“Live the Life You’ve Imagined”

Investment Commentary

May 2022

Rising inflation, ongoing supply chain issues, central bank tightening, and the Russia/Ukraine war continued to pressure financial markets. Both stock and bond returns plunged in April as volatility spiked higher.

- After rallying almost 4% in March, the S&P 500 dropped almost 9% in April, its worst monthly performance since March 2020.
- Tech stocks were pummeled and the Nasdaq dipped more than 13%, its worst monthly performance in more than 10 years.
- Inflation in the U.S. surged to 8.5% (year over year) in March, a 41-year-high. This led to fears the Fed will adopt a more aggressive tightening strategy. The Fed increased interest rates by 50-basis points for the first time since May 2000.
- Foreign developed and emerging stocks also declined but fared better than U.S. stocks.
- Interest rates increased across the board, leading to steep losses for bonds.

Return (%)	1 MO	3 MO	YTD	1 YR
S&P 500	-8.72	-8.17	-12.92	0.21
Russell 2000	-9.91	-7.82	-16.69	-16.87
MSCI EAFE	-6.38	-7.33	-11.80	-7.70
MSCI Emerging Markets	-5.55	-10.40	-12.09	-18.06
Bloomberg U.S. Aggregate Bond	-3.79	-7.51	-9.50	-8.51

Data as of 4/30/2022, Performance in USD. Source. FactSet.

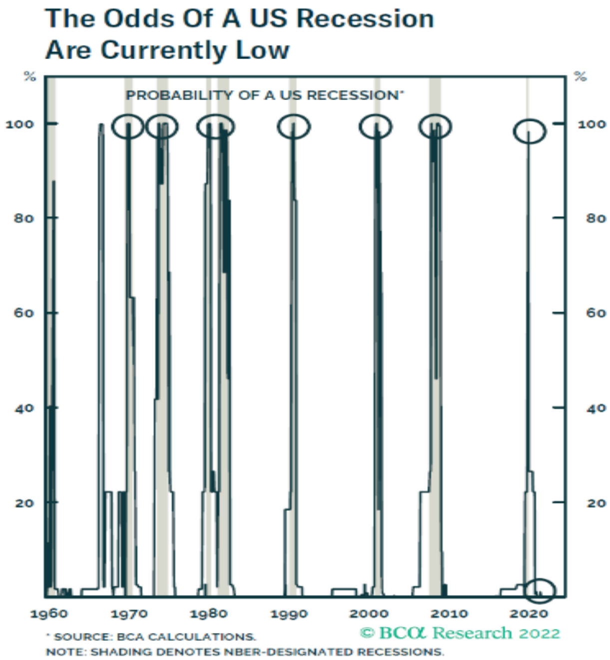
This month we discuss some of the factors that could ‘go right’ for the financial markets and what could go wrong; we also highlight some thoughts on investment strategy for this stage of the cycle.

What Could Go Right; What Could Go Wrong

There are certain times when uncertainty about the economic and financial market is extremely high. Today is one of those times! Given the current geopolitical and economic environment a case can be made for either an improvement or deterioration in financial markets. Below we share some ideas on what could go right and what could go wrong for the economy and financial markets. Several of these ideas come from strategists we follow closely- BCA Research, Goldman Sachs, Leuthold, and others.

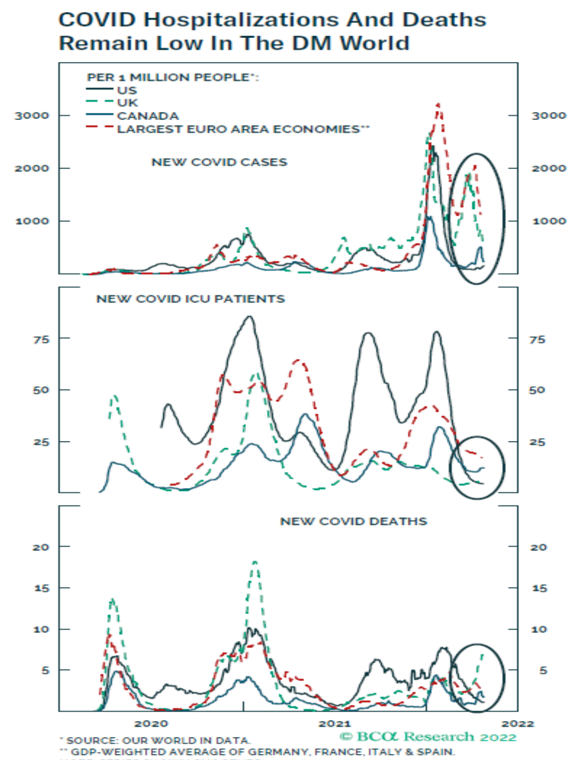
What Could Go Right:

