

The Cycle Usually Outlasts the Event

“I cannot forecast to you the action of Russia. It is a riddle wrapped inside a mystery inside an enigma.”

– Winston Churchill (1939)

With the recent geopolitical event of Russia invading Ukraine, the human impact is the immediate focus and our thoughts go out to the Ukrainian people while history will likely judge Russian leadership harshly. What follows are our dispassionate thoughts about the potential impact of this event on the financial markets.

While events can often trigger an emotional response, we’d argue that paying attention to cycles in the financial markets is critical to following the fundamentals. As a result and especially right now, we think it’s important to remember the following:

(1) Does the event change one’s long-term strategic asset allocation (i.e. financial plan)? It only does to the extent that it changes one’s long-term risk tolerance. Remember, short term volatility is the price one pays for long-term returns. Following a major market low, as can be seen in the table at right, the easy money gets made in the first twelve months. The second year gets tougher with more moderate returns and increased volatility. While the event itself is unusual, this pattern is very typical.

SECOND YEAR TOUGHER THAN THE FIRST
S&P 500 Index, Since 1950

Major Low - S&P 500	First 12 Months After Low	Next 12 Months	Maximum Drawdown In 2nd Year
10/22/57	32.0%	10.5%	-9.2%
6/26/62	34.2%	15.5%	-6.5%
10/7/66	32.1%	6.6%	-10.0%
5/26/70	46.2%	5.5%	-11.0%
10/3/74	34.7%	27.3%	-5.1%
8/12/82	55.4%	-0.7%	-14.4%
12/4/87	22.2%	26.3%	-7.6%
10/11/90	28.8%	7.8%	-6.2%
10/9/02	33.8%	9.2%	-8.2%
3/9/09	68.3%	14.9%	-16.0%
3/23/2020*	74.8%	11.9%	-14.6%
Average	42.0%	12.3%	-9.4%
Median	34.2%	9.9%	-8.7%

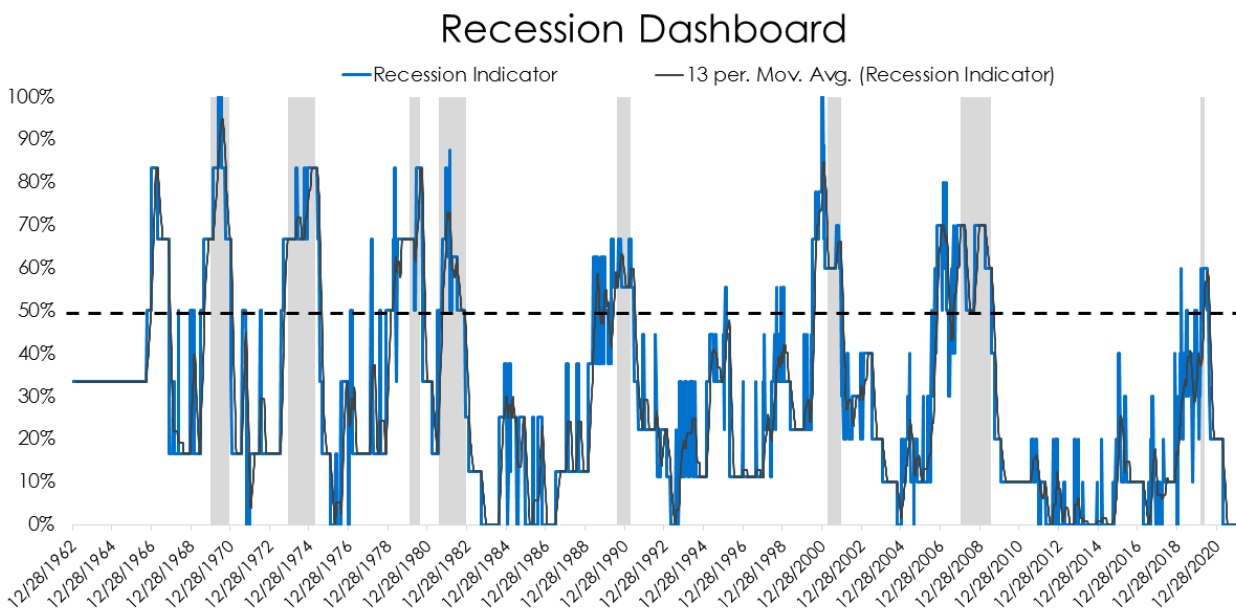
(2) The cycle usually outlasts the event. Responses to events are emotional. Cycles root one back to the fundamentals. The event becomes increasingly important to the extent that it influences the cycle.

