Quarterly Insights

– April 2022

Inflation, Geopolitics, and Rising Rates Weigh on Markets in the First Quarter

After a historically calm 2021, volatility returned in the first quarter of 2022, as inflation surged to 40-year highs, the Federal Reserve promised to raise interest rates faster than previously thought, and Russia surprised the world with a full-scale military invasion of Ukraine, marking the first major military conflict in Europe in decades. Those factors fueled a rise in volatility and pushed stocks lower in the first three months of the year. We have seen days with the worst decline in the S&P 500 since March 2020, and we have also seen the best day in the S&P 500 since March 2020.

Both fixed income and equity investors came into 2022 concerned about rising interest rates and inflation. Then the Russian invasion of Ukraine occurred, forcing investors to consider the significant humanitarian, geopolitical, and economic impacts of a major military conflict. Clearly, the combined effects of rising interest rates, high inflation, and the invasion of Ukraine make the current investment environment challenging.

The S&P has dropped by -14.6% since reaching an all-time high on January 3. The Nasdaq Composite reached bear market territory—declining by 21.6% from its high in November to March 14. Following is a chart showing the decline by the S&P 500 from January 4 to February 24:

@CharlieBilello	S&P 500 Corrections >5% since March 2009 Low				
Correction Period	# Days	S&P High	S&P Low	% Decline	"Stocks Fall On..."
2022: Jan 4 - Feb 24	51	4819	4115	-14.6%	Inflation Fears, Rising Rates, Fed Tighening, Russia/Ukraine Conflict
2021: Nov 22 - Dec 3	11	4744	4495	-5.2%	Covid Omicron Variant, Fed Taper Fears
2021: Sep 2 - Oct 4	32	4546	4279	-5.9%	China Contagion Fears, Fed Taper Fears, Covid Delta Variant
2021: Feb 16 - Mar 4	16	3950	3723	-5.7%	Inflation Fears, Rising Rates
2020: Sep 2 - Sep 24	22	3588	3209	-10.6%	Coronavirus, No New Stimulus Deal, Election Fears
2020: Feb 19 - Mar 23	33	3394	2192	-35.4%	Coronavirus, Global Depression Fears
2019: Jul 26 - Aug 5	10	3028	2822	-6.8%	Trade War, Tariffs, Yuan Devaluation, Recession Fears
2019: May 1 - Jun 3	33	2954	2729	-7.6%	Trade War, Tariffs, Inverted Yield Curve, Global Slowdown/Recession Fears
2018: Sep 21 - Dec 26	96	2941	2347	-20.2%	Rising Rates, China Slowdown, Trade War/Tariffs, Housing Slowdown
2018: Jan 26 - Feb 9	14	2873	2533	-11.8%	Inflation Fears, Rising Rates
2016: Aug 15 - Nov 4	81	2194	2084	-5.0%	Election Fears/Concerns/Jitters
2015/16: May 20 - Feb 11	267	2135	1810	-15.2%	Greece Default, China Stock Crash, EM Currencies, Falling Oil, North Korea
2014/15: Dec 29 - Feb 2	35	2094	1981	-5.4%	Falling Oil, Strong Dollar, Weak Earnings
2014: Dec 5 - Dec 16	11	2079	1973	-5.1%	Falling Oil, Strong Dollar
2014: Sep 19 - Oct 15	26	2019	1821	-9.8%	Ebola, Global Growth Fears, Falling Oil
2014: Jan 15 - Feb 5	21	1851	1738	-6.1%	Fed Taper, European Deflation Fears, EM Currency Turmoil
2013: May 22 - Jun 24	33	1687	1560	-7.5%	Fed Taper Fears
2012: Sep 14 - Nov 16	63	1475	1343	-8.9%	Fiscal Cliff Concerns, Obama's Re-Election
2012: Apr 2 - Jun 4	63	1422	1267	-10.9%	Europe's Debt Crisis
2011: May 2 - Oct 4	155	1371	1075	-21.6%	Europe's Debt Crisis, Double-Dip Recession Fears, US Debt Downgrade
2011: Feb 18 - Mar 16	26	1344	1249	-7.1%	Libyan Civil War, Japan Earthquake/Nuclear Disaster
2010: Apr 26 - Jul 1	66	1220	1011	-17.1%	Europe's Debt Crisis, Flash Crash, Growth Concerns
2010: Jan 19 - Feb 5	17	1150	1045	-9.2%	China's Lending Curbs, Obama Bank Regulation Plan
2009: Oct 21 - Nov 2	12	1101	1029	-6.5%	Worries About The Recovery
2009: Sep 23 - Oct 2	9	1080	1020	-5.6%	Worries About The Recovery
2009: Jun 11 - Jul 7	26	956	869	-9.1%	World Bank Neg Growth Forecast; Fears Market Is Ahead Of Recovery
2009: May 8 - 15	7	930	879	-5.5%	Worries That Market Has Gotten Ahead Of Itself
Median	**26**			**-7.6%**	COMPOUND

We have endured a rocky start to 2022, but opportunities can still emerge, which we will discuss in the final section of our quarterly update. In just the first quarter of 2022, the S&P 500 had its worst start in 90 years. The tech-heavy Nasdaq had its worst start since January of 2008; and if you were investing then, I'm sure you remember that the markets were in the depths of the financial crisis...and even the market's most popular, highest-profile "disruptive" companies—tech stocks—have gotten whacked.

