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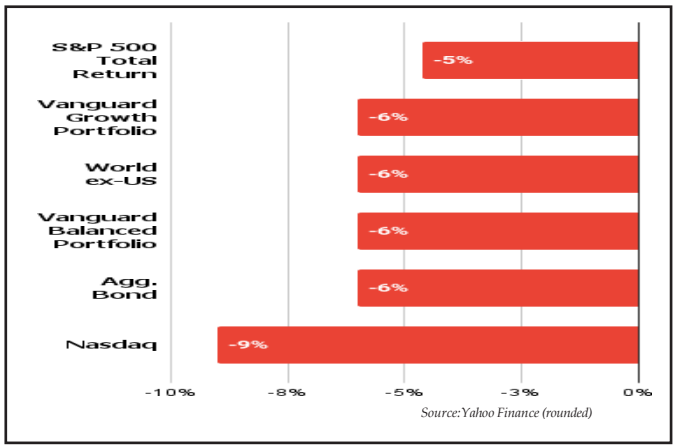
FIRST QUARTER 2022 MARKET COMMENTARY

It has been over ten years since we have experienced such volatile securities markets as we witnessed this first quarter. It started the second half of last year when markets became fragile with the realization that inflation was going to persist and that drastic steps would be necessary in order to bring it under control. Higher inflation readings these first three months, the Federal Reserve setting forth their plans to hike interest rates in response, and Russia invading Ukraine all combined to bring things to a head in the form of turbulent stock and bond markets leading to first quarter losses.

FIRST QUARTER INDEX PERFORMANCE



The market's erratic behavior reflects the manic pace of economic change we are seeing this year: from no inflation to the highest in 40 years. From zero interest rates to as high as they need to go to kill inflation. From having an oil glut and being a net energy exporter to needing to tap the Strategic Petroleum Reserve for a million barrels a day. These are considerable uncertainties that will not be resolved in the short term. Because of this, we expect sustained volatility in both the stock and bond markets as investors all over the world adjust expectations to this new normal.

Volatile Start to New Year

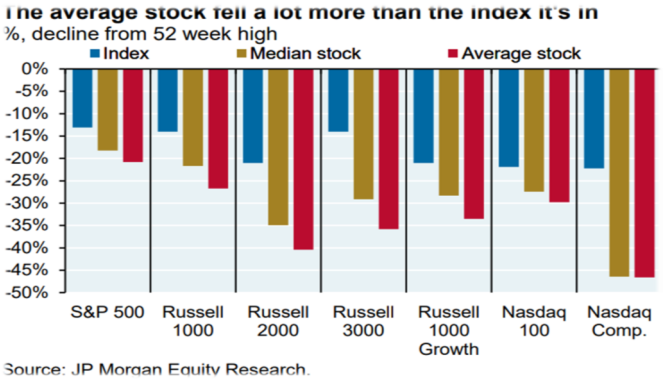
First quarter markets were chaotic. Intraday volatility for the S&P 500—how much the market moves from 9:30 to 4:00 each day—was higher than the bear market of 2020. Adding to the chaos was the fact that the stock market's manic movement was trendless. Painful down days were followed by up days and vice versa so that the average streak of positive or negative days stood at only two.

Vladimir Putin's decision to invade Ukraine pushed stocks, over the edge. The S&P 500 suffered a correction (a -10% drop from a recent peak) and the Nasdaq fell into a bear market (a drop of -20% from a recent peak). The Nasdaq's fall can be attributed to the market's reappraisal of technology and growth stock valuations in light of both higher inflation and higher interest rates. The tech sector and related internet companies took the brunt of Q1's sell-off as investors retreated from these riskier corners of the market.

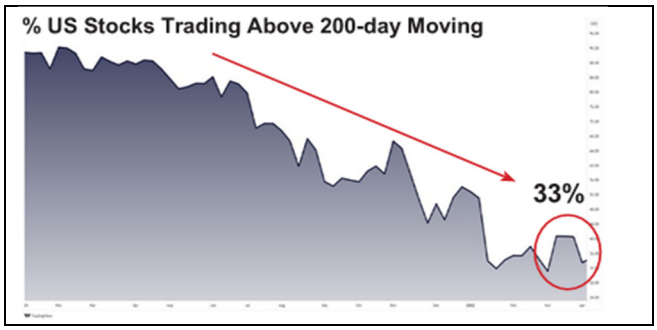
Stealth Bear Market

Headline index performance numbers often fail as a measure of what the average investor experiences in their portfolio. These numbers are heavily skewed by the largest companies in the index, and they effectively mask how the majority of stocks in the index have performed. This can result in a stealth bear market where the headline returns do not reflect the substantial losses suffered by most of the underlying stocks. The first quarter was just such a stealth bear market.

In March, 77% of Nasdaq companies were in a bear market. The average decline in the first quarter for S&P 500 companies was over -20%, also a bear market. As you can see in the chart below, the average stock (red) significantly underperformed the index (blue) to which it belonged.

