First Quarter Market Review and Comment
April 2022

Updated Market Performance

Returns	1st Quarter 2022	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**-4.60%**	**15.65%**	**18.92%**	**15.99%**	**14.64%**
DJIA	**-4.10%**	**7.11%**	**12.57%**	**13.40%**	**12.77%**

Performance: January gave back December's gains and then some posting a return of -5.17%. We continued the downward trend in February returning –2.99%. March rose 3.71%, ending the downward trend started in January leaving us with a 1st QTR 2022 total return of -4.60%.

After the 4th quarter 2021 posted a gain of 11.03%, the 1st quarter 2022 started the year off weak posting a return of -4.60%. The Dow Jones Industrial Average (DJIA) outperformed the SP500, posting -4.10% loss over the same period. For the previous twelve months the SP500 has returned 15.65%, handily outpacing the DJIA which returned 7.11% over the same period. The annualized three-year returns are well above average (around 10.50%) with the SP500 three-year returns posting 18.92% and the DJIA three-year returns increasing 12.57%. Over the last five years the annualized returns are continuing to run well above historical norms (around 10.50%), with the SP500 returning 15.99% and the DJIA posting 13.40%. The ten-year annualized numbers are also running above long-term averages (around 10.50%), with the S&P500 returning 14.64% versus the DJIA which turned in 12.77%.

Breaking down the returns for the Q1 2022, we note that there were seven outperforming sectors and four underperformers. **The best sectors were Energy (37.66%), Utilities (3.96%) and Consumer Staples (-1.63%). The underperformers during the quarter were Communication Services (-12.11%), Consumer Discretionary (-9.19%) and Information Technology (-8.55%).** The best sectors over the last twelve months were Energy (57.33%), Real Estate (22.44%) and Information Technology (19.86%). Following behind, were Communication Services (-1.75%), Industrials (4.63%) and Consumer Discretionary (9.08%).

Economy: Growth in the economy will begin to decelerate and be below average (Historical growth is ~3.00%). Expectations are that the first half will be weaker than the second half albeit not by much. Inflation was supposed ease meaningfully in 2022, but the Russia-Ukraine conflict thwarted that. The Fed has begun to tighten monetary policy to prevent runaway inflation. The Fed started raising interest rates at the end of Q1 2022. Normally when the federal reserve begins to tighten monetary policy and raise short term rates, they usually end up hindering growth and causing the economy to go into recession. Recession risks are currently low, however with higher inflation slowing consumer spending and a Fed that has telegraphed more aggressive monetary tightening than anticipated, we anticipate we will have a recession sometime in 2023 or 2024.

The third estimate of 4th quarter 2022 Gross Domestic Product (GDP) is 6.9% according to the report released at the end of March by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 4th quarter increased 4.6% from the 3rd quarter 2021 third estimate of 2.3%. GDP for 2021 came in at 5.7% compared to -3.5% in 2020, 2.2% in 2019, 2.9% in 2018 and 2.2% in 2017. Currently the Atlanta Fed GDPNow estimate (Forecast of U.S. GDP Growth) has forecasted 2021 Q1 GDP growth at 1.1%. By comparison, China says their GDP increased at 4.0% in the 4th quarter of 2021. Decreasing from 3rd quarter 2021 reading of 4.9%. China's 2021 GDP was 8.1%, 2.3% in 2020, 6.1% in 2019, 6.6% in 2018 and 6.8% in 2017. Growth rates for the European Union (EU) and the Euro Area were 4.8% and 4.6% respectively in the 4th quarter 2021. For 2021, GDP grew 5.3% for the EU and 5.3 for the Euro Area. For 2020, GDP fell -6.1% for the EU and -6.37% for the Euro Area. For 2019, GDP rose 1.5% for the EU and 1.2% for the Euro Area. This is down from the 1.9% growth achieved by the EU and the 1.8% achieved by the Euro Area in 2018. GDP Growth forecasts for the end of the 1st QTR 2022 are 6.2% for the EU and 4.2% for the Euro Area.

Unemployment is continuing to trend down and continues to be below historical norms (~5.76%). According to the Bureau of Labor Statistics, March unemployment decreased to 3.6% from 3.8% in February. Unemployment for 2021 came in at 5.36%. Unemployment was 8.11% and 3.67% in 2020 and 2019 respectively. The number of unemployed fell by 318,000 in March to 6.0 million. These are little changed from their pre-pandemic levels in February 2020 of 3.5% and 5.7 million, respectively. The labor force participation rate was little changed in March at 62.4% but remains 1% lower than in February 2020.

Inflation increased 8.5% in March continuing to run hot and above average trend. After averaging 6.13% in the 4th quarter 2021, inflation as measured by the Consumer Price Index (CPI) increased to an average of 7.97% for the 1st quarter 2022. The average rate of inflation for 2021 was 4.70% and was above average by historical standards (~2.47% over last 30 years and 3.23% from 1914-2021). The energy index rose 32% over the last 12 months, and the food index increased 8.8% over the same period. This is the largest 12 month increase since May 1981.

Consumption is an important driver of the economy as it represented 68.0% of 4th quarter 2021 nominal GDP. The U.S. Census Bureau announced in March that retail sales for February 2022 were up 0.3% from January and were up 17.6% above February 2021. Gasoline stations were up 36.4% from February 2021, while the food services and drinking places were up 33.0%.

