Market Outlook

SPRING 2022

HOWE & RUSLING
WEALTH MANAGEMENT

On Our Minds

A bull in a china shop.

Thinking about the present state of the economy, the bull in a china shop metaphor pretty much sums up how markets, central banks, and investors are looking to the future—delicate steps.

While there are some intended puns in picking that phrase as our lead-in to this Outlook, we have seen our pandemic-related bull market take a hit on the chin this past quarter, and the future is very uncertain. We firmly have inflationary issues, markets which are perplexed from war related events (both the tragedy of human loss and suffering in Ukraine as well as the economic consequences), a central bank that was serving punch to the bulls by barrels but is now ready to begin removing the punch bowl, and finally toss in the threat of virus surges (parts of China in lock-down again). With all this, our bull will need the grace of a ballerina to keep from tipping over those expensive Wedgewood or Lenox china collectables as it navigates forward.

As we oversee portfolios we see the risks, but also opportunities, as this is how markets work. The challenge ahead is looking at all the risks, which have elevated over the past 3 months, understanding those risks, and then positioning portfolios to each investor's risk tolerance. So, while the Federal Reserve has pulled away the crystal punch bowl, investors will need to seek advice on creating a blueprint as they navigate through the china shop.

The next few pages are hopefully some blueprints for our china shop, pointing out paths of narrow or wide openings, and using these blueprints to craft a path for our clients. On behalf of our Macroeconomic Team, I hope you enjoy our 2022 Spring Market Outlook.

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Table of Contents

SPRING 2022

Our Core Signals

FIXED INCOME & INTEREST RATES

Bond Values

Bond investors have been scratching their heads, as usually in times of uncertainty, bonds perform well. The raw fact is rising rates do have an impact on bond values, and with questions at every turn in our china shop about how the Federal Reserve will move rates up, and at what pace they will move through the shop, bond markets have been watching some delicate pieces of china get chipped.

However, before we truly call it a stampede, let us point out that the bond market does not exhibit the dramatic sways that can be seen in equity markets. The chart to the right makes this very easy to see.

While most eyes instantly focus on the black and gold jagged lines, the almost straight-as-an-arrow blue line is a bond fund of both government and corporate bonds with maturities from 2 to 10 years. While this

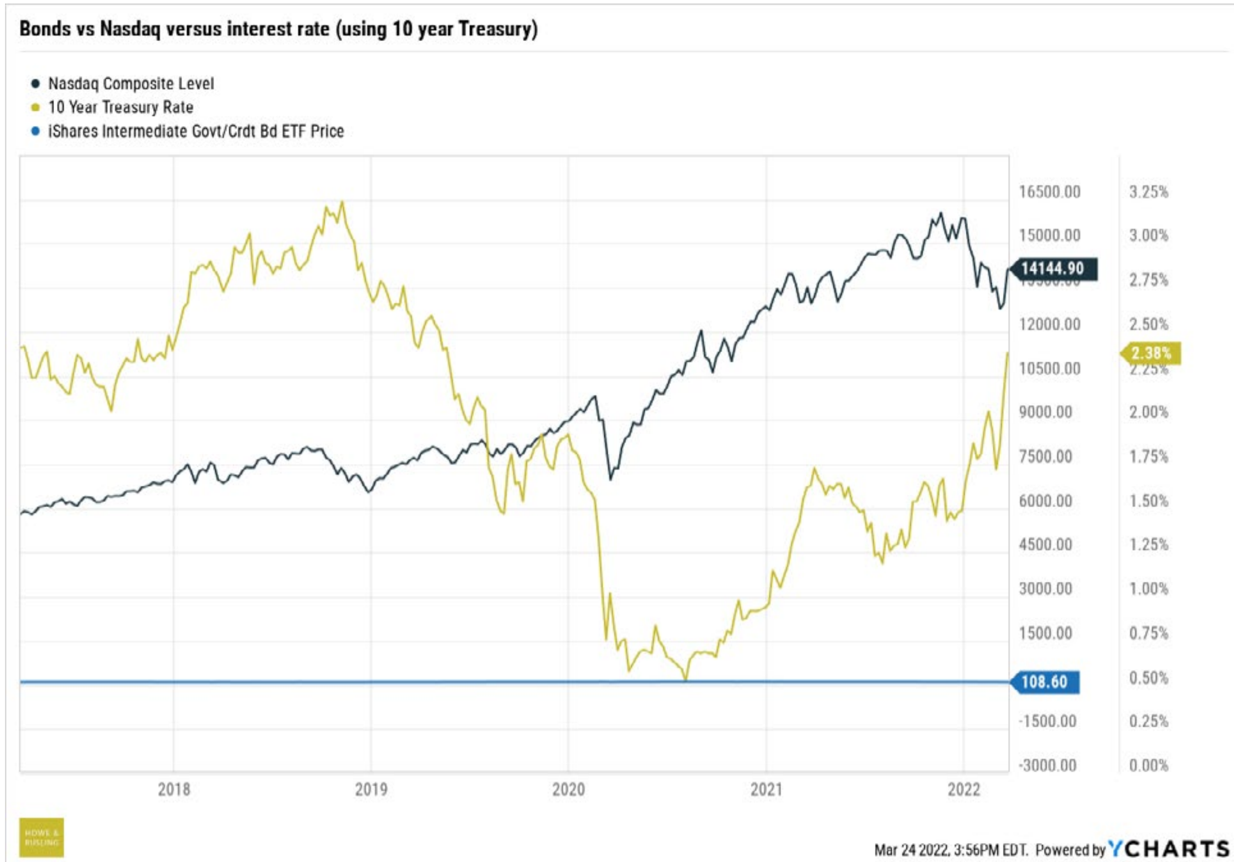
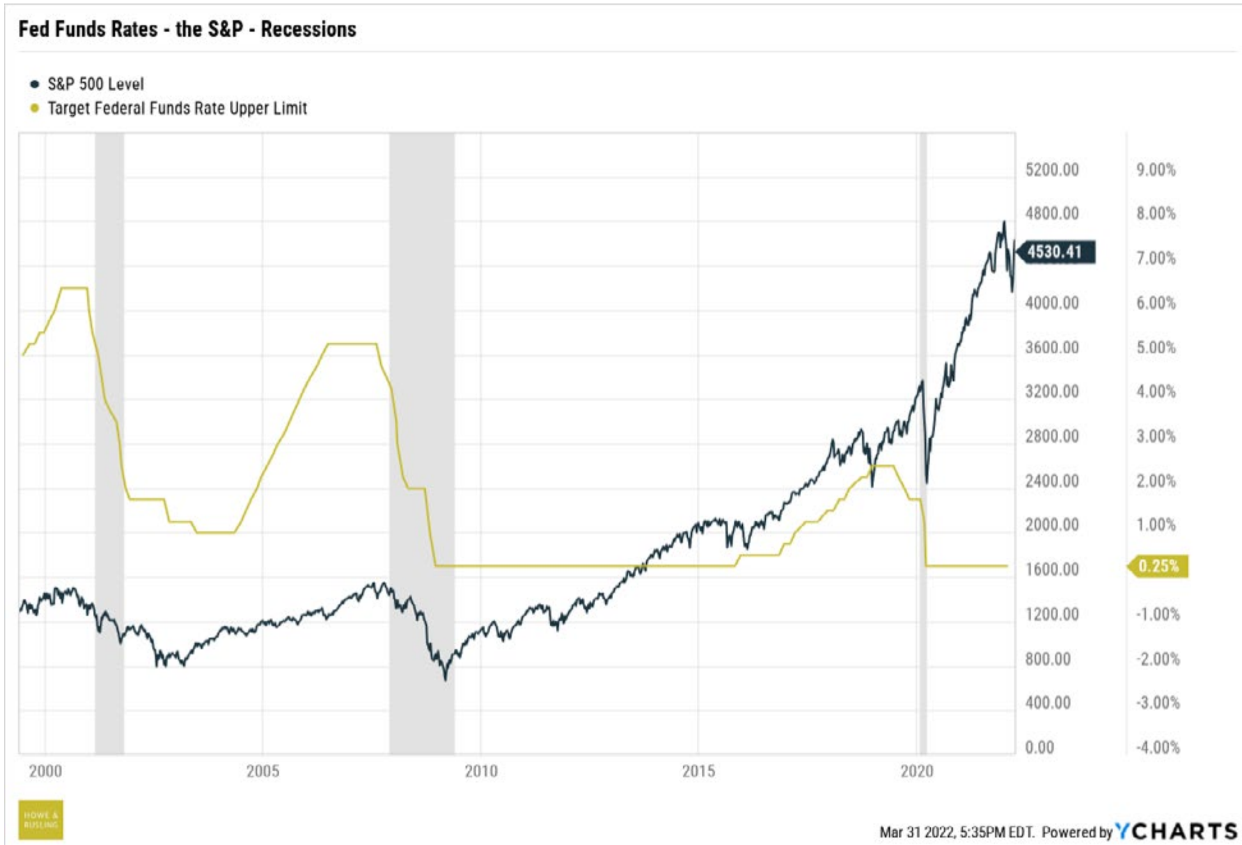


