



First Quarter CIO Update

The financial markets have been volatile in 2022, following three consecutive years which provided strong, positive returns in most diversified portfolios. Even with the pandemic drawdown/recession, the markets did very well through that period.

In the history of the financial markets, drawdowns have happened regularly, and are the price (risk) that investors accept in exchange for the potential of attractive returns on their investments over time. Even knowing this, a market decline can feel particularly unpleasant after an extended period of positive returns such as were experienced in 2019, 2020, and 2021.

Behavioral researchers have found that the psychological pain investors feel from losses is significantly more acute than the pleasure they receive from gains of a similar size. This behavioral bias can lead to feeling that things are worse than they really are, overlooking the good returns experienced prior to the turn of the calendar year.

Market Volatility

What is driving the increased volatility in the financial markets? The simple answer is, uncertainty. The world is transitioning from a period of synchronized economic expansion, relatively stable prices, and international cooperation, to one of economic decoupling, rising prices, and increasing geopolitical tensions.

The Fed

A brief review of how 2022 transitioned to an aggressive Fed trying to control the damage to their reputation:

The FOMC statement from March 17, 2021 opined that, “Inflation continues to run below 2%...the ongoing public health crisis continues to weigh on...inflation...with inflation running persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2% for some time.” At this point, the February CPI data was available showing inflation of 1.7%.

A month later, the FOMC statement from April 28, 2021 acknowledged that “Inflation has risen,” but characterizes the rise as, “largely reflecting transitory factors.” The Minutes of the Federal Open Market Committee of April 27–28, 2021 state that, “The 12-month changes in total and core PCE prices were expected to move above 2% in coming months...Inflation was then projected to dip slightly below 2% in 2022 as the influence of these transitory factors diminished. The March CPI data was available showing inflation of 2.6%.

This misunderstanding of the building inflationary pressures continued through most of 2021, until November 30th when Fed Chairman Jerome Powell said while discussing the characterization of inflation as transitory, “I think it’s probably a good time to retire that word...factors pushing inflation upward will linger well into next year.”

