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Market Review
First Quarter 2022

In the first quarter, the country finally succumbed to "issue fatigue".

In addition to a seemingly never-ending pandemic, households struggled to cope with spiking gas, staples, and services prices. This was evidenced by the weakest Consumer Sentiment reports in a decade, despite a strong labor market and rapidly re-opening economy.

Investors had the added burden of contending with a Federal Reserve that abruptly pivoted from "transitory" to "entrenched" inflation. During the quarter, each communique read more hawkish than the prior, despite rising uncertainty. In March, the Federal Open Markets Committee commenced with the first interest rate increase since December 2018. The accompanying "dot plot" projected a median of seven rate hikes in 2022 to 1.875%, up from three hikes in December.

Everyone, everywhere has struggled to come to grips with the Russian incursion into Ukraine, now in its seventh week. For anyone with a link to the Cold War era, or casual interest in history, it is hard to accept the first major invasion in Europe since World War II. In addition to human tragedy and suffering, the potential for escalation is high and nuclear saber rattling has become commonplace. It is also unclear if the world is gravitating towards a more unified West, or a new, multi-polar set of alliances and world order.

Not surprisingly, global stock markets struggled in the first three months of yet another confounding year. In the U.S., large and small cap stocks declined -4.60% and -7.53%, respectively, while the Nasdaq Composite sank -9.10%. Value trounced growth on both ends of the market cap spectrum. Returns would have been significantly worse if not for a sharp two-week, growth-led rally into quarter-end.

The real action, however, was in the commodity and bond markets. Already spiking commodity prices were further buoyed because Ukraine is a major agricultural exporter. Reflexive financial sanctions also made Russia's oil, gas, aluminum, and nickel production less accessible to most of the world under normal purchasing conditions. As a result, WTI oil soared to $130 per barrel in early March before settling back at lower levels. The Bloomberg Commodity Index rocketed +25.45%.

The same dynamic also ratcheted up inflation further to the detriment of bonds. In February, Consumer Prices increased at the fastest annual pace since 1982, quashing hopes that a more benign Fed could cushion some of the economic shock of war. As a result, the Bloomberg U.S. Aggregate Bond Index declined -5.93% in the period, marking the largest quarterly loss since 1980. Yields for both short duration and long duration U.S. Treasury Bonds – which rise when prices fall – increased sharply, and more recently inverted at different points along the curve.

At this point, the most pressing issues for investors are, first, whether the recent rally in stocks is sustainable and, second, how to interpret the inverted yield curve. They are also intertwined.

As it pertains to the former, because the end of quarter rally was sudden and steep, our belief is it is more of a bounce from oversold conditions than the beginning of a sustainable ascent. With so many crosscurrents complicating the outlook for the economy, corporate earnings, and valuation, the driver for higher stock prices going forward is likely to come from fewer structural headwinds – whether a ceasefire in Europe or lessening inflationary pressures enabling a more accommodative Fed.

As it pertains to the latter, the most pragmatic interpretation of the yield curve inversions is that current circumstances make it hard for the Federal Reserve to engineer a soft landing. By dis-incenting spending at a time when demand is already vulnerable, it is hard to ignore the possibility of recession. It is also going to take time for the bond market to reach a natural equilibrium when the Federal Reserve begins the process of reducing bond purchases (and holdings) in the next phase of tightening later this year.

While this sounds like gloom and doom, we are much more constructive on the outlook for small cap stocks going forward than for other parts of the market. Unlike the S&P 500, which is off just -5.49% from its January peak, the Russell 2000 Growth peaked over one year ago and ended March 23.27% below those levels. The outperformance of large cap stocks in the first quarter also suggests that the market hasn't refocused on domestic-oriented businesses, which we believe are more predictable in the current environment. Valuation-sensitive invested has worked well for the past five quarters. We expect continued, if not an expanding, market focus on profitability and valuation going forward; a focus central to our bottom-up stock selection process.

Sources: *FactSet, GICS Sector Classification, University of Michigan Consumer Sentiment, The Summary of Economic Projections, Wall Street Journal, Federal Reserve, U.S. Bureau of Labor Statistics*

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The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

The Nasdaq Composite Index is the market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks, as well as limited partnership interests. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities.

Bloomberg Commodity Index (BCOM) is calculated on an excess return basis and reflects commodity futures price movements. The index rebalances annually weighted 2/3 by trading volume and 1/3 by world production and weight-caps are applied at the commodity, sector and group level for diversification. Roll period typically occurs from 6th-10th business day based on the roll schedule.

The Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. S&P 500 is part of a series of S&P U.S. indices that can be used as building blocks for portfolio construction.

The Russell 2000® Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-value ratios and higher forecasted growth values. The Russell 2000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the small-cap growth segment. The Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set and that the represented companies continue to reflect growth characteristics.

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Index Definition Sources: *Standard & Poor's, FTSE Russell, Nasdaq, Bloomberg*