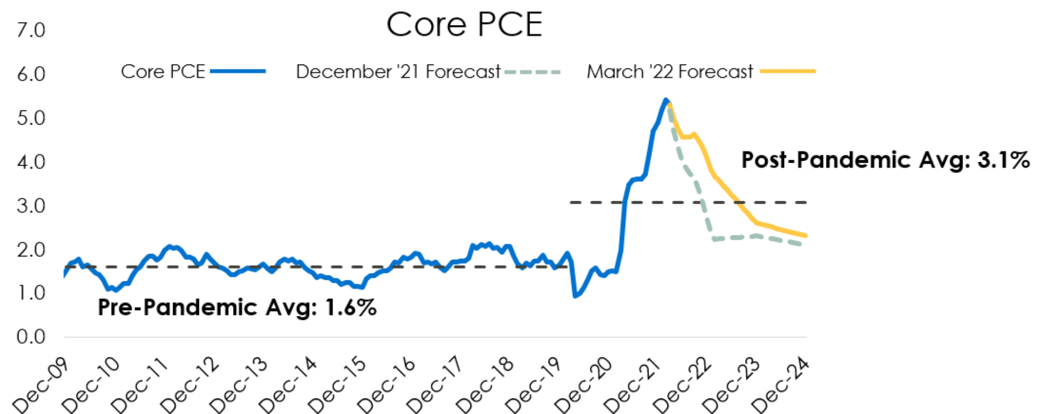
Spring Forward, Glide Back

"In the Spring, I have counted 136 different kinds of weather inside of 24 hours."

– Mark Twain (1835-1910)

Hope springs eternal. After a long and dreary winter, spring often ushers in feelings of rejuvination. If you're in the Midwest, March can be a difficult month represented by the tug of war between the winter to spring transition. Weather patterns can make it feel like Mother Nature has a cruel sense of humor. March is also the month of daylight savings, where we "Spring Forward" our clocks to capture an extra hour of sunlight on the back end.

Investors, businesses and consumers are feeling the "Spring Forward" of inflation. While we've written about these trends starting back in August of 2020, inflation has now come front and center, catching the increased attention of the Fed. Policymakers have acknowledged it as a problem that needs to be addressed and have taken their inflation forecasts up accordingly. As can be seen in the chart below, the Core PCE – the Fed's preferred measure of inflation – has quite literally "sprung forward" post COVID to levels not seen in decades. The Fed's introduction of their Flexible Average Inflation Target (FAIT) policy, combined with massive stimulus dollars, COVID restrictions, subsequent supply chain disruptions and the Russian invasion of Ukraine have all played a role. The question now becomes, how does inflation evolve going forward? The Fed recently updated their inflation forecasts at the March FOMC meeting which resulted in inflation projections that more gradually glide back down over the next



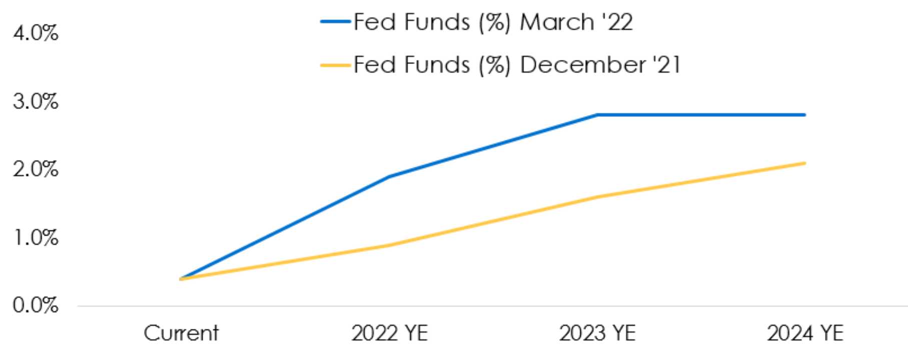
Source: Factset; PCE forecasts are produced by the Federal Reserve as of December 2021 and March 2022 and are smoothed evenly over time.

The information contained or topics discussed in this piece are not FDIC insured and are not bank deposit products.

