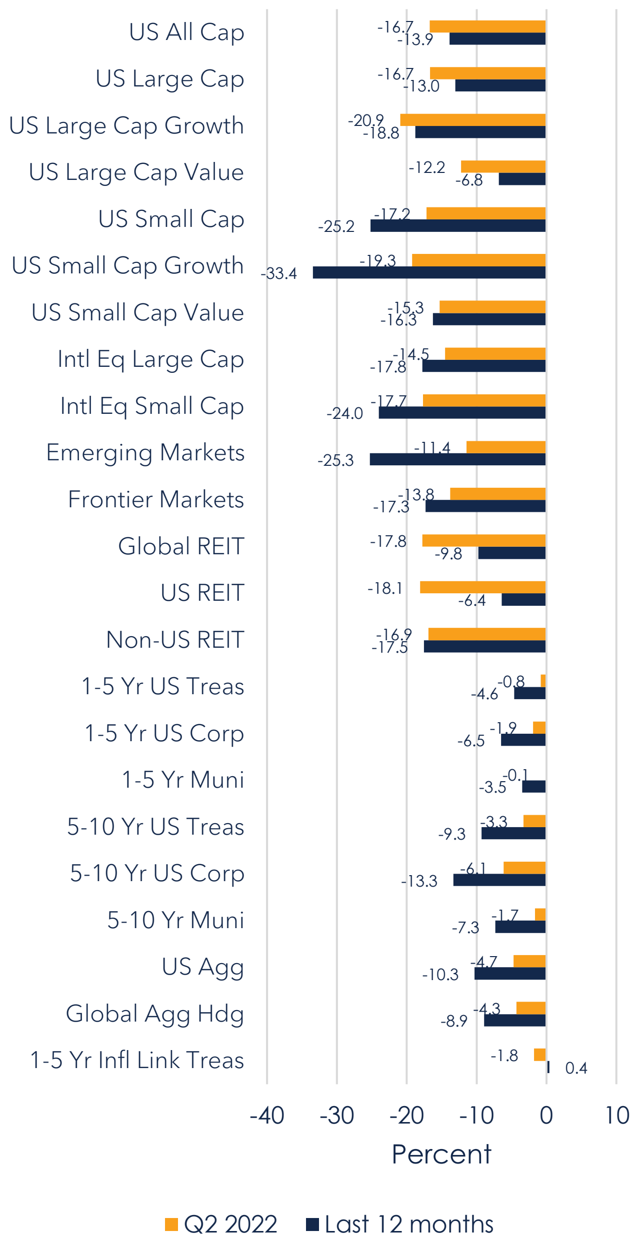
EASTBAY INVESTMENT SOLUTIONS

Quarterly Investment Commentary – Q2 2022

PERIODIC RETURNS



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

KEEPING A BALANCED APPROACH

Summary:

- **Cocktail of high inflation, rising rates, slowing growth, and Russian invasion of Ukraine led to historically poor first 6-month returns for 2022 across equity and fixed income markets**
- **Central banks across the globe increasing rates to combat inflation. In the US, the Fed increased rates by 50 bps in May and 75 bps in June.**

Positive Signals:

- ✓ **Per Fed Chairman Powell, the US economy is still "in pretty good shape"**
- ✓ **Unemployment rate remained at 3.6% through quarter-end.**
- ✓ **There is now even more "income" available in fixed income; the 10-year US Treasury ended Q2 at 2.98%**

