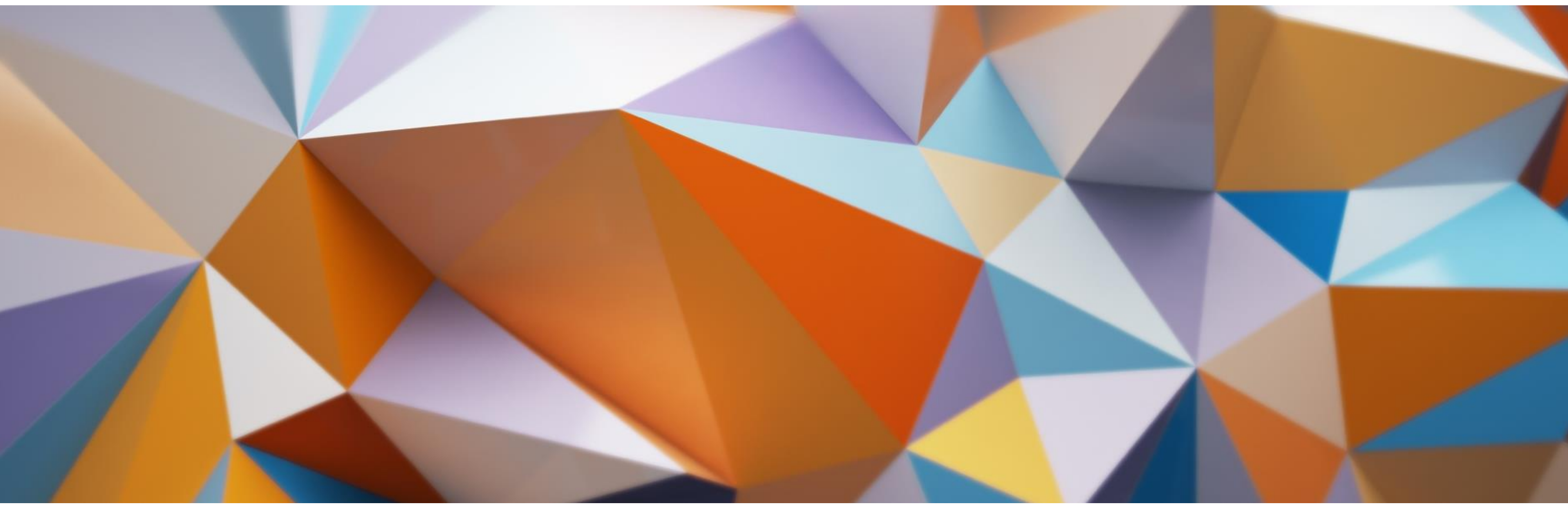
1Q22 Market Commentary
This Time is Different



The breakdown of the traditional 60% equity/40% bond portfolio turned into a painful reality for investors in 1Q22. This classic diversification mechanism backfired as both sides of the equation declined for the quarter. Outside of the Great Recession and associated credit collapse, this has happened in less than 5% of the quarters over the past 30 years. The devastating invasion of Russia into Ukraine, inflation rising at the fastest pace in 40 years, economic growth slowing and the Federal Reserve doing an about face on interest rate policy left investors with limited options to escape a negative total return to start 2022.

As we navigate through this interest rate paradigm shift, assess the impact of a prolonged war between Russia and Ukraine and accept a higher level of inflation than we have been accustomed to for decades, we acknowledge there are many questions to be answered. Most significantly, can the economy handle slower economic growth and an aggressive Fed tightening cycle or is a recession imminent? Does the current bull market have legs? Will bonds ever be a diversification tool again? In this outlook we will address some of the many questions that are at the forefront of investors' minds as we move through what is expected to be a highly volatile remainder of 2022.

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Past performance is not indicative of future returns

U.S. Economy – Still Fuel Left in the Fire

In 1Q22, the U.S. economy likely grew at the slowest quarterly pace **(Chart 1)** since the steep drop witnessed at the start of the pandemic (1Q and 2Q20). Ongoing supply chain disruptions, the lack of fiscal stimulus and surging costs on everything from food, energy and housing has contributed to the slowdown in economic growth. While a deceleration of growth in 1H22 was widely expected after the powerful recovery from the pandemic, the unabating inflation pressures are forcing the Fed to act more aggressively than previously expected.

