Insights: April 2022

Market Overview and Performance

After three straight years of positive equity returns averaging +26% and 12 of the last 13 years delivering positive results for investors, the first few months of 2022 have presented quite a shock to some investors. This experience has been made worse by the fact that long-duration fixed income assets, which are generally perceived to be safe haven investments over the long term, have fared equally poorly thus far in 2022. As of writing, the S&P 500 was down a little over -12% for the year and aggregate US bonds have declined by roughly -9%. While much of this year's challenging environment can be attributed to the US Federal Reserve beginning its well telegraphed intention of removing quantitative easing combined with an increase in interest rates, more dark clouds appeared on the horizon this month with the lock-down of major economic centers in China. This raises legitimate concerns about a global growth slowdown in the second half of this year. The consensus view heading into 2022 was that the first half of the year would be somewhat volatile as the market digested the path taken by the Fed, while the second half of the year would prove to be much more constructive. However, the invasion of Ukraine was a wildly unexpected threat to globally stability, particularly within the energy complex. With the draconian lockdowns in China creating another unanticipated impediment to global commerce, the future global growth trajectory remains a question mark. Yet within the US, The Fed is steadfast on raising rates. As Chairman Powell stated last week, "*We really are committed to using our tools to get 2% inflation back…So it is appropriate in my view to be moving a little more quickly. And, I also think there's something in the idea of front-end loading whatever accommodation one thinks is appropriate.*" The market does not entirely believe him at this point, but it will depend on what transpires in the coming months. Thank you for reading our latest Insights.

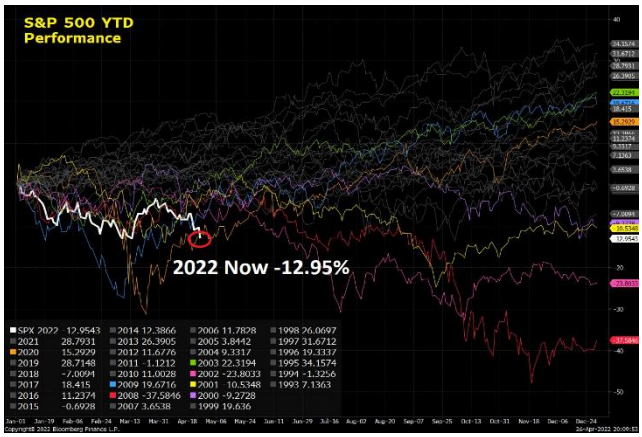
	Quarter to Date March 31	***Year to Date March 31***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	-4.60	**-4.60**
Russell 2000 Index	-7.53	-7.53
MSCI EAFE Index	-5.91	**-5.91**
MSCI Emerging Markets Index	-6.97	-6.97
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-5.93	**-5.93**
Barclay's U.S. Aggregate Credit Index	-11.23	**-11.23**
Barclay's U.S. Aggregate Corporate High Yield Index	-4.84	-4.84
Barclay's Municipal Bond Index	-6.23	**-6.23**
Macro Measures		
Gold	6.86	**6.86**
Crude Oil	33.33	**33.33**
CBOE Volatility Index	19.44	**19.44**
USD Dollar Index	2.44	2.44

Current Theme – Worst Start to a Calendar Year for Both Equities and Bonds Leaves Investors Nervous as the Interest Rate Hiking Cycle is Just Beginning

While Geopolitical Tensions Remain Prominent, Investor Concerns Begin to Increasingly Transition Away From Inflation and Toward Potentially Slowing Economic Growth

While the start of 2022 has proven to be surprisingly painful to investors, the severity and velocity of the damage has not been widely publicized. Consider that while the current -13% drawdown of the S&P 500 matches the average annual drawdown since 1980, at this point in the year, the Index level decline is now the worst in 30 years – even worse than 2020 experienced.

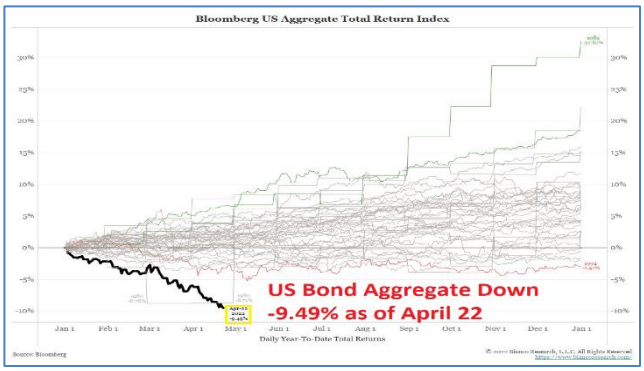
S&P 500 -13% Start Worst in 30 Years – Worse than 2020



Source: Bloomberg; Michael McDonough

Even less highlighted is the fact that the bond market, traditionally inversely corelated to the equities, is also suffering through its worst start ever by a large margin.

