First Quarter 2022 Key Takeaways

A period of rising inflation and rising interest rates creates challenges for both bonds and stocks, and in turn for a traditional balanced portfolio comprised only (or largely) of core bonds and stocks.

Global stocks (MSCI ACWI Index) fell 5.4% for the quarter. The S&P 500 was a relative outperformer, dropping 4.6%, compared to developed international markets (MSCI EAFE Index) down 5.9% and emerging markets (EM) down 7.0%.

The damage was worse in the U.S. core bond market than the broad U.S. stock market. The benchmark Bloomberg U.S. Aggregate Bond Index ("AGG") fell 5.9% for the quarter. This was the second-worst quarter for the AGG since Q1 of 1980, when Paul Volcker's Fed was in full-bore tightening mode.

Energy, utilities, gold and commodities were the standout performers with these benchmarks all solidly in the black for the quarter.

The war in Ukraine has had wide-ranging but diverse impacts on the global economy and individual regions. Besides Ukraine itself, the most direct and damaging economic impact is on Russia. Given that Russia's economy is less than 2% of global GDP and that our portfolios had close to zero exposure to Russian stocks or bonds, it is immaterial.

The war is a "stagflationary" supply-shock: it fuels higher inflation via sharply rising commodity prices (especially oil) while also depressing economic growth via negative impacts on consumer spending. It is also triggering various government and central bank policy responses, which create additional risks and uncertainties.

Longer-term inflation expectations remain mostly "anchored" in a range consistent with the Fed's 2% long-term core inflation target.

Capital Economics cut their global real GDP growth forecast from 4% to 3.2% for this year, which is only slightly above the economy's long-term trend growth rate. The Federal Reserve, at its March FOMC meeting, cut its 2022 U.S. real GDP growth forecast from 4% to 2.8%.

Growth forecasts for Europe have taken the biggest hit since the war. For example, Ned Davis Research (NDR) cut their 2022 Europe real GDP growth forecast from 4% to 2.7%.

The weight of the evidence also suggests a U.S. recession in the next 12 months is unlikely.

The Fed has finally begun to raise interest rates (the fed funds policy rate), starting with a 25-basis point (0.25%) increase at the March FOMC meeting.

Meaningful new stimulus appears unlikely. Instead, the economy faces a fiscal growth drag, estimated by the Brookings Institute to be in the range of negative 2.5 to 3.0 percentage points this year.

Despite the recent drop, the S&P 500 still looks expensive on an *absolute* valuation basis. But, *relative* to still-low (but not *as* low) bond yields, U.S. stocks are still attractive.

My analysis continues to indicate we are being more than fairly compensated for investing in European and emerging markets over the medium-term (5-year).

First Quarter Market Recap

A lot has happened since my year-end commentary. In this letter, I will highlight the key developments as they relate to the global economy and financial markets. The biggest macro event is Russia's brutal invasion of Ukraine. As is my job, my focus here is on the economic and financial market impact of this event. Clearly, the human impact has been devastating and tragic. With no resolution yet in sight, our hearts and support are with the Ukrainian people.

Financial markets had a rough first quarter across the board—stocks, bonds, U.S., international and emerging markets—hurt by rising interest rates, inflation and the war in Ukraine.

Global stocks (MSCI ACWI Index) fell 5.4% for the quarter. Among major global markets, the S&P 500 was a relative outperformer, dropping 4.6%, compared to developed international markets (MSCI EAFE Index) down 5.9% and Emerging Market (EM) stocks down 7.0%.

The relatively mild declines for the full quarter masked the intra-quarter volatility. At its low point on March 8, the S&P 500 was down 13% from its high on January 3. The developed international and EM stock indexes had drawdowns in the 16-17% range during the quarter, before rebounding roughly 10% by quarter-end. And many hyper-growth stocks in the U.S., those that benefitted most from the changes brought on by the pandemic, saw declines of 30% to 50% in the quarter.

Unusually, *the damage was worse in the U.S. core bond market than the broad U.S. stock market*. The benchmark Bloomberg U.S. Aggregate Bond Index ("AGG") fell 5.9% for the quarter. This was the second-worst quarter for the AGG since Q1 of 1980, when Paul Volcker's Fed was in full-bore tightening mode.

As I've previously discussed, a period of rising inflation and rising interest rates creates challenges for both bonds and stocks, and in turn for a traditional balanced portfolio comprised only (or largely) of core bonds and stocks. Diversification into other asset classes, market segments and alternative strategies can be particularly valuable in such an environment.

In the fixed-income markets outside of core bonds, high-yield bonds (lower credit quality) lost 4.5%, while floating-rate loans had just a 0.1% decline.