Through recent rhetoric, it is clear the Fed will sacrifice economic growth in the near term to stifle consumer prices that are increasing at the fastest pace since the early 1980s. **(Chart 2 – next page).** This is a notable pivot from the ultra-accommodative Fed policy that we have been accustomed to. In addition, the raging war between Russia and Ukraine has disrupted the global food supply, hampered sentiment and is likely to result in near term economic pain for many European and emerging market countries. While downside risks to the trajectory of U.S. growth are clearly rising, we do not see a recession as imminent for several reasons including

- **Manufacturing:** Manufacturing as measured by the ISM Manufacturing Index has been slowing from its post pandemic peak but remains in expansion territory. In addition, the components within the index that are leading indicators for economic growth (e.g., production and new orders) are also supportive of a continuation of the expansion **(Chart 3 – next page).**

- **Interest rates to tighten but not tight enough for recession…yet:** Monetary policy that is too tight often led to economic recessions. While we expect the Fed to deliver the fastest increase in the benchmark rate since 1994 (the committee raised the fed funds rate 300 bps in 12 months between 1994-1995), long term real rates (considering inflation) are still in negative territory. Going back to all the recessions since 1969, the average real 10 YR Treasury yield in the 12 months leading up to a recession is ~3.0% **(Chart 4 – next page).**

Chart 1

U.S. Economic Growth to Slow

Estimates are using Bloomberg estimates as of April 20, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors

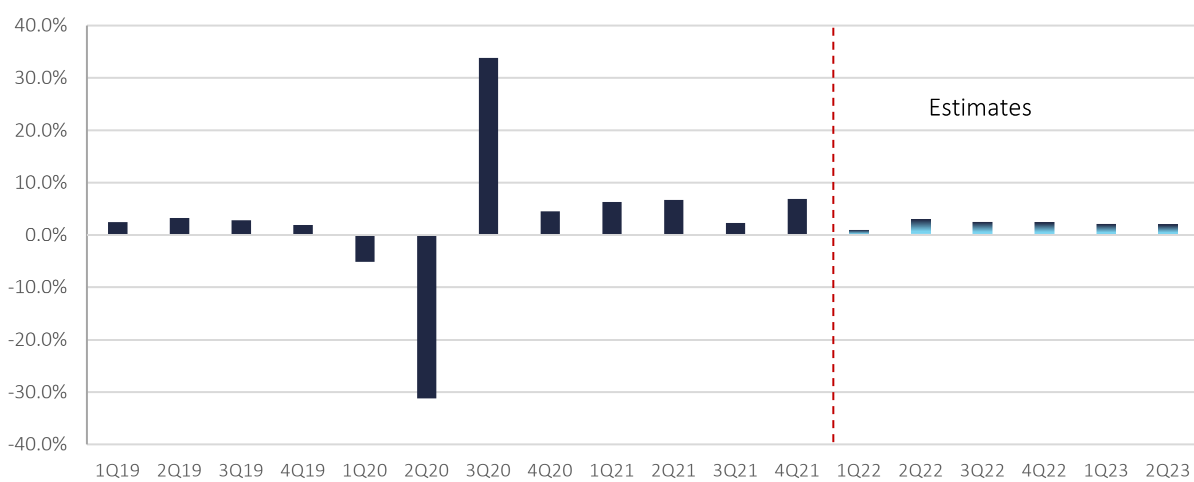


Chart 2

Inflation Growing at Multi-Decade Highs

Data is as of March 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 3

Manufacturing Slowing but Still Supportive of Growth

Data is as of March 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors

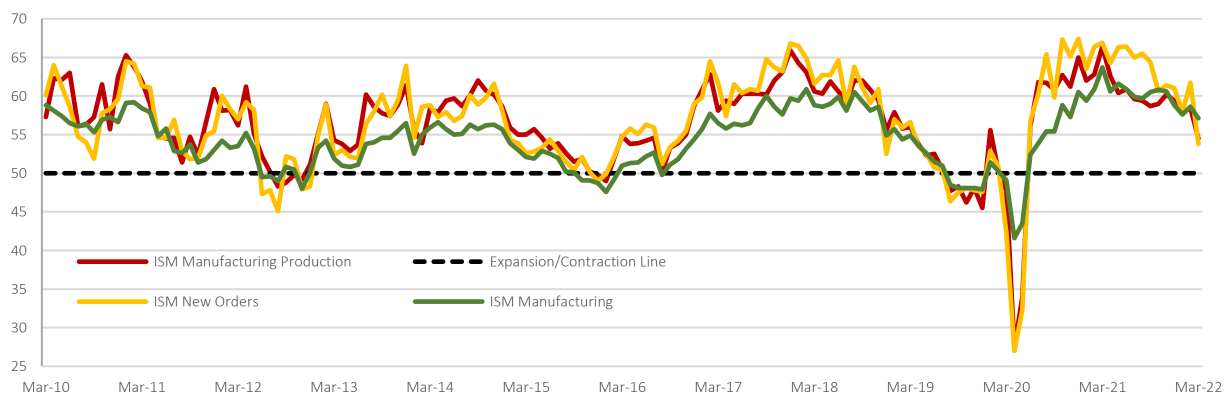


Chart 4

Interest Rates Rising but Not Tight… Yet

Data is as of March 2022 and using PCE Core (YoY) as the inflation indicator. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

- **Green shoots developing in the supply chain:** The supply chain has been a fundamental drag on economic activity. However, there are some signs that we may be turning a corner in the supply chain woes. Inventories in the manufacturing sector (as measured by the ISM Manufacturing Index) have been rising for three consecutive months. The backlog of manufacturing orders peaked in May 2021 and has been steadily declining. The congestion in the major U.S. ports is slowly improving. In addition, at the expense of GDP growth consumer demand is softening, especially in the goods sector which can help manufacturers try to catch up from the pandemic related pent-up demand

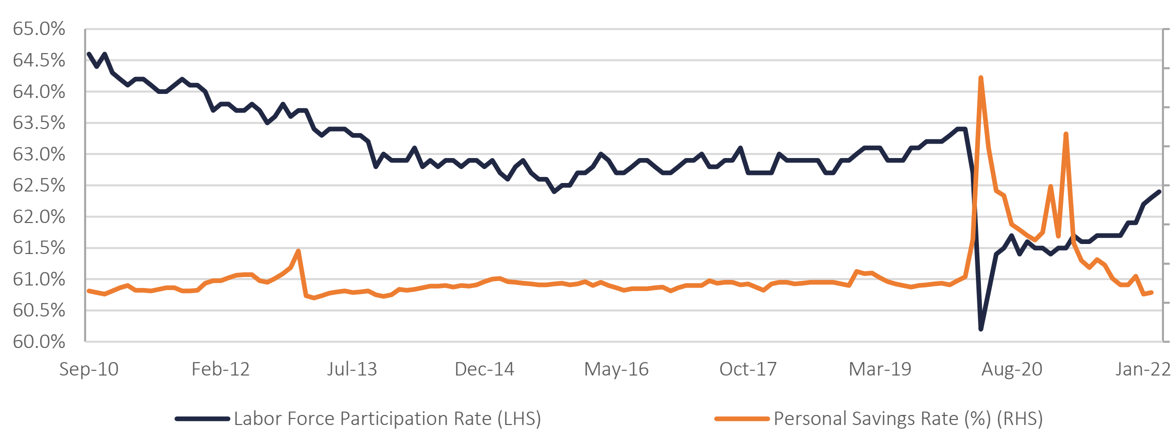
- **Americans coming back to work:** The labor market remains tight with more than 11 million job postings for less than 6 million Americans unemployed. However, Americans are starting to return to the labor force. With wages rising, fiscal stimulus fading, the cost of everyday necessities becoming burdensome, savings rates dwindling and COVID becoming less of a dangerous concern, the labor force participation rate has been steadily rising. (Chart 5). The rise in labor force participation has been broad based by age range, including some Americans coming out of retirement. This is positive for the consumer to withstand the current economic challenges but can also help business productivity.

As we navigate through the many economic challenges in 2022 and accept a higher level of inflation than we have seen in recent decades, we realize that the risk of a recession is rising. Since 1945, recessions occur every 4-5 years. However, prior to the long business cycles that we have been fortunate to experience since 1990, recessions occurred every 3-4 years. The ultimate length of the current economic cycle will be dependent on how aggressively the Fed will need to tighten monetary policy. We think 50 bps rate hikes at the next one or two meetings is likely as the Fed needs to catch up to the current level of inflation. As a result, select areas of the economy may suffer in the near term (e.g., housing, consumer). We will closely monitor many other economic indicators (e.g., real yields, manufacturing, capex spending, consumer health and confidence) to gauge the health and longevity of the current economic cycle.

