Market Recap

The first quarter of 2022 featured a long-awaited return of volatility in financial markets. In January, the S&P 500 got off to one of the worst starts to a year in its history, declining over 10% before a sharp rally recovered about half of the month's losses. In contrast to most periods of equity market weakness over the past 20 years, high quality corporate bonds and U.S. Treasuries also suffered notable losses during January. The broad weakness in stocks continued in February and early-March, exacerbated by Russia's shocking invasion of Ukraine and subsequent Western economic sanctions creating extreme price spikes for a broad array of commodities. The highest inflation readings in several decades for the U.S. and many European countries, along with the U.S. Federal Reserve embarking on what is expected to be one of its fastest rate hike cycles on record, added to the challenging macro backdrop. Somewhat impressively, global stocks staged a recovery in the second half of March and the S&P 500 ended the quarter down less than 5%. The Fixed income market, however, endured one of its worst quarters on record with the Bloomberg U.S. Aggregate Bond Index down nearly 6%. Commodities and commodity-related stocks proved to be an effective diversifier, with gold up more than 5%, the Bloomberg Commodity Index up more than 25%, and the S&P 500 energy sector gaining almost 39% during the quarter.

Index Returns as of March 31, 2022			
		Q1`22	1-YR
Domestic Equity	S&P 500 TR	-4.60%	15.63%
	Russell 2000	-7.53%	-5.79%
Intl Equity	MSCI EAFE NR	-5.91%	1.16%
	MSCI Emerging NR	-6.98%	-11.37%
Fixed-Income	Bloomberg U.S. Aggregate	-5.93%	-4.15%
	Bloomberg U.S. High Yield	-4.84%	-0.66%
	Bloomberg U.S. Corporate	-8.50%	-4.48%

The recent market resilience has been noteworthy, with the S&P 500 regaining its 200-day moving average and more than 90% of the stocks in the index trading above their 10-day moving averages. However, there are several ongoing headwinds that may lead to heightened volatility for at least several quarters. First, even if a cease-fire agreement is reached, the economic sanctions against Russia are likely to remain in place. The supply outlook was already tight for many commodities before the conflict and restricted supplies from Russia could lead to ongoing extreme volatility in commodity markets. Meanwhile, parts of the U.S. Treasury yield curve have begun to invert, signaling bond market concern about intermediate-term economic growth coming under severe pressure. Recession risk in Europe appears especially heightened considering the region's acute dependence on Russian oil and natural gas. There are some mitigating factors, however, including the Conference Board's Leading Economic Index remaining far stronger than prior to previous recessions and credit markets recently stabilizing without showing the degree of stress that preceded the 2000 and 2008 bear markets. As the second quarter begins, the portfolio maintains overweight exposure to high quality, dividend-paying stocks and inflation-protected bonds. We continue to believe an emphasis on diversification across equity sectors and regions is prudent in the current environment and we are carefully monitoring our macro indicators for signals that would warrant reducing exposure to stocks and corporate credit.

Market Review and Outlook

The table below provides a summary of asset class returns for the first quarter of 2022 and the trailing twelve-month period. Building on a theme which developed in 2021, small-cap value stocks outperformed their growth

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peers by a wide margin. In sharp contrast to last year, the large-cap value segment also significantly outperformed large-cap growth despite a major late-quarter rally for growth stocks.

Broad commodity returns remained very robust in the first quarter and, in contrast to last year, gold also participated in the upside. As mentioned above, fixed income markets suffered one of their worst quarters on record, with all major bond segments in the red and the Bloomberg US Aggregate Bond Index down 5.93%.

Exhibit 1. Asset Class Returns (%)