EQUAL OPPORTUNITY LENDER EQUAL HOUSING LENDER FDIC

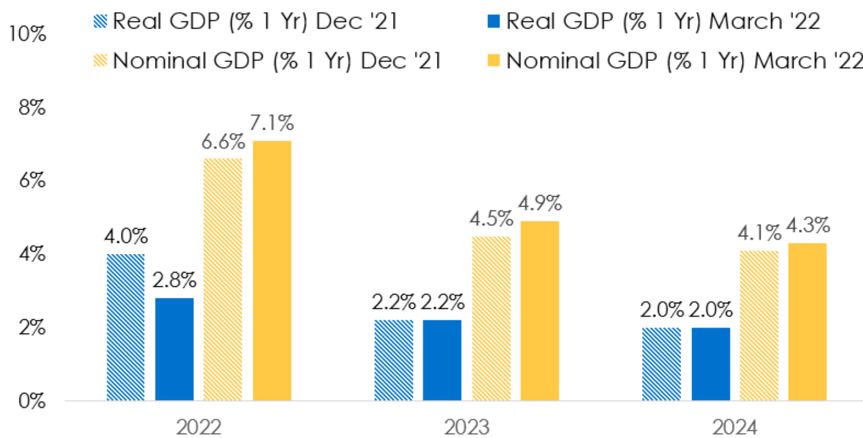
several years. This compares to the steeper decline in inflation that was projected back in December (see December and March forecasts on the prior page).

Policymakers have now come to grips with the idea that inflation is not moderating as fast as they initially expected. As a result, policy accommodation is now reversing. In other words, the Fed is anticipating the need to raise short term interest rates more quickly than previously expected. As can be seen in the chart at right, at the March meeting, policymakers pulled forward more than twice the number of rate hikes previously anticipated for this year (7 hikes including the recently announced 25 bps rate hike). The same three hikes remain on the table for next year, which projects the Fed Funds rate close to 3% by the end of 2023.



Source: FOMC; Projections for the Fed Funds rate are the value of the midpoint of the projected appropriate target range for Fed Funds at the end of the specified calendar year. Projections are based on the Fed forecasts at the December 2021 meeting and March 2022 meeting.

Also, included at that meeting were the Fed's real GDP growth projections. As noted in the table below, while the Fed downgraded their forecasts for real GDP growth this year, their increased forecasts for inflation imply higher nominal GDP growth over the next several years. It remains to be seen if the Fed can engineer a soft landing – keeping GDP growth positive while pushing inflation sufficiently back down.



Source: FOMC; Projections of change in Real GDP are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. Nominal GDP projections incorporate the Real GDP projections plus PCE inflation projections. Projections are based on the Fed forecasts at the December 2021 meeting and March 2022 meeting.

Much will depend on the evolution of inflation, the Fed's response and the progression of the fundamentals.

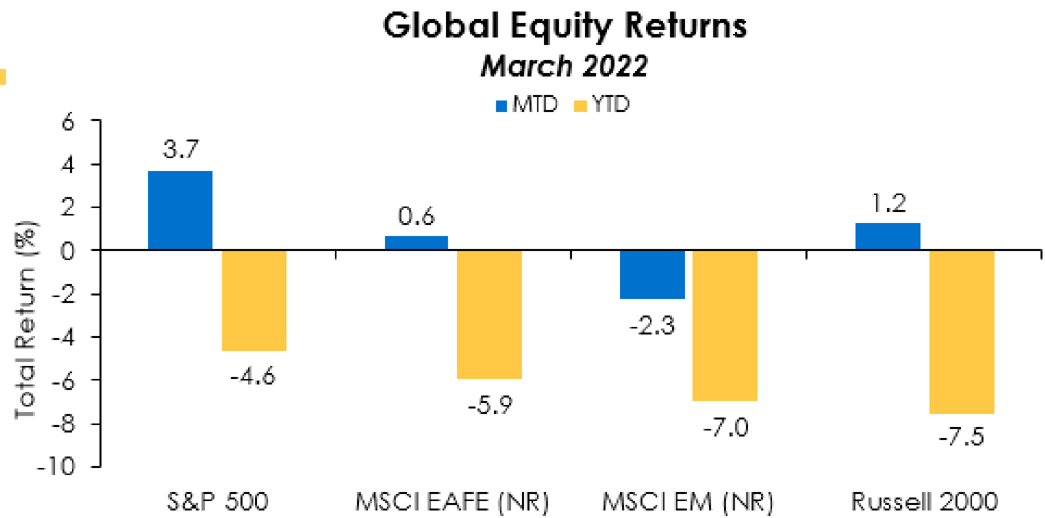
For now, we'll simply say – spring has sprung.