First Quarter Performance Review

All four major equity indices posted negative returns for the first quarter of 2022, although the S&P 500 and the Dow Industrials saw only mild losses compared to the Nasdaq and Russell 2000. Investors rotated out of growth-oriented, high-technology stocks and into sectors that were more exposed to the traditional economy, which, generally speaking, trades at a cheaper valuation relative to the tech sector. That rotation benefitted the Dow Jones Industrial Average primarily while the Nasdaq Composite badly lagged both the S&P 500 and the Dow.

By market capitalization, large-cap stocks outperformed small-cap stocks in the first quarter, and that was to be expected given the geopolitical uncertainty and rising interest rates. Small-cap stocks typically are more reliant on debt financing to sustain their businesses, and therefore, rising interest rates can be a headwind on small-cap stocks. Additionally, investors flocked to the relative safety of large caps amid the rise in volatility over the course of the quarter.

Stock Index Performance

Index	Week	YTD	12-mo.	2021	5-yr.
Dow Jones Industrial Avg. (34,818)	-0.12%	-3.72%	6.98%	20.95%	13.47%
S&P 500 (4,546)	0.08%	-4.28%	14.66%	28.68%	16.04%
NASDAQ 100 (14,861)	0.73%	-8.77%	12.27%	27.51%	23.42%
S&P 500 Growth	0.25%	-8.44%	16.55%	32.00%	19.93%
S&P 500 Value	-0.10%	0.35%	12.23%	24.86%	11.22%
S&P MidCap 400 Growth	0.19%	-8.32%	-1.26%	18.89%	11.56%
S&P MidCap 400 Value	-0.26%	-0.19%	8.68%	30.61%	10.42%
S&P SmallCap 600 Growth	0.20%	-8.61%	-2.11%	22.56%	11.73%
S&P SmallCap 600 Value	-0.02%	-0.72%	3.29%	30.85%	10.11%
MSCI EAFE	0.78%	-6.36%	0.17%	11.26%	6.61%
MSCI World (ex US)	1.01%	-5.62%	-2.51%	7.82%	6.71%
MSCI World	0.34%	-5.03%	9.15%	21.82%	12.44%
MSCI Emerging Markets	1.91%	-6.64%	-12.31%	-2.54%	6.04%
S&P GSCI	-7.72%	32.58%	61.59%	40.35%	9.88%

Source: Bloomberg. Returns are total returns. *5-yr. return is an average annual.* One-week, YTD, 12-mo. and 5-yr. performance returns calculated through 4/1/22. An index cannot be purchased directly by investors. Past performance is no guarantee of future results.

On a sector level, only two of the 11 sectors in the S&P 500 finished the first quarter with a positive return. Energy was the clear standout as the sector benefitted from the increase in geopolitical uncertainty and subsequent surge in oil and natural gas prices in response to the Russia-Ukraine war. Utilities, a traditionally defensive sector, logged a modestly positive return as investors rotated to defensive sectors in response to elevated market volatility and geopolitical uncertainty. Finally, financials relatively outperformed the S&P 500 and saw only a small loss as the sector has historically benefited from rising interest rates, although concerns about exposure to the Russian economy weighed on many financial stocks in February and early March.

S&P Sector Performance

Index	Week	YTD	12-mo.	2021	5-yr.
Communication Services	-0.05%	-11.14%	-2.07%	21.57%	9.76%
Consumer Discretionary	0.89%	-8.83%	8.95%	24.43%	17.18%
Consumer Staples	2.36%	0.23%	17.84%	18.63%	10.42%
Energy	-2.40%	40.17%	61.09%	54.39%	6.86%
Financials	-3.25%	-1.69%	12.95%	34.87%	12.24%
Health Care	1.26%	-1.69%	20.43%	26.13%	15.29%
Industrials	-1.47%	-3.05%	4.96%	21.10%	11.07%
Information Technology	0.12%	-8.51%	18.21%	34.52%	26.73%
Materials	-0.20%	-1.27%	14.14%	27.28%	13.51%
Real Estate	4.53%	-4.43%	26.12%	46.14%	13.02%
Utilities	3.74%	6.30%	21.69%	17.67%	11.74%

Source: Bloomberg. Returns are total returns. *5-yr. return is an average annual.* One-week, YTD, 12-mo. and 5-yr. performance returns calculated through 4/1/22. An index cannot be purchased directly by investors. Past performance is no guarantee of future results. On 9/28/18, the Global Industry Classification Standard (GICS) was reconstituted and the Telecommunications Services sector was renamed Communication Services. GICS sector information for periods prior to 9/28/18 may not necessarily be comparable to the reconstituted sectors.

Sector laggards included the communication services, tech, and consumer discretionary sectors as they saw material declines in the first quarter thanks primarily to the broad rotation away from the more highly valued corners of the market. Specifically, internet stocks weighed on the communications sector, while online retail stocks were a drag on the consumer discretionary sector. Away from tech and tech-related sectors, most other sectors in the S&P 500 saw modest declines that did not stray too far from the performance of the S&P 500.