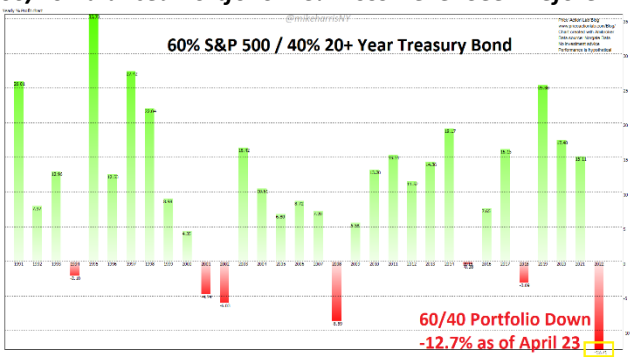
US Aggregate Bond Index Having Its Worst Year By Far



Source: Bloomberg; Bianco Research

This is a shocking result for bond investors. Negative annual returns for bonds are generally quite rare and even during negative return years for bonds such as 1994, losses have more or less been contained to around -2.5% or better. To make matters worse, those investors who counted on their bond positions to protect them during a steep equity sell off have not seen the benefit of diversification whatsoever. Consider the illustration below which charts the annual performance of a 60% Equity / 40% Bond portfolio.

60/40 Balanced Portfolio -13% Loss Never Seen Before



Source: Michael Harris; PriceActionLab.com; Norgate Data

The return of this historically trusted moderate asset allocation is -13% in 2022. As one can plainly see, this is well beyond the scope of experience for the average balanced investor over the past 32 years. Only a handful of years have seen negative returns over that period and none were anywhere close to -13%. Even the crisis year of 2008 declined only -8%.

S&P 500 Index Level Masks Underlying Stock Damage

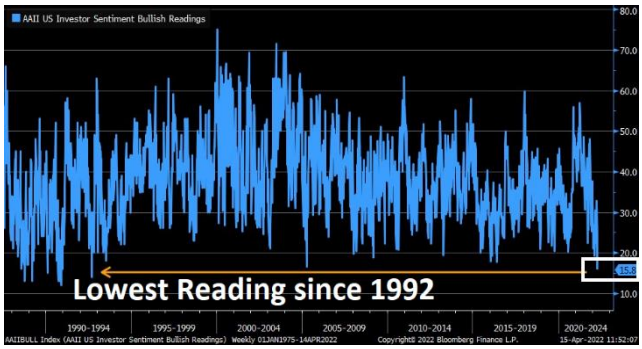
INDEX	2022 YTD Return	Drawdown From 52W High	Average Member Drawdown From YTD High	Average Member Drawdown From 52W High
S&P 500	-10%	-13%	-20%	-25%
NASDAQ	-18%	-22%	-31%	-47%
RUSSELL 2000	-14%	-21%	-31%	-45%

Source: Liz Ann Sonders Charles Schwab; Bloomberg; as of April 22

While high single digit declines are never pleasant, the above table shows that the underlying currents for equities are actually much worse. As of April 22, the S&P 500 was down about -10% year-to-date, the NASDAQ down -18% and the Russell 2000 small cap index down -14%. Yet looking to the right, one can see

that the experience for the average stock within those indices is actually about twice as bad. For example, the average S&P 500 stock is down -20% in 2022 and is -25% off of its 52-week high price level. NASDAQ and Small Cap stocks have fared even worse falling roughly *-31%* year-to-date and *-45%* from their 52-week high.

