

Review & Outlook

FIRST QUARTER 2022



119 N. Commercial St., Ste. 191 • PO Box 1618 • Bellingham, WA 98227
P: 360.671.0148 • P: 800.292.8794 • F: 360.671.8936

Review and Outlook

We start this review by expressing our sadness about all the death and destruction in Ukraine. We hope for a peaceful end to the violence, but worry that the conflict could continue for quite a while.

We made no mention of potential war in our last Review & Outlook. While Russia was moving troops towards Ukraine in late

2021, we, like so many others, envisioned a lot of political posturing and threatening rhetoric, but we did not anticipate a military invasion.

In early 2022, the financial markets were looking ahead to likely action from the Federal Reserve to manage inflation. There was also concern about company earnings slowing a bit, as the impact from the stimulus money that was provided in 2020 and early 2021 would start to fade in 2022. Stock prices and bond prices were falling prior to Russia's invasion of Ukraine. In fact, as we write this, U.S. stocks are slightly higher than when Russia invaded Ukraine in late February. The chart below shows the change in broad stock and bond indexes since the start of the year. Bond prices are lower, due to increased concern about inflation and the Federal Reserve's significant raising of short-term rates.

At the start of 2022, the outlook was rather positive. Yes, inflation was a worry, but it was expected to fall over the course of the year as supply chain constraints eased. There was still enough push from all the stimulus money that most people felt GDP would increase

more than 3% over the year. The Delta and Omicron COVID variants delayed the growth expected from the stimulus, and lowered the rate of expected growth, but the outlook still remained rather positive.

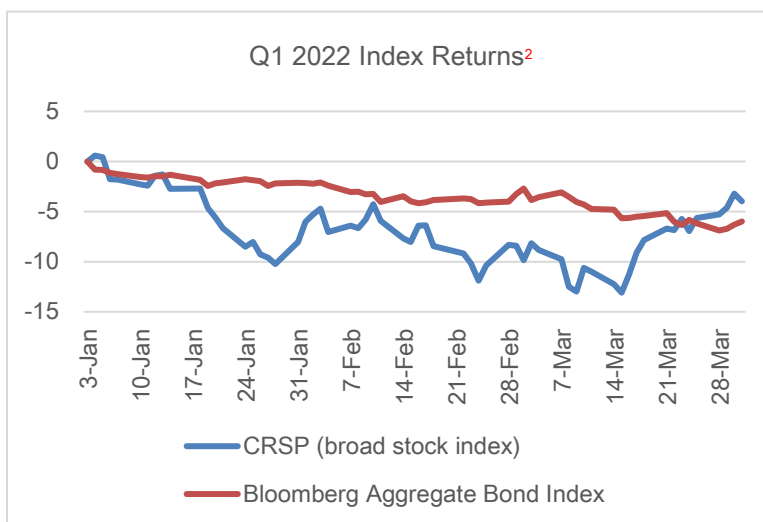
Now here we are at the end of March with a variety of new challenges. Inflation has become a bigger problem than we thought a few months ago, and is likely to linger longer. At the same time, the Federal Reserve has to worry about a weaker economy when deciding how much to raise interest rates to slow inflation. The economy is weaker due to higher energy prices, higher commodity prices, and more.

The new outlook from the National Association for Business Economics calls for inflation to stay above 3% through the end of 2023, and a range of forecasters have lowered their expectations for GDP, because of inflation, deteriorating sentiment, and the war in Ukraine. At the same time, wages have been rising, credit is available, and businesses are hiring. All that hiring means unemployment should remain low, though the unemployment rate could tick up if labor force participation rates increase.

Index Performance Data
Total Return as of 3/31/2022

Indices ¹	Q1 2022	Trailing 12 Months
CRSP U.S. Total Stock Market Index	-5.44%	11.66%
MSCI Global ex-U.S. Total Stock Market Index	-5.58%	-4.20%
Bloomberg Barclays U.S. Aggregate Bond Index	-5.93%	-4.14%

Q1 2022 Index Returns²



You will hear talk of a possible recession, with references to an inverted yield curve and other concerns, but we do not think an actual decline in economic activity is in the cards for 2022. We see GDP growth in the 2-3% range this year, inflation falling towards 3% by late 2022

(which is still above the desired target of 2%), and low unemployment.

The crisis in Ukraine adds a great deal of uncertainty to that outlook. We can imagine scenarios that would be extremely problematic, but can also see a peaceful cease-fire in the very near term that would lead to a much brighter outlook.

Policy mistakes, especially on the part of the Federal Reserve, are another potential risk. Some would even say the Fed has already made a mistake, and now has to decide between addressing inflation at the expense of harming the economy or ignoring it altogether.

The Federal Reserve has been talking recently about doing whatever they need to do to bring inflation under control, including sharply increasing interest rates. We think the Fed's bark may be worse than the bite. First, raising interest rates is not a perfect policy response to address inflation caused by supply chain shocks. And second, the Fed does not want to raise interest rates when the economy is already slowing. So, we think the tough talk is to manage expectations, and any actual rate increases for the next six months will be modest.

We also expect that the higher level of uncertainty in the economy means continued volatility for the stock markets.

In Focus

We want to take this opportunity to explain how and why we reallocated our clients' portfolios during the first quarter.

For bonds, higher inflation and higher interest rates mean that existing bonds fall in value. We've seen this dynamic playing out since the start of the year, and it could continue a while longer. Some of the bonds we purchased in our clients' portfolios matured last year, and we kept the resulting cash until this month. We did not want to reinvest the funds back into bonds last year or early this year only to have the new holdings fall in value, but we also didn't want to hold cash for

too long, since cash gives no return. As such, we waited until interest rates increased, which allowed us to purchase additional holdings of very short-term bonds at a discounted price. We know the bonds we purchased could fall in value if interest rates climb noticeably from current levels, but we do not anticipate rates going up significantly, and we do not plan on selling them; instead, we intend to hold them until they mature, collecting interest along the way.

Turning to global funds. We reduced our clients' global holdings in the fourth quarter of 2021, then eliminated those holdings completely in the middle of the first quarter of 2022. Just before the end of the quarter, we added global holdings back to our clients' portfolios, paying special attention to the disruptions caused by the invasion of Ukraine. In particular, we think the war in Ukraine means changes in commodity flows. Many countries are now looking for alternatives to the oil, grain, and other commodities they receive from Russia. Commodity flows from Ukraine have also been disrupted. As such, we see growth in countries that export many of those same commodities. These countries include Canada, Australia, and Brazil, and our clients have exposure to those countries in their portfolios.

Turning to U.S. funds and individual equities, we note that inflation is not necessarily bad for stocks. It can mean lower earnings for certain companies. In addition, higher interest rates tend to reduce the value today of future earnings. That means we have to be careful, and perhaps avoid companies that do not have the ability to raise the price of their goods to offset higher operating costs, and/or companies where the value is really based on earnings expected sometime in the future as opposed to strong earnings now. As such, we are focusing heavily on free cash flow and strong earnings in our selection of U.S. mutual funds and individual stocks.

In the end, we are hoping for the best in Ukraine, planning for continued volatility in the financial markets, and wishing you a happy spring.

1. Index price and performance data is provided by Black Diamond Wealth Platform, an SS&C Advent product.

2. Index data provided by YCharts.

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