Source: Strategas, Yellow Cardinal Research; Second Year calculations are as of 2/28/22. Average and Median calculations do not include the most recent major low for the S&P 500 (3/23/20).



(3) Typically, events don't change the pre-established trends within a cycle.

- Inflation remains entrenched – further exacerbated by energy disruptions and tendencies towards de-globalization. While energy disruptions may be shorter lived, COVID and geopolitical discord further engrain the notion of de-globalization efforts making them longer lasting. Countries and companies appear to have a greater desire for more control and reliability over their supply chain networks, which may come at the expense of their lowest cost option. This is inherently inflationary.
- Growth and returns are moderating coupled with increased volatility. Coming into this year, the combination of a peak in corporate earnings growth, a midterm election year and elevated inflation all pointed to a greater likelihood for the above. We don't think geopolitics do anything to change that and, if anything, may speed up the moderation process. It's important to note that while many of our recession indicators are no longer improving, none of them are flashing warning signs. Typically, when 50% or more of the weighted average of these signals are triggered, recession is on the table in the not too distant future. We're staying tuned in.



Source: Yellow Cardinal Research; the Recession Indicator is a proprietary dashboard of financial conditions that historically have provided some lead time on recessionary events. When more than half of the weighted average signals were triggered, this often precluded a recession. The Recessionary Indicator is a weekly signal with the 13 week moving average smoothing the volatility.



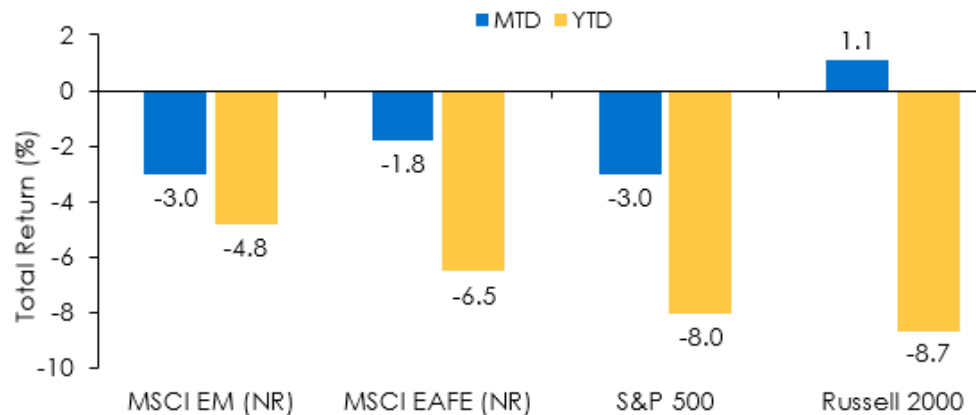
After such heady returns for risk assets in 2021, investors took profits in some of these areas to begin the year. As such, the S&P 500 suffered its worst two-month start since February of 2020. Stocks, Bonds and REITs finished the month with mostly negative returns while Commodities remained the bright spot.

Stocks

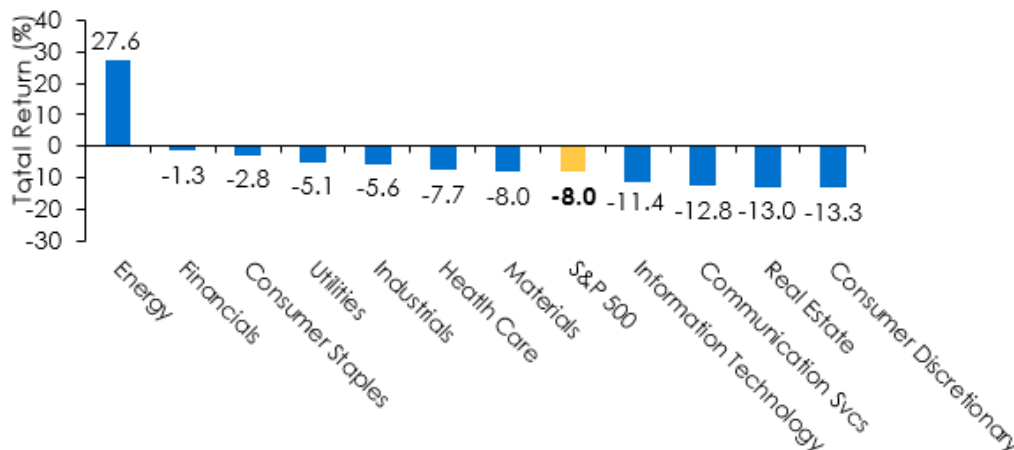
Stocks traded lower across the board to begin the year. Year-to-date, domestic markets (S&P 500 and Russell 2000) underperformed international markets (MSCI EAFE and MSCI EM) – as high P/E stocks become the most valuation

sensitive to elevated inflation conditions. In February, the geopolitical environment saw a flight to safety back to the US with Small Caps posting positive returns given more insulated domestic exposure. All but one sector within the S&P 500 finished in negative 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).

