Insights: January 2022

Market Overview and Performance

Capped by one of the largest "Santa Claus" rallies in recent memory of +5.5%, the S&P 500 hit a new all time high of just over 4800 on January 4, 2022. In fact, as Guggenheim Partners points out, as of December 31st, 2021, the S&P 500 Index had risen +99.8% from the low reached on March 16 of 2020. Stretching the lookback window out to a full three years, the S&P 500 has experienced high double digits returns during 2019, 2020 and 2021 with an annualized return of over +24%. Without question, these are extraordinary results. But in reality, US equity markets have been remarkably constructive for quite some time. Since the low in March 2009 during the Global Financial Crisis, the S&P 500 has risen over +800% or just shy of +19% per year for roughly 13 straight years. The historical average of over the past 90 years is closer to +10%. As a consequence, a decline of about -10% during the first few weeks of 2022 has rattled some investors who have become accustomed to the steady upward trend. In short, the negative reaction is due entirely to the pivoting Federal Reserve who now seem quite determined to follow down their well telegraphed path of raising rates and shrinking their balance sheet. Goldman Sachs summarized Chairman Powell's January 26th comments as follows. "*First, he emphasized that the economy is in a very different place than when the FOMC hiked last cycle. Second, he acknowledged the uncertainty about the inflation outlook and said that monetary policy needs to be in a position to address different outcomes, including one in which inflation runs higher. Third, he said that the FOMC would move "steadily" away from its current policy stance, avoiding the term "gradual" used last cycle".* Both the equity and bond markets have their doubts about just how much action the Fed can take and how quickly that can be accomplished without disrupting either the economy or the financial markets. Time will tell.

As always, thank you for reading our latest Insights.

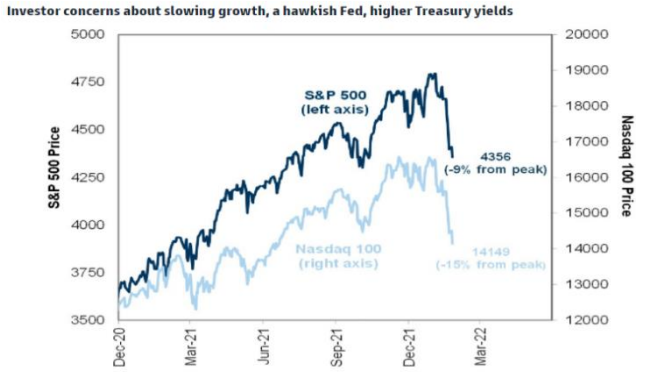
	Quarter to Date December 31	***Year to Date December 30***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	**7.87**	**28.71**
Russell 2000 Index	2.14	14.82
MSCI EAFE Index	2.69	11.26
MSCI Emerging Markets Index	**-1.31**	**-2.54**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.01	**-1.54**
Barclay's U.S. Aggregate Credit Index	1.52	**-1.18**
Barclay's U.S. Aggregate Corporate High Yield Index	0.71	**5.28**
Barclay's Municipal Bond Index	0.72	1.52
Macro Measures		
Gold	4.08	**-3.51**
Crude Oil	0.24	**55.01**
CBOE Volatility Index	**-25.58**	**-24.31**
USD Dollar Index	1.85	6.72

Current Theme – After a Very Strong Three-Year Period, Equities Experience Their First Correction as Potential Actions from the Federal Reserve Revive Memories of Past Policy Mistakes

In Addition to the Fed Raising Rates, Investors are Also Concerned About Persistent Inflation, Slowing Economic Growth and Geopolitical Tensions

As clearly illustrated below, the opening days of 2022 have not been kind to US equity investors, particularly those exposed to the largest component of the indices, large cap technology. While never pleasant, drawdowns are exceedingly common for risk assets – market participants have simply been spoiled by a very timid period as of late with little volatility.