The information contained or topics discussed in this piece are not FDIC insured and are not bank deposit products.

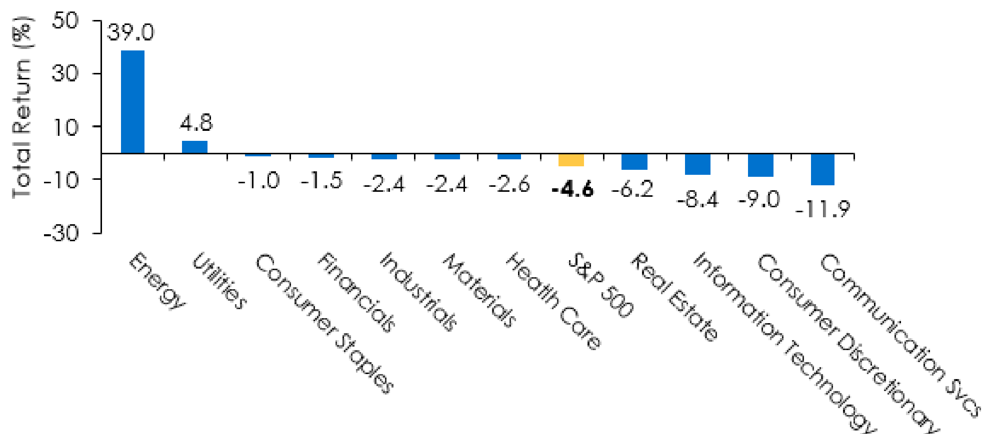
EQUAL OPPORTUNITY LENDER EQUAL HOUSING LENDER FDIC

After such heady returns for risk assets in 2021, investors took profits in most of these areas to begin the year. As such, the S&P 500 suffered its worst year-to-date return since 1Q20. Commodities were the lone bright spot though March saw better returns for Stocks and REIT's. Meanwhile, Bonds remained pressured given high inflation and rising interest rates.

Stocks



Stocks traded lower to begin the year though most areas saw a bounce in March. Year-to-date, domestic markets (S&P 500 and Russell 2000) outperperformed international markets (MSCI EAFE and MSCI EM). While more expensive US LC valuations led to relative underperformance in January, the geopolitical environment gave way to a flight to safety back to the US and relative outperformance in the quarter. Still, only two sectors within the S&P 500 finished in positive return territory. Sector performance was influenced by valuation sensitivities and geopolitics as well. Higher priced Cyclical Growth sectors (Discretionary, Technology and Communication Services) were down the most while Defensive sectors (Consumer Staples, Utilities, Health Care) outperformed along with the least expensive Cyclical Value sectors (Energy, Financials, Industrials, Materials).

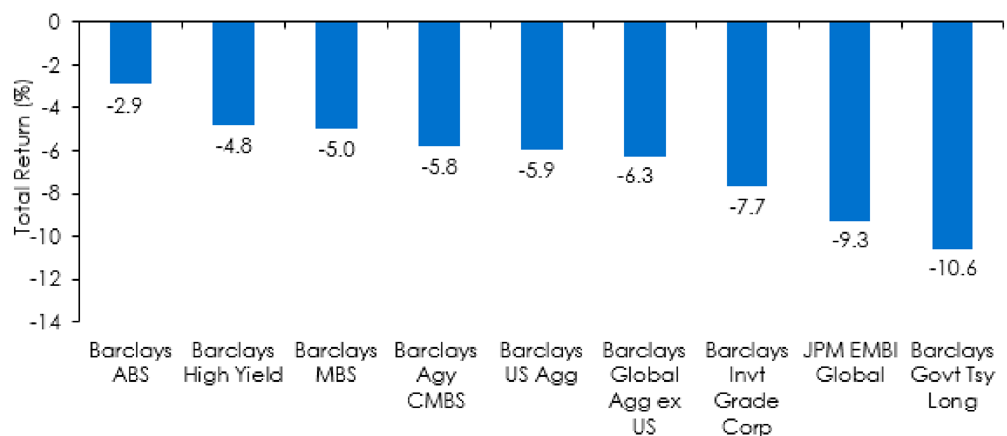


The information contained or topics discussed in this piece are not FDIC insured and are not bank deposit products.