Global Equity Returns
February 2022



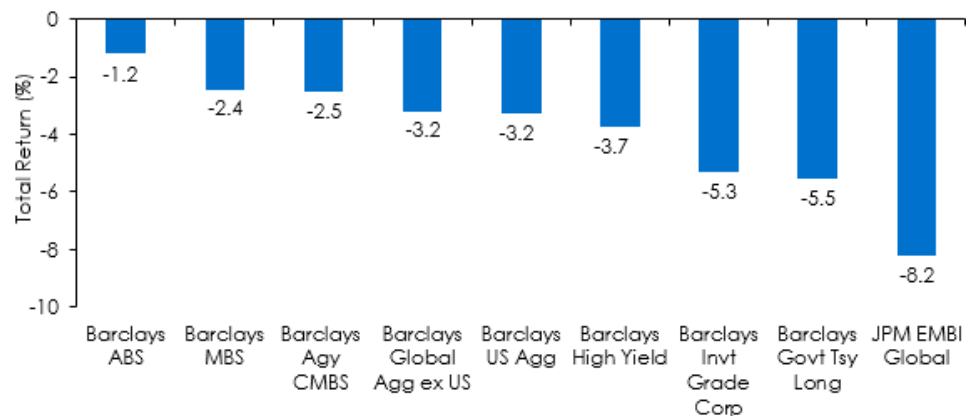
S&P 500 Sector Returns
February 2022 - YTD



Bonds

Bond returns started the year in negative territory amid the continuation of an upward but uneven rate bias. Long-term rates began trending higher in August of 2020, then traded sideways since April of last year before moving up again in January while giving some back at the end of February (“risk off” posture). Since October, shorter term rates have moved up more steadily as rate markets are pricing in multiple Fed rate hikes this year in 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 these past two months (Russia). As a result, bonds that carried shorter durations – namely Securitized Assets (ABS, MBS, CMBS) – were better insulated. Conversely, both High Yield and Investment Grade corporate bonds and more duration sensitive areas (Govt Tsy Long) were harder hit. Emerging market debt (JPM EMBI Global) was the most negatively impacted given the geopolitical backdrop.

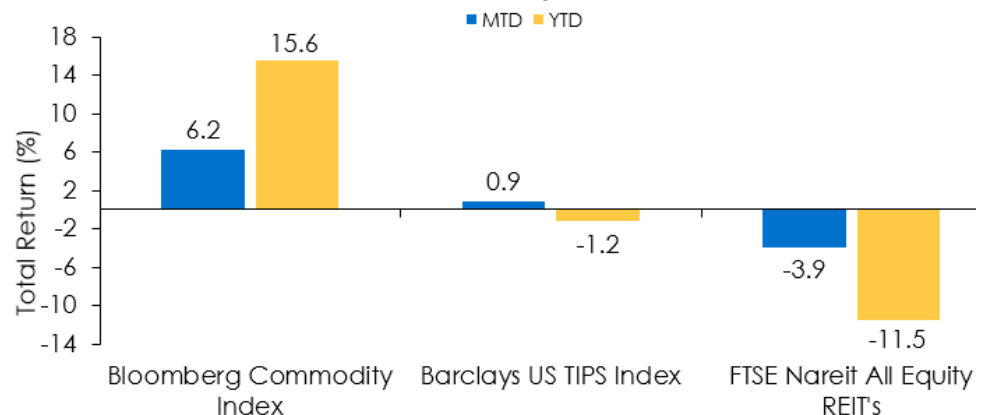
Global Fixed Income Returns
February 2022 - YTD



Alternatives

Alternatives posted the most disparate of returns to start the year – publicly traded Real Estate (REITs) was among the harder hit areas while Commodities posted among the strongest (and positive) returns. The former was viewed as a profit taking opportunity given last year’s strength. The latter proved to be more resilient as an inflationary hedge with particular strength in Energy, Agriculture and Industrial Metals prices – and with Precious Metals catching a bid this past month.

Alternative Market Returns
February 2022



Market Outlook

“It’s tough to make predictions, especially about the future.”

