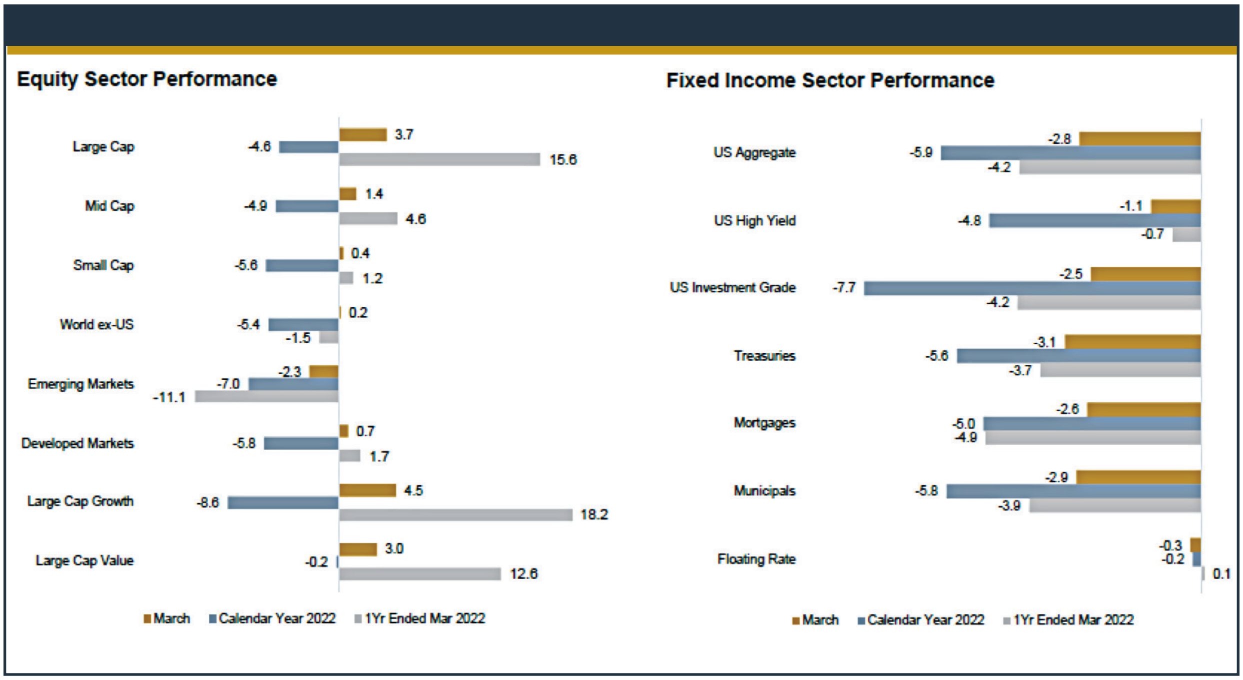
Spring 2022 Market Commentary

High levels of consumer and producer price inflation not seen in over 40 years caused volatile and correlated downside price action across many markets in the first quarter of 2022. The typical inverse relationship between equity and fixed income markets unraveled with prices in both asset classes sinking lower. The war in Ukraine further exacerbated inflation on a broad scale with key supplies of energy and agricultural commodities no longer available for export to countries dependent on those resources. This war, notwithstanding its tragic impact on human lives in the region, has been global in its devastating reach.

