Investment Perspective

There are always worries on the horizon, but today's uncertainties are more diverse than usual which is clouding the investment outlook

The investment environment has changed considerably in the last six months. Several factors envisioned as potential threats have become real risks. These include the Russia-Ukraine war, higher than expected inflation, surging energy prices and tighter monetary policy. There are always worries on the horizon, but today's uncertainties are more diverse than usual which is clouding the investment outlook. Broad-based U.S. stock and bond indices both delivered negative returns for the first quarter, an unusual occurrence. Stocks are correcting, but bonds have entered a bear market. The Bloomberg U.S. Aggregate Bond Index declined -1.54% in 2021 (vs. +28.7% for S&P 500) and -9% year-to-date. The first quarter marked the bond index's worst quarterly return since 1980. Historically, bonds usually provide positive returns when stocks are negative – but not this year. The Federal Reserve has adopted a more aggressive posture to fighting inflation, shifting from its extraordinarily accommodative policies to tightening. Market participants expect the Fed to raise interest rates by 50 basis points at each of the next few meetings and begin reducing its balance sheet. In response, the 10-year Treasury yield has risen from 1.51% at year end to 2.81% and the enthusiasm for equities is moderating. We expect continued volatility as investors digest the various crosscurrents from the Russia-Ukraine war, higher inflation, Chinese COVID-19 lockdowns and headwinds to global growth. A potential Russian bond default may also upset the market. At this time, demand trends remain solid with reasonable growth forecast for real GDP and corporate earnings. A summary of year-to-date index returns for the period ending March 31, 2022 is as follows:

Dow Jones Industrials	-4.1%	Russell 2500	-5.8%
MSCI EAFE	-5.8%	S&P 500	-4.6%
NASDAQ Composite	-8.9%	Wilshire 5000	-4.9%

GLOBAL ECONOMY

Estimates for Europe are declining due to the Russia-Ukraine war, high energy prices and elevated inflation

Expectations of world economic growth (ex. U.S.) in 2022 are slowing to 3.5% from prior views of 4.5%. All major regions are seeing downward revisions albeit for different reasons. China's growth is imperiled by the emergence of a coronavirus variant in Shanghai that precipitated lockdowns, plus the deleveraging of real estate debt. These problems will reduce demand and worsen supply chain disruptions. The Chinese government officially set 5.5% as the GDP growth target for 2022, but private estimates are now 4.2%. Estimates for Europe are declining due to the Russia-Ukraine war, high energy prices and elevated inflation. The U.K. is expected to grow 3.6%, the Euro area 2.8% and Japan 2.4% in 2022. The global economic situation is durable enough to avoid recession in the near-term, but fears are rising about the duration of the global expansion. The risk is to the downside. Russia's invasion combined with China's increasing belligerence has derailed the globalization era likely suppressing world growth in the years ahead.

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The U.S. economy is expected to grow 2.7% this year and 1.8% in 2023 after 5.7% growth in 2021. The key to U.S. economic growth is the balance among the major drivers, including consumer spending at 3.3%, capital expenditures at 4.7% and nonresidential and residential construction at 4.9% and 1.9%, respectively. None of the major sectors are providing outsized growth; however, all are contributing. Services should show more relative strength compared to manufacturing. The purchasing managers index (PMI) for services increased in March to 58.3, up from 56.5 in February, while the manufacturing PMI recently declined to 57.1 from 58.6. Net imports will serve as a small drag on growth while government spending will contribute a small amount after contributing strongly in 2020 – the pandemic recession year. With the unemployment rate at 3.6% and reliable labor in short supply, wages are rising with average hourly earnings up 5.3% y/y. Labor force participation continues to improve from the pandemic lows. The number of people employed part-time for economic reasons has fallen from 11 million in 2020 to 4.2 million. As a result, the demand for autos and housing is high but supply is constrained. Auto sales are estimated at 14.7 million vehicles but could be over 17 million without semiconductor shortages. Demand for housing remains buoyant as families respond to work-from-home trends, better wage growth and healthier balance sheets. However, supply is limited as many homeowners are not selling. The sharp rise in mortgage rates is also suppressing the strong housing market and existing home sales declined 4.5% y/y. In summary, the biggest economic issues relate to the supply side, including accelerating inflation, higher energy prices, rising interest rates and labor shortages. Looking ahead, the world's current problems will eventually benefit the U.S economy and its capital markets.