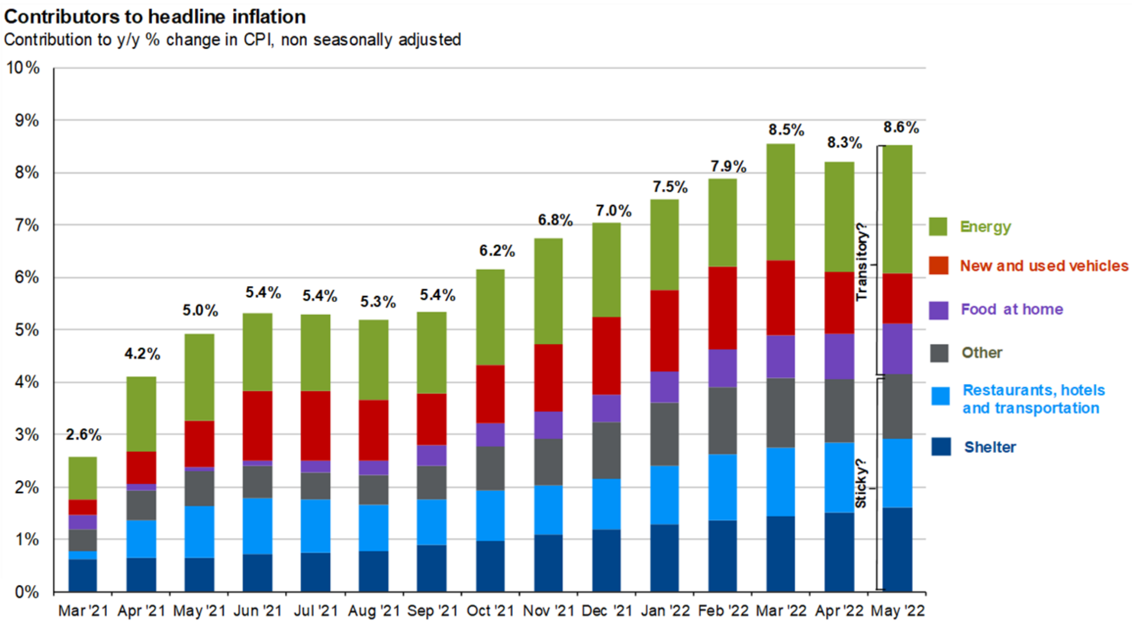
Reasons for concern:

- ? **Chances of a "soft landing" are decreasing; Fed will do what is necessary to lower inflation, even if it means odds of recession increase**
- ? **The Fed only controls so much; no impact on supply chain issues, wages, Covid-19 lockdowns in China, or commodity prices.**
- ? **Global economic activity experienced a slowdown from March through June**

<u>Inflation running hot</u>

Everything seems more expensive now than it did just a few months ago, that is the impact of inflation. Inflation is one of the main ingredients of the cocktail that drove equity and fixed income returns to their worst six-months to start a year (more on this later). Some of the other ingredients include increased demand, the Covid-19 lockdowns in China hurting the supply chain, and the war in Ukraine causing increases in food and energy prices. In the US and across the globe the inflation story is pretty simple: inflation was higher and stickier than originally expected → central banks tightened, aggressively in some cases → stocks and bonds react negatively to tighter financial conditions. While we don't see any economists currently anticipating 1970's style inflation, the current levels are still uncomfortable.

Exhibit 1



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 June 30, 2022

Looking back on the quarter, when CPI fell to 8.3% in April, there was talk that we had possibly seen peak inflation. But then, in May, headline inflation increased again to 8.6%, well over the Fed's average target of 2%. On the bright side, as Exhibit 1 shows, the contribution from those inflationary components that are referred to as "sticky," did not increase significantly. In fact, energy and food, components that are referred to as "transitory," or temporary, is actually where a good amount of the more recent increase has come from. As energy prices have started to come down slightly over the last few weeks, there is anticipation of what the next CPI reading will look like.

As a reminder, the Fed has a dual mandate. One part of the Fed mandate is to maintain stable prices, which means the Fed really wants to bring inflation down to their preferred level. In fact, in recent comments Fed Chairman Powell noted that the Fed is willing to do what is necessary to lower inflation, even if that means the odds of a recession increase. At the same time, it is important to remember that the Fed can only control so much. For example, while the Fed can somewhat impact demand by raising the cost of borrowing, they have no control over supply chain problems, Covid-19 lockdowns in China, or commodity prices.

With Chairman Powell recently stating the worst mistake the Fed could make is to fail to bring down inflation, we have seen the Fed become more aggressive with their tightening policies. After raising the Fed Funds rate by 25 bps in March, they increased rates by 50 bps in May and another 75 bps in June, with more expected in July. The Fed is trying to orchestrate what is referred to as a "soft landing," where inflation comes down and a recession is avoided. However, over the quarter, levels of confidence in a soft landing decreased, with chances of a "hard landing" (inflation falls but at the cost of a recession and higher unemployment) increasing. An often-used definition of a recession is two consecutive declining quarters of GDP, and we experienced a -1.5% decline in GDP during the first quarter of 2022. If we were to see GDP decline in the second quarter as well, you can bet the press and others will be mentioning the "R" word with even more frequency. If we were to see a recession in the current environment, it would be somewhat unusual as even though growth may have slowed, unemployment is still incredibly low (3.6% as of June 2022) and wages are still strong. Other conflicting data includes spending levels vs. consumer sentiment. Through May, the levels of consumer spending were still considered to be healthy as consumers shifted their purchases away from goods and toward services, while sentiment as measured by the University of Michigan Sentiment Index, has been declining over the same time period.

