Q1 2022
Investment Perspectives

Dave Keevins
Chief Investment Officer

Andrew Krei, CFA
Head of Investment Research

April 2022

- **RUSSIAN INVASION:** Tragic scenes emerged from Ukraine as Russia invaded in late February. Countries around the world acted quickly to impose a variety of sanctions, hoping that the threat of economic pain would deter further escalation. Markets were roiled by the conflict and commodity prices jumped.
- **RAMPING UP RATE HIKES:** The Fed moved their benchmark policy rate off the zero bound, hiking rates 25 basis points in Q1. The first post-COVID rate increase was accompanied by an increasingly hawkish tone from Fed Chair Jerome Powell and other members of the Fed's Open Market Committee (FOMC). Bond yields rose sharply as markets rapidly repriced the likely path of Fed policy in 2022 and beyond.
- **SKY HIGH PRICES:** Lingering supply chain issues, elevated commodity prices, and a tight labor market kept inflation prints running at uncomfortably high levels in 2022. Demand has remained robust in the face of higher prices thus far, but deteriorating consumer confidence and manufacturing data may foretell a period of cyclical weakness over the coming quarters.

Market Recap

After a strong 2021, risk assets were broadly lower in Q1 2022 alongside a wave of Omicron variant COVID infections, elevated geopolitical risks, and stubbornly high inflation readings. Even customary safe havens—like investment grade bonds—experienced a bout of significant price weakness during the quarter, leading to declines for investors across the risk spectrum. As evidence of the pain for diversified portfolios, a traditionally constructed 60% US equity / 40% US bond allocation declined roughly 5.5% during the quarter.

At the heart of the volatility in Q1 was the Fed's renewed focus on fighting inflation. Fed Chair Jerome Powell pivoted toward a more hawkish posture as the headline Consumer Price Index (CPI) increased 8.5% on a year-over-year basis in March, reaching its highest level since the early 1980s. Chair Powell and his colleagues on the FOMC boosted their estimates for the number of rate hikes in 2022 and communicated an accelerated plan to reduce the Fed's approximately $9 trillion balance sheet—measures that would begin to tighten financial conditions and drain liquidity from the system.

continued on page 2

FIXED INCOME

	USD Total Return (%)	
Index	Q1	2021
Barclays 1-10 Yr Muni	-4.8%	0.5%
Barclays US Agg. Bond	-5.9%	-1.5%
BofA/ML HY Master II	-4.5%	5.4%

EQUITIES

	USD Total Return (%)	
Index	Q1	2021
Russell 3000	-5.3%	25.7%
S&P 500	-4.6%	28.7%
Russell 2000	-7.5%	14.8%
MSCI All Country World	-5.4%	18.5%
MSCI EAFE	-5.9%	11.3%
MSCI Emerging Mkts	-7.0%	-2.5%

Source: Bloomberg (Data as of 3/31/2022)

The Fed's pivot led to a dramatic repricing within rates markets, sending short and long-term Treasury rates higher. After starting the year at roughly 1.5%, the benchmark 10-year Treasury yield surged to over 2.3% by quarter-end—the third largest 3-month jump in the last decade. This led to a concomitant increase in yields throughout investment grade and high yield credit markets. As yields rose, bond prices dropped, and longer duration issues exhibited the greatest degree of price sensitivity to these yield changes. For instance, the Bloomberg US Aggregate 10+ Year Index declined 11.0% during the quarter relative to the Bloomberg US Aggregate 1-3 Year Index only falling 2.5%. The broad investment grade market—as measured by the Bloomberg US Aggregate Index—tumbled 5.9%, marking its worst quarter since Q3 1980.

Despite the ructions in Treasury markets, US credit spreads—or the excess yield that investors demand for holding riskier debt relative to Treasuries—remained in check. The BofA/ML High Yield Index outperformed the broader investment grade market by nearly 1.5% during the quarter, suggesting that the performance dynamics were largely driven by the interest rate reset rather than concerns about corporate health and rising default risks. In fact, a key index tracking floating rate debt—i.e., loans that have minimal interest rate risk—from lower quality issuers (S&P Leveraged Loan Index) was only down 0.1% for the quarter.

