INSIDER

www.insider.com March 9, 2022

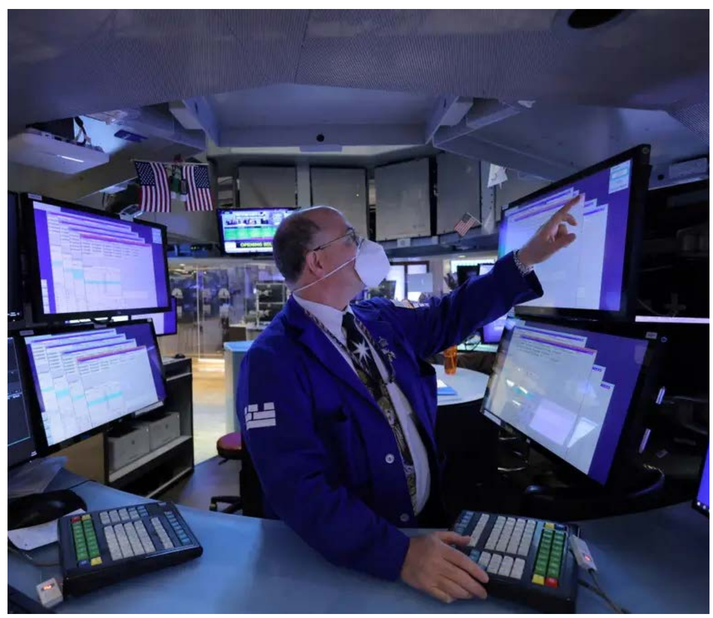
PREMIUM

MARKETS

The chief stock market strategist at Federated Hermes shares 5 sectors to invest in now to defend your portfolio as he warns that "stagflation risk is here" as energy prices surge to 13-year highs

James Faris

- **Stocks are firmly in correction territory as stagflation and recession risks rise in 2022.**
- **Phil Orlando, Federated Hermes' chief equity market strategist, downplays one of those threats.**
- **Five sectors should stay strong – including the scorching-hot energy sector.**



ANDREW KELLY/REUTERS

Stagflation risk is rising, but the US still should avoid a recession.

Stock market bulls would likely call Phil Orlando too pessimistic — but bears would say he's too optimistic.

The chief equity market strategist at Federated Hermes, which manages $669 billion in assets, recently cut his Q1 2022 GDP estimate to 2.3% from 3.5% because he believes the US economy is "losing steam." However, he still thinks full-year growth will clock in at a historically strong mark of 3.8%.

And though Orlando doesn't see a recession on the horizon, he's still worried about stagflation.

Concerns about stagnant growth and rampant inflation have gripped investors in early 2022, with the Russia-Ukraine war wrecking growth estimates and inflation recently hitting 40-year highs. The combination has proven to be too much for markets, with the S&P 500 and Nasdaq Composite down 12.5% and 19% this year, respectively.

"Stagflation risk is here," Orlando told Insider in a recent interview.

The price at the pump

There appears to be a common culprit for both weaker growth and rising inflation: energy prices.

The price of gas has surged to 13-year highs because of supply-demand imbalances caused by both the pandemic and by Russia's invasion of Ukraine. Years of underinvestment in production capacity has kept energy suppliers from meeting surging demand as the economy has reopened.

Low supply and high demand has been a dream scenario for energy investors this year, but it may prove to be nightmarish for the US economy.

Every one-cent rise in gas prices lowers consumer spending by roughly $1.2 billion, Orlando said, borrowing a rule of thumb from Cornerstone Analytics. Some back-of-the-envelope math based on that guideline means a $2 increase in gas per gallon, as has happened in the past two years, translates to a $240 billion decline in consumer spending. That alone would've shaved off over 1% of the US's GDP in 2021, Orlando noted.

The Federal Reserve, tasked with keeping prices stable while maximizing employment, now faces a daunting choice that could decide whether the US enters a recession: continue to let inflation run unchecked, or slam the brakes on the economy by rapidly raising interest rates.

Unlike some of his peers, Orlando believes that the Fed will "successfully stick the landing" and avoid both a policy error and a recession. There's enough monetary and fiscal stimulus floating around, in Orlando's view, that if a downturn does come, it would likely be "two years out rather than next week" — unless oil prices spike further to absurd levels like $200 per barrel.

But the Federated Hermes strategy chief is still nervous.

"They're going to have to thread the needle here to get this right," Orlando said. "And this is the thing that I think concerns me the most: that somehow, they make a mistake."

Ideally, Fed chair Jerome Powell and company steer the US economy away from both runaway inflation and a recession, though that may be wishful thinking. When asked whether he'd rather see the Fed make an error by being overly dovish or too hawkish, Orlando said he wants the US central bank to make slowing inflation its top priority and be aggressive in doing so if necessary.

"If the Fed does not get their hands around the inflation genie and stuff it back in the bottle, we could be looking at an even bigger problem somewhere down the road, which might require an even more draconian, Volcker-esque policy response," Orlando said. "I think the Fed has to do the right thing here and get ahead of the curve as opposed to behind the curve."

Inflation investing strategy: Sectors to target

Stock market prognostication is an inexact science. Entering the year, Wall Street's top minds were unanimously bullish on energy. But no strategist could have predicted that, through the year's first 44 trading days, the sector would rise 37% while all of its peers would be stuck trading in the red.

And while Orlando expected an uptick in volatility in 2022, as his December 16 note attests, trading has been far rougher than his S&P 500 price target of 5,300 — tied for the Street high — would suggest. Still, the market could turn an ugly start to the year around if the Fed threads the needle and the economy stays on track, as the strategy chief predicts.

The following five sectors are Orlando's best bets to invest in right now: **Energy, Financials, Industrials, Materials**, and **Healthcare**.

Energy, which Orlando said has been his favorite sector for the past year and a half, has dominated as supply-side issues have pushed oil and gas prices to new heights. In fact, the strategy chief wrote in a December 2020 note that oil would reach $60 per barrel by late 2021 — a level it hit by March of this year. Unless the Russia-Ukraine war suddenly ends or demand drops off, Orlando said the trend of sky-high oil prices will continue. The energy sector is up 36.9% year-to-date.

A trio of economically sensitive sectors — financials, industrials, and materials — have had lackluster returns to start the year, which can be explained by investors beginning to price in a higher likelihood of a recession. However, those cyclical sectors should build off their middling performance if the US dodges a recession, as Orlando predicts. The financials sector is down 8.5% this year, while industrials are down 7.9% and materials are down 11.7%.

Healthcare stocks have outperformed the broader market, with the sector down retreating 7.8% in 2022. But healthcare stocks could bounce back because the world may not be "completely out of COVID woods just yet," Orlando said. Within the sector, the strategy chief is a fan of the biotechnology industry, even though those names have gotten slammed as interest rate expectations rise.

"Biotechnology stocks did well early in the cycle but really have underperformed later," Orlando said. "We're still believers that biotech is part of the solution here, and I think healthcare stocks should continue to work."

Past performance is no guarantee of future results.

Fund and firm assets in the article are as of Dec. 31, 2021.

Views are as of March 9, 2022, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

There is no guarantee that any investment strategy will be successful.

S&P 500 Index: Is an unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Nasdaq Composite: a large market-cap-weighted index of more than 3,000 stocks, American depositary receipts (ADRs), and real estate investment trusts (REITs), among others.

Indexes are unmanaged and investments cannot be made in an index. Index and market performance is for illustrative purposes only and is not representative of any specific investment.

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50716 (4/22)