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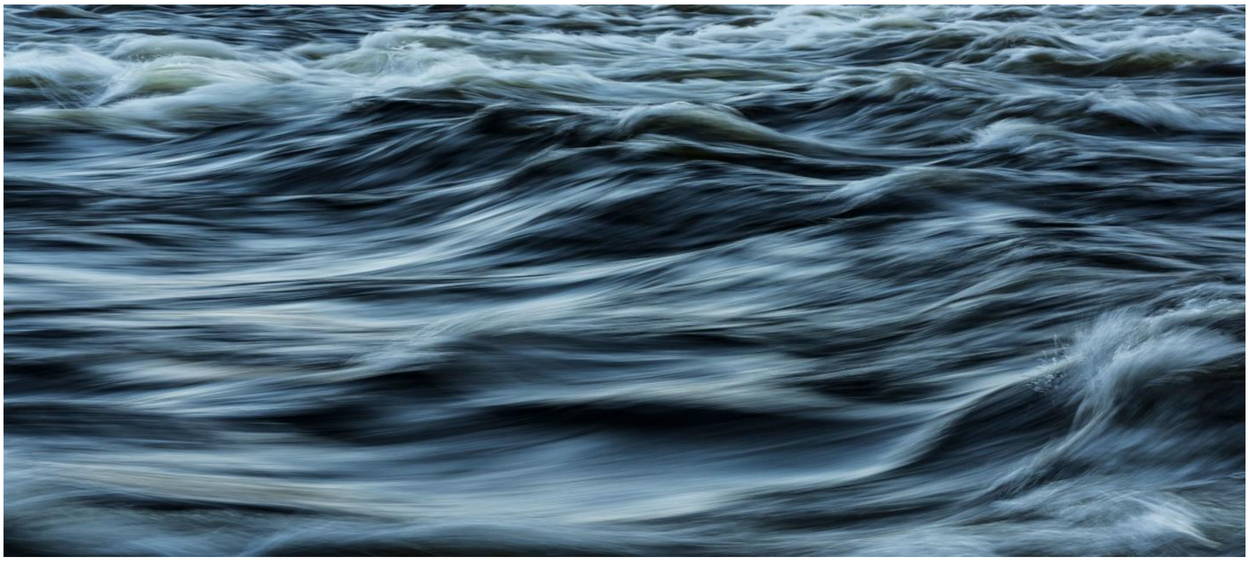
First Quarter 2022 Market Commentary:

Navigating Choppy Waters

April 2022



After experiencing a correction in January – February 2022, U.S. equity markets closed the first quarter down about 5%, despite heightened volatility over the Russia-Ukraine conflict and monetary policy uncertainty resulting from continuously high inflation data. At its lowest, the S&P 500 fell over 10% bottoming on March 8th, before rebounding towards the end of the quarter. Value equity indices, however, have withstood much of the market turbulence, finishing the quarter down only about 1%. The rebound is attributable to the Fed's guidance regarding the path of interest rates going forward and investors' increased hopes that the Russia-Ukraine conflict will be a slog that will eventually result in a negotiated cease-fire. As the S&P 500 exited correction territory towards the end of the quarter, historical market data illustrates that equities tend to continue to advance higher out of a correction, particularly when viewed twelve months later. On average since 1928, the S&P 500 has advanced 13.96% one year after exiting a correction.

Economically, the U.S. is coming off a particularly strong end of 2021, as recently announced in March. U.S. corporate profits hit a record high in the fourth quarter, growing 25% year-over-year. Relatedly, GDP rose 6.9% in the fourth quarter and 5.7% for 2021 as a whole, while consumer spending rose 2.5% in the fourth quarter. This indicates the ability of strong U.S. businesses with pricing power to withstand higher input costs caused by inflation by passing them on to consumers that are continuing to buy their goods and services. It also reflects the economic benefits of the pandemic re-opening as pent-up demand was unleashed across the country. More recent data has indicated consumer spending may be slowing with inflation persistently high. However, unemployment is low (3.5% unemployment rate, lowest since 1969), and the economy can continue to grow assuming inflation can be brought under control through effective monetary policy that does not unduly restrict business activity. This balancing act is one that the Fed will have to navigate as it looks to steer the economy into a “soft landing” as it tames inflation without inducing an economic recession.

