Independence Asset Advisors

Market Reflections

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MarketMatters

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To say this quarter has been unusual would be an understatement. Before the start of 2022, we cautioned that the easy money had been made, considering about 20%+ annual equity returns over the last three years. Although there were warnings to expect a U.S. stock market correction, we did not expect this kind of volatility:

- Across equities and fixed income markets broadly, the least-bad performance across U.S. assets were declines of 4.9% in the S&P 500 and high yield bonds after equities suffered their worst January since 2009.
- They were followed by a 5.6% decline in Treasuries and 7.8% slide in investment grade corporate bonds.
- Inflation accelerated even further with oil up 80% at one point. Many other commodities were even worse.
- 70% of the Nasdaq and Russell 2000 stocks were in bear markets (down 20%). 50% of Nasdaq (growth) stocks were down more than 40%. 25% of Nasdaq stocks were down over 75%.
- The quarter ended with the 10 year / 2 year Treasury yield flat (inverted intraday) and warning a recession is increasingly possible. 2-year Treasury yields spiked from 0.73% to 2.35%…in just 3 months!

This set of circumstances would typically lead one to believe stocks were crushed during the quarter. They were, but then staged a massive March rally, leaving the S&P to only be down ~5%. Growth suffered while Value handily outperformed. The Russell 1000 Value Index was flat, while the Growth index dropped 9%. Quite the contrast from the past decade, but well within the range of normal annual pullbacks.

These will be the worst quarterly returns in fixed income in decades. The 2-year yield tripled during the quarter, rising 155+ basis points for the largest rise since 1984. The largest Core bond ETF, iShares Core U.S. Aggregate Bond, was down over 6% - worse than many stock indices. High yield bonds held up with high-quality issuers, which is a real positive. We would worry more about a recession if high yield bond spreads were significantly widening due to bankruptcy or default fears.

With all of this as prelude, this issue of MarketMatters will focus on three key issues facing investors today:

1. Inflation;
2. The war in Ukraine; and
3. Recession risk.

We hope you find these articles interesting and informative.

KEY TAKEAWAYS

- With inflation at a 40-year high, markets are pricing in an additional 180 basis points of tightening in 2022, implying an increase of 0.50% at one of the upcoming meetings.
- We are unlikely to see a U.S. economic recession in 2022, but the risk is higher by late 2023 or early 2024.
- The War in Ukraine has shocked commodities markets and could cause higher inflation to persist, raising recessionary pressures on Europe.

INFLATION

"There is an obvious need to move expeditiously to return the stance of monetary policy to a more neutral level, and then to move to more restrictive levels if that is what is required to restore price stability."

These were comments made by Federal Reserve Chair Jerome Powell less than a week after the FOMC elected to lift interest rates by 0.25%, at which time it also issued a projection that it intended to raise rates at each of the remaining six meetings in 2022. The rationale behind the Fed's decision to raise interest rates is to moderate high inflation, with the Consumer Price Index (CPI) hitting a four-decade high of 7.9% in February. By raising interest rates, the Fed makes it more expensive for consumers to get mortgages, auto loans, and credit card loans. If done properly, the Fed's tightening will result in a "soft landing" for the U.S. economy, whereby inflation is controlled, but rising interest rates do not result in a recession.

While the U.S. economy is currently strong, uncertainties including Russia's war with Ukraine and a new round of Covid-19 lockdowns in China stand to exacerbate price pressures on energy and goods. This could force the Fed to take more aggressive action to slow the overheating economy and could result in an unfavorable "hard landing," more commonly known as a recession.

With the Fed seemingly intent to slow the U.S. economy, many investors are now asking the question, how could higher interest rates affect my investment portfolio returns?