chart shows point to point, and its scale is large to accommodate the other metrics, the movement of the bond fund over the years is extremely nominal. When talk at every corner is about bond values in disarray, we cannot lose sight of this important factor, that disarray is in the eye of the beholder.

Bonds in their truest meaning are about income; hence the category name—fixed income. Long before retirees started to use the term “I’m on a fixed income” in reference to their social security payment, this phrase came from the asset class itself, as bond income was the fixed income for retirees. Hence, to establish that fixed income, stability had to be the primary factor.

Despite all the hype about bond values, very few investors trade bonds in their portfolios, so the incidental value drop gives them the opportunity to rebalance (from equity to bond) and purchase an asset they will hold for a long period of time. As investment managers, at this stage of the economic cycle, this fits nicely into our blueprint as when others sell, a buying opportunity presents itself.



Interest Rates

While we demonstrate the lack of real volatility in the bond market over time, the interest rate associated with bonds are the instrument of choice for the Federal Reserve to control the economy, especially now as they attempt to harness inflation.

On March 16, the FOMC initiated its first rise in rates since 2018, moving the federal funds rate to 0.25 - 0.50% from 0% - 0.25% (which the Fed brought down from 1.75% at the start of the pandemic). This 0.25% move was labeled as the first of six rate increases for 2022.

This rate increase, as small as it is, has caused more movement in the markets than any single rate increase in recent times, and most of the movement happened from markets trying to interpret Fed comments, estimating its moves while also seeing inflation rage. To add more misery to fragile markets, days after the announcement, but prior to the implementation, the Federal Reserve Chair hinted subsequent moves would be "as needed" (meaning maybe 0.50% at one time if "needed"). The problem with all this communication is the markets do not like surprises, and with ambiguous language, volatility follows.

There is no hiding the fact the Fed as the lead "bull" refrained from entering the china shop for far too long. It had its reasons, as over the last two years, the virus has been the major market mover, and the economy has resembled an overcrowded china shop with very little room for navigating. Once an aisle opening was starting to emerge, it quickly narrowed from new outbreaks, which resulted in the slowing of economic activity. Toss in a war with more supply chain disruptions, rising wages from too few workers, and daylight from the virus, and just like that, inflation is far beyond transitory.

Our belief is our Fed bull unfortunately has no choice at present and will move faster through the shop (raise rates) than it had hoped to have to. We will talk more on inflation, but there will be some plates falling off the shelves in the coming months.

Rate Spreads

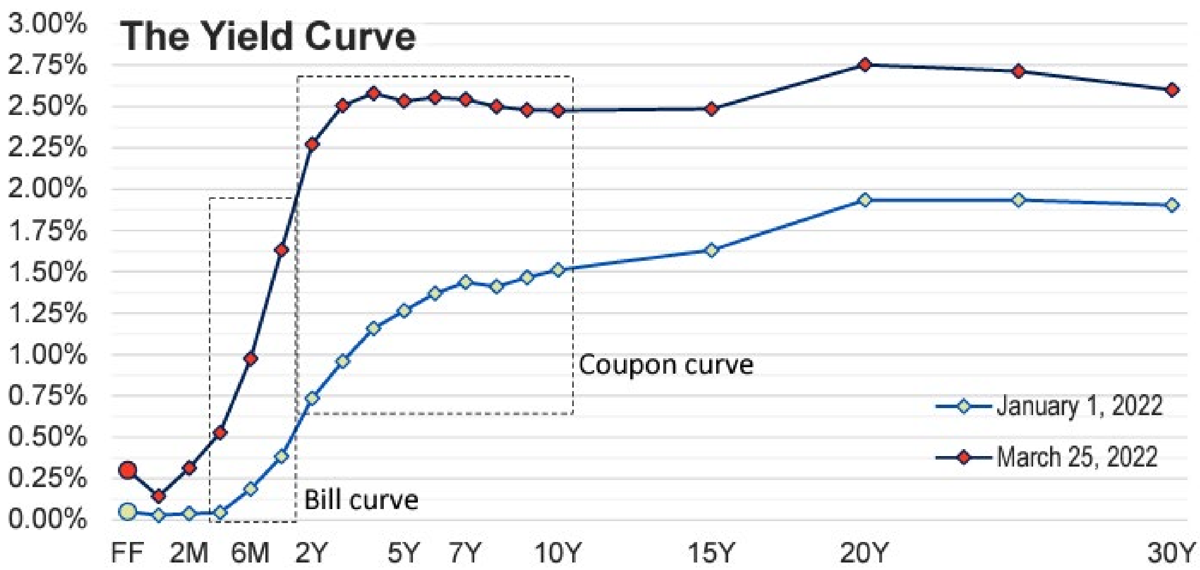
As we have mentioned over time, the Fed has two mandates: employment and stable prices (stable prices meaning controlled inflation). While it has a slew of tools to help in both regards, interest rate movement is its primary weapon via the federal funds rate (as seen in the prior chart). The theory is simple: raise rates to suppress demand, and less demand means less inflation (or so the story goes).

