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Market Commentary Q1 2022

With the first quarter of 2022 now over, the U.S. stock and bond markets have left investors to decide between which signal to follow. Equities posted their first negative quarter in two years along with a rare -5% drawdown for a 60/40 portfolio (60% stock, 40% bonds). The year started off with the S&P 500 recording its worst January since 2009, only to come roaring back from a double-digit decline to finish the quarter -4.9%.[1] It was a rebound that defied worries over tighter monetary policy and geopolitical instability stemming from the war in Ukraine. Finally, in the last week of March, the 2/10-year portion of the US Treasury yield curve inverted, raising fears among investors that a recession may be in the cards.

For some additional historical perspective, of the 185 quarters since 1976, a negative quarterly return for both stocks and bonds has occurred only 19 times or 10% of the time, including the first quarter of 2022.[1] Furthermore, over the same period, there are just four instances where both stocks and bonds are negative for two consecutive quarters with three of those four instances associated with a recession.[1]

Leading US Indices (Total Return)	2020	1Q'21	2Q'21	3Q'21	4Q'21	2021	1Q'22 (sorted)	YTD
S&P/Citigroup Value	1.4%	10.8%	5.0%	-0.8%	8.3%	24.9%	-0.2%	-0.2%
S&P 500 Total Return	**18.4%**	**6.2%**	**8.5%**	**0.6%**	**11.0%**	**28.7%**	**-4.6%**	**-4.6%**
S&P 100 Mega-Cap	21.5%	5.1%	9.4%	1.0%	11.3%	29.4%	-4.6%	-4.6%
S&P 400 Mid-Cap	13.7%	13.5%	3.6%	-1.8%	8.0%	24.8%	-4.9%	-4.9%
S&P 600 Small-Cap	11.3%	18.2%	4.5%	-2.8%	5.6%	26.8%	-5.6%	-5.6%
Dow Jones Wilshire 5000	20.0%	5.8%	8.1%	-0.6%	8.1%	22.8%	-5.9%	-5.9%
Russell 2000	20.0%	12.7%	4.3%	-4.4%	2.1%	14.8%	-7.5%	-7.5%
S&P/Citigroup Growth	33.5%	2.1%	11.9%	1.9%	13.4%	32.0%	-8.6%	-8.6%
Nasdaq	44.9%	3.0%	9.7%	-0.2%	8.4%	22.2%	-8.9%	-8.9%

S&P 500 Sectors (Total Return)	2020	1Q'21	2Q'21	3Q'21	4Q'21	2021	1Q'22 (sorted)	YTD
Energy	-33.7%	30.9%	11.3%	-1.7%	8.0%	54.6%	39.0%	39.0%
Utilities	0.5%	2.8%	-0.4%	1.8%	12.9%	17.7%	4.8%	4.8%
Staples	10.7%	1.1%	3.8%	-0.3%	13.3%	18.6%	-1.0%	-1.0%
Financials	-1.7%	16.0%	8.4%	2.7%	4.6%	35.0%	-1.5%	-1.5%
Industrials	11.1%	11.4%	4.5%	-4.2%	8.6%	21.1%	-2.4%	-2.4%
Materials	20.7%	9.1%	5.0%	-3.5%	15.2%	27.3%	-2.4%	-2.4%
Health Care	13.4%	3.2%	8.4%	1.4%	11.2%	26.1%	-2.6%	-2.6%
S&P 500 Total Return	**18.4%**	**6.2%**	**8.5%**	**0.6%**	**11.0%**	**28.7%**	**-4.6%**	**-4.6%**
Real Estate	-2.2%	9.0%	13.1%	0.9%	17.5%	46.2%	-6.2%	-6.2%
Technology	43.9%	2.0%	11.6%	1.3%	16.7%	34.5%	-8.4%	-8.4%
Discretionary	33.3%	3.1%	6.9%	0.0%	12.8%	24.4%	-9.0%	-9.0%
Communication Services	23.6%	8.1%	10.7%	1.6%	0.0%	21.6%	-11.9%	-11.9%

Source – Strategas Securities, LLC

Rate hikes directly impact the effective Federal funds target rate, which is the intra-bank lending rate. This rate is then passed through into other lending securities, which include a spread for additional risks. The objective of the Federal Reserve ("Fed") is to slow the pace of inflation while maintaining a healthy jobs market, economic growth, and price stability. If they can execute this, it will be only the second time in the history of Fed tightening policy that does not result in a recession.