U.S. Monetary Policy Clarity Provides Some Comfort

Markets abhor uncertainty more than anything else. With a known positive or negative development, investors can pick and choose winners and losers, but uncertainty scares markets from taking a position either way. In recent years, this market dynamic has been best witnessed in response to Fed interest rate policy. With U.S. inflation data remaining persistently high over the past 6-9 months, a shift in Fed interest rate policy has been expected for some time. In the first quarter, the Fed finally announced that it would begin raising interest rates, starting with the March meeting, and continuing throughout 2022 until the Fed Funds rate reaches approximately 2%. Additionally, the Fed will allow up to $95 billion of treasuries and mortgage-backed securities to roll off its balance sheet each month.

While higher rates are normally negative for equities, investors appeared to take comfort in the clarity of the Fed’s plan, in that it was not significantly more hawkish than anticipated, and reacted on the news. Economists still anticipate inflation data will trend lower in coming quarters as pandemic related bottlenecks and supply chain constraints finally ease. Recently, the treasury yield curve has also drawn attention for its flattening and inversion in some cases (e.g. the 5-30 year rate spread). Investors remember that the yield curve also inverted in recent years during prior Fed rate hike cycles, however it historically has been considered a recession indicator. This is normally due to the fed raising rates in an overheating economy that was peaking and the rate hikes along with the normal economic cycle caused the yield curve inversion. We do not feel that this is a true recession indicator now as the economic data has been distorted somewhat by the pandemic economy of 2019-2020, Fed interest rate policy, and uncertainty in the global economy that has unusually depressed rates lower on the longer-dated maturity treasuries. As investors digest the Fed’s forward rate guidance further, longer-dated rates should rise over time.

Russia-Ukraine Conflict Causes Geopolitical Uncertainty

Global economic uncertainty moved markets in the quarter due to the continued conflict in Ukraine. As the war has dragged on, markets appear to be increasingly confident that the U.S. and NATO are unlikely to become directly involved militarily, thus reducing the conflict to a regional war between neighbors. In our most recent commentary on this conflict, we illustrated how markets typically drop immediately after a major geopolitical shock but tend to recover lost ground within a few months of the shock. Even in an extreme military scenario such as Pearl Harbor, equity markets had recovered from the initial shock within one year. While no one is comfortable with the tragic human consequences of war and loss of life, from a business/economic perspective, investors appear to be gauging this conflict as more limited in nature, which will therefore have a more limited impact on U.S. businesses.

Nevertheless, the conflict is feeding into the higher inflation already being felt in the U.S. through further disruption of the supply chains of food and commodities, including oil. Russia is increasingly more isolated from the global economy as the war drags on, disrupting global trade and calling into doubt the trend towards globalization as nations may increasingly look to national sources of production for goods and services. Additionally, there is still much uncertainty as to Russia's continued potential for aggression outside of Ukraine as well as their reaction to further economic sanctions from the West. Markets likely will remain volatile and geopolitical developments will continue to move markets in the short run, even as the parties might eventually reach a cease-fire settlement.

Proposed Tax and Regulatory Changes Affecting Investors

At quarter-end, the Biden administration announced proposed tax law changes as part of the 2023 budget proposal that may impact high net worth investors directly. Additionally, the House of Representatives passed legislation that proposes several key changes that affect retirement plan participants and retirees, if it is passed by the Senate and becomes law. Some of the key provisions of these proposals are:

- <u>Minimum Tax for Ultra High Net Worth</u>: This provision included in the budget proposal would effectively institute a 20% minimum tax on income and unrealized capital gains for any American with more than $100 million in assets. While this is targeted at a very high asset level that wouldn't affect many Americans, it is important in that it includes the concept of taxing unrealized capital gains, effectively a tax on wealth. Were the proposal to become law, it's possible if not likely that the targeted wealth level could expand in later years, bringing more people into the wealth tax regime. This is what happened with the income tax and alternative minimum tax that initially targeted high earners but have been continuously expanded over time. Importantly, this has implications for owners of private businesses, whose equity would be included in this concept, valued as of the last valuation event and increased annually by a rate set by the Treasury.

- Increase of Corporate and Individual Tax Rates: The budget proposal would increase the corporate tax rate from 21% to 28% and the top individual tax rate from 37% to 39.6%.

- Later Required Minimum Distribution Age: The House of Representatives recently passed legislation that would allow retirement investors to delay taking their first required minimum distribution from a 401(k) plan, IRA or similar retirement plan until age 75 (from age 72 currently). This benefits retirement savers that would like to preserve the benefits of tax deferral for as long as possible. The rule change, if it becomes law, would be phased in over the next decade.

- Increased Contribution Limits for Older Workers: The House bill also would increase the amount of money that workers age 62 - 64 can contribute as "catch-up contributions" to retirement plans from an extra $6,500 to $10,000 for a 401(k) plan, however this higher catch-up contribution would have to be made after-tax.

As usual, all comments are welcome and appreciated.