Finally, energy, utilities, gold and commodities were the standout performers with these benchmarks all solidly in the black for the quarter.

Portfolio Update

A period of rising inflation and rising interest rates creates challenges for both bonds and stocks, and in turn for a traditional balanced portfolio comprised only (or largely) of core bonds and stocks. Diversification into other asset classes, market segments and alternative strategies can be particularly valuable in such an environment. To that point, gold and energy master limited partnerships ("MLP") were standout performers in certain of our BCA Flexible portfolios, with the iShares Gold Trust (IAU) gaining 6.64% for the quarter and the Tortoise North American Pipeline fund (TPYP) posting a 20.36% gain for the quarter. Trends in interest rates and bonds have been a powerful contributor to portfolio performance this year, a sharp contrast to the losses in investment-grade bonds.

In terms of our fixed-income allocation, our portfolios use bonds primarily as a defensive tool, to protect against a turbulent stock market, to be a ballast in the storm so to speak. In theory, when market turbulence rises, our position in bonds should stabilize portfolio values and help avoid the full force of a stock market storm. The unique nature of today's circumstances – rising interest rates and rising inflation, exacerbated by Russia's invasion into Ukraine – have changed that equation. The prospect of an extended period of high energy prices is looking more and more likely. Analysts were mostly expecting inflation to be "transitory" and to moderate once global supply chain issues worked themselves out, but that thesis is now being reconsidered.

The PIMCO Income fund (PONAX & PIMIX), a broadly diversified multi-sector bond fund, lost 4.30% for the quarter, while our passively-managed bond funds, the Vanguard Intermediate Term Bond fund (BIV) and the Vanguard Intermediate Term Corporate Bond fund (VCIT) were down 6.31% and 6.96% respectively for the quarter.

This quarter's bond market performance is telling me that bond investors now believe inflation is here to stay. What could be leading them to this conclusion?

Petroleum, the primary driver of current inflation, is used in thousands of products, not just gasoline to power our cars. It's used for heating our homes, for electricity generation, for plastic toys, for hair gel, for lubricants, for shoes, for paint, for candles, and so on. Every one of these products becomes more expensive to make as its component ingredient becomes more expensive, and at $100+ per barrel petroleum is more expensive today than it has been in some time, up more than 65% in the last 12 months; Natural gas at $6.69 MMBtu is up 155% from its price 12 months ago.

Russia accounts for roughly 50% of Europe's natural gas imports and 25% of its oil imports. The war itself and sanctions imposed on Russia by the West are having, and for the foreseeable future will continue to have, a material impact on global economic growth and inflation. Add to this Europe's realization that they must wean themselves off of cheap Russian oil if they are ever to be energy-secure, and what you have is a world in which oil and gas supplies to the West will remain constrained for the foreseeable future, even while the world ramps up production from alternative energy sources.

With the above as a backdrop, and with the cost of living in the U.S. rising at 8.5% (4/12/22 CPI print), an investment in a 10-year Treasury bond earing 2.7% per year is an investment guaranteed to lose money *in real terms*. Is it any wonder that the bond market is selling off?

Also on the downside, our tactical overweight to Emerging Market stocks detracted from relative performance. After a strong January, EM stocks gave up ground in the latter half of the quarter, trailing U.S. stocks and bonds. Our active

EM fund manager, the PGIM Jennison Emerging Markets Equity Opportunity fund (PDEZX) lost 21.51% for the quarter, badly trailing its peer group, even though the fund's exposure to Russian stocks is less than 0.50%.

A relative bright spot was our overweight in what I call "slow growth" stocks (also referred to as "value" stocks). Fear of higher interest rates and general global uncertainty, drove stock investors out of "fast growth" stocks and into (safer) "slow growth" stocks. The Schwab U.S. Dividend Equity fund (SCHD) plies its trade on investing in "slow growth" stocks and benefitted from this quarter's rotation away from "fast growth." For the quarter, the fund lost just 1.79% compared to an 8.95% loss for the large U.S. growth company category.

