



Market Recap

A lot has happened since our year-end letter just three months ago. The biggest macro event is Russia's brutal invasion of Ukraine. While the human impact has been devastating and tragic—and our hearts and support are with the Ukrainian people—our job here is to focus on the economic and financial market impact of this event.

Financial markets had a rough first quarter across the board—stocks, bonds, U.S., international and emerging markets all 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. Remarkably, the damage was worse in the U.S. core bond market than the U.S. stock market. The benchmark Bloomberg U.S. Aggregate Bond Index (the "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.

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

Finally, as we discuss next, managed futures strategies were the standout performers with the benchmark SG Trend Index gaining 17.9% for the quarter and posting gains in each month.

Portfolio Update & Key Performance Drivers*

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. Absolute returns for the period were negative across the board, encompassing equity and fixed-income funds.

Diversification into other asset classes, market segments and alternative strategies can be particularly valuable in such an environment. To that point, trend-following managed futures strategies were the standout performers with the benchmark SG Trend Index gaining 17.9% for the quarter and posting



gains in each month. As a reminder, managed futures funds can take long and short positions across global fixed-income, equity, commodity, and currency markets. Trends in interest rates and bonds have been a powerful contributor to their performance this year, providing a sharp contrast to the losses in investment-grade bonds, which have suffered losses as rates have risen.

In terms of our fixed-income allocation, our tactical positions in flexible, actively managed bond funds, floating-rate loan funds and inflation-protected treasuries (TIPs) again added value relative to the core bond index from which the positions are funded, although they posted absolute losses. This was not surprising given the interest rate and credit market backdrop during the period, with Treasury yields sharply rising and corporate bond spreads widening.

On the downside, our tactical (international) equal weight to EM stocks was the biggest retractor 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. Ironically, our developed international (Europe) positions outperformed the major US indexes despite the turmoil in Ukraine.

As noted in our Market Recap above, there was a lot of volatility in Q1. But as the quarter ended, most major global equity markets were only 5%-7% below where they started the year. Lower prices are a long-term investor's friend, as they set the stage for higher future expected returns, all else equal. But of course, volatility is unsettling in the moment.

Our job as long-term investors are to sift through the shorter-term market noise, stand back from the emotional whipsaw of the day-to-day headlines, and remain focused on the interplay between underlying economic fundamentals and the financial markets' current pricing.

When we gain conviction that the current market pricing is significantly out of whack with our view of the fundamentals, as expressed across our range of plausible scenarios, we will tactically re-position our portfolios. Otherwise, we stay the course, confident that our portfolios have a well-diversified balance of defensive assets (depending on the portfolio risk profile) able to withstand shorter-term negative outcomes or shocks, and riskier "offensive" assets that are the primary long-term return generators and wealth builders.

This is a long way of saying that we did not make any portfolio changes (outside of rebalancing) in the first quarter because our 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.

*Does not apply to all portfolios



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, 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 medium-to-long-term expectations are that inflation will moderate. Should the longer-term measures move higher, we'd expect the Fed to accelerate its tightening pace.

The COVID-19 pandemic is another wildcard but here the news has been getting better. Over time, with continued rising immunity rates and wide distributions of effective vaccines, the economic damage and disruption should continue to recede. If so, this should both support economic growth *and* mitigate some of the inflationary pressures the U.S. and global economy experienced over the past year caused by supply-chain bottlenecks and supply/demand mismatches for durable goods (e.g., autos).

Taking all of these factors into account, our 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 we can't rule out, this macroeconomic backdrop should be generally supportive for “risk asset” returns, such as global equity and credit markets, and a headwind for core bonds in the face of rising government bond yields.

We'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.



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. As we write this, the path, timing, impact, and ultimate outcome of the war are highly uncertain. Russian and Ukrainian commodity exports could be further disrupted forcing prices even higher; the conflict with Russia could expand beyond Ukraine, with even more death and destruction. On the other hand, we may be positively surprised by a quicker and/or less destructive resolution than the current consensus. As we've often said about shocking events such as this: the truth is *no one knows*.

Crises, as painful as they are, often create opportunities. As such, we continue to frame our macro-outlook and market analysis by incorporating a range of scenarios and outcomes we believe are plausible. We construct our client portfolios to be balanced, diversified and resilient across this range. We also proceed with a large dose of humility. The future is inherently uncertain. We should be prepared to be—*expect* to be—surprised again and again as it unfolds. In short, we want to build portfolios that are resilient in the face of surprises rather than ones whose success depends on predicting them.

While tilting towards our highest-conviction tactical views, our 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 our cautiously optimistic base case occur.

We are confident that our long-term, team-driven investment process, research depth and discipline will enable us 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.

We sincerely appreciate your continued confidence and trust.

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