From the Peak, S&P 500 and Nasdaq down -9% and -15%



Source: Factset, Goldman Sachs Global Investment Research

The average intra-year drawdown for the S&P 500 over the past 94 years is -16.5% according to Ben Carlson at Ritholtz Wealth Management, with declines exceeding -10% occurring during two thirds of those years.

Three Sectors Account for 80% of S&P 500 YTD Decline

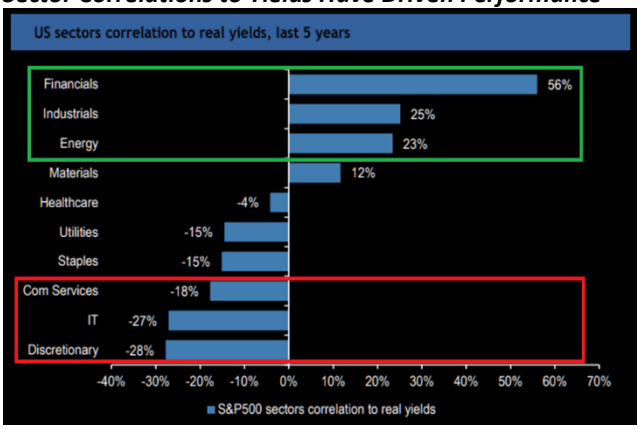
S&P 500 Return Attribution

Sector	Weight on Jan. 3, 2022	Return since peak	Basis points of S&P 500 return
Energy	**3 %**	**14 %**	**39 bp**
Utilities	2	(5)	(13)
Consumer Staples	6	(3)	(18)
Materials	3	(7)	(17)
Real Estate	3	(8)	(23)
Industrials	8	(4)	(31)
Financials	11	(3)	(30)
Health Care	13	(8)	(108)
Comm. Services	10	(11)	(114)
Cons. Discretionary	13	(15)	(193)
Info Tech	29	(14)	(411)
S&P 500	**100 %**	**(9)%**	**(918)bp**

Source: Factset, Goldman Sachs Global Investment Research

While we have experienced broad selling during the most recent correction, the previous chart highlights the fact that 80% of the S&P 500 downdraft can be attributable to just 3 sectors - Information Technology, Consumer Discretionary and Communication Services. This makes sense given that these sectors are the most negatively correlated to rising real yields, or yields that take inflation into account. Investors are well aware of these dynamics and have been rotating into those sectors which fare better during rising yield periods such as Financials, Industrials and Energy.

Sector Correlations to Yields Have Driven Performance



Source: JP Morgan

What many forget is that this pattern occurred at the beginning of 2021 as well, although with a much less severe impact on stock prices. Fortunately, when markets do decline in a rapid fashion, the recovery tends to be quick as well. In the table below, LPL Research analyzed the previous 6 times the S&P 500 fell from an all-time high to down -10% in less than one month. As the yellow highlights show, over the next 3- and 6-month time periods, the Index was positive 100% of the time with average returns of +7.6% and +14.7% respectively.

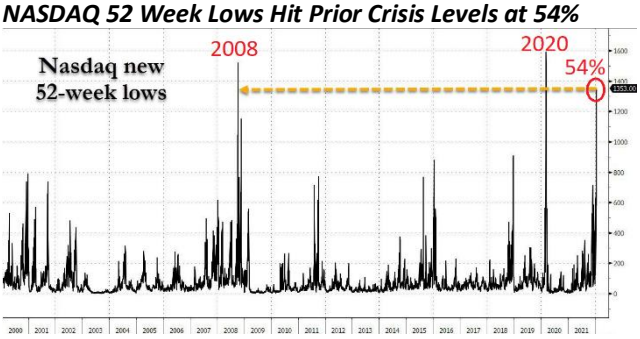
Quick Corrections Typically Reverse Quickly as Well

Date	Days to 10% Corrcection	Next 3 Months	Next 6 Months	Next 12 Months
10/11/1955	12	10%	18%	15%
10/27/1997	14	12%	25%	22%
8/14/1998	20	5%	17%	25%
4/14/2000	15	11%	1%	-12%
2/8/2018	9	6%	11%	5%
2/27/2020	6	2%	17%	28%
1/24/2022	14	?	?	?
Average		7.6%	14.7%	13.7%
Median		7.6%	16.8%	18.1%
% Positive		100.0%	100.0%	83.3%