Chart 5

Americans Being Driven Back to Workforce

Data is as of March 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



Global Equities – Looking at Areas that are Pricing in Elevated Uncertainty

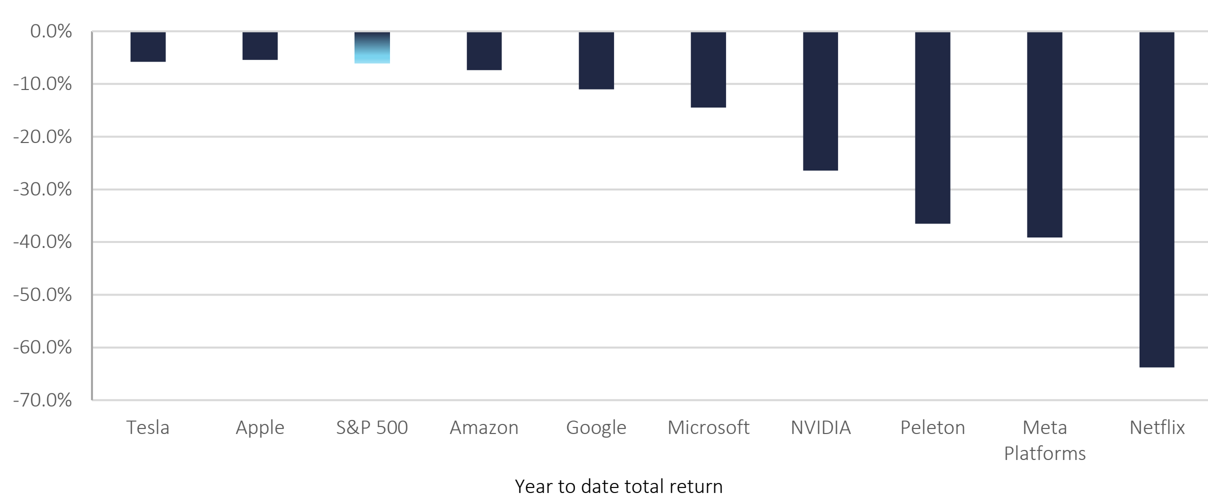
In 1Q22, global equity investors faced the somber truth that the Fed will no longer be providing extraordinarily easy money, supporting inflated valuations, and encouraging speculative investing. In addition, the world was reminded of an unsettling and unstable geopolitical environment. These one two punches for investors resulted in the MSCI AC World Index posting its worst one quarter decline since the start of the pandemic (1Q20) and sent many global indices sinking into bear market territory. While we expect a more challenging environment for global equities this year, we believe select areas of the global equity markets may already be reflecting the downside risks and current prices may be too pessimistic about upside potential. Some of our recommendations in the global equity market include:

- **Valuation correction may not be over for some:** The sharp correction in price to earnings multiples has been felt across most global equity indices as investors realize the decades low level of funding costs is coming to an end. In addition, investors are no longer willing to overpay for companies that may struggle in the unfamiliar interest rate and inflation paradigm. There is no better example than to see the massive repricing in some of the most beloved high growth stocks year to date. **(Chart 6).** While price to earnings multiples have fallen to more realistic levels, we would be cautious getting aggressive with large cap growth stocks and think there may still be some valuation correction to be seen. Instead, consider overweighting the U.S. value sectors that have pricing power (e.g., industrials, materials) and can benefit from higher interest rates (e.g., financials).