So, what are the chances of a recession over the next year or two? As of June 30, 2022, the difference between the two-year and ten-year Treasuries (known as the 2s/10s spread) was only 6 bps, signifying a fairly flat yield curve. Per Exhibit 2, this 6 bps difference suggests a 22% chance of recession over the next year and a 62% chance over the next two years.

Exhibit 2

	Recession Probability (%)		
2s/10s spread (bp)	within 12 months	within 24 months	within 36 months
-10	27.0	74.9	97.8
-5	26.7	74.2	96.9
0	25.6	71.1	92.8
5	22.4	62.3	81.4
10	16.6	46.1	60.3

Source: Piper Sandler

Inflation is not an issue unique to the US today, inflation is running hot across much of the globe. For example, while inflation is 8.6% in the US, it is 9.1% in the UK, 8.7% in Germany and 7.7% in Canada. Much like the Fed in the US, their corresponding central banks are also raising rates. For example, the Bank of England raised their rates by 25 bps in each of their February, March, May, and June 2022 meetings, and now have 1.25% as their rate. The European Central Bank, who earlier this year stated they had no plans to raise rates in 2022, changed their plans in June when they announced their intentions to raise rates in July and possibly again in September. Similarly, the Bank of Canada increased their policy rate by 25 bps in March, and then by 50 bps in both April and June, so it now sits at 1.5%.

The obvious question is what an investor does with all this information regarding where inflation might go with interest rates to follow. It is critical for investors to remember that current expectations for future market movements are already priced into stock and bond markets.

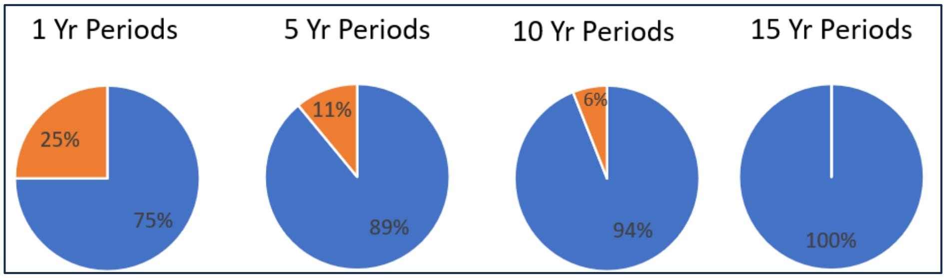
<u>What is happening to cryptocurrency?</u>

As Bitcoin's value continued to increase to astronomical levels over the previous years, cryptocurrency has been portrayed as many things from being close to replacing the dollar as the world's reserve currency, to being a medium of exchange, to being an inflation hedge, to being uncorrelated with traditional stocks and bonds. Currently, none of those arguments seem to hold any water as the value of cryptocurrencies plummeted through the quarter as investors continued their move away from risky assets, including cryptocurrency. Using Bitcoin as an example, one Bitcoin was valued just over $65K in early November 2021, $45K as of March 31, 2022, but fell to just under $20K as of June 30. The challenges of cryptocurrency aren't just impacting Bitcoin. Coinbase (ticker=COIN), which touts itself as a secure online platform for buying, selling, transferring, and storing cryptocurrency, saw its stock value dive from 252.37/share on December 31, 2021 to just 47.02 as of June 30, 2022 (source: Yahoo! Finance for Bitcoin and Coinbase data) while also having to lay off 18% of its workforce, due to what their CEO referred to as an upcoming "crypto winter."

<u>U.S. Equity</u>

It was another dismal quarter for US equities. Putting the first six months of 2022 in perspective, the -20% return of the S&P 500 over that time period was the worst start to a year, going back to 1970. The next worse 6-months starts to a year came in 1970 (-19.5%), 2002 (-13.2%) and 2008 (-11.9%). With a first half this poor, what is the second half of 2022 going to look like? Well, it turns out it is a literal coin flip. Per S&P Dow Jones Indices, since 1957, in the years when the S&P 500 had a negative first half, it had a negative second half about 50% of the time, which also means there is a 50% chance that the second half of 2022 is a positive returning one.