With interest rates moving higher and the Fed guiding toward a more aggressive policy path, US equity markets struggled for direction. As evidenced by the elevated levels of volatility during Q1, the consequences of tightening financial conditions caused consternation among investors. Small cap stocks—generally more sensitive to overall levels of risk appetite—tumbled 7.5% during the period while large cap stocks fared better, only falling 4.6%. Similar to the high yield market, US equity performance was driven by a re-rating of valuation multiples rather than analysts revising earnings forecasts lower—the latter factor suggesting limited concern about the fundamental economic backdrop for now.

Non-US stocks once again lagged US markets during the quarter. European stocks were roiled based on the Russia/Ukraine conflict's disproportionate impact on the continent's energy markets—large portions of which are reliant on Russian oil and gas. Moreover, China continued to pursue its "zero COVID" policy in the face of the Omicron variant's rapid spread, ultimately leading to wide scale shutdowns of major cities. There are early signs in credit data that authorities intend to inject stimulus into the flagging economy, but the MSCI China Index's Q1 decline of 14.2% suggests that investors remain skeptical about China's ability to effectively navigate economic headwinds over the coming quarters.

Commodity markets were also noteworthy during the quarter as inflationary pressures continued to build. A diversified measure of commodity prices, the Bloomberg Commodity Index, showed a 25.5% increase during Q1 and was 49.1% higher than the same time one year ago. Not only were energy components higher as crude oil prices closed the quarter at roughly $100 per barrel, but other segments such as agricultural commodities (+19.8%) and industrial metals (+22.6%) surged during the quarter, reflecting the broader impulse of higher prices.

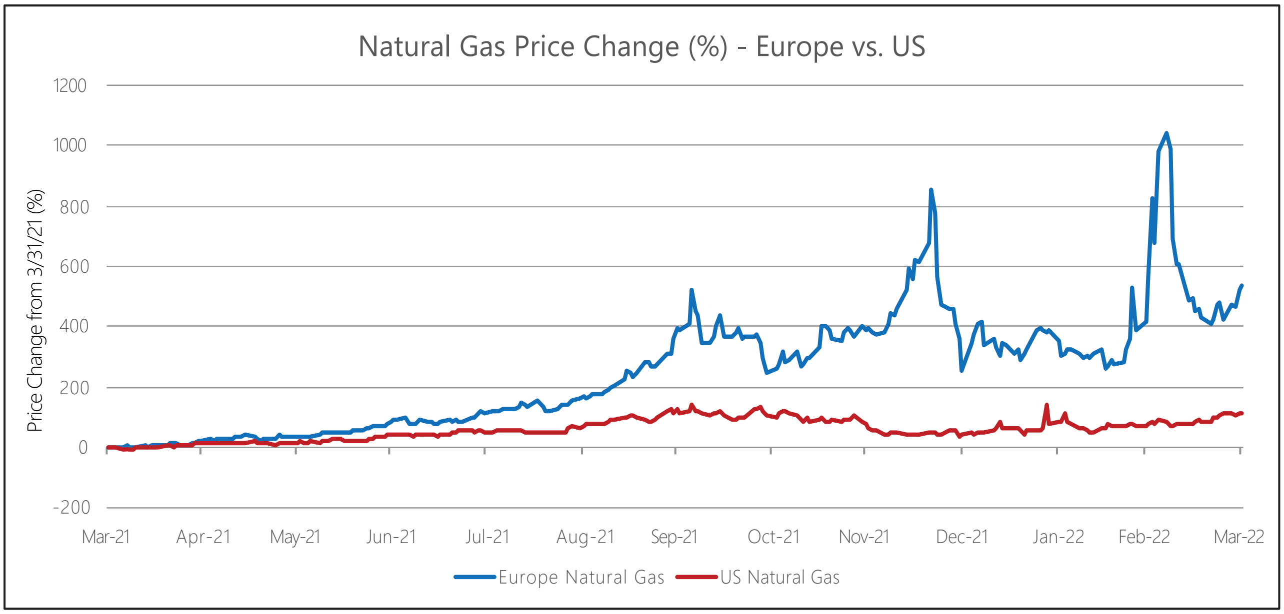
GEOPOLITICAL GYRATIONS

The Russian invasion of Ukraine had investors on edge in Q1, fearing an escalation and/or expansion of the conflict into NATO territory. However, as it became increasingly clear that the Russians were struggling to make material progress against the Ukrainian forces, some of the immediate risk premium priced into risk assets was unwound. While we do not want to minimize the human toll, this pattern of performance is consistent with historical experiences; the lessons from events like Pearl Harbor, the Iraqi invasion of Kuwait, September 11, and others have demonstrated that these types of high-profile incidents have a relatively short-lived impact on markets. Investor attention and performance drivers have traditionally reverted to the key trends that were unfolding prior to those catalytic moments within a few months.

continued on page 3

The historical lessons of market performance during these periods of uncertainty are useful context, but one unique element of this conflict is the outsized influence Russian energy markets have on the European economy. Per data from the International Energy Agency, Russian natural gas accounted for roughly 40% of all EU gas usage in 2021. Around 25% of EU oil imports came from Russia in 2020, according to the EU's statistics office.