Category	Asset Class	Index	Q1 '22	1YR
Large Cap	**All Stocks**	MSCI ACWI	-5.36	7.28
	Large Cap	S&P 500	-4.60	15.63
	Large Growth	Russell 1000 Growth	-9.04	14.98
	Large Value	Russell 1000 Value	-0.74	11.67
Small & Mid	**Mid Cap**	Russell Mid Cap	-5.68	6.90
	Small Growth	Russell 2000 Growth	-12.63	-14.35
	Small Value	Russell 2000 Value	-2.41	3.27
International	**EAFE**	MSCI EAFE	-5.91	1.16
	Emerging	MSCI Emerging	-6.98	-11.37
Alternatives	**Commodity**	Bloomberg Commodity TR	27.13	59.76
	Gold	S&P GSCI Gold Official Close	6.59	13.13
	REIT	DJ US Select REIT	-3.71	27.72
	Emerging Debt	JPM EMBI Global	-9.26	-6.18
Fixed Income	**Aggregate Bond**	Bloomberg US Aggregate Bond	-5.93	-4.15
	U.S. Treasuries	Bloomberg US Treasury	-5.58	-3.67
	Muni Bond	Bloomberg Municipal	-6.23	-4.47
	TIPS	Bloomberg US TIPS 5-15 Years	-3.25	3.89
	Corporate	Bloomberg US Corp IG	-8.50	-4.48
	Intl Treasury	S&P/Citi Intl Treasury Bond ex US	-7.12	-10.16
	Hi Yield	Bloomberg Us Corporate High Yield	-4.84	-0.66

Source: Bloomberg

The materially negative returns for both stocks and bonds in the first quarter was something of an anomaly looking at the past 20 years, when bonds have tended to be a strong diversifier during period of equity market weakness. Historically, however, it has not been unusual for stocks and bonds to exhibit positive correlations during periods of sustained inflationary pressures. With evidence mounting that the global economy has entered a new secular regime of higher inflation, this has implications for portfolio construction. In particular, the diversification benefits of long-term government bonds may be somewhat diminished and the case for increasing exposure to commodities, inflation-protected bonds, corporate credit, and high quality, dividend-paying stocks may be enhanced. The chart below from Vanguard shows the rolling 24-month correlation between U.S. stocks and bonds for the post-2000 (low inflation) regime versus the higher inflation regimes (using 10-year trailing inflation) of the 1950s, 1970s, and 1990s.

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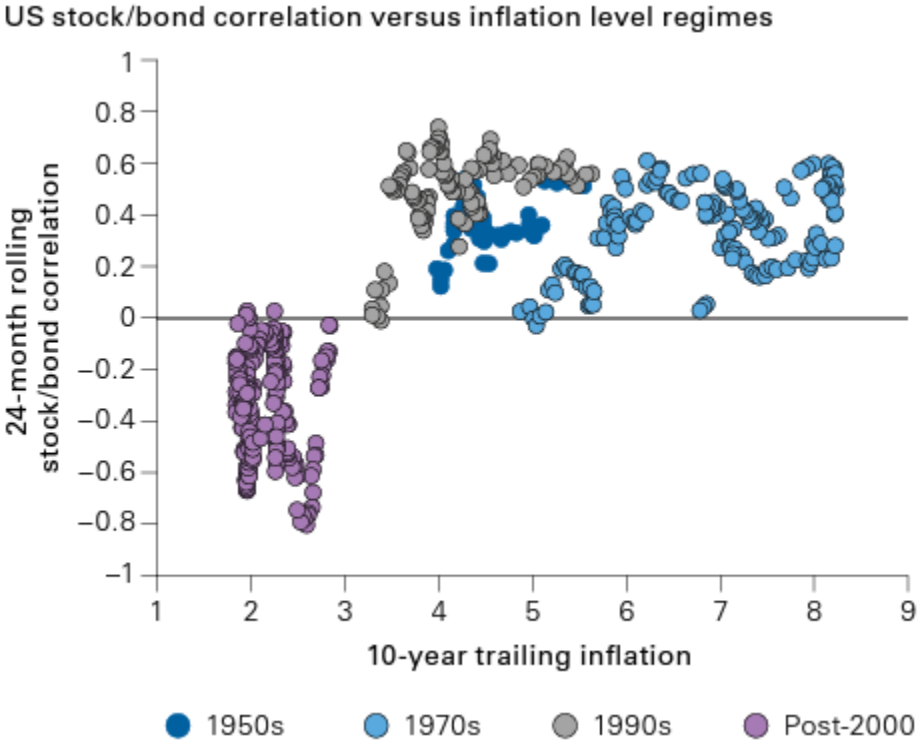
Exhibit 2. US Stock/Bond Correlations vs. 10-Year Trailing Inflation



Source: Vanguard

Late-Cycle Dynamics at the Fore

From an asset allocation perspective, the war in Ukraine and resulting severe economic sanctions against Russia have increased the risk of elevated inflationary pressures persisting for at least several years and dampened the intermediate-term outlook for global economic growth. On the inflation front, the potential broad impact of very tight commodity supplies on consumer prices for energy and food is a widespread and justified concern. Perhaps less widely reported is the potential for the war to accelerate a bourgeoning trend away from globalization which began several years ago and gained steam with pandemic-induced supply disruptions. Although Russia's aggression has had the perhaps unexpected effect of bringing the West closer together politically and economically, it has also likely increased the potential for a multi-polar world dominated by China in the East and the U.S. in the West. In short, the war and its fallout has potentially added urgency to multinational companies' and Western governments desire to make supply chains more resilient at the expense of cost efficiency. As a result, one of the big disinflationary forces of the past 30 years – globalization – appears at high risk of reversing.