While the fed funds rate is the starting point, the day-to-day rates in the market are the effect in action, most notably the 10-year Treasury and the 2-year Treasury. Rate watching and rate comparing are important market tools, and yield spread curves are the methods of choice. Yield curves are nothing more than comparing two different bond rates (yield) and seeing if the spread between them is increasing (known as a steepening yield curve—usually a favorable economic signal), if the spread is narrowing (known as a flattening yield curve—moving towards zero and a warning sign), or if the longer maturity yield is less than the shorter maturity (creating a negative sum and known as inverted—this is usually not a good sign).

The most watched yield curve is the above 10-year versus 2-year US Treasury curve. This curve typically inverts when the Fed has "gone too far" in raising rates.

As of now, the Fed has barely lifted a finger, and the curve inverted on April 1—and unfortunately this was not an April Fool's joke. A day later the spread started to steepen again; minor as that was, it provided a bit of relief. Economists believe anytime this curve inverts, a recession typically follows anywhere from 6-20 months later. It is a fairly reliable indicator, with seven of the last eight recessions predicted, so this cannot be taken lightly. The chatter is "this time is different," but will it be?

While the economic bellwether 10-2 spread curve garners all the crystal trophies, the Federal Reserve is saying the real curve to watch is the 10 year/3-month curve. Given the Fed has barely made any interest rate moves, and the 10-2 inverted, it certainly needs another metric.



The Federal Reserve Chair (who also has his own preferred curve) says this curve more accurately predicts recessions. As the phrase goes, "Don't fight the Fed," so the Fed must see something most market observers do not, and for that we need to take pause.

To add just a bit more here, the 10-2 has been under pressure for years, principally from a depressed 10-year Treasury yield. Why? Because the rest of the world has had negative interest rates, so international investors have been flocking to the US 10-year for safety and a return that is better than their negative yields. Plus, the current Eastern European conflict pushed the 10-year yield down a bit, as both domestic and international investors sought shelter. Remember, when demand is high, the price rises, and subsequently the yield comes down. With this, the 10-year yield has been suppressed for years. Furthermore, add in the very accommodative monetary policies of central banks globally, and there is no reason the 10-year rate needed to be higher, which makes it easier for the 2-year to stay close to it, or even exceed it.

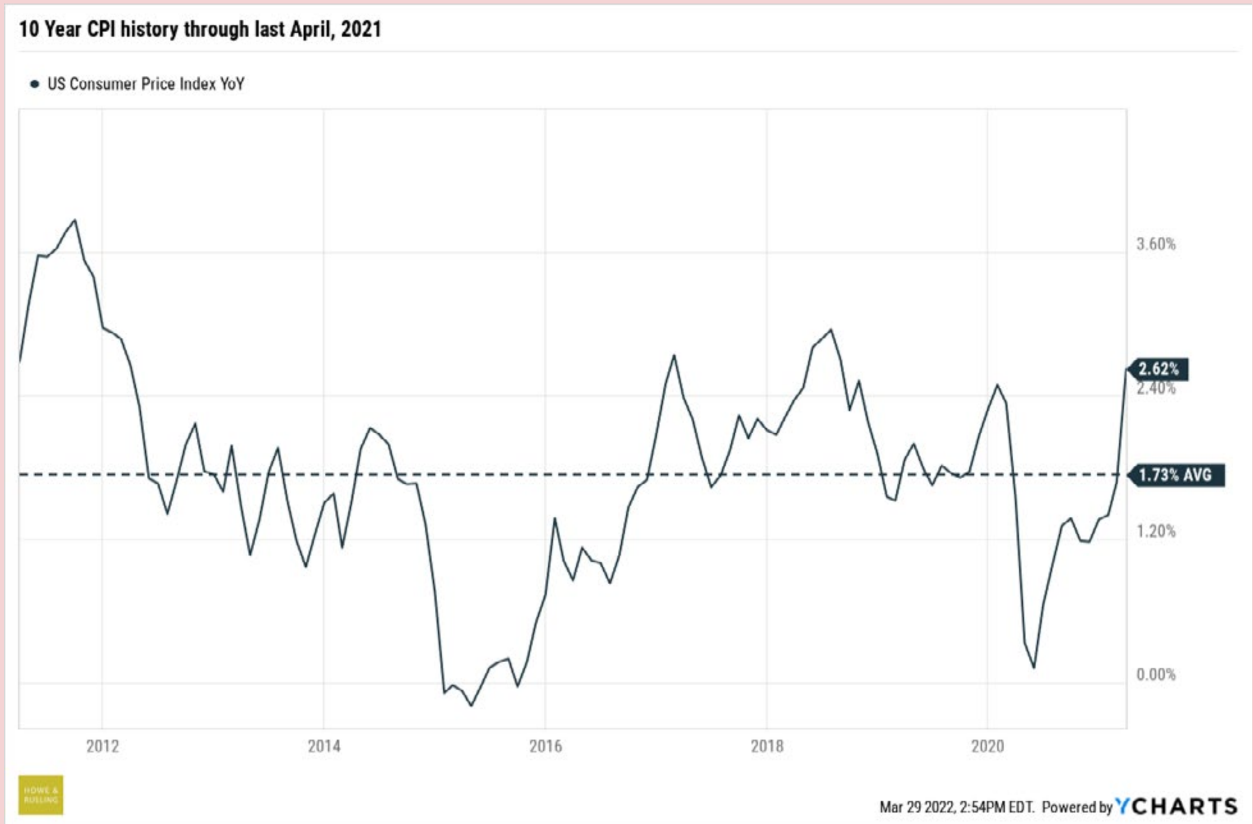
The real challenge here is with the inversion of the 10-2, as short as it was. Will this be a self-fulfilling prophecy with a recession to follow? The reason for inversion is the market (as gauged by the 2-year) suggests the forward-looking rate increases by the Fed are too aggressive and do not match up to inflation and growth outlooks that are priced in the longer-term yields. Perhaps the Fed will back down from projected moves, and their 10year/3month curve will be the real indicator. At present, we are slightly favoring the Fed's view, but markets do sometimes prove self-fulfilling prophecies, for which we will be vigilantly watching. Given record employment, an uptick in consumer confidence, and a good housing market, we believe the runway is longer before any potential recession.