EQUAL OPPORTUNITY LENDER · EQUAL HOUSING LENDER · FDIC

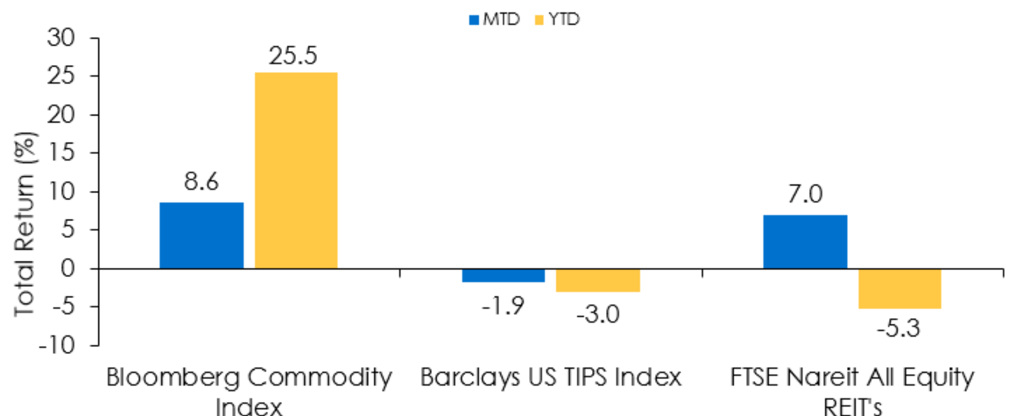
Bonds

Bond returns remained in negative territory amid the continuation of an upward rate bias consistent with elevated and persistent inflation. Long-term rates began trending higher in August of 2020, then traded sideways since April of last year before taking another leg higher year-to-date. Since October, shorter term rates have moved up more quickly as rate markets are pricing in a more aggressive Fed response to the inflation backdrop. While credit spreads held steady for much of the past year, they began to move wider in November (Omicron) and again in January and February (Russia) before tightening in again in March. As a result, bonds that carried shorter durations – namely Securitized Assets (ABS, MBS, CMBS) – were better insulated. High Yield also benefited from the improving credit trends in March. Conversely, Investment Grade corporate bonds and more duration sensitive areas (Govt Tsy Long) were harder hit along with emerging market debt (JPM EMBI Global) given the geopolitical backdrop.



Alternatives

Alternatives posted the most disparate of returns in 1Q22 – publicly traded Real Estate (REIT's) rallied in March but remained down YTD. Meanwhile, Commodities posted among the strongest (and positive) returns as they've proven to be more resilient as an inflationary hedge with particular strength in Energy, Industrial Metals and Agriculture prices.



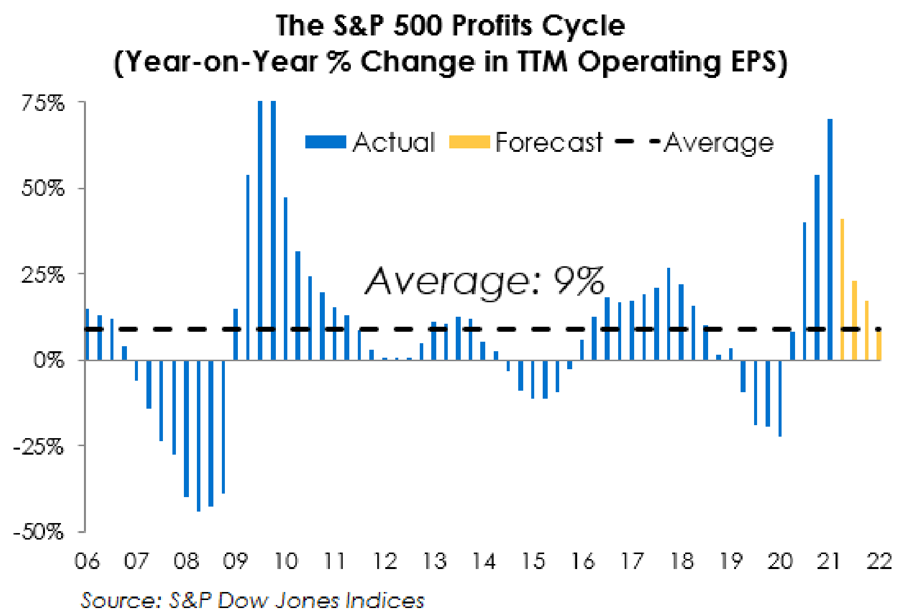
Market Outlook

"It's tough to make predictions, especially about the future."

