QUARTERLY MARKET UPDATE

APRIL 2022

MARKET LANDSCAPE

Name	2022 YTD Returns (%)
Barclays US Aggregate Bond	-5.9
Barclays US Credit	-7.4
S&P 500 TR USD	-4.6
Barclays US Corporate High Yield	-4.8
MSCI Emerging Markets	-7.0
MSCI EAFE	-5.9
Russell 2000 TR USD	-7.5

Data Source: Morningstar Direct

Changing Conditions

2021 was a remarkable year and proved kind to global stocks. In the US, the combination of government fiscal and monetary support, coupled with a recovering economy, was a potent mixture supportive of markets.

The continued monetary assistance of the Federal Reserve (Fed) demonstrated how institutional support has been a significant backdrop to the economic picture. The Fed has held the Fed Funds Rate to very low levels over the past decade plus. Nine of the last fourteen years has seen the rate range bound from 0.00 - 0.25%, which is unprecedented.

Additionally, the Fed has undertaken various episodes of quantitative easing, where it prints money and buys bonds issued by the United States Treasury to keep longer-term interest rates lower.

Fiscal policy has also been extremely accommodative the last couple of years. Since the beginning of 2020, the US Government has spent almost $6 trillion directly related to COVID relief, much of that in the form of direct transfer payments to businesses and individuals.

All of this has created a situation where people and businesses can borrow more easily, amplifying economic activity in terms of more jobs, higher incomes, greater spending, increased corporate profits, and ultimately strong markets.

Given this backdrop, it was not a terribly bold assertion that markets, or specifically risk assets would thrive last year. Predictions regarding market behavior were decidedly less complicated than they are now. The magnitude of these tailwinds is diminished, and the economic landscape is much less certain.

The Federal Reserve has embarked on a rate hiking regimen to combat high inflation, supply chain disruptions remain aggravated by the Russian invasion of Ukraine, and increased energy costs and second and third order effects of financial sanctions towards Russia threaten European, US and global growth projections, as well as corporate earnings prospects this year.

As such, broad based indexes have struggled (though have recovered from intra-quarter lows), with the Standard and Poor's (S&P) 500 having fallen approximately 5% percent year-to-date (YTD), international stocks having declined around 6% percent, and bonds also falling commensurately.

Sector Returns

S&P 500 Sectors	2022 YTD Returns (%)
Communication Services	-11.9
Consumer Discretionary	-9.0
Consumer Staples	-1.0
Energy	39.0
Financials	-1.5
Health Care	-2.6
Industrials	-2.4
Information Technology	-8.4
Materials	-2.4
Real Estate	-6.2
S&P 500	-4.6
Utilities	4.8

Data Source: Morningstar Direct

Inflation

The Federal Reserve's number one priority currently is to address inflation. Events in Ukraine and Europe have complicated the mission, as agricultural, material, and energy prices are significantly impacting producers and consumers. Global expenditures on transportation, heating and food continue to increase significantly.

The annual inflation rate in the US accelerated to 7.9% in

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February of 2022, the highest since January of 1982. This elevated level might suggest that peak inflation is near, though given its trend over the past number of months, this assertion might be premature as inflation has kept drifting higher.

This expectation is predicated on some resolution to supply chain issues, as well as continued wage gains attracting greater numbers of workforce participants. Even if we ended the year at levels consistent with the Fed's expectations, it would still result in the average inflation for the year to register in the mid 5% range.

Our projection is less optimistic in part due to corporate reluctance to embrace profit margin compression that would follow from voluntarily relinquishing current pricing power. Not until there's a pronounced drop off in sales from consumers no longer willing to pay higher prices will companies willingly cut prices. We do recognize, though, the possibility of an aggressive Fed accelerating this dynamic as higher interest rates will pressure consumer demand.

Fear of Recession-Stagflation

As we move into a period of tightening fiscal and monetary conditions, questions regarding the impact these changes will have on consumers remain. Spending activity over the past year and a half cannot be sustained as artificial stimulus is removed.

