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1st Quarter 2022 Market Commentary

Several Themes Play Out in the in the 1st Quarter, Some Expected and Some Not

War, inflation, the prospect of interest rate rises, a tech stock pullback...it was a newsworthy quarter. The results, however, were not all doom and gloom. A late rally elevated our diversified portfolios to finish only a few percentage points in the red for the quarter, despite a continued spike in overall market volatility and the overbearing threat of a major escalation in Europe.

So much has happened in the last three months, it is hard to know where to begin. We have been very active, writing messages and communicating with our investors throughout this contentious time. For this message, we will not rehash all the timely data and analysis we shared with advisors throughout the quarter, we will instead focus on how events affected overall results and what we feel will be most impactful issues in the coming quarter and beyond.

After discussing Q1 2022 financial market results, we will address three topics important to TOPS portfolio returns and strategies:

1) Inflation, the Fed and the impact on stocks and bonds.
2) The Russian invasion of Ukraine: Latest update and expected implications on portfolios.
3) Return expectations: Revisiting our discussion last quarter on potential softness in large cap growth stocks and how it played out to benefit diversified portfolios.

Year-To-Date Markets Review

It was a rocky start to the year, with most equity indexes having negative returns in the first quarter. Value stocks (S&P 500 Value) far outperformed growth stocks (S&P 500 Growth), returning -0.2% and -8.6% respectively. Large cap equities (S&P 500, -4.6%) outperformed both midcap (S&P 400, -4.9%) and small cap (S&P 600, -5.6%). Developed international (MSCI EAFE) returned -5.9%, outpacing emerging markets (MSCI Emerging Markets) which retuned -7.0%. Real estate (MSCI World Real Estate) was also negative at -5.8%. The lone positive for equity markets were natural resources. The S&P GSSI Natural Resources Index finished +29.4% for the first quarter.

With respect to fixed income, as would be expected, rising rates led to broadly negative fixed income returns. The 10-year US Treasury yield increased from 1.52% to 2.32% in the first quarter, driving the Bloomberg US Aggregate Bond index to a -5.9% return. While credit (ICE BofA US Corporate Index, -7.7%) underperformed government (ICE US Treasury Core Bond Index, -5.4%), shorter duration holdings outperformed longer duration. This was seen in both credit markets, with the Bloomberg US Corporate 1-3 year (-2.5%), and government markets, Bloomberg US Treasury 1-3 Year (-2.5%) where the shorter duration indexes outperformed the previously mentioned full duration indexes. While outperforming their nominal Treasury counterparts, TIP bonds (Barclay's US TIPs) were negative, returning -3.0%. High yield (Solactive USD High Yield Corporates, -4.4%), international bond indexes (Bloomberg Global

Aggregate ex-USD, -5.0%), and investment grade corporates (-8.3%) were also negative for the year.

Inflation, the Fed and the impact on stocks and bonds

Mortgage Rates, on a 15-year fixed rate, have nearly doubled from their 52-week low. Crude oil prices are up over 38% YTD. Food is more expensive, with corn up about 24% and wheat up about 34% (Bloomberg). There is little question prices have increased in many areas during the first quarter. For our investors, it is important to understand how these increases in prices translate into reported measures of inflation and impact actions of the Federal Reserve and prices on stocks and bonds.

The Headline Consumer Price Index (CPI) annual increase, as of the end of February, was 7.9%. This is the highest CPI reading since the early 1980s. Thus, inflation is not simply a rumor or anecdotal to personal experiences at the grocery store. The price increases we are all experiencing in our lives are translating into figures watched closely by traders and the Federal Reserve.

Let’s focus on some good news first. The most widely used proxy of longer-term inflation, the difference in yield between the 10-year nominal U.S. Treasury Bond and the 10 Year TIPS bond, is currently a little less than 3%. What this means is the markets expect the annualized inflation rate over the next 10 years to fall below 3%, which would leave inflation within the comfort zone of the Fed’s 2% long term inflation target. The Fed has given guidance over the last few years they would like inflation to “average” near 2%, not cap at 2%, understanding they will allow inflation to drift above that level at times. So, for longer term investors, we appear to be on the right path towards price stability and a proper environment to foster long term economic growth.

However, the Federal Reserve cannot put its head down and rely upon everything working out in the long run. They are expected to maintain adequate price stability in the short term and to foster an environment where full employment can exist. If shorter term inflation is permitted to run rampant, it could very well threaten the ecology of the U.S. economy. Likewise, given the Federal Reserve has increased the money supply significantly in recent years and kept short term interest rates near zero, they have inarguably been an active participant in creating the problem they must now venture to solve.