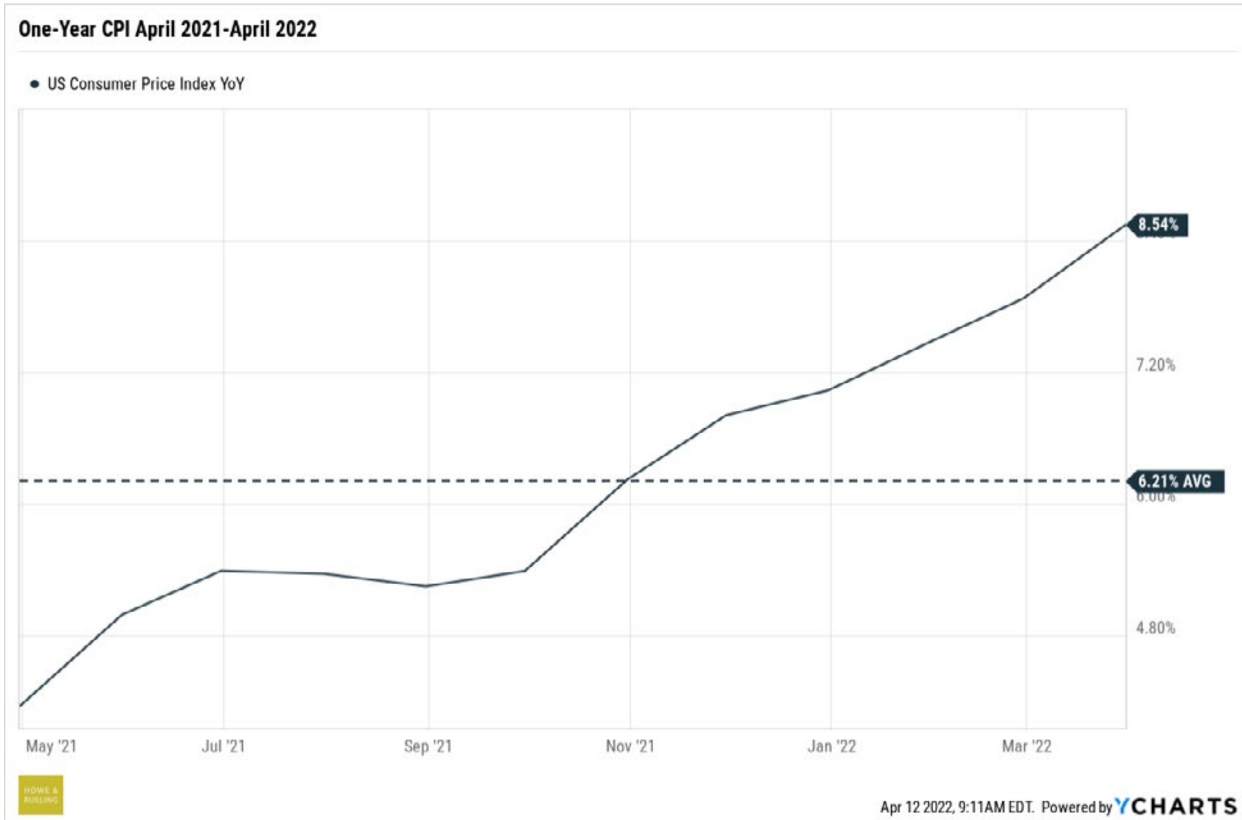
STRATEGY

Do not panic as bond values adjust to rate increases. Bond volatility and value changes are minor in comparison to the overall investment world. Know this relationship and collect your "fixed income" along the way.

INFLATION

What a difference two years makes. The word inflation was almost lost from the American vocabulary over the past decade with an average rate of 1.73% between March 2011 and March 2021.





Then came April 2021, and the runaway broke loose.

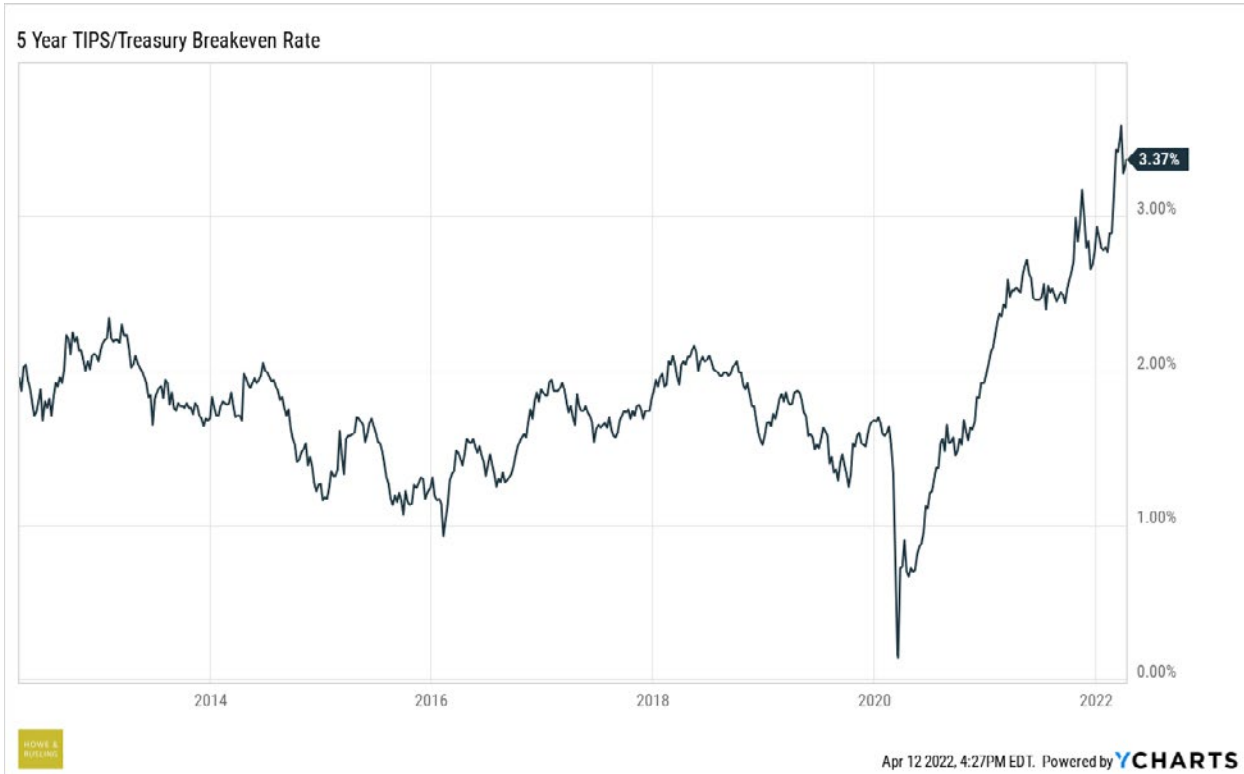
Inflation is real; we see it in prices from the pump to the grocery store to virtually every item you can imagine, with gasoline prices being the inflation flagship. Energy, as part of the CPI calculation, only accounts for 7.4% of the CPI, which includes gasoline products, electric, and natural gas. Broken down further, the gasoline complex of diesel fuel and standard gasoline are only 4% of the full CPI.