	50-yr. avg.	Jan. 2022	Feb. 2022
Headline CPI	3.9%	7.5%	7.9%
Core CPI	3.8%	6.0%	6.4%
Food CPI	4.0%	7.0%	7.9%
Energy CPI	4.8%	27.0%	25.7%
Headline PCE deflator	3.4%	6.1%	-
Core PCE deflator	3.3%	5.2%	-

Source: JP Morgan Guide to the Markets

Sources: www.federalreserve.com, JP Morgan

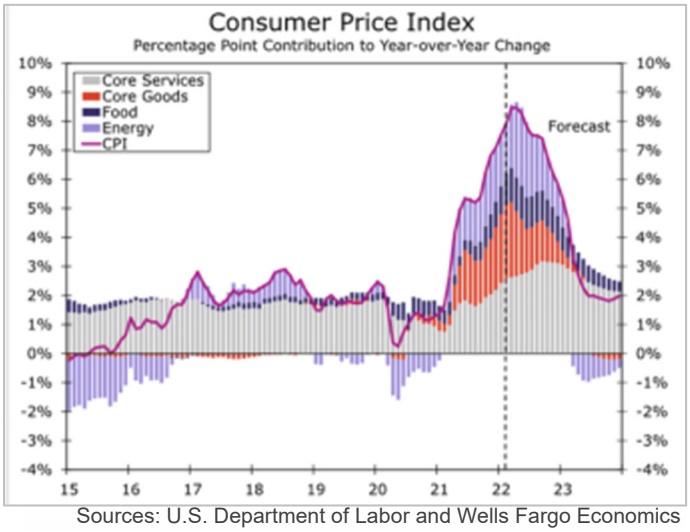
While no two cycles are the same, in prior Fed tightening cycles, the S&P 500 Index has usually outperformed 10-year government bonds over 1-, 2- and 3-year periods. In 16 tightening cycles since WW2, stocks generated positive returns in 81% of 1-year periods, 87% of 2-year periods and 81% of 3-year periods. On average, stocks have almost always outperformed in the years following the start of a tightening cycle, but persistent inflationary pressures are a risk. In spite of the overall favorable performance of stocks, they have not had such an impressive hit rate in the four cycles with the highest initial inflation rate, underperforming 50% of the time over the 1-year period. That said, stocks still outperformed bonds in 75% of the 2-year periods and 100% of the 3-year periods. The takeaway? Stay invested. Historically speaking, investors with balanced allocations that stayed the course during the highest inflationary periods would have gained on average 0.7%, 3.1% and 7.8%, over the 1-, 2- and 3-years periods following the start of a rate hike cycle.

	1-year forward		2-years forward		3-years forward	
Fed Tightening Period	**10-Year UST**	**S&P 500**	**10-Year UST**	**S&P 500**	**10-Year UST**	**S&P 500**
June 1947 - April 1953	-0.7	16.2	1.6	2.3	1.4	11.8
June 1954 - October 1957	-0.6	46.7	0.3	32.1	-0.7	22.2
May 1958 - November 1959	-6.8	37.6	-1.4	16.3	2.0	18.6
July 1961 - November 1966	3.1	-10.0	3.7	5.1	3.4	11.0
July 1967 - August 1969	3.9	6.4	0.3	1.5	0.9	-3.1
March 1971 -August 1971	1.8	10.2	1.8	8.6	1.9	0.9
February 1972 - September 1973	1.9	7.8	3.1	-2.0	3.5	-5.1
February 1974 - July 1974	4.5	-11.1	5.2	6.4	6.9	5.6
January 1977 - May 1980	3.6	-8.1	2.5	4.1	-0.2	9.4
July 1980 - June 1981	-11.8	13.0	4.0	-1.0	11.0	16.0
February 1983 -August 1984	-0.6	10.8	6.5	15.7	17.6	20.5
March 1988 - March 1989	4.0	18.1	8.7	18.7	9.8	17.3
December 1993 - April 1995	-7.9	1.3	7.0	18.1	4.7	19.7
January 1999 - July 2000	-9.5	10.3	2.6	4.6	3.2	-2.8
June 2004 - July 2006	9.7	6.3	1.9	7.5	3.0	11.7
November 2015 - January 2019	-0.3	8.1	0.7	15.2	-0.4	12.2
Average	**-0.4**	**10.2**	**3.0**	**9.6**	**4.2**	**10.4**
Average - High Inflation	**-1.1**	**2.5**	**3.3**	**2.9**	**4.8**	**10.7**
Average - Low Inflation	**-1.8**	**13.8**	**1.8**	**14.2**	**1.4**	**10.7**

