Quarterly Market Review

1st QUARTER 2021 REVIEW AND OUTLOOK

Inflation, Invasion, and Inversion…

Overview

The past quarter saw dramatic shifts in financial market conditions and expectations. Interest rates increased dramatically in the United States as the Federal Reserve began the process of normalizing interest rates. Inflation rose to levels not seen in decades. Russia's invasion of Ukraine, and the West's coordinated response have altered global economic relationships in ways unimaginable just a few months ago. The reality of a new "iron curtain" isolating Russia from most developed market economies has far-reaching implications as conventional trading blocs and supply chains are reconsidered around the world. Consumption patterns and public health policies in response to follow-on CoVid-19 variants have delayed a return to economic "normalcy" and continue to pose challenges to supply chain normalization.

Expectations for the pace and scale of the removal of monetary policy accommodation accelerated notably during the quarter due to the persistent inflation backdrop, robust job market, and healthy economy. The Federal Reserve raised interest rates by 25 basis points in mid-March, the first increase since December 2018, and set expectations for a series of hikes taking Fed Funds to approximately 2% by year end. The Fed also commenced and completed a tapering their bond buying program and weighed plans to begin to reduce the size of its balance sheet, which currently stands at almost $9 trillion. Quantitative tightening details are expected to be announced in May with expectations for shedding up to $60 billion of Treasury securities and $35 billion of agency mortgage-backed securities each month. Over the last two years, the Fed purchased over $4 trillion in assets, mostly U.S. Treasuries and agency mortgage-backed securities amassing nearly 28% of the Treasury market in the process.

The developments over the quarter have bolstered a cautious view of risk assets in the short term but this is countered by robust global economic conditions across most developed markets. We are maintaining a cautiously optimistic outlook over the intermediate term and are favoring value-oriented exposures over higher valuation/growth segments which may continue to face headwinds as interest rates increase. Fixed income investors should continue to maintain a modestly short duration and remain overweight credit sectors.

Quarterly Market Review

Constructive Observations
• Low unemployment, robust wage growth, and strong consumer balance sheets suggest a healthy and resilient cycle could persist. • Corporate capital expenditure trends and PMI data indicate healthy output and demand trends around the globe as supply chains and inventories are repaired. • The CoVid pandemic is increasingly being perceived as an endemic, facilitating a return to work in many sectors of the economy and some alleviation of supply chain bottlenecks. • Inflation tends to stimulate the supply-side of the economy, increasing workforce productivity and output.

Cautious Observations
• There have been noteworthy declines in consumer confidence across the globe in March; with many Wall Street firms increasing the likelihood of a recession materializing over the next two years. • Central bank tightening and commodity inflation exacerbated by Russia's invasion of Ukraine threatens to derail the bull market that's been in place since the onset of the CoVid pandemic. • Acceleration in Chinese CoVid cases could create a slow-down in that economy and have spillover effects both regionally and globally. • The mid-term election cycle is often weak as displeasure with incumbents materializes.

MACRO OVERVIEW

As the first quarter drew to a close, much of the market's focus is centered on the trajectory of inflation, the level of aggressiveness the Fed will adopt, and whether those dynamics will push the economy into recession. CPI has spiked to 8.5% and unemployment has fallen to a multi-decade low of 3.6% so the Fed will be walking a fine line as it seeks to act with resolve, while not endangering the economy by embracing overly aggressive measures. The appropriate pace of Fed action has become a hotly debated topic among economists this quarter. Headlines abounded on the last day of the quarter heralding an inversion of the Treasury yield curve for the first time since 2019. At one point that day, the yield on the 2-year was 2.337% while the yield on the 10-year fell to 2.331%. After a brief inversion, the yield on 2-year Treasuries closed the month 4 basis points below that of the 10-year (2.28% vs. 2.32%). Bespoke Investment Group notes that after six instances where the 2-year and 10-year yields inverted going back to 1978 the stock market continued to perform positively. The S&P 500 was up an average of 1.6% a month after the inversion but was up an average 13.3% a year later. Fed officials believe the 3-month yield to the 10-year yield is a more accurate recession forecaster, and that curve has not flattened at all. That spread has been widening (from 1.47% on 12/31 to 1.80% on 3/31), a signal for better economic growth. The 1-year/10-year (which has the longest historical dataset) has inverted on average 15 months before the onset of a recession, with a range from 7 – 24 months. Since mid-March the Atlanta Fed's GDPNow estimate for real GDP growth in the 1st quarter has hovered right around 1%.