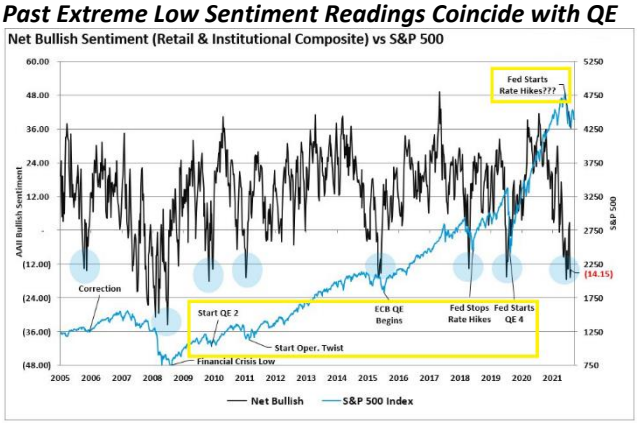
Individual Investor Sentiment is the Lowest in 30 Years



Source: Bloomberg; AAII Investor Sentiment Survey

Given those returns, it's no surprise that the 2022 market "feels" worse than the index level data would suggest. And we have evidence of this. Consider the chart above which tracks "Bullish Sentiment" in the American Association of Individual Investors survey. At present, that reading is the lowest seen since *1992*. This is astounding when taking into account that this 30 year window includes the Dot Com Bubble, the Global Financial Crisis, and the Covid Pandemic.

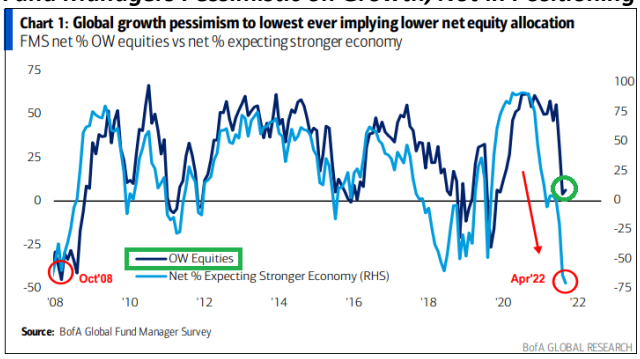
Past Extreme Low Sentiment Readings Coincide with QE



Source: Lance Roberts; Real Investment Advice

Broadening out the sentiment reading to include institutional investors as Investment Strategist Lance Roberts has done in the above chart, one can see another unusual element to the current poor sentiment levels. On the past five occasions when market sentiment collapsed to such depressed levels, central banks were on the cusp of launching quantitative easing into the financial system. Investors are now faced with the opposite policy action with the Federal Reserve on a tightening path.

Fund Managers Pessimistic on Growth, Not in Positioning



Source: BofA Global Fund Manager Survey

According to BofA Global Research, fund managers are not immune to the extreme negativity either. As seen above, the percentage of managers expecting stronger economic growth is *below* the level seen in late 2008. What is also notable in their chart is the percent of managers overweight equities (dark blue line). Over time, this measure has closely tracked the growth expectations reading. However, as of now, managers remain overweight in their equity allocations.

Earnings Estimates Have Risen Continuously Since March

S&P 500 EPS growth expectations rose again last week

Date	1Q22E EPS Growth	2Q22E EPS Growth	3Q22E EPS Growth	4Q22E EPS Growth
12/1/2021	9.00%	1.83%	9.25%	-
1/1/2022	9.82%	2.55%	9.71%	14.92%
2/1/2022	9.12%	3.17%	10.53%	12.94%
3/1/2022	6.66%	2.74%	11.29%	12.79%
4/1/2022	7.01%	2.54%	11.30%	12.93%
4/18/2022	7.00%	3.06%	11.88%	13.62%
4/25/2022	8.31%	3.27%	12.20%	13.98%

Source: The Earnings Scout

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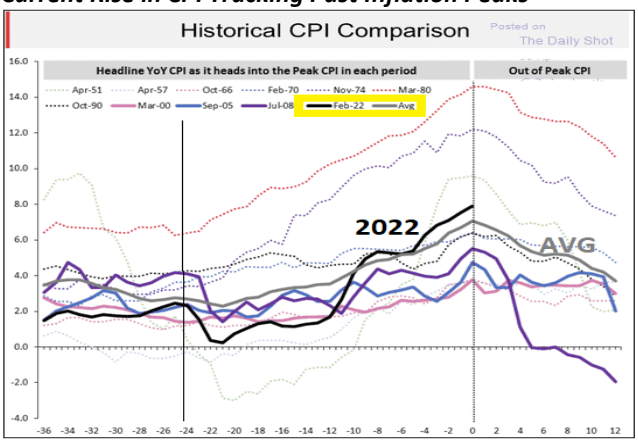
Why this gap? It seems that regardless of the negative outlook predominant among investors, few actually have the conviction to position themselves overly defensively. We see evidence of this in measures such as equity fund flows, ETF flows, and insider buying which have all remained consistently positive. Investors may "feel" concerned about the future, but fundamental drivers of risk asset prices continue to deliver positive results. The table above from The

Earnings Scout, highlights the fact that since the beginning of March, earnings estimates for the next four quarters have risen at a steady pace. In fact, on April 25th, Credit Suisse suggested that based on the results they have seen thus far this earnings season, Q1 earnings growth could be +11.9%, well ahead of the +7% estimate at the start of reporting season.