Despite calls for more strict sanctions on Russian energy imports, it appears that European politicians are reckoning with the practical implications before moving forward with actions that risk crimping their economies. In fact, the chart below shows the increase of benchmark natural gas prices in Europe (blue) and the US (red) over the last 12 months and illustrates that circumstances were already difficult in Europe; gas prices had been steadily increasing and were over 1,000% higher in the immediate wake of Russia's invasion. With US gas price increases looking benign in comparison thanks to ample domestic supplies, perhaps this was a key reason investors felt comfortable pressing their bets on US outperformance going forward.



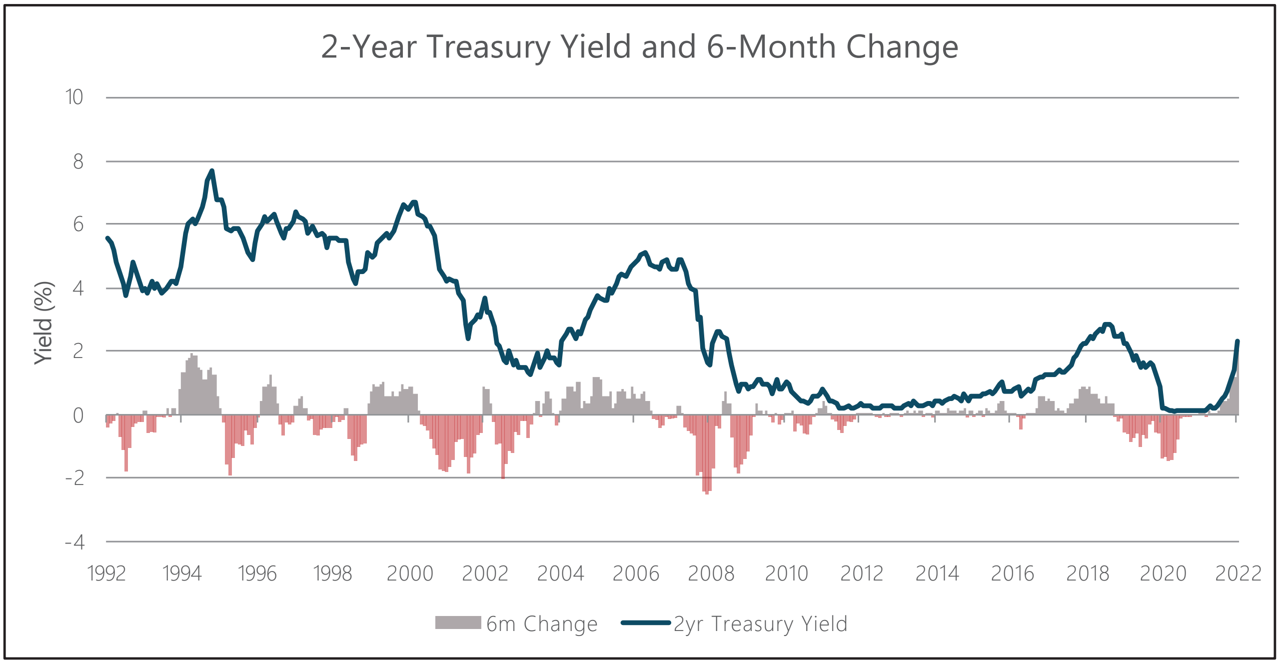
Source: Bloomberg (Data as of 3/31/2022)

RAPID REPRICING

As discussed in the opening section, the Fed's shift away from its stance that inflation would be "transitory" toward a hawkish approach caused dramatic moves within fixed income markets in Q1. For historical context, the chart on the following page shows the 2-Year Treasury yield (navy line) and its 6-month change (gray/red bars). As the navy line has gone parabolic in recent months, the 6-month rate of change has hit its highest level in 30 years—slightly edging out a similarly steep increase in the mid-1990s.