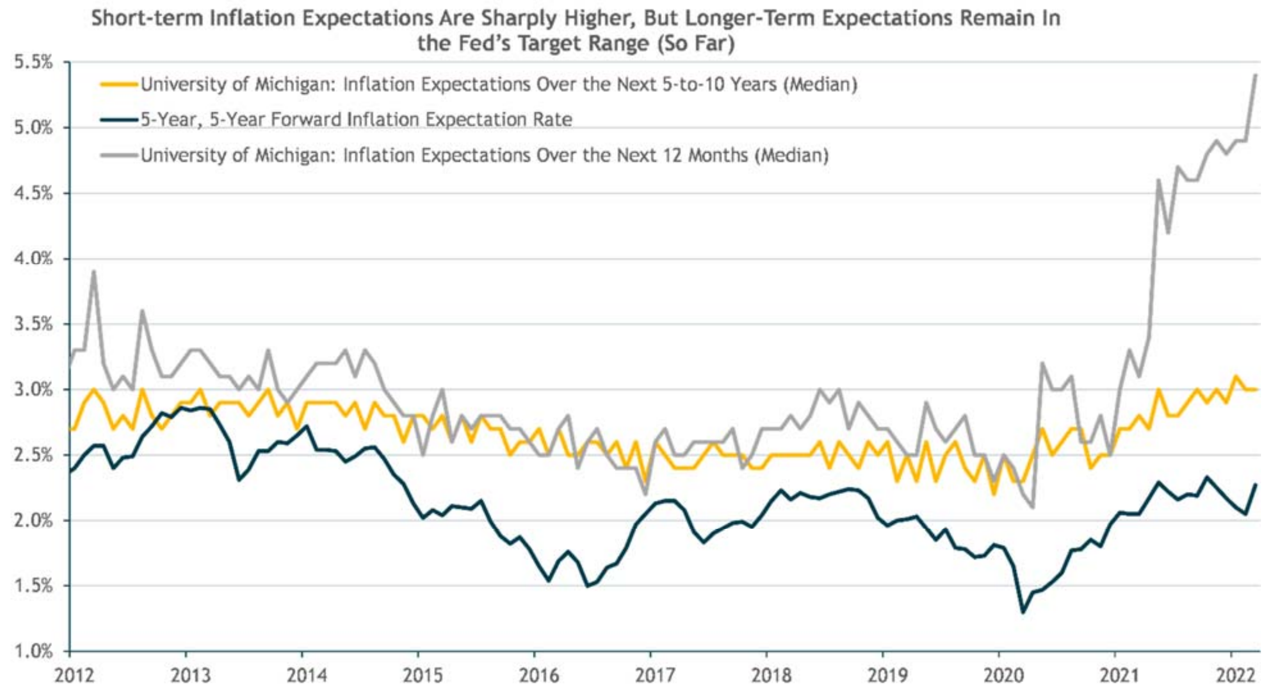
Investment Outlook

The war in Ukraine has had wide-ranging but diverse impacts on the global economy and individual regions. Besides Ukraine itself, the most direct and damaging economic impact is on Russia. Given that Russia's economy is less than 2% of global GDP and that our portfolios had close to zero exposure to Russian stocks or bonds, it is immaterial.

However, Russia is a major producer and exporter of oil and natural gas—to Europe in particular, (as mentioned above) accounting for roughly 50% of Europe's natural gas imports and 25% of its oil imports—and certain agricultural commodities and base metals. As such, the war and the sanctions imposed on Russia by the West are having, and for the foreseeable future will continue to have, a material impact on global economic growth and inflation.

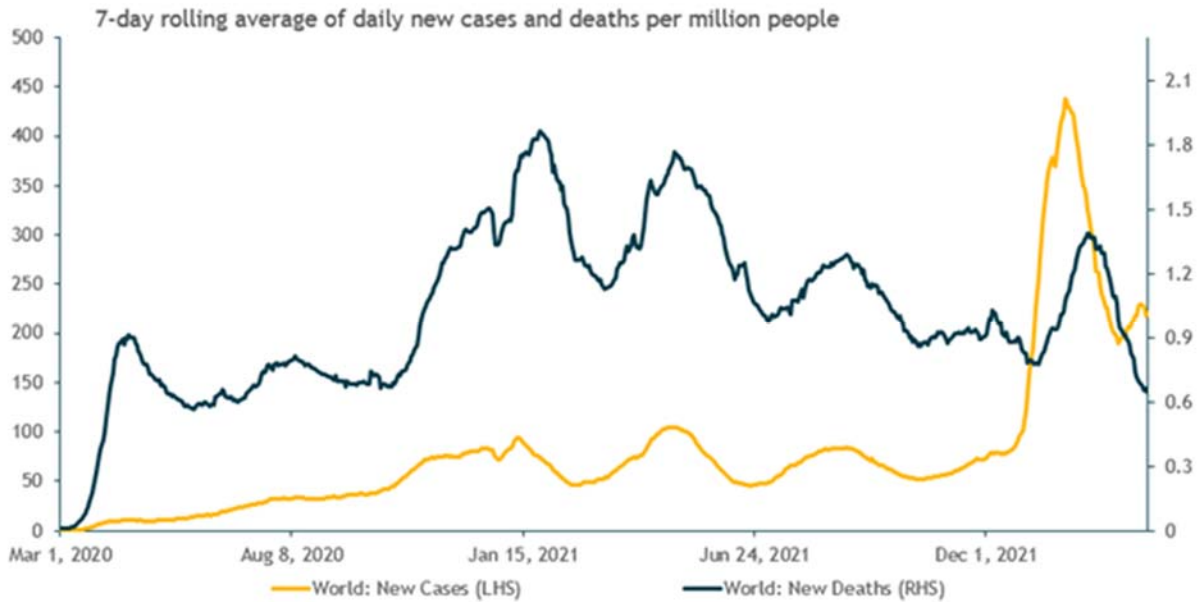
In a nutshell, the war is a "stagflationary" supply-shock: it fuels higher inflation via sharply rising commodity prices (especially oil) while also depressing economic growth via negative impacts on consumer spending. It is also triggering various government and central bank policy responses, which create additional risks and uncertainties for the economy and markets. In response to broadening and persistence inflation, the Federal Reserve has finally begun raising interest rates (the Fed funds policy rate).