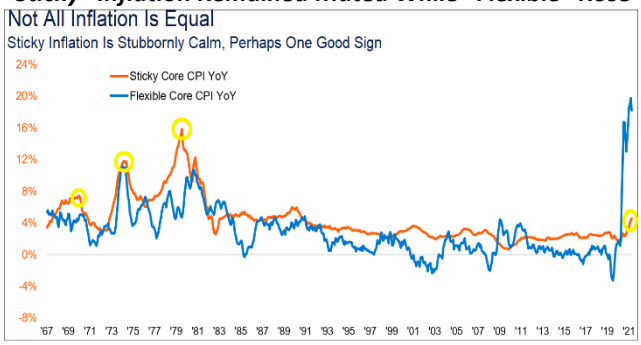
Current Rise in CPI Tracking Past Inflation Peaks



Source: FRED; MUFG US Macro Strategy

Clearly, the market has concerns beyond just company fundamentals at this point however, most pointedly inflation. There is no question that a headline CPI measure of 8% is a frightening development for many investors, however, it is important understand some of the dynamics driving that number. As the chart above from MUFG Bank illustrates, in the previous 10 instances of CPI peaks since 1950, headline inflation tended to climb for 24 months before the inflection point and then decline rapidly in the next 12 months.

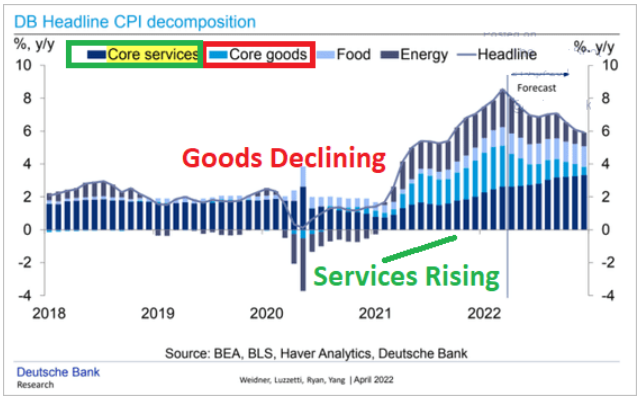
"Sticky" Inflation Remained Muted While "Flexible" Rose



Source: LPL Research; Federal Reserve Bank of Atlanta

The trend often reverses because the things that drove up inflation tend to recede just as quickly. Consider the chart above from LPL Research which differentiates the paths of what the Federal Reserve terms "flexible" items versus "sticky" items in measuring inflation. Flexible items are logically things like used car prices, apparel, and hotel prices, etc., which tend to fluctuate greatly. Sticky items on the other hand are mostly necessities, i.e., medical care, education, household operations and such. As one can clearly see, "flexible"" inflation has raced higher while "sticky" inflation has remained muted. This has a lot to do with what happened in the US economy during the pandemic which is notably different than the structural inflationary problems of the 1970's (yellow circles).

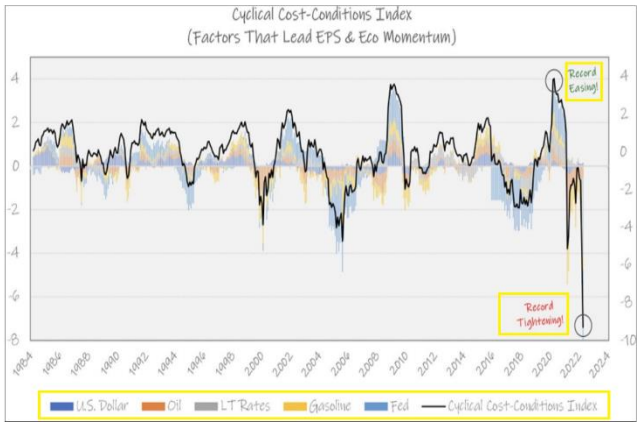
Falling Demand for Goods Will Relieve CPI Pressure



Source: Deutsche Bank; BEA; BLS; Haver Analytics

And we do have evidence that demand for discretionary goods is in decline. As the chart above from Deutsche Bank suggests, as these pressures ease, overall CPI should decline shortly thereafter.

