In the first quarter of 2022, markets have had to contend with many crosscurrents that have increased volatility this year. Investors have had to digest the economic implications of higher inflation, rising energy and commodity prices, Covid variants, actions from the Federal Reserve (the Fed), and the geopolitical consequences surrounding Russia's invasion of Ukraine. Along with these concerns has been diminishing consumer confidence.

Yet, as we end the quarter, markets have shown signs of stability since the Federal Reserve's announcement in mid-March that they were raising interest rates. The Federal Reserve has begun raising interest rates for the first time since 2018. This process is commonly referred to as "liftoff" because policy rates have remained grounded at zero percent since the Fed's pandemic rate cuts two years ago. The Fed rate hike in March is only the beginning of the process. The Fed's own projections show the federal funds rate rising from the current 0.25% to reach 1.75% by the end of the year. This would equate to six additional 0.25% rate hikes in 2022 across six remaining Fed meetings. Fed officials recently signaled some of those hikes might come in the form of a 0.50% rate hike.

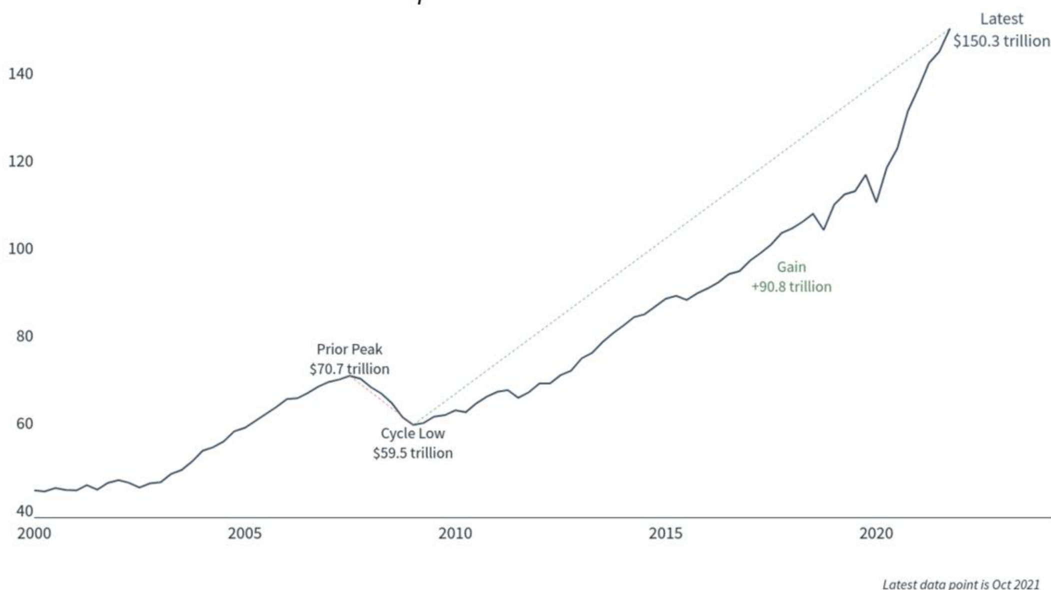
History shows that Fed tightening is not usually something for investors to fear. Although markets performed well when Fed policy kept interest rates low, this is a matter of correlation rather than causation - both markets and the Fed are driven by strong economic conditions, not just low interest rates. Thus, it is not the case that Fed policy of higher interest rates directly cause bear markets.

Market expectations seemed to have now factored in these rate hikes and tightening activities. Furthermore, despite risks surrounding the war in Ukraine, the economy remains fundamentally strong. Unemployment has fallen to 3.6% (92% of the jobs lost during the pandemic have been recovered) and the average consumer is financially stable.

However, rising oil prices are certainly weighing on consumer sentiment. The average price per gallon of regular unleaded is now above $4. These price increases are highly visible and impact consumers directly, and their sudden jump can stir emotional and psychological responses. For many, driving is unavoidable, whether it's to commute to work, to go to the grocery store or to take the kids to school.

The concerns over rising inflation and oil prices have hurt consumer confidence, leading to the possibility of weaker spending. The University of Michigan Consumer Sentiment Index, for instance, shows that consumers are the most pessimistic since 2011. Weaker consumer sentiment and weaker spending would normally be taken as a negative for financial markets. However, in the current inflationary environment, a softening of consumer demand could be exactly what the economy needs to lessen inflation. Inflation has been driven by several factors, including supply chain disruptions. If we get some pullback in consumer demand, it may provide the necessary time for supply to catch up with demand and present a more balanced landscape.