With the curve briefly inverting, we figured it best to provide some context on previous inversions and how the market has reacted. Generally, curve inversions lead recessions by 12-18 months. The S&P 500 has averaged +7.7% in the first year the Fed raises rates.[1] Further, the S&P 500 showed positive returns throughout 11 of the past 12 rate-hike cycles at an average annualized rate of +9.4%.[1]

So, is this time different? While rate hikes and reduced Fed buying does increase the cost of borrowing, it cannot speed up the transportation of ocean freighters, it does not increase the supply of oil and it does not push pandemic retirees to return to work. With that said, at the time of this writing, we are seeing a healthy consumer and strong corporate balance sheets that we anticipate will help contribute to GDP, albeit at a lower level. It is these factors that add conviction amongst Fed members that the economy can handle higher rates, we will see.

The inflation trajectory remains crucial for markets. It is and has been the biggest priority because it is the biggest risk to the economy. If inflation starts to normalize with the broader economy, it can take some heat off the Fed and allows it to hit its goals without slamming on the brakes. On the flipside, if inflation continues to gather steam or run this hot, then the Fed may end up inducing a recession to bring it back to target like it has in the past. It is for these reasons that the equity market is a beneficiary of, and hedge towards, inflation. Much like we have portfolios aligned.

The U.S. labor market is very robust. Historically, the U.S. economy doesn't go into recession without labor market weakness. So, as we see it, the Fed has a green light to remove accommodation faster, and push through multiple rate hikes. We are even hearing in Fed meetings, the proposal of +0.50% rate hikes. The Fed is now likely in a tighten until something breaks mode.

It is prudent to separate the market panic from real impact on company earnings when it comes to the war between Russia and Ukraine. The markets have already recovered and surpassed their levels since Russia invaded. Without diminishing the lives lost and devastating impact on the Ukrainian people, it's becoming increasingly evident that the most significant effect for global markets is related to commodities, more specifically, energy. The U.S. and the EU among other nations along with many independent companies, continue to impose new sanctions or restrictions aimed at Russia, including the ban of Russian oil imports. Commodity prices have surged due to the supply constraints and uncertainties. Higher commodity costs and supply uncertainties contribute further to the inflationary pressure already impacting the price of goods. We do not believe there will be a deal in Ukraine anytime soon and we do not believe sanctions are coming off anytime soon.

Getting to energy. The White House decided to dip into the country's strategic petroleum reserves, in a push to pump the brakes on soaring gas prices (FYI: it's an election year). Some states have even temporarily suspended their gas tax! President Biden authorized tapping 1 million barrels/day from the strategic petroleum reserve for six months (total: 180M barrels), the largest release ever.

For further context, the U.S. consumes approximately 20 million barrels of oil every day. Adding 1 million barrels to the daily supply could in theory lower crude prices, which would trickle down to the pump. But it's not a sure bet. As we know, oil prices are set on complex global futures markets and OPEC, among other things. As of now, many analysts expect any dips to be temporary.

Shifting gears to fixed income, the Bloomberg Barclays US Aggregate Bond index ("Agg"), which acts as a proxy for the investment-grade bond market, decreased by almost -6% in the quarter, the worst quarterly decline since 1980.[1] The increase in interest rates had a negative impact on returns (bond prices move inversely to interest rates). We hold fixed income to provide stability and income to portfolios and they have done just that in our clients' portfolios. We maintain a short-duration, high quality mix of bonds that has outpaced the Agg so far this year.

With higher costs of necessary capital projects, municipalities may choose to increase the amount of debt financing or draw down on cash on hand to absorb cost overages. Both options can ultimately begin to reduce credit quality over time. We are seeing wage pressures impacting operations and resulting in higher pension liabilities due to increasing cost-of-living adjustments as well. While all municipal bond issuers would be impacted, not all are equally equipped to navigate the changing landscape. Individual security analysis is required.

