recent rise in interest rates has weighed on bond performance (as yields rise, prices fall). The broad US bond market is down (-1.8%) to start the year after losing just (-1.5%) for the entirety of 2021.

The big questions are: why, and what's next? We have some thoughts, but first, a quick point: the news media needs a ten word headline to describe why the market is falling, often opting for something eye-catching, but the reality is always more nuanced. The "market" is comprised of hundreds of thousands of investors and millions of transactions a day – to try and identify one reason for broad selling is difficult if not impossible. But of course, we'll take a few educated guesses, too:

- **The Federal Reserve.** The Fed is planning to raise rates in 2022 after years of historically market-friendly policy. And with higher inflation lingering, they seem to want to get more aggressive by the day. While stocks may have even stomached a few rate hikes in 2022 (in fact, it was priced for three on January 3 when the S&P 500 hit an all-time high), four or more (plus other tightening measures) seem to be proving too much, particularly for the high-flying growth stocks that so benefitted from low rates. The still-uncertain timing and pace of Fed action could also be weighing.
- **Bond yields.** Short- and long-term rates are up significantly in recent months, and this has weighed hard on high growth shares. This makes sense, as stocks with more of their earnings potential farther out in the future are disproportionately hurt by higher rates. This is also why Value stocks (e.g. Energy, Financials) have held up well so far.
- **Earnings.** It's early, but results for the 4Q21 earnings season have been mixed so far. Since the pandemic began, US companies have crushed analyst expectations at nearly every turn, while profit margins and earnings have soared to record highs. Now, expectations have caught up to reality at the same time rising labor costs, Omicron, and supply chain woes are weighing. The bar has been raised, and performance can be more challenging at this point in a market cycle.
- **Valuation.** The market has been richly valued for some time, particularly given its weight in expensive Technology and Growth companies. And while this alone rarely causes a selloff, the higher the market's valuation is, the more downside potential there might be. The Fed may be the spark, but rich valuation is certainly dry kindling.

So where to from here? First, we need to remember [a key investing truth](#): **short-term volatility is the cost to participate in the stock market's long-term gains**. Since 1950, the S&P 500 has averaged a drawdown of 13.6% over the course of a calendar year. [Over this period, there have been 36 double-digit corrections](#), good for once every 2 years. Selloffs happen.

And further, a shifting environment does not mean that investing is impossible. In a higher rate, higher inflation environment, [Value sectors can outperform](#). Commodities and real assets can act as strong diversifiers. And higher quality companies – those that can protect profit margins, find (and pay) labor, and brush off marginally higher interest rates – can thrive.

Volatility may remain elevated. Inflation is lingering, [it's a mid-term election year](#), and the bar has been raised for performance after a historic three-year run. But the fundamentals of the US economy and companies are strong, **and we remain bullish**.

Disclosures

This is not a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

This report does not provide recipients with information or advice that is sufficient on which to base an investment decision. This report does not take into account the specific investment objectives, financial situation, or need of any particular client and may not be suitable for all types of investors. Recipients should not consider the contents of this report as a single factor in making an investment decision. Additional fundamental and other analyses would be required to make an investment decision about any individual security identified in this report.

For investment advice specific to your situation, or for additional information, please contact your Baird Financial Advisor and/or your tax or legal advisor.

Fixed income yield and equity multiples do not correlate and while they can be used as a general comparison, the investments carry material differences in how they are structured and how they are valued. Both carry unique risks that the other may not.

Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index.

Copyright 2020 Robert W. Baird & Co. Incorporated.

Other Disclosures

UK disclosure requirements for the purpose of distributing this research into the UK and other countries for which Robert W. Baird Limited holds an ISD passport.

This report is for distribution into the United Kingdom only to persons who fall within Article 19 or Article 49(2) of the Financial Services and Markets Act 2000 (financial promotion) order 2001 being persons who are investment professionals and may not be distributed to private clients. Issued in the United Kingdom by Robert W. Baird Limited, which has an office at Finsbury Circus House, 15 Finsbury Circus, London EC2M 7EB, and is a company authorized and regulated by the Financial Conduct Authority. For the purposes of the Financial Conduct Authority requirements, this investment research report is classified as objective.

Robert W. Baird Limited ("RWBL") is exempt from the requirement to hold an Australian financial services license. RWBL is regulated by the Financial Conduct Authority ("FCA") under UK laws and those laws may differ from Australian laws. This document has been prepared in accordance with FCA requirements and not Australian laws.