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OUR VIEW

APRIL 2022

Global markets in the first quarter generated negative returns with a narrow distribution (Table 1), although declines were modest in proportion to potential risks. It is noteworthy that bonds correlated with equities and underperformed, providing no relief for investors. This is not a time to deploy an aggressive portfolio construction, rather it is a time to stay attentive and patient, knowing that the market will inevitably resolve its concerns or create an opportunity to deploy capital into attractive investments.

Q1 Equity Market Returns

U.S.	-5.3%
Non-U.S.	-5.3%
U.S. Bonds	-5.9%
Global Bonds	-6.2%

Source: Bloomberg. Table 1

A Paradigm Shift?

The present value of an asset is the discounted value of its future cash flows. Two key elements comprise the discount rate, a risk-free rate of return[1] and a subjective equity risk premium. The higher the discount rate the lower the present value of the cash flows. For a long time, the world has enjoyed lower discount rates, allowing for higher equity valuations. Now, it appears we are entering an entirely different paradigm, one in which the discount rate is rising, which in turn requires higher cash flows to achieve the same valuation.

[1]For example, the yield on a 10-year U.S. Treasury Bond.

The Risk-Free Rate is Increasing

Inflation has been the primary driver of higher rates with a myriad of new inputs making it less transitory than central bankers originally anticipated. Pent-up consumer demand and global supply chain disruptions were among the initial catalysts for higher prices. Now we can add stickier forms of inflation such as higher wages due to labor shortages and rent increases. War is typically inflationary, and while it is unknowable what the duration of the current crisis in Ukraine will be, it is reasonable to assume the spike in energy prices is not solely the result of the war but

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primarily the result of years of underinvestment in oil and gas production.

Two further complications are the increase in geo-political polarization, which may lead to resource nationalism around the supply of important commodities such as oil and gas, fertilizers, agriculture, rare earth, and industrial minerals to favored "alliance" states. As well as a growing shift toward de-globalization, which began several years ago and appears to be accelerating as re-shoring of industry, manufacturing, and supply chains gains popular and political support.   Since the great financial crisis we have lived in a world where deflation was the primary concern. This no longer appears to be the case. In the U.S. we are at the end of quantitative easing (QE) and heading toward quantitative tightening (QT). Yields across the curve are increasing and it may be one of the most impactful changes on asset pricing we have seen in recent memory.

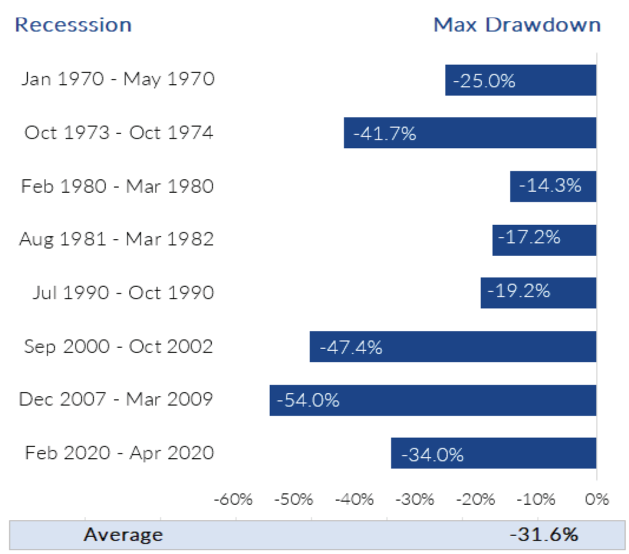
Equity Risk-Premiums are Elevated

There is a subjective element to equity risk premiums as investors calculate what return they require to invest their hard-earned capital. However, new to the equation is the Russia-Ukraine War, and the global ramifications of drawing other countries directly into the conflict. Warfare is no longer solely a physical confrontation. In response to Russia's aggression the U.S. has essentially "weaponized" the U.S. Dollar, freezing accounts, not just of the Russian Government so that it cannot access its foreign reserves, but also of private citizens with known Russian government affiliations. None of this is lost on the rest of the world which may now consider diversifying away from the world's dominant reserve currency. Ultimately, the impact could be meaningful and lasting, including the selling of U.S. Treasuries by foreign government to diversify their holdings, which would raise U.S. bond yields and weaken the U.S. Dollar. The bottom line is uncertainty has increased, which equates to higher risk premiums and lower valuations.

Recession Risks have Risen

Six months ago it was reasonable to assume the global economy was finally emerging from the pandemic as vaccine production increased and workers began to return to their jobs in greater numbers. The ensuing period of time has been tougher than anticipated. The Omicron variant further delayed economic recovery and the Russia-Ukraine war is reminding us of global fragilities. Recession risks and the threat of more modest corporate profits have subsequently increased. In the U.S. the combination of reduced fiscal spending, rising input costs, rising rates and the potential for tighter credit all indicate real and potential headwinds to corporate profits. To be clear, a U.S. recession does not appear imminent, but the risks are increasing and historically recessions equate to negative equity markets (Chart 1).

Max Drawdown during Major Recessions in the U.S.



Source: S&P 500 Total Return. Source Bloomberg. Chart 1

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Silver Linings

Still, there are reasons to be constructive. Inflation has been elevated for over a year and the base effect suggests we should begin to see year-over-year inflation rates decelerating. This, in combination with repairs to global supply chains, could help alleviate some concern and reduce inflation expectations. Additionally, the steepness of the short end of the Treasury yield curve suggests the market expects the Fed is prepared to rapidly raise interest rates, therefore any future path of increases that comes in lower or slower would likely be viewed positively. Interest rates would be higher than in 2020-2021, but still quite low by historical standards. This would assure equity investors that the discount rate applied to equity market valuations need not be punitive.

The war in Ukraine has demonstrated the importance of historically relevant institutions such as NATO, reinvigorating a complacent alliance and catalyzing the West to recommit to its shared goals and values. The unity and strength of the western world's reaction to Russia's invasion has also provided China important information relative to any potential designs, and the subsequent costs, it would bare to reunite Taiwan as part of "One China". A quick conclusion to the war could resolve several headwinds and would certainly improve market sentiment.

Positioning Portfolios

This leaves us with a few conclusions in an evolving and fluid market:

- Equity Valuations – should be lower than they have been recently, but still above historical averages. High valuation stocks will be more sensitive to changes in rates and risks.

- Quality – we favor high cash flow companies with competitive advantages that can self-finance their growth via superior balance sheets and business models.

- Fixed Income – our preference is to keep fixed income duration short and to remain underweight traditional fixed income. This has been beneficial over the last year, and we don't see the risk of recession being prominent yet.

- Diversifiers – investments that are truly uncorrelated to equities and fixed income will be valuable in the current environment, lowering portfolio risk with unique drivers of returns.

- Cash – we remain comfortable holding above average cash levels with the intent of redeploying the cash when the market offers opportunities to do so at attractive valuations.

It is important to remember that risks come and go, a key part of an investment strategy is to tune out the noise and focus on the long-term. We are reminded that we are living in a dynamic and evolving world with exciting opportunities emerging faster than ever before. Patience is, and will be, a virtue.