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INVESTMENT MANAGEMENT

QUARTERLY REPORT MARCH 31, 2022

2022 1st Quarter Review

Economic Commentary

Inflation and interest rates have dominated the economic outlook discussion as the US Federal Reserve ("the Fed") attempts to control the former by exerting upwards pressure on the latter. The Fed closed out 2021 by laying out its roadmap for interest rate hikes, consisting of two or three rate hikes, but that plan has predictably gone out the window as the Fed is now calling for double the original plan. The Fed now plans to bring its benchmark rate to near 2% in 2022 and to reach 2.75% by 2023. To achieve this goal, the Fed would need six quarter-point hikes this year; although it is widely expected that we will get at least two half-point hikes, one each in May and June, to slow the economy and inflation sooner.

Trailing twelve-month persistent inflation readings of nearly triple its 2% target have necessitated the hawkish Fed policy shift. Otherwise-strong economic data, particularly on the employment front, gives the Fed the runway to tighten policy just enough to cool inflation but avoid a recession, if all goes according to the Fed plan. Given the precision needed to achieve a "Goldilocks" just-right monetary policy, one that cools growth without bringing about recession, we should expect the Fed's forecasted approach to change multiple times throughout 2022. New data will require revisions, and there is a major wildcard in play in the form of geopolitical conflict with the war in Ukraine. Also, while the Covid-19 pandemic seems like a bygone event for Americans, China is still actively battling the pandemic, with 26 million Shanghai residents temporarily locked down at quarter-end March 31. The supply chain bottlenecks that caused inflation are at risk of worsening if the outbreak necessitates expanded or extended lockdowns in Asia.

Where we currently stand, one quarter into 2022, unemployment is back to pre-Covid levels of 3.6%, wages are growing at 5.6%, nearly double the pre-pandemic average of 3%, and consumer spending has surprisingly continued despite the cessation of pandemic stimulus programs. The bad news is that inflation (using the Fed's preferred metric, the Core Personal Consumption Expenditures Index) is 5.2%, effectively negating the wage-growth gains. As the Fed embarks on its rate hike balancing act, many are pointing to the inverted 2-year and 10-year yield curve as an indication that the market expects the Fed to overshoot and trigger recession. While yield curve inversions are not to be ignored, the accuracy of the 2-10 yield curve as a recession forecaster is debatable and inversions typically precede recessions by as much as two years. There are immediate consequences of the Fed rate hikes, as consumers are already feeling the impact in the form of higher borrowing costs for mortgages, auto loans, and credit card debt.

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Market Commentary

US equity markets ended the first quarter battered but not broken, thanks to a remarkably swift mid-March bounce that brought the S&P 500's year-to-date losses from a low point of -12.2% to a more palatable -4.3%. The Nasdaq Composite, comprised of more tech-oriented and higher growth stocks, experienced a similar bounce off the mid-March low, cutting its year-to-date losses from -19.0% to -8.8% as of quarter-end. From its peak on November 19, 2021, the Nasdaq had declined by -22.6%, which meets the generally accepted criteria for a "bear market". Despite the market's resiliency, it remains possible that the quick surge over the quarter's final two weeks is simply a "bear market rally" that could fade as the Fed enacts rate increases and supply chain issues continue to complicate corporate earnings.

As of quarter-end, the S&P 500 has paused around the 4,550 range where 2021's prolonged uptrend paused and consolidated before surging to new all time-highs at the close of last year. On the positive side, the S&P 500 did break out of the downtrend pattern of lower lows and lower highs and pushed back above the 50 and 200-day moving average trendlines. For the market to take another leg up and retest the all-time highs, we will need very strong earnings results and perhaps more importantly, positive forward earnings guidance. While earnings could be good given the resiliency of the US consumer spending data, guidance may be less optimistic, given the supply chain challenges that have only grown with the war in Ukraine.

Exhibit 1. S&P 500, 1 year chart

Source: StockCharts.com, commentary by Hanlon Investment Management

Aside from supply chain logistics, businesses must adapt to the end of easy money from the Fed. More recently the Fed has revealed its plans to aggressively lessen the Fed balance sheet and raise rates, which explains the underperformance of growth and technology stocks that started around December 2021 and has continued this year as investors reallocated their exposure into companies with healthier balance sheets and lower P/E ratios. It can be argued that the most aggressive growth stocks have already had their valuations dramatically cut with some stocks off their August 2021 peaks by over 50%. However, rate hike expectations and geopolitical risks both continue to trend upwards, giving investors little reason to attempt to call a bottom in growth stocks. In contrast, value stocks have held up rather well, with the Vanguard Value ETF (VTV) up 1.0% year-to-date. It has been a long time since value has outperformed growth so only time will tell if this

