The Capital Markets

For the last two years, the global pandemic has forced investors to operate in an environment with limited visibility. Unfortunately, just as the world was showing signs of moving beyond COVID-19, investors were hit with yet another exogenous shock: Russia's invasion of Ukraine. Aside from the tragic humanitarian impact of the conflict in Ukraine, this event has also introduced fresh uncertainty to the outlook for financial markets and the economy.

The war in Ukraine has reverberated across the rest of the world, where surging commodity prices have stirred echoes of the 1973 oil embargo on the U.S. Complicating matters further is the fact that monetary policy, which was a primary driver of returns over the last two years, is now turning more restrictive as policymakers look to stem persistently elevated inflation.

Of course, every crisis is different, and today's environment of high inflation and aggressive policy tightening is taking place against a backdrop of a post-pandemic rebound supported by strong consumer balance sheets. Although we maintain a favorable outlook for growth in the U.S., there is no denying that risks to the economy have increased in recent months.

We expect market volatility to continue over the short term as investors react to the latest headlines surrounding the events in Ukraine and acclimate to a higher interest rate environment. However, volatility is nothing new, and we encourage our clients to remain focused on their long-term portfolio strategy as we make our way through this period of uncertainty.

In this quarterly update, we will provide our assessment of the economy and evaluate the risks and opportunities facing investors in the months ahead. Finally, we will share how we are allocating investment portfolios to navigate the changing landscape.

Newsletter Highlights:

Recent events in Ukraine have put additional strain on the fragile economic recovery, but the near-term risk of a recession remains low.

We maintain a favorable view on equities but expect additional volatility in the months ahead as investors navigate the changing landscape

Bonds post worst quearterly returns since 1980

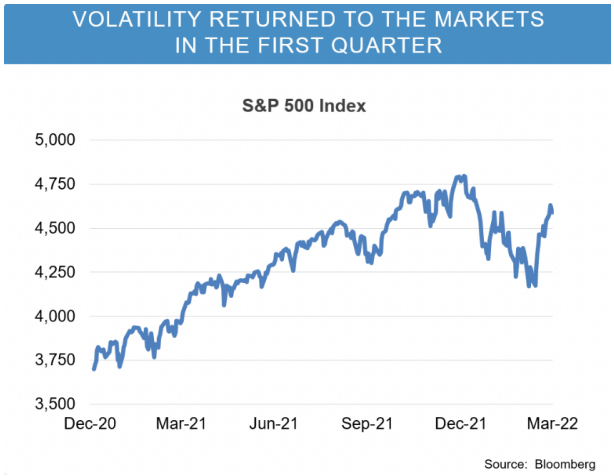
War In Ukraine Adds to Inflation Concerns

The Federal Reserve has responded to increasing inflationary pressures by foreshadowing more aggressive policy tightening in the months ahead

Volatility Returns to Stocks in the First Quarter

Elevated uncertainty did little to hinder equity performance over the last two years, thanks in large part to unprecedented policy measures designed to cushion the economic blow of the COVID-19 pandemic. In fact, the S&P 500 posted 68 record closing highs in 2021 alone (the most since 1995).

Of course, all good things must come to an end, and it did not take long for equities to return to more normal behavior as 2022 got underway. Following another record close on January 3, volatility returned to the stock market as increasingly hawkish comments from the Federal Reserve signaled the central bank's commitment to rein in inflation by unwinding its accommodative pandemic-era policies. Meanwhile, Russia's invasion of Ukraine in late February only added to investor anxiety, ultimately tipping the broad index into correction territory (defined as a 10% decline from the peak level) as the conflict continued to escalate.

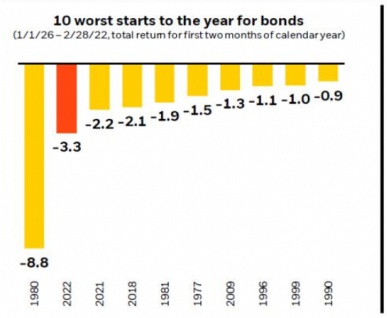


After falling as much as 13% from the record high set in early January, the market would eventually pare its losses to end the quarter with a decline of 5%. Of course, as is often the case, looking at one measure of market performance only tells part of the story.

For example, the clear leader in the first quarter was the Energy sector, which gained approx 38% as geopolitical events drove oil prices to their highest level since 2014. Meanwhile, the tech-heavy Nasdaq Composite shed 9% (after declining more than 20%) as investors took gains on high-flying stocks and sought refuge in more dividend-oriented companies.

