First Quarter 2022 Key Takeaways

It's been a rough year, with equity markets down more than 20% and "low-risk" bond markets registering low double-digit losses.

Over the past few months, the economic backdrop has worsened with sustained high inflation and slowing growth, as the Federal Reserve and other global central banks aggressively tighten monetary policy.

In the near-term, it's prudent to expect more equity market pain as an economic slowdown and potential recession will likely lead to corporate earnings disappointments, which would likely trigger further stock price declines. But with global stock markets already down 20%-plus due to valuation compression and sharply higher bond yields, *much* of the damage has already been done.

Over a medium-term horizon, this correction is setting the stage for more attractive forward-looking returns.

In response to disappointing May inflation data, the Fed turned even more hawkish, hiking the federal funds rate a larger-than-expected 75 basis points. Tighter financial conditions in turn depress consumer and business spending, reducing aggregate demand in the economy.

Expect continued and potentially sharp deceleration in economic growth driven by rapidly tightening monetary policy in response to sustained high inflation. A recession is a reasonable conservative assumption but not a certainty.

If the U.S. economy does fall into a recession, it is likely to be a shallow cyclical recession (in other words, a "normal" recession) rather than a recession like that following the 2008-09 financial crisis when housing demand collapsed, the 2000-2002 dotcom bubble bust when business capital spending collapsed, or the 2020 COVID recession.

I believe stock markets in the U.S. and abroad have largely *already priced in* the risk of recession with year-to-date declines of 20%-30%, bringing the cost of $1.00 of earnings to $15.94 in the U.S., $11.70 in China, $11.20 in the broad emerging markets, and $11.60 in Europe -- attractive valuations by historical standards.

A repeat of the Great Financial Crisis of 2008-09, when the market fell 57% from its October 2007 high to its March 2009 low, can't be categorically ruled out, but there is little evidence the economy and markets are facing anywhere near that level of systemic financial risk and rot in the current circumstances.

Portfolios maintain an overweight to international stocks, coming mostly from emerging market stocks. My base case five-year expected returns for EM and developed international stocks are in the low double digits, supported by low starting valuations and cyclically depressed earnings.

Portfolio maintain an underweight to fixed-income with rising interest rates and inflation. What remains of our core bond exposure carries very little credit risk, protection against a possible recession.

2022 So Far

It's been a rough year, with equity markets down more than 20% and "low-risk" bond markets registering low double-digit losses. Over the past few months, the economic backdrop has worsened with sustained high inflation and slowing growth, as the Federal Reserve and other global central banks aggressively tighten monetary policy. Exogenous shocks -- the Russian war on Ukraine and China's zero-COVID lockdowns -- continue to further disrupt the global economy and financial markets.

It's natural to be concerned about these developments and worry about what the future holds. It feels better when our investment portfolios are going up than when they're going down. But when it comes to investing, doing what *feels* good in the moment isn't usually the best long-term decision.

In this investment commentary, I will dig into the recent market and economic developments, what's changed since the first quarter, and how it has impacted my near-term (six to 12 month) and medium-term (five-year) outlooks.

In a nutshell: In the near-term, I think it prudent to expect more equity market pain as an economic slowdown and potential recession will likely lead to corporate earnings disappointments, which may trigger further stock price declines. But with global stock markets already down 20%-plus due to valuation compression and sharply higher bond yields, I believe *much* of the damage has already been done.

For some perspective, let's go back to the end of 2021. At that time, investors were paying over $22 for a dollar of S&P 500 earnings; as I write this, investors are paying $15.94, a more reasonable price to pay and one that's more in-line with historic averages. So, clearly valuations have become more attractive than they were at the end of 2021. This is important because when there are deals to be gotten, investors are more willing to look past their immediate concerns and invest in stocks. However, valuation compression is just one part of the equation.

