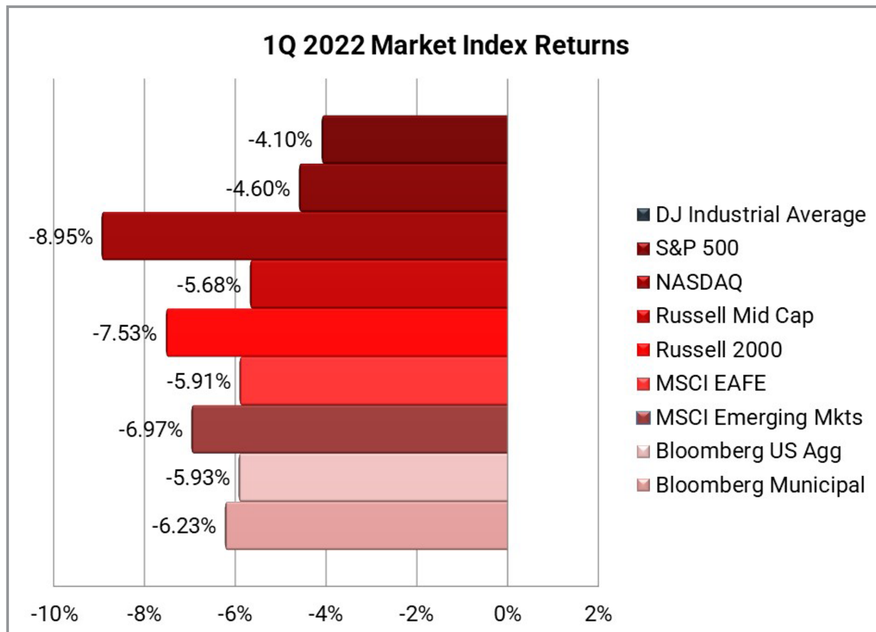
QUARTERLY MARKET COMMENTARY: *First Quarter 2022*

the ECONOMY

The ongoing war in the Ukraine is a humanitarian tragedy. And with the world seemingly turning the corner on the coronavirus pandemic, it presents a new set of challenges for the global economy. Coinciding with these challenges has been the resurgence of volatility, largely absent as stock investors had enjoyed nearly uninterrupted gains since the market bottomed in March of 2020. And while even the most experienced among us are liable to get distracted by the day-to-day gyrations of the stock market, it pays to take a step back and evaluate the underlying economic fundamentals.

On that score, the U.S. economy has, thus far, performed well. To be sure, first quarter GDP growth is tracking at a below average 1.5% according to Federal Reserve (Fed) estimates. But lest we forget, a significant wave from the Omicron variant of the coronavirus was a material headwind in January. Since then, the pace has picked up. A look at recent labor market data attests to that pick-up. Over two million new jobs have been created over the past three months, bringing the unemployment rate down to 3.6%, just a hair shy of the pre-pandemic low of 3.5%. And it's not just the currently unemployed who are finding work. A steady increase in the labor force participation rate suggests that people who weren't previously looking for a job, are coming off the sidelines in response to the availability of work, along with the potential for higher wages. Of course, that the income boost from government stimulus programs is also fading is likely another factor incentivizing job searchers.



The employment gains and earnings growth have supported strong consumer spending, which represents the largest component of GDP. We've also noticed that as coronavirus restrictions are lifted, that spending patterns are returning to a more normal mix of goods versus services. During the worst of the pandemic, spending was heavily skewed towards the former.

While we certainly like to see wage growth accelerating and healthy consumer spending, we do have to look at it in the context of multi-decade high inflation. At last check, the Consumer Price Index (CPI) was up 7.9% over the past year. The primary driver being the increase in energy prices, which rose 25.6% over that same period. Though energy prices are difficult to forecast, we'd note that oil prices have settled down somewhat at the end of March, well off their highs from earlier in the month. Also, the excessive spending on goods mentioned earlier was a key driver of the present inflation. Used cars prices, for example, rose almost 50%, an increase that we've never come close to experiencing before. Fortunately, prices for many of those goods are now in retreat, which should relieve some the inflationary pressure going forward. We do need to be mindful of surging home values though, which have shown yearly increases of nearly 20% for the past three months. Eventually, this will flow through into a higher rent calculation in the CPI.