Exhibit 3



Source: CRSP 1-10 benchmark, data from January 1926 through 2021, cumulative returns used in the calculation, shaded blue area shows positive returns, past performance is not indicative of future results

History is also on the side of investors that stay invested for the long term. As Exhibit 3 shows, US stocks have had a positive return over 10-year periods 94% of the time and have never experienced a negative return over a 15-year period.

Sticking with the S&P 500, the energy sector was the only one to contribute a positive return during the first half of the year (0.85%) with the information technology sector detracting the most (-7.9%). This is opposite to what occurred in many of the previous years when tech was high-flying.

Speaking of high-flying stocks, many of the stocks that were the darlings of the last decade have fallen in recent times. It is likely you have heard of the FAANG stocks (Facebook-now Meta, Apple, Amazon, Netflix, and Google – now Alphabet). Not only have several of them of these companies changed names since the concept of FAANG was first introduced (though the term FAANG is still used), like other growth companies their stock valuations and prices are being negatively impacted by rising rates.

Exhibit 4

Name	Ticker	Total Return YTD through 6/30/22
Meta Platforms Inc Class A	META	-52.1
Apple Inc	AAPL	-22.8
Amazon.com Inc	AMZN	-36.3
Netflix Inc	NFLX	-71.0
Alphabet Inc Class A	GOOGL	-24.8
Alphabet Inc Class C	GOOG	-24.4

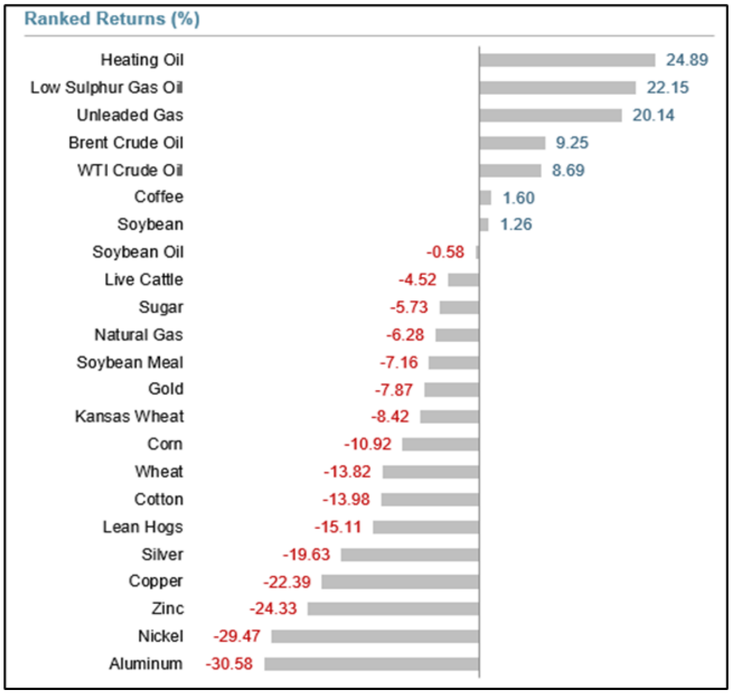
Source: Morningstar Direct

Part of the reason why these drops in value are interesting has to do with how index companies determine how stocks get classified into their various indexes. For example, the family of Russell indexes underwent their annual rebalancing in late June. Russell indexes have a methodology whereby stocks can be included in both of their growth and value-oriented indexes at the same time. With the recent downturn shown in Exhibit 4, Meta Platforms (the parent company for Facebook) and Netflix actually had higher weights in the Russell 1000 Value index than they did in the Russell 1000 Growth index for quarter end (source: iShares.com, a review of the holdings for IWD and IWF as of 6/30/22).

What about commodities?

With the previous discussions about high inflation and energy stocks providing a positive contribution to the S&P 500, it is expected that questions about commodities will arise. As commodity prices usually rise when inflation is accelerating, it is often said that investing in commodities may provide portfolios with a hedge against inflation (we can have a separate debate as to whether it's actually true or not). However, before investors jump into commodity investments, there are a few things to highlight. For one, commodities do not generate economic value the way stocks do (via retained and distributed earnings) or the way bonds do (via coupon payments). Rather, their return is derived solely from changes in their prices due to supply and demand. Second, it was not all positive news for commodities as the commodity sectors that generated positive returns during the second quarter were mostly concentrated in oil and gas as shown in Exhibit 5.

