ONE DAY IN JULY | SHELBURNE FIDUCIARY PARTNERS

First Quarter 2022 Market and Strategy Overview

April 19, 2022

The volatility and uncertainty that began to infiltrate markets in the second half of 2021 accelerated materially in the first quarter of 2022, driven by the dual impacts of Russia's invasion of Ukraine and a much more hawkish Federal Reserve. The former has been at least partially responsible for the latter, as Russia's actions exacerbated inflationary dynamics that were already in place due to COVID-related supply chain backlogs and worker shortages. While it had seemed feasible that inflationary pressures might start to recede, the recent spike in energy prices has made that less likely in the near term. As a result, formerly cautious Fed governors have been increasingly vocal about the need to more aggressively tighten monetary conditions in the coming months.

Because the energy and supply chain issues seem unlikely to resolve themselves quickly, the surest path to reducing inflation is by engineering a reduction in consumer and business demand. This includes tamping down on wage growth by reducing the gap between the number of workers and the number of available jobs, a gap that is currently as large as it has ever been. As the Federal Reserve raises interest rates and shrinks the size of its balance sheet to accomplish this, a slowdown in economic growth becomes almost unavoidable.

Thus, the Federal Reserve now finds itself in the unenviable position of trying to thread the needle. If they err on the side of too little tightening, they risk inflation rising even further and becoming more engrained in the economy. If they err on the side of overly-aggressive tightening, they risk throwing the economy into a recession. And they are attempting to strike that balance in an environment where factors over which they have very little control are exerting an unusually large influence.

The U.S. stock and bond markets both responded negatively to the evolving backdrop. After being down about 10% in the wake of Russia's invasion of Ukraine, the U.S. stock market (as measured by the Russell 3000 index) rebounded somewhat in March, closing the quarter down 5.3%.

There was considerable variability in the underlying components of this return. Inflation pressures favored dividend-paying value companies over growth companies. In particular, the almost 30% increase in crude oil prices during the first quarter had an outsized impact on sector performance. In fact, the only two equity sectors to post a positive return in the first quarter were Energy (up a whopping 39%) and Utilities. Other value-focused sectors like Consumer Staples, Health Care, Industrials and Materials were negative for the quarter, but less so than the overall market. On the other side of the spectrum, growth-oriented sectors like Technology, Consumer Discretionary Products, and Communications were each down between 9% and 12%[1].

In terms of company size, large companies outperformed mid and small-sized firms during the quarter, helped in part by large energy companies. Within the small-cap space, growth firms were hit particularly hard, as investors shied away from businesses that exhibit lower current profitability and trade at higher valuation levels.

International stock markets provided no relief either, with the MSCI ACWI ex-US index posting a negative 5.5% return. Developed international markets generally outperformed emerging markets, but neither performed better than the U.S. market. This continues a pattern witnessed throughout 2021.

The U.S. bond market (as measured by the Bloomberg Barclays Aggregate index) was down about 5.9% during the quarter. While bonds understandably rallied at the outset of Russia's invasion, mounting inflation pressure and a more aggressive Federal Reserve policy eventually drove market interest rates higher and bond prices lower. As a barometer, the yield on the benchmark 10-year U.S. Treasury Note increased from 1.52% at the end of 2021 to 2.32% at the end of March. It has continued to move higher since then.

Outlook and Positioning

Market consensus is that, following a quarter point hike at its most recent meeting, the Federal Reserve will increase short-term borrowing rates at each meeting over the remainder of 2022, with more aggressive half-point hikes expected in the next few meetings.

Despite the increase in longer-term rates we have already witnessed, real interest rates (defined as the difference between current rates and the anticipated future rate of inflation) remain quite low. In fact, 10-year real interest rates are only now approaching zero after being negative since early 2020. It is impossible to know how high real interest rates will need to go in order for growth to slow enough to bring inflation under control. However, it seems unlikely that they can remain significantly negative. For real rates to increase further, either nominal interest rates need to continue to rise, or inflation needs to begin to gradually decline.

After the recent spike in energy prices, it is possible that inflation may be at least starting to plateau. However, with no visible end to the conflict in Ukraine and a material portion of China's population still under COVID lockdowns, it also seems unlikely that inflation will drop materially right away. Absent other influences, that may be enough to keep a floor under the level of market interest rates. It may also be enough to allow value-focused stocks to extend their outperformance further into 2022.

As 2022 progresses, if inflation does begin to moderate, risks are likely to shift to the economic growth side, particularly if the market begins to believe the Federal Reserve has over-corrected by tightening policy too much. In that environment, market interest rates are more likely to decline and profitable growth companies may regain some of the ground they have lost so far this year.

Given the uncertainties, we made some preliminary portfolio adjustments during December of 2021, and have made subsequent adjustments in response to events during the first quarter. In December, we reduced exposure to mid and small-cap growth companies, which have come under pressure as inflation and interest rates have increased. While we specifically targeted small growth companies for the reduction, we still maintain a healthy weighting to small companies overall. This reflects both a belief in the long-term benefits of diversifying by company size and a belief that the balance of the small cap universe (i.e., excluding growth companies) is priced at an attractive level relative to the large cap universe.

We increased exposure to the Vanguard High Dividend Yield ETF (ticker VYM), our favorite ETF for high dividend paying equities. Not only does VYM pay a relatively high dividend rate, but companies that pay higher dividends generally fall into the value category as well, an area we continue to favor. We think

value-oriented equities may remain less volatile than the overall market, and can play a defensive role during periods of turbulence. This was the case during the first quarter, as VYM posted a total return of +0.72% for the period in the face of a declining overall market.

We also added sector-specific exposure to health care equities with the purchase of the Health Care Select Sector ETF (XLV). Similar to value-oriented equities, we believe the health care sector should help dampen overall portfolio volatility during market contractions. XLV posted a total return for the quarter of -2.46%, more than 2% better than the U.S. market as a whole.

In our year-end letter, we referenced concerns about geopolitical risk. Although we mentioned the developing situation in Ukraine, we were more focused on China at the time. We sold the vast majority of our non-U.S. equity exposure in late 2021 and early 2022. Like many, we have been surprised and dismayed by the degree of aggression from Russia. The idea of unpredictability and risk in international markets remains a central theme, one which has clearly only accelerated in the last three months.

On the bond side, we reduced our overall sensitivity to interest rate changes by lowering the average maturity of the holdings. Specifically, we reduced 7-10 year Treasury holdings and replaced that with exposure to 2 year Treasury holdings. As market rates have increased, the income available on shorter maturity bonds has increased to the point where it is approximately equal to the income available on longer maturities. Shorter bonds should also be less adversely impacted if rates continue to increase from here. Of course, the opposite is also true, as they benefit less when interest rates decline. However, in the current environment, we prefer to err on the side of less sensitivity to interest rates.

In general, we expect the balance of 2022 to remain choppy for both the stock and bond markets. Though markets are always characterized by uncertainty, the number of moving parts today makes the current backdrop particularly challenging. Yet we think that this may ultimately be a healthy process in that it should wring out some of the excesses built up over a number of years and create a more normalized interest rate, growth and inflation environment.

Despite the current challenges, we have found that clients remain generally sanguine about the long-term prospects for the market and the economy. We agree. Regardless of near-term noise, market returns over time are basically a function of one thing: the steady growth of the U.S. economy and the resulting earnings power it creates for the underlying businesses. There have been plenty of bumps over the last century, but that one underlying trend has remained consistently powerful.

Frank, Josh and Keith

Notes and Disclosures

1. Sector performance is proxied using the returns on Vanguard's suite of sector specific ETFs.