1st Quarter 2022 Commentary

The initial market selloff from the Russian invasion of Ukraine on February 24th was short-lived with markets rallying into the end of the quarter. While it is certainly possible investors were anticipating the invasion, markets have historically proven to be quite resilient to geopolitical conflicts. However, even though the reaction proved to be short-lived, the invasion of Ukraine will have lasting impacts on the U.S. and global economy for years to come.

We have seen increasing momentum from countries around the world to focus inwards since the trade war with China began in 2018. This focus continued with the pandemic and ensuing supply chain crises that left many economies around the world shuttered. It could be argued that globalization's retreat began in 2008 when global trade reached a peak of 31% of global GDP. By 2020, the trend was clear with global trade dropping to 26% of global GDP.[1] The Russian invasion of Ukraine and the ensuing effort by the U.S. and West to sanction, restrict, and otherwise completely wall off Russia for the atrocities committed in Ukraine is the latest sign that nations are now increasingly focusing inwards.

Over the past 30 years, globalization has benefitted economies through the spread of technology and innovation, lower cost of production, access to new markets and talent, and higher standards of living. The war undeniably turns back time on the spread of technology and innovation with borders closing and businesses leaving Russia. Costs or factors of production such as oil, natural gas, coal, metals, chemicals, and agriculture, which represent the bulk of the Russian and Ukrainian output, have already increased markedly and are expected to remain elevated due to ongoing supply constraints. Labor markets will also be challenged with millions fleeing Ukraine to the West for safety and shelter. Russia has experienced a similar but much smaller migration to the west as many younger Russians attempt to escape authoritarian rule and propaganda. Any resolution, particularly after recent evidence of war crimes, would not automatically reverse the unintended consequences of the war and ensuing sanctions. As the Wall Street Journal's Jon Sindreu stated, "no matter how the war in Ukraine ends, investors can't expect the global economy to remain as tightly integrated as it once was".[2]

U.S. business in general has been insulated from the conflict due to Russia and Ukraine's relatively small representation of GDP to the global economy. However, Russia and Ukraine are commodity and agriculture powerhouses. Sanctions and other economic restrictions have already led to significant increases in commodity prices which are expected to have an outsized impact on emerging and developing economies. We all see the impact of the conflict at the gas pump. Higher commodity prices will unfortunately only serve to exacerbate supply chain constraints and inflationary headwinds in the United States and other developed economies.

Make no mistake, the cost to the global economy does not compare to the cost being borne by the Ukrainian people.

According to a recent Gallup poll, the high cost of living is now the most important problem facing Americans. Concern regarding inflation has reached levels last witnessed in 1985 which, unsurprisingly,

[1] Zumbrun, Josh. Economic Blacklist of Russia Marks New Blow for Globalization. March 10, 2022. WSJ. Economic Blacklist of Russia Marks New Blow for Globalization

[2] Sindreu, Jon. Russian Sanctions Created a New World-And It Can't Be Undone. April 5, 2022. WSJ. Russian Sanctions Created A New World-And It Can't Be Undone

is the last time we witnessed inflation at these levels (See Fig. 1).[3] The Federal Reserve's rapid shift to combat inflation should therefore come as no surprise. Economists and investors are now expecting the rate setting mechanism to end the year at 1.75%, up from .25% today, with some Fed officials openly advocating for higher levels. How do we get there and what does the path look like? We do not know. We do know, however, that "interest rates are to asset prices like gravity is to the apple. They power everything in the economic universe".[4]