Exhibit 5



Source: Commodities returns represent the return of the Bloomberg Commodity Total Return Index. Individual commodities are sub-index values of the Bloomberg Commodity Total Return Index. Data provided by Bloomberg. Past performance is not indicative of future results.

Third, commodities can go long periods of time without earning positive returns for investors. The Bloomberg Commodity index and the S&P GSCI index are the two most popular commodity indexes. Part of the reason these indexes are garnering so much attention today is that they have earned returns of 18.4% and 35.8%, respectively YTD through 6/30/22 (the S&P GSCI has a much higher weight to energy commodities), though the

Bloomberg Commodity index fell by -5.7% during the second quarter. However, remember why we remind investors that past performance is not indicative of future results, and not to place too much emphasis on recent results. If we placed $100 into the Bloomberg Commodity index on January 1, 2005, you would have $99 on 6/30/22, while investors that put the same $100 into the S&P GSCI at the same time, would have only $71. And remember, as these are index figures, they exclude fees and taxes, which would only make the results worse if they were actual investments. For reference, $100 invested in the S&P 500 would have resulted in $450 over the same time period (source: Morningstar Direct).

Non-U.S. Equity

Similar to US equities, all of the international equity indexes we track had negative returns for the second quarter (which was also the case for the first quarter) with international developed stocks (MSCI EAFE) falling -14.5% and international developed small cap stocks (MSCI EAFE Small Cap) dropping -17.7%. 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. The dollar has continued to strengthen over the second quarter as investors tend to prefer the USD over other currencies during periods of concern for a global growth slowdown, and given higher, more attractive interest rates on US-issued securities

From a country perspective, no developed countries in the MSCI World ex-USA IMI index had a positive return (in USD) in the second quarter though countries like Spain, UK, Japan, and Singapore outperformed the US. It is critical to remember that investing in places like Europe is not solely a judgement on the European economy, as many of the companies within those borders receive revenue from sales outside of its borders.

In the emerging markets, China remains the largest country exposure by far, at roughly one-third of the entire index. China was actually the only emerging market country that had a positive return over the quarter, increasing by 3.3%. This was at least partially surprising given the continued Covid-19 lockdowns that China experienced for most of the quarter, though places like Beijing did start lifting some restrictions in early June. Also somewhat surprising is that emerging market stocks outperformed developed large cap stocks over the last three months. This is surprising because emerging market currencies normally depreciate, sometimes significantly, versus a strengthening dollar. It is believed that at least some of this is investors buying currencies of commodity-rich countries.

Global REITs

Like global equities, global REITs, as represented by the Dow Jones Global Select REIT, declined by -17.8% over the quarter. U.S. REITs underperformed non-US REITs over the same time period (-18.1% vs.-16.9%). While REITs tend to outperform equities during periods of rising inflation, that was not the case this past quarter.

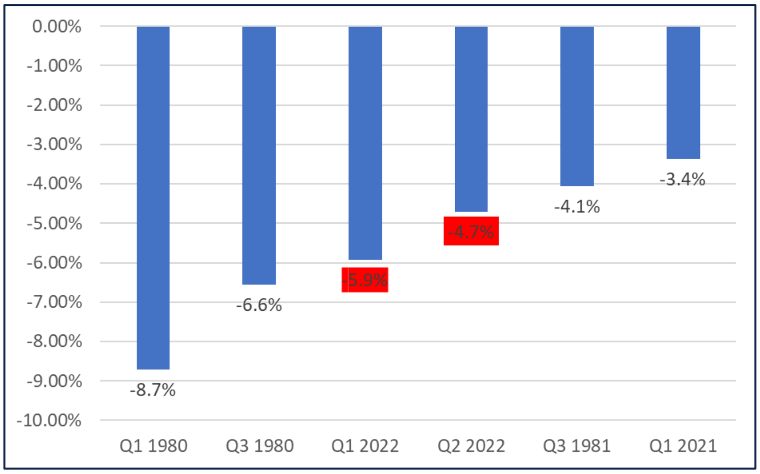
Diving deeper into the YTD sector returns for the FTSE NAREIT US index (a REIT index that does provide sector returns publicly), all of the sectors show negative returns with the office sector declining -27.5% while specialty REITs only fell -8.4%. Source: NAREIT

Global Fixed Income

The fixed income indexes we follow were all negative for the second quarter with the exception of the 3-month Tbill, which only gained 10 bps. For the last 12 months, only the 3-month Tbill (17 bps) and the 1-5 Year Inflation Linked Treasury index (43 bps) have a positive return.

