Quarterly Investment Commentary – Q1 2022

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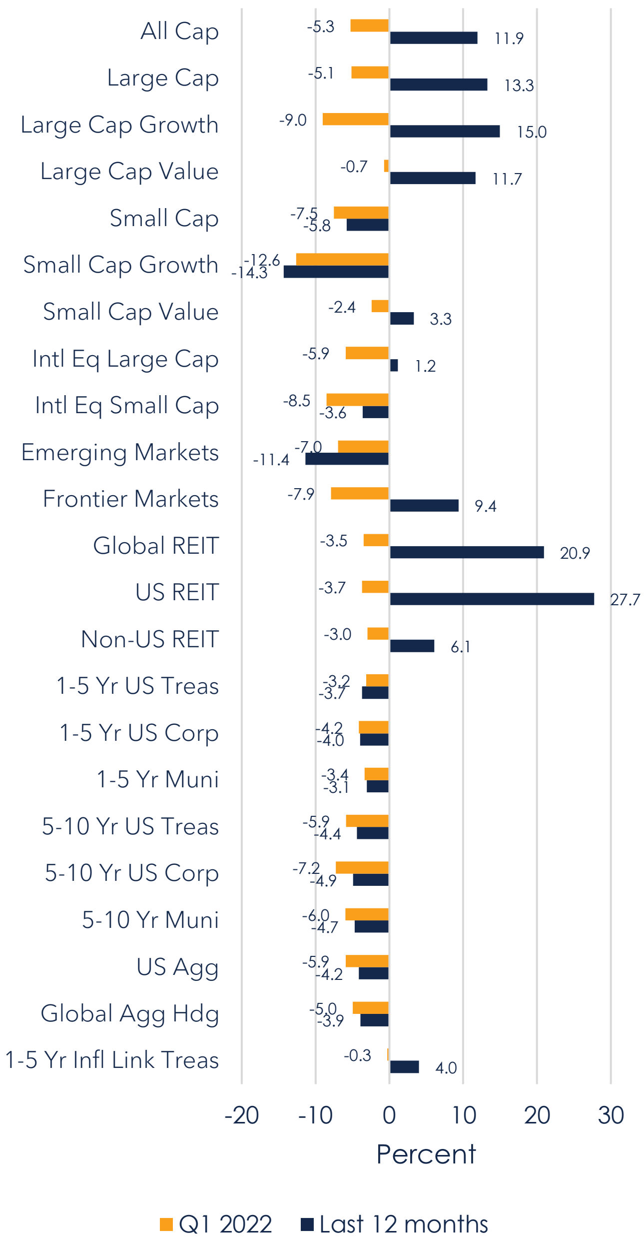
PERIODIC RETURNS



KEEPING A BALANCED APPROACH

Summary:

- **Global economy being impacted by several items including the continuation of Covid-19, geopolitical fallout from invasion of Ukraine, plus Fed tightening of monetary policy**
- **Volatility is normal and is expected**

Positive Signals:

- ✓ **In the US, various statistics tell us people are trying to get back to normal**
- ✓ **Unemployment fell to 3.6% in March**
- ✓ **Economic indicators mostly stable/improving**
- ✓ **There is now more "income" available in fixed income**

Reasons for concern:

- ? **Inflation has been rising and is well above 2% Fed target**
- ? **Rising rates can be painful while it's occurring; the Bloomberg US Aggregate experienced its third worst quarter in history, falling -5.9%**
- ? **Will the Fed get it right? Did they not tap the brakes early/hard enough? Are they going to slam brakes in the future?**

Source: Morningstar; Russell, MSCI, Dow Jones, Bloomberg, ICE BoA ML benchmarks shown; past performance is not indicative of future results

Uncertainty reigns supreme

More than we can remember in the recent past, there is one word we read and see more of in the financial press. That word is "uncertainty". The uncertainty comes at many levels including economic, geopolitical, and health, all areas where there appear to be more questions than solid answers. In addition, events could unfold rapidly, so the paragraphs below have the potential to be stale by the time you actually get to read them.