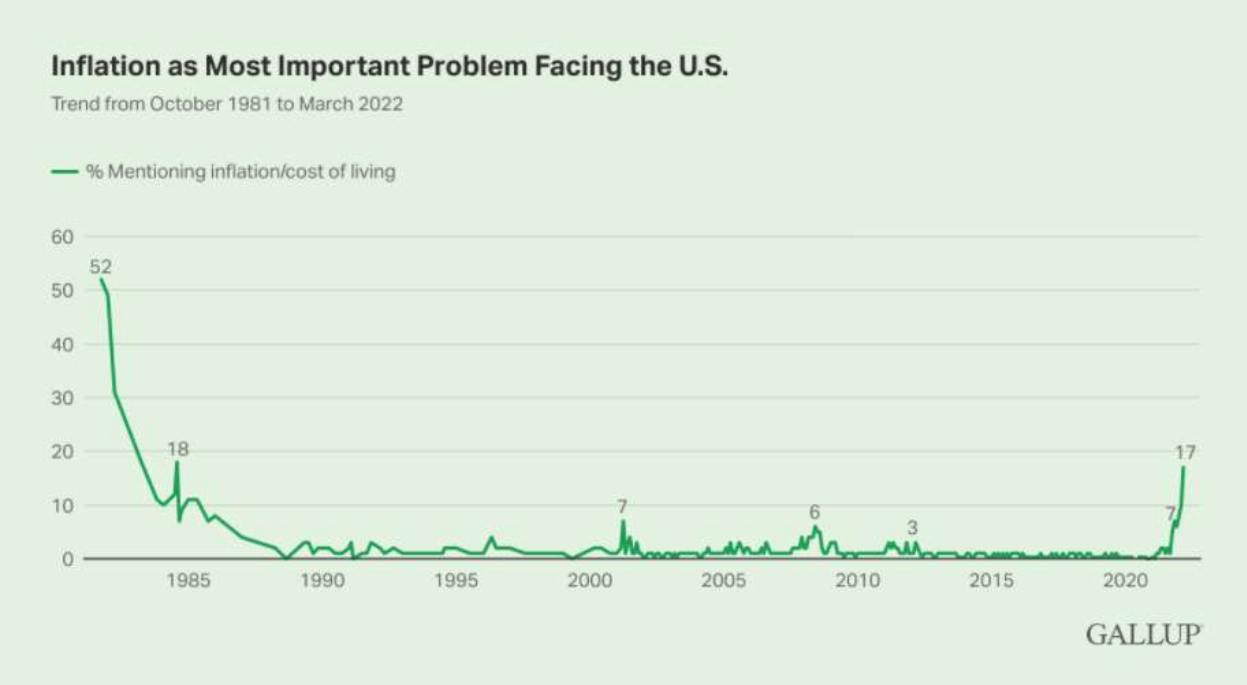

Fig. 1. Inflation as Most Important Problem Facing the U.S. (Source: Gallup)

The S&P 500 dropped into correction territory, defined as down 10%, twice in the quarter before rallying to close -4.6% for the quarter. This was quite a change for markets which, as you may remember, did not experience a drop of more than 5% at any point in 2021, while making 70 new highs during the year. This in turn was quite unusual historically, since the market has dropped 5% or more in 95% of the years dating back to 1928, and 10% or more in 63% of the years dating to 1928. In that context, investors should not have been surprised by the market's recent performance. Market corrections are common and healthy, clearing the market and economy of excesses, even if underlying conditions do not always appear so. Even bear markets, defined as a 20% or more drop from prior highs, are relatively common. They occurred in 26% of the years dating to 1928.[5] In each instance, whether due to war, pandemic, inflation, debt, or some other reason, the market recovered and advanced higher in time.

[3] Saad, Lydia. Inflation Dominates Americans' Economic Concerns in March. March 29, 2022. Gallup. Inflation Dominates Americans' Economic Concerns in March (gallup.com)
[4] Buffett, Warren. 2001.
[5] Carlson, Ben. How Often Should You Expect a Stock Market Correction?. January 20, 2022. A Wealth of Common Sense. How Often Should You Expect a Stock Market Correction?

We do not expect today's headwinds to be unique in this sense. Nonetheless, market volatility is likely to remain elevated due to rising rates, inflationary concerns, continued supply constraints, and the Russian invasion of Ukraine. The retreat of globalization will likely continue to exacerbate these headwinds leading to lower margins and future earnings growth.

With that in mind, we continue to selectively trim positions in cyclical businesses that trade at a premium while using the proceeds to opportunistically invest in businesses with long-term secular growth characteristics that trade at a discount. We hope to use short-term volatility over the course of the year to our long-term advantage.

Fixed income continues to be a challenging space to generate decent levels of future income despite rising rates. At the end of the quarter, the 10-year treasury bond was priced to yield 2.36% which, after inflation, means investors are still poised to generate a negative real return. It is hard to believe that nearly 18 months ago investors could, and did, purchase a 10-year treasury bond priced to yield .5%. In a rising rate environment and with inflation in excess of 5%, we continue to hold higher levels of cash and selectively purchase shorter term bonds. With the 2-year treasury bond priced to yield to same today as the 10-year, owning shorter duration bonds seems prudent. This strategy will give us the benefit of generating some income and the flexibility to follow rates higher, if indeed, they move higher over time.

We thank you for the chance to manage your assets. If you have any questions about this report and/or your investment portfolio, please do not hesitate to contact us at 484-584-4885.

Sincerely,

J. August Gerhardt, CFA

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