Investment Update

First Quarter 2022

The challenge of investing in the first quarter of 2022 could be summed up as weighing the war in Ukraine and persistently high inflation readings against a positive backdrop featuring an upbeat domestic job market and strong corporate earnings. The Omicron variant seems to have represented the end of the pandemic, or at least put an end to its widespread economic impact. Consumer spending in the U.S. is likely to further shift back towards services from the pandemic-induced focus on goods spending. This is a modest negative for the S&P 500 which is more goods-oriented than the services-oriented overall economy.

Although the S&P 500 reached an all-time high in the first few trading days of the year, a sell-off of expensive growth companies had been well underway since November and spread to the entire market through January and February. As disconcerting as the Russia-Ukraine war has been, the damage in the U.S. stock market had already been done by the time the invasion occurred on February 24th, with the S&P 500 and the growth-oriented Nasdaq 100 down about 13% and 20% respectively. The S&P 500 traded sideways for two weeks before a rally ensued, even as rates were continuing to move up sharply.

Equity Markets (Total Return)	1Q'22	1-Year
Dow Jones Industrials	-4.1%	7.1%
S&P 500	-4.6%	15.6%
S&P Mid-Cap	-4.9%	4.6%
S&P Small-Cap	-5.6%	1.2%
MSCI All-Country World	-5.3%	7.7%
MSCI Foreign Developed Markets	-5.8%	1.6%
MSCI Foreign Emerging Markets	-6.9%	-11.1%
US Bond Markets (Total Return)	**1Q'22**	**1-Year**
Bloomberg US Treasury	-5.6%	-3.7%
Bloomberg US Municipal	-6.2%	-4.5%
Bloomberg US Corporate Investment Grade	-7.7%	-4.2%

The US monetary policy response to the pandemic, both traditional (low rates) and unconventional (open market bond buying), was more aggressive than in other countries. This led to a stronger recovery, and probably to unintended consequences that now need to be cleaned up. As it became more apparent that the Fed was already behind the curve with regard to inflation, expectations for the timing and pace of the Fed's various policies being unwound changed considerably in the fourth quarter of 2021. With the benefit of hindsight, the bond market was arguably also behind the curve, with rates only rising modestly to levels still as much as 5% below reported inflation. In the first quarter of 2022 there has been more talk of possible 50 basis point increases (twice the "normal" 25), and in March the Fed finally took action, no longer buying bonds and implementing the first 25 basis point rate increase. Market-based rates also rose across the yield curve causing the worst quarterly bond returns in decades. All this has certainly caused a reset in asset values, but so far, unlike in the fall of 2018, there seems to be no debate over whether the Fed should be raising rates or not.

As if the context within which the Fed is operating was not already unique enough, a war has been added to the mix. As with Covid two years ago, there is little we can say about the Ukraine situation that you do not already know, but we would reiterate that together the two countries are significant producers of a long list of industrial and agricultural commodities, the prices of which have surged. This makes for another exogenous factor outside the Fed's control that is producing upward pressure

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on price levels. While its effect on inflation will take longer to play out, the war seems very likely to accelerate the de-globalization trend started by Trump trade policies and the supply chain issues that surfaced during the pandemic.

Predictably given the conflict in Ukraine, defense and energy stocks have outperformed through all the volatility in the first quarter. These are two areas of the market that are generally under-represented in our clients' portfolios. First and foremost, we are frequently and unsurprisingly asked to avoid such companies. While the stocks may be unpalatable to many, the revenue streams of pure-play defense companies are non-cyclical due to the nature of government spending (making their shares relatively stable) and they often do well in the midst of a geopolitical crisis. By contrast, traditional energy companies have struggled to "out earn" the fact that even the largest oil and gas producers have no material control over the global prices of their products. The stocks loosely track those unpredictable commodity prices and as a result, the sector then has a knack for being either one of the best or worst performing in a given year.

Although an extreme example, in April 2020, a barrel of West Texas Intermediate crude oil was briefly priced at well below $0 per barrel. We did not spend any time discussing it here at the time as it was mostly due to technicalities (and there were other things to worry about at the height of the pandemic). This anomaly occurred at the end of a seven-year stretch during which energy was far and away the worst performing sector in the S&P 500. It was then the strongest performer in 2021 as increasing demand and disciplined production spending by companies drove oil prices up from that artificial low. The sector has again massively outperformed in 2022 with the new tailwind of supply constraints due to the Ukraine situation. We have been progressively de-emphasizing exposure to traditional energy companies over the years, and the market has as well, with the sector's weighting in the S&P 500 declining from as much as 30% in the early 1980s to a nadir of under 3% in 2020. While the weighting is back up a bit from there, many individual companies in other sectors with index weightings nearly as large or even larger have vastly better prospects. That said, we are always revisiting this stance because we suspect our carbon-based dependency may last longer than hoped, best intentions notwithstanding.

With de-globalization, supply chain issues, higher commodity prices and a very strong economy, it is hard to imagine that inflation will get back down to the 2% level it struggled to reach for the last decade any time soon. We continue to recommend equities as the best asset class to defend portfolios and maintain your purchasing power against inflation. While some companies may struggle more than others with input cost inflation, or may struggle more than others to pass those cost increases on, historically a broadly diversified set of companies has proven to be able to reliably grow revenues in real terms (i.e., at a rate greater than inflation). Even if input cost inflation may prove temporarily erosive to margins, that top line revenue growth has also been able to support real bottom line earnings growth. Despite the recent tumult, we have been continuing to put money into equities where appropriate, believing that the historical trends will stay intact, and that in the long run this most recent sell-off will prove to be an opportune time to buy more of the stocks that we already like, at better prices.

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