"Market is Doing the Fed's Work For Them" = Tightening

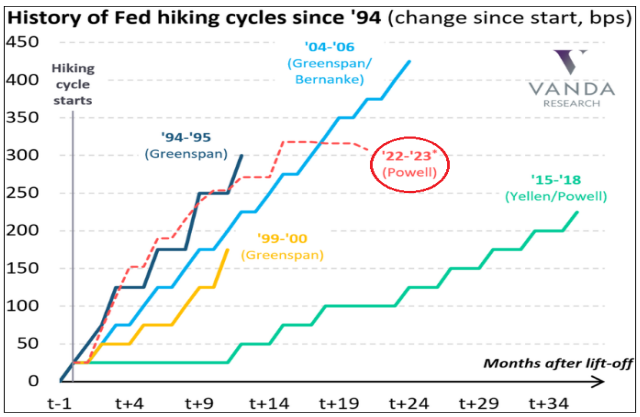


Source: Zero Hedge, Piper Sandler, Michael Kantrowitz

This is precisely what the Federal Reserve would like to see transpire – they want to temper demand in the

economy. As Piper Sandler compiles in the previous chart, the components of their "Cyclical Cost Conditions Index" (US dollar, Oil, long-term rates, Gas, Fed), have all combined to equate to record tightening of financial conditions without the Fed essentially having to do anything at all in terms of rate increases.

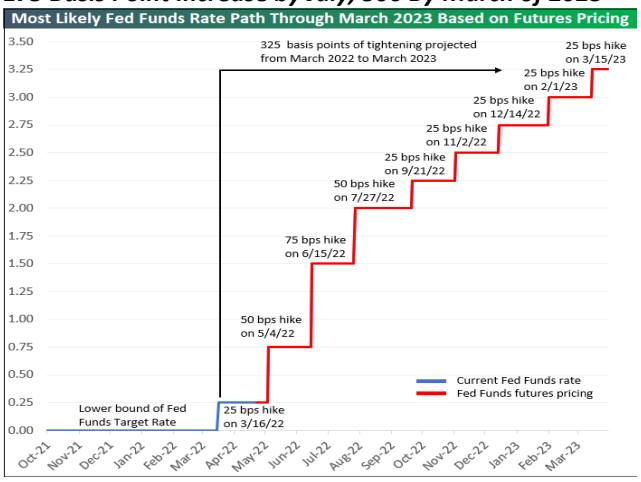
Market Has Priced in a Very Steep Rate Increase Path



Source: Bloomberg; Vanda Research

Even with the desired cooling in demand, the market still anticipates the Fed to raise rates at the fastest pace since 1995 as seen above, and much faster than they did in 2015 (green line). Interestingly, the market has already priced in rate cuts in 2023.

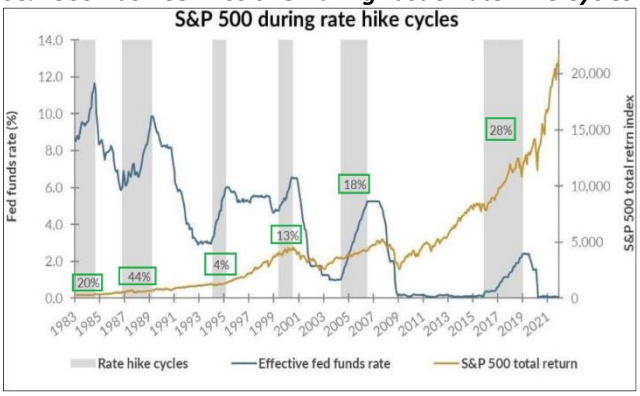
175 Basis Point Increase by July, 300 By March of 2023



Source: Bespoke Research; CME Group Fed Watch Tool

As we cited in our opening comments, Fed Chairman Powell has clearly articulated his desire to move aggressively with regard to rate increases and the market has taken that to heart. As seen above, rate increases of 50, 75 and 50 basis points are anticipated by the market in May, June and July respectively. In fact, about 275-300 basis points of rate hikes are anticipated in 2022 which matches the current 10-Year Treasury Bond yield as well as the 5-Year Forward Inflation expectation, suggesting that the market has largely "priced in" the increases.