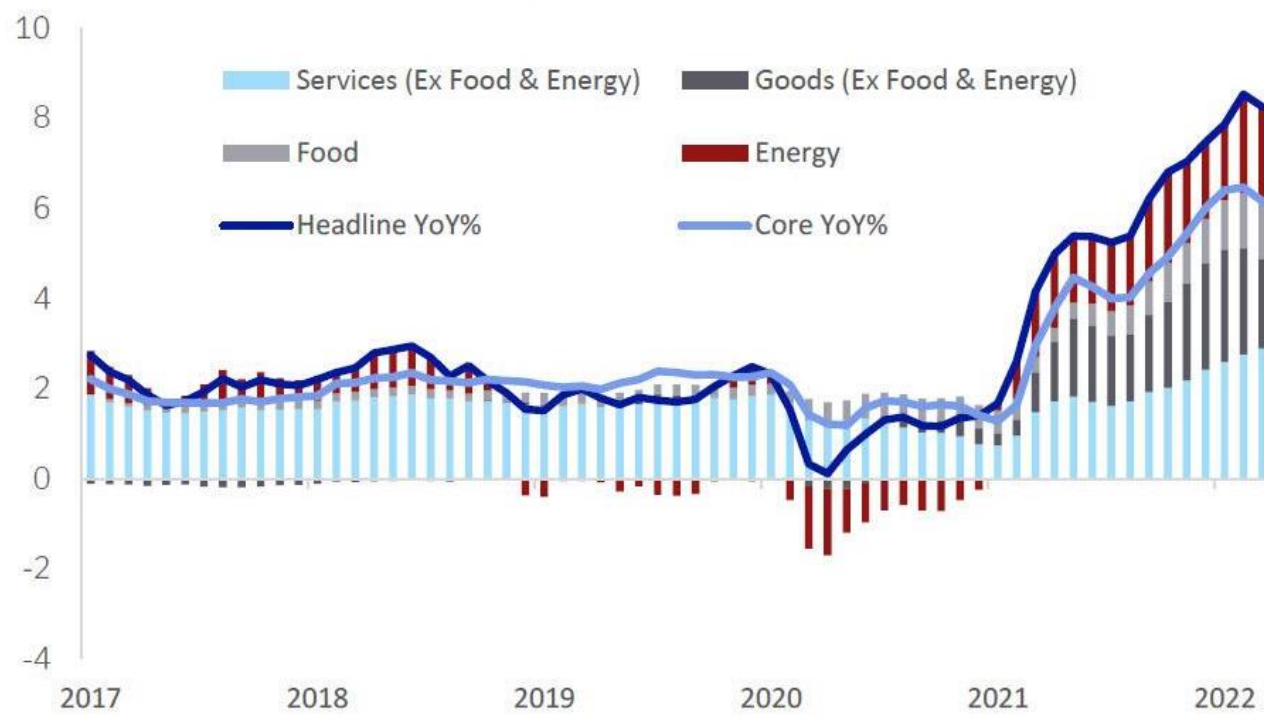


The Fed was completely wrong, their analysis was flawed, but not incompetent. It did discuss the base effect that would push up inflation readings as the low pandemic inflation levels transitioned into the Year over Year CPI calculation. They also considered the possibility of additional supply chain issues causing problems. The probability that they assigned to ongoing issues (or new, compounding issues) appears to have been minimal. Even as issues contributing to elevated inflation grew stronger and multiplied, the Fed’s blinders remained on. A behavioral finance explanation for this could be anchoring and adjustment bias, where the initial estimate/expectation of inflation (based on low pandemic or even pre-pandemic levels) becomes an anchor that keeps future revisions from differing significantly, even as new information becomes available. The Fed’s analysis appears to have taken place within ceteris paribus guardrails. Holding “everything else constant” is a way to simplify analysis, but a poor assumption during a period of global turmoil.

Inflation

With the Federal Reserve slow to act, inflation has had quite a head start on their monetary policy response. The Fed continued to purchase treasury and mortgage bonds as inflation pushed up, through, and far beyond their target of 2%.

CORE SERVICES ARE COMPRISING A GROWING PORTION OF INFLATION INDICES, WHICH POINTS TO MORE PERSISTENT PRICE PRESSURES



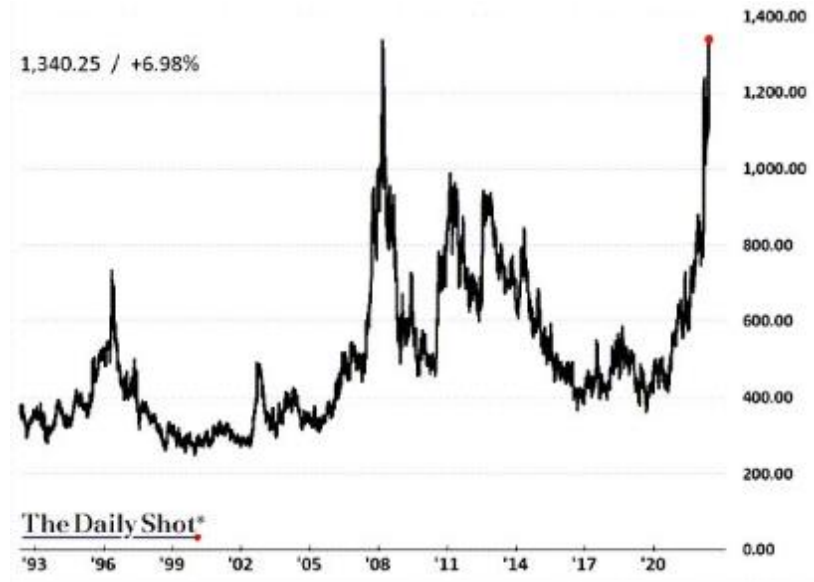
Source: Bloomberg Finance LP

With inflation above 8% and the Fed Funds rate now at 1% following two consecutive hikes, there remains a significant amount of work to be done. The most recent CPI release on May 11th (April data) showed an increase of 8.3%. While this is lower than the 8.5% from the prior month, and many headlines claimed that the March data was the high point for inflation that is yet to be seen. With the war in Ukraine continuing, and China's zero COVID policy still in place, there are too many variables still in play to make that call. *"What we need to see is clear and convincing evidence that inflation pressures are abating and inflation is coming down — and if we don't see that, then we'll have to consider moving more aggressively."* - Chairperson Powell