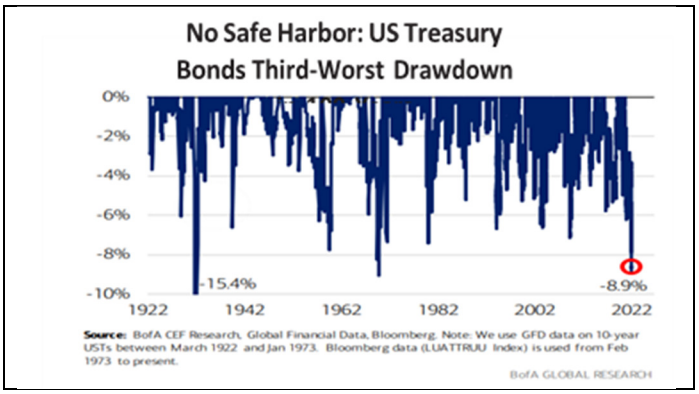


The chaotic sell-off of the first quarter was thus more widespread and more severe than the headline index returns would have you believe. Let's look at the 200-day moving average for stocks. This statistic charts a stock's average closing price over the past 200 days and is helpful in determining long-term trends. Trading above the 200-day moving average indicates a bullish, positive trend while the reverse is a bearish, negative trend. This next chart shows the percentage of stocks in the total US stock market trading above their 200-day moving average and so exhibiting a positive trend.

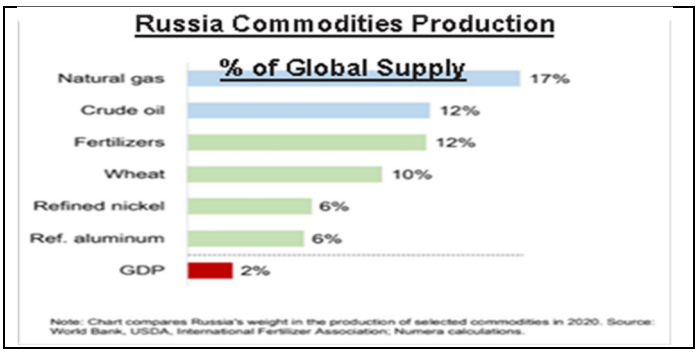


The trend is unmistakable. The percentage of US stocks showing bullish trends peaked last February, dropped steadily through last year, and hovered around 33% for much of the first quarter. In other words, fully two-thirds of domestic stocks were and are showing long-term downtrends. Weakness in stocks was broad and deep, and it was poorly communicated by headline indexes.

Bonds offered no protection in the first quarter. Often considered a safe harbor from volatile stock markets, bonds were at times more volatile and suffered worse quarterly performance than stocks. The single benchmark index for bonds is the Bloomberg Aggregate Bond Index, also called the Agg. The Agg is off to its worst start to a year since the early 1980s when, like today, inflation and interest rates were running wild. The Agg ended the quarter down -6%, its third- worst quarterly performance on record. United States Treasury bonds, the ultimate symbol of safety, fell -9% for their third-worst drawdown in 100 years. Bond prices fall as interest rates rise and so the Federal Reserve making it crystal clear their intentions of hiking rates to combat inflation means that bonds will continue to struggle in the months ahead.



Energy and commodities were the beneficiaries of the post-covid global instability. Oil prices were already on the march higher thanks to overwhelming demand and hobbled supply and then spiked as nearly the entire world agreed to sanction Russian exports. Russia is the world's second-largest energy exporter (one out of every ten barrels of oil consumed comes from Russia) not to mention its being a significant producer of industrial metals, fertilizer, and grains.



Energy affects every corner of the economy—think power generation, freight, food production—so surging inflation is going to get worse before it gets any better.

Challenging Year Ahead

Elevated inflation is a drag on economic growth because it directly harms average Americans. Now with 8.5% inflation (highest since 1981) and wage growth failing to keep pace at 5.6%, we are starting to see consumer behavior change. Spending is slowing month-to- month and consumer sentiment is at its lowest since the depths of the 2008 Financial Crisis. Consumption makes up over 2/3 of GDP growth so should inflation persist and continue to eat away disposable incomes, the likelihood of a recession increases. However, consumers have managed to stock away over $2.4 trillion in excess savings since the beginning of the pandemic. This extra savings may help to absorb the worst excesses of inflation, particularly if its peak is reached this first half of the year.

American business has proven itself capable of adapting in the face of the incredibly adverse conditions we are seeing this year. The same public companies that posted record earnings growth last year, even while contending with a partially revived economy, are seeing estimates for their 2022 earnings go up even after the volatility and sell-off of the first quarter.

That being said, the cure for inflation is to tap the brakes on growth by raising interest rates. The task for Chairman Jerome Powell and the Federal Reserve will be to find the sweet spot of hiking rates enough to tame inflation without slowing growth to such an extent that it tips the economy into a recession. This delicate balancing act hasn't been undertaken in 40 years and is the market's primary concern. Because of this lingering uncertainty, stocks and bonds face a challenging environment going forward.

Given the magnitude of the headwinds described above, we can be certain that the market's erratic behavior will continue at least through the first half of the year. We will navigate through the choppy waters as we have in the past: making investment decisions based on a disciplined assessment of what the market is doing right now. These decisions become more difficult when the market lacks any discernible trends.

Allowing the market's whipsaw movement to dictate your emotional reactions can wreak havoc on your portfolio. Our investment process, enhanced by our quantitative portfolio management system, is driven by a mathematical analysis of price movement alone. It is critical, especially in volatile markets like we are seeing this year, to take an unemotional approach to volatility: discover growth where it is presenting itself and seek protection when necessary. Safe harbors—bonds and cash—cannot promise safety or stable purchasing power in a rising rate, inflationary market environment. And so, we have seen this year that investors are left with little alternative to domestic stocks with healthy financials and a perceived ability to weather continued economic and market volatility.

Performance Disclaimer

No investment strategy or methodology can guarantee profits or protect against losses.

Investment risk is inherent in every individual portfolio and no computer model or modeling program used or relied upon in making investment choices for a portfolio can eliminate risk.

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