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April 2022 Market Insights: What's Next?

Just as we're about to put the global pandemic behind us, Russia invades Ukraine. Oil prices and inflation spike, interest rates move higher, and the stock market experiences its first correction since the onset of the pandemic in 1st quarter 2020. So, what comes next? Is it time to rethink asset allocation strategy and build up cash positions? In this version of Market Insights, we attempt to make sense of the current environment and plot a course forward.

Capital Markets Review

To recap the markets' performances, we present the table below. Equities were down for the first time since the start of the pandemic, with U.S. large cap stocks down 4.6%, small cap down 7.5%, international developed down 5.9%, and emerging markets down 7.0%. The disparity between growth and value stocks was wide, with growth down 8.5% and value down just 0.7%

The bond market fared poorly, and the 10-year Treasury yield spiked from 1.51% at the beginning of the year to 2.32% at quarter's end. The Bloomberg U.S. Aggregate Bond Index ("the Agg") was down 5.9% for the 1st quarter, and high yield bonds were down 5.2%. Alternative investments, broadly measured by the HFRX Global Hedge Fund Index, limited losses with a -1.4% return.

Despite a challenging quarter for both equities and fixed income, our overweight to U.S. equities, underweight to core bonds, and overweight to liquid alternatives helped to limit the damage. Our commitment to building diversified portfolios and "staying the course" through difficult market environments also served us well during a difficult start to the year.

Asset Class Returns

Asset Class	Benchmark	March 2022	Q1 2022	2021
U.S. Large Cap	S&P 500	3.7	-4.6	28.7
U.S. Small Cap	Russell 2000	1.2	-7.5	14.8
International Developed	MSCI EAFE	0.6	-5.9	11.3
Emerging Markets	MSCI EM	-2.3	-7.0	-2.5
U.S. Investment Grade	Barclays U.S. Aggregate Bond	-2.8	-5.9	-1.5
U.S. Inflation-Indexed	Barclays U.S. TIPS	-1.9	-3.0	6.0
U.S. High Yield	BBgBarc U.S. Corp High Yield	-1.1	-4.8	5.3
EM U.S. $ Debt	JPM EMBI Global	-0.9	-10.0	-1.8
Absolute Return	HFRX Global Hedge Fund	0.5	-1.4	6.2

Source: Morningstar

A closer look at U.S. markets

Looking at U.S. Sectors, Energy (+39%) was the top performer, followed by Utilities (+4.8%), while Communication Services (-11.9%) and Consumer Discretionary (-9.0%) were the worst-performing sectors for the quarter.

Sector Returns: Q4 and 2021

Sectors	Index	March 2022	Q1 2022	2021
Information Technology	S&P 500 / Info Technology	3.5	-8.4	34.5
Real Estate	S&P 500 / Real Estate	7.8	-6.2	46.2
Industrials	S&P 500 / Industrials	3.4	-2.4	21.1
Energy	S&P 500 / Energy	9.0	39.0	54.6
Consumer Discretionary	S&P 500 / Cons Discretionary	4.9	-9.0	24.4
Communication Services	S&P 500 / Commun Services	1.0	-11.9	21.6
Consumer Staples	S&P 500 / Cons Staples	1.8	-1.0	18.6
Utilities	S&P 500 / Utilities	10.4	4.8	17.7
Materials	S&P 500 / Materials	6.1	-2.4	27.3
Financials	S&P 500 / Financials	-0.2	-1.5	35.0
Health Care	S&P 500 / Health Care	5.6	-2.6	26.1

Source: Morningstar

Investment Themes Review

At the beginning of the year, we laid out three themes that we felt would heavily influence portfolio results. Below, we discuss how each of those themes played out in the 1st quarter, and what might come next.

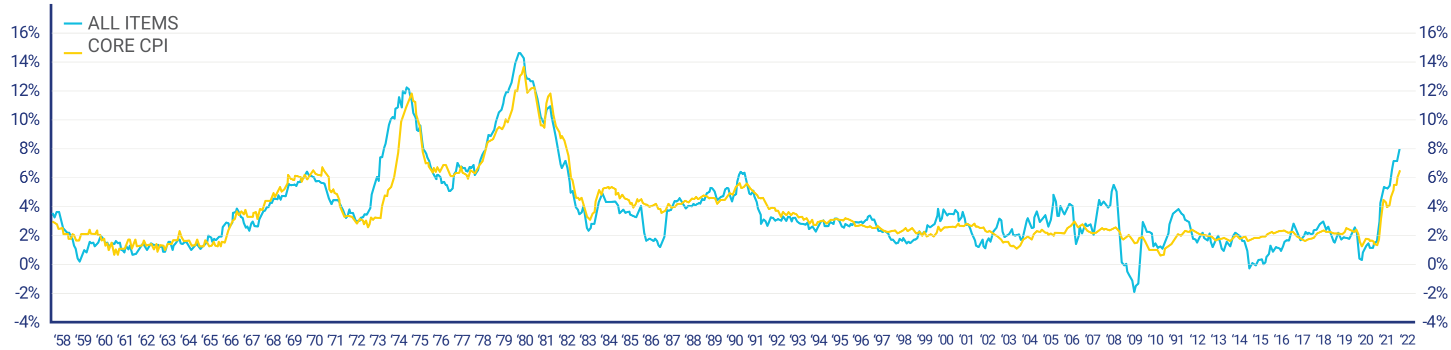
THEME 1: COVID SLOWS, ECONOMIC REOPENING ACCELERATES

As had been expected, the healthy U.S. consumer continued to return to normal in the first quarter of 2022 as COVID-19 cases fell and lockdowns were lifted. High-frequency economic activity metrics, including credit/debit card transactions, hotel occupancy, U.S. seated diners, and TSA traveler traffic, all continued to improve. We believe that these trends will continue for the remainder of the year, and we expect economic growth to be strong as a result. The Federal Reserve, in fact, projects GDP growth of 2.8% for full-year 2022 (Federal Reserve's Summary of Economic Projections, dated March 16, 2022). While this would be noticeably slower than 2021's torrid pace, it is important to note that it is still above the long-term trend rate and certainly not indicative of a recession or a "stagflation" scenario.