On the more positive side, *longer-term* inflation expectations remain mostly "anchored" in a range consistent with the Fed's 2% long-term core inflation target. Short-term (12-month) inflation expectations have spiked higher, consistent with the recent sharp rise in gasoline prices and overall CPI, but over the long-term, expectations are that inflation will moderate. Should the longer-term measures move higher, I'd expect the Fed to accelerate its tightening pace.



The disheartening events in Ukraine came as the COVID-19 pandemic news was getting better, with the Omicron wave sharply receding. Of course, the risk remains of new or more severe waves of the virus. As the chart below shows, there has been a recent uptick in new cases globally -- in China (leading to full lockdowns in the affected areas under China's "zero-COVID" approach), other Asian countries and Europe. The U.S. may soon face a similar uptick. But over time, with continued rising immunity rates, vaccines, medical advancements, and social and business adaptation, the economic damage and disruption should continue to recede. That is my base case.

If so, this should both support economic growth via consumer and business spending *and* mitigate some of the inflationary pressures the U.S. and global economy experienced last year caused by widespread supply-chain bottlenecks, supply/demand mismatches for consumer durable goods (e.g., autos) and the sub-par recovery in the U.S. labor force participation rate, which has contributed to higher U.S. wage inflation and increased the risk of a self-reinforcing wage-price spiral taking hold.



Source: Our World in Data, Johns Hopkins University CSSE COVID-19 Data. Data as of 3/22/2022.

Economic Conditions: Growth and Inflation

With the war in Ukraine, most economists and investment strategists have lowered their 2022 economic growth forecasts and upped their inflation forecasts, reflecting the expected stagflationary impacts discussed above.