As a great example of the uncertainty, a recent webinar from a well-known portfolio manager placed his thoughts in opposing if-then statements. In one instance, "if" supply-side factors continue to pressure inflation higher for longer, "then" investors should adjust their long-term real return expectations lower (possible stagflation scenario). BUT…"if" supply side factors and inflation ease, long-term inflation expectations don't need to rise further and may even fall (stagflation not expected in this scenario). Obviously, these are mutually exclusive events with very different economic outcomes.

Another asset management firm, Nuveen, created their own vision of how they view the current uncertainty by placing odds on various scenarios including the chance of recession (roughly 10%), soft landing by the Fed (roughly 50%), and stagflation (roughly 10%). They also placed the chance of a completely different outcome from these three, what they referred to as an "unknown unknown" at close to 30% (see Exhibit 1).

Exhibit 1

RECESSION Growth and inflation decline rapidly	SOFT LANDING Slower but still strong real growth, with lower inflation	STAGFLATION Inflation remains highand real growth declines
Fed reverses course	Fed hikes to "neutral" rate	Fed hikes past "neutral" rate
Rate-sensitive assets recover	Rate-sensitive asset returns muted	Rate-sensitive assets struggle, then eventually outperform
Earnings estimates weaker	Earnings estimates higher	Earnings estimates weaker
Stock P/Es mixed-higher Higher quality credit spreads tighter	Stock P/Es mixed Credit spreads stable-tighter	Stock P/Es fall Credit spreads wider
Commodities and productive real assets struggle	Productive real assets outperform	Commodities and productive real assets outperform
Nuveen CIO odds = ~10%	Nuveen CIO odds = ~50%	Nuveen CIO odds = ~10%

"Unknown unknowns"
(a different outcome from any of the above)
Nuveen CIO odds= ~30%

Source: Nuveen Portfolio Strategy. For illustrative purposes only.

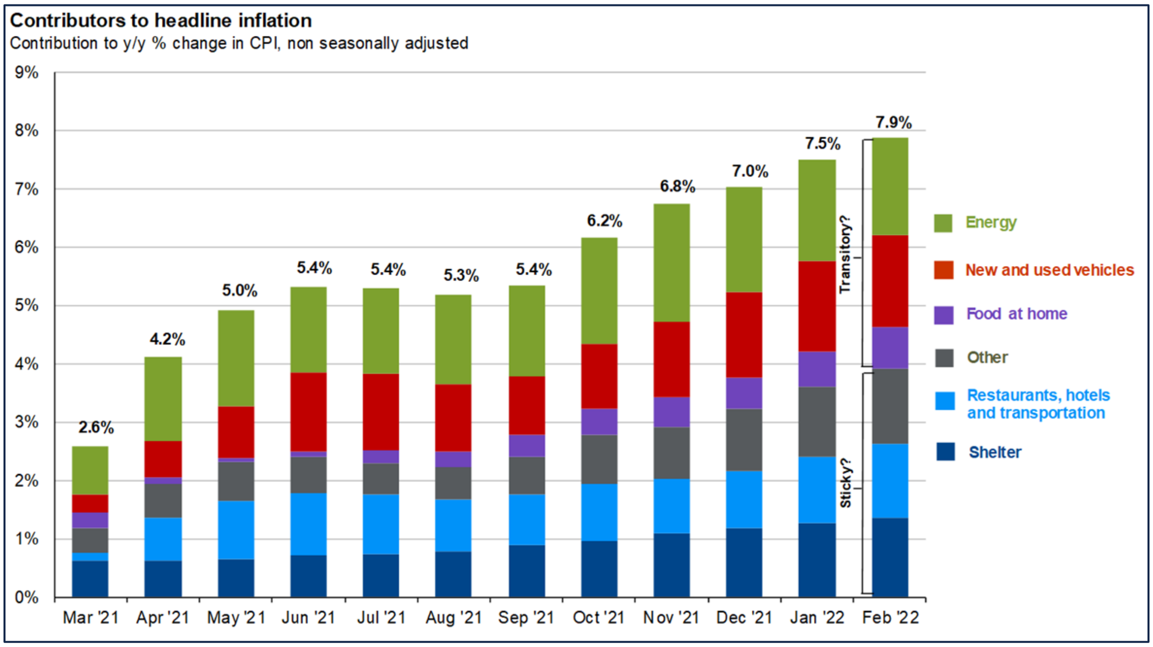
If you are a regular reader of this quarterly commentary, you have likely heard us say that one thing financial markets don't like is uncertainty. It is exactly this uncertainty that has led to volatility in both fixed income and equity markets. And while no one likes seeing negative returns, we understand they will happen from time to time.