Even though petroleum products are small contributors to the overall CPI, they are indirect contributors to broad inflation. The reason is simple: every product we buy had to get to its destination, which means it likely was delivered by a diesel consuming truck. This same diesel fuel truck will only average 6.5 mpg in fuel usage at over $5.00 a gallon. Therefore, suppliers and haulers have started again to tack the dreaded "fuel surcharge" onto invoices. This price gets added to the general price of whatever product has been delivered. Hence, these fuel increases are far reaching into the inflation saga.

The good news is the price of diesel might have hit its peak the last week of March, partly due to Brent oil and West Texas Intermediate both falling from their spikes as related to the Russia/Ukraine crisis. Also, diesel refining uses the same components as home heating oil, and in the later spring/summer months, the demand for heating oil lessens and diesel prices usually fall. Furthermore, the recent release of national reserves will take some pressure off supply, and for regular gasoline, the White House announced it relaxed the mandatory summer

blend requirement, which adds cost to the price from more refining. Hence, the prices of all goods might get some relief as the summer progresses.

While we could go on and on about all the components of inflation (wages, shelter costs, food inputs, vehicles, airline fees), we want to jump to the future where things might not look so grim.



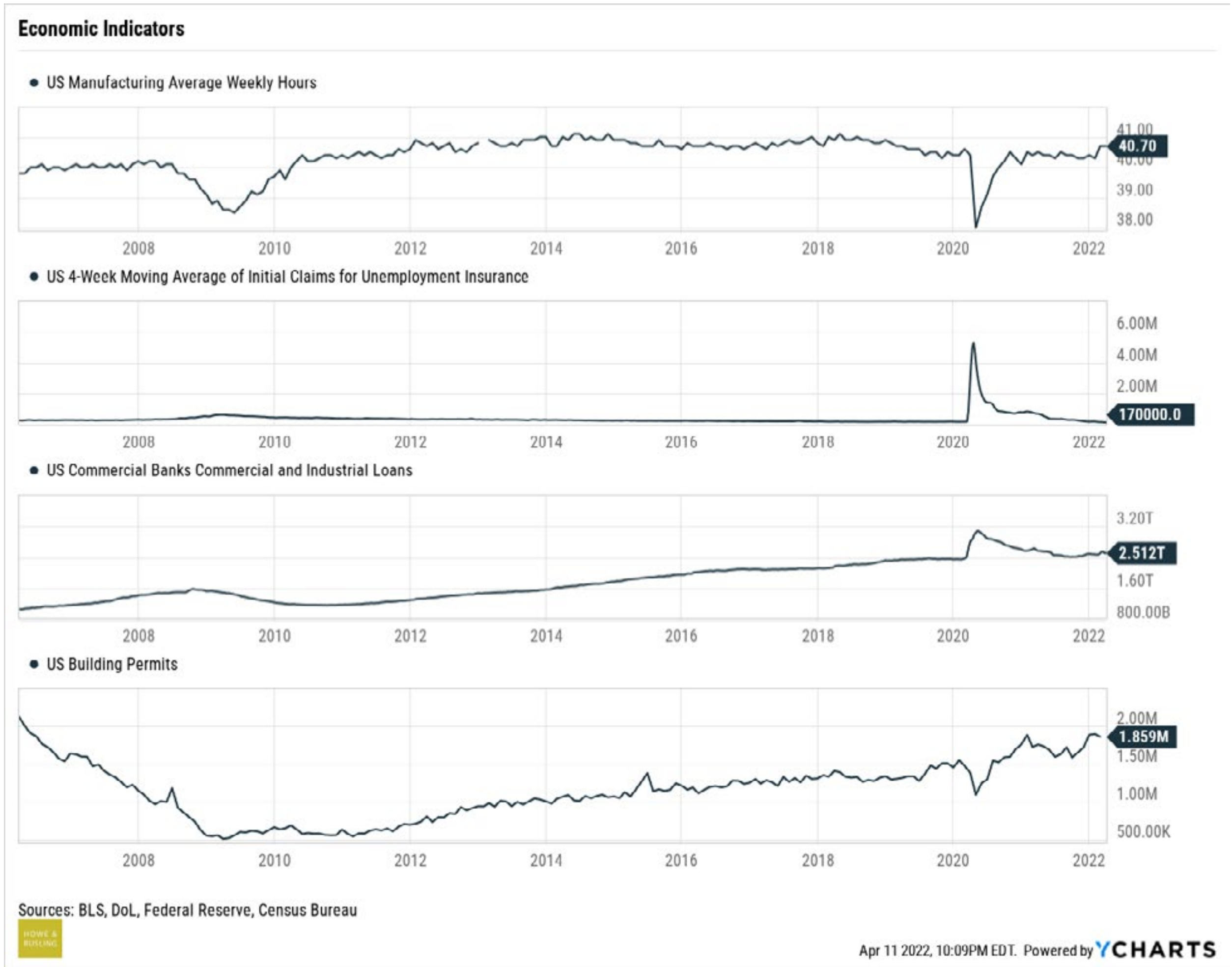
Even though we are at the highest level of inflation in over 40 years, inflation outlooks suggest this surge could be short-term. We use the 5-year TIPS/Treasury Breakeven rate as an indicator of future inflation for the next five years, on average. This yield spread curve shows the difference between the 5-year Treasury rate and the 5-year Treasury inflation-indexed rate. Hence, knowing the near term will have a higher factor (8.5%), the balance of the next four years will have to be lower to average (3.37%). For this we find some room for our bull in the china shop to wiggle just a bit.