As we have discussed in previous messages, the Fed has several tools to help battle inflation above desired levels. The most powerful of which is the Fed Funds Target Rate, set by the Fed’s Open Market Committee (FOMC). There is no greater example of wielding this power than previous Fed Chair Paul Volcker, who raised rates aggressively to stop hyperinflation in the early 1980s, pushing the economy over the edge into recession. A measure applauded by many in hindsight, yet tough for all at the time.

Few question it is likely to be incredibly difficult for the Federal Reserve to engineer a soft landing for inflation. Chairman Powell has acknowledged in recent messages the odds are stacked against them. However, he noted “some grounds for optimism” looking at historical context. The Fed was able to successfully raise rates without causing a recession in 1965, 1984 and 1994 (Yardeni Research). Given recent numbers, the Fed is tightening into a very significant inflation situation though.

The biggest risk is they go too far and/or too fast. At the time of this writing, they recently increased the Fed Fund Rates (FFR) to a target range of 0.25%-0.50%. Further, markets are currently pricing in a 70% likelihood of 0.50% increase in the Fed funds rate at the next meeting in May and roughly a 20% chance of a 0.75% rise at the following meeting, which would be rare.

As we always say, there are thousands of inputs impacting stock and bond prices at any given time. Investors should resist the urge to try and use algebra when complicated calculus is required. Likewise, the financial markets typically cannot be explained by simple “if/then” statements. This being said, even sophisticated investors can fall victim to relying upon easy signals. One popular signal of an economic slowdown which is coming into focus currently is called an inverted yield curve.

In an inverted yield curve, shorter term bonds pay a higher rate of interest than longer term bonds. This is considered inverted when compared to a normal yield curve, where longer term bonds would compensate investors with a higher rate of interest than shorter term bonds.

Most market participants would credit the difference between the 10-year Treasury bond yield and the FFR as the key yield-curve spread. As such, this spread is one of the 10 components of the Index of Leading Economic Indicators (LEI). This key yield curve spread is currently at about 2%, which would signal continued economic growth. Similarly, the LEI remains at record highs, a positive sign for the economy and markets.

The key yield curve spread of 10 year/FFR is not the only definition of an inverted yield curve though. Those investors watching or reading financial news in the last few days of the quarter would be aware the 2/10-year yield curve inverted in the final trading days of the quarter, the first time since 2019. While typically followed by an inversion of the 3 month/10 year spread, which can be a stronger recessionary signal, the inversion has not yet transmitted to the shorter maturities. Likewise, as noted in previous messages, inverted yield curves do precede most recessions, but every inverted yield curve is not immediately followed by a recession. There is a lot of variability in lead time to recession and markets have historically done well in periods between inversion and realization of a recession, according to Charles Schwab research. As such, the efficacy of the yield curve inversion as a recession indicator varies. Also, breadth and depth matter. Making this debate even more perplexing, since the start of the 2-year yield data in 1976, never have the yield curve spreads between the 2/10 and FFR/10 diverged more (Yardeni Research). So, fans of the key FFR/10 spread would say things are fine, while those pounding the drum on the 2/10 spread would be playing a different tune.

Dr. Ed Yardeni, a leading economist and contributor to research for our Portfolio Management Team wrote in 2019: “After studying the relationship between the yield curve and the monetary, credit, and business cycles, we have concluded that it is credit crunches—not an inverted yield curve and not aging economic expansions—that cause recessions. The yield curve is just keeping score on how the Fed is reacting to and influencing these cycles.”

If investors are in Dr. Ed’s camp, that is a good sign, as there are no signs of a credit crunch developing. Looking at the yield spread between the corporate high-yield composite and the 10-year US Treasury bond, Dr. Ed notes it has widened from 279bps at the start of this year to 364bps recently. A level far below what would normally be required to signal a credit crunch, a recession, or a bear market.

Yield curve spreads typically narrow during periods when the Fed is raising interest rates, a phenomenon which is simple algebra. The biggest risk remains further Fed rate hikes could trigger the economy to rollover into a recession. The 12-month FFR futures are signaling the Fed will increase the FFR to about 2.50% by March 2023, implying eight 25bps hikes over this period.