Even with the uncertainty, there are some positive economic signals out there. For example, at least in the US, people appear to be trying to get back to their pre-pandemic lives as hotel occupancy rates, TSA traveler traffic and the number of people eating out are all approaching the level they were at the same time in 2019. Overall, this shows a shift of consumers once again spending more on services and leisure activities over just purchasing goods. Also, most leading and coincident economic indicators like unemployment claims, building permits and industrial production are at strong levels with trends that are either stable or improving. In addition, the unemployment rate fell to 3.6% in March 2022. To paraphrase Oprah, "you get a job, and you get a job."

Even with these positive signals, one of the main concerns is higher and possibly still increasing inflation, which eats away at investor return. As of this writing, the last readings we had for headline CPI (a common measure of inflation) and PCE (the Fed's preferred measure of inflation) were 7.9% and 6.4% respectively, both of which are considerably higher vs. the Fed's average inflation target of 2%.

The causes of the current inflation spike are well documented and include tight supply chains, worker shortages, increased consumer spending and rising energy prices. Last quarter we mentioned the "Powell Pivot," a reference to Fed Chairman Powell's movement away from calling inflation transitory, or temporary, suggesting inflation may be more persistent. Looking at Exhibit 2, there may actually be some components of headline CPI inflation that are temporary. For example, if more supply becomes available, we might see a decrease in energy costs. Similarly, if supply chain issues decrease, in particular when it comes to semiconductor chips, we would expect to see an increase in new car production, which should reverse the significant increases in used car prices that we have seen. At the same time, there are some components of inflation that may be stickier, with shelter as an example. This is important because shelter comprises roughly one-third of the CPI measurement.

Exhibit 2



Source: BLS, J.P. Morgan Asset Management. Contributions mirror the BLS methodology on Table 7 of the CPI report. Values may not sum to headline CPI figures due to rounding and underlying calculations. “Shelter” includes owners equivalent rent and rent of primary residence. “Other” primarily reflects household furnishings, apparel and medical care services. *Guide to the Markets – U.S.* Data are as of March 31, 2022.

Inflation spike leads to Fed action

Oh, how quickly things change. If you look back a few months to late 2021, the Fed was still referring to inflation as temporary and the market was predicting there would be one, maybe two, Federal Funds rate increases in 2022. Fast forward a few months and things have changed. As inflationary pressures have broadened and intensified, not only did the Federal Open Market Committee increase rates by 25 bps in March 2022, the first increase in over 3 years, but they were also penciling in six more rate increases in 2022. Of course, the number of increases is still to be determined and at least partially depends on the size of the increases. For example, while the March increase was 25 bps, there is broad speculation that there may be a 50 bps increase at the next meeting in May. As Chairman Powell has indicated, they are more comfortable moving away from near-zero interest rates now that inflation is expected to exceed 2% and their definition of maximum employment has been satisfied.

As we have previously discussed, the Fed is in an unenviable position. Some would argue that they didn’t take their foot of the gas fast enough, alluding to the opinion that they didn’t move away from the pandemic-related accommodative policies soon enough. On the other hand, if they push rates up too high and too fast, they risk undoing the positives we have recently seen, risking a cooling of the economy which could potentially lead to a recession.