The global growth outlook has also become far less certain in the past two months. Europe's economy was actually showing signs of accelerating prior to Russia's invasion, with the Markit Eurozone Composite PMI for February at a level consistent with above-trend economic growth. However, driven by extremely high natural gas prices and broader inflation, financial conditions were already tightening in Europe heading into 2022 and worsened significantly in the first quarter. While the near and intermediate-term recession risk in Europe is elevated, there are some mitigating factors to consider including natural gas usage passing its peak seasonality, a

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large boost in defense-related fiscal spending, a high savings rate for European consumers over the past two years, and the European Central Bank likely taking a more cautious approach to policy tightening given the highly uncertain economic outlook.

The outlook for the U.S. economy has also deteriorated to some degree in recent months. Several parts of the U.S. Treasury yield curve inverted during March, including the 2-year Treasury note yield briefly topping the 10-year note yield. An inversion of the 2- and 10-year Treasury yields has proven a reliable recession warning historically and understandably is a widely followed market indicator. While justifiably alarming, our analysis suggests it is prudent to wait for additional confirmation from an array of indicators before establishing a highly defensive posture in response to the yield curve inversion. First, while the 2-10 inversion has preceded prior recessions, it has had a long and variable lead time and in several cases stocks have gone significantly higher before peaking. There are also several different yield curve measures that have historically worked just as well as the 2-10 for predicting recessions which are not yet sending warning signals, including the 3-month to 10-year Treasury yield spread and the real (inflation adjusted) yield curve.

Beyond the yield curve, there are additional potential warning signs that the risk is growing of a major deceleration in U.S. economic growth. For example, there has been very notable deterioration in the housing affordability index in recent months from a combination of rising prices and sharply rising mortgage rates. The stocks of many homebuilders were down over 20% in the first quarter, an indication investors are growing very wary of the industry's outlook.

Exhibit 3. Housing Affordability Index and Existing Home Sales

Source: BofA Global Research

Given housing's tendency to lead major turns in the broad economy, we will be watching for signs that building permits (a leading indicator) are rolling over. As shown below, thus far the Conference Board's measure of building permits has yet to turn decisively lower.