War

Russia has shown itself to be willing to use energy as a weapon (cutting off gas supplies to Poland and Bulgaria, and electricity to Finland), while threatening to do the same to other European nations. Moscow's demand that European energy customers begin paying in Rubles, rather than Euros or Dollars, has been described by the European Commission as attempted "blackmail." The uncertainty of the war hangs over the market. The world has been receiving a constant drip of troubling news: consistent reports of civilian casualties and war crimes, displaced refugees, the potential for expansion of the war beyond Ukraine, disruptions in the energy and agricultural markets, and the rise of protectionism, with some countries banning wheat exports (e.g. Russia, and now India), and more.

CBOT HARD RED WINTER WHEAT (1ST NEARBY)



GLOBAL WHEAT STOCKS EXPECTED TO DECLINE FURTHER



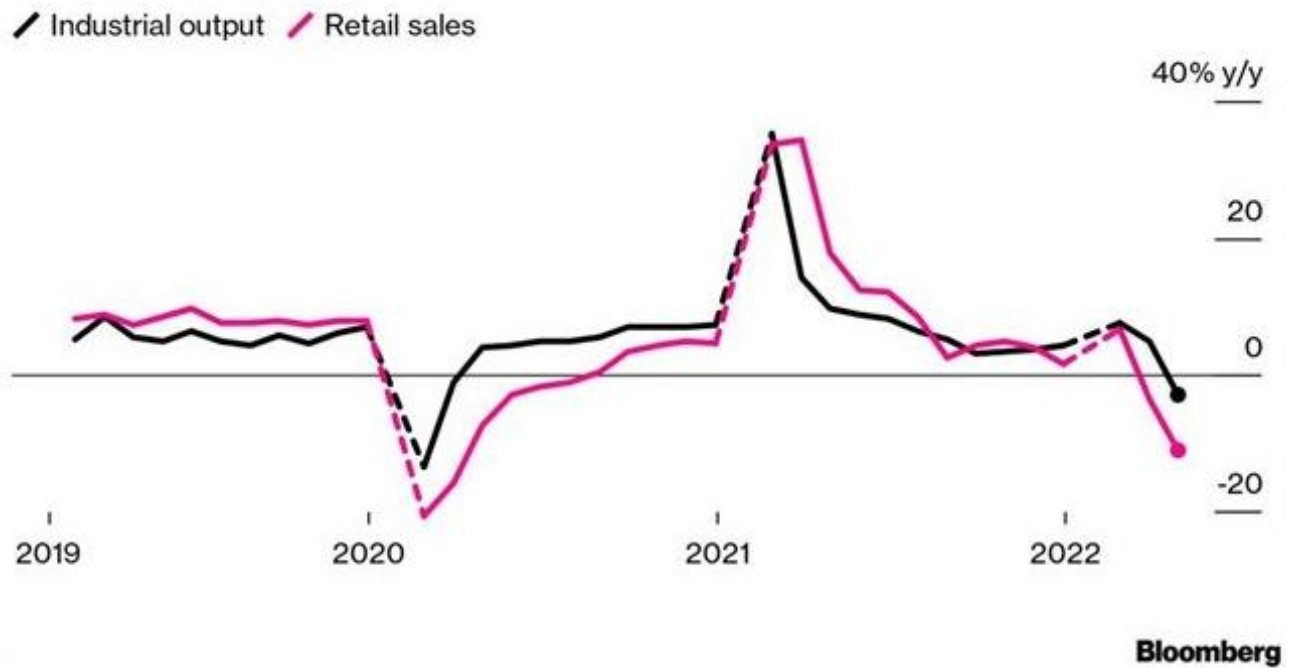
These all create greater uncertainty for the world, and uncertainty weighs on growth and financial markets.