Outside of the US, the Bank of England increased rates by 25 bps in December 2021, February 2022, and their most recent March 2022 meeting, with their rate now reaching 0.75%, in line with its pre-pandemic levels. Separately, the European Central Bank has not publicly stated any indication they will be raising rates soon.

U.S. Equity

It wasn’t a great quarter for most investments, including US stocks, as all the indexes we track suffered negative returns for the quarter (though they were all positive in March, somewhat mitigating their poor returns in January and February). Overall, the mood on Wall Street could be described as sour as the theme of uncertainty, the invasion of Ukraine, and concerns over increasing inflation led to the down markets. For the quarter, value stocks outpaced their growth counterparts in both the large cap space (-0.7% vs. -9.0%) and in small caps (-2.4% vs. -12.6%) (Source: Morningstar Direct, Russell indexes). This was not terribly surprising as rising rates are generally expected to have a negative impact on growth stocks, as their future earnings are less attractive in today’s dollars.

In thinking about stocks in general, it is critical to remember that volatility, including down markets, is both expected and normal. To put the first quarter of 2022 in perspective, the S&P 500 experienced a decline of -13%. However, let's consider a few other notes and figures:

- Since 1980, the average intra-year decline of the S&P is 14%, so the first quarter's decline was slightly better than average.
- 2021 was more of an anomaly as the S&P 500 experienced an intra-yar decline of only -5%.
- Even with these intra-year declines in most years, the S&P 500 was still positive in 32 of 42 years.

Source: FactSet, Standard & Poor's, JP Morgan Asset Management. Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns are shown calendar year returns from 1980-2021, over which time period the average annual return was 9.4%. Guide to the markets – US Data are as of 3/31/2022

Non-U.S. Equity

Similar to US equities, all of the international equity indexes we track had negative returns for the first quarter with international developed stocks (MSCI EAFE) declining -5.9% and international developed small cap stocks (MSCI EAFE Small Cap) dropping -8.5%. Similar to last quarter, at least some of non-U.S. equities underperformance versus their U.S. counterparts can be attributed to the dollar's strength over the quarter, as we know a stronger dollar hurts international equity returns. Some of the negative return, for at least the Eurozone countries, is related to their ties to Russia and Ukraine given the unfolding events.

From a country perspective, only two (Canada and UK) of the top five developed country weights outperformed the US (Japan, France and Switzerland all underperformed). Looking at these top five countries, it may come as a surprise that Germany is the sixth largest country weight in international developed indexes. (Source: MSCI All Country World IMI Index, Russell 3000 for US).

In the emerging markets, China remains the largest country exposure by far, at just under one-third of the entire index. China fell by -14.3% over the quarter as continued Covid outbreaks followed by harsh lockdowns stifled a more positive outcome. The other large country weightings in the MSCI EM index (Taiwan, India, South Korea) all experienced negative returns for the quarter.

As we talk about emerging markets, we have to talk about the Russian invasion of Ukraine. While we are not here to be political, we believe it is safe to say that the sanctions placed on Russia have been devastating to the Russian economy. As a result, various index providers now considering Russia uninvestable, and therefore Russian stocks were removed from indexes created by MSCI and FTSE, for example. Fortunately, this change hasn't been too impactful for emerging market investments that are index-like. This is because, as Exhibit 3 shows, the weight of Russia in the MSCI EM index has steadily declined since 2008, when it comprised roughly 10% of the index. For reference, it had fallen to roughly 4% at the beginning of 2022. To put this in dollar terms, for investors with $1M invested in their portfolios with 60% allocated to equities and 40% to fixed income, if we assume a global market cap weight of 12% allocated to emerging markets, that equates to just under $2,900 allocated to Russia, a relatively small amount.