MARKETS OVERVIEW

Equities

For major equity indices, 1st quarter 2022 was the worst quarter in two years. The S&P 500 declined -4.6%. Growth stocks dramatically under-performed value stocks in practically all market-cap ranges and geographies. Among U.S. large-cap stocks the Russell 1000 Growth index fell -9.04%; whereas the associated Value index declined -0.74%. Among sectors, Energy was by far the clear stand-out, increasing +39% year-to-date. Utilities rose +4.8%, whereas every other sector fell between -1% (Consumer Staples) and -12% (Communication Services).

The Information Technology sector has outperformed the broad equity market each of the last eight years (24.7% annualized vs. 14.8%). That leadership reversed in the first quarter with the sector falling -8.4%. Mid-cap (Russell Midcap) and small-cap (Russell 2000) stocks lagged large-caps at quarter-end, returning -5.7% and -7.5%, respectively.

Prior to Russia's invasion of Ukraine, international stocks started the year on better footing than U.S. stocks. MSCI EAFE and Emerging Markets indices returned -6.5% and -4.8%, respectively, through February. The S&P 500 was down -8.0% then. By the end of March, both MSCI indices were down -5.8% and -6.9%, respectively, giving up their slight edge over U.S. stocks. European stocks declined -9.4% and Asian stocks fell -7.4% this quarter.