Zero COVID

China's continued policy of Zero COVID has further strained already stretched supply chains. Economic shutdowns have created domestic unrest and slowed Chinese growth to the point that stimulus measures are being discussed.

SHARP SLUMP

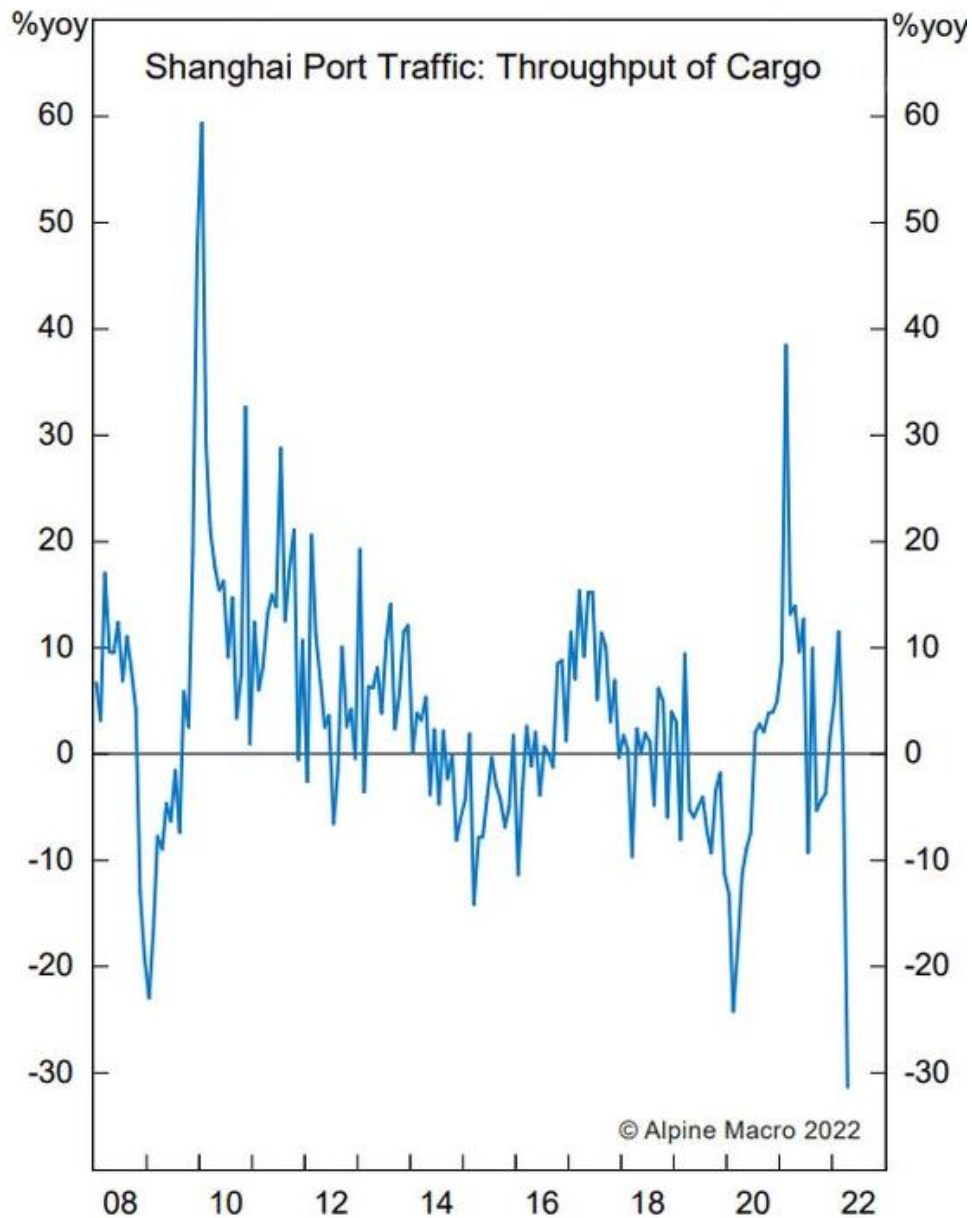
COVID and lockdowns drive China into contraction for a second time



Source: China's National Bureau of Statistics
Note: Jan.-Feb. data is combined by source

President Xi expects to be elected leader for life in November and is attempting to keep COVID numbers down and growth strong until then.