Source: GW&K Investment Management

Looking ahead, we should expect the sanctions on Russian oil to mean that energy prices will remain elevated, which could push headline inflation above 8% in March. But we expect inflation to start coming down during the second half of the year, as energy inflation and inflation in categories that saw intense shortages last year is expected to decline as we reach the anniversary of last spring's big increases. Used motor vehicle prices have already begun to decline, and there are broader signs of easing shortages, with the backlog of container ships waiting at U.S. ports falling to a nine-month low.

That should reduce some of the pressure on the Fed to tighten monetary policy aggressively later in the year, as should the recently announced release of 180 million barrels of crude oil, which is being introduced to the market from the U.S. strategic petroleum reserve over the next six months. Recent inflation has been driven by energy and goods (see CPI table), which might suggest transitory inflation. However, with the more cyclically-driven categories of inflation still rising, economists seem to agree that the rate hikes that kicked off in March may need to continue well into next year, with rates reaching 2.75% to 3.25%, or higher.



Sources: U.S. Department of Labor and Wells Fargo Economics

Sources: GW&K Investment Management, Capital Economics, U.S. Department of Labor

KEY INSIGHTS:

- The conflict persists with few glimmers of hope. Little progress has been made in peace negotiations.
- Sanctions have had a steep economic impact on Russia, but have also damaged European economies.
- Energy and food prices have increased steeply. Commodities markets are likely to remain volatile.
- The War's effects on inflation could be persistent. The Fed is paying attention.
- Eyes are on Europe to determine how far sanctions will go and what its near-term economic future will look like.

Introduction:

On February 24th Russia invaded Ukraine. The regime has not specified a credible reason to justify the invasion, though the current accepted motivation is Vladimir Putin's desire to decapitate the Ukrainian government and install a puppet regime loyal to Moscow. Ukraine has become a democratic, West-leaning nation since the dissolution of the USSR in 1986, and its desire for inclusion in bodies such as NATO and the EU have increasingly angered the Russian state.

It is estimated that thousands of Russian and Ukrainian troops have been killed, along with many more thousands of civilians. Russia's relentless targeting of Ukrainian civilians has been deemed War Crimes. The battle has caused a mass migration out of Ukraine, consisting mostly of women, children and the elderly. Ten million people in total have been displaced, internally and externally, with 4 million having emigrated and most of the rest moving to Ukraine's western regions.

Ukraine has proven to be a resilient adversary, with a significant portion of the population taking up arms and fighting for their homeland. The Russian military are in control of only one major city, Kherson, though their brutal assault has also reduced most of Mariupol to rubble. The capital of Kyiv remains in Ukrainian control, and Ukraine's president, Volodymyr Zelensky, remains in power. Russia has abandoned its efforts to take Kyiv and is regrouping to focus on control of eastern Ukraine.

Sanctions:

In response to the Russian invasion, the U.S., Britain, Europe, Japan, Australia, Taiwan, and Switzerland, among others, have levied heavy sanctions on Russia with the intent to isolate the country from the rest of the world financially and make Russia suffer maximal economic consequences for the War. Some of the most prominent of these sanctions are listed below:

