

Quarterly Investment Review and Monthly Outlook

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■ At a Glance

- » After an extended period of abnormally low volatility coming out of the brief, but severe, bear market of March/April 2020, most global equity markets experienced at least a 10%+ peak-to-trough price correction during the first quarter.
- » The Fed and other developed market central banks are being forced to confront more persistent inflationary pressures.
- » With commodity prices driven largely by supply constraints that may last awhile, market observers and central banks will try to discern the effects of these price increases on global demand and the inflation outlook.

After an extended period of abnormally low volatility coming out of the brief, but severe, bear market of March/April 2020, most global equity markets experienced at least a 10%+ peak-to-trough price correction during the first quarter.

The year began with a broad expectation of heightened volatility. Investors assessed the risk of the Fed beginning to tighten monetary policy given the strong economic growth seen at year-end, combined with the surprising persistence of inflationary pressures. The rapid spread of the Omicron variant of Covid-19 in January delayed the expected supply chain improvement while flush consumer balance sheets helped maintain overall demand.

An additional and somewhat unexpected jolt to global markets came in February with the Russian invasion of Ukraine. The surprise was not so much the invasion into the eastern provinces of the country which had been fighting skirmishes with Russian separatists for years, but the attack on virtually the entire country, particularly the capital of Kyiv, in an apparent move to replace the current Ukrainian government with a group friendly to Moscow.

Equally surprising was the extent of the sanctions placed on Russia by the Western allies. They are crippling the Russian economy and exacerbating inflationary pressures, not only in the energy space, but in industrial metals and agricultural commodities. These sanctions may be difficult to unwind given the ongoing brutal bombardment of Ukrainian cities and Russia quickly becoming a pariah nation around most of the globe. The era of globalization that dominated the economic landscape for much of the 21st century and has been a major contributor to low inflation through most of the world, may be evolving to its next phase, one with less free trade and more domestic onshoring of intermediate product and ultimate manufacturing.

■ Risk of a Monetary Policy Error

The Fed and other developed market central banks are being forced to confront these more persistent inflationary pressures. In hindsight, the Fed probably should have begun the tightening process last year as the economy was growing rapidly and inflationary pressures were lingering. Now they appear to be catching up to the current reality of the highest inflation rates since the early 1980's. The dilemma they are now confronting is they are only beginning the tightening cycle into an economy that is already showing signs of slowing. As much as Fed Chair Jerome Powell would probably prefer to let inflation naturally dissipate through slower demand, these inflation pressures may force an even more aggressive approach.

After ending the extraordinary bond buying program, the Fed announced its first funds rate increase of 25 basis points at the March Federal Open Market Committee (FOMC) meeting. It also said it would address its strategy for reducing its bloated balance sheet at the upcoming May meeting. The projections of the various Fed members were for additional 25 basis point increases at each remaining meeting this year which would take the fed funds rate up from 0.50% at the end of the first quarter to 2.00% by year end. Three more similar projected rate increases in 2023 would bring the fed funds rate to 2.75% which some economists believe to be above the somewhat arbitrary neutral level of 2.50% and a sign of a truly tight monetary policy after years of extraordinary ease.

The bond market had an arguably more interesting and potentially ominous reaction than the stock market to the heightened risk the Fed may be tightening too aggressively into an already slowing environment. Longer term yields, particularly the closely followed 10-year treasury note, spiked 100 bps higher to 2.50% during the quarter, but shorter maturity rates increased even more with the yield spread between the two- and ten-year treasury narrowing from approximately 80 bps at the beginning of the year to near zero at quarter end.

Collectively, this may be a sign that the bond market is anticipating much slower economic growth and perhaps a recession over the next six to nine months.

Implications of an Inverted Yield Curve

Looking beyond the two to 10 years spread which began the second quarter basically flat, certain portions of the treasury curve have already inverted with the three-year note yielding 15 bps more than the 10-year. Optimistic economists are already dismissing the recessionary implications of the flat to inverted curve by pointing out that inverted curves are a necessary, but not sufficient condition leading to recessions. Excess inventory accumulations, credit freezes, and government-imposed lockdowns have been the greatest drivers of the past three recessions, but each recession was preceded by a yield curve inversion brought about by an extended Fed tightening cycle.