The question on the minds of many investors, with earnings season just around the corner, is whether corporate earnings are about to disappoint. For example, assume aggregate corporate earnings come in at 7% less than expected, now that $15.94 investment isn't buying $1.00 of S&P 500 earnings, it's buying $0.93 of earnings, making the true cost for $1.00 of earnings, $17.14, which takes valuations back up – the wrong direction! The hope, of course, is that earnings will be in-line with expectations and support the "attractive valuations" scenario. All eyes then are on coming earnings announcements…

Over a medium-term horizon, I see this as largely a healthy "re-set" for the markets: a normal cyclical downturn setting the stage for more attractive forward-looking returns.

As always, investment discipline and patience – staying the course and remaining invested through these choppy waters -- is necessary to be in position to realize the better returns to come. Given the wide range of potential outcomes, risks and unknowns, portfolio diversification beyond traditional U.S. stocks and core bonds also remains important, in my view.

Second Quarter Market Recap

After a rough first quarter, global stocks and bonds suffered further sharp markdowns in the second quarter as stagflation fears and rising interest rates pummeled both broad asset classes.

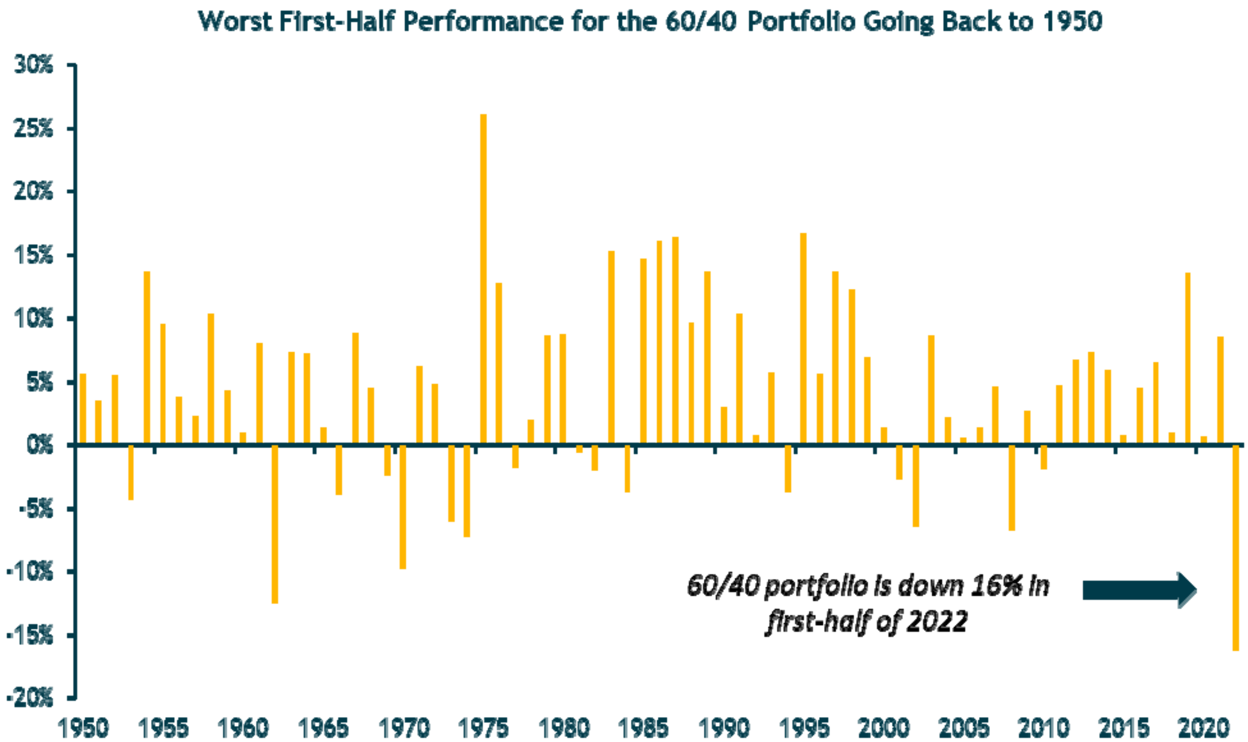
Global stocks (MSCI ACWI Index) fell 15.7% for the quarter and are down 20.2% for the year. The S&P 500 dropped 16.1% for the quarter and is also down 20% for the year, after being down as much as 24% through mid-June. Developed international markets (MSCI EAFE Index) were down 14.5% for the quarter and 19.6% YTD. Emerging Market stocks (MSCI Emerging Markets Index) held up a bit better, dropping 11.4% for the quarter, and down 17.6% YTD.