– Yogi Berra (1925-2015)

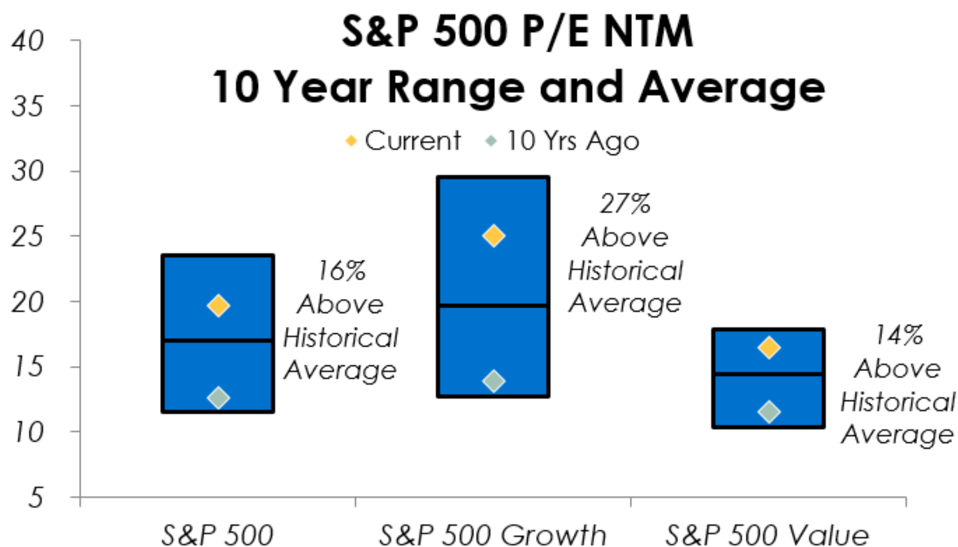
As we move through the course of 2022, we think the phrase "Moderate Resilience" might still best define the environment. Said another way, growth rates moderating from elevated levels might apply to everything from corporate earnings to nominal GDP to inflation. Embedded within that view is the idea that the cycle is maturing, but well above average growth in the money suppy (a key measure of liqudity) last year suggests some resiliency to nominal growth this year.

From a cyclical standpoint, our view is that growth is slowing but it's not necessarily slow, quite yet. As can be seen in the chart below, coming off last year's S&P 500 earnings growth of more than 50% suggests that we have some room before we get to the zero bound. As a consequence, calls for an imminent recession seem premature. This is, of course, not without risks. A COVID strain that's more virulent, an escalation in Russia's invasion of Ukraine and/or the Fed's aggressiveness on rate hikes are all scenarios that could lead to recession but, from our view, the downward trajectory of the fundamentals isn't steep enough to get us there as a base case at this point.



Coming into this year, our expectation was for more moderate market returns with an increased likelihood for more volatility. Several conditions led us to that way of thinking including forward returns following a peak in corporate profits growth, above average volatility in mid-term election years, valuation pressures when inflation is elevated and just more modest returns as a bull market ages. That perspective led us to focus on the importance of managing the overall exposure and mix of risk assets within portfolios – with an acknowledgement that the business cycle was maturing and a transition was occurring to the deceleration phase of the profit cycle.

From a secular perspective, we're still sympathetic to the view that inflation might linger for longer than expected. While today's inflation is consensus, the persistence of future inflation may not be. If the inflation paradigm is changing this creates both risks and opportunities in the market. As can be seen in the chart at right, S&P 500 Growth valuations remain notably more expensive even after their underperformance year-to-date. These winners of the past – given their valuation vulnerabilities – may not be the same winners in the future. This continues to bias our view towards maintaining pro-inflationary tilts within portfolios.