Bonds Post Worst Quarterly Return Since 1980

There is no sugarcoating the disappointing performance of bonds in the first three months of the year. In fact, the asset class that investors rely on for stability declined by nearly 6%, marking the worst quarterly performance since 1980. Unfortunately, even though we maintain an underweight allocation to fixed income as well as a bias to shorter-duration securities (to reduce interest rate sensitivity), there were few places for investors to hide as rising inflation expectations drove a surge in yields across the bond market.



Returns after each "worst start"
(1/1/1926 - 2/28/22)

Year	First 2 months	Next 10 months
1980	-8.8	12.6
2022	-3.3	?
2021	-2.2	0.6
2018	-2.1	2.1
1981	-1.9	8.3
1977	-1.5	4.7
2009	-1.3	7.3
1996	-1.1	4.8
1999	-1.0	0.2
1990	-0.9	9.9
Avg.	-2.5	5.6

Source: Morningstar as of 2/28/22. U.S. bonds represented by the IA SBBI US Gov IT Index before 1/3/89 and the Bloomberg U.S.Agg Bond TR Index after 1/3/89. Past performance does not guarantee or indicate future results. Index performance is illustrative purposes only. You cannot invest directly in the index.

Although bonds could remain challenging going forward, now that the market has caught up to the current inflation and policy environment, we expect future rate moves to be more orderly.

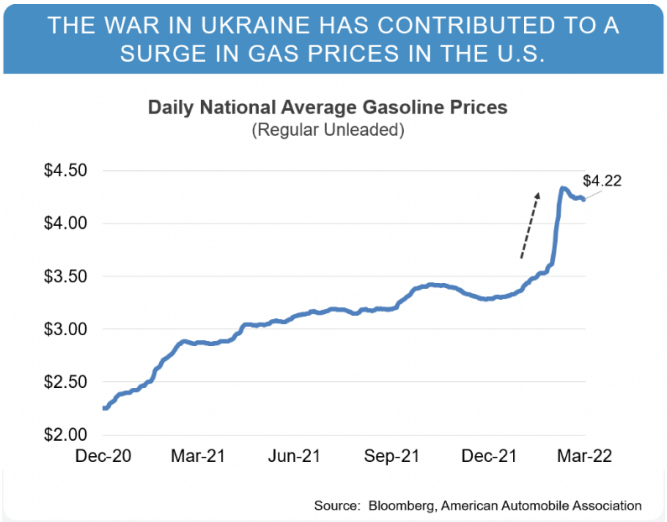
War In Ukraine Adds to Inflation Concerns

Where financial markets go from here will depend in large part on how and when the situation in Ukraine is resolved. With the economy still reeling from the effects of the global supply chain disruption, the geopolitical crisis has put additional strain on what was already a fragile economic recovery.

Although Russia accounts for just three percent of the global economy, investors in recent weeks have become painfully aware of just how much the world relies on Russian exports to meet demand. Perhaps nowhere is this dependency more apparent than in global energy markets, where Russia supplies 11% of the world's oil and 17% of its natural gas. It is therefore not surprising to see that following the invasion on February 24, prices for oil surged as much as 35%. Meanwhile, Europe, which receives 40% of its gas imports from Russia, saw natural gas prices soar more than 60% at the height of the tension.

For households in the U.S., there is no escaping the recent spike in energy prices, which has resulted in the highest gasoline prices in history. In fact, the nationwide average price per gallon of fuel ended the quarter at $4.22 (a bargain to those of us in California), representing a nearly 30% jump from the beginning of the year.

Higher prices at the pump represent a cruel irony for many Americans – now that the nation has taken meaningful steps towards returning to normal following the two-year pandemic, it has become prohibitively expensive to do so. Not surprisingly, the higher costs of living are reflected in recent consumer sentiment data, which recently declined to the lowest level in more than ten years.