The quickness of the move clearly caught some fixed income investors off-guard and was a stark reminder of duration risk—the concept that bond prices have varying sensitivities to changes in interest rates depending on their coupon and maturity. Shorter-maturity and higher-yielding bonds will have less interest rate risk, and vice versa (all things equal). Of equal significance, the swift move higher in 2-year Treasury yields narrowed the gap between its yield and the yield on 10-year Treasuries—a commonly cited indicator of the "yield curve". When this measure is flat or negative (i.e., 2-year yields higher than 10-year yields, termed an "inversion"), it generally suggests that the likely trajectory of short-term rates is too aggressive relative to the longer-term growth potential for the economy. In other words, investors expect that the Fed will tighten financial conditions to the point where it curbs economic growth, and practically speaking, this has historically been an early warning sign that a recessionary period is on the horizon.

continued on page 4



Source: Bloomberg (Data as of 3/31/2022)

How much further this move in rates can go remains to be seen. Investors with new money to deploy will celebrate the increased income from higher yields, but existing fixed income investors would appreciate a more quiescent environment to avoid a repeat of the Q1 mark-to-market losses. More generally, if the shape of the 2-year/10-year yield curve is any indication, the market is sending a warning signal to the Fed that it runs the risk of overtightening. This will be a key dynamic to watch over the coming quarters: Can the Fed thread the needle by tamping down inflation without materially impacting economic growth, or will it increase rates to a point where it pushes the economy into a recession?

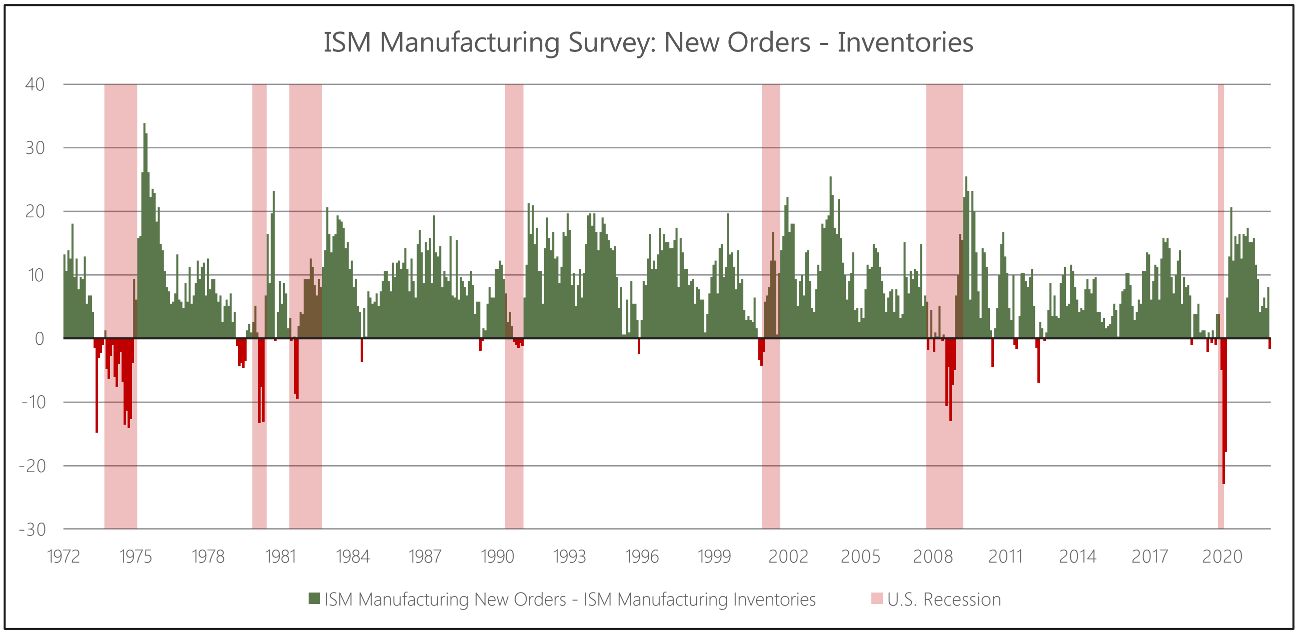
LET'S GET CYCLICAL, CYCLICAL

Zooming out from some of the specific issues that dominated Q1, a sober assessment of the business cycle and key cyclical indicators suggests that the US economy will be slowing off its torrid pace from 2021 when real US GDP growth topped 5%. Slowing, however, does not mean contracting, nor does it imply that risk assets are necessarily imperiled. It can simply be a useful contextual input to an allocation process that may make modest tilts based on the cyclical landscape.