Inflation

Inflation Reached 7.9% in February; Consumer Prices Are the Highest in 40 Years

Surging energy costs related to Russian invasion of Ukraine are pushing prices higher

We have been adamant that inflation will be with us longer and at a higher level than most analysts and economists believe. Rising prices for energy, food, rent, and services pushed already elevated U.S. inflation to a 7.9% annual rate last month—another four-decade high—with oil and commodity market disruptions from the Ukraine crisis expected to add more cost pressures. The Consumer Price Index, which measures the cost of goods and services across the economy, hasn't climbed so fast since it rose at an 8.4% annual rate in January 1982, when the nation was in recession and trying to tame what had been double-digit inflation.

Higher energy prices, including gasoline price increases, helped push up the inflation reading, along with cost gains for groceries, restaurant food, transportation services, and apparel.[1]

The sanctions on Russia, while necessary, will exacerbate inflation in the near term. Furthermore, sanctions naturally complicate the outlook for both businesses and investors. The scarcity and shortage concerns for all commodities and goods sourced from Ukraine and Russia are significant. These existing or pending shortages have caused major commodity inflationary pressures, notably in oil, liquified natural gas, wheat, and nickel, to name a few. There is the potential that if sanctions remain for a long period of time, these economic impacts will become the new normal and the commodity price reset could be permanent.

High Food Prices to Pressure Inflation This Year

Developing countries are especially at risk as drought, demand and the war in Ukraine push up crop prices

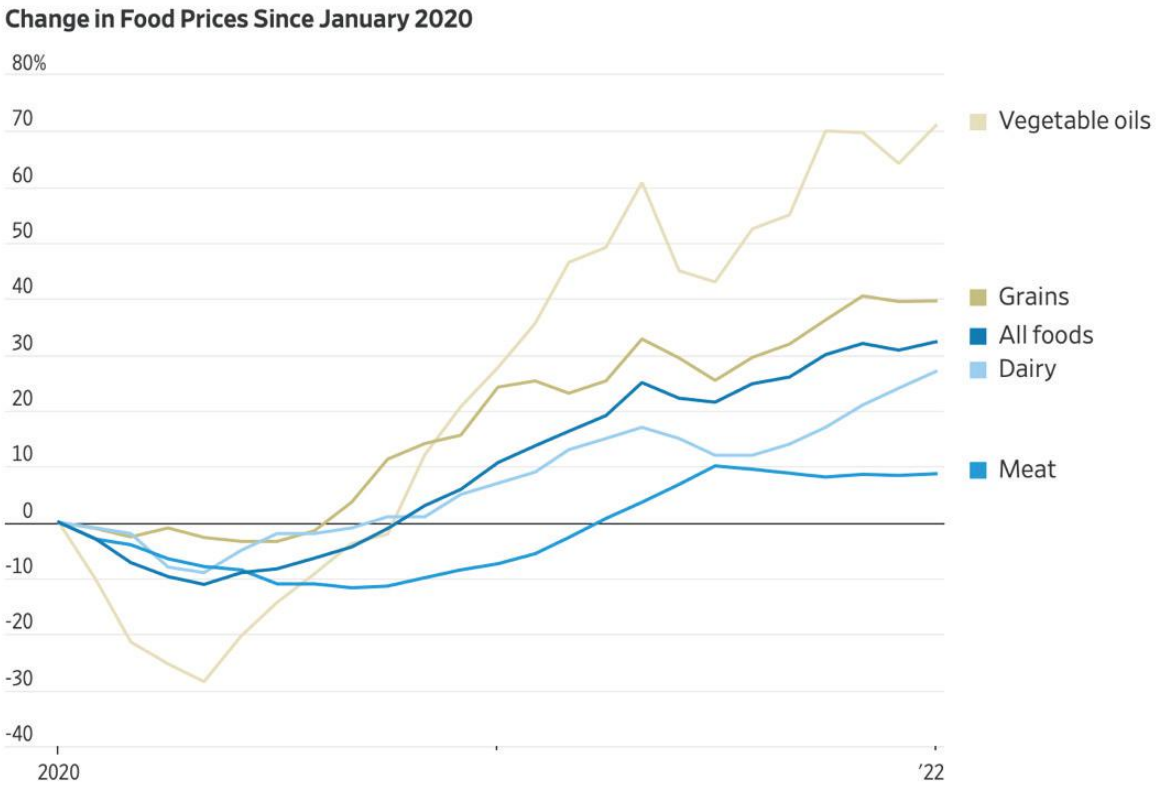
The Russia–Ukraine conflict will worsen food inflation

The Russian invasion into Ukraine is going to accelerate inflation. Ukraine, of course, is the breadbasket of Europe. Russia's invasion of Ukraine poses another risk. The two countries combined account for 29% of global wheat exports, according to the U.S. Agriculture Department. We're going to have food inflation along with energy inflation. Rising food prices are emerging as a significant headwind to the economic recovery from the pandemic this year. Russia's invasion of Ukraine could make those headwinds even stronger.

The price of basic staples such as wheat, corn, and soybeans rose steeply last year, which would translate into higher grocery prices worldwide this year. Consumer food prices tend to lag behind commodity prices by several months. Even if food commodity inflation slows, as many forecasters expect, households will still face higher grocery bills in the months ahead.

John Allan, the chairman of Tesco PLC, Britain's largest supermarket chain, told the BBC earlier this month that "the worst is yet to come" for food inflation.[2]

Following is a chart illustrating the increase in grains, vegetable oils, dairy, and meat since 2020:



Source: Food and Agriculture Organization

In sum, the first quarter of 2022 was the most volatile quarter for markets since the depths of the pandemic in 2020, as numerous threats to economic growth emerged. As we start the second quarter, investors will need to see incrementally positive progress across geopolitics, monetary policy expectations, and the outlook for inflation if the late-March rally is to continue.