Foreign equity market returns for U.S. dollar-based investors were hurt (again) by the sharp appreciation of the dollar; the ICE U.S. Dollar Index was up 6.5% for the quarter and 9.5% on the year. Conversely, a weakening dollar versus other currencies would benefit foreign asset returns, as I continue to expect over the medium-term.

Core investment-grade bonds were pummeled again in the second quarter, with the benchmark Bloomberg U.S. Aggregate Bond Index (the "Agg") dropping 4.7%. This puts the "safe-haven" Agg down a whopping 10.3% for the year to date -- *its worst first-half ever*. In other segments of the fixed-income market, high-yield bonds (ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index) fell 9.9% and floating rate loans (S&P/LSTA Leveraged Loan Index) dropped 4.5% for the quarter.

As I have long been pointing out, core bonds are not low-risk or defensive assets in an inflationary (rising interest rate) environment. Taken together with the equity bear market, at a loss of 16.1%, this is *by far* the worst first-half performance for a traditional "60/40" balanced portfolio (60% S&P 500/40% Aggregate Bond Index) in modern history. The previous worst first half was 1962, down 12%. One bright note gleaned from these statistics: the 12-month periods following the 10 worst first-half performances for a 60/40 portfolio going back to 1926, showed average returns of 12.6%. One can hope…

Portfolio diversification into "non-traditional" asset classes, non-core fixed-income market niches, and alternative strategies can be particularly valuable in an inflationary environment. We saw this in the first quarter and it continued in the second quarter. Trend-following managed-futures strategies again led the way posting double-digit positive returns; the benchmark SG Trend Index gained 9.6%, benefiting from its short positions in bond and stock markets, i.e., it benefited as these markets declined. It's also worth noting the Trend Index and the active managed futures funds we now own outperformed both global stocks (MSCI ACWI) and bonds (the Agg) by wide margins over the past three and five years.