With that as backdrop, the chart on the following page shows the relationship between business orders and inventories within the US manufacturing sector over the last 50 years. Specifically, the Institute for Supply Management tracks data from across the United States on whether companies' new orders are expanding or contracting and whether inventories are increasing or being drawn down. Comparing these two measures provides a helpful proxy for the business cycle; as new orders decline and inventories build, it is reasonable to expect a period of cyclical softness (lower readings). Conversely, as new orders increase and inventories are being depleted, a period of cyclical strength is likely on the horizon (higher readings). These cycles frequently run in 18 to 24-month waves, and the most dramatic periods of inventories building relative to new orders tend to coincide with economic recessions (shaded red areas).

What is the data telling us now? For starters, we have already seen a deterioration in this measure (i.e., new orders falling and inventories rising) which would confirm the economic deceleration narrative and perhaps helps to account for some of the market weakness in recent months. Going forward, the intersection of a more aggressive Fed and a relatively weak reading from this measure of cyclical health likely marks a key inflection point.

continued on page 5



Source: Bloomberg (Data as of 3/31/2022)

Reiterating comments from the prior section, if the Fed is overly aggressive, it risks exacerbating a run of the mill cyclical slowdown. Alternatively, if the Fed successfully slows inflation without meaningfully harming growth or employment, investors can look forward to a renewed period of cyclical strength.●

The Inflationary Wall of Worry – Point/Counterpoint

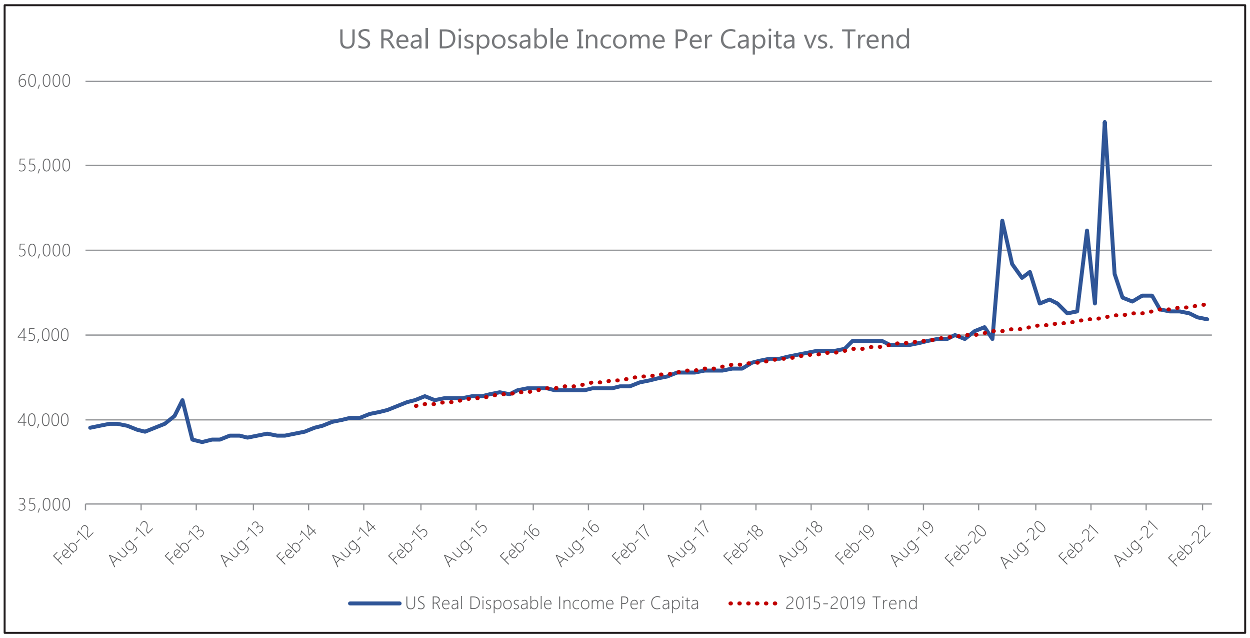
Investors are constantly faced with the challenge of evaluating risks and assessing whether the returns on offer across various asset classes provide sufficient compensation for taking those risks. Historically, markets tend to scale a proverbial "wall of worry"—overcoming risks and rewarding patient investors with an attractive rate of return.