Commodities registered massively positive returns in the first quarter primarily thanks to rising geopolitical risks. Oil, wheat, natural gas, corn, and other essential commodities surged on a combination of actual production outages related to the Russia-Ukraine war (which reduced current supply) and buyers locking in supply for fear of any future production disruptions should the war continue for months or spread beyond Ukraine's borders.

Commodity Indexes	Q1 Return	YTD
S&P GSCI (Broad-Based Commodities)	33.13%	33.13%
WTI Crude Oil	34.42%	34.42%
Gold Price	6.61%	6.61%

Source: YCharts/Koyfin.com

Rising Interest Rates and the Federal Reserve

Fed Raises Interest Rates for First Time Since 2018

Officials signal quarter-point increase will be followed by six more this year to combat inflation

The Federal Reserve raised interest rates on March 17 by 25 basis points (.25%) and penciled in six more increases by year's end, the most aggressive pace in more than 15 years, in an escalating effort to slow inflation that is running at its highest levels in four decades. The Federal Reserve will do what it takes to fight inflation; in other words, it's prepared to raise interest rates more aggressively.

While speaking to the National Association for Business Economics, Federal Reserve Chair Jerome Powell said the labor market remains extraordinarily strong but price increases are much too high. The central bank needs to do much more to slow inflation, and that includes more rate hikes and shrinking its balance sheet. And due to the rapid rise in inflation, the Fed needs to move more quickly than it has recently.

Powell noted the rise in inflation prior to Russia's invasion of Ukraine was much stronger than it had anticipated. The outlook had been easing from last April into September before suddenly turning higher. The change led to the central bank raising the 2022 inflation forecast from 1.6% to 4.3%. Powell said the Fed did not expect supply-chain problems to persist. Because of these influences, he said the central bank has to adjust its thinking about setting policy. Powell said it can't anticipate any relief in supply-chain issues; the Fed must assume the worst and hope for the best when making interest rate and balance sheet decisions going forward.

This is why the central bank's forecast for rate hikes this year has changed. In other words, the FOMC needs to raise interest rates by 25 basis points at every meeting through year-end to get to a 1.75% to 2% target range.

But even with those adjustments, Powell still expects it will take another three years before inflation falls back to the 2% level. That's a stark contrast compared with the central bank's outlook last year where the Federal Reserve was insistent that inflation was transitory (or short term) in nature.

Powell noted the commodity disruptions related to Russia's invasion of Ukraine are on an unprecedented scale. He said the outcome remains uncertain. And even if the conflict in Ukraine ends soon, there could still be unforeseen spillover effects. So, the central bank believes domestic growth could slow quickly as reopening effects fade and government spending support eases. Powell said the central bank is willing to raise interest rates by more than 25 basis points at any of the upcoming meetings if it feels the change is necessary. Higher probabilities exist that the Federal Reserve will raise interest rates by 50 basis points (.50%) at their next meeting in May, and possibly at their next meeting in June as well.

An increase in interest rates has driven the 30-year mortgage rates to the highest level since January 2019. The surge in home prices is coming at the same time that borrowing costs are skyrocketing, with the 30-year mortgage rate moving up to 4.42%. In the last three months we've seen a 1.37% increase in the 30-year rate, the largest three-month spike since May 1994.

You have the same mortgage rate as January 2019, but the average price of a new home in the U.S. is up over 42% since then ($361k to $511k) with many areas of the country rising even more.

So, the central bank has a fine line to walk going forward. On the one hand, it wants to maintain steady economic growth. On the other hand, it needs to bring down inflation. The two tend not to go together.

Near-Term Pain for Long-Term Gain

When the Federal Reserve starts with their first interest rate increase, over a 6- and 12-month time period, the S&P 500 is positive 6 out of 7 years with an average gain of 10.2% over 12 months.

What Happens After The First Rate Hike? Stocks Do Well

S&P 500 Index Performance After The First Fed Rate Hike

		S&P 500 Index Future Returns		
Date Of First Hike	Size Of First Hike	Next Three Months	Next Six Months	Next Twelve Months
8/8/1983	0.50%	2.0%	-0.7%	2.1%
4/1/1987	0.25%	3.6%	10.1%	-11.7%
5/11/1988	0.50%	3.4%	8.6%	20.7%
2/4/1994	0.25%	-5.9%	-2.5%	2.4%
3/25/1997	0.25%	13.6%	20.6%	39.6%
6/30/1999	0.25%	-7.6%	6.6%	6.0%
6/30/2004	0.25%	-2.3%	6.4%	5.2%
12/16/2015	0.25%	-1.1%	0.1%	9.1%
Average		0.7%	6.1%	9.2%
Median		0.5%	6.5%	5.6%
% Positive		50.0%	75.0%	87.5%

Source: LPL Research, Bloomberg 01/10/22
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Expectations are for six more interest rate increases this year. We have seen many years with up to 27 rate increases, such as 1980. Here's how stocks have performed with years of multiple interest-rate increases. The mid-2000s cycle is what has our attention, as there were 17 total rate hikes in 2004, 2005, and 2006, yet the S&P 500 managed to gain in every year. The bottom line is that rate hikes usually are not bearish events, and we do not expect this to be any different, at least for this year.