The ability of monetary policymakers to engineer a so-called “soft landing” of an overheating economy is questionable. The market may be sending a strong signal for central banks, particularly the Fed, to tread carefully.

Some market observers prefer to look at the entire yield curve from the fed funds rate to the 30-year treasury which is still comfortably steep at over two full percentage points. Others point out that there have been extended lags of as much as two to four years between a curve inversion and an ensuing recession with rather strong equity market performance occurring in the interim period. This is likely due to the Fed implementing a tightening cycle in response to a strong economy which is generating above average corporate profits growth.

There are always nuanced differences when comparing one period to another and this one has been characterized by the curve flattening at the very beginning of the tightening cycle when it usually occurs after several central bank rate increases. An offsetting market indicator of a possible oncoming recession is the year-to-date movement of below investment grade credit spreads which widened only slightly through the quarter and is indicative of a continued low default rate for this risky debt. Fears of an imminent recession would normally lead to more distinct spread widening.

How Pinched is the U.S. Consumer?

U.S. GDP was inevitably going to slow coming into 2022 from its policy-induced hyper growth rate. However, higher energy and other commodity prices should increase the magnitude of the slowdown. When reported at the end of April, 1Q GDP will have been roughly 2%, a big decline from the 7% delivered in 4Q21, but closer to the longer-term potential growth rate of such a mature economy. Savings rates declined from the extremely elevated levels resulting from the various government fiscal relief packages, but consumer balance sheets remain strong. There appears to be much pent-up demand for travel/leisure experiences in an environment where Covid-19 is waning, and the economy is broadly reopening.

It is natural to expect higher prices in certain products to negatively impact demand for those products. Or less demand overall for other products in the case of energy, which people have no choice but to consume. However, through greater efficiency and conservation in what has become a largely services driven economy, energy consumption has steadily declined over the last 40 years as a percentage of American consumer expenditures. Of course, a continued spike higher in oil, natural gas, and other commodities with higher interest rates thrown in for good measure, could strain consumer spending enough to provoke a recession.

A major support to continued consumer spending advances is the strong jobs and wage growth seen in the first quarter which should be maintained through the summer as employers look to fill a record number of job openings and prospective employees return to the labor force. Flush corporate balance sheets are driving labor demand as companies continue to replenish depleted inventories. To the extent that businesses must pay higher wages to attract talent in a labor-constrained economy, look for them to protect their margins by continuing to invest heavily in productivity enhancing technology equipment across both the manufacturing and services sectors of the economy.

Equity Markets May Have Already Registered the Lows for the Year

After establishing lows a few weeks after the Russian invasion of Ukraine, equity markets recovered roughly two thirds of the losses by quarter end with an accompanying dramatic drop in volatility. This rally could merely be a rebound from extremely oversold conditions, but it appears to confirm that the first quarter market decline may have been a more typical market correction as opposed to a more sinister beginning of a bear market. Continued economic and corporate earnings growth will be key in an environment where low interest rates will no longer be a tailwind to valuation.

First quarter earnings growth for the S&P 500 stocks is expected to be 5-7% when fully reported by early May as the year over year comparisons become much more difficult given the strong 2021 economic recovery. Also, earnings estimates declined from the beginning of the quarter as companies are reporting margin pressure from higher input and wage costs.

There was distinct outperformance of the more cyclical sectors of the market compared to the steadier growth sectors in the first quarter as a rebounding economy and the impact of the war on commodity prices drove the energy and materials sectors while higher interest rates caused contraction in the valuations in the technology, consumer discretionary, and communication services sectors. Perhaps a somewhat positive byproduct of the correction was that some of the excesses were taken out of the rather expensive growth stocks. A slowing, but still growing, economy moving into the second quarter should put more of a premium on companies in both the cyclical and defensive sectors with strong balance sheets who could deploy their capital to dividends, share buybacks and prospectively accretive mergers.