Manufacturing economy grew in December. Economic activity in the manufacturing sector expanded for the month of March, with the overall economy notched its 22nd consecutive month of growth. The Purchasing Managers Index (PMI®) registered 57.1; a decrease of 1.5 from February's reading of 58.6. The Manufacturing PMI® continued to indicate strong sector expansion and U.S. economic growth in March. All five subindices that directly factor into the Manufacturing PMI® were in growth territory. Five of the six biggest manufacturing industries Food, Beverage & Tobacco Products; Machinery; Transportation Equipment; Chemical Products; and Computer & Electronic Products registered moderate-to-strong growth in March. The New Orders and Production indices remained in expansion territory. The Supplier Deliveries Index softened slightly, and the Inventories Index increased, indicating easing of supply chain congestion. All 10 of the subindices were positive for the period; a reading of 'too low' for the Customers' Inventories Index is considered a positive for future production. A reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting. The overall economy grew for the 22nd consecutive month, according to the nation's supply executives in the latest Manufacturing ISM® *Report on Business®*. Based on historical relationships between PMI and GDP, a PMI of 57.1 corresponds to a 2.9% increase in real gross domestic profit (GDP) on an annualized basis.

Home prices remained high in January but increasing mortgage rates may start to impact home prices. According to the S&P Case-Shiller Home Price Indices home prices in January rose 19.2% over the last 12 months which is up 0.30% from the previous month's 18.9%. Phoenix, Tampa, and Miami had the largest year over year increases with 32.6% for Phoenix followed by 30.8% for Tampa and 28.1% for Miami. According to the National Association of Realtors, the year over year change in existing home sales was 2.8% in February for Single family homes between $250,000-$500,000 and housing supply continued to remain tight in February with 1.9 months of supply.

Markets: The markets have been digesting new information and retreating after hitting an all-time high on the S&P 500 January 3rd 2022 at 4,796.5. At this time, the market is being driven by hawkish monetary policy, inflation, rising interest rates, and the conflict between Russia-Ukraine.

What will drive the markets moving forward:

- **Earnings: Earnings growth for the SP500 is expected to increase 6.1% for the 1^{st} quarter 2022 (excluding energy earnings expectations are 0.6%).** ***Earnings growth has slowed after being above 20% for the last 4 quarters.*** According to FACTSET, of the SP500 companies that have reported earnings as of April 8^{th} (approximately 20), 70% reported earnings above the mean estimate, and 80% have reported sales above the mean estimate. Looking at future quarters, analysts project earnings growth for the 2^{nd} QTR 2022 to be 6.9% (exclude energy and the growth rate declines to 2.1%).
- **Valuations: While valuations remain stretched based on historical averages, they are lower than they were at the beginning of the year.** The current 12-month forward Price to Earnings is 19.5. We do not see a lot of room for valuations to move higher without growth. Lower interest rates allow for higher multiples, so we could maintain these higher levels of P/E's until interest rates return to meaningful levels. According to a study done by JP Morgan Asset Management between 1965 and January 2009 stocks and rates move together until yields rise to 4.5% and then move in opposite directions. Between February 2009 to present stocks and rates have moved together until yields rise to 3.6% and then move in opposite directions.
- **Monetary Policy/Interest Rates: Short Term Interest Rates remain low, but the Fed will begin to accelerate the tapering of their bond buying programs and have recently started raise short term interest rates.** The Federal Reserve raised the federal funds rate by.25% to a range between .25%-.50% in its latest meeting in March. The Fed continues to closely monitor developments and is prepared to adequately adjust plans. The 10-year U.S. Treasury Bond closed at 2.34% (after reaching 2.55%), up from last month's 1.85% (1.51% at year-end 2021, 0.92% at year-end 2020, 1.92% at year-end 2019, 2.69% at year-end 2018, and 2.41% at year-end 2017). Since closing at 2.34% at the end of the quarter the yield has risen to ~2.78% as of April 11^{th}.
- **Inflation: Inflation increased 8.5% for the twelve months ending in March marking the largest increase since December 1981.** The only silver lining is that gasoline prices accounted for approximately half of the increase. Inflation currently does not seem to be going anywhere. We had thought inflation would cool off the second half of the year, but the Russia-Ukraine conflict has recently increased Oil and gas prices as well as other commodities. Currently the Fed has committed to increasing interest rates and decreasing their balance sheet to try to fight inflation. This comes at a time when growth is about to slow. If growth slows and inflation stays elevated/high, we will end up with stagflation.
- **Russia-Ukraine Conflict: The current conflict is expected to weaken the European economy, with some speculation of a recession in some countries (especially Germany).** We are currently feeling the impact through higher oil and commodity prices. At this time it is hard to determine the total impact this conflict will have on the US.

Forecast:

We think the biggest threats to the stock market are interest rates continuing to increase accompanied by runaway inflation, the Fed tightening monetary policy, and the Russia-Ukraine conflict. We think the SP500 will end the Q2 2022 between 4500 and 4600. At this juncture, we venture a guess that stocks will end the year somewhere between 3% and 5% for the year.

For the next six to twelve months, the Federal Funds rate will most likely increase from its current range of .25%-0.50% to 1.50-1.75%. **The 10-year Treasury which is currently priced at ~2.65 % should remain in a range between 2.40%-2.70% through the end of the 2^{nd} quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

Julian F. Patton, Jr. CFA, CFP®, CAIA