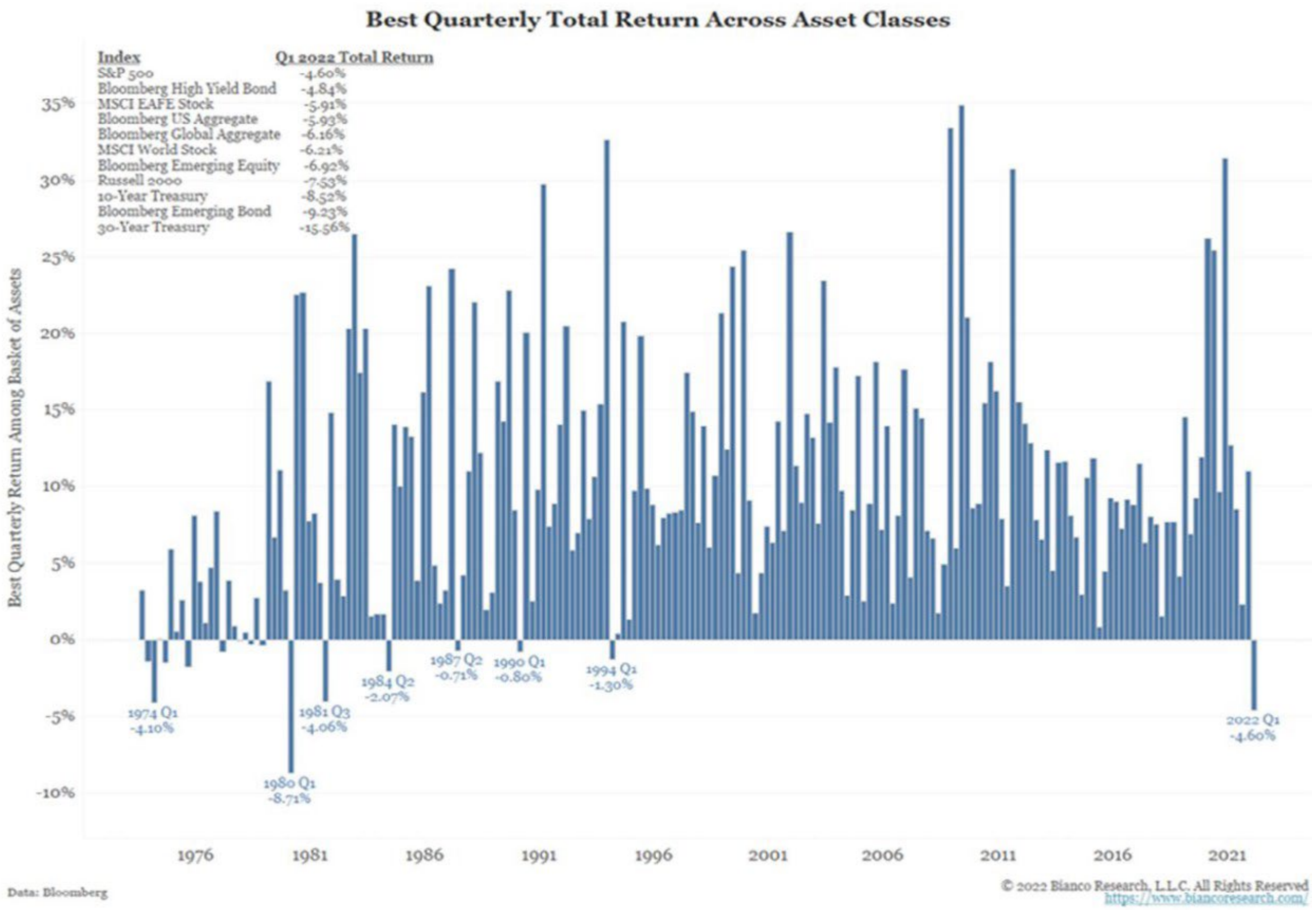
Fixed Income

It is unusual for both stocks and bonds to have negative returns simultaneously in a quarter, but this quarter proved to be one of the exceptions. The Bloomberg US Aggregate Bond index declined -5.9%. Long-dated Treasuries (20+ Years) fell -11% this quarter as interest rates rose. High yield index spreads reached their widest levels in mid- March since December 2020 but have retraced some of that widening by month end. The fixed income market is currently pricing in a total of ten rate hikes by the end of 2022 (including March's 25bps hike). The market is pricing three straight 50bps hikes, which would bring the funds rate to a range of 1.75% - 2.00% at the July meeting. A month ago, traders placed a 90% probability on a 25bps rate hike in May. Now the odds of a 50bps hike in May are 71%.

Real Assets

The first quarter saw a notable rotation into inflation sensitive assets. The S&P GSCI increased 29% in the first quarter, its biggest gain since 1990. Crude oil surged 33% to $100.28 a barrel and rose as high as $123.70 in early March, a level last seen in 2008. Wheat prices have increased 31% this year and corn has risen 26%. Many metals, including aluminum, copper, nickel and palladium have hit new highs as well. Increased consumer demand, coupled with tight supply conditions due to shipping bottlenecks and bad weather have all contributed to the increases, not to mention the war in Ukraine.

THE WORST QUARTER FOR ASSET ALLOCATION IN 40 YEARS



SOURCE: BIANCO RESEARCH

IT'S RARE FOR BOTH STOCKS AND BONDS TO PRODUCE NEGATIVE RETURNS IN THE SAME QUARTER

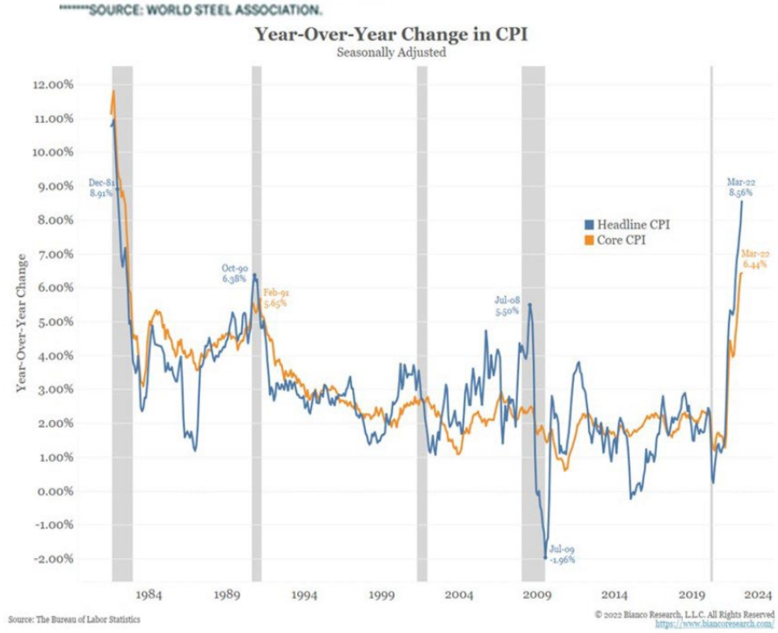
Quarters With Both Negative Returns For Stocks and Bonds				
Quarter-End	**S&P 500**	**Next Quarter Return**	**Barclays Agg.**	**Next Quarter Return**
Mar-77	-8.40%	2.09%	-0.80%	3.04%
Dec-77	-1.50%	-6.19%	-0.10%	0.47%
Dec-78	-6.30%	5.70%	-1.40%	2.48%
Dec-79	-1.30%	-5.40%	-3.10%	-8.70%
Mar-80	-5.40%	11.90%	-8.70%	18.78%
Jun-81	-3.50%	-11.50%	-0.30%	-4.10%
Sep-81	-11.50%	5.48%	-4.10%	10.48%
Jun-84	-3.80%	8.43%	-2.10%	8.78%
Mar-90	-3.80%	5.32%	-0.80%	3.65%
Mar-92	-3.20%	1.10%	-1.30%	4.03%
Mar-94	-4.40%	-0.30%	-2.90%	-1.00%
Jun-94	-0.30%	4.15%	-1.00%	0.61%
Mar-05	-2.60%	0.91%	-0.50%	3.01%
Jun-06	-1.90%	5.17%	-0.10%	3.81%
Jun-08	-3.20%	-8.90%	-1.0%	-0.50%
Sep-08	-8.90%	-22.56%	-0.50%	4.58%
Jun-15	-0.20%	-6.94%	-1.70%	1.23%
Mar-18	-1.20%	2.93%	-1.50%	-0.16%
Mar-22	-4.90%	?	-5.90%	?
Average:		**-0.48%**		**2.81%**