Volatility will continue in this tense geopolitical and monetary tightening environment, but perhaps not as much as markets experienced in the first quarter. Oil prices remain very much a wild card as the most important commodity to the global economy and a major component of the headline inflationary indicators. With alternative energy sources such as wind and solar not yet developed enough to fill the gap for what may be permanently unavailable Russian supply, U.S. domestic producers should be willing to step up production at these high prices.

The lack of a meaningful response to date may be indicative of both the external and self-imposed barriers placed on the energy industry in a global effort to decrease our reliance on fossil fuels. Any spikes higher in West Texas Intermediate crude prices could both hamper economic growth and/or force the Fed into a more aggressive tightening stance which could include 50-basis point rate increases at upcoming meetings.

After taking into account currency depreciation, international equities in both the developed and emerging markets declined more than those in the U.S. throughout the quarter. The one notable exception in developed markets was the UK equity market which is skewed relatively heavily towards the energy and materials sectors which benefitted from higher commodity prices. Continental Europe, particularly Germany which is a major energy importer, was much more impacted by the war and subsequent sanctions and may have entered the second quarter already in an economic recession. The southern tier countries should benefit from the positive effect of a broad economic reopening on their important travel and leisure industries.

Emerging market equities, whose indices included Russian equities before they were removed after the invasion, were the most directly impacted by the prominent geopolitical instability in the quarter. China, the largest component of this asset class, is a large commodity importer and continues to struggle with U.S. trade restrictions.

However, there are strong signs that the government is committed to their 5.5% GDP growth targets for this year and is ready to support the economy with both fiscal and monetary policy accommodation. Lost in the struggles of eastern Europe and Asia was the very strong, positive performance in the quarter of most Latin American equity markets which are very leveraged to the year-to-date bull market in commodities.

■ Outlook for the Bond Market

Adding to the speculation we may have already seen the lows for the year in equity markets, there are thoughts that we may have also seen the highs for the year in the 10-year treasury yield. That may be a tougher call as persistent inflation and continued albeit slower economic growth could pressure yields higher in an environment where the Fed is meaningfully reducing its presence in the intermediate duration sectors of the fixed income markets.

Positive offsets which should prevent another sharp upward spike in yields could be less issuance of bonds by the treasury. As tax receipts have risen notably in this strong economy and continued foreign demand for treasuries both as a safe haven and a higher yielding alternative to their domestic markets.

■ Outsized Near Term Importance of Commodity Markets

With commodity prices driven largely by supply constraints that may last awhile, market observers and central banks will try to discern the effects of these price increases on global demand and the inflation outlook. Strong balance sheets and healthy jobs and wage growth may prevent any meaningful demand destruction at these higher price levels and could lead to persistent inflation as businesses see little problem in passing cost increases through to the ultimate consumer, particularly if competition declines in a less globalized economy. The Fed would likely have to tighten faster and much more aggressively to slow demand and prevent the inflationary trend from becoming entrenched.

An interesting market anomaly began to occur late last year and carried into the first quarter: the US dollar and commodity markets became positively correlated. Usually, higher commodity prices are indicative of strong global demand and greater investor willingness to diversify portfolios outside the safer, dollar-based assets. The positive correlation in this market cycle is likely due to the commodity prices moving higher not so much due to demand, but to supply issues and the first real war in Europe since World War II. There is hope that a stronger dollar can relieve the inflationary pressures on imported products.

■ What This All Means for Investors

The U.S. economy is experiencing its first meaningful inflationary cycle since the early 1980's. There are significant differences in the structure of the economy and the demographics of the population and labor force since that time which should prevent this inflation from becoming entrenched. However, the Fed is feeling enormous pressure to tighten more aggressively into an economy that is already beginning to slow.

Markets will be looking for signals such as yield curve inversion, corporate credit spread widening and company earnings warnings to gauge whether the economy is merely slowing from unsustainably high rates or beginning to recede. Pent-up consumer demand, strong jobs and wage growth, and healthy corporate balance sheets should prevent a recession from developing this year, but a more intense central bank tightening cycle could cause the clouds to gather more ominously for 2023.