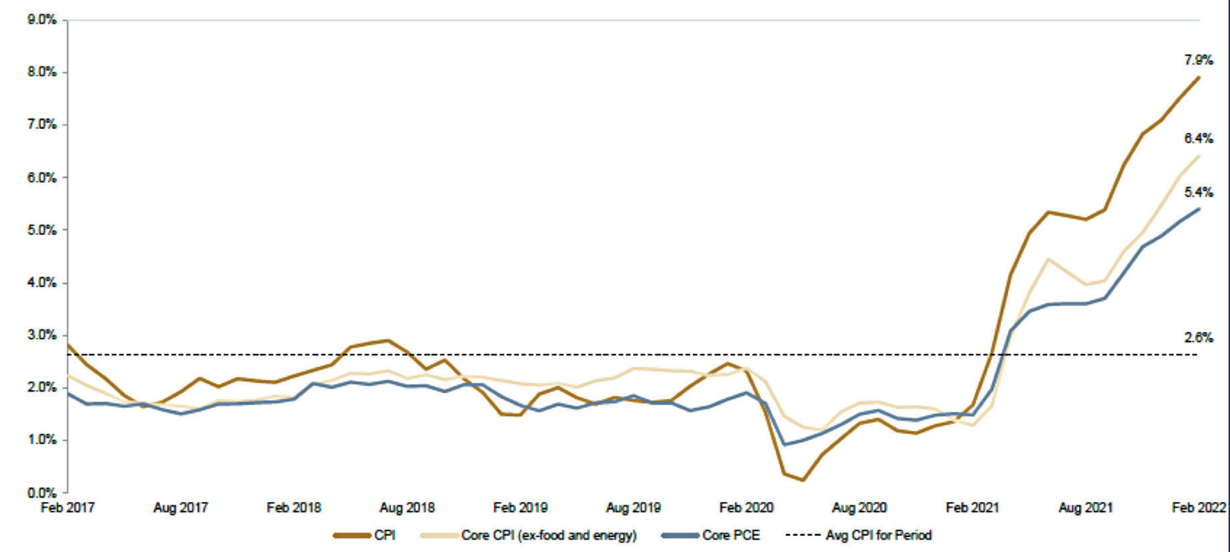
The US Treasury bond market experienced the worst quarterly decline in value in 40 years. On a total return basis, valuation declines were most severe for longer duration maturities (maturities greater than 10 years fell by more than 10%) while the US Aggregate Index (used as a proxy for the entire US bond market) with a duration of ~6 years experienced a quarterly decline of -5.93%. Likewise, equity markets struggled with the S&P 500 index dropping by -4.6% on a total return basis. The tech heavy NASDAQ index and Russell 2000 small cap index fell by -8.9% and -7.5%, respectively. International equities were also under pressure with the MSCI EAFE developed international index down -5.91%, and the Emerging Markets equity index falling by nearly -6.92%. Rising energy and food prices drove the CRB commodity index higher by a whopping 27% in the first quarter.



The intent of the Fed's accommodative policy maintained throughout the tumultuous COVID-19 pandemic period was to keep interest rates low to stimulate consumer and investment demand to prop up the economy. The Fed's policy, combined with unprecedented levels of fiscal stimulus in the form of direct payments from the US government to households, funneled money into consumers' wallets as well as into the real estate and financial asset markets, as evidenced by soaring home and equity prices in the past two years.

Unfortunately, at the same time, pandemic-related supply chain disruptions and shortages of raw materials crimped global manufacturing output. The unintended consequence of both Fed and fiscal policies on demand concurrent with reduced supplies has been an explosion in inflation, a major problem for all which must now be addressed. How we eventually emerge from the current state of market instability will test the acumen of the Federal Reserve as it attempts to reduce and remove its backstop policy accommodations.

U.S. INFLATION METRICS (% Change Year/Year)



The Fed initiated its first 0.25% hike in the Federal Funds rate from the zero bound at its March FOMC meeting and has since telegraphed to market participants its intentions of continuing rate hikes of 0.25-0.50% at every subsequent meeting until inflation is brought under control. The Fed has only limited tools to tamp down inflationary demand impulses and must do so incrementally and tactically to avoid creating an economic recession. By raising borrowing costs, from mortgage to auto loan and credit card rates, the Fed hopes to slow demand and investment enough to generate disinflation. As a result, growth in corporate sales and earnings are expected to slow, while the level of inflation experienced by consumers may remain "sticky" high as wages and rents are unlikely to trend down anytime soon. The Q1 2022 GDP growth rate expected by the Atlanta Fed has dropped to 1.1% down from a reported Q4 2021 growth rate of 7%. Much of this decline is related to the absence of fiscal stimulus when compared to the $1.3 trillion in pandemic relief handouts from the prior year period. Achieving this 'soft landing' objective is possible, but the probability of success is a highly debated topic within the investment community.

The supply side of the inflation problem is the wildcard. The Fed cannot "print" more oil, grains, microchips, or workers to fill service jobs to alleviate the supply side shortages. Unknowable factors affecting the supply side of the inflation equation are how COVID will impact the economies of key commodity and goods exporters such as China, and of course the trajectory and duration of the Ukraine war which has been hugely disruptive on many fronts. On a positive note, energy prices are beginning to trend down from their recent peak levels, as are prices for lumber and some other industrial commodities.

Expectations for slowing economic growth have already rippled through the equity markets with a good amount of froth coming out of the bubbly technology and consumer discretionary sectors. Diversification in investment portfolio holdings is ever more important and investors are advised to renew their focus on less speculative segments of the market and focus on strong balance sheets, free cash flow, low leverage, and potential for earnings growth amidst a backdrop of slowing demand. Periods of extreme uncertainty are often uncomfortable for investors, particularly those with shorter investment time horizons. In times like the present, we recommend that investors reassess their investment objectives and risk tolerance and notify their advisor if anything has materially changed in their financial or personal circumstances. Coupon interest rates on US Treasury and high-grade short-term corporate securities have risen to the point where they now produce meaningful income and pose minimal downside risk to a portfolio if held to maturity. In the event the economy does fall into a recession, these fixed income securities should hold value as interest rate increases level off and perhaps even decline over time.