CHINESE ECONOMY'S SUDDEN STOP

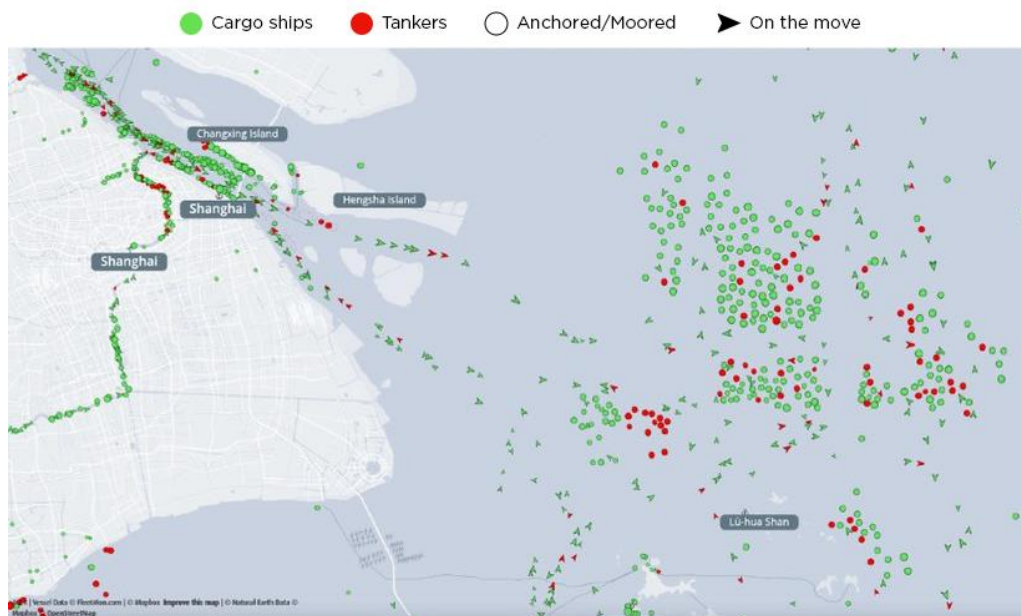


Source: Shanghai International Port (Group) Company Limited

Chinese ports are backed up due to the shutdowns, delaying the movement of goods, and further exacerbating supply lines.

SHANGHAI SHIP JAM SPELLS SUPPLY CHAIN TROUBLE

Cargo and tankers in Shanghai port area on April 28, 2022



Source: FleetMon

This fosters higher prices/inflationary pressures for the countries waiting for the delayed goods.

If China does implement stimulus measures while continuing with the zero COVID policy, they will likely see domestic inflationary pressures build.

Inversion

While more recently, we have experienced a steepening yield curve, there remains some concern over the yield curve movement on April 1st. The 2-year treasury yield briefly exceeded the 10-year treasury yield.