While it is important to acknowledge the inflation risks facing issuers, we also acknowledge the ongoing state of municipal finances. Thanks to a record influx of federal aid, many municipalities are in better shape than they were prior to the pandemic. In this uncertain interest rate and economic environment, shorter-maturity bonds have outperformed longer maturities, while municipal bonds with higher relative credit ratings have outperformed bonds of lower quality.

US Yields	4Q'20	1Q'21	2Q'21	3Q'21	4Q'21	1Q'22	Q/Q Chg (bps)	Y/Y Chg (bps)
Fed Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.50	25	25
3-Month T-Bill	0.08	0.01	0.05	0.04	0.05	0.52	47	51
2-Year Note	0.11	0.11	0.25	0.28	0.73	2.28	155	217
5-Year Note	0.31	0.74	0.69	0.74	1.07	2.51	144	176
10-Year Bond	0.87	1.70	1.40	1.46	1.44	2.36	92	66
30-Year Bond	1.64	2.42	2.07	2.09	1.89	2.44	55	2

Source – Strategas Securities, LLC

We witnessed historic lows in European equities in the first quarter of 2021. The region has close economic ties with Ukraine and Russia, particularly when it comes to reliance on Russian oil and gas. The invasion led to a spike in energy prices and caused some fears about security of supply throughout the region.

In response to rising inflation, the European Central Bank ("ECB") outlined plans to end bond purchases by the end of September. ECB President Christine Lagarde indicated that a first interest rate rise could potentially come this year. The ongoing war in Ukraine and rising inflation led to a small pullback in forward-looking measures of economic activity with the flash eurozone composite purchasing managers' index or PMI, slipped to 54.5 in March from 55.5 in February, though a level over 50 still represents expansion.[1]

Emerging market ("EM") equities overall were firmly down in the first quarter as geopolitical tensions took center stage following Russia's launch of a full-scale invasion of Ukraine. China lagged by a wide margin as daily new cases of COVID-19 spiked, and lockdowns were imposed in several cities, including Shanghai. Regulatory concerns relating to US-listed Chinese stocks also contributed to market volatility. Stocks in China had their worst quarter since 2015.[1]

Conversely, the Latin American markets all generated strong gains, led higher by Brazil. Other EM net commodity exporters posted sizeable gains as well. Russia was removed from the MSCI Emerging Markets Index in March, at a price that is effectively zero.

International Indices (Price Chg)	2020	1Q'21	2Q'21	3Q'21	4Q'21	2021	1Q'22 (sorted)	YTD
Bovespa (Brazil)	2.9%	-2.0%	8.7%	-12.5%	-5.5%	-11.9%	14.5%	14.5%
Bolsa (Mexico)	1.2%	7.2%	6.4%	2.2%	3.7%	20.9%	6.1%	6.1%
S&P/TSX (Canada)	2.2%	7.3%	7.8%	-0.5%	5.7%	21.7%	3.1%	3.1%
FTSE 100 (UK)	-14.3%	3.9%	4.8%	0.7%	4.2%	14.3%	1.8%	1.8%
Sensex (India)	15.8%	3.7%	6.0%	12.7%	-1.5%	22.0%	0.5%	0.5%
All Ordinaries (Australia)	**0.7%**	**2.4%**	**8.1%**	**0.6%**	**2.0%**	**13.6%**	**0.1%**	0.1%
IBEX 35 (Spain)	-15.5%	6.3%	2.8%	-0.3%	-0.9%	7.9%	-3.1%	-3.1%
Nikkei 225 (Japan)	16.0%	6.3%	-1.3%	2.3%	-2.2%	4.9%	-3.4%	-3.4%
Swiss Market Index	0.8%	3.2%	8.1%	-2.5%	10.6%	20.3%	-5.5%	-5.5%
Hang Seng (Hong Kong)	-3.4%	4.2%	1.6%	-14.8%	-4.8%	-14.1%	-6.0%	-6.0%
CAC 40 (France)	-7.1%	9.3%	7.3%	0.2%	9.7%	28.9%	-6.9%	-6.9%
Kospi (South Korea)	30.8%	6.5%	7.7%	-6.9%	-3.0%	3.6%	-7.4%	-7.4%
DAX (Germany)	0.4%	9.1%	1.5%	-1.8%	4.1%	13.0%	-9.5%	-9.5%
OMX Stockholm 30 (Sweden)	5.8%	17.0%	3.2%	-0.2%	7.1%	29.1%	-13.4%	-13.4%
Shenzhen SE A Shares (China)	35.2%	-4.8%	11.2%	-2.9%	5.6%	8.6%	-16.3%	-16.3%