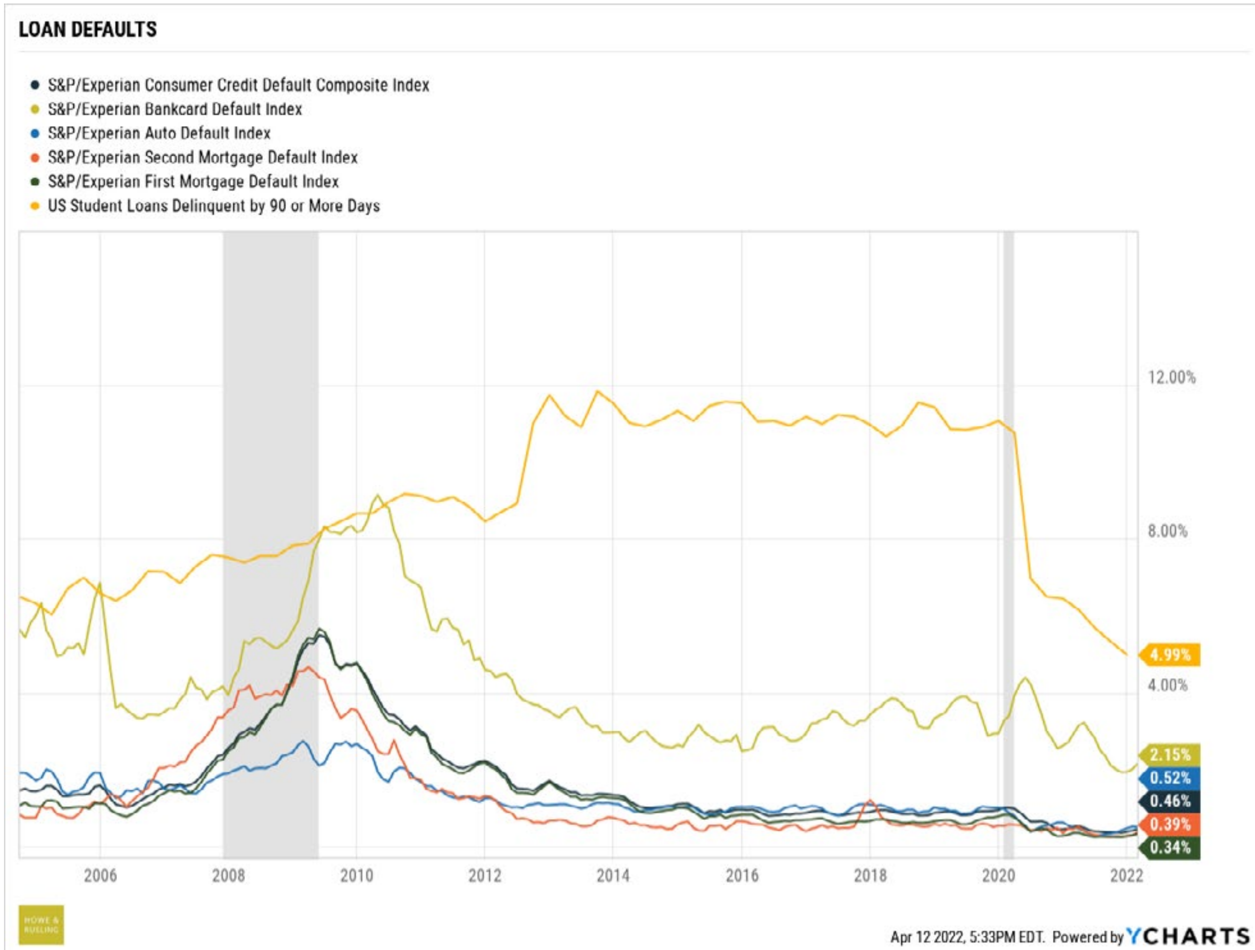
STRATEGY

Inflation can be good for asset appreciation. Holding a multi asset portfolio can help ride the wave over time as a hedge, while garnering some income.

RECESSION… OR NOT

We will have a recession; the question is whether it will be soon or some time out. Recessions are critical parts of the economic structure, so there is no sense in saying we will not have one. The present climate has some of the makings, like low bond spreads and a central bank ready to embark on an aggressive campaign to fight high inflation. However, despite how hard the press wants to create a recession, there are far too many positive factors in the economy.