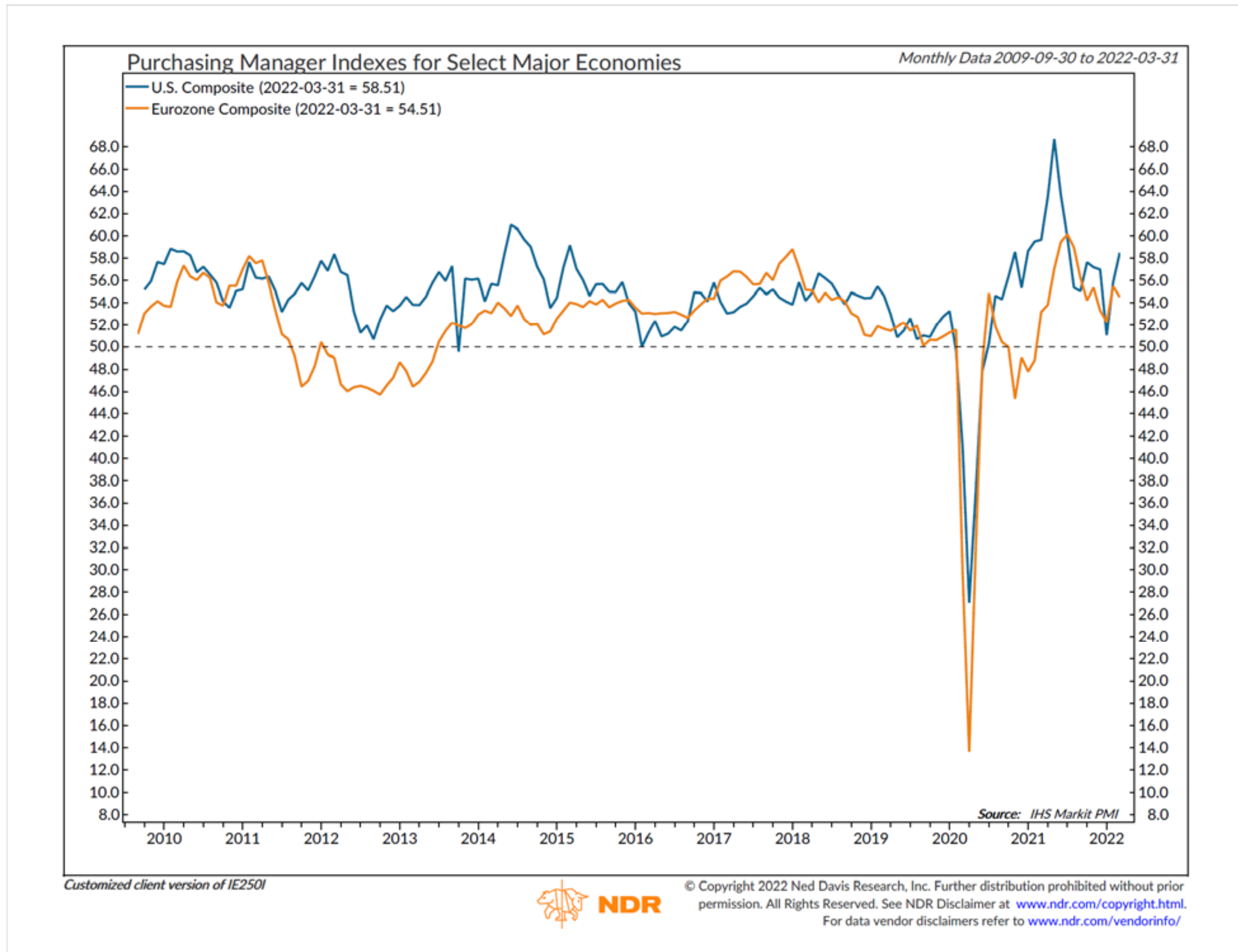
Growth

On the growth side, for example, Capital Economics cut their global real GDP growth forecast from 4% to 3.2% for this year, which is only slightly above the economy's long-term trend growth rate. The Federal Reserve, at its March FOMC meeting, cut its 2022 U.S. real GDP growth forecast from 4% to 2.8%.

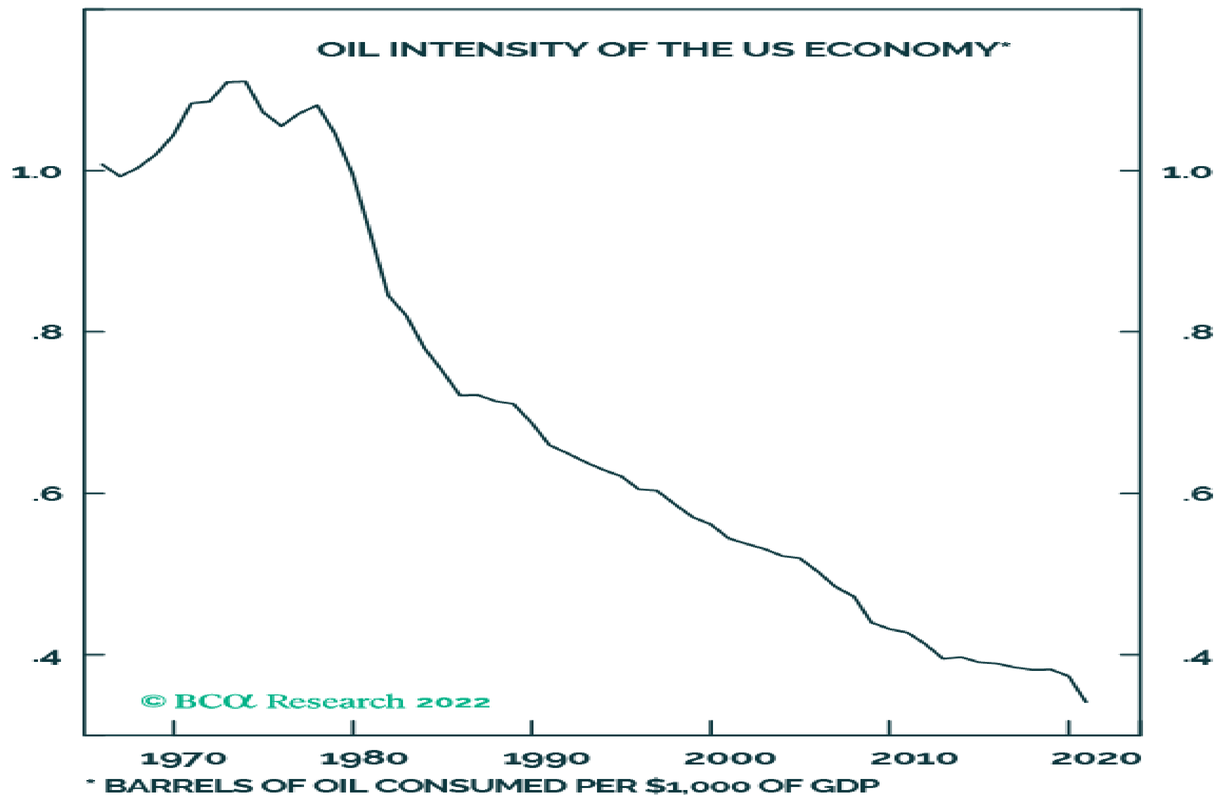
Growth forecasts for Europe have taken the biggest hit since the war. For example, Ned Davis Research (NDR) cut their 2022 Europe real GDP growth forecast from 4% to 2.7%. Year-to date, oil prices are up more than 30% to around $100 per barrel, while European natural gas prices have soared nearly 80% YTD. NDR estimates that a $20 increase in real (inflation-adjusted) oil prices shaves 0.6 percentage points off European GDP growth. However, absent a severe deterioration in the war, NDR (and most other research I follow) still sees a low risk of recession in Europe this year due to large household savings, pent-up consumer demand from the pandemic, a strong job market (Eurozone unemployment recently hit a record low at 6.8%), and additional fiscal stimulus on the way.