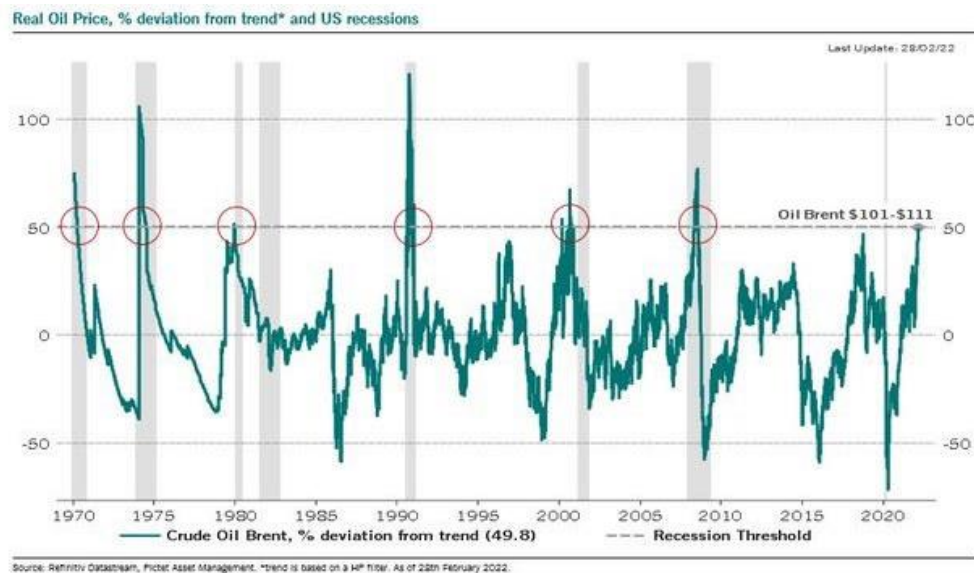


When longer maturity treasuries have lower yields than shorter maturity bonds, the curve is said to be “inverted.” A yield curve inversion has typically preceded recessions by 12-18 months. The academic research that supports yield curve inversions as a recession indicator uses a slightly more nuanced formula. Cam Harvey, a Duke professor who developed the research, looks for a sustained inversion. He typically wants to see the inversion last for a full calendar quarter. His research also focused on an inversion between the 3-month portion of the treasury curve and the 10-year treasury yield. So far, neither of the two triggers that have historically started the recession countdown clock have occurred.



Other concerns include the Federal Reserve rate hiking cycle and historic oil price shocks. Both of these have typically led to a recessionary period.

SURGE IN ENERGY PRICES SUGGESTS HIGH PROBABILITY OF RECESSION



The Fed continues to convey confidence that they can avoid recession by orchestrating a “soft landing,” but their track record does not lend support to this assertion.



We are actively monitoring these concerns.

Risk-Off

With these issues seemingly acting as storm clouds on the horizon, the financial markets have become skittish. Not Pandemic or Great Financial Crisis level fear, but a more generalized concern. Emerging from all-time low interest rates in the U.S., negative rates in Europe and Japan, creates valuation confusion. Future cash flows now must be discounted at a higher rate, shrinking their present value. If the assumptions underlying these future cash flows have become weaker, that creates additional downward pressure on the present value. Some Venture Capital backed companies that had been rising stars have imploded or run into difficulty raising additional funds. The markets are beginning to place a higher value on current cash flow, and becoming more skeptical about pro forma future revenue.

Stocks

Global equity markets have repriced based on the less supportive backdrop. The broad equity indices have performed in-line with one another, declining at a similar pace. U.S. exposure has held up well on a relative basis. Small and Mid-Cap stocks have drawn down less than Large-Cap. We have favored U.S. exposure, and within our U.S. exposure, we are overweight Small and Mid-Cap, capturing this performance. Within Emerging Markets, we have been underweight China. This was also beneficial, as Chinese stocks have underperformed the broader Emerging Markets index.



Across global equity markets we have seen a rebound in the performance of Value stocks relative to Growth stocks.

