2022 SPRING INVESTMENT OUTLOOK

The capital markets are entering the spring season with the same volatility that has persisted throughout the winter months. Major stock indices are experiencing a price correction that has lasted for more than four months with some meeting the bear market definition of a decline of more than 20% from peak prices. Sentiment has shifted towards a more defensive posture, evidenced by sectors such as consumer staples, healthcare, and utilities outperforming their more cyclical counterparts on a relative basis since November 1st amidst the deepest stock market drawdown since the March 2020 bottom.

The tech-laden Nasdaq Composite Index declined 21.7% by March 14th from its November peak while the Russell 2000 small cap index closed January 27th down 20.9% from its cycle high. The so-called FANG+ stocks comprised of high growth technology names were down even more, declining 32.0% from peak-to-trough, while an index of non-profitable technology shares are off more than 45% since autumn. Although the S&P 500 has seen a more modest 13.1% drop during the correction, the average stock in the index has experienced a drawdown of more than 25%.

Sharp relief rallies like the nearly 7% advance to cap off last week are not uncommon during highly volatile periods as investors contemplate the cumulative impact of tighter monetary conditions and rising geopolitical tensions against underlying economic fundamentals, which remain relatively sanguine for now. This tug of war is particularly contrasting when examining recent institutional behavior with the retail investor. According to Morgan Stanley, institutions have dumped more than $200 billion of equities to start the year as hedge funds and computer-driven quantitative strategies slash exposure and reduce leverage amidst rising volatility. On the other hand, JPMorgan says individual investors, conditioned by years of successfully buying dips, poured a net $39 billion into stocks since January, the most during the first quarter in more than five years.

The current stock market correction is occurring in concert with a decline in the fixed income markets, the first of significance in many decades, as interest rates increase at the sharpest pace since the early 1980s in response to persistently high inflation. Headline CPI rose 7.9% in February, a 40-year high, and the Fed's preferred core PCE price measure is rising at a 5.2% clip, well above the central bank's intended 2% target. Such price pressures have pushed a broad gauge of U.S. Treasuries down 4.6% to start 2022 (worst start to a year since 1974) and corporate bonds have declined 7.4% in aggregate out of the gates and are heading toward their worst quarter since 2008. The simultaneous decline in both stocks and bonds has meant a tough start to the year for so-called balanced funds with the broad Lipper Balanced benchmark down 5.1%.

Unsurprisingly, commodities have flourished in such an inflationary environment with the Bloomberg Commodity Spot Index rising 23.4% year-to-date and with a particularly sharp inflection higher since the Russian invasion of Ukraine in late February as market participants worry about the conflict causing shortages in many important inputs for both consumer and business goods. Brent crude oil prices have been particularly volatile due to the importance of Russian production for global supply-demand balance with prices briefly spiking above $130 per barrel in early March. Current prices of more than $114 per barrel are 47% higher than December 31st levels. Gold prices have also moved higher and diversified portfolios with

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equity investments in both energy and gold mining companies have likely weathered the winter months far better than the headline indices. Energy stocks have returned nearly 34% to start the year while gold and silver mining companies are more than 18% higher.

2022 YTD Total Returns

	3/18/22	% Change
Dow 30 Industrials	34,755	-3.9%
S&P 500	4,463	-6.1%
NASDAQ Composite	13,894	-11.0%
MSCI ACWI ex-USA	319	-6.8%

Outlook

The Federal Reserve finally lifted its key fed funds policy rate off the zero bound, capping off the last week of winter with its first interest rate hike since 2018. At the same time, the central bank lowered its own GDP growth expectations for 2022 to 2.8% from 4.0% at the end of December. Capital markets had been leading the Fed towards such a policy shift and downgrade in growth for many months. The short end of the yield curve through the eyes of 2-year Treasury note has already risen by 174 bps since the end of the third quarter to a current 2.02%. High yield credit spreads, a leading indicator of both economic and corporate profit growth, had widened by as much as 140 bps since late December lows to nearly 400 bps, signaling slower growth expectations ahead both sequentially and year-over-year. Bloomberg consensus is forecasting a substantial deceleration in first quarter sequential growth to just 1.5% from 7.0% in the fourth quarter, affirmed by the Atlanta Fed's NowCast model of just a 1.3% expansion to start the year.

Some are urging the Fed to be more aggressive in raising interest rates to address unexpectedly and stubbornly high inflation in order for the central bank to maintain its historical inflation-fighting credibility. St. Louis Fed President James Bullard (who was the lone dissenter at last week's meeting, preferring a 50 bps hike instead of 25 bps) recommends the FOMC try to achieve a fed funds rate above 3% this year. Former Treasury Secretary Larry Summers opined that the Fed will ultimately need to hike rates to at least 4-5% to beat inflation. Meanwhile, the median estimate by Fed officials at last week's meeting was for the fed funds benchmark to end this year at about 1.9% before rising to 2.8% in 2023 and staying there in 2024. Hawks and doves aside, the central bank is guiding for a substantial tightening of policy amidst the most significant slowdown in growth this cycle, a rarity in the post-WWII monetary era.