As we noted earlier, the focus for investors remains squarely on how the Fed might land the plane. To us, it seems like one of three scenarios are likely.

- *Soft Landing* – involves the Fed engineering inflation back down to pre-pandemic levels and growth moderating in a benign way. In this scenario, winners of the past might continue as the prior inflation paradigm remains unchanged.

- *Hard Landing* – involves a Fed induced recession whereby policymakers move aggressively to address inflation and, thus, also materially slow demand. This is the "hike until something breaks" scenario with risk assets suffering as a result.

- *Delayed Landing* – involves the Fed staying behind the curve, which allows inflation to persist longer than expected and nominal growth to stay elevated as a consequence. Pro-inflationary assets might be preferred in this backdrop. This outcome could eventually lead to the hard landing scenario as it will likely force the Fed to tighten the screws.

These outcomes are complicated by the fact that inflation is a moving target as is the Fed's response, which also can influence the progression of the fundamentals or growth trajectory. We continue to ask the

The information contained or topics discussed in this piece are not FDIC insured and are not bank deposit products.
EQUAL OPPORTUNITY LENDER EQUAL HOUSING LENDER FDIC

questions, (1) how fast will the Fed hike within the context of what's likely to be some natural moderation in inflation? (2) how fast will the fundmentals and earnings slow in response?

We think that the volatility that we've witnessed in stocks thus far has been driven more by downward pressure on valuations (given elevated inflation) rather than a quick deterioration in the fundamentals (which are slowing but not yet slow). Liquidity, however, is coming out of the market which tends to impact the fundamentals with a lag so this bears watching.

<u>From a portfolio positioning perspective, we continue to believe that it's important to strike the right balance between Moderation and Resilience.</u> To us, that means managing the overall exposure and mix of risk assets consistent with a maturing cycle (i.e. Moderation) while also being cognizant of the continued need for pro-inflationary tilts (i.e. Resilience).

In acknowledging the moderating and maturing business cycle, earlier this year we took the opportunity to, once again, trim our modest OW to risk assets and remix within Alternatives (trimming Real Estate and Commodities and adding to Diversified Alternatives as a volatility hedge) and Equities (remixing within US Large Caps to incorporate more balance among sector OW's between Cyclical Value and Defensive stocks – consistent with the deceleration of the profit cycle – while also adding to less expensive International Developed Markets).

<u>Within equities,</u> our positioning has moved slightly OW and continues to favor a pro-inflation bias with a value sector tilt within our US exposure (albeit with a quality bias) and an OW to Developed versus Emerging Markets.

<u>Within fixed income,</u> to mitigate some portfolio risk, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) but our US Core managers are OW credit relative to treasuries. We also continue to carry a shorter duration bias (less interest rate sensitivity). Our US Core Fixed Income exposure remains an OW supplemented by our UW position in International Fixed Income which remains a hedge against a weaker dollar environment.

<u>Within alternatives,</u> we remain more barbelled with an OW to Commodities as a way to bolster inflationary hedges while also adding to Diversified Alternatives which provides some hedge against market volatility. Real Estate was trimmed previously – taking advantage of outsized profits last year.

The information contained or topics discussed in this piece are not FDIC insured and are not bank deposit products.

EQUAL OPPORTUNITY LENDER FDIC

The information presented in the material is general in nature and should not be considered investment advice, is not designed to address your investment objectives, financial situation or particular needs. Information is gathered from sources deemed reliable but its accuracy or completeness is not guaranteed. The opinions expressed herein may not come to pass, are as of the date of publication and are subject to change based on market, economic or other conditions.

You cannot invest directly in an index. Indexes are unmanaged and measure the changes in market conditions based on the average performance of the securities that make up the index. Investing in small and mid-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. Asset allocation and diversification does not ensure a profit or protect against a loss.

Yellow Cardinal Advisory Group, a division of First Financial Bank, provides investment advisory, wealth management and fiduciary services. Yellow Cardinal Advisory Group does not provide legal, tax, or accounting advice. The products and services made available by Yellow Cardinal Advisory Group:

Not Deposits | Not FDIC Insured | Have No Bank or Federal Government Guarantee | May Lose Value