Fear A Lot Of Rate Hikes In 2022?

Federal Reserve Bank Hikes Per Year (Since 1970)

Year	Rate Hikes	S&P 500 Index Yearly % Change
1971	4	10.8%
1972	5	15.8%
1973	16	(17.4%)
1974	13	(29.7%)
1975	4	31.5%
1977	6	(11.5%)
1978	15	1.1%
1979	12	12.3%
1980	27	25.8%
1981	7	(9.7%)
1984	4	1.4%
1987	5	2.0%
1988	4	12.4%
1994	6	(1.5%)
2004	5	9.0%
2005	8	3.0%
2006	4	13.6%
2018	4	(6.2%)
Average		3.5%
Median		2.5%
% Positive		66.7%

Source: LPL Research, Bloomberg 02/01/2022
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Energy Prices

Oil Market Faces Biggest Supply Crisis in Decades Unless OPEC Boosts Output, IEA Says

Three million barrels a day of Russian oil output could be lost from April because of sanctions, agency says

Analysts at Bank of America said if most of Russia's oil exports were cut off, there could be a shortfall of 5 million barrels per day (bpd) or larger than that, pushing prices as high as $200.

Russia is the world's top exporter of crude and oil products combined, with exports of around 7 million bpd, or 7% of global supply. Last week, Pioneer Natural Resources CEO Scott Sheffield said he expects the U.S. to take two or three years to replace the crude oil it buys from Russia. That number is roughly 672,000 barrels per day according to The Wall Street Journal. That's less than we import from Canada and Mexico but more than what we receive from Saudi Arabia.

We're also now seeing many Western oil businesses backing away from doing business with Russia due to reputational risk. BP and Shell? Out of Russia. Exxon? Gone, willing to abandon an operation valued at more than $4 billion. Between official sanctions and these corporate self-imposed, de facto sanctions, the oil markets could soon be knocked off balance yet again. From the International Energy Agency (IEA) last Wednesday:

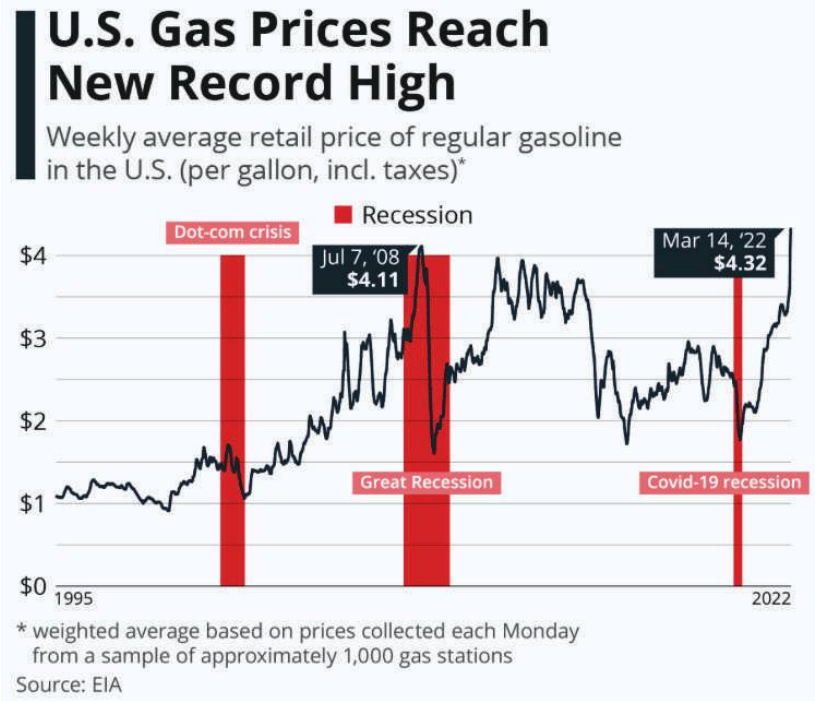
The prospect of large-scale disruptions to Russian oil production is threatening to create a global oil supply shock.... The implications of a potential loss of Russian oil exports to global markets cannot be understated. The IEA report went on to add that we could face "the biggest supply crisis in decades."[4]

Where Do We Stand With the Global Ability to Make up This Missed Oil Output From Russia?

According to The Wall Street Journal on March 16:

The oil market will slip into a deficit as early as the second quarter unless the OPEC group of oil producers increase their supply levels, the IEA said. Beyond the spare capacity of leading OPEC members Saudi Arabia and the United Arab Emirates, there are no other sources of additional supply that can balance the market. Oil inventories have already been depleted to multiyear lows and the prospect of additional supplies from Iran seems a long way off.3

If March gasoline prices average $4.22 a gallon, as they have so far, they still show that motorists will have been saddled with the biggest month-over-month price increase since EIA records began in the mid-'70s. The next-highest increase was after Hurricane Katrina in 2005.



Biden to Draw Down Oil Reserves in Bid to Ease Gas Prices

U.S. will tap record 180 million barrels over six months; oil industry says president should instead remove barriers to energy investment

For the second time in four months, the President has announced a release of oil from the Strategic Petroleum Reserve (SPR). In this case, it's a big promise: a million barrels a day for six months, or roughly 180 million barrels. That's about a third of the U.S. SPR.[5]

Will it Bring Down Oil Prices?