SOURCE: STRATEGAS

RUSSIA/UKRAINE CONFLICT HAS EXACERBATED ALREADY FIRM INFLATION NUMBERS

COMMODITY	RUSSIA'S PRODUCTION AS A % OF GLOBAL CONSUMPTION
PALLADIUM*	35.6%
NATURAL GAS**	16.6%
POTASH, PHOSPHATE, AND NITROGEN CONTAINING FERTILIZERS***	13.0%
OIL**	11.4%
LUMBER****	11.0%
WHEAT*****	10.0%
PRIMARY ALUMINUM******	5.9%
THERMAL COAL**	5.0%
NICKEL******	4.4%
COPPER******	4.2%
STEEL*******	4.0%
ALUMINUM BOXITE******	1.6%

NOTE: ALL SERIES ANNUALIZED AND CALCULATED IN VOLUME TERMS.
* SOURCE: BLOOMBERG FINANCE L.P.
** SOURCE: BRITISH PETROLEUM.
*** SOURCE: AGWEB.COM.
**** SOURCE: FOREST ECONOMIC ADVISORS.
***** AVERAGE OF 2017-2021 PRODUCTION.
****** SOURCE: WORLD BUREAU OF METAL STATISTICS.
*******SOURCE: WORLD STEEL ASSOCIATION.