Source: LPL Financial; Ryan Detrick

It may seem naive to simply say that the Market can simply revert higher because it has in the past. However, the intensity of the selling has occurred in the largest components of the indices – tech, consumer and communications services. These sectors comprise over 50% of the S&P 500 and about 85% of the NASADQ 100. As seen below, new 52-week lows within the NASDAQ have reached depths only seen during the market crashes of early 2020 and 2008. These companies also dominate the earnings and sales growth within the indices, so a shift in sentiment if they deliver solid results would not be surprising.

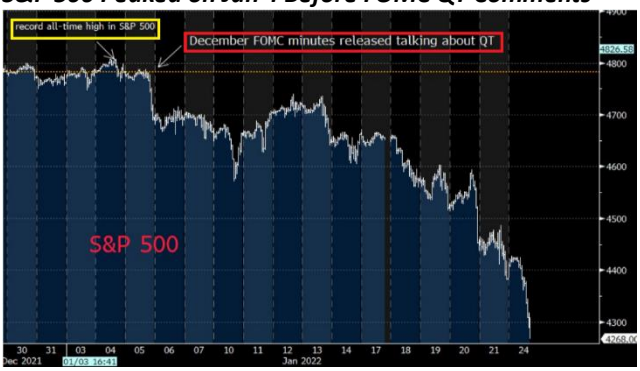
NASDAQ 52 Week Lows Hit Prior Crisis Levels at 54%



Source: Zero Hedge

So what caused this whole cascade in the first place? It's pretty straightforward to point to the Fed minutes from January 4th as the culprit. The statement included the following: "*it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated. Some participants also noted that it could be appropriate to begin to reduce the size of the Federal Reserve's balance sheet relatively soon after beginning to raise the federal funds rate".* Faster rate increases and the initiation of a reduction in the Fed balance sheet was not being priced into the markets at the end of 2021.

S&P 500 Peaked on Jan 4 Before FOMC QT Comments



Source: Bloomberg, John Authers

That's not to say that the topic was not already top-of-mind throughout the year based on rising inflation and previous Fed commentary. In fact, the 10-Year Treasury nominal and real yield had spiked in early 2021 as one can see in the chart below.

"Taper Tantrum" Developed at the Start of 2021 as Well

Source: Bloomberg

The market decline in January of 2021 was only a little over -1% and the market soon recovered, however it is certainly widely perceived that Fed rate hikes will "kill the market". This is not borne out in the data if we look back at the history of rising rate cycles.

S&P 500 Often Choppy After 1st Hike, Strength Thereafter

SPX Performance Around Rate Hike Cycles (Initial Hike Dates, 1982 - Current)								
Hike Cycle Starts	12M Prior	6M Prior	3M Prior	1M Prior	1M After	3M After	6M After	12M After
1/31/1982	-7.06%	-8.04%	-1.22%	-1.75%	-6.05%	-3.29%	-11.05%	20.68%
1/31/1984	12.46%	0.52%	-0.09%	-0.92%	-3.89%	-2.06%	-7.80%	9.93%
6/30/1988	-10.03%	10.34%	5.98%	7.92%	-0.54%	-0.58%	1.54%	16.26%
2/4/1994	4.50%	4.74%	2.69%	0.63%	-1.08%	-3.85%	-2.43%	1.88%
6/30/1999	21.07%	11.43%	5.53%	5.44%	-3.20%	-6.56%	6.68%	5.97%
6/30/2004	17.07%	2.81%	1.23%	1.80%	-3.43%	-2.30%	6.37%	4.43%
12/17/2015	1.44%	-2.79%	2.60%	-0.42%	-7.91%	-0.06%	1.44%	10.59%
1/26/2022 ?	14.24%	-0.56%	-3.87%	-6.94%	-	-	-	-
Average	6.71%	2.31%	1.61%	0.72%	-3.73%	-2.67%	-0.75%	9.96%
Pct. Pos.	75.0%	62.5%	62.5%	50.0%	0.0%	0.0%	57.1%	100.0%