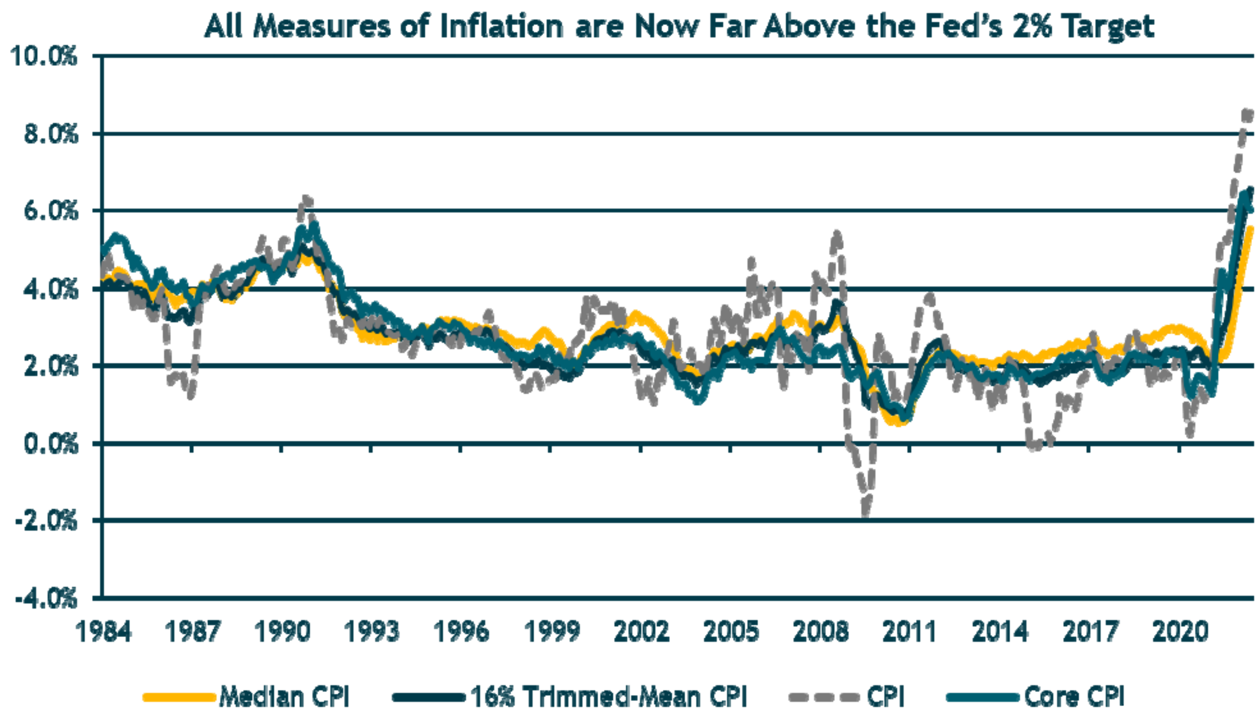


Data as of 6/30/2022. Source: Morningstar Direct. From 1950 through 1975, 60/40 portfolio is represented by 60% S&P 500 Index and 40% Ibbotson SBBI US Intermediate-Term Government Bond Index. From 1976 onward, portfolio is represented by 60% S&P 500 Index and 40% Bloomberg US Aggregate Bond Index. Portfolio rebalanced annually.

Investment Outlook

In response to disappointing May inflation data, the Fed turned even more hawkish, hiking the federal funds rate a larger-than-expected 75 basis points. Tighter financial conditions in turn depress consumer and business spending, reducing aggregate demand in the economy. Lower demand (lower GDP growth) should reduce overall price pressures and hence inflation. That's the Fed's playbook and toolkit.

The ideal outcome would be the elusive "soft landing," in which inflation is subdued without causing a recession. But the simple economic cause-and-effect influenced by the Fed's toolkit assumes the supply side of the economy remains steady. So far, this has not been the case due to (1) the Russia/Ukraine war's impact on energy and agricultural commodities, and (2) COVID-related supply chain disruptions. I expect (hope) these shocks will recede with time. But the Fed can't do anything about them. BCA's U.S. investment strategist, Doug Peta put it well: "Soft landings are extremely elusive. It is fiendishly difficult to fine-tune a complex multi-faceted economy with central bankers' blunt tools."



Source: Federal Reserve Bank of Cleveland and U.S. Bureau of Labor Statistics. Data as of 6/27/2022.

Balancing these and many other data points, I expect continued and potentially sharp deceleration in economic growth driven by rapidly tightening monetary policy in response to sustained high inflation. A recession is a reasonable conservative assumption but not a certainty.

My best guess at this point is that if the U.S. economy does fall into a recession, it is likely to be a shallow cyclical recession (i.e. a "normal" recession) rather than a recession like those following the 2008-09 financial crisis when housing demand collapsed, the 2000-2002 dotcom bubble bust when business capital spending collapsed, or the 2020 COVID recession when business inventories collapsed. Unlike the economic environments that gave birth to those recessions, the current economic environment lacks signs that any of the four horseman of economic disaster – collapsing business inventories, vehicle sales, housing demand, and business demand – are at play.

Given the sharp stock and bond market declines we've already experienced this year, this leads me to a relatively positive medium-term (five-year) outlook for financial markets and asset class returns. And if U.S. stocks drop further this year – for example, due to increasing recession fears – I will look to add incrementally more to our portfolio allocations to take advantage of more attractive valuations.

Nevertheless, one might ask why I'm not tactically reducing exposure to stocks, given my view that the risk of recession is materially higher now than a few months ago. The answer is that I believe stock markets in the U.S. and abroad have largely *already priced in* this risk with year-to-date declines of 20%-30%, bringing the cost of $1.00 of earnings to $15.94 in the U.S., $11.70 in China, $11.20 in the broad emerging markets, and $11.60 in Europe -- attractive valuations by historical standards.

As I've often stated: *the key question for a fundamental investor is, "What's in the price?"* What consensus expectations and assumptions are implicitly being discounted in current market prices? Then I ask: "Do I have a *different* view from the consensus?" And if so, "Do I have *conviction* – based on research, analysis and seasoned judgment – that I have a *high probability* of being right and the current market consensus reflected in current asset prices is wrong?"