- Banking: Some Russian banks' access to the SWIFT international payment system is blocked, cutting them off from processing international monetary transactions. Nearly all of Russia's major organizations have been blocked from trade with the West. Assets of Russian banks held overseas in many countries, including the U.S., have been frozen.
- Divestment: Corporations and Sovereign Wealth Funds are disowning or selling their Russian assets. Many companies have discontinued operations in Russia.
- Energy: The U.S. has banned Russian oil and energy imports; Canada has instituted a similar ban. The E.U. has pledged to reduce its dependence on Russian energy as expeditiously as possible.
- Other Imports and Exports: The E.U., U.S. and other democratic countries have banned specified commodities and goods from Russia. Several countries have also banned exports of strategic goods to Russia.
- Individuals: Personal assets of wealthy Russian Oligarchs have been frozen or seized in many countries.
- Airspace and Travel: Russian aircraft have been banned from U.S., E.U. and Canadian airspace. Travel bans on Russian citizens have also been implemented.

Influence on Inflation and the Global Economy:

The impact of sanctions has been apparent. Russia's currency, the Ruble, initially lost almost half of its value, recovering only with significant Russian government intervention. Corporate divestment and sanctions together have caused significant inflation, economic decline and recession in the country, which is unlikely to reverse in the near-term. Russia's second largest trading partner after Europe, China, has not curtailed any financial or trade arrangements. Importantly, economic sanctions are a road block rather than an impervious barrier. The longer the conflict continues, the more ways Russia will find to evade them, though it will be expensive and circuitous to do so.

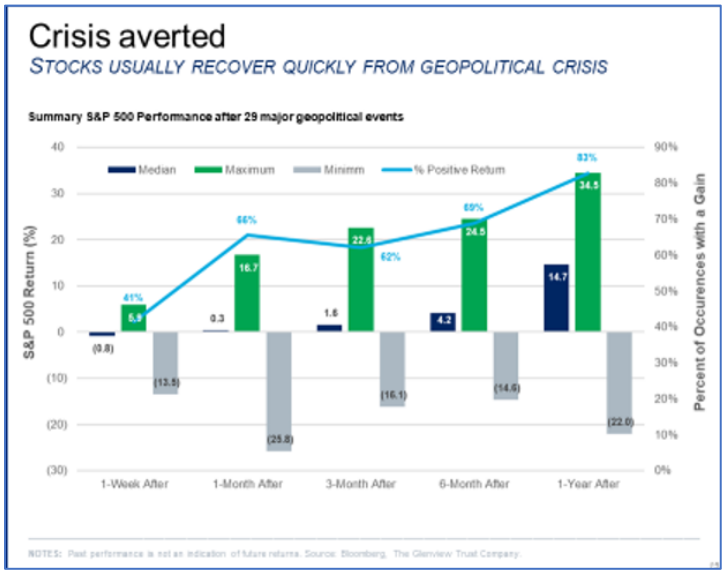
Russians aren't the only ones seeing eye-watering inflation due to sanctions- the West is also imperiled. Since the beginning of the war, the Brent crude global oil benchmark has gone from $90/barrel to a high of $139, settling back down in the 1-tens or 1-teens for an overall increase of ~30%. Other commodities that have seen significant inflationary impacts include natural gas, coal, aluminum, wood, and wheat. Aside from high cereal prices, fertilizer is at an all-time high due to high gas prices and Russia's (the world's top supplier of many fertilizers) ban on exports, causing other crop prices to increase. The rise in raw

commodity prices and shortages of crops could also lead to food shortages and global instability caused by hunger in developing nations.

Commodities aren't the only goods seeing inflationary impacts. Intermediate goods produced by Ukraine and Russia that are now unavailable are also causing supply shortages. Wire harnesses for new Volkswagen and BMW cars, for instance, were curtailed in supply due to a Ukrainian plant being out of commission. Semi-finished iron or steel goods and machine parts were other popular Russian exports. Supply chain disruptions and high shipping costs are once again prominent economic hurdles. These ripple effects will only cause the recent inflationary trends in the economy to persist. U.S. inflation year-over-year was 7.9% as of February 28th, up from 7.5% the month before. February numbers didn't include the surge in energy and other costs after the start of the war. At the beginning of the year, analysts expected inflation to peak in March and end the year at a lower value compared to 2021 (though still well above the target range). Guidance at the last FOMC meeting on March 16th forecasted U.S. inflation at around 4.3% for calendar year 2022, declining to 2.7% in 2023. The War in Europe could potentially stretch those expectations.