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PUTIN'S WAR: RUSSIA INVADES UKRAINE

Russia invaded Ukraine on February 24 with an estimated 190,000 troops and hundreds of artillery pieces, attack aircraft, missiles and tanks. This aggressive and unprompted action sent commodity and energy prices soaring. President Putin said the goal is to "demilitarize" Ukraine. Geo-political analysts say that Putin is trying to reunify the old Soviet bloc countries and demonstrate regional dominance through aggression, brutality and intimidation. Specifically, Russia has focused on securing the Donbas and Crimean regions while toppling Ukrainian leadership with an advance on the capital, Kyiv. The first advance on Kyiv failed as Ukraine mounted a spirited defense. Subsequently, Russia withdrew from the Kyiv region to regroup on the eastern side of Ukraine. Strategists predict that another large Russian advance will aim to secure the Donbas and the southern areas bordering Crimea and the Black Sea. The invasion has been a military failure with the U.S. Department of Defense estimating that Russia has lost 20% of its fighting force since February 24. Significant NATO contributions of anti-armor and surface–to–air missiles have been helpful in bolstering the resistance. A quick Russian victory was expected, but fierce Ukrainian resistance has proven effective and a long arduous conflict appears likely. Additionally, there is no easy exit for Putin as Ukraine has proven its ability and determination to fight for independence. Russia's invasion awakened the "sleeping giants" of NATO and the unified response revealed a surprising resilience.

CORONAVIRUS SHIFTING TO ENDEMIC

The world continues to grapple with COVID-19 variants after 500 million infections and 6.2 million deaths. The latest variants have spread rapidly in Asia, particularly Hong Kong and large Chinese cities like Shanghai, prompting full lockdowns of some cities. Shanghai has reported many cases with new daily cases accelerating recently. Shanghai just started reporting deaths on April 17 and they are averaging about 55 per day. The case trends in China continue to worsen as Beijing is now experiencing a surge, but the number of severely ill is reported to be low. Positively, Omicron variants may accelerate global herd immunity due to its contagious yet milder profile. Additionally, it is well understood that "reported" cases by government agencies significantly understates the infection rate over the last several months. Many people have contracted the virus without disclosing it or seeking medical attention. Approximately 220 million in the U.S. are vaccinated, although the pace of vaccinations has slowed dramatically. Concurrently, the pace of infections has slowed precipitously from 800,000 per day in mid-January to 51,000 in late-April. The mortality rate has proven to be low, which has lessened fear and risk from this public health crisis. The improving trends indicate the acute phase of the coronavirus disease is ending while the endemic phase is starting. This phase may entail a high rate of annual contagiousness and a low rate of mortality similar to the common cold or flu. Importantly, this will reduce COVID-19 related restrictions that have challenged supply chains. The new reality will be less risky for the average person, but not riskless. In the U.S., approximately 60% of the population or 200 million has been infected with one million deaths since the pandemic's beginning.

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INFLATION & INTEREST RATES

Inflation has suddenly become a wildcard in the investment outlook. The Federal Reserve is behind the curve in fighting inflation and is pivoting to a tighter monetary stance. Inflation is higher than usual due to several factors including rising commodity prices, increasing labor costs and higher rents. In addition, food and energy costs are jumping in response to the Russia-Ukraine war. Based on March CPI data, food prices were up 8.8% y/y, energy prices increased 32.0% and commodities excluding food and energy rose 12.4%. The Fed's preferred measure of inflation, the core personal consumption expenditure (PCE) price index, which excludes the impact of food and energy prices, gained 5.4% y/y. Headline inflation as measured by the consumer price index (CPI) was up 8.5% y/y - the fastest pace since January 1982. Core inflation (CPI excluding food and energy) rose 6.5% y/y - the largest increase since August 1982. In addition, the producer price index (PPI) gained 10.1% over the past year. The Fed and economists expect core inflation to remain elevated this year near 4.6% and then decline moderately next year to 2.9%. The market pricing of bonds and inflation-protected securities implies an expectation of 3.2% inflation in five years - versus 2.5% a year ago.

The Federal Reserve is behind the curve in fighting inflation and is pivoting to a tighter monetary stance

At this time, inflation is significantly higher than the Fed's 2% target and above their previously stated tolerance to let it "run above the target" for a brief period. That experiment is over, and the Fed is becoming more hawkish. At the March 15-16 FOMC meeting, the

Fed increased the fed funds rate by 25 basis points and subsequently indicated that 50 basis point hikes were in play over the next few meetings. The fed funds rate may finish the year at 200 basis points and possibly approach 275-300 in 2023. In addition, "quantitative tightening" (QT) will likely start in June. QT occurs when the Federal Reserve's $9 trillion balance sheet shrinks either due to maturities or outright sales. Economists expect that QT will shrink the Fed's balance sheet by approximately $1 trillion per year over the next few years, although this pace could accelerate with the outright sale of bonds. Reflecting this, the 10-year Treasury yield has risen to 2.81% from 1.43% in early December. We expect both short and long-term interest rates to rise further this year. The risk is that persistently high inflation might force the Fed to tighten more aggressively than indicated.