If all those conditions are not met, I stay the course with my existing long-term, *strategic* portfolio allocations, confident that my portfolios have a well-diversified balance of defensive assets to buffer against shorter-term negative outcomes or shocks, and riskier higher-returning assets to serve as the portfolios' primary long-term wealth builders. Diversification is what makes a largely buy-and-hold strategy possible. And history has shown that investors who hold on through difficult times come out ahead.

Charlie Munger, Warren Buffet's lesser-known sidekick, put it well saying, "*The first rule of compound investing is to never interrupt it unnecessarily*." Louis Rukeyser, famed host of PBS's *Wall Street Week* (on which I cut my financial teeth), put it another way proclaiming, "*Don't just do something, stand there*." Sometimes, in fact most of the time, the best course of action is no action.

Given the precipitous decline in global stocks as our backdrop, what does history suggest we can expect from here?

Post-WWII market history shows the average S&P 500 bear market has lost roughly 30%; the median loss is 27%. (Note: In the table below, I am defining a bear market as a market drawdown of 19% or more. There have been four bear markets with losses between 19% and 20%, and 13 bear markets down 20% or more. If I strictly count only 20%+ bear markets, the average post-WWII bear market loss is 33% and the median is 31%.)

In bear markets associated with recessions, the average loss has been somewhat worse at 35%, with the median loss 34%. So, when the S&P closed down 24%, at 3,667 on June 16, 2022, one could argue the market was discounting roughly a 70% probability of an average recession (assuming the remaining probabilities for more positive and more negative scenarios roughly canceled each other out). The average 35% recessionary bear market decline from the S&P 500's high of 4,800 would bring the S&P 500 down to 3,120; 70% of 35% is 24%, or 3,667.

My confidence about the likelihood of an oncoming recession, or its severity, is not sufficiently high, nor is it different from the consensus-weighted 70% probability. So, I have not made a tactical move to reduce stock exposure based on the probability of a recession.

As shown in the table, the worst bear market in post-WWII history was during the Great Financial Crisis of 2008-09 when the market fell 57% from its October 2007 high to its March 2009 low. A repeat of that type of decline can't be categorically ruled out, but there is little evidence our current economy and markets face anywhere near that level of systemic financial risk.

The same goes for comparisons to the 1973-74 decline of 48%, although there are some current echoes with that period's OPEC oil price shock and the dominance and subsequent crash of the Nifty Fifty "growth at any price" stocks (e.g., compared to the "FAANG" stocks now). However, I think the differences are more compelling: such as, the current tightening fiscal and monetary policy stance, more reasonable equity valuations relative to bond yields, stable longer-term inflation expectations, lack of a wage-price spiral (so far), and the absence of a presidential scandal and resignation (Watergate-Nixon).

Yes, we face plenty of other problems now that were not around back in the 1970s or 2008. But rather than assume an extreme negative risk scenario will play out, I expect this to be a more typical cyclical recession, where central bank (and fiscal) tightening in response to an overheating economy and rising inflation ultimately trigger a bear market and a shallow economic downturn.

Bear Markets				
Peak	Trough	% Loss	Months	Recession?
5/29/1946	5/19/1947	-28.5%	11.7	No
6/15/1948	6/13/1949	-20.6%	11.9	Yes
8/2/1956	10/22/1957	-21.6%	14.7	Yes
12/12/1961	6/26/1962	-28.0%	6.5	No
2/9/1966	10/7/1966	-22.2%	7.9	No
11/29/1968	5/26/1970	-36.1%	17.9	Yes
1/11/1973	10/3/1974	-48.2%	20.7	Yes
9/21/1976	3/6/1978	-19.4%	17.5	No
11/28/1980	8/12/1982	-27.1%	20.5	Yes
8/25/1987	12/4/1987	-33.5%	3.3	No
7/16/1990	10/11/1990	-19.9%	2.8	Yes
7/17/1998	8/31/1998	-19.3%	1.5	No
3/24/2000	10/9/2002	-49.1%	30.5	Yes
10/9/2007	3/9/2009	-56.8%	17.0	Yes
4/29/2011	10/3/2011	-19.4%	5.1	No
9/20/2018	12/24/2018	-19.8%	3.1	No
2/19/2020	3/23/2020	-33.9%	1.1	Yes
1/3/2022	???	-23.6%	???	???
Average		-29.3%	11.4	
Median		-25.3%	11.7	

Source: Morningstar Direct. Data as of 06/29/2022.