Chart 6

Repricing in Select Beloved Stocks

Total Return as of April 19, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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- **U.S. small and midcap – Finding value in the undervalued:** The underperformance of small and midcap stocks over the past year (compared to large cap) may be pricing in too pessimistic of an outlook for economic growth. While small and midcap stocks outperformed coming out of the pandemic, they are significantly underperforming large cap stocks over the past year and year to date. Current earnings estimates are looking for superior growth over the next year and estimates have been slashed along with the uncertain economic outlook which may be too pessimistic. **(Table 1 – next page).** In addition, historically small cap stocks tend to outperform large cap stocks in the 12 and 18 months after a Fed starts a tightening cycle.
- **International equities – Looking for a rebound:** Despite the heightened uncertainty about economic growth due to the Russia/Ukraine war and ensuing energy crisis we believe the underperformance of developed international equities is reflecting the likely slowdown and high recession probability for many European economies. Valuations compared to U.S. equities have been cheap even before the crisis but are now the cheapest on record. **(Chart 7 – next page)**. In addition, the ECB has decided to begin removing nontraditional monetary policy but is not acting nearly as aggressive as the Federal Reserve which could divert some funds from expensive U.S. sectors to international equities in search of value.

The weaker economic environment, geopolitical uncertainty and shifting of a decades-old interest rate environment is likely to keep volatility heightened in 2022. In addition, investors should be prepared to accept more muted returns this year as the earnings climate becomes more challenging. That does not mean we would sell out of our global equity exposure. Primarily because we still favor equities for the long-term over bonds. It does mean that selectivity and due diligence is important. We will continue to look at areas of the global equity markets that are unfairly penalized in periods of volatility and that may present good long term entry points.

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Chart 7

International Valuations Cheapest on Record Compared to U.S.

Data is as of April 18, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors

Table 1

Finding Value in the Undervalued

Data is most recent as of April 18, 2022. Source: Bloomberg Finance LP, FactSet, Verdence Capital Advisors.

U.S. Equity Index	1 Year Total Return	Change in NTM Earnings Estimate	NTM Earnings Growth Estimate
Large Cap Value	8.7%	3.5%	8.9%
Large Cap	8.0%	2.9%	9.9%
Mid Cap Value	4.2%	5.1%	14.9%
Large Cap Growth	2.8%	1.4%	12.3%
Small Cap Value	0.9%	2.9%	22.2%
Mid Cap	-3.8%	2.8%	17.5%
Small Cap	-8.7%	-0.9%	30.1%
Mid Cap Growth	-15.1%	-4.3%	28.7%
Small Cap Growth	-17.7%	-10.1%	61.8%

Fixed Income – A Seismic Shift in Monetary Policy

The Bloomberg Barclays Aggregate Index saw its worst one quarter decline since 1980 to start 2022 with nearly every sector of the fixed income market declining. **(Chart 8).** Unfortunately, we believe the remainder of 2022 will present further challenges to bond investors. The Fed's complete reversal of opinion on inflation and the pace of rate hikes is likely to leave investors with little to no total return in fixed income for the year. The sole purpose of fixed income will be for diversification purposes and as interest rates rise, we will look to see if there are modest income opportunities. Currently, we would consider the following exposure in fixed income.

- **Defensive in a rising rate environment:** The first quarter of 2022 saw a drastic repricing of interest rates that even impacted short term yields. In fact, the move in short term Treasuries (2YR yield) was the single largest one quarter move in yield seen since 1984. **(Chart 9 – Next page).** Markets are quick to reprice expectations and while we expect short term rates to continue to move higher, the dramatic shock in 1Q22 has likely priced in the expectation for more aggressive hikes in the upcoming quarters. We still think the best place to be in fixed income is short duration to mitigate the losses in the expected move higher in interest rates. In addition, we believe that floating rate notes offer an opportunity for bond investors as they are structured to offer a higher level of interest as interest rates rise.

- **Do not reach for yield…yet:** While higher yielding fixed income carries a lower duration given its high coupon, investment grade and high yield fixed income did not escape the selloff in 1Q22. While we do not see the credit environment deteriorating because of higher interest rates, the weakness illustrates how expensive these sectors had become in recent years. We will continue to monitor further weakness and assess the credit environment to see if there is opportunity to add yield to our fixed income portfolio. However, we expect ongoing volatility as we navigate through the upcoming Fed tightening cycle.