Back in September, China released oil from its strategic reserve for the first time ever. Oil prices went up, not down. Two months later, Biden issued an order to release 50 million barrels from the U.S. SPR. The price of oil did very little that day. But the next day, on the evening of Thanksgiving, the news of the Omicron variant hit the wires, and the price of oil (and most markets) fell sharply.

Within six weeks, oil prices were higher. What should we expect from this big oil supply injection from the Biden administration? Higher prices.

Why? Not only have we (and much of the world) committed to defunding new oil exploration, and regulating down domestic supplies, we are now (voluntarily) drawing down our reserves.

This SPR release only weakens our position—from an already weak position. OPEC countries will be even happier to sell us all the oil we will need, just at higher and higher prices. And so will the domestic producers that have survived this planned supply destruction of the fossil fuels industry.

Goldman Sachs believes any lower prices we'll see this time around will be similarly unsustainable. That's because they're not treating the core problem, which is a structural supply issue.

From the Goldman commodities research note: "This would remain, however, a release of oil inventories, not a persistent source of supply for coming years. Such a release would therefore not resolve the structural supply deficit, years in the making."

Why Can't U.S. Oil & Gas Companies Increase Oil & Gas Production?

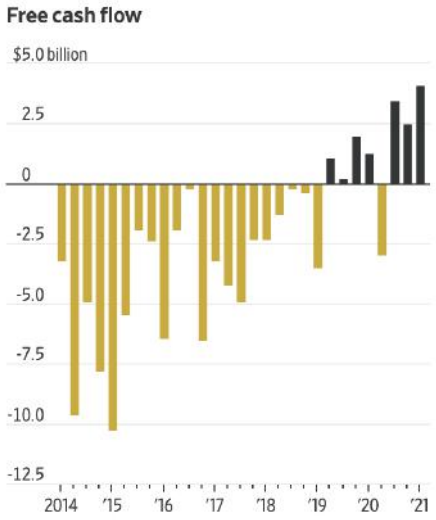
This is one of the most asked questions we get, so let me give you the answer. This is a topic we discussed during our 2021 Halftime update.

Shale companies pumped with abandon anytime oil prices rose sharply last decade. But as crude tops $90 a barrel, they are barely doing enough to sustain U.S. production.

Fracking companies have been forced to rein in spending after many investors lost faith in the companies. Following years of poor returns, lenders reduced their credit lines and capital markets showed little interest in funding expansive new drilling campaigns.

The companies are raking in more cash than ever. Public shale companies that drill primarily for oil collectively generated a record $4.1 billion in free cash flow in the first quarter of 2021 and are poised to take in almost $15 billion for the year if prices remain higher, according to consulting firm Rystad Energy.

U.S. shale producers generated more free cash flow in the first quarter than any time in the industry's history, analysts said.



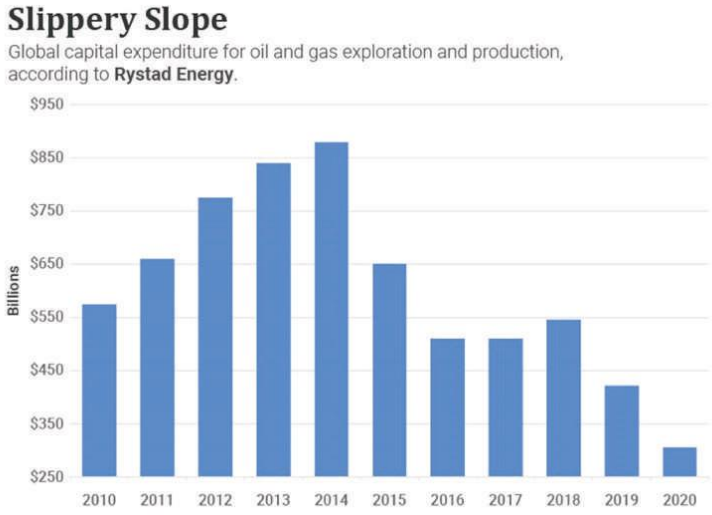
Source: Rystad Energy

Discipline continues to dominate the industry. Shareholders and lenders continue to demand a return on capital, and until it becomes unavoidably obvious that high energy prices will sustain, there will be no exploration spending.

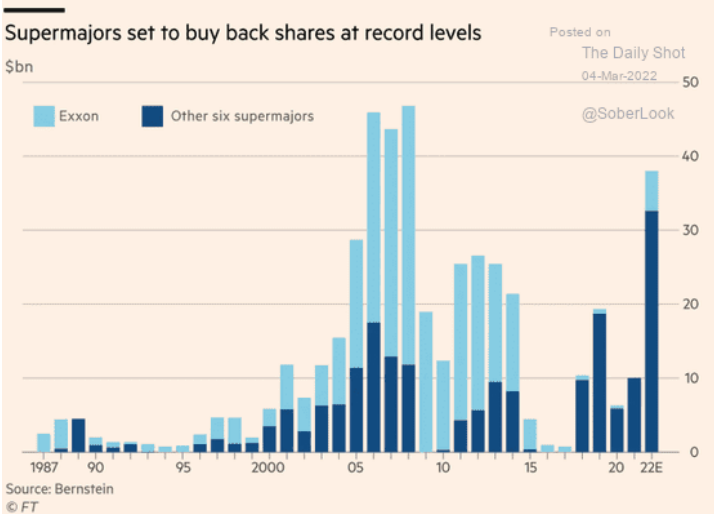
In this upcycle, investors have made it clear they wanted to see spending discipline. So far, exploration and production companies for the most part are exhibiting capital discipline. A significant part of E&P capital spending growth this year (2022 versus 2021) will be consumed by cost inflation as the cost for all inputs continues to increase against a backdrop of supply-chain challenges and limited incremental equipment being reactivated (due to fiscal constraints and manpower challenges within oilfield services and related suppliers).