Portfolio Positioning

My tactical views and positioning on international and emerging market (EM) stocks have not changed. As such, I maintain an overweight to this area, coming mostly from emerging market stocks. My base case five-year expected returns for EM and developed international stocks are in the low double digits, supported by low starting valuations and cyclically depressed earnings. This offers a margin of safety for investors, as a lot of bad news and negative sentiment is already priced into these markets – more so than for the S&P 500 in my view. Things don't have to be great to generate strong returns from here; they just need to get better from currently depressed levels (and I don't expect the pandemic and war to be permanent).

In terms of fixed-income positioning in balanced portfolios, I'm maintaining an underweight to traditional core bonds and recently swapped out a 3% position in the Vanguard Intermediate Corporate Bond fund for a position in a PIMCO Trend-following Managed Futures fund, which offers additional protection against rising interest rates and inflation.

Our portfolios' fixed-income sleeve has performed largely in-line with peers as interest rates have shot higher, and my choices have shown themselves as not immune to recent fixed-income price declines. However, what remains of our core bond exposure carries very little credit risk, which serves as a hedge against the prospect of a slumping economy and the wave of bond defaults that typically follow.

Our position in the PIMCO Income fund provides broad exposure to multiple sectors across the fixed-income markets, and is a form of protection in itself, but even this broadly diversified fund has struggled recently. The PIMCO Income fund has historically prospered from investing in mortgage-backed bonds, a segment of the bond market in which PIMCO is a large player, but these bonds have sold off recently due to fears of rising mortgage defaults as interest rates rise. However, investor fears may be misplaced in this case, as the vast majority of mortgages held in PIMCO's portfolio are *fixed-rate* mortgages, which aren't impacted by rising rates.

A key part of my diversification has been to allocate to "Alternatives." I believe well-managed alternative strategies with reasonable fees can add beneficial diversification and improve risk-adjusted returns as part of traditional stock/bond balanced portfolios. Alternative investments have different risk and return drivers than traditional stock and bond investments. Given the current macro risks and market backdrop, I think they are especially valuable. In June of this year, we allocated 3% of most portfolios to the PIMCO Trends Managed Futures Strategy fund.

Portfolio diversification into these "non-traditional" asset classes can be particularly valuable in an inflationary environment as has been the case this year. Trend-following managed futures strategies again led the way posting double-digit positive returns. It's worth noting the PIMCO Trends Managed Futures Strategy fund we now own has outperformed both global stocks (MSCI ACWI) and bonds (the Agg) by wide margins over the past three and five years, and most especially for year-to-date 2022.

Closing Thoughts

I'm not in the business of making short-term predictions, but nonetheless believe it is prudent to be prepared for more downside for the stock market over the next several months or quarters. Declines thus far have been driven by valuations coming down even as earnings have risen slightly. But I expect to see earnings impacted at some point and this could drive further shorter-term market declines. If further declines happen and reach my target valuation for the overall market, I will look to add incrementally to U.S. stocks at lower prices and higher expected returns. On the other hand, if the economy avoids recession (for now) and the markets rebound, our portfolios are well-positioned to benefit with a full allocation to stocks.

Our balanced portfolios remain positioned with (1) a small overweight to global equities, coming from a tactical overweight to EM stocks; (2) a core positions in alternative strategies; and (3) a large underweight to core bonds (relative to a traditional 60/40 stock/bond benchmark).

While tilting towards these highest-conviction allocations, portfolios remain strategically balanced and well-diversified across multiple global asset classes, investment strategies, equity styles and risk-factor exposures.

As always, it is a privilege to serve you and I welcome any questions you may have.

Best,

Kelly D. Kane, ChFC®, CFP®