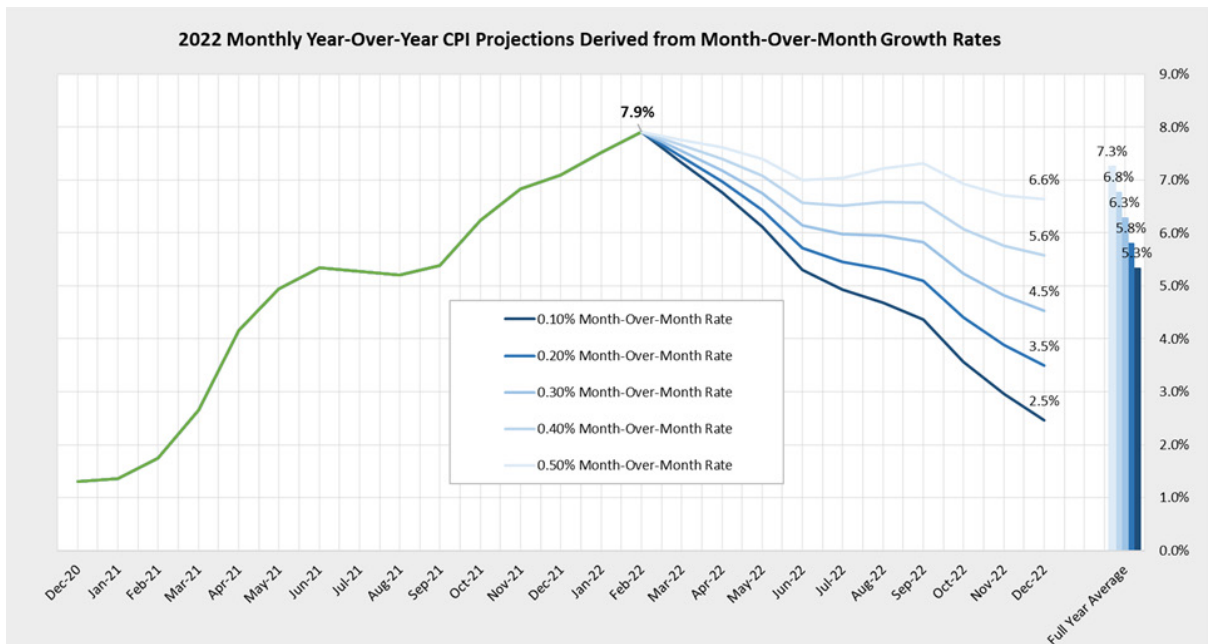
And as the Fed pivots to address inflation, some fear that its response will dampen economic activity too severely and cause a recession or stagflation. This perception references an inverted yield curve, which is where short-term interest rates (commonly cited as the 2-year Treasury yield) are higher than longer-term interest rates (as measured by the 10-year Treasury yield). Inverted yield curves are viewed as recession predictors.

Additionally, consumer sentiment is waning. The University of Michigan consumer sentiment for the US was revised slightly lower to 59.4 in March of 2022, the lowest reading since August of 2011. Respondents not surprisingly referenced inflation and higher cost of living as the key culprit and is causing a 6% annualized differential in retail sales to inflation.

However, this pessimism discounts the importance of a reopening economy. Throughout the pandemic, government support disincentivized employment to some degree. What has been termed the "great resignation" severely impacted workforce participation. As these benefits have diminished, we've seen 1.7 million jobs created in the first three months this year. Expectations place total job creation at greater than 4 million by year end.

All of this combines to the prospect of decent gross domestic product (GDP) growth this year, likely in the 2.5- 3.0% range, accompanied by inflation in the 5.0% range. Certainly not ideal, but

Chart 1 - Inflation Projections



Source: YCharts

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we can't forget the equity markets are fundamentally a function of business profitability. Therefore, despite current circumstances, we expect economic growth to continue apace, allowing for the generation of solid corporate profits.

Relating to the inverted yield curve, we view this as not necessarily a prelude to recession, but the bond market telegraphing fewer than anticipated rate hikes this year, and perhaps even a reversal in its tightening policy at some point down the road, even if inflation remains elevated.

Geopolitical Events

Geopolitical events have been the biggest wild card to global markets this year. While investors have been focused on the prospect of rising interest rates for some time, the Russian invasion of Ukraine caught markets off guard.

Aside from the humanitarian tragedy we are witnessing, these events have triggered secondary and tertiary effects that will be felt for a long time to come, some of which will not be known right away. Of course, we're experiencing the immediate impact of others.

The energy price spikes, most prominently in Europe but cascading globally, are causing great difficulty. Crude oil prices are up approximately 43% in 2022 and natural gas prices are up almost 60%. The geography impacted by the incursion is resource rich, and prices for raw materials outside of energy have also rapidly inflated.