Chart 8

Fixed Income Fails to Diversify

Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

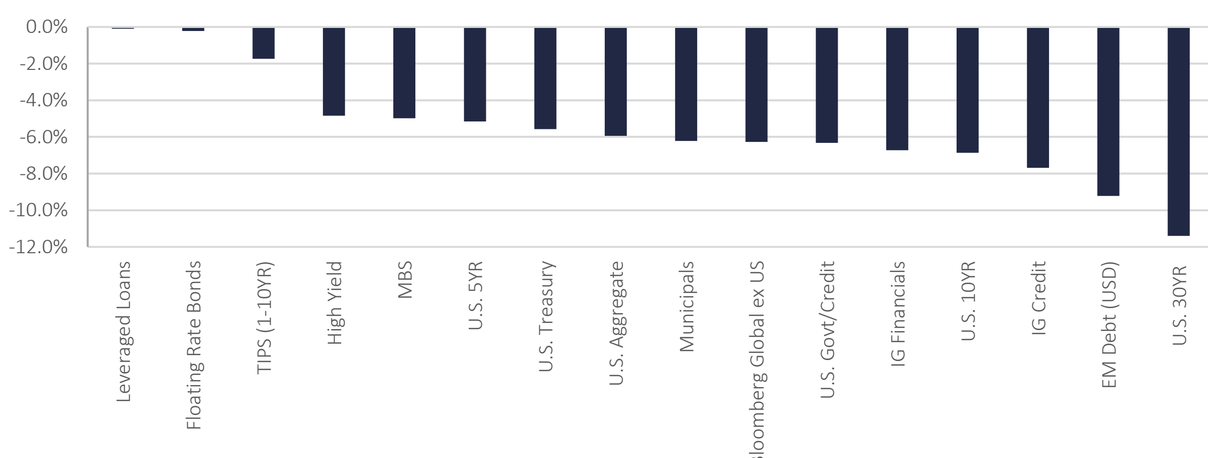

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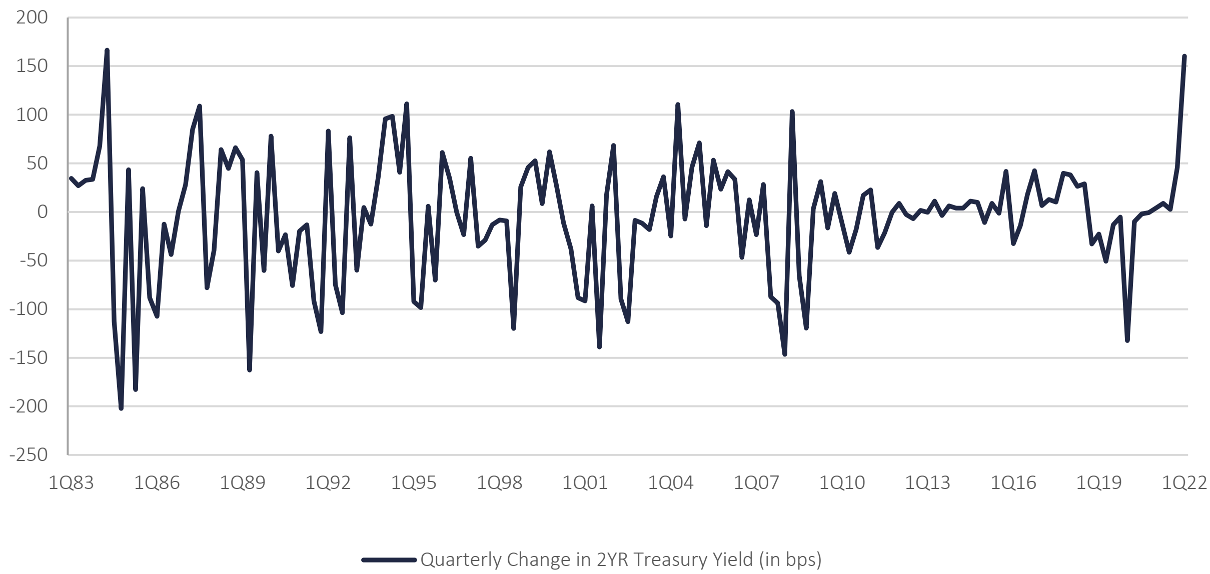
Chart 9

Sharp Repricing in Short Term Rates

Data is as of 1Q22. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



Alternatives – What to do When the Conventional Becomes Unexceptional

Unfortunately, for those investors focused on a strict 60% equity/40% fixed income portfolio, we believe returns will be challenging for the remainder of this year. Bond yields are still too low considering the inflation and economic environment and are likely to move higher. In addition, we expect the earnings and return environment to be muted for equities in 2022 as we navigate through the new interest rate paradigm. Those investors who were diversified with alternatives and real assets (including commodities) in their portfolios in 1Q22 were able to mitigate the losses seen in the traditional 60% equity/40% bond portfolio. Commodities posted their best one quarter rally since 3Q90 which was another quarter with a geopolitical event (i.e., Operation Desert Storm). **(Chart 10)**. In addition, real assets (e.g., real estate) also posted positive gains as investors sought ways to protect against inflation.