Because so many oil companies around the world have slashed investment in both exploration and production, they cannot boost supplies… no matter how high the oil price soars.

Data from Rystad Energy shows that global investments in oil and gas exploration and production peaked eight years ago and has plummeted about 65% since then.



In all likelihood, the supply picture will not improve until after multiple years of increasing investment. Major oil producing companies such as Exxon, BP, Mobil, Shell, Conoco Phillips and Total Energy Companies are using free cash flow to buy back shares, the most since 2006-2008.



Second Quarter Market Outlook

As we start a new quarter, markets are facing the most uncertainty since the pandemic, as headwinds from inflation, less accommodative monetary policy, and geopolitics remain in place.

Inflation still sits near a 40-year high as we start the second quarter, and with major commodities such as oil, wheat, corn, and natural gas surging in response to the Russia-Ukraine war, it's unlikely that key inflation indicators like the Consumer Price Index (inflation readings) will meaningfully decline anytime soon. Until there is a definitive peak in inflation, the Federal Reserve is likely to continue to aggressively raise interest rates, and over time, higher rates will become a drag on economic growth.

The Federal Reserve, meanwhile, has consistently warned markets that aggressive interest rate hikes are coming in the months ahead, and this quarter we expect the Fed will reveal its balance sheet reduction plan, which will detail how the Fed plans to unload the assets it acquired via the Quantitative Easing program over the past two years. If the details of this balance sheet reduction plan are more aggressive than markets expect, or the Fed commits to more rate hikes than are currently forecasted by markets, that could weigh on stocks and bonds alike.

So, What's the Playbook From Here?

The last time Jerome Powell and the Federal Reserve attempted to hike rates quickly, it ended poorly for stocks. In January of 2018, the fed funds rate stood at 1.41%. By December, Powell had pushed it to 2.27%. At that point, the market said "enough" and promptly declined about 20% top to bottom. The March 17th Fed meeting suggested we'll be moving from an effective fed funds rate of 0.08% to 1.9% just nine months from now. So, double the amount of hiking in about a quarter less time compared to 2018.

How do we position your portfolio in such a way that it's more resistant to a pullback if we see a repeat of 2018, yet also capable of climbing if the markets prove resilient?

As we entered 2022, we wanted to put extra emphasis on profitable companies. This is the "show me the money" year. In the face of tightening monetary conditions, investors aren't willing to take big leaps of faith on companies that promise to make money tomorrow. Rather, they are only buying stocks of companies that have profits today. We believe profitable stocks will outperform unprofitable stocks over the next few months. The recent trading action can be characterized as a flight to low-risk, high-quality assets. We suspect this flight to quality will persist. We are focusing on companies with strong balance sheets, great cash flows, and high gross profit margins.

We continue to buy through dollar-cost averaging large-cap growth stocks, semiconductor companies, dividend-paying companies with strong cash flow ETF and technology stocks.
But while clearly there are risks to portfolios as we start the new quarter, it's also important to note that the U.S. economy is very strong and unemployment remains historically low, a reality that is helping support asset markets. Additionally, interest rates are rising but remain far below levels where most economists forecast they will begin to slow the economy. Finally, consumer spending, which is one of the main engines of growth for the U.S. economy, is robust, and corporate and personal balance sheets are healthy.

What Should Investors Think About With All This in Mind?

Have you seen all the negative things that have been thrown at the market of late? Well, if you have not, let me tell you what you missed.

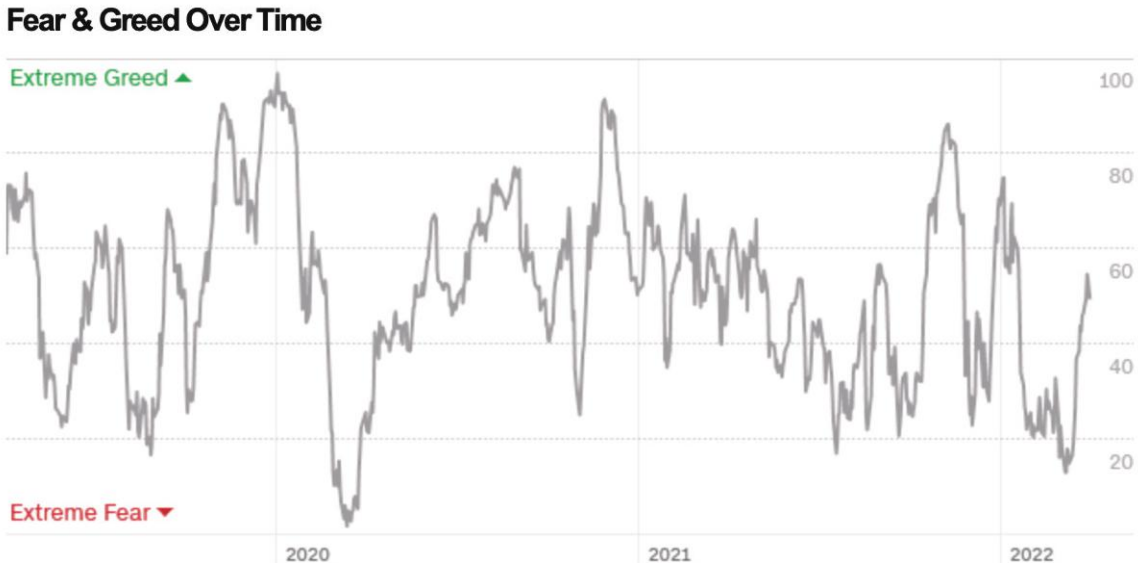
We had the Russia-Ukraine war, oil rallying strongly, the supposed death of the U.S. Dollar, China shutting down because of another COVID variant, nuclear threats, an earthquake and tsunami warning in Japan, the Fed raising rates, reducing its balance sheet, and outlining six more rate hikes...and inflation at 40-year highs.