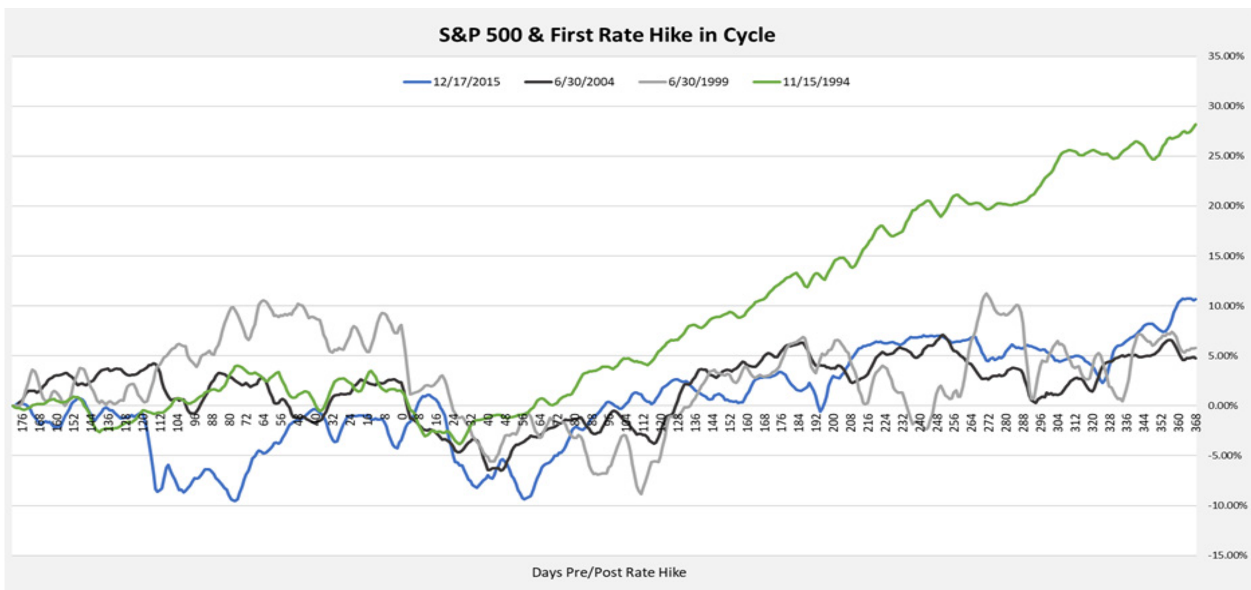
The US dollar has been strengthening, posing difficulty for multinational companies, while another round of supply chain disruptions impact consumers struggling with a decline in inflation adjusted wages. Additionally, global market volatility and declining consumer confidence diminishes the psychological wealth effect enhanced by recent market performance.

The combined headwinds created by the mixture of geopolitical and institutional uncertainty have not, however, sufficiently diminished global growth and earnings expectations. Downward revisions are warranted, but so far, the tangible quantitative impacts are not as severe as their psychological counterparts.

It's worth mentioning that market valuation, being diminished by current events, could provide a catalyst for late cycle strengthening if/as hostilities curtail or become less of a market focal point.

Volatility in Context

Chart 2 - Rate Hikes Cause Short-Lived Selloffs



Source: YCharts

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As we embark on another interest rate tightening cycle, it's worth revisiting how investor psychology is historically impacted and what it means for markets down the line. Obviously, low rates are supportive of risk assets, and inject much more of a risk-on attitude into investors. As interest rates are telegraphed to increase, though, investor attitudes initially turn cautious. Chart 2 demonstrates this.

This injection of restraint results in short term selloffs as investors attempt to assess the real impacts. However, we see that this assessment period is essentially short-lived and does not cause significant or lengthy periods of downside volatility. Anywhere from two to four months after the initial rate hike from the Fed, markets have recovered from their jitters and continue to post positive returns.

We do recognize, however, that we are currently in an unprecedented environment. We have been in an exceptionally long bull market, created through low interest rates and an expanding Fed balance sheet supporting economic growth and corporate profits. Market valuations are no longer considered cheap, inflation is rising, and geopolitical events are creating uncertainties which are impacting global growth to an unknown degree.

And we also understand the difficult position in which the Federal Reserve finds itself. It is trying to raise interest rates to combat inflation, which is a de facto growth dampener, while not affecting economic growth to an undo degree. This won't be easy, and we don't have any illusions that it will be perfectly successful.

There is a lot going on which investors must digest, but given the underlying broad based global economic strength, we remain optimistic regarding constructive outcomes in capital markets yet this year. This assertion rests on an assumption that the US will see approximately 2.5% GDP growth in 2022, a 10-year Treasury yield between 2.50 to 2.75%, and S&P 500 earnings growth of about 8 to 10%.

Because the fact is, capital markets, or stock markets specifically, are pricing mechanisms predicated on earnings expectations discounted by an interest rate. Valuation models are simple math based on these inputs. If these assumptions prove somewhat accurate, it's reasonable to think that neither a period of rising interest rates, nor current events in Russia and Europe on their own will generate negative growth scenarios.

However, we do not expect the sizable returns of both stocks and bonds of the recent past to continue and would caution investors to reduce return expectations going forward.

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