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INVESTMENT OUTLOOK

The outlook for stocks and bonds is being impacted by the threat of higher inflation. Simply, sustained inflation reduces the purchasing power of money and causes interest rates to rise. These secondary effects impact real economic growth and asset prices. Higher commodity prices and supply disruptions associated with the Russia-Ukraine war and Chinese lockdowns intensify the problem. It is not easy to predict when inflation will peak. In response to these challenges, the Fed is changing monetary policy from extraordinarily accommodative to more restrictive to slow demand. Investor sentiment is growing more cautious because of the dual threats from rising interest rates to both valuation multiples and earnings growth. Positively, fundamental factors, such as high single digit earnings growth and a solid demand environment support the investment environment. Supply bottlenecks should ease in the next few quarters and provide some relief. Additionally, corporate buybacks are the largest in history. S&P 500 companies repurchased a record $882 billion in 2021, up 70% from the levels in 2020. The pace of buybacks in 2022 may eclipse that record and provide support for equities. We expect the equity markets to experience periods of consolidation, volatility and modest gains as the year progresses. Historically, the stock market gains during rising interest rate cycles. For example, the S&P 500(SPX) experienced an average annual increase of 9% during the 12 Fed hiking cycles since the mid 1950's and rose 92% of the time.

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The specific fundamentals supporting the investment outlook include solid economic and earnings growth combined with high liquidity and strong asset flows. We expect an S&P 500 operating earnings increase of 9% this year to $229 per share following last year's explosive growth of 49% to $208 from the pandemic recession in 2020. We expect our investments to report favorable first quarter earnings and provide encouraging commentary regarding the balance of the year. The SPX is valued at 18.3x estimated 2022 earnings versus its long-term average of 16.6x. For the first time in 20 years, valuations represent a concern because of accelerating inflation and rising interest rates. Higher than average inflation and interest rates can pressure P/E multiples even if nominal earnings are growing.

Leadership continues to change as there is a tug of war between inflation and recession risks

From a technical perspective, the stock market is off to a weak start and there is little positive momentum. "Sell the rip" has replaced "buy the dip." However, technical analysts describe the situation as a cyclical correction within a secular bull market. Breadth indicators are offering mixed signals as rotation helps certain sectors and hurts others. The major indices have performed better than their smaller capitalization peers which is indicative of investors finding safe harbor in the biggest names. In addition, all major indices have declined less than the average holding in the respective index. For example, the average holding in the Russell 2000 has declined 40% from the 52-week highs while the index is down 20%. The S&P 500 entered 2022 on a new high, but the smaller capitalization indices peaked in November and may have bottomed in the sharp January - February correction. Leadership continues to change as there is a tug of war between inflation and recession risks. The fear gauge -- the VIX option volatility index -- is 32 in late-April and has gyrated between a year-to-date low of 17 and recent high of 36 in early March.

The U.S. capital markets will also benefit from the TINAC effect – There Is No Alternative Country

We expect a more challenging year in the stock market that will gradually climb a "wall of worry." Monetary policy will weigh on investor sentiment and create a cautious environment. If recession fears abate, the stock market lows for the year have probably occurred during the first quarter. However, if tighter monetary policy crimps growth, the stock market may correct further. We expect the year will be marked by consolidation and volatility with an upward bias. Positives include tremendous global liquidity, favorable earnings fundamentals, decade high asset flows and strong corporate buybacks. The U.S. capital markets will also benefit from the TINAC effect – There Is No Alternative Country. Finally, the stock market increases most years (82% of the time since 1989) despite periodic 5-15% intra-year corrections. We favor adding to equities during periods of individual issue or overall market weakness. The key risks include China's lockdowns, coronavirus variants, cyber-attacks, earnings slowdown, war in Ukraine, and rapidly rising interest rates. In our opinion, quality small and medium-sized growth companies remain likely to achieve above-average annual returns over the next few years. We are cautiously optimistic and remain alert to take advantage of stock market opportunities as they arise.