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CHIEF INVESTMENT OFFICE

Investment Insights

Uncertainty at Its Highest Level but the Repricing of Risk Is In Its Final Stages

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All data, projections and opinions are as of the date of this report and subject to change.

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Data as of 02/24/2022 and subject to change.

Global markets are under significant pressure with many indexes in Europe down around 4% to 5% and in the U.S. about 3% on the back of Russia's invasion of Ukraine overnight. The S&P 500 has now fallen further into correction territory, with a loss of over 13% year-to-date, and the Nasdaq-100 Index reached bear market territory (down 20% or more from its 52-week high). Since the beginning of the year, investors have been reducing risk as inflation has been running hot, the Federal Reserve (Fed) pivoted to a more aggressive tightening bias, growth concerns gathered momentum due to the new Omicron variant, and, most recently, geopolitical risk rose to the highest level in many years.

With all of these developments converging at once, market volatility spiked sharply and has stayed at elevated levels. The 12-month forward price-to-earnings multiple on the S&P 500 has come down over 10% since the end of 2021, the 10-year Treasury yield pierced 2% recently, gold prices at are at their highest level since September 2020, and the price of West Texas Intermediate oil touched $100 per barrel today. As we discussed in our last report, we believe the equity market is caught in a vortex of uncertainty in which investors are repricing risk within a short time frame (further accelerated by the Russia and Ukraine situation). Making this more difficult is the fact that this is occurring from a premium valuation starting point. Valuations normalizing over time as rates rise and/or profits adjust steadily is considered a perpetual and normal element in investing cycles. However, if rates rise sharply and/or profits are significantly dented, the hit to valuations tends to be more dramatic. The knee-jerk reaction is for markets to sell-off over a period of time as uncertainty rises and questions build regarding the growth outlook mixed with monetary policy tightening. This could last for an extended period, particularly as new concerns present themselves at the same time. At present, we believe the repricing of risk and valuation adjustment is in its final stages (perhaps accelerated by the Ukraine invasion) and we expect markets to ultimately climb the "wall of worry" as profits signal that growth is still healthy and policy not yet too tight. In fact, despite the growing fears of a monetary policy error in the next year, recession risks are still very low and subdued.

In 2021, the S&P 500 experienced only one 5% pullback, while on average there have been two to three 5% pullbacks per year and generally one 10% correction annually. To begin 2022, we are already past the 10% correction territory. This repricing of risk downdraft first occurred in the long-duration, low-profit growth stocks as yields moved higher and investors began to increase exposure to higher-quality, more attractively valued areas that are producing solid profits now—not years away. Many of the long-duration growth, highly valued segments of the market are down well over 40% to 50% from their highs, which has caused pressure on other parts of the market that have

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high weights in market indexes, such as the Technology sector. This recycling within the market mixed with a risk rerating has been building since the Fed's initial pivot earlier this year and has now reached a new level of uncertainty given the situation unfolding in Ukraine.

What do we expect from here?

- Short-term elevated volatility with a grind up and down into the spring
- Continued repricing of risk as models are adjusted and portfolios continue to be repositioned
- Equity markets trying to find a floor; market technicals matter in the short term
- Investor sentiment to hit extreme lows in the next week; currently, the American Association of Individual Investors' latest bearish reading is at 54% and the bullish reading is only 23%—both are at multiyear extremes
- Even though the market has now backtracked to discounting only a 25 basis points (bps) hike from a 50 bps hike in March to the fed funds rate, we still expect the Fed to lift rates at a steady bump at each meeting for the rest of the year
- Longer-dated bond yields have dropped in the past few days as risk aversion has risen; we expect them to drift higher again as geopolitical uncertainty subsides
- Market direction is a "grind-it-out" type of atmosphere for the rest of the year once order is restored
- Small-caps are at 20-year lows relative to large-caps in the U.S. and we expect this large gap to narrow somewhat as the economy fully reopens
- We continue to prefer U.S. versus non-U.S. Equity investments given our higher-quality view but also the fact that Europe is more exposed to the downside of higher oil and gas prices and the elevated geopolitical risk in Eastern Europe
- The U.S. dollar has rallied with a flight-to-quality and we expect this to continue or at least remain stable
- Gold prices are at their highest levels in a year and could break out to the upside further as uncertainty remains
- Oil prices have been steadily rising and are now up over 5% today but are vulnerable to a de-escalation and/or a supply response in the coming weeks/months
- Credit spreads have been widening recently but are still in a range that is not signaling a major tightening in financial conditions is afoot
- We continue to focus on higher-quality Fixed Income such as municipals, shorter-dated Investment-grade credit, and below average duration in general
- With our view that yields should resume their drift higher in 2022, yield-focused investors may want to consider shifting some risk to attractive dividend-producing areas of the equity markets

What are some of the potential catalysts to calm markets?

- As valuations find their footing and with investor sentiment so poor new Equity flows and a release of the repricing of risk will need clear fundamental catalysts to create a more stable environment, in our view

- We believe the catalysts are:
  - de-escalation in Russia and Ukraine
  - full reopening of the U.S. and European economies
  - a measured but diligent Fed
  - corporate profit growth to surprise positively
  - longer-dated yields to drift higher, not shoot higher
  - no major widening of credit spreads
  - stabilization in oil prices
  - investors beginning to increase exposure to established Technology companies

This may seem like a lot to ask for but they all work together and a chain reaction could ensue as each trend develops again. This is what can re-establish a grind-higher market environment that tracks the fundamental profit cycle for the remainder of the year.

What should investors consider during this time of major uncertainty?

- Continue to focus on diversification, higher-quality investments in Equities and Fixed Income
- Consider rebalancing up in Equities if portfolio exposures are below the long-term asset allocation targets as volatility begins to subside
- For more active investors, during portfolio rebalancing episodes, adding to well-established, highly profitable, solid balance sheet, and attractively valued areas of the market is preferred
- We believe many sectors (both cyclical and defensive) have well-established companies with high quality characteristics, solid dividend growth, and good value
- We continue to prefer Energy, Materials, and Financials, as well as big, established areas in Technology and Industrials with high free cash flow; the more defensive sectors such as Healthcare are likely to provide some growth and stability
- We also believe more thematic areas such as travel, leisure and entertainment are attractive given our view of a full reopening of the economy in the coming weeks/months
- For more passive investors, we believe adding to higher-quality U.S. markets and sectors relative to the rest of the world also makes sense on a broad level given the sharp correction in valuations from their peaks late last year

The terrible situation in Ukraine is likely to keep investors on the sidelines until there is some clarity on the immediate future. Eventually, market direction should be dictated by economic and corporate fundamentals, but investors will need some comfort that recession probabilities will still stay low as the Fed tightens policy. We will continue to focus on risk and fundamental indicators such as credit spreads, the yield curve, investor sentiment, consumer spending and jobs, earnings revisions, inflation dynamics, and volatility, just to name a few, to help gauge whether this latest downdraft is another sharp correction or the end of this cycle.

We do not believe this is the end of the long-term bull cycle for Equities in general given our view that the profit cycle is still positive and growing, valuations are now more attractive, household and corporate balance sheets are healthy, demographics are favorable and another major innovation wave is just beginning.

We suggest staying diversified and staying the course.

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S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

Nasdaq-100 Index is a stock market index made up of 101 equity securities issued by 100 of the largest non-financial companies listed on the Nasdaq stock market. It is a modified capitalization-weighted index.

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