Though the U.S. economy has held up well, much of Europe will likely bear the brunt of the economic fallout resulting from the Russia/Ukraine conflict. Not just because of geographical proximity, but thanks to many countries' heavy reliance on commodities imported from Russia for energy. Due to this, Russian energy companies have largely been exempted from sanctions put in place by European countries. But still, there remains a large difference in what the U.S. and Europe are paying for commodities like natural gas. That said, the European Union (E.U.) unemployment rate is currently 6.2%, the lowest in the bloc's history. But with declining business sentiment amongst continental Europe's major manufacturers, we'll keep watch for a change in this trend. The United Kingdom (U.K.) on the other hand, stands out as a relative bright spot. Many of its largest companies are involved in metals, mining, and energy, which stand to benefit from higher commodity prices, or consumer staples, which are less susceptible to external disruptions.

Moving East, Australia and Japan, while not immune to issues stemming from geopolitical events, have managed well through the first quarter. Australia's economy generally benefits from higher commodity prices, so we may see a modest growth surprise early this year. Japan has handled the pandemic better than most, and recently lifted the majority of its remaining COVID restrictions. Anecdotally, corporate Japan is reporting an improved ability to raise prices and production, which ought to be a tailwind for profits.

In emerging markets, it's really a tale of two hemispheres. In the West, many Latin America companies benefit from above average inflation and have seen both their stock and currency markets strengthen. In the East, though, markets in China, South Korea, and Taiwan have struggled. China's ongoing Zero-COVID policy threatens to delay needed improvements in global supply chains.

CENTRAL BANKS

With the persistence of inflation here in the U.S., the Fed is now fully committed to tightening monetary policy going forward. In fact, recent language from Fed officials indicate they may now be more concerned with fighting inflation than supporting the labor market. At this time last year, those priorities would certainly have been reversed. In any event, the Fed increased the federal funds rate by 0.25% after its March meeting and is forecasting six to seven more rate hikes through 2022. In addition, a plan is in place to end its open market bond buying program. With government deficits shrinking however, ending the bond purchases will likely be less impactful than it appears, since there are simply fewer bonds outstanding to buy.

Overseas, the Bank of England (BoE) has already increased rates three times. The European Central Bank (ECB), however, seems more reluctant to take action, especially given that European inflation is even more affected by rising energy prices, over which the ECB has little control.

BONDS

There's no sugarcoating it – it was a rough quarter for bond investors. Rising interest rates around the world took their toll on bond prices, which move inversely with rates. In the U.S., the 2-year Treasury yield climbed all the way from 0.76% at the start of the year, to 2.43% by the end of March. The long-term 10-year security moved from 1.63%, to 2.33% over the same period. Corporate and mortgage-backed bonds experienced similar shifts. When it was all said and done, the Bloomberg U.S. Aggregate Bond index – composed of domestic investment grade bonds – was down 5.93% for the first quarter.