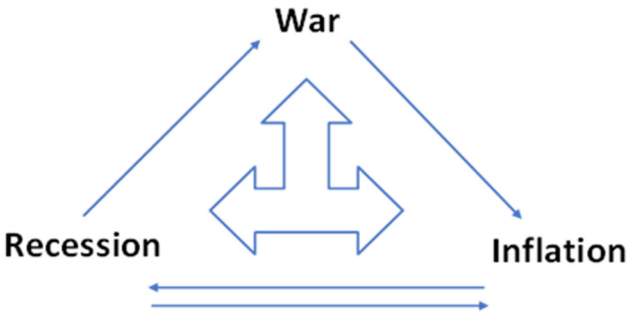
Portfolio Risk Factors:

First Order: While IAA's client portfolios have either minute or zero exposure to Russian currency and/or Russian companies, some portfolios will experience more direct effects of the sanctions levied against Russia. Exposure to commodities like oil and natural gas will buoy client portfolios, but other effects of the crisis will most likely be indirect and negative in nature. Exposure to metals is expected to continue to be volatile. Western companies that have ended their operations in Russia may lose revenue, and supply chain issues stemming from component production difficulties and shipping interruptions may harm valuations.

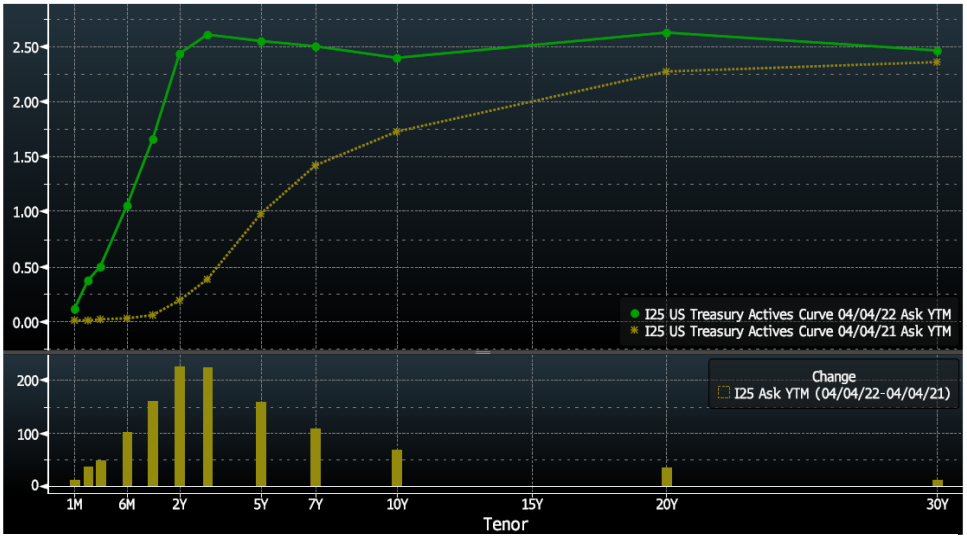


Second Order: International stocks have already suffered significant losses since the war began. Developed economies in Europe that were expected to make a strong post-Covid recovery are now contending with skyrocketing energy and food prices and a humanitarian crisis the nature of which hasn't been seen since World War II. Year-to-Date, the broad international index has lost +5%.