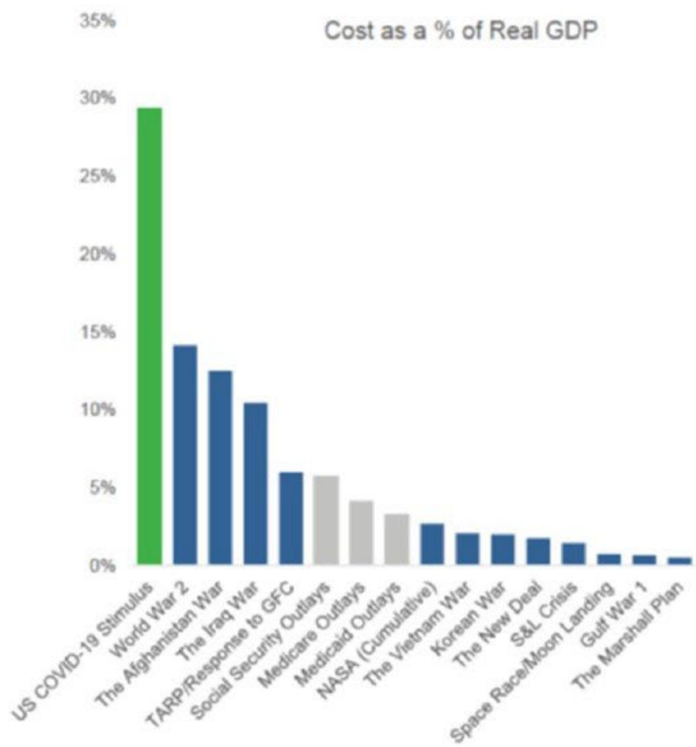


SOURCE: BCA RESEARCH / BIANCO RESEARCH

UNPRECEDENTED STIMULUS IS HELPING U.S. CONSUMERS POWER THROUGH THE INFLATION SPIKE

Market Insight | **COVID-19 Stimulus Exceeds Any Previous Government Actions**

Large Government Outlays	Year	Dollar Cost ($B)	2021 Dollar Cost ($B)
US COVID-19 Stimulus	2020	$5,400	$5,400
World War 2	1945	$288	$4,141
The Afghanistan War	2020	$2,300	$2,300
The Iraq War	2020	$1,922	$1,922
TARP/Response to GFC	2008	$939	$1,129
Social Security Outlays	2020	$1,059	$1,059
Medicare Outlays	2020	$750	$750
The Vietnam War	1972	$111	$687
Medicaid Outlays	2020	$597	$597
Korean War	1953	$54	$523
NASA (Cumulative)	2008	$417	$501
The New Deal	1943	$32	$479
S&L Crisis	1995	$153	$260
Space Race/Moon Landing	1969	$36	$257
The Marshall Plan	1951	$13	$126
Gulf War 1	1991	$61	$116
Panama Canal	1914	$0.38	$10
The Hoover Dam	1935	$0.05	$9
Louisiana Purchase	1803	$0.02	$0.34



Source: Bloomberg, U.S. Government, Westwood. Bar chart represents all Outlays since 1940 and uses original dollar cost relative to the real GDP figure for the given year listed. Past Performance is not indicative of future results.

SOURCE: WESTWOOD

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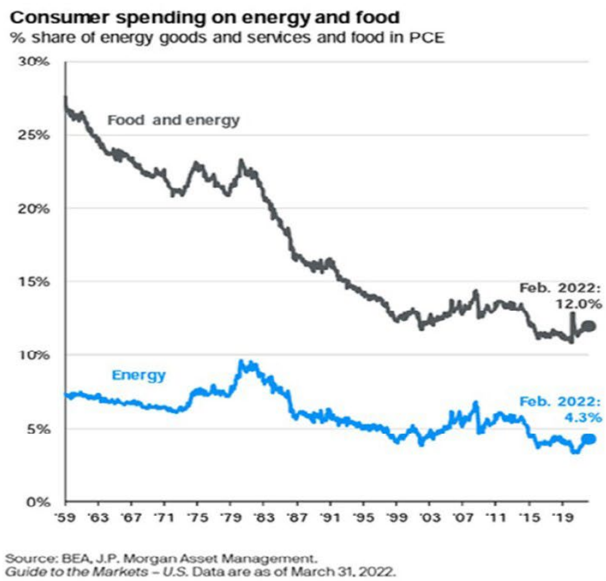