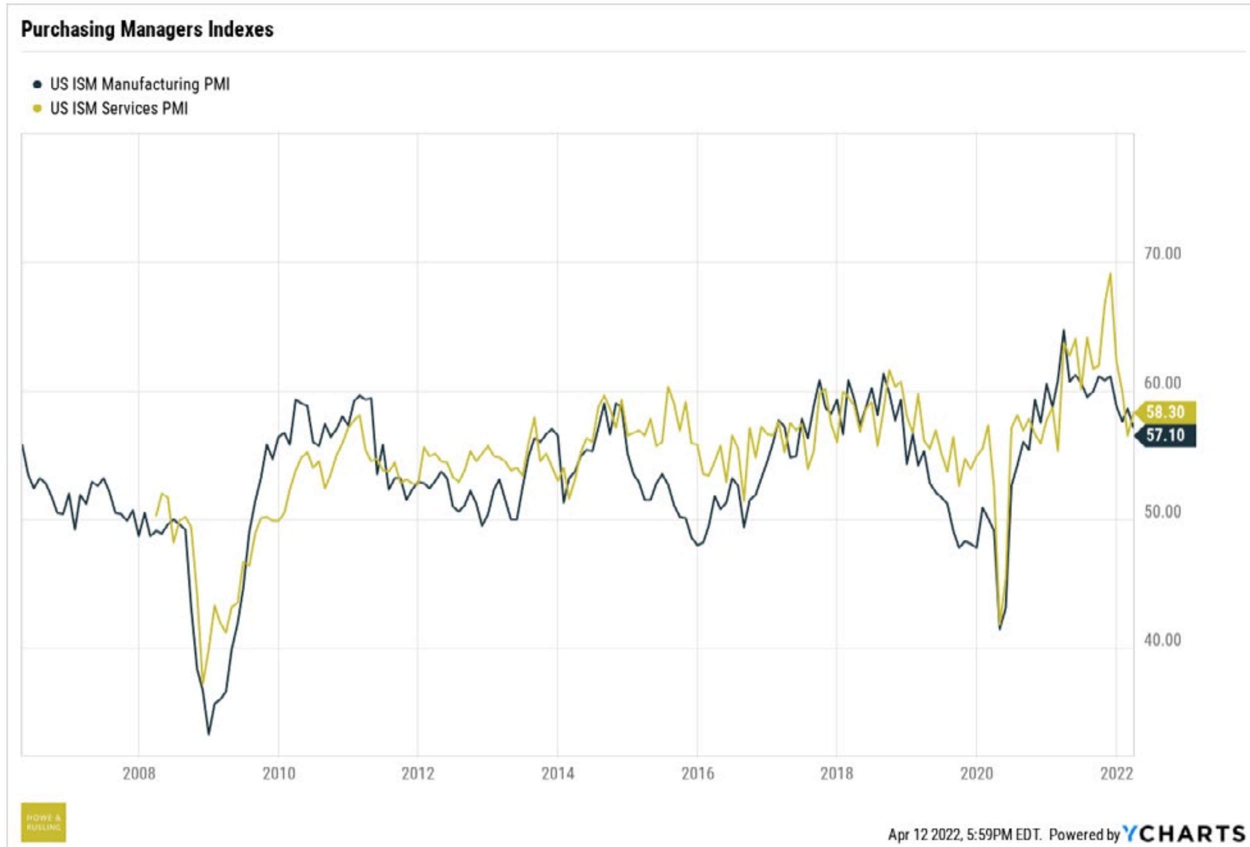




At present, the above key indicators are still in favorable status relative to an economy that is still healthy. In addition, an indicator of stress is non-performing bank loans and default loans. As can be seen, defaults are extremely low in all categories. With the student loan payment pause, defaults have dropped significantly and points to borrowers using these proceeds to pay down other debt, which is very positive. Granted, as rates rise, all this could change, but the prime lending rate is only 3.5%, which is very low for business. Loan performance is a very good indicator, as recessions (such as the Great Financial Crisis in gray) are usually preceded by a rise in delinquencies.

Another very good indicator of recession pressure is the monthly surveys of purchasing managers in both the manufacturing and services industries. These Purchasing Managers Indexes are diffusion indexes summarizing economic activity in the manufacturing and service sectors in the US. The indexes are based on a survey of industry executives conducted by the Institute of Supply Management. Participants are asked to gauge activity in several categories such as new orders or bookings, inventories, and production and these sub-indices are then combined to create the PMI. A PMI above 50 designates an overall expansion whereas a PMI below 50 signifies a shrinking of the respective economy. Both, while coming off highs, are still above 50 and at average highs since 2006.

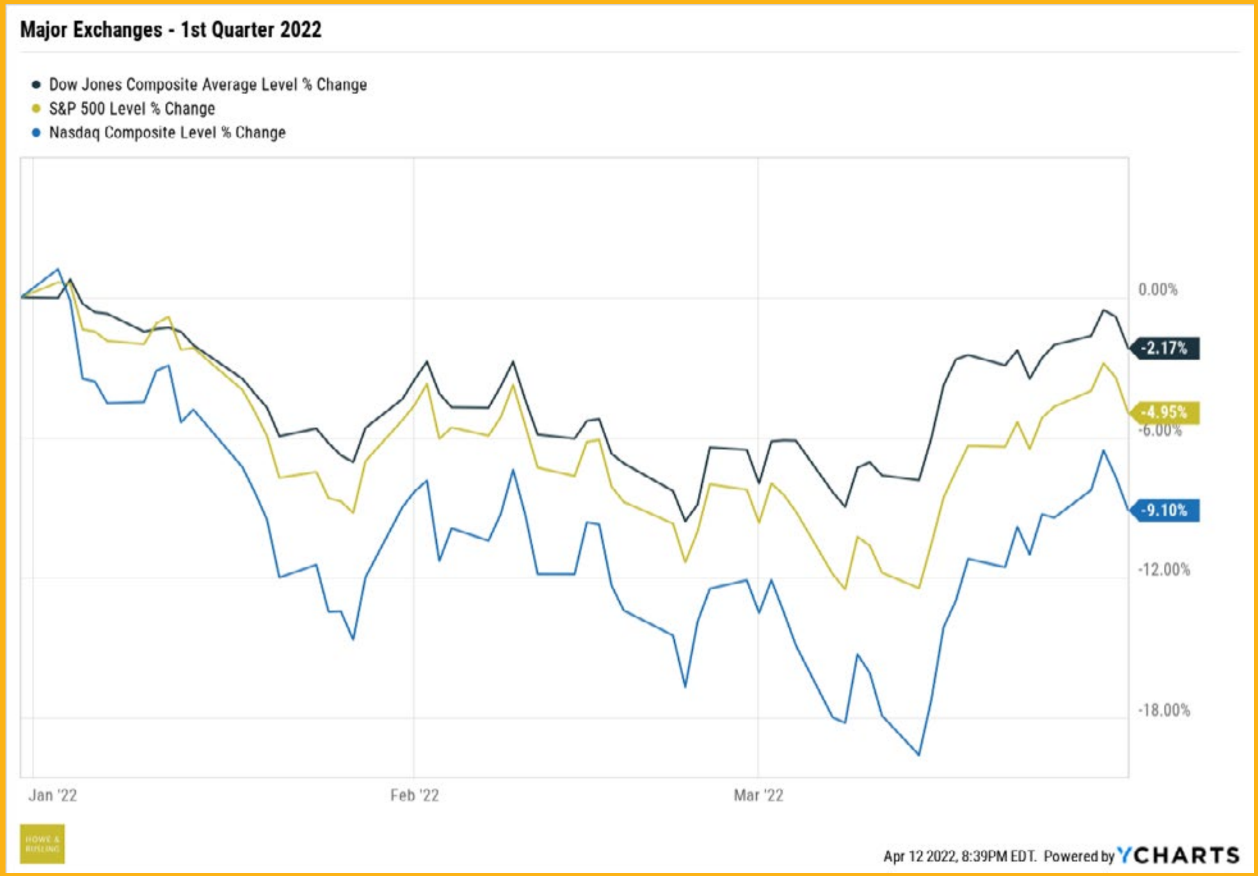
While times are challenging, and many talking heads seem to only have a vocabulary of two words, recession and inflation, most indicators are not pointing to any immediate recession. Granted, every day brings new news, and new data points, but from our viewpoint, a recession is not likely in 2022.