The weight of the evidence also suggests a U.S. recession in the next 12 months is unlikely – I'd call it in a *rough* ballpark of 25% odds or less. Several recent U.S. economic data points have been solid/strong, including expansionary Purchasing Manager Index (PMI) readings, record-high job openings, record-low weekly new unemployment claims, and a positive Leading Economic Indicator (LEI). Household wealth and savings are also high, which should support consumer borrowing and spending even with high inflation and rising interest rates. Corporate balance sheets are also generally in good shape.

Purchasing Manager Indexes for U.S. and Europe Remain Expansionary (above 50)



Moreover, the “oil intensity” of the U.S. economy has dropped sharply over the past four decades. The economy is less sensitive to oil price spikes, and *much* less exposed than during the 1970s OPEC oil crisis. The U.S. is also now a slight net *exporter* of petroleum, which mitigates the overall economic damage from rising oil prices, although domestic consumers—lower income households in particular—certainly suffer



With the Ukraine war and COVID as wildcards, the growth backdrop could certainly deteriorate further, possibly leading to a recession next year. But as things currently stand, the U.S. and global economy still look likely to post solid, above-trend growth this year, albeit lower than was expected three months ago.

Inflation

Moving on to the inflation backdrop in the U.S., the news has gotten worse over the past three months as can be seen across any number of inflation measures: core, median, trimmed mean – take your pick.

However, the highest inflation by far is still coming from the consumer goods side of the economy, where the supply/demand imbalances due to COVID are worst. These imbalances should recede as the pandemic recedes, reducing at least some of the broad inflationary pressure.

While most forecasters expect U.S. inflation to be lower by year-end than it is now, the consensus estimate has risen compared to three months ago. This includes the Fed. At its March FOMC meeting it projected core PCE inflation of 4.1% for this year, up from its 2.7% forecast last December.

The persistence of high and broadening inflation has led to a further hawkish shift in the Fed's monetary policy stance, to which I will now turn.

Monetary and Fiscal Policy

Monetary Policy

The Fed has finally begun to raise interest rates (the fed funds policy rate), starting with a 25-basis point (0.25%) increase at the March FOMC meeting. The chart below shows the sharp increase in the fed funds rate the FMOC now expects in 2022 and 2023 compared to their previous meeting in December: 1.9% (2022) and 2.8% (2023) vs. 0.9% and 1.6%, respectively.

The Fed also indicated it will start to shrink its $9 trillion balance sheet of Treasury and government agency mortgage-backed securities this year. This is another form of monetary tightening—quantitative tightening (QT), the opposite of quantitative easing (QE). A fancy way to say the government will begin to sell bonds on the open market, which it hopes will push bond prices down and bond yield up.

Powell and the Fed are in a tough spot. They know they need to tighten to combat high inflation, keep longer-term inflation expectations anchored, and prevent a wage-price spiral from taking hold. If they fail, it will require even more drastic policy tightening down the road. Yet, much of the current inflation is driven by exogenous supply-side disruptions due to COVID and the Ukraine war that the Fed can't control. Raising rates is intended to crimp aggregate *demand*, i.e., consumer and business spending. This should eventually have a downward impact on inflation (basic Econ 101 supply and demand). But it also raises the risk of driving the economy into recession or near-recession and increasing unemployment to unhealthily high levels.

In terms of monetary policy outside the United States, roughly two-thirds of global central banks (including developed and emerging markets) have also been raising interest rates. The notable exceptions continue to be the European Central Bank (ECB) and the Bank of Japan (BoJ), although the ECB has signaled potential rate hikes later this year.