No one knows exactly what the rate path will be, nor what inflation numbers will show. Our portfolios are built contemplating scenarios such as those discussed here. Through our diversification, we provide exposure to asset classes which tend to do well in inflationary environments, such as TIPS bonds and stock of companies primarily involved in natural resource markets. Likewise, we have shortened the duration of our bond holdings, reducing the risk of principal loss in the event an increasing yield curve. Further, we hold several types of bonds, such as floating rate bonds and high yield bonds, which are favored in these scenarios. As the environment shifts, we will continue to monitor risk and opportunity, adjusting assets within our best judgement.

The Russian Invasion of Ukraine: Latest update and expected implications on portfolios

As of quarter end, the war in Ukraine has been raging for over a month. The world was initially shocked by how the situation developed into the first major ground war in Europe since 1945. While the conflict has been carrying on in some respect since 2014, Russia's aggressive escalation was a surprise to many and led to a geopolitical firestorm.

At first markets were shaken, as investors gathered their bearings. There are many examples of global conflict over the last 50 years, typically resulting in a moderate initial shock and a muted longer-term impact. However, it quickly became apparent the impact of Russia's invasion would go beyond the tragic loss of lives. The world at large decided Russia's actions would lead to pariah status for Putin and a new cold shoulder to Russia's economy.

In our message released before markets opened on the day of Russia's official invasion, we noted the size of Russia's stock market relative to global stock market capitalization. At the time, the initial market shock exceeded Russia's aggregate percentage share of the global pie. We encouraged investors to remain focused on the long run and stick to their investment plans.

As investors have been given the chance to process the scope of the Russian invasion, markets have recovered. At this point, the overall impact has arguably washed through markets, as investor attention has turned back to the aforementioned cocktail of inflation and rates. We believe there still is some risk overhang though. Markets reacted positively in the closing trading days of the quarter, as conversations continue towards a negotiated off ramp, which we feel is the base case for the conflict in Ukraine.

We are encouraged that peace talks continue in Turkey between Russia and Ukraine. Markets reacted positively on March 29 to reports Russia says it will "reduce military activity" near Kyiv. We hope the reports prove true and continue to wish for a quick end to the war and an immediate stop to the pain and suffering of those impacted.

Return Expectations: Revisiting our discussion last quarter on potential softness in large cap growth stocks and how it played out

Last quarter, we wrote a section entitled, *Return Expectations: Is it the time to search for a new leader beyond large cap growth?* In the commentary we highlighted concern over heightened valuations of large cap growth stocks, which we felt could translate into lower relative returns in coming years. Similarly, we noted heightened valuations may be attributable to extreme levels of liquidity provided by monetary and fiscal policies and rising interest rates can be a headwind for growth stocks.

When we noted last quarter, *looking forward to 2022, the path to outperformance for large cap growth stocks appears to be different,* we must have been reading the tea leaves well. Valuations were tested in the face of market pressures and growth stocks fell over 8% for the quarter, even after a quarter end rally. The growth stock pullback illustrated the benefits of diversifying risk into a wide range of global asset classes, as other asset classes in the portfolio outperformed growth stocks in the first quarter and helped our investors experience fair performance in a period when large cap growth US stocks struggled.

For the remainder of 2022, we will remain heavily focused on earnings. While earnings are always important, they are particularly crucial in periods of higher uncertainty. Will earnings hold up? We have seen analysts issue relatively conservative expectations recently, lowering the bar for companies to overcome. Over the last seven quarters, earnings expectations beats have averaged over 80% (Schwab). While it does appear some slowing in earnings is expected, an optimistic viewpoint would be that analysts have set expectations too low and the surprise will come to the upside.

TOPS Portfolio Strategies

When market volatility spikes and the path of the world's markets seem less clear, it is a good time to remind our investors of the robust methods TOPS employs. With two decades of track record, TOPS is a long-standing investment process providing the opportunity for appropriate risk-adjusted returns over time. A key part of the investment process, and one of the tools we use to carry out our duty to investors, is the discipline of regular rebalancing. With regular rebalancing, we will adjust portfolio positions which have drifted over time back to their strategic portfolio targets. We consistently monitor portfolio allocations for drift and will rebalance the portfolios as necessary to maintain appropriate allocation ranges and overall risk.

TOPS® Portfolio Management Team
Michael McClary – Chief Investment Officer
Adam Schenck, CFA – Senior Portfolio Advisor
Tyler Denholm, CFA, CMT – Vice President, Investment Management & Research