Source: Jefferies Financial Group; The Market Ear

Jefferies Financial Group analyzed the last 7 rate hikes cycles and the 12 months that followed the first rate hike. As seen above, during this potential cycle, equities have declined in the 3 and 6 month build-up which is atypical. However looking beyond the first rate increase, the S&P 500 historically has been choppy over the proceeding 6 months before rallying over the full 12 month post hike period. The average forward 12 month return over the 7 cycles has been 9.9% and the instances of positive returns was 100%. Beyond the impact during just the first year of rate hikes, Truist Advisory Services analyzed the returns of the S&P 500

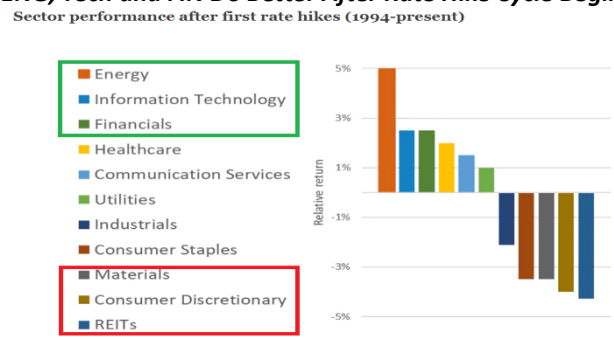
over the full duration of the past 12 Fed rate hike cycles. They found that 11 out of 12 of those cycles proved to be positive for equities with an average return of +9%. In fact, the only period that was not positive for equities was the 1972-1973 timeframe that coincided with the 1973-1975 recession.

11 of 12 Fed Rate Hike Cycles Have Been Positive for S&P

Source: Bloomberg; Trusist Advisory Services

Both those studies are quite encouraging for disciplined investors who remain committed to allocating capital based on longer term results. As we discussed at the start of our comments however, certain areas of the market are sold more aggressively than others leading up to a rate hike cycle. So what areas stand to benefit relative to the broad market over a cycle? Ned Davis Research looked at the forward 12 month returns after the first rate hike by sector and found the following.

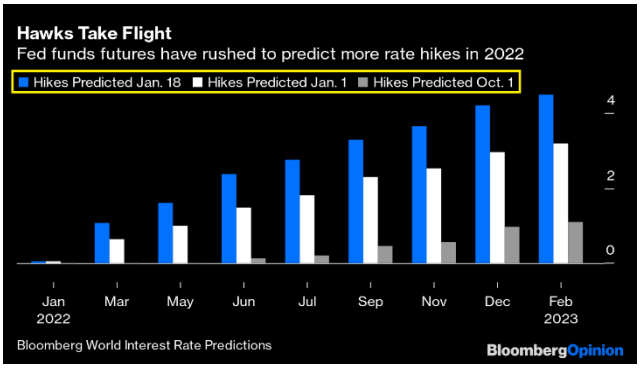
ENG, Tech and FIN Do Better After Rate Hike Cycle Begins



Source: Charles Schwab; Ned Davis Research

The energy sector fared best, beating the index return by +5%, as it is logically tied to the price of oil which is high during inflationary periods. Surprising to some people however, is the technology sector. It is the second best relative performer, outpacing the market by over +3%, based largely off its superior growth characteristics. Financials perform better as well since they are direct beneficiaries of increased interest rates. So we have encouraging data about the future prospects based on past history, but what do investors actually think is the Fed going do with rates? As seen below, rate increase expectations have moved fairly dramatically. At the start of the fourth quarter of 2021, investors were only pricing in one rate hike by the end of 2022 as measured by Fed Fund futures (gray bar). By January 1st, that barometer had moved to 3 hikes by the end of 2022 (white bar). And now, investors have anticipated more than 4 hikes by the end of the year (blue bar).