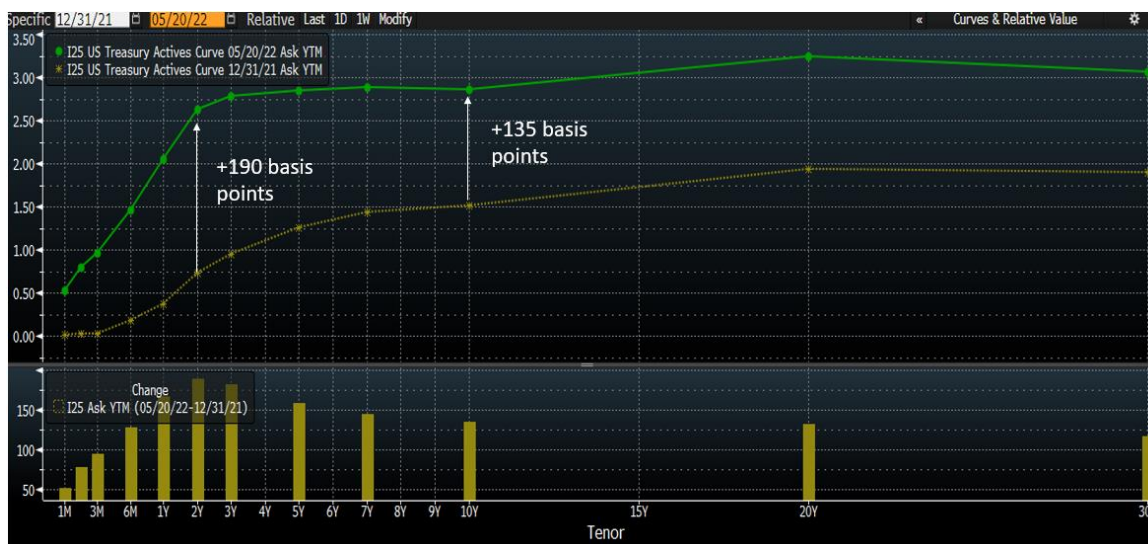


This is visible within the U.S., the ACWI, and Emerging Markets. Wherever you look, value investing has staged a comeback in 2022. Performance is still negative, but significantly less so than for Growth names, allowing Value exposure to be a relative outperformer in 2022 after many years of lagging behind Growth.

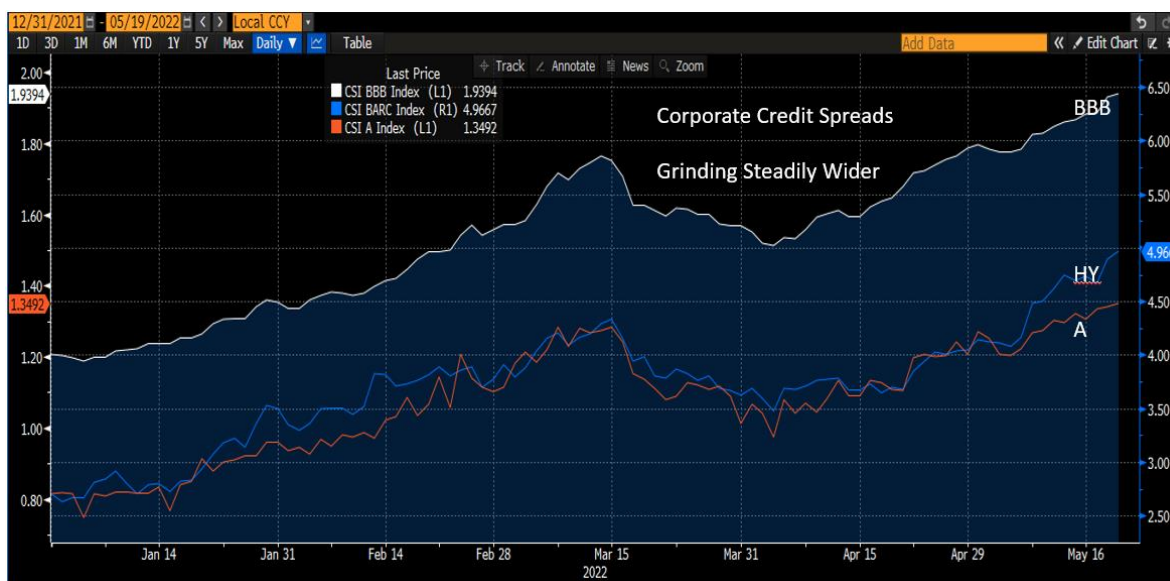
Bonds

The bond market has also faced a difficult environment this year. Inflationary pressures and a Federal Reserve that was too slow to react led to a significant repricing of market yields in a short period of time. With treasury yields adjusting significantly higher, bond prices declined along with the equity markets.