It seems that everything has been thrown at the market, including the kitchen sink, yet we have seen quite a strong rally. In fact, how many of you even realize that the market bottomed on the exact day that Russia invaded Ukraine, and has now rallied 350 points (8.5%) off the bottom struck that day?

I know this has left many of you scratching your heads. But if you're scratching your head, I guess you did not learn the lesson the market taught in the spring of 2020. While the worst of the COVID death rates were being reported, while there were economic lockdowns being reported throughout the United States, while companies were drastically lowering their earnings expectations, while we were seeing record levels of unemployment, and while economists were proclaiming we were about to go into a recession, the stock market rallied over 1,000 points in an almost straight line higher, as per our expectations at the time. I know many of you have seen me post this picture before, but it tells the story so well:

Yeah, I know. With all the craziness going on in the world, the stock market is still rallying. It just does not make sense to most. I know it sounds counterintuitive, and many still fight accepting this, but the market does not pay as much attention to these factors as so many believe. In fact, all these factors only lend themselves to extreme negative sentiment which often marks major market bottoms. All the market really cares about is where we are in the sentiment trend. We talk a lot about the CNN Fear & Greed index to try and teach you about market sentiment, which in turn will tell you the best time to be investing (or taking profits).

Following is a chart of the Fear & Greed index over time. Ideally, we want to be able to take advantage of opportunities when the index is below 25. Warren Buffett once said that it is wise for investors to be "fearful when others are greedy, and greedy when others are fearful." As you can see on the chart below, we saw the Fear & Greed index get to a reading of 18 on February 24 (the day Russia invaded Ukraine) and got down to a reading of 20 on March 11. Historically, when the Fear & Greed index has declined below 25, these have proven to be short-lived and excellent buying opportunities before the market has stabilized and reversed higher.



https://money.cnn.com/data/fear-and-greed/

Where Do We Go From Here?

Lastly, I want to remind you to look at the forest and not just the pretty leaves. My primary expectation remains that the S&P 500 can reach the 5500 region in the coming year or so. That means that we have over 975 points of overhead potential, or 21.5% higher, based upon where we closed on Friday.

During the first quarter and into April, we have focused on field position for your accounts. In order for a football team to have a greater chance of scoring points and winning, if they have better field position throughout the game, they may score more points and win. We want to do the same by getting your account in a better position to potentially make more money as the market recovers by purchasing investments when the market has declined, as it has during the first quarter. The cheaper we can buy an investment, the greater the gain when the market recovers, as we believe it will.

As we entered 2022, we expected two things: first, we would see greater volatility; second, we would see a decline in the S&P 500 between 7-10%, which I expected would carry us into the first quarter of 2022 and would not likely end until it convinces most of the world, including many of you, that the bull market is over. You see, the market had to eviscerate the positive sentiment that was pervasive at the market highs, and cause us to descend to the depths of extreme negativity. And even though I warned you to mentally and emotionally prepare for it, it's always tough to weather a decline in the stock market when you see your account values going down!

If you glance at any sentiment indicators, such as the CNN Fear & Greed indicator discussed above, you will also recognize that we have reached an extreme in negativity that may have only been exceeded by the point in time when we struck the lows in March of 2020. And many of those indicators were actually at the same levels of March of 2020.

So, consider that we are now immersed in the longest pullback from an all-time high seen since the fall of 2018. While we have seen much deeper drops in less time, the current pullback is not something we have experienced from a timing perspective for over three years. And this has generated extremes of negativity that will likely fuel the impending move up toward the 5500 region in the coming year or so.

So, for now, our word for the spring is going to be "patience." After positioning ourselves really well for the next major rally I expect, we can afford to have some patience until the market bulls and bears battle it out over the next several months. This will likely take us into late summertime or even the early fall time frame until we see our next major breakout.

We understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this challenging investment environment. Successful investing is a marathon, not a sprint, and even temporary bouts of volatility like we experienced over the past three months are unlikely to alter an approach set up to meet your long-term investment goals.

Therefore, it's critical for you to remain patient and stick to the plan, as we've worked with you to establish a unique, personal allocation target based on your financial position, risk tolerance, and investment timeline.

Rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

Sincerely,

Matthew Gaude & Shawn McGuire

Disclosure

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