Third Order: Equities markets have mostly recovered from the initial shock of the invasion. Historically, stock markets have shown a resiliency in the face of geopolitical crises. They are, however, at the mercy of the global ripple effects that these crises create. Higher-than-previously-forecasted inflation in conjunction with monetary tightening is the main threat to U.S. stocks. Supply chain disruptions, higher shipping and raw materials costs, and higher labor costs are not auspicious for corporate profits. With U.S. economic growth projected to significantly moderate this year and the Fed taking a hawkish stance on monetary policy, these factors could have a more critical impact than the supply chain and inflationary pressures faced in 2021. Persistent inflation and supply chain issues also threaten to cause Demand Destruction, where consumers permanently reduce their purchases of certain products due to high prices or unavailability. Often associated with commodities like oil, coal, or gas, consumers' behavioral changes can materialize in a more widespread manner when spending on goods and services exhibits a sustained decline in response to affordability inflection points- e.g., substituting staycations for travel or inferior goods for luxury items. This could more quickly shift the economic picture from the higher-growth, post-covid recovery to a repressed or stagnant period. If energy prices continue to climb steeply in Europe, possibly from a more concerted embargo of Russian oil and gas, there is a further threat that the Continent could sink into a prolonged recessionary period. This would not only cause international stocks to sink further, it would tangentially lead to a downward effect on domestic stocks from the European contraction. Keep reading for more detail on recession risk in the next section.



Historically, economists have looked to the Treasury yield curve as one of several leading indicators of a recession. The normally positive sloping yield curve is said to invert when the longer 10-year treasury note yield is lower than the shorter 2-year yield. Since early March, the key 2-year to 10-year Treasury spread narrowed substantially, and inverted slightly for a brief time in April.



Since Paul Volker used the Federal Reserve's ability to raise short-term interest rates to tame inflation in 1980, every rate hiking cycle that has inverted the yield curve has led to a recession within one to three years. So, in recent decades, there has been a 100% correlation of significant yield curve inversions to future recessions. The blue line on the graph below shows the 2- to 10-year treasury spread with recessionary periods shaded grey.

Source: University of Surrey, Luciano Rispoli

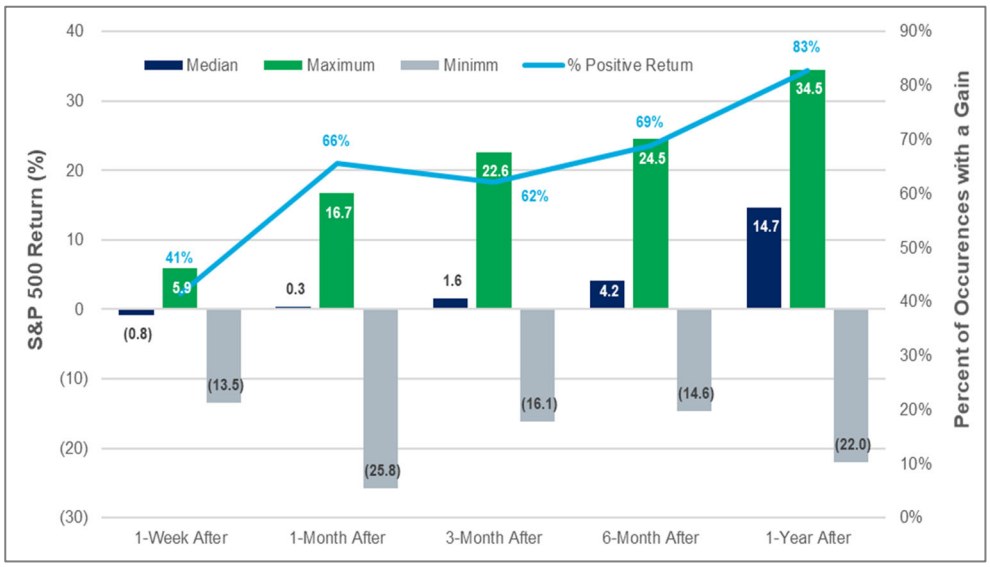
An inverted yield curve does not cause a recession, but it indicates the bond market's pessimism for long-term growth and lower inflation. We believe the current flattening yield curve is being driven by two major headwinds. Bond investors have been betting that growth and inflation will not exceed 2.5% to 3% over the long-term and market participants are engaging in a flight to quality and are willing to accept negative real returns to insure the return of their money. We believe both factors are at work.