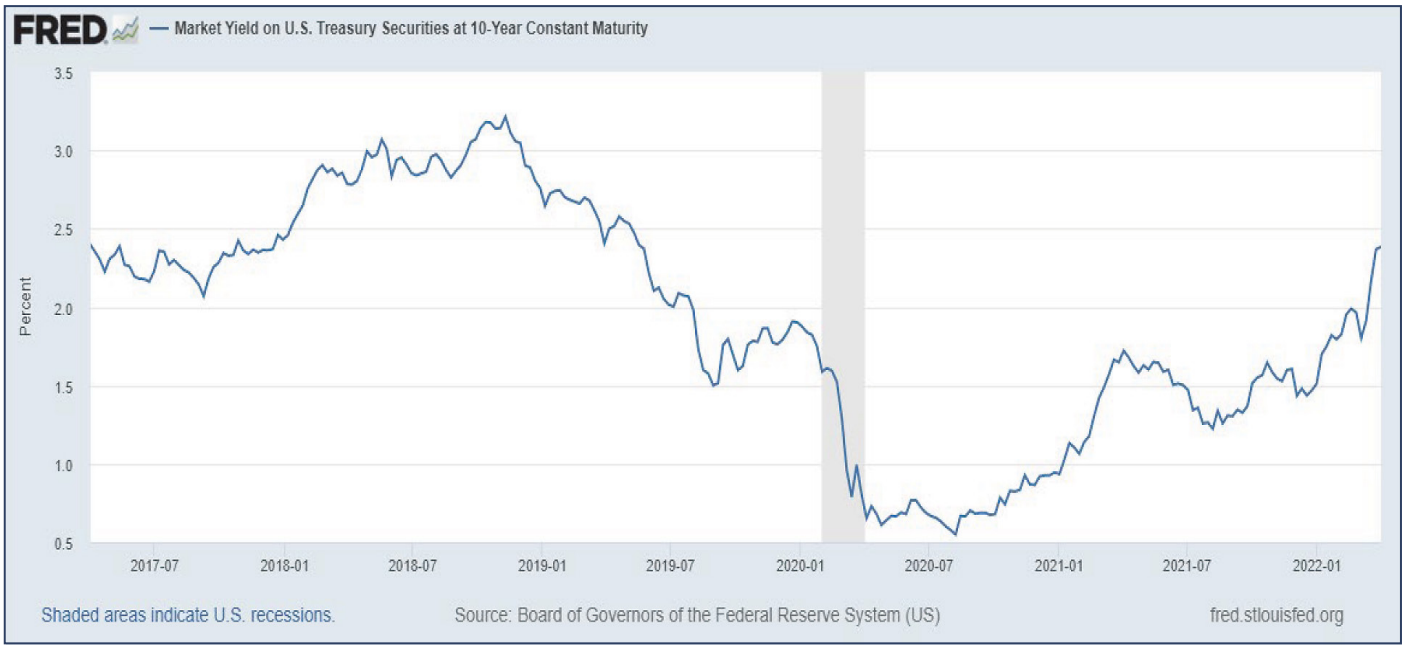
diversifying allocation of some value stocks in one's portfolio will provide the targeted benefits.

Outside the US, investors in foreign markets seemingly cannot catch a break. Developed International markets were a popular pick to outperform heading into 2022, given their cheaper valuations, higher dividend yield, and relatively more accommodative central banks. All those positive theses were thrown out the window with the invasion of Ukraine by Russia. European stocks are now exposed to immense geopolitical risk and the Eurozone economy is hostage to Russian gas supply manipulation. Year-to-date, the iShares EAFE ETF (EFA) is down -6.5%, once again lagging the S&P 500.

Emerging Market stocks are also floundering to start the year, largely due to a reassessment of the Chinese stock market as "un-investable" by many investors stemming from the Chinese government's draconian measures. Last year, China took aggressive action against high-profile tech companies, wiping out over $1 trillion in market value. This heavy-handed approach has continued, with new regulations and restrictions to exert control over tech industries and prevent what Beijing deems "anti-competitive" practices. Government restrictions preventing audit firms from transmitting records prompted a crash in American depository receipts (ADRs) of Chinese companies, as US regulators warned of potential delisting from US exchanges. The Chinese government has pivoted a bit on the audit requirement, however nothing concrete has been finalized and therefore Chinese stocks remain a high-risk investment.

Fixed income markets usually take a back seat to equities in the news, but with the Fed set to raise interest rates and begin quantitative tightening, all eyes are on the bond market. The 10-Year US Treasury Note yield began 2022 just above 1.5% but quickly surged to test the 2% level in February. Yields pulled back a bit to start March but quickly resumed their upward trajectory and as of quarter-end, 2.5% looks like a support level until the Fed enacts their next rate hike.

Exhibit 2. 10 Year Treasury Yield, 5-year chart



Data Source: St. Louis Federal Reserve.

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As the Fed unwinds its balance sheet and exerts pressure on rates, corporate borrowers no longer have the luxury of refinancing their existing debt at lower rates, as they have done for much of the last decade. When the Covid-19 downturn initially shut down the economy in 2020, bond rating agencies warned that we would see an unprecedented wave of defaults for high yield "junk" bonds. This prediction proved to be remarkably inaccurate. The Fed's intervention, buying junk bonds with its balance sheet for the first time in history, provided an opportunity for high yield issuers to refinance or issue new bonds at rock-bottom rates, and in February 2022 Fitch Ratings reported the US High Yield trailing 12-month default rate hit an all-time low of 0.3%. This debt will eventually come due, however, and without the option of kicking the can down the road by issuing new, cheaper, debt we will undoubtedly see an uptick in defaults.

This year, capital has fled the high yield bond sector, with first quarter outflows of roughly $6.6 billion from the largest high yield ETF, the iShares iBoxx High Yield ETF (HYG). As yields on government debt and investment grade corporate bonds rise, investors who have taken on extra risk in the high yield sector will likely move into safer investments, as they no longer need to chase yield.

Closing Remarks

After decades of easy money policies, the Fed's day of reckoning seems to have finally arrived. When the Fed stepped in during the initial pandemic selloff, the market acknowledged that the stimulus was necessary but one day the bill would come due. If the Fed can engineer a "soft landing", markets will certainly celebrate with new highs, perhaps before the end of this year. Remaining flexible and adaptive during the current market environment is crucial, and in our view the downside risks remain considerable, and we will continue to do our best to remain vigilant and protect our clients' investments as markets evolve. Thank you for the opportunity to be of service.

Sincerely,

Sean Hanlon, CFP®
CEO and Co-Chief Investment Officer

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