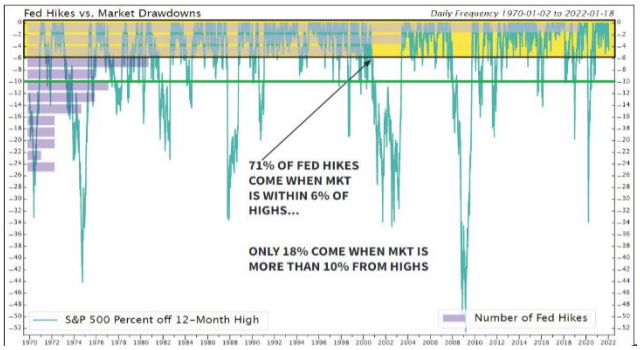
Fed Fund Futures Now Predict Over 4 Rate Hikes in 2022



Source: Bloomberg

The translation here is that the market is essentially doing the Fed's job for them. The market has adjusted to the prospect of experiencing 4 rate hikes over the next 12 months at the cost of roughly -10% in equity prices. Keep in mind the Fed has done absolutely nothing yet other than make statements. Now, if they deliver less than the 4 rate hikes, the market would view this as Dovish which is positive for risk assets. And there is good reason to believe that this might actually be the path that develops.

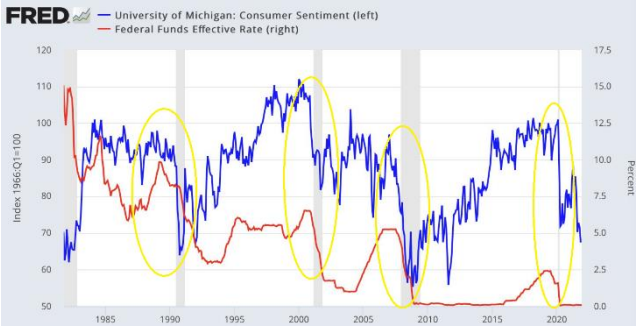
82% of Rate Hikes Occur Within 10% of Eq. Market Highs



Source: 3Fourteen Research; Willie Delwiche

The previous chart is an important one. Since 1970, 82% of Fed rate hikes occurred when the S&P 500 was within 10% of its all its all-time highs. If we exclude the rise in rates in the 1970's, that figure rises to 89%. Investors therefore have strong evidence that the Fed is reluctant to take action when equity markets are weak. The Fed has other factors to consider as well.

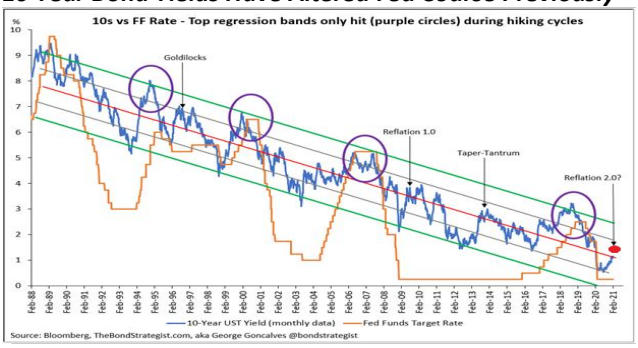
Past Fed Rate Hikes Have Damaged Consumer Sentiment



Source: Federal reserve Economic Data

As seen above, during past hiking cycles, consumer sentiment (blue line) has collapsed and led to a recession. As it stands now, consumer sentiment as measured by the University of Michigan's widely followed index is already at the lowest since 2011.

10 Year Bond Yields Have Altered Fed Course Previously



Source: Bloomberg; The Bond Strategist; George Goncalves

Similarly, many are curious why bond yields aren't actually higher. As the chart above demonstrates, they are capped somewhat. During the last 4 episodes of rate increases, the yield on the 10 year treasury hit the top of a declining range before the Fed capitulated. Today, the top of that range would only be about a 2.5% yield on the 10 Year which currently trades at a 1.78% yield as of writing. The most logical push back to this argument is that unlike during those periods, inflation levels are currently very high. That is true, however, the primary driver of inflation at the moment is supply constraints and not an overheating economy. As seen below in the chart from Alpine Macro, supply disruptions difficulties are easing.