Those navigating the current environment could be forgiven for being increasingly skeptical given the numerous issues at play, ranging from geopolitics and armed conflict to elevated inflation and commodity costs. A key consideration for US-oriented investors is the effect of these risks on the consumer given consumption's outsized impact on US growth. In an effort to distill current concerns into a few charts, we are presenting a "point/counterpoint" exercise below.

POINT: INFLATION IS HARMING THE CONSUMER

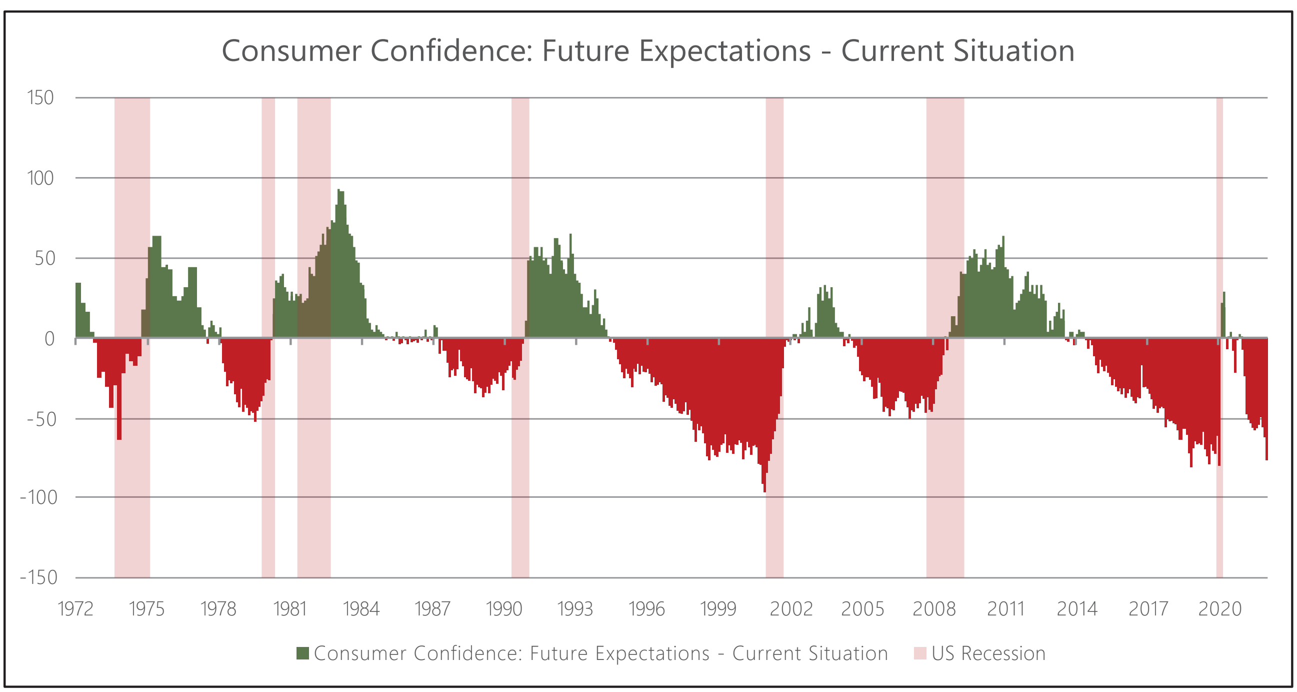
- *US Real Disposable Income Per Capita*. The chart on the following page illustrates the impact of inflation on per capita incomes in the US. After brief but material upticks during COVID due to stimulus payments, consumer spending power has started to erode in recent months as wage increases have failed to match the rate of price inflation. For context, the dotted red line shows the 2015-2019 pre-COVID trend. How resilient can the US consumer be with more money going toward expenses like housing and gas each month?

continued on page 6



Source: Bloomberg (Data as of 3/31/2022)

- *Consumer Confidence: Future Expectations less Current Situation.* The chart below uses survey data from the Conference Board to compare consumers' feelings about how strong the economy will be in 12 months relative to how strong it is today. As consumers become less upbeat about the future relative to the present, this measure produces negative readings—historically, a precursor to a recession, albeit with widely varied lead times. Despite strong headline growth and a robust labor market, consumers are clearly less upbeat about the economy's prospects for the next year as inflation eats into their pocketbooks each month.