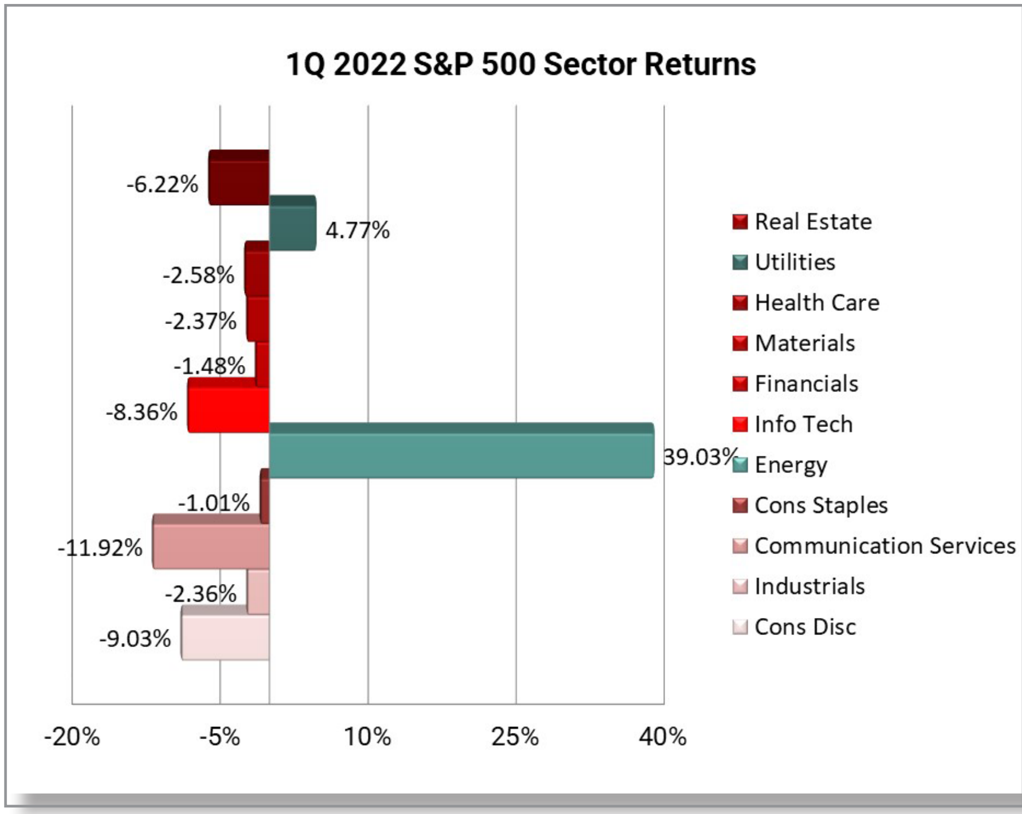
The decline in bond prices happened quickly, but it is important to note that we don't believe it reflects a deterioration in credit quality or fundamentals. Corporate America, in aggregate, is in a very healthy financial position in our opinion. Default rates are still historically low, even for lower-rated high yield bonds. So, we wouldn't take recent performance as an indication that bonds are no longer serving their purpose as safer investments, but rather a necessary adjustment to a higher interest rate environment.

The municipal market tracked their taxable peers in the first quarter. The Bloomberg Municipal index fell 6.23%. But like the corporate sector, most state and local governments are in solid financial shape. In fact, state tax revenues are at all-time highs in many locations.

STOCKS

As we mentioned earlier, volatility, long dormant, has returned for stocks. The combination of rising interest rates, persistent inflation, and geopolitical turmoil briefly sent the S&P 500 down 15% from peak to trough in the first quarter. And while these types of corrections are certainly unnerving, the average market correction for the past 40 years is about 14%. So, recent volatility has been, in short, pretty normal. Stocks did rebound off their lows in February, with the S&P 500 finishing down just 4.60% over the past three months. The value side of the market held up relatively well, down 0.74%, while growth stocks were off considerably more, falling 9.04%. Within value, there is a much higher weighting to energy stocks, which have been one of the few standouts in 2022, rising 39.03%.

It's a mixed bag outside of the U.S. Markets that are more exposed to energy, materials, and consumer staples firms have turned in positive performance. The U.K. and Australian markets, for example, are up 1.83% and 7.25%, respectively. Looking to the emerging world, the Latin American Index, which includes the likes of Brazil, Mexico, and Columbia, gained 26.96%. Germany on the other hand, which is heavily dependent on Russian energy exports, as well as emerging Asia that's dealing with a resurgence of COVID issues, were both down double digits.



Recent market drawdowns have modestly improved valuations. U.S. stocks currently sport a 4.09% free cash flow yield. Still more expensive than the long-term average, but reasonable in our view. Aggregate international markets look cheaper, with a free cash flow yield of 8.21%, though that likely reflects exposure to certain risks that are less salient in the U.S.