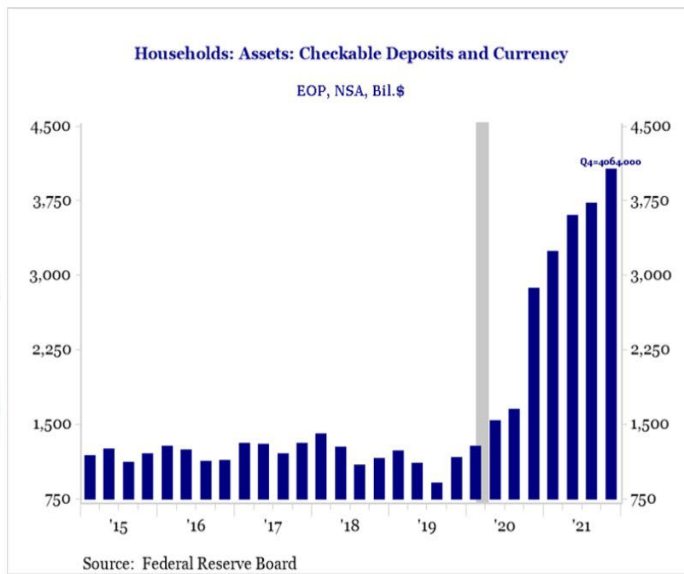

SOURCE: JP MORGAN / FEDERAL RESERVE

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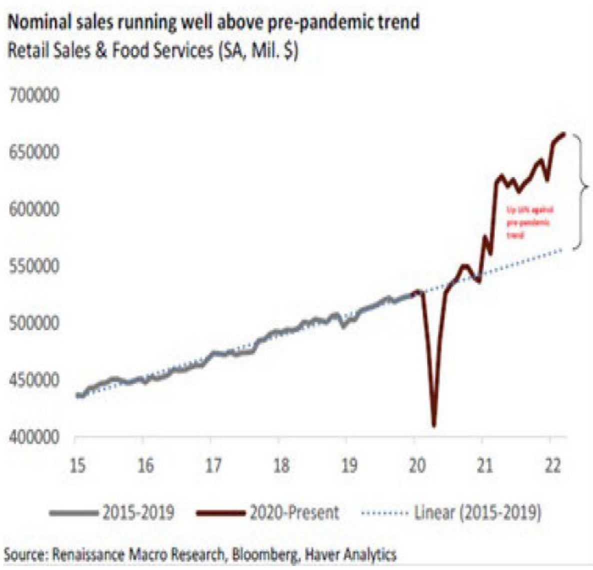
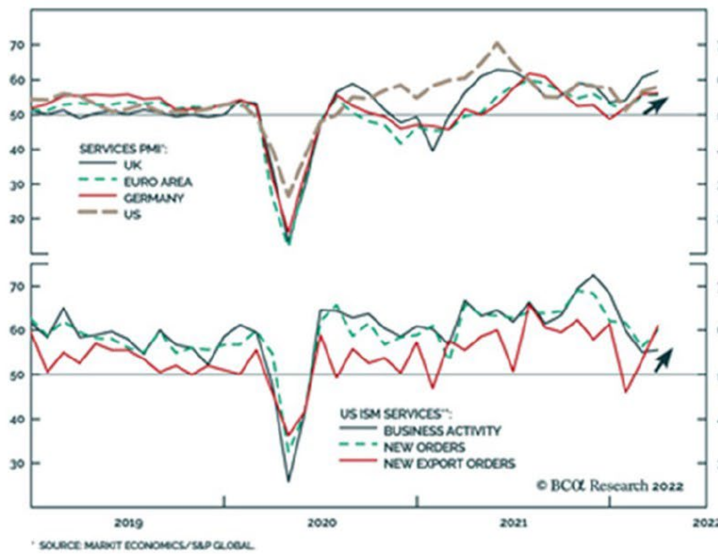
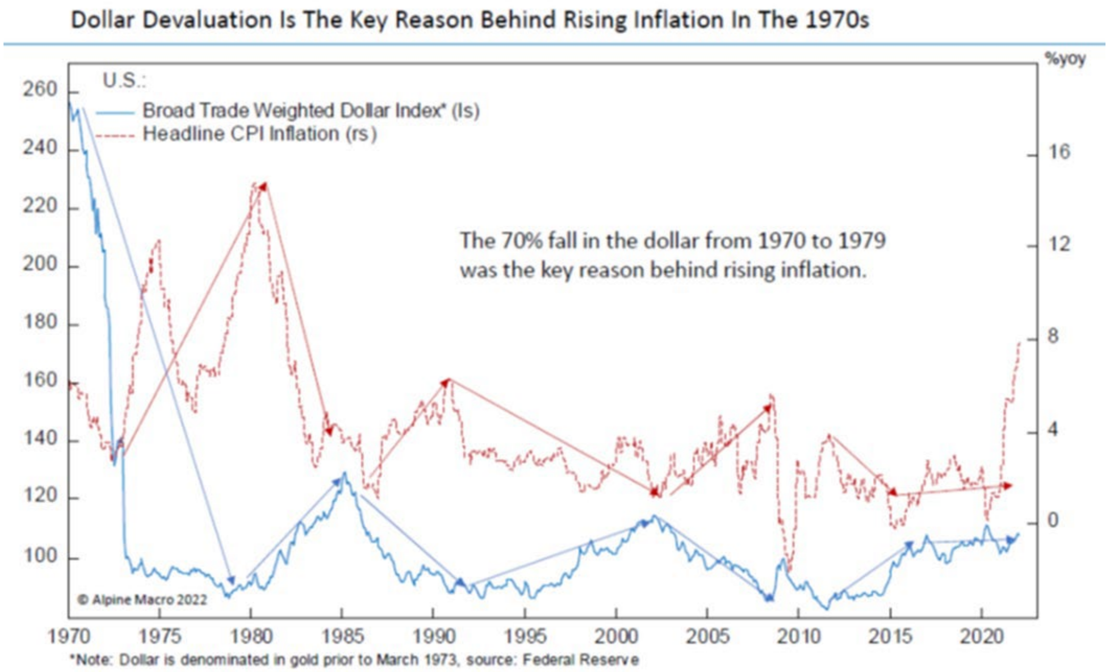




SOURCE: RENAISSANCE MACRO / BCA RESEARCH

ALTHOUGH INFLATION IS HIGH, THIS ISN'T THE 1970'S



SOURCE: ALPINE MACRO / HEIMSTADEN AND MACROBOND

ALTHOUGH INFLATION IS HIGH, THIS ISN'T THE 1970'S

SOURCE: STRATEGAS

IMPORTANT DISCLOSURES

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