The US is likely to avoid a recession in the next year. Several strategists and models that we follow show a low probability of a recession in the next 12 months. On the next page, we show a model from BCA, which has a pretty good history of predicting recessions, indicating the current probability of a recession as being very low. Other models, the Federal Reserve Bank of NY, show similar results. Looking over a 24-month time horizon, we expect the probability of a recession to increase sharply as there is a lag time between monetary tightening



cycles and the economy. If the market becomes convinced a recession in the next year is a low probability event there is room for stock performance to improve.

Headline inflation is likely to come down. Inflation today is extremely high, however, there are multiple signs that it may have peaked and will start to turn down. Below, the Citigroup inflation surprise index has recently had its largest drop since the start of this recovery. Other signals of inflation cooling are: commodity prices showing signs of turning down; tighter monetary policy; labor supply is picking up; freight prices are coming down, etc.



The pandemic may recede in importance, supporting services spending. While the pandemic is not over in China, it is likely to continue to recede in importance in the US and other highly vaccinated, and relatively highly exposed countries. The chart to the right from BCA illustrates that although cases of COVID-19 have increased in the developed markets (DM), there has been very little increase in ICU patients or deaths. Assuming this trend continues, supply chains will continue to recover and spending on services will pick up, helping improve both inflation and global economies.

What Could Go Wrong:

The US will likely experience a recession scare. Even if the US economy avoids a recession in the next 12 months, growth is likely to slow and the chances of a ‘recession scare’ are high. The fact that the 2-10 yield curve briefly inverted has investors on heightened recession watch, and any slowdown is likely to trigger fears of a recession. We expect growth in manufacturing and goods to slow and the recent jump in mortgage rates may slow residential activity.

The European economy may enter a recession. The risk of a recession in Europe has increased and may become a reality if the Russian war leads to a complete shut-off of energy exports. A recession in Europe has the potential to spread to other countries and could increase the risk to global stocks.

Omicron continues to spread in China. It is clear that China's zero-tolerance policy has failed to contain the spread of COVID-19 and cases are surging. The further spread could lead to supply chain issues and ultimately to higher shipping costs, which would be a negative for the economy and inflation.

Inflation expectations increase despite slowing inflation. Even as inflation has spiked to the highest level in decades, the expectation for longer-term inflation has stayed relatively muted. Long-term inflation has a psychological component and if consumers begin to believe long-term inflation will rise sharply, it can have a self-fulfilling effect. Higher inflation expectations could force the Fed to take a more aggressive approach

What's Next?

The high level of uncertainty for both the economy and financial markets is leading to market sell-offs. In times of high uncertainty and volatility, the market tends to sell the most speculative and overpriced stocks first, namely speculative technology stocks and growth stocks that got extremely overvalued. That's happening now.

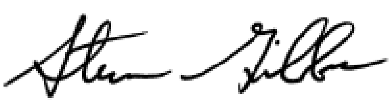
Business Cycles in a Slowdown State

Business Cycle	Recovery	Expansion	Slowdown	Contraction
Growth	Low but Improving	Accelerating	High but Slowing	Low and Falling
Inflation	Low	Medium	Elevated	Low
Capacity Utilization	Low	Rising	High	Falling
Liquidity	Improving	Abundant	Abundant	Scarce
Valuations	Cheap	Moderate	Rich	Falling
Risk Aversion	High	Low	Medium	High
Policy	Fiscal and Monetary Easing	Easy	Tightening Commences	Tight But Calls For Easing

We're confident that the business cycle is going through a slowdown and the risk of a recession in the next 24 months has increased substantially. The following chart from BCA nicely sums up why we are in the slowdown phase of the business cycle.

At this stage of the cycle, it's important to adapt your investment strategy. We believe the market has lost faith in speculative unprofitable growth names and will begin to pay a premium for higher quality companies with stable earnings, high margins, and growing dividends. We refer to these types of companies as quality-at-a-reasonable-price or QARP. When all stocks are getting sold off, it is an excellent time to upgrade the quality of your portfolio. We will actively be looking for opportunities to upgrade portfolios, do some tax-loss harvesting, and rotate into positions that are attractively valued for the long-term during this correction.

If you have any questions about your portfolio or investment strategy don't hesitate to give us a call. Best



regards,

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