Beacon Trust
INNOVATING WEALTH STRATEGY

Market Outlook 1Q 2022 Review	April 5, 2022

First Quarter Summary

Stocks fell during the first quarter resulting in the first correction since 2020Q1, the time frame near the commencement of the COVID-19 pandemic. The peak to trough intra-quarter drop for the S&P 500 was 14.5%, but stocks rallied in March to trim the quarterly losses to 4.6%. The catalysts for the market decline were soaring inflation, a more hawkish Federal Reserve, and Russia's invasion of Ukraine. While stock market investors were licking their wounds, bonds suffered losses of epic proportions, at least for investment grade bonds. The benchmark Bloomberg Barclays Aggregate Index fell 5.9% in Q1, its largest quarterly drop in more than *40 years* (1980Q2).

We recognize and are saddened by the ongoing humanitarian tragedy in Ukraine and wish for peace. From an economic standpoint the main impact of the war is on rising commodity inflation, especially in those areas (e.g., Oil, Natural Gas, Fertilizer, Titanium, etc.) where Russia has historically been a large exporter. Longer term, our view is that we are in Cold War II with a retrenchment in the globalization trends that have characterized the past 40+ years. China's economic rise and Russia's aggression, combined with political and value systems far different from those in the West, create a new investment climate that deserves careful consideration as we construct client portfolios in the days and months ahead.

The Federal Reserve raised interest rates 0.25% in March for the first time since the pandemic forced them to slash short-term interest rates to 0%. Judging from the Fed's comments, several more rate hikes loom on the horizon, starting with the expectation of another 0.5% hike after their May meeting. The Fed is grappling with an inflation problem, with the CPI inflation rate running at a 40-year high of roughly 8%. The market's expectations of further rate hikes have resulted in an inverted yield curve, often a harbinger of a future recession. However, the inversion is very modest and a near term recession is unlikely. Historically, it takes about a year and a half, on average, for a recession to occur after the initial inversion.

Circling back to the bond market, the news may not be as bad as it appears on the surface, at least for Beacon clients. For years we have tilted our fixed income portfolios towards short duration, investment grade bonds. These bonds fared far better than the Barclays Aggregate figure cited above. In addition, as bonds mature and coupons are received, these cash flows will be reinvested at higher rates, offering the prospect that losses will be trimmed as the year unfolds.

Market Outlook

We continue to believe that 2022 will be a year of consolidation for stocks, with modest return expectations, on the heels of three exceptional years for equities. Surging inflation is clearly sapping consumer purchasing power, with 2022Q1 GDP expected to show less than 2% growth. Despite the prospect of somewhat tepid returns for equities, we still prefer them over fixed income assets due to what is likely a secular rise in interest rates. The war in Ukraine and somewhat elevated valuations result in further headwinds for equities. Smart stock picking and our risk controlled strategies, which use options to enhance returns, may further improve performance amidst a sluggish environment.

The direction of future Federal Reserve strategy is clear – a tightening of monetary policy. The Fed has a dual mandate, which consists of contained inflation (i.e., in the neighborhood of 2%) and full employment (i.e., in the ballpark of 3%-4%). The Fed has failed in its first objective with the highest inflation rates in decades, but gets high marks for its policies in addressing job growth. Hence, we believe the Fed's hands will be forced to raise interest rates until inflation gets somewhat under control. Futures markets are estimating short-term interest rates will be 2.75% by the end of the year. In our view, longer-term interest rates will also drift upward. The benchmark 10-Year Treasury Note is currently yielding 2.6% and we expect it to approach and perhaps exceed 3% over the course of the year. The Fed also has the challenging task of shrinking its enormous $9 trillion balance sheet as another tool to control inflation. It is unlikely to reinvest the maturing coupon and principal repayments from their portfolio and more likely to let maturing bond holdings run off the balance sheet. We await further guidance of the Fed's plan to shrink its balance sheet beyond these simple measures after its May meeting.

Clearly, the war between Russia and Ukraine dominates the geopolitical headlines and remains a major risk for financial assets. Although we hope for peace, we cannot completely rule out the risk that we are near the beginning of World War III, in light of the atrocious war crimes that appear to have been committed. U.S. and China relations remain frosty, with China refusing to condemn Russia's invasion of Ukraine. China's growth is an important source of earnings for many global companies and the prospect of U.S. sanctions on Chinese companies that are doing business with Russia further complicates the global recovery. North Korea, a wildcard country with a reported nuclear arsenal, upped the geopolitical risk ante by launching its first intercontinental ballistic missile since 2017. Among the risks at home include the likelihood of higher corporate and individual taxes which may further crimp economic growth.

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