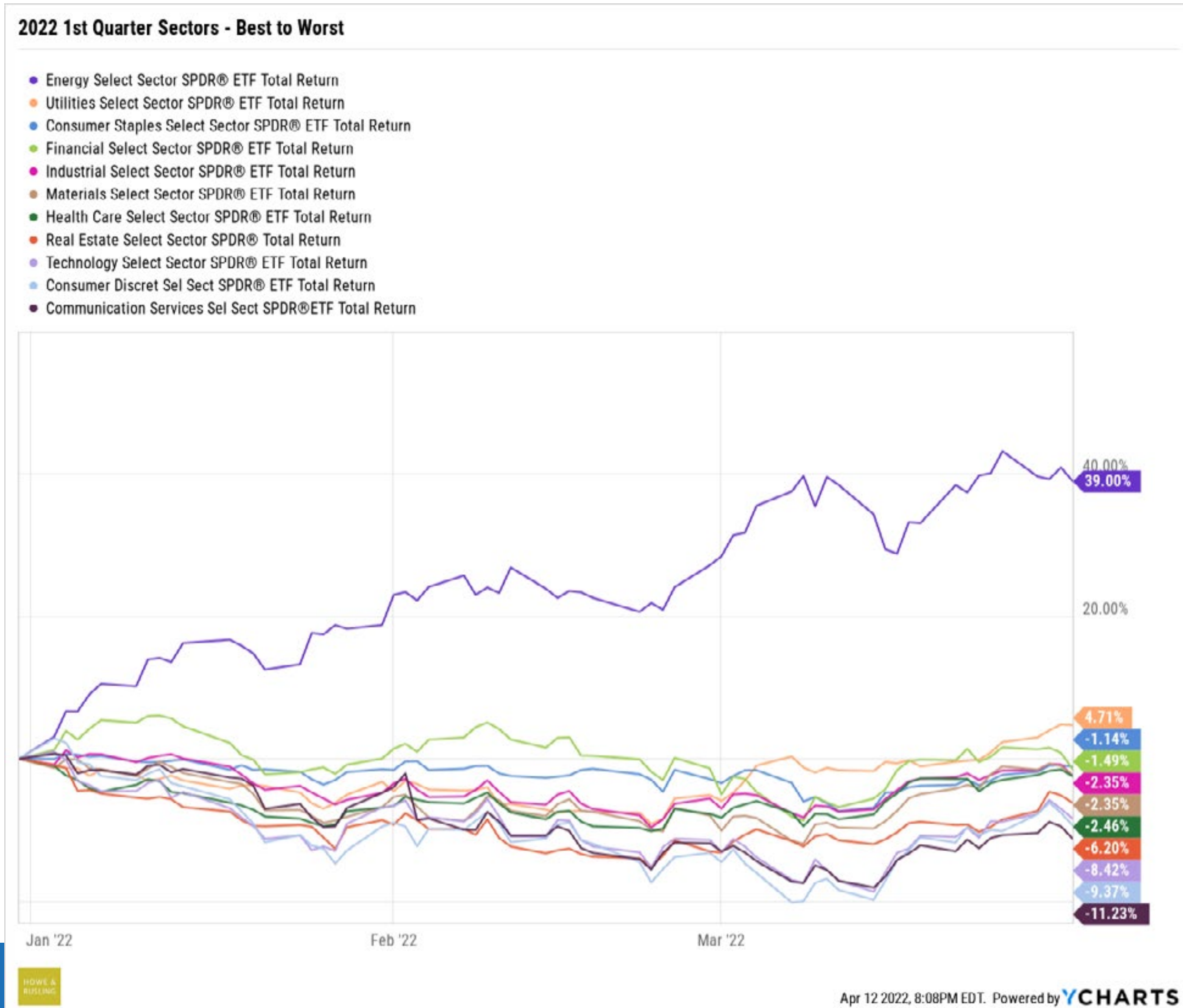
EQUITY MARKETS

The first quarter and the start of the second have brought nothing but disaster for some sectors of the equity markets. Most notably, the Nasdaq exchange, which was down (9.10%) at quarter end, had sunk as low as (19.58%) in mid-March from the start of the year. In fact, from the high on December 27, it was down (21.14%) when it hit its low on March 14, 2022. This essentially put it in bear market territory. A correction is defined as down 10%, and a bear market is down 20%.

The S&P 500 and Dow Jones also hit correction territory, a day apart in later February, both having had their highs on January 4, 2022. All three exchanges have partially recovered from their lows, but still have a way to go to recover the start of the year highs.



The primary reason behind these drops, especially in the broad exchanges, is their top-heavy market caps from the top ten stocks in each exchange. The Nasdaq, and the S&P, have high tech embedded in their top ten holdings, which dragged down both exchange indexes faster than the Dow which has a broader market exposure for the top ten. These technology related firms have a severe dislike for rising interest rates, as higher interest expenses result in less capital for expansion. With their then current valuations priced for growth in the future, models factoring in new discount rates removed future profitability. Discount rates are the interest rate used in discounted cash flow analysis to determine present values of future cash flows.



STRATEGY Don't chase winners, as some day they could be the losers. Diversify, especially in times of market stress. Likewise, understand your longer-term goals, as short-term moves are easy to make but usually carry long-term consequences.

We mention this top-heavy market cap influence, as not all sectors of the market are created equal (and it is why an active manager can adjust portfolios to changing market conditions).

Obviously there have been winners and losers this year, with communication services taking a toll, principally due to a massive drop in Facebook earlier in the year. As no surprise, the energy sector has outperformed all sectors by a huge margin. While it would have been great to put all your money in the energy basket, it is too easy to look in the rear-view mirror. In fact, if you put all your funds in energy four years ago, the accompanying chart would be flipped, as energy would be the worst performing sector and technology with communication services would be top. Diversification is key.

The final word on equities is earning season is upon us and we will see how companies fared in the first quarter. For the most part, results should come in line with estimates, with a chance for some upside. The challenge is while firms may report results in line with expectations, the critical part of these announcements will be their estimates for the next quarter and through 2022. Given everything we have discussed, and the pressures from inflation on price transfer (to the consumer), companies might not be rewarded for past results.

Our Vision

Our bull in the china shop has a very difficult road ahead with obstacles in every aisle. While the past two years have been about navigating a health crisis which transformed into an economic crisis, historical economic trends did not provide a clear blueprint. Oddly enough, we are in a somewhat similar scenario given inflation which has not been in the equation for more than 40 years. Add to that a war and a virus still affecting the globe, and all moves require extremely calculated and delicate implementation.

The path ahead will be challenging but not impassable. A clear understanding of market cycles under various conditions (inflation, rising rates, supply shortages) is critical in forming a blueprint. The interaction between stocks and bonds and tilts to sectors, sub-sectors, and then individual holdings will be paramount. All are challenging tasks, but doable.

We take our role seriously, as the road ahead has many obstacles. Our commitment is to create a blueprint designed to manage the challenges. Together, nothing is impassable.

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