Exhibit 3

Source: https://www.msci.com/research-and-insights/russia-ukraine-war/russias-diminished-role-in-emerging-markets

Global REITs

Like global equities, global REITs, as represented by the Dow Jones Global Select REIT, declined by -3.5% over the quarter. U.S. REITs underperformed non-US REITs over the same time period (-3.7% vs.-3.0%).

Looking more deeply in the quarterly sector returns for the FTSE NAREIT US index (a REIT index that does provide sector returns publicly), lodging/resorts (6.9%) health care (5.4%), office (2.8%), and specialty (0.2%) were the only four of the fourteen sectors with positive returns for the quarter. Source: NAREIT

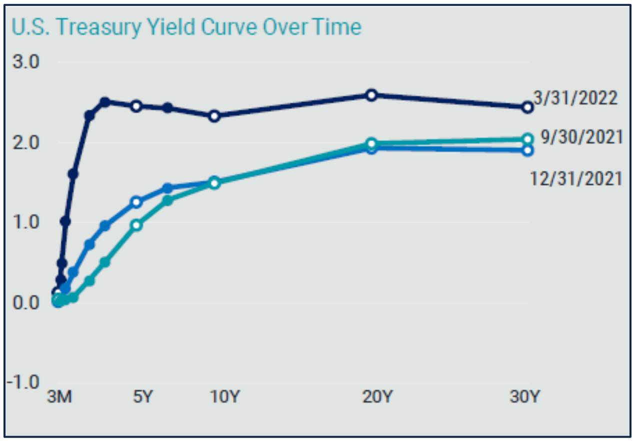
Global Fixed Income

The fixed income indexes we follow were all negative for the first quarter and are negative too for the last 12 months, with the exception of the 1-5 Year Inflation Linked Treasury index.

How bad has this most recent period been for fixed income? Well, let's consider the history of the Bloomberg US Aggregate index, probably the most common US fixed income index. If we look back to 1980, the earliest data we have available, that constitutes 169 quarterly return periods. The Q1 2022 return of -5.9% places it third worst all-time, behind Q1 1980 (-8.7%) and Q3 1980 (-6.6%). As a comparison to today, [in January 1980 inflation was a whopping 13.9% and unemployment was 6.3%]. I think it's safe to say this time is different. Interestingly, the worst annual return for the Agg occurred in 1994, when it dropped -2.9%.

Exhibit 4 provides the best picture for what has happened. Specifically, while yields have risen across the yield curve, you can see how sharply yields rose at the front end of the yield curve. These increases are occurring as market participants expect the Fed to increase the Fed Funds rate in order to combat inflation. Notice, however, that longer term rates (10-30 years), while they have increased, have not done so as much as shorter term yields. One potential explanation for this is that investors don't trust the Fed to pull off a soft landing; meaning they are suggesting the Fed's rate increases will dampen growth in the long term, with the possibility of a recession to follow.