	PRICE	2Q21	3Q21	4Q21	1Q22	YTD	Annualized			
							1-Year	3-Year	5-Year	10-Year
US EQUITY BENCHMARKS										
Dow Jones Industrial	34,858	5.08	(1.46)	6.15	(4.10)	(4.10)	7.08	12.51	13.35	12.73
Nasdaq Index Composite	14,964	9.68	(0.23)	7.97	(8.95)	(8.95)	8.02	23.43	20.24	17.70
S&P 500	4,561	8.55	0.58	9.71	(4.60)	(4.60)	15.58	18.82	15.94	14.58
Russell 1000 (Large Cap)	4,867	8.54	0.21	8.57	(5.13)	(5.13)	13.22	18.61	15.77	14.48
Russell 1000 Growth	2,815	11.93	1.16	10.82	(9.04)	(9.04)	14.92	23.47	20.81	16.98
Russell 1000 Value	1,013	5.21	(0.78)	6.17	(0.74)	(0.74)	11.62	12.95	10.25	11.66
Russell Mid Cap	8,084	7.50	(0.93)	2.63	(5.68)	(5.68)	6.89	14.81	12.58	12.81
Russell Mid Cap Growth	10,303	11.07	(0.76)	(0.53)	(12.58)	(12.58)	(0.89)	14.73	15.05	13.47
Russell Mid Cap Value	2,821	5.66	(1.01)	4.83	(1.82)	(1.82)	11.41	13.61	9.96	11.97
Russell 2000 (Small Cap)	2,204	4.29	(4.36)	1.19	(7.53)	(7.53)	(5.76)	11.68	9.71	11.00
Russell 2000 Growth	1,492	3.92	(5.65)	(0.79)	(12.63)	(12.63)	(14.28)	9.83	10.29	11.17
Russell 2000 Value	2,397	4.56	(2.98)	3.24	(2.40)	(2.40)	3.31	12.66	8.54	10.50
S&P GICS SECTORS										
Consumer Discretionary	12.5%	6.95	0.01	12.54	(6.88)	(6.88)	11.39	18.57	17.87	17.08
Consumer Staples	5.9%	3.83	(0.31)	5.88	(0.72)	(0.72)	17.31	14.84	10.34	11.62
Energy	2.7%	11.30	(1.66)	2.67	38.93	38.93	60.89	11.18	6.81	4.42
Financials	10.7%	8.36	2.74	10.69	(2.58)	(2.58)	12.36	15.21	12.30	13.94
Health Care	13.3%	8.40	1.43	13.29	(2.84)	(2.84)	19.36	16.68	15.12	15.92
Industrials	7.8%	4.48	(4.23)	7.78	(3.59)	(3.59)	4.76	11.97	11.07	12.69
Information Technology	29.1%	11.56	1.34	29.17	(6.96)	(6.96)	20.29	30.34	27.26	20.81
Materials	2.6%	4.97	(3.51)	2.56	(1.78)	(1.78)	13.98	17.97	13.51	11.56
Communication Services	10.1%	10.72	1.60	10.16	(9.31)	(9.31)	0.16	15.57	10.10	10.20
Utilities	2.5%	(0.41)	1.78	2.50	4.64	4.64	20.54	12.85	11.48	11.79
Real Estate	2.8%	13.09	0.88	2.77	(5.29)	(5.29)	25.67	14.32	13.03	11.64