Positioning for inflation

The strong economic growth has been accompanied by elevated levels of inflation. In February, the consumer price index saw prices for consumer goods and services increase by 7.9% when compared to the previous year (see CPI chart below). This has caused investors, concerned about inflation's impact on profit margins, to begin reassessing their investment portfolio positioning. This reassessment has resulted in increased short-term market volatility. While some of the concern so far in 2022 has been warranted, the Federal Reserve is taking action to adjust its policy to combat inflation, and market participants have calmed, with stocks rallying off the lows and volatility falling at the end of the first quarter. Our take is that inflation will stay elevated, but gradually start to recede (particularly on the "goods inflation" side, where Covid-induced Supply Chain disruptions are starting to improve). However, we need to keep an eye on areas such as wage inflation which tend to be "stickier." We would expect positioning for elevated inflation to remain an important part of our job as portfolio managers throughout 2022.

U.S. Consumer Price Inflation (%1 YR)



THEME 2: FED TAKES ACTION TO NORMALIZE RATE STRUCTURE

Federal Reserve Chairman Jerome Powell communicated in late 2021 the Federal Reserve's plans to remove emergency levels of monetary policy from the U.S. economy. This process, which we expected, has begun. The process is two-pronged and includes the Federal Reserve board of governors increasing the Federal Funds overnight lending rate and a gradual reduction to the Fed's bond buying program. The Fed began the process of raising the Federal Funds rate with a 25 bps increase at their March meeting. We would expect, as almost everyone does, that more increases will follow at Fed meetings throughout the year. The goal of the process is to combat inflation and return economic growth to its long-term potential.

Bonds continue to be challenged

As we have previously communicated, the low levels of interest rates, and the Fed's plans to push yields higher over the short to medium term, have reduced the downside protection that bonds have historically provided to balanced portfolios. This was painfully evident for bondholders in the 1st quarter, as "core bonds" (defined by the Bloomberg Barclays U.S. Aggregate Bond Index) suffered their second-worst start to a year in history, dating back to 1926 (Source: BlackRock). We expect that bond prices will continue to be challenged. As a result, we will continue to underweight our exposure to the asset class as a whole, and maintain a shorter duration in the remaining bond allocation in order to lessen the impact of rising rates. We will continue to offset the underweight bond position with increased allocations to liquid alternative funds to help manage the variability of portfolio returns.

THEME 3: EQUITIES CONTINUE TO LEAD

As we discussed in the Capital Markets Review on page 1, the major asset classes posted losses for the first quarter. Stocks sustained a correction during the quarter, declining 10.4% between January 4 and February 24, but recovered coming into the end of the quarter. While market pundits stoked fears of runaway inflation, an overzealous Federal Reserve, and even the "R" word (recession), the stock market bottomed on February 24 as Russia invaded Ukraine, then recovered

5.8% by March 31. Surprisingly, stocks (S&P 500) ended the quarter with smaller declines than the bond market (Bloomberg Barclays Aggregate Bond Index). As we enter earnings season, S&P 500 earnings growth is estimated at 4.7% for the first quarter of 2022 (FactSet: Earnings Insight April 1, 2022). While 4.7% is a far cry from the four consecutive quarters of 20% growth the market had previously enjoyed, the impact of high inflation and rising rates will no doubt be felt as the economy endures growing pains associated with the reopening. Yet we remain bullish, with the belief that the positive forces behind the reopening outweigh the challenges laid out above.

Emphasis on quality

We at the Webster Private Bank Investment Team continue to emphasize quality in the individual stocks and investment managers to which we allocate client assets. Whether selecting mutual funds or buying individual securities, our focus remains on innovation, strong pricing power, and cyclical sensitivity to improving economic growth. From a regional stock positioning standpoint, we continue to favor the U.S. over international markets due to the ongoing issues overseas (e.g., war in Ukraine, Chinese Zero-Covid policy), and confidence that U.S. companies are currently in a better position for earnings growth than their international counterparts.

Looking Forward

Still bullish, but mindful of challenges

Investors currently face the challenge of high inflation, rising interest rates, continued (but improving) supply chain disruptions, and extreme geopolitical turmoil. As tragic as the Russian invasion of Ukraine is, the likely fallout from an economic perspective is somewhat limited, and it factored into our asset allocation positioning.

We remain bullish, with the understanding that volatility will spike as data points surprise on the downside. The influence of higher interest rates and stubborn inflation data will put a drag on the economy, but we don't see a recession on the horizon at this point. Granted, we remain in uncharted waters as the pandemic continues to fade, and unforeseen developments are always possible. So, we "read the tea leaves," consider the risks, and attempt to make prudent decisions in the management of the funds that you have entrusted to us.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you during these difficult times, and we appreciate the trust you have placed in us.