The key question heading into the middle of the year is whether the economy can handle such a quick and dramatic tightening of financial conditions. Can the Federal Reserve thread the needle and achieve its goals without causing a recession? Visibility into such an outcome is unlikely to be apparent until late summer/early fall as shifts in policy have historically worked into the economy at approximately a 9-month lag. The subsequent performance of the stock market around 10% market corrections from peak levels also takes a similar amount of time to resolve its ultimate path, which depends on whether the U.S. tips into recession or not. Thus, we would not be surprised if the major stock indices sketched out a wide but trendless path over the coming months as new price breakouts rarely occur when growth is slowing, inflation is rising, and policy is tightening.

The Fed normally commences tightening as the economy is experiencing its so-called escape velocity during the second year of an expansion when it can organically support itself. However, the current cycle has been interrupted by the evolution of COVID-19 and its variants, leading policymakers to take an extra cautious stance last year despite the recovery. Rarely if ever has the Fed been this far behind the curve at the start of a tightening cycle, meaning never has inflation deviated so far above the 2% target alongside an

unemployment rate that is meaningfully below the CBO's estimate of full employment (i.e., the level that is noninflationary).

The recent spike in crude oil prices following the Russian invasion of Ukraine complicates the central bank's mission. If the rise in price persists, then it is likely to sustain broader inflation pressures as businesses pass along the cost yet again to the end-consumer. High inflation typically leads a slowdown in economic activity by approximately 18 months but the spike in energy prices is particularly troubling given that past surges of 50% or more in inflation-adjusted Brent crude prices above the prevailing trend have preceded nearly every recession of the past 50 years. Thus, investors should take note and caution given this 50% deviation level currently sits at approximately $101-$111 per barrel.

The bond market will have a lot to say about whether or not the Federal Reserve can thread the needle during this tightening cycle. While the Fed can influence short term rates, longer maturities are more dependent on a confluence of factors beyond monetary policy such as the trajectory of economic growth and longer-term inflation expectations. Yield curve inversions (when 10-year Treasuries yield less than 2-year Treasuries) have led every recession of the past 50 years by 18-24 months and the current 10-2 spread is a slim 22 bps, indicating limits to the Fed achieving its policy objective without causing a significant slowdown in growth or even a recession. Fed fund futures and swap markets (where large businesses and investment banks hedge transactions expected to settle at a forward date) are even pricing in an interest rate cut by 2024, showing how delicate this balancing act will be between inflation and growth over the coming year or so, and the increasing likelihood the current economic cycle will be shorter in duration than those of recent memory.

As the COVID-19 pandemic transitions into an endemic stage, there is hope that a "re-opening 2.0" occurs over the coming quarters and that household demand reorients more towards the service economy, giving the goods sector some breathing room as supply chains become untangled. Chairman Powell is also hoping that an increase in the labor supply will relieve some of the upward pressure on nominal wages, without necessitating a rise in the unemployment rate. This was evident in the most recent employment report for the month of February, although one month does not make a trend. There is still room for prime age worker (ages 25-54) participation to rise to the pre-pandemic 83.1% level of January 2020, which would essentially fill the 2.1 million shortfall in workers employed that still exists relative to early 2020. Employment data is a lagging indicator, however, so it bears watching if the tighter financial conditions begin to bite in the coming months.

Over the past couple of economic cycles the global economy could depend on China to lift it out of weaker periods. However, Chinese leadership has prioritized political goals over economic ones recently, which has led to sharply slower growth. These measures include tightening controls on technology companies, restricting overseas share listings, and banning Australian coal. It also continues to deal with the fallout in the property sector and the financial failure of several large property developers. The wisdom of China's so-called "Zero-COVID" policy, which entails relatively severe mitigation strategies compared to those experienced in democracies, is also being questioned as it has played a large part in much of the supply-chain induced inflation experienced by the global economy due to the halting of manufacturing production for weeks at a time in regions with significant outbreaks. The MSCI China stock index was down more than 54% from its 52-week peak recently before Chinese officials announced a course-correction on March 16th, promising to stabilize markets, ease the regulatory crackdown, and support its private companies.

The Russian invasion of Ukraine has created the largest humanitarian crisis in Europe since WWII but has further united the free world against authoritarianism. Russian President Vladimir Putin has miscalculated the will of the Ukrainian people to fight for their freedom, supported by the united resolve of the West. The quickly imposed economic sanctions has forced both countries and corporations to make political and economic decisions that will have implications for years to come. Peak globalization seems to be in the rearview mirror in a global economy that had already begun to reorient some supply chains like

semiconductors in the name of national security to combat the rise of China as a global power. The current sanctions regime has the potential to accelerate the shake-up of geopolitics and economic decision-making based on shared values and strategic goals, which could change both the price of goods and how business is conducted in the years ahead.

Investment Conclusion

Diversification has enabled office accounts to weather the current correction better than the headline indices. Strong gains in energy and commodity-related equities along with holdings in consumer staples and healthcare have helped cushion stock portfolios while maturing bonds and above average cash levels provide ample liquidity for reinvestment. Paring back on successful stock positions has enabled us to lower equity exposure on the margin in many cases while partially re-deploying proceeds into highly-researched distinctive competence companies that will ensure portfolios remain fresh for the long run. We are also buying short maturity Treasury notes near 2% yields and some corporate bonds above 3% in many balanced accounts, the most attractive levels in more than three years. Cash levels remain ample and portfolios are appropriately positioned should volatility continue in the months ahead.

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