OUTLOOK

The Russia/Ukraine conflict has turned what was a mostly positive outlook to start the year into one that is far more uncertain. To be sure, a global downturn is not our base case, but there are a host of new risks to be cognizant of as we look ahead.

First, is that the sanctions placed upon Russia are unprecedented in scope. Russia's total economic output and market capitalization are small on a global scale, but it is difficult to quantify the aggregate impact of the sanctions, especially without a historical analogue. Second, while Russia is a small percentage of world trade, its primary energy industries are crucial to the smooth operations of those businesses and countries that depend on it. It's an imperfect analogy, but we think of Russia like a neighborhood gas station, from an economic perspective. We typically don't spend a big chunk of our income there, but if it were to close shop or meaningfully increase prices, that would lead to some headaches. The lasting impact of the above, as long as the conflict continues and the sanctions remain in place, is likely to be higher commodity prices than we'd otherwise experience, along with additional commodity price volatility, making it more difficult for firms and consumers to plan for the future.

This uncertainty around the future is one reason that consumer confidence here in the U.S. has declined over the first quarter. But despite that, what consumers are doing doesn't necessarily align with what they are saying, at least not yet. Overall consumption has been solid, especially in service industries like travel, leisure, and entertainment. If consumers are unhappy, it certainly hasn't impacted their desire to take vacations and go out to eat, two highly discretionary endeavors. Indeed, the ISM Services survey, designed to measure business confidence in those sectors, recently checked in at 58.3, pointing to solid demand overall. Any reading above 50 signals expansion. We think the service side of the economy is poised to continue growing, as consumers decide to spend money on experiences after loading up on home goods during the pandemic. The employment market also shows no signs of slowing. Current job openings are above 11 million, near a record high. And initial jobless claims, a proxy for weekly layoffs, are at their lowest level since the 1960s. Things change of course, but historically the economy hasn't entered a recession when demand for labor is this strong. On top of that, our view is that both consumer and corporate balance sheets are in very good shape, with manageable debt levels and low debt servicing costs.

The European economy is not as well insulated as the U.S., so odds of a slowdown there are higher. Yet we think it's important to note that not all slowdowns necessarily entail deep recessions and bear markets. Those are the ones we remember, of course, but we wouldn't call that the norm. In emerging markets, we touched on the some of the positive tailwinds in Latin America. China, however, does have some unique issues of its own. The property market is clearly slowing, and a haphazard Zero-COVID policy threatens to prolong supply chain issues. But the expectation is still for moderate growth through 2022. Also, China's central bank may be the one major institution that is actually easing policy, as opposed to tightening it.

Another important dynamic we're keeping an eye on, is the fading fiscal stimulus in the U.S. Deficits aren't great for long-term fiscal health, but they certainly appear to have helped corporate profits. To the extent that stimulus diminishes, earnings likely grow at somewhat slower rates. But to be sure, we still do expect growth for the remainder of this year. Interestingly, while fiscal stimulus in the U.S. is set to wane, it may just be getting started in Europe. Spurred by the coronavirus pandemic and even further accelerated by recent geopolitical events, the long-term E.U. budget combined with the NextGenerationEU recovery package will likely end up as $2 trillion in additional stimulus over the next 5 years, much of which directed towards energy infrastructure and defense spending. It's the largest stimulus package in the history of Europe.

In conclusion, the outlook today certainly warrants more caution compared to the beginning of the year. And while we're carefully monitoring each and every new geopolitical development, our base case is for continued global growth, albeit at a modestly lower pace than previously expected. Also, midterm election years have been historically more volatile than average. So far, 2022 fits the pattern. The good news though, is that markets have tended to settle down once the elections pass. And it's always good to remind ourselves that these times of uncertainty are an inevitable part of investing, and that long-term success requires a disciplined approach and adherence to an appropriate plan. As always, we are continuously evaluating new information as it develops and are ready to adapt portfolios as evolving conditions warrant.

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