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GLOBAL EQUITY BENCHMARKS										
MSCI ACWI	3,006	7.39	(1.05)	6.01	(5.36)	(5.36)	7.25	13.68	11.60	9.96
MSCI AC World x-USA	341	5.48	(2.99)	1.87	(5.44)	(5.44)	7.47	6.74	5.53	7.45
MSCI EAFE	2,281	5.17	(0.45)	2.70	(5.91)	(5.91)	1.16	7.74	6.70	6.25
MSCI EAFE Growth	2,208	7.42	0.07	4.31	(11.94)	(11.94)	(1.47)	9.72	8.91	7.43
MSCI EAFE Value	2,828	3.01	(0.97)	0.96	0.33	0.33	3.54	5.21	4.17	4.85
MSCI Emerging Markets	1,253	5.05	(8.09)	(1.17)	(6.97)	(6.97)	(11.32)	4.91	5.96	3.35
MSCI BRIC	360	5.40	(11.28)	(5.03)	(13.28)	(13.28)	(22.89)	(0.82)	4.10	2.24
MSCI Japan	4,015	(0.28)	4.56	(4.05)	(6.61)	(6.61)	(6.45)	6.80	6.08	6.44
INTEREST RATES										
	YIELD									
3m Treasury Bill	0.66	0.05	0.03	0.05	0.37	0.37	0.03	1.18	1.16	0.63
US LIBOR 3m	0.97	0.15	0.13	0.21	0.96	0.96	0.20	2.59	1.15	0.47
US Treasury 3m	0.56	0.05	0.04	0.05	0.52	0.52	0.02	2.43	0.79	0.06
US Treasury 10yr	2.41	1.45	1.53	1.51	2.32	2.32	1.69	2.51	2.36	2.23
US Treasury 30yr	2.47	2.06	2.09	1.90	2.45	2.45	2.34	2.91	3.00	3.36
FIXED INCOME										
	PRICE									
Citi 3-month T-bill	660	0.01	0.01	0.01	0.03	0.03	0.76	1.09	0.60	0.60
BC U.S. Gov't & Related 5-7	105	1.44	(0.00)	(0.58)	(5.36)	(5.36)	1.78	2.49	2.46	3.28
BC Municipal Bond 1-10 Year	113	0.62	(0.01)	0.14	(4.76)	(4.76)	1.03	1.77	2.00	2.72
BC TIPS	114	3.25	1.75	2.43	(3.02)	(3.02)	6.18	4.42	2.68	3.11
BC Aggregate	106	1.83	0.05	0.03	(5.93)	(5.93)	1.68	2.14	2.23	3.00
ML High Yield Master II	106	2.77	0.94	0.63	(4.51)	(4.51)	4.38	4.55	5.68	7.27
Citi World Gov't Bond Index	955	0.74	(0.01)	(0.02)	(4.79)	(4.79)	1.11	2.16	2.80	3.43
JPMorgan EMBI Global	917	3.93	(0.70)	(0.54)	(10.02)	(10.02)	(7.41)	0.01	1.68	3.73

	PRICE	2Q21	3Q21	4Q21	1Q22	YTD	Annualized				
							1-Year	3-Year	5-Year	10-Year	
REAL ESTATE											
MSCI US REIT	1,365	12.00	0.01	14.38	(4.06)	(4.06)	26.09	11.08	9.62	9.70	
FTSE EPRA/NAREIT Europe	1,917	10.95	(2.01)	5.81	(7.15)	(7.15)	5.18	4.40	7.02	7.56	
COMMODITIES											
Bloomberg Commodity Index	126	13.30	6.59	5.94	25.45	25.45	49.45	15.91	9.21	(0.54)	
Energy	47	23.23	20.99	(11.80)	49.58	49.58	91.39	7.81	6.57	(5.92)	
Agriculturals	74	12.77	(1.03)	5.94	20.84	20.84	49.07	4.37	2.11	(1.23)	
Livestock	23	(1.46)	(2.01)	2.03	6.42	6.42	1.23	(9.95)	(3.02)	(3.42)	
Softs	52	18.68	16.54	6.70	7.75	7.75	61.65	18.56	3.84	(3.70)	
Industrial Metals	215	9.41	2.05	7.71	23.24	23.24	48.69	4.17	2.42	1.41	
Precious Metals	231	3.93	(4.56)	3.00	7.58	7.58	8.05	13.41	6.91	(0.19)	
CURRENCIES											
ICE Dollar Index	94	(0.85)	1.94	1.84	2.44	2.44	5.45	0.35	(0.41)	2.21	
Euro / US Dollar	1	0.90	(2.27)	(3.30)	(1.17)	(1.17)	(6.46)	(0.66)	0.62	(1.75)	
Pound / US Dollar	1	0.13	(2.40)	(3.17)	(0.39)	(0.39)	(5.08)	0.09	1.05	(1.89)	
US Dollar / Yen	111	0.44	0.53	6.57	1.11	1.11	10.90	3.22	2.11	4.05	

Source: Factset, Morningstar Direct, iShares

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