DRAMATIC RISE IN YIELDS Year to Date 2022

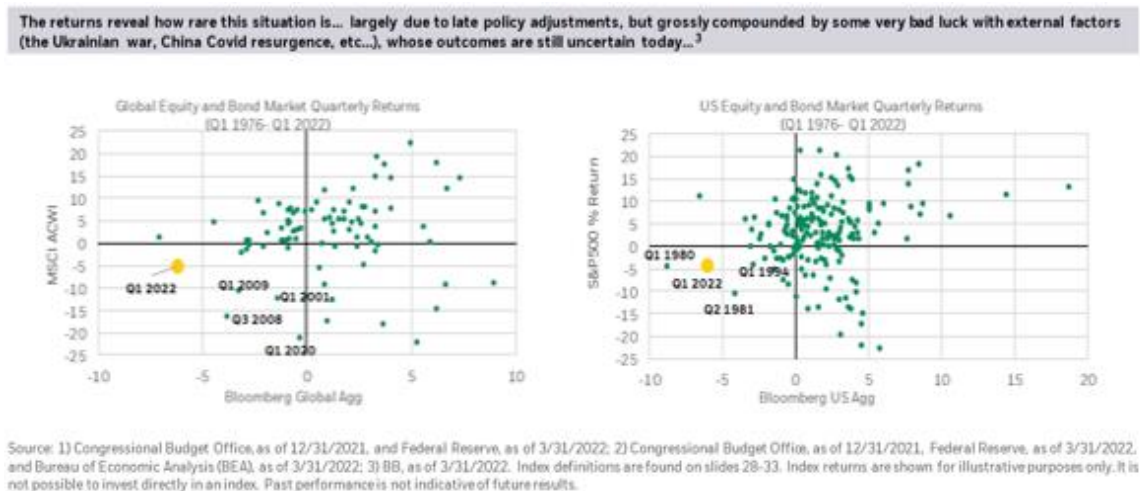


Credit spreads have widened steadily through 2022. This has put additional pressure on corporate bond prices. Investment Grade and High Yield bonds have all been affected. Current spread levels exhibit the concern in the market over the uncertainties that exist, but are not currently pricing in a recession. This means there is the potential for further widening if growth does contract significantly.



Our fixed income positioning continues to revolve around two goals, having less interest rate risk/duration than our benchmark, and having a higher portfolio yield than our benchmark. Positioning this way helps us to minimize the negative impact that rising interest rates have on bond portfolio returns.

In 2022, we have seen stock and bond prices move lower in tandem (lower left quadrant).



Historical returns show that this is an unusual scenario. Traditionally, high quality bonds can be expected to provide diversification, with bond prices moving inversely to stocks. This reduces portfolio volatility and allows for rebalancing opportunities.

Bitcoin

Bitcoin/crypto exposure had been trumpeted by many as a store of value, or the equivalent of “digital gold.” The 2022 experience has not been supportive of this assertion, with Bitcoin declining significantly more than either the S&P 500 or the broad-based bond indices. Bitcoin was roughly in line with the market decline through March 31st, then declined at triple the rate of the S&P 500. It is not a store of value, it is a risk asset.



Conclusion

As we approach mid-year 2022, we continue to focus on managing portfolio risk. The environment has shifted and we are responding. One of the benefits of a globally diversified portfolio is that it allows us to take advantage of relative value opportunities across the globe. As there are new developments, and valuations change, our team reacts to that by adjusting our outlook and how it is reflected in portfolios. We continue to diligently monitor the developments discussed as well as others, to position portfolios appropriately for market conditions. We work and live in the markets. I like to say it is a lifestyle choice. Downtime is limited, there is always something happening in the markets that needs our attention. Fortunately, we enjoy the intellectual challenge of our profession, and the reward of helping those depending on us, to accomplish their financial goals. Do not hesitate to reach out if you would like to discuss your portfolio, or simply chat about our market outlook.

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