Many banks and economic forecasters expect U.S. real GDP growth to regress to trend of 2% to 2.5%. Long term demographic and productivity trends do not support a sustained 3% U.S. growth rate.

With that said, many forecasters make the argument that future inflation will be higher than the prior decade. Several of the deflationary reasons for low U.S. inflation may be changing. Globalization is expected to reverse as supply chain resilience and national security concerns move more production and sourcing onshore or to safer Western allies. A new cold war with Russia will have a long-lasting impact on energy supplies and markets. Energy to replace Russian supplies will take a long time to develop and may lead to elevated costs for several years.

Sources: Bloomberg, J.P. Morgan, Morgan Stanley, Schroders, Wells Fargo

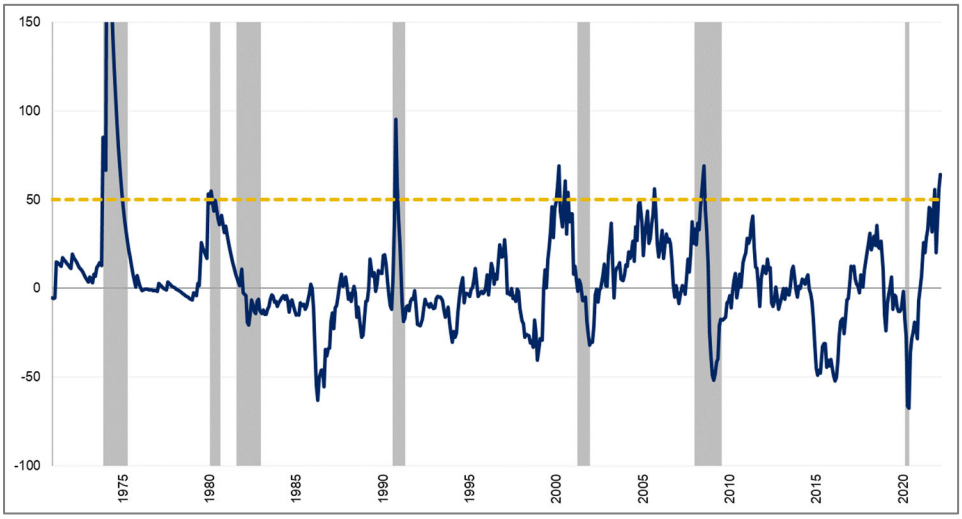
Geopolitical risks and war in Ukraine certainly add to inflation and recession risk. But the impact of past wars and major terrorist attacks have had only temporary impacts on the U.S. stock market. The chart to the right demonstrates the impact of wars since 1940, where market returns are positive after 83% of events and the median return of 14.7% after 1 year.



Stocks were positive one year after the start of over 80% of events, with a median increase of 14%. Of course, a 1-in-5 chance of a negative return slightly exceeds the 1-in-6 years negative market returns over the last 45 years.

History suggests oil shocks raise the probability of a U.S. recession. The chart below shows that in the past 50 years, every time oil prices rose 50% above trend (adjusted for inflation), a recession followed.

Europe is now expected to enter recession this year due to severe energy cost increases and supply risk. The outlook for the U.S. looks much more positive as it became energy independent and a major LNG (liquefied natural gas) exporter. U.S. consumers will feel the higher cost of energy, but the U.S. does not face an actual supply shortage of gas or oil.



CONCLUSION

Recession risk has become elevated, although the risk seems most likely in 2023 or 2024, depending on the tightening path the Federal Reserve takes. A more aggressive Fed with rate hikes over 3% could push the U.S. into recession in 2023. A Fed that pauses and slows rate increases into mid-2023 may get lucky with a soft landing or short and shallow recession.

Sources: Bloomberg, J.P. Morgan, Morgan Stanley, Schroders, Wells Fargo

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