Source – Strategas Securities, LLC

So, what does all of this add up to when we look out towards the back half of the year. There are many economic indicators that are flashing positive and negative, and the question is, which ones will win out? Forward-looking markets are concerned about what comes next. Fed tightening should generate a period of below-trend growth. Overdoing tightening often risks going negative. Bottom line is that there is a long list of global risks at the moment. The Fed is still trying for an economic soft landing, but the pathway has gotten narrower for this outcome.

This is going to have to be a joint effort from both the Fed and the private sector. The Fed cannot bring inflation down by themselves without tightening substantially. Our base case remains a mid-cycle slowdown as the private sector helps the Fed bring inflation under control. With the domestic labor market still solid and JOLTS job openings elevated, it remains difficult to make a U.S. recession call now.

March 23rd marked the 2-year anniversary of the COVID lows. The S&P has been stellar since then with a move that borders on a 99th percentile 2-year percent change.[1] When you consider all the noise out there currently, the market hasn't been that volatile. We haven't seen real volatility in a long time, in fact, we've had a couple of the least volatile years on record recently. The first quarter barely qualified as a correction. The average correction has around a -14.4% drop.[1] At our low, we were down 13%.[1] The market's higher now than when Russia invaded Ukraine!

Historically, following yield curve inversions, defensive sectors have led the market in the 12-months following an inversion.[1] While this should come as no surprise, we get the sense that most portfolio positioning across our industry largely does not yet reflect this due to the decade of outperformance from growth. The virtues of an active approach to both stock selection and risk management can be most evident at times of significant market disruption. Hence the reason most of our client portfolios have actively managed funds or strategies.

In writing this commentary, a question we get from a lot of individuals that are closing in on retirement or that are in retirement is, how do you reduce portfolio risk in retirement when bonds aren't the hedge they used to be? Times have changed, investors must start thinking more about total return as opposed to just income. If you look at where we are when it comes to inflation, you might feel good having a low volatility portfolio that's paying you a few percent, but you're going to wake up a decade from now and have a real problem. A lot of investors view things going down as risk, but things going up but not as much as the cost of inflation is also a risk. At the end of the day, all you need to care about is do you have enough money to buy what we need in the future.

Yes, there's going to be some volatility. But by introducing these riskier assets, you reduce the risk of the overall portfolio over the long-term. The prevailing backdrop highlights the importance of building resilience into portfolios. We believe this is best achieved through diversification and a focus on quality stocks of companies with strong balance sheets and healthy free cash flow characteristics.

As we mentioned in a previous market commentary, diversification not only entails owning stocks and bonds but also alternatives. We continue to implement and recommend that our clients hold a meaningful weight in alternatives such as private equity, real assets such as real estate and infrastructure, non-correlated hedge funds, gold, and managed futures.

We believe investors are currently facing a significant question today, can the Fed get control of inflation without inducing a recession? Something that has had mixed results in the past. The rally in growth stocks in March seemed to be suggesting that a slowdown rather than a recession might be in the cards. When you access the broader macroeconomic picture, you see full employment, plentiful job openings, strong corporate and personal balance sheets, and still-accommodative monetary policy. This would argue against a recession in 2022. Still, the

odds of a recession next year are increasing as the Fed seems to be indicating that it has little choice but to continue to tighten until significant progress is made on inflation.

To discuss this commentary further, please contact us at 914-825-8630.

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