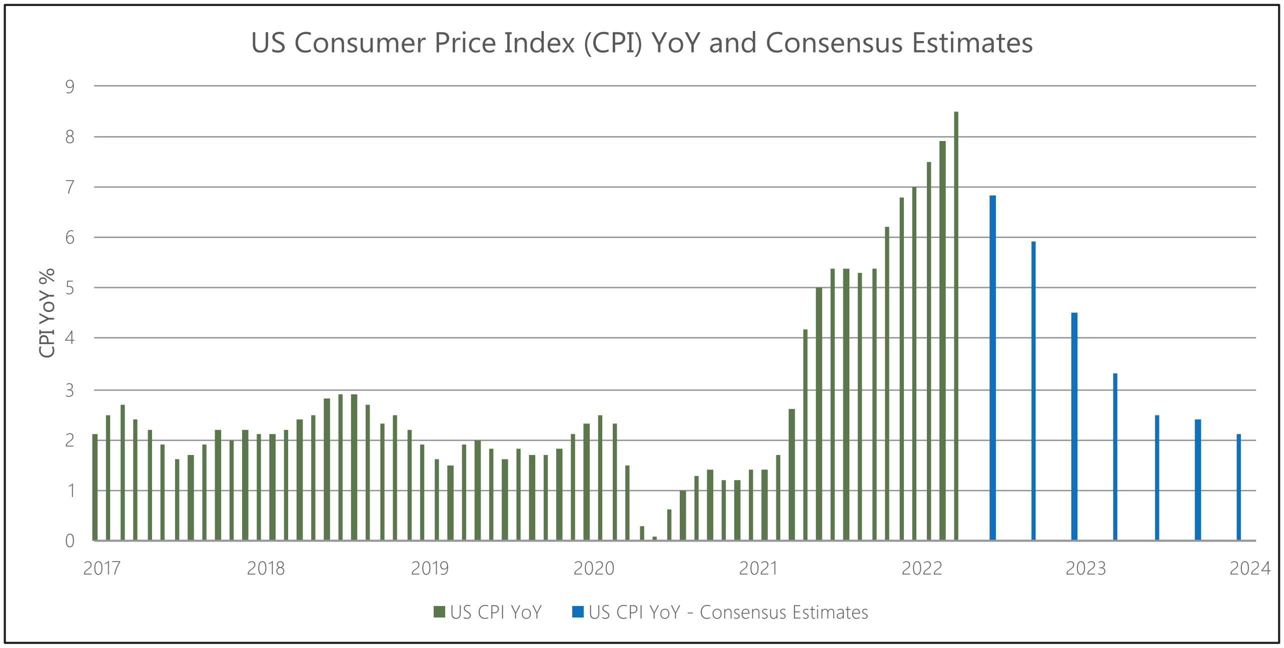


Source: Bloomberg (Data as of 3/31/2022)

continued on page 7

COUNTERPOINT: THE WORST OF INFLATION IS LIKELY OVER

- *US Consumer Price Index (CPI) and Consensus Estimates*. The chart below shows the recent path of inflation readings in the US, accelerating from levels of roughly 2-3% pre-COVID to north of 8%. The good news? The blue bars show consensus estimates for the path of inflation over the balance of 2022 and 2023, per Bloomberg survey data. If economists are correct, the upward pressure on CPI should abate and inflation will be trending closer to normalized levels by the beginning of next year. Consumer fears may be a case of looking in the rearview mirror rather than out the windshield.



Source: Bloomberg (Data as of 3/31/2022)

As inflation falls to more normalized levels, consumer spending may feel less of a pinch, and the Fed may begin backing off its more aggressive stance. Each of these would be a welcome development and offer a more supportive market backdrop. Keep an eye on these trends over the coming quarters.●

Chart of the Quarter

As inflation has continued to accelerate higher, discussions of elevated prices have permeated the financial and mainstream media. To be sure, the numbers are eye-watering in the context of recent history, and the impacts on families and businesses may be profound—especially if inflation remains elevated for an extended period. In the context of financial markets, sustained levels of inflation can have material impacts as well; for one, inflation levels have historically had a strong relationship with the valuations that investors will pay for risky assets.