Meanwhile, as I noted last quarter, China is a notable outlier in that it has started *loosening* monetary policy—cutting interest rates and Chinese banks' reserve requirement ratio, allowing for additional lending. The PBoC is expected to continue to loosen in the months ahead to support the economy and markets. On March 16, senior Chinese authorities also signaled additional fiscal stimulus, regulatory relaxation and equity market support. This triggered an incredible 20% rebound in the MSCI China Index ETF that day; Alibaba and Tencent's stock prices soared over 30%, off depressed levels. It remains to be seen if, how and when the authorities' words translate into substantive policy actions. But BCA Research estimates China's fiscal spending impulse will increase to over 3% of China GDP this year.

Fiscal Policy

As I wrote at year-end, after unprecedented stimulus in 2020 and 2021, both fiscal and monetary policy in the United States were set to tighten in 2022. There hasn't been any major change on the fiscal side. Meaningful new stimulus appears unlikely. Instead, the economy faces a fiscal growth drag, estimated by the Brookings Institute to be in the range of negative 2.5 to 3.0 percentage points this year.

Economic Outlook

Taking all of these factors into account, my base case shorter-term (12-month) economic outlook is for decelerating economic growth and still-high but moderating inflation. Absent a recession, which of course can't be ruled out, this macroeconomic backdrop should be generally supportive for "risk asset" returns, such as global equity and credit (higher yield/risk) markets, and a headwind for core bonds in the face of rising government bond yields.

I've seen the latter play out so far this year, with sharply negative bond returns. Risk asset markets have also been generally negative, but not much worse than core bonds and in some cases better. As I'll discuss in the next section, looking forward I believe equities and credit have relatively attractive return potential from current levels.

To summarize the key risks that could upend my cautiously optimistic base case:

- The war in Ukraine expands to other countries and/or intensifies causing deeper economic damage, beyond the terrible human toll.

- A new highly infectious and deadly COVID-19 variant emerges, leading to renewed lockdowns with resultant economic and social impacts.

- The Fed makes a policy mistake: Either (1) tightens too much triggering a severe slowdown/recession; or (2) allows inflation to become entrenched, inflation expectations un-anchored and a wage-price inflation spiral takes hold.

- The Chinese economy has a sharp downturn ("hard landing"), for example, due to a policy mistake related to the property-market deleveraging, or possibly Western sanctions if China supports Russia's war in Ukraine.

- Another geopolitical or exogenous shock impacts the global economy (always a possibility).

Financial Markets Outlook and Our Portfolio Positioning

I did not make any portfolio changes in the first quarter because my fundamental views *relative to the current market pricing* are still in-line with where they stood at year-end. Said differently, the war in Ukraine has increased upside inflation risk and downside growth risk. But looking through the day-to-day gyrations, the financial markets have reacted reasonably rationally, with U.S. interest rates rising sharply and riskier assets/equities falling moderately during the quarter.

Equities

<u>U.S. stocks</u>

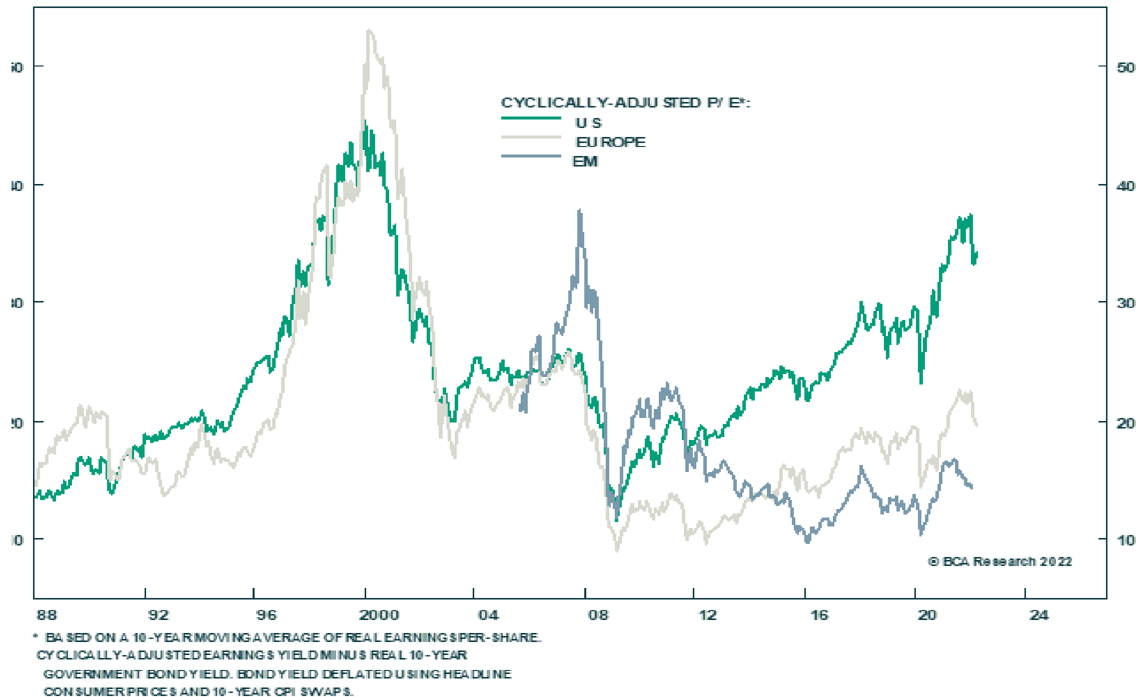
Despite the recent drop, the S&P 500 still looks expensive on an *absolute* valuation basis. But, *relative* to still-low (but not *as* low) bond yields, U.S. stocks are still attractive.