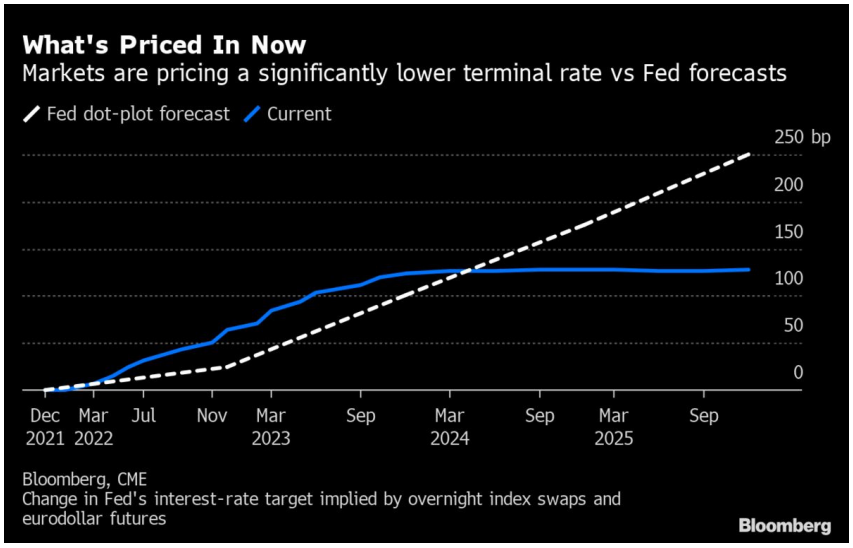
We have lift off: Fed Hikes Rates First Time Since 2018

The long-awaited interest rate rising cycle commenced with the Fed increasing interest rates 25 basis points (bps) at their March meeting and signaling further rate rises for 2022 and 2023. Going into 2022, we believed the Fed was likely to be a key source of market volatility as they sought to get ahead of the curve. However, Russia's invasion of Ukraine made the market more sensitive to economic growth expectations and put the Fed in a challenging position where they've needed to increase transparency and reduce the potential for surprises. However, as the initial invasion shock wore off, the language from the Fed became stronger with an increased focus on regaining control over inflation.

All historical comparisons aside, there is no denying that the latest supply shock could not have come at a worse time for U.S. policymakers. Prior to the Russian invasion, Jerome Powell and his colleagues at the Fed signaled their commitment to fighting inflation by telegraphing a series of gradual interest rate hikes at their upcoming policy meetings.

After seeing price levels rise 7.9% over the prior year in February (the most since 1982), many now fear that inflation could get worse before it gets better. As a result, at their policy meeting in March, the Fed responded to recent developments by making a series of announcements that highlighted the need for more aggressive action.

In addition to raising rates (by one-quarter of one percent) for the first time since 2018, policymakers shared forward projections that implied the potential for an additional six rate hikes this year. Meanwhile, Chairman Powell announced that the central bank could begin reducing the size of its $9 trillion dollar balance sheet as soon as May to further unwind pandemic-era support.



Overall, we expect an aggressive Fed interest rate raising cycle, with policy rates rising to 2-3% by year end.

Keeping it "Real"

So where does this leave investors heading into the second quarter? In an environment with persistently high inflation, it is becoming increasingly important to focus on "real," or inflation-adjusted returns. Therefore, within balanced portfolios, we remain meaningfully underweighting our long-term target allocations to fixed income. On the other hand, despite expectations for more normal levels of volatility, equities remain an attractive investment for long-term investors.

Amid the uncertainty surrounding near-term inflation and economic growth in the U.S., we are encouraged to see that analyst projections for corporate earnings remain strong. The financial sector, and banks in particular benefit from higher long-term yields.

In addition, following a record amount of share repurchases last year, research from Goldman Sachs suggests buybacks could rise another 12% to $1 trillion in 2022, which speaks to the strength of corporate balance sheets as well as management's confidence in their underlying businesses.

Meanwhile, as Fed tightening gets underway, it is important to highlight that higher policy rates alone do not pose a near-term risk to stocks. In fact, stocks have averaged annual gains of more than 9% during the last twelve rate hike cycles.

The Financial sector, and banks, in particular, benefit from higher long-term yields. This sector held up well as yields rose prior to the invasion. As the focus shifted to economic growth concerns, this sector faced some headwinds. But stronger language from Fed and the rapid movement in Treasury yields propelled financials to a strong end to the quarter.

Patients is a Virtue...

With the accommodative policies of the last two years set to reverse, it is fair to assume that the days of uninterrupted gains in the stock market are over. In addition, although equities have now recovered to levels that prevailed prior to the invasion of Ukraine, the war's impact on the global economy and financial markets is likely to last beyond any announcement of a ceasefire.

Ultimately, it is important to remember that volatility is a normal part of any market cycle. In the weeks and months ahead, we will remain disciplined but nimble as we navigate the changing landscape. As always, any portfolio changes we make will be based on data and research rather than market noise and headlines.

If you have any concerns about your own portfolio, we encourage you to review your financial plan with your advisor.

"The Stock market is a device to transfer money from the impatient to the patient"

Warren Buffet...