2021 Supply Disruption Challenges Are Improving in 2022

Source: Alpine Macro; Andreas Steno Larsen

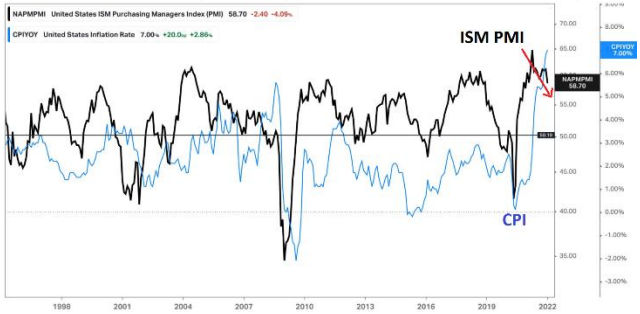
Further, food and energy costs, which account for a significant portion of the Consumer Price Index (CPI) and which highly influence consumer sentiment, also appear to be in decline from the recent peak.

Food and Energy Costs Appear to Have Peaked

Source: Pantheon Macro

And finally, US economic activity as measured by the ISM Purchasing Mangers Index, which is highly correlated to CPI, has now began to fall as well.

US ISM Purchasing Managers Index in Now Receding



Source: Koyfin Research

Going Forward

Without question, financial markets across assets 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. On one hand, the evidence that they are "behind the curve" in moving away from crisis-level monetary policy is strong. 2021 4Q US GDP growth was 6.9%. The unemployment rate is just 3.9%. And perhaps most damning, the Fed balance is *still expanding* as it approaches close to $9 Trillion dollars. On the other hand, the Fed is trying 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. As we suggested earlier, the good news for the Fed is that their statements alone have allowed the markets to do a lot of the heavy lifting for them before any policy changes have actually been implemented. The highly speculative segments of the equity markets have collapsed, and broad equity markets have declined to a level that could hardly be described as "exuberant". Similarly, bond yields have climbed, albeit mildly, which serves to temper the forced allocation of capital to riskier (higher yielding) portions of the market. Additionally, the supply chain issues should resolve meaningfully by the second half of 2022. The danger of a Fed policy error does still exist however. Pushing rates higher in a declining growth environment could invert the yield curve and force the economy into recession. We don't believe that will happen, however, the first half of 2022 is likely to see more volatility before a more stable environment is established in the back half of 2022.

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. Unlike the period of the September peak when we similarly raised cash, this year's sales included decreasing risk exposures as well as booking profits. 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 and healthcare sectors. This most recent earnings season has confirmed the durability of the cash generative abilities of many of the companies we have identified. At the end of January, we added capital to selected positions across industry groups that we believe are well positioned for the balance of the year and will continue to do so as further opportunities develop.

Small and mid-cap stocks have suffered more than their large cap alternatives during the recent market drawdown. We used the opportunity to remove a portion of risk from portfolios by reducing some exposure to these market cap segments when we raised cash during January.

We continue to believe that compelling opportunities exist within non-US exposure. Europe and Asia in particular may prove to be a strong area of opportunity in 2022. Both of those regions offer much more compelling valuation metrics combined with solid and improving fundamentals at both the company and broader economic levels. These regions are also "under-owned" relative to US equities which could lead to potential upside as investment dollars are re-balanced away from the US and into international markets.

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. While the prospect for returns remains muted in treasuries for example, we do believe that allocations to other areas can offer better results and diversification benefits. With that said, at some point, rising rates could make fixed income more attractive at some point in the future.

Our measured allocation to gold has continued to serve as a non-correlated asset despite the recent declines. In addition, we believe that broader commodity exposure 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.