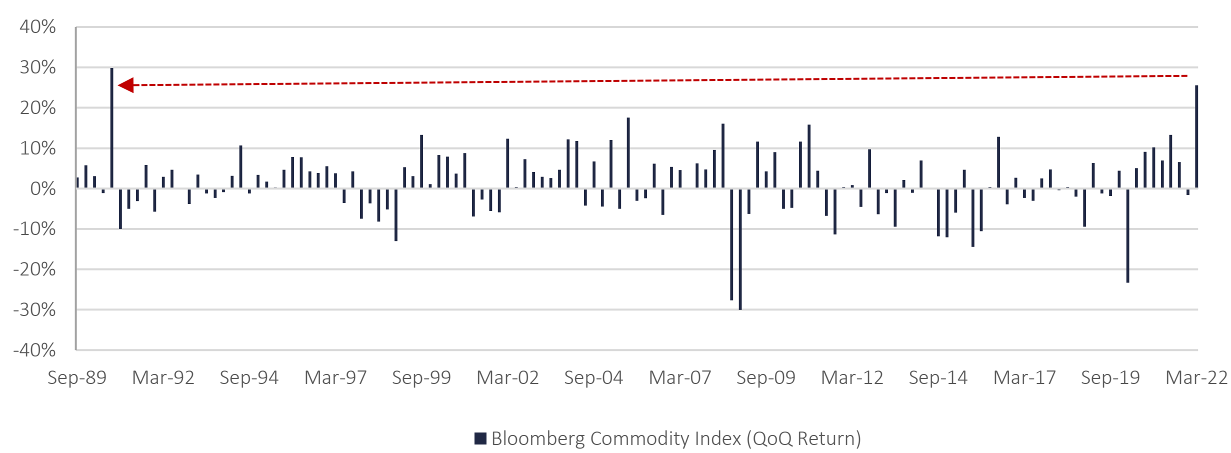
While commodity prices may remain elevated due to food constraints with a prolonged Russia/Ukraine war and ongoing supply/demand imbalance in energy, we do not expect raw commodities investing to deliver the same quarterly returns as seen in 1Q22. Instead, we would prefer looking at other alternative investments, especially in the private space as valuations are relatively more attractive, investments are less correlated to traditional asset classes and are not subject to the daily volatility seen in the public markets. Sectors in the private alternative space that we favor for qualified investors include:

- **Real estate** remains in short supply and significant investments will need to be made to keep up with demand.
- **Infrastructure** investment has proven to be a necessity during the supply chain crisis and search for energy independence.
- **Credit** in the public space continues to look expensive with spreads near historically low levels. However, private credit appears to offer better yield potential.
- **Hedge Funds**, especially low volatility hedge funds, can offer another layer of diversification, add return potential, and serve as a hedge for investors public market equity exposure.

Chart 10

Commodities Benefit from Geopolitical Event

Data is as of 1Q22. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Bottom Line:

The first quarter was a challenging and extraordinary period for all to absorb. The humanitarian crisis in Ukraine has been appalling to witness and from an investment perspective the losses across nearly all asset classes were startling. We realize that the economic outlook is becoming more challenging than we expected coming into 2022 and recession risks are growing. We will continuously monitor portfolios for fundamental changes that should be made but also acknowledge that pullbacks and even recessions, as unpleasant as they may be, are a normal part of an investment and economic cycle.

At times of heightened volatility and uncertainty, it is also important to assess whether investments are properly balancing the risks versus the reward. Evaluating whether the pendulum of pessimism has swung too far to the negative side and may already be reflecting the complete downside risk to an investment is important. We are seeing this overwhelming level of pessimism in select areas of the global equity market and will continue to assess pullbacks as potential long-term buying opportunities. We are confident that active management is the best way to benefit in this highly abnormal and volatile time and that having dry powder is not a bad thing to take advantage of opportunities as they arise.

As always, if you have any questions about our perspective, please do not hesitate to reach out to your advisor.

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