From a historical perspective, as Exhibit 6 shows, the Bloomberg US Aggregate Index, the most common US fixed income benchmark, experienced its third and fourth worst quarterly returns in history during the first two quarters of 2022. Combined, its -10.3% return was the worst first six-month start to the year, and it wasn't even close. The next worse 6-months starts to a year came in 1994 (-3.9%), 2013 (-2.4%), and 1984 (-1.7%).

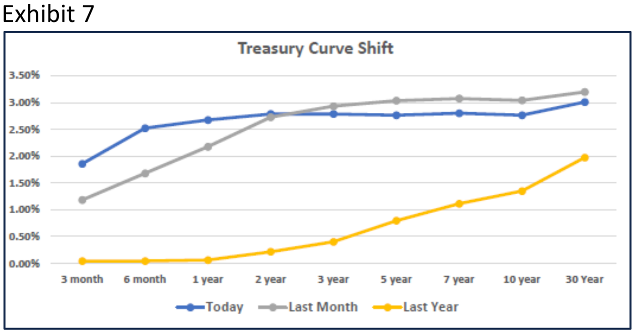
Exhibit 6



Source: Morningstar Direct, data from Jan 1980 –June 2022, Bloomberg US Aggregate Index Total Return, Past performance is not indicative of future results

Exhibit 7 shows how dramatically yields have changed over the last 12 months specifically, with even some significant moves over the last month. Overall, yields have risen across the yield curve from 12 months ago, in particular at the short end of the curve as markets continued to price in expectations for future rate hikes. We even saw 10-year Treasury yields climb above 3% in early May, a level we had not seen since late 2018. Remember, it was less than two years ago (August 4, 2020) when the 10-year Treasury yield closed at a paltry 52 bps.

Exhibit 7

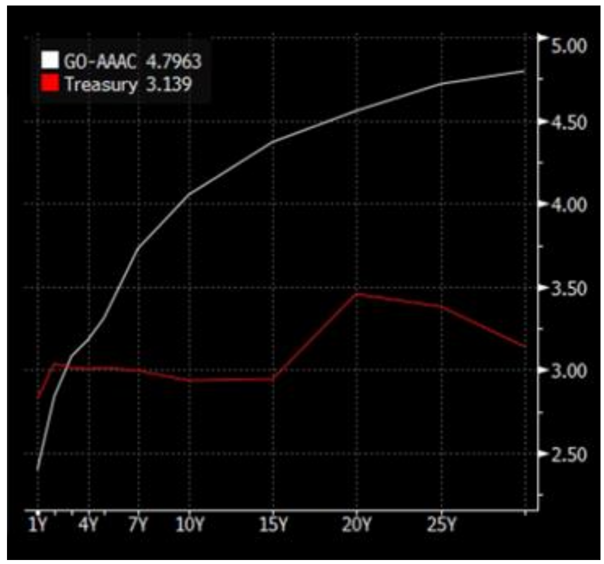


Source: Bloomberg, data as of July 6, 2022

While the chart shows the difference between today and last month, it doesn't show the change that happened intra-month in June. From June 14 through the end of the month, yields from 1-year through 30-years all saw their yields drop by at least 30 bps during that time period as investor concern of an economic downturn grew.

Municipal bond performance was also negative for the quarter across the muni yield curve. However, as Exhibit 8 shows, the municipal tax equivalent yield (the white line) is quite attractive relative to US Treasuries (the red line) in the intermediate and long-term sections of the yield curve.

Exhibit 8



Source: Bloomberg LP, Municipal tax-equivalent yield assumes a top-income tax bracket rate of 37% and represent AAA Callable General Obligation tax exempt bonds , data as of July 6, 2022

Remember, 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 yield remains the best predictor of future bond returns.

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.