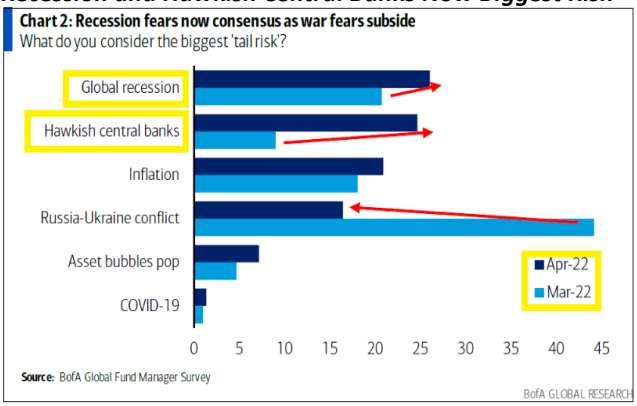
S&P 500 Has Been Positive During Last 6 Rate Hike Cycles



Source: Zero Hedge; Plante Moran FA; FRED; Morningstar

Given the forthrightness of the Fed and the market already incorporating the likely path forward, it's worth pointing out that counter to intuition, equities have historically performed well during past hiking cycles. As seen above, during the last 6 cycles, the S&P 500 experienced positive returns on each occasion.

Recession and Hawkish Central Banks Now Biggest Risk



Source: BofA Global Fund Manager Survey

As we have discussed in previous Insights, the lingering concern in the market has always been that when the Fed moves away from the stimulative policy of zero percent rates, they will error on the pace, act too aggressively, and force the economy into an uncontrolled slowdown or even a recession. As seen above, these notions are now the primary risks in the minds of fund managers as the hiking cycle begins in earnest over the coming months.

Going Forward

In our last Insights letter, we wrote the following which is still very much true today. "Financial markets across asset classes are intently focused on the likely actions of the US Federal Reserve and the implications of those policy decisions. This is not an enviable position for the Fed…the Fed is trying to raise rates in an environment with extremely poor consumer sentiment, high but rolling over inflation and equity markets that essentially don't believe the Fed will continue to raise rates if stock prices decline materially." Quite a few things have changed since we published that letter however.

Obviously, the invasion of Ukraine was a complete Black Swan event which most, including ourselves, had underestimated as a possibility. Yet, remarkably equities are up since the invasion in late February and impacted assets such as oil and gold have retraced much of their post invasion spikes. With that said, as we mentioned earlier, investor focus has transitioned away from geopolitics to a degree and toward the Fed. The other big change of over the last few months is the increase in yields as the market digests the telegraphed rate hikes. The severity of losses in the bond market this year as a result has crated a "can't win" situation for many investors as previously non-correlated assets (equities and bonds) fell in tandem. In fact, the only places where investors enjoyed positive returns during the first quarter were gold, up about +7%, and non-precious metals commodities which were up roughly +33% as a group. We significantly increased our commodity exposure in late January/early February and continue to believe that this area will provide both diversification and constructive returns as supply constraints in many areas look as if they will persist for quite some time.

With US equity markets peaking in early January after a very strong December rally, we did take the opportunity to raise some cash during the month of January. As markets deteriorated throughout the following months due to both the Ukraine and the Fed, we increased and maintain a higher than normal cash allocation. With portions of the US equity market down by anywhere from -10 to -20%, we believe there are opportunities in quality companies which we view as trading at discounts to their long-term value, namely in the information technology, financial, energy, healthcare and material sectors. We look forward to allocating capital to selected positions across industry groups that we believe are well positioned as further opportunities develop, particularly in light of what has been a better-than-expected earnings season thus far.

Small and mid-cap stocks have suffered more than their large cap alternatives during the recent market drawdown. At this time however, we believe that there is greater opportunity for long term gains in oversold quality large cap companies.

We began 2022 with the belief that Europe and Asia would prove to be fruitful areas of focus for the year. Both of those regions offer much more compelling valuation metrics combined with solid and improving fundamentals at both the company and broader economic levels. However, given the conflict in Europe and the severe policies being used to combat COVID in China, non-US markets will remain challenged for the time being, particularly in light of a very strong US Dollar.

Within fixed income, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We also favor municipal bonds and short-term corporate bonds based on the belief that the opportunity in these segments provides a better relative value. Fixed income allocations have been very challenging for investors for some time now and have been heightened by the recent sharp losses. However, with the move up in yields potential new allocations to fixed income have become much more appealing for some investors. Additionally, JP Morgan has found in their research that there is strong appetite for institutions to rotate some of their allocations back into bonds around the 3% yield level which could spur demand.

As mentioned, we believe that commodity exposure including both gold and non-precious metals (agriculture, industrial metals, energy) will be additive throughout 2022.

Thank you for taking the time to read our thoughts on the markets and we look forward to speaking soon.