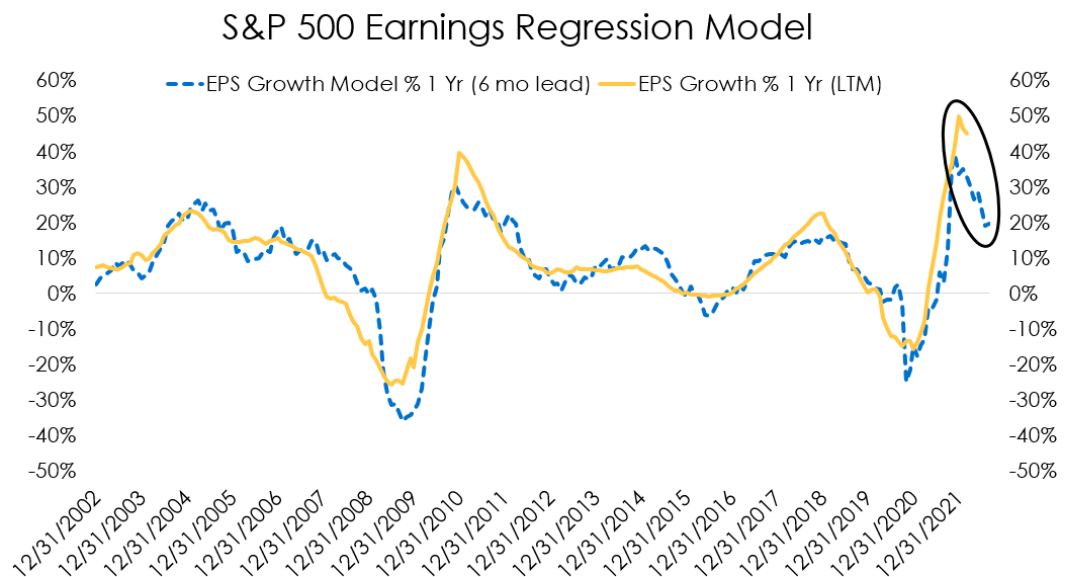
– Yogi Berra (1925-2015)

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 money supply (a key measure of liquidity) still growing at a well above average level last year suggests some resiliency to nominal growth this year.

Russia’s attack on Ukraine is concerning and suggests the bias is to the downside, but thus far, our S&P 500 profit cycle forecast points to confirmation of the above framework – earnings growth is set to moderate from elevated levels with a 6 month lead time. The chart below illustrates our proprietary S&P 500 earnings regression model which has served as a decent proxy for forward earnings growth historically. Slowing but not slow profit growth remains the forecast through mid year. As we noted earlier, this moderating growth trend was in place before the geopolitical event and we expect it to remain in place thereafter.

The important takeaway is that this transition to positive but moderating growth argues that we’ve now shifted to the deceleration phase in the profit cycle. This, combined with the other pre-existing trend – entrenched inflation – suggests the following takeaways for 2022:

- Market returns are expected to be more moderate on balance with a greater likelihood for more volatility.



Source: Factset; Yellow Cardinal Research. EPS Growth Model is a proprietary regression model based on economic inputs that are found to be good predictors of the S&P 500 profit cycle with a 6 month lead time.



- Managing the overall exposure and mix of risk assets will be an important consideration and should reflect a moderating business cycle.
- Maintaining pro-inflationary tilts might continue to make sense especially should inflation linger at resiliently higher levels for longer than expected.
- Avoiding valuation vulnerabilities will be critical especially if the disconnect between rates and inflation is unsustainable.

Of course, it will be important to monitor a number of risk factors as the year plays out.

- Russia's invasion of Ukraine is obviously noteworthy especially to the extent that it influences the business cycle. Does Europe's energy reliance on Russia create a stagflationary environment and does that flow through to the US?
- The Fed's reponse to inflation will continue to be a key factor to the backdrop as well. Inflation is likely to moderate but does it moderate enough to appease policymakers or does the Fed get more restrictive to stomp inflation out regardless of earnings and economic consequences?
- Midterm election years often come with renewed volatility and should be watched for policy implications.
- COVID remains the wild card given its unpredictability with a more contagious and more severe strain the main concern.

From a portfolio positioning perspective, we think it will be important to strike the right balance between Moderation and Resilience. To us, that means managing the overall exposure and mix of risk assets (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, we recently 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). We also maintained our pro-inflation tilts by shifting away from valuation vulnerabilities, which included a modest trim of (more expensive) US exposure in favor of (less expensive) International Developed Markets.

Within equities, our positioning has moved closer to neutral but continues to favor a pro-inflation bias with a value sector tilt within our US exposure (albeit with a quality bias) and a slight OW to International Developed Markets.

Within fixed income, 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 and UW (defensive)



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.

Within alternatives, 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 recently – taking advantage of outsized profits last year.

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