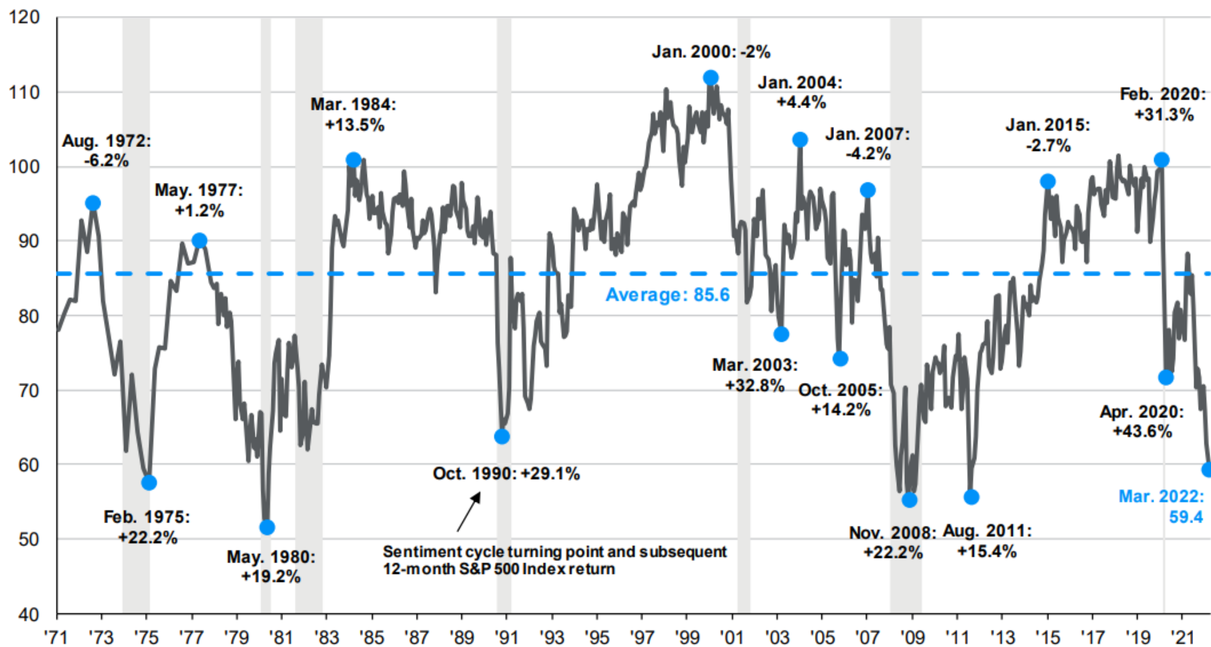
Despite these challenges, there are a few factors to keep in mind. First, although consumers are feeling pessimistic, they are arguably in their strongest financial positions in years. The job market is robust with many more job openings than unemployed individuals. Wages are rising, house prices are climbing, and household net worth has reached new all-time highs. Along with high savings rates during the pandemic lockdowns, the average consumer can, at least for now, absorb higher expenses.



Second, the initial shock of rising prices is the hardest to overcome. In the short run, there is very little choice but to cut spending elsewhere. In the long run, consumers can adjust their behavior to offset these costs. Oil prices, which spiked as high as $128 per barrel in early March, have also come back down. While energy prices are still elevated, this suggests there could be stability in gasoline prices as well, especially as more production comes online. Of course, some of this depends on how the ongoing conflict between Russia and Ukraine plays out.

Finally, perhaps the most important fact for investors to remember is that consumer sentiment is often a *contrarian* indicator for markets - i.e., it is often better to invest when consumers are nervous than when they are confident. Over the course of a business cycle, how consumers feel tends to rise and fall with economic conditions. In hindsight, the market is often the most attractive when consumers and investors are the most fearful.

Consumer Sentiment Index and subsequent 12-month S&P 500 returns



Source: FactSet, Standard & Poor's, University of Michigan, J.P. Morgan Asset Management.
Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month S&P 500 returns are price returns only, which excludes dividends. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of March 31, 2022.

J.P.Morgan
ASSET MANAGEMENT

At the moment, the data suggest that everyday individuals and households will need prices to stabilize and the Russia/Ukraine conflict to resolve before they feel better about the world. And while some are worried about a recession in the near future, this is not yet inevitable. Overreacting to this possibility could be counterproductive to long-term investors. History reminds us that those investors who have the time horizon to be patient can often benefit from market uncertainty. That is why investors should remain diversified and continue to reflect on whether their financial plans and portfolios support their long-term goals. If we can answer any questions or help you review your broader financial goals, please do not hesitate to call your Relationship Manager.

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