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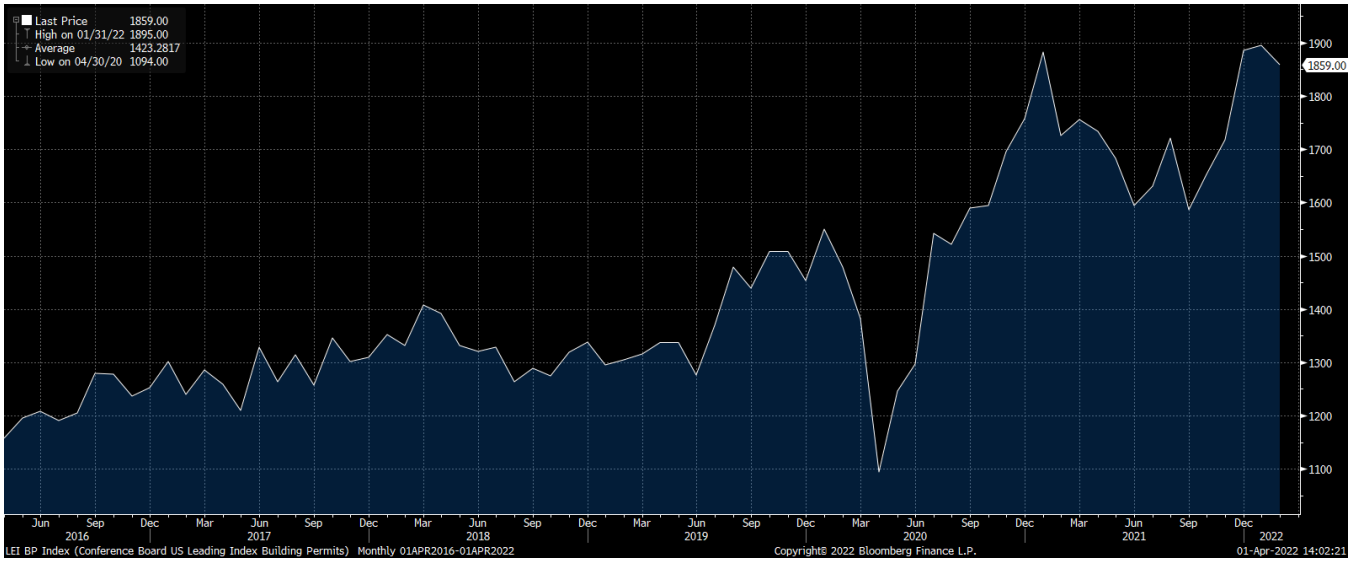
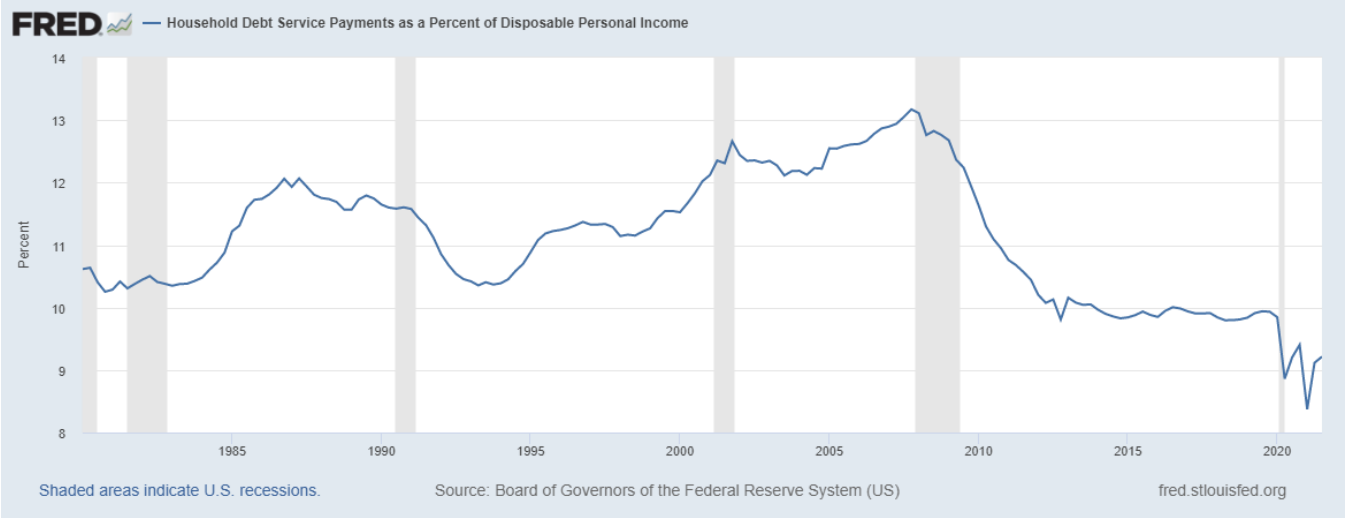
Exhibit 4. Conference Board US Leading Index Building Permits



Source: Bloomberg

The weak year-to-date performance of many consumer discretionary stocks suggests the combination of very high inflation and rising interest rates may soon impact overall consumer spending. While this is a legitimate concern that warrants close watching, savings built up during the pandemic and generally healthy consumer balance sheets may help the consumer economy weather these headwinds for an extended period. As shown in the chart below, household debt service payments as a percentage of disposable personal income were near multi-decade lows through the third quarter of 2021. While overall debt service costs are likely to rise with interest rates, U.S. consumers in aggregate appeared to be well positioned heading into 2022.

Exhibit 5. Household Debt Service Payments as a Percentage of Disposable Income



Source: Federal Reserve Bank of St. Louis

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Summary

The recent inversion of parts of the U.S. Treasury yield curve and the weak price action of many consumer cyclical stocks suggests that the risk of a major economic downturn in the next 12-24 months is rising. We take a weight of the evidence approach and should credit spreads and leading economic indicators begin to confirm that recession risk is very elevated, we will shift to a more defensive portfolio positioning. For now, our interpretation of the yield curve's message is that recession risk has notably risen for 2023-2024 but near-term economic momentum remains relatively robust.