Exhibit 4

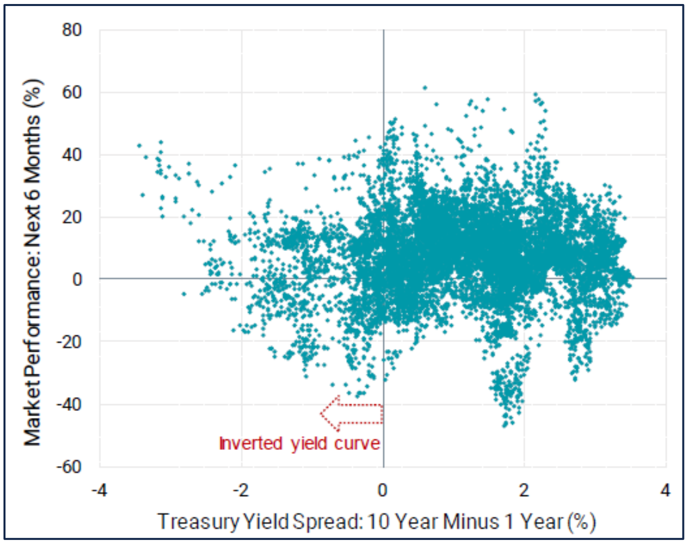


Source: Bloomberg, data as of 3/31/2022

Astute observers will also notice that parts of the current yield curve are inverted, which occurs when shorter term rates are higher versus longer term rates (a "normal" yield curve slopes upward). As of quarter end, there was still a small (4 bps) but positive difference of the 10-year over the 2-year (a traditional measure of inversion is the 2-yr vs. the 10-yr), though the 3, 5, and 7-year Treasury were all above the 10-year Treasury. Overall, the yield curve is relatively flat as of quarter-end across much of the curve, meaning longer term bondholders are being compensated similarly to shorter term bondholders, even though the risks of longer bonds are greater.

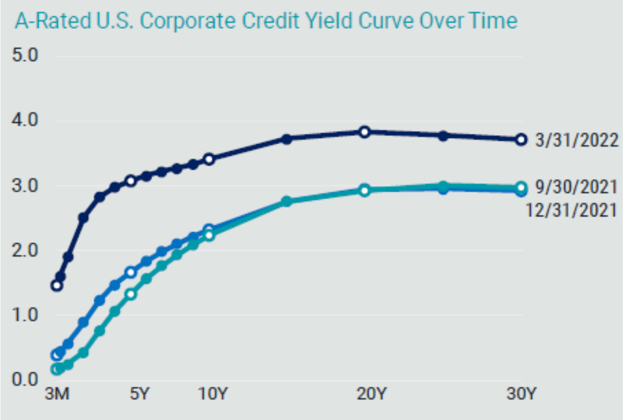
Why does this all matter? The short answer is because in recent history, yield curve inversions have preceded recessions. Therefore, it is not surprising that some are sounding alarm bells expecting the next recession is right around the corner. However, it is important to remember several items. First, while inverted yield curves may be correlated with recessions, they do not cause recessions. The yield curve inversion in 2019 is a great example. While there was a recession that followed in 2020, it is widely believed the economic fallout occurred due to the Covid-19 pandemic, something completely unrelated to the inverted yield curve. Second, there are times when recessions have occurred when the yield curve wasn't inverted beforehand, so clearly there must be other events that bring about recessions. Finally, as Exhibit 6 shows, if you look over a longer time period, there are clearly many periods of positive returns for stocks that follow inverted yield curves.

Exhibit 5



Source: Data from 10/31/1973 – 12/31/2021. St Louis Federal Reserve Bank (FRED), Avantis Investors. The CRSP US Total Market Index represents US stock market performance. Past performance is no guarantee of future results.

Exhibit 6



Source: Bloomberg, data as of 3/31/2022

It is important for investors to remember that bonds other than US Treasuries have their own, separate yield curve. For example, Exhibit 6 shows the yield curve for A-Rated US Corporates.

If you compare this chart versus Exhibit 4, you will notice two main differences. For one, the yield on A-rated corporates is generally higher than similar Treasuries. This makes intuitive sense as investors expect to be compensated for taking on additional credit risk. Second, the corporate yield curve is more normally shaped.

On a positive note, higher yields means that there is more income in fixed income, which is good for savers and those wishing to generate income from their fixed income portfolio. And while rising rates may create some pain for fixed income investors in the short run, the current interest rate remains the best predictor of future bond returns.

Municipal performance was also negative for the quarter across the muni yield curve. Like the corporate yield curve, the muni yield curve is more normally shaped than the Treasury curve. On a positive muni note, one prominent muni manager, Baird Advisors, stated "by any measure, municipal credits are strong and improving" noting budget surpluses from tax revenues including sales tax as well as property tax.

We continue to view fixed income as a method of reducing overall portfolio risk (as measured by standard deviation), given that equities are expected to have much higher volatility. Our portfolio's focus will continue to be on high quality bonds with an emphasis on short to intermediate duration government and corporate bonds, where default risk has historically been relatively low. For some investors, muni bonds are attractive for their tax-free income.