<u>International and Emerging Markets Stocks</u>

International and EM stocks are also higher-risk, even more so than U.S. stocks during the past decade-plus. Once again in the first quarter they were harder hit, due largely to the war in Ukraine. Consensus earnings estimates for both regions have come down this year as the economic risks have risen. But unlike the S&P 500, the European and EM stock indexes are selling at reasonably attractive valuations, both absolute and relative to bonds. They are also selling at deep discounts to the U.S. market – deeper than their historical discounts.

Europe and EM Absolute Valuations are Reasonably Attractive

While I acknowledge their higher shorter-term risks, especially in the current environment, my analysis continues to indicate we are being more than fairly compensated for investing in European and emerging markets over the medium-term (5-year) scenarios I believe are most likely to play out. And I believe my underlying analytical assumptions are, if anything, conservative, providing an additional margin of safety.



Most significantly, I expect to see a rebound in EM and European corporate earnings growth back towards their historical longer-term trends, after being deeply depressed for many years. For example, in my base case, the five-year implied EM EPS growth is a bit above 8%. I assume only a small increase in the EM index valuation multiple—from roughly 13x currently to 14x five years out. There is an argument to be made that we could see a larger multiple expansion on top of the stronger earnings growth as investor sentiment shifts in favor of these markets. Adding in the EM market index dividend yield, I estimate annualized five-year expected returns in the low double digits for EM stock markets. As such, I retain a tactical overweight to EM stocks, which is funded primarily from our underweight to core bonds and, depending on the specific portfolio, somewhat from U.S. stocks.

Fixed Income

My broad outlook for fixed-income assets has not materially changed. I've been expecting interest rates to rise putting continued pressure on core bond returns, and that played out in spades in Q1. With the core bond index now yielding 3%, expected 5-year returns have increased. But they are still very low and are susceptible to heightened inflation risk over the near-term and medium-term.

As such, I have a significant underweight to core bonds relative to a traditional bond benchmark. But our more conservative portfolios still carry meaningful exposure to core bond allocations as ballast in the event of a deflationary recession or traditional "flight-to-safety" market shock. However, core bonds will provide little benefit in a stagflationary recession scenario, which is an increasing risk as I've discussed.

Closing Thoughts

The war in Ukraine has caused massive human suffering. From an economic and investment perspective, it has added to already-high uncertainty, degraded the near-term growth outlook, and added additional fuel to the inflationary fire. Crises, as painful as they are, often create opportunities. However, the equity and fixed-income markets have

reacted quickly to the headlines, and as currently priced aren't offering any compelling *new* top-down tactical asset allocation opportunities, in my view.

Our balanced portfolios remain positioned with (1) a small overweight to global equities, coming from a tactical overweight to Emerging Market stocks; (2) a large overweight to "slow growth" U.S. stocks, which remain reasonably valued relative to "fast growth" U.S. stocks; (3) a large underweight to core bonds, but still meaningful allocations in our most conservative portfolios.

While tilting towards my highest-conviction tactical views, BCA Flexible portfolios remain strategically balanced and well-diversified across multiple global asset classes, investment strategies, equity styles and risk-factor exposures. This should enable them to be resilient should a risk scenario or shock outside my cautiously optimistic base case occur.

I am confident that my long-term investment process and discipline, and my access to exceptional research, will enable me to continue to navigate whatever macro and market environments come our way. We can all hope whatever comes next is not as grim as a pandemic or war. But as investors we need to be prepared for worse, even as we hope for better.

I sincerely appreciate your continued confidence and trust.

Best,
Kelly D. Kane, ChFC, CFP

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