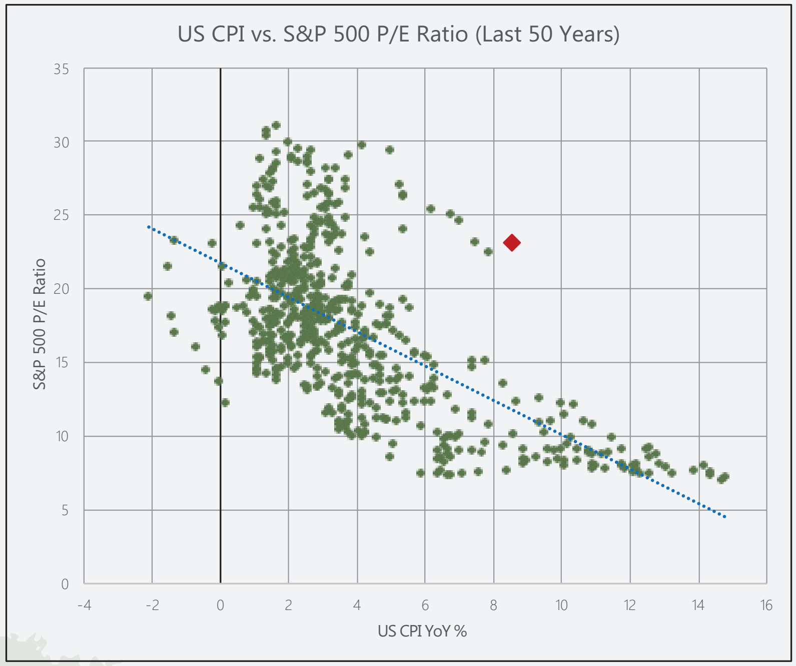
The Q1 Chart of the Quarter (following page) examines this relationship by looking at the Consumer Price Index year-over-year (horizontal axis) relative to a common measure for S&P 500 valuations, the price/earnings or "P/E" ratio (vertical axis), over the last 50 years. There is a clear correlation between the two variables; as inflation rates increase, stock valuations have historically trended lower, and vice versa for lower rates of inflation. The dotted blue "best fit" line illustrates the statistical relationship.

The generally accepted explanation for the link between these variables is that investors command a quicker payback and higher rates of return on their investment via earnings (i.e., a lower P/E ratio) during high levels of inflation and elevated price uncertainty. Conversely, when prices are stable at low levels of inflation, investors are more willing to accept a longer payback period on their investments and valuations that imply lower rates of return (i.e., a higher P/E ratio).

continued on page 8

The rub comes when we look at the current reading, noted on the chart by the red diamond. With the annual inflation rate running over 8%, the historical relationship between these factors would suggest that the P/E multiple for the S&P 500 should be somewhere closer to 12-13 and not 22-23. Even if we account for a wide error term and other variables such as low yields, it is still reasonable to suggest that the directional pull on valuation multiples should be lower at current inflation levels.

Of course, this is just one analysis of two data points—albeit widely followed data points—but it would imply that something has to give over the coming quarters: Either stocks have it correct and inflation will normalize to justify an elevated P/E ratio, or equities need to be revalued lower based on persistently higher inflation readings. How this resolves itself remains to be seen, but investors should take note of this anomaly.●



Source: Bloomberg (Data as of 3/31/2022)

Dave Keevins
Chief Investment Officer
Managing Director

Andrew Krei, CFA
Head of Investment Research
Client Advisor

Blake Durham
Client Advisor

Gary Gawryleski
Senior Client Advisor

Gregg George
Managing Director

Chris Jauch
Client Advisor

Nick Kochanski
Managing Director

David Ness
Institutional
Portfolio Manager

Robert Peterson
Senior Wealth Advisor

Mitchell Prosk
Senior Client Advisor

Shanna Venne
Wealth Advisor

Elizabeth Watkins
Chief Operating Officer
Chief Compliance Officer

Dustin Wolk
Wealth Advisor

James Wood
Senior Client Advisor

Tony Wright
Senior Client Advisor

Contact us

Crescent Grove Advisors, LLC
100 Field Drive, Suite 215, Lake Forest, IL 60045 • 847.752.0292
313 N. Plankinton Avenue, Suite 216, Milwaukee, WI 53203 • 414.386.5340
3284 Northside Parkway NW, Suite 495, Atlanta, GA 30327 • 678.585.6625
crescentgroveadvisors.com
www.linkedin.com/company/crescent-grove-advisors