Index Definitions

BofAML 3-Month U.S. T-Bill: An index of short-term U.S. Government securities with a remaining term to final maturity of less than three months.

Bloomberg Commodity: A broadly diversified commodity price index distributed by Bloomberg Index Services Limited. The index tracks prices of futures contracts on physical commodities on the commodity markets. The index is designed to minimize concentration in any one commodity or sector. It currently has 23 commodity futures in six sectors

Bloomberg Global. Aggregate: A broad base index, maintained by Bloomberg, and is often used to represent global investment grade bonds

Bloomberg Municipal: The Bloomberg Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market

Bloomberg U.S. Aggregate: A broad base index, maintained by Bloomberg, and is often used to represent investment grade bonds being traded in the U.S. Bloomberg U.S. Aggregate Bond Index is made up of the Bloomberg. Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Based Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

Bloomberg U.S. Corporate High Yield: A measurement of the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/ BB+ or below, excluding emerging market debt.

Bloomberg U.S. Corporate Investment Grade (IG): A measurement of the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

Bloomberg U.S. TIPS : 5-15 Year Index measure the performance of the US Treasury Inflation Protected Securities (TIPS) market. Federal Reserve holdings of US TIPS are not index eligible and are excluded from the face amount outstanding of each bond in the index.

Bloomberg U.S. Treasury: The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

DJ U.S. Select REIT: The tracks the performance of publicly traded REITs and REIT-like securities and is designed to serve as a proxy for direct real estate investment, in part by excluding companies whose performance may be driven by factors other than the value of real estate.

ICE BofA US High Yield Index: The ICE BofAML U.S. High Yield Index is a market-capitalization-weighted index of domestic and Yankee high-yield bonds. The index tracks the performance of high-yield securities traded in the U.S. bond market.

ISM Manufacturing Index: Also known as the purchasing managers' index (PMI), is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of the state of the U.S. economy.

JPM EMBI Global Index: A benchmark index for measuring the total return performance of international government and corporate bonds issued by emerging market countries that meet specific liquidity and structural requirements.

MSCI All Country World Index (ACWI): MSCI's flagship global equity index designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 26 emerging markets. As of December 2018, it covers more than 2,700 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market.

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MSCI EAFE NR: A free float-adjusted, market capitalization index that is designed to measure the equity market performance of developed markets consisting of 21 developed country indexes, excluding the U.S. and Canada. Net return (NR) indices subtract from dividend reinvestment calculations the withholding taxes retained at the source for foreigners who do not benefit from a double taxation treaty.

MSCI Emerging NR: An index that serves as a benchmark of the performance in global emerging markets as represented by 23 emerging economies. Net return (NR) indices subtract from dividend reinvestment calculations the withholding taxes retained at the source for foreigners who do not benefit from a double taxation treaty.

MSCI USA: The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market. With 624 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US.

Russell 1000: The Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000. The Russell 3000 Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market.

Russell 1000 Growth: The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value: The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values.

Russell 2000: An index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the U.S.

Russell 2000 Growth: The Russell 2000 Growth Index refers to a composite of small cap companies located in the United States that also exhibit a growth probability.

Russell Mid Cap: The Russell Mid Cap Index is a market capitalization-weighted index comprised of 800 publicly traded U.S. companies with market caps of between $2 and $10 billion. The 800 companies in the Russell Midcap Index are the 800 smallest of the 1,000 companies that comprise Russell 1000 Index.

Russell 2000 Value: The Russell 2000 Value Index refers to a composite of small cap companies located in the United States that also exhibit a value probability.

S&P/Citigroup International Treasury Bond: The Index is designed to measure the performance of treasury bonds issued in local currencies by developed market countries outside the U.S.

S&P 500 TR: An index of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

S&P CoreLogic Case-Shiller National Home Price Index: Also known as simply the Case-Shiller Home Price Indexes, are a group of indexes that track changes in home prices throughout the United States.

S&P GSCI Gold: An index that provides investors with a reliable and publicly available benchmark tracking the COMEX gold future.

Treasury Inflation Protected Securities (TIPS): A type of Treasury security issued by the U.S. government that are designed to provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index.

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