First Affirmative FINANCIAL NETWORK
Invest for a Sustainable Future

Nowhere to Hide

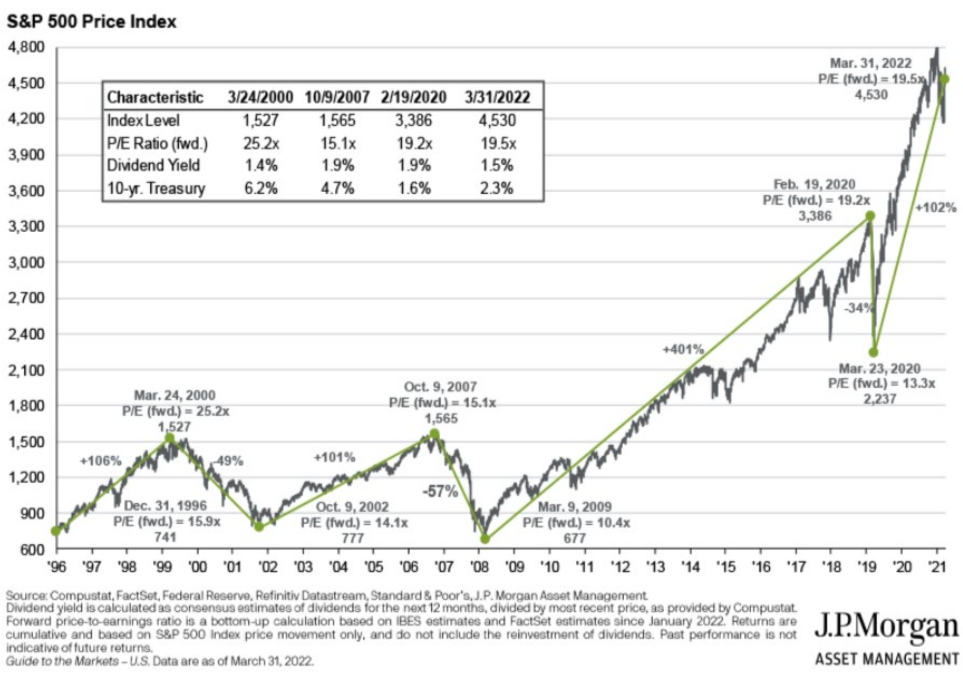
By Theresa Gusman
April 20, 2022

"It's only when the tide goes out that you learn who has been swimming naked."
Warren Buffet

Overview

Remember when…The S&P 500 advanced 27% in 2021, at year end the US 10-year Treasury yield was 1.5% and regular gasoline cost $3.28/gallon, and the COVID pandemic was our primary concern. In the first quarter, the S&P 500 fell 4.6%, the 10-year advanced to 2.3%, gasoline prices surged 29.0% to $4.23, and our concerns now include Russia's war in Ukraine, 8.5% consumer price inflation, rapidly rising interest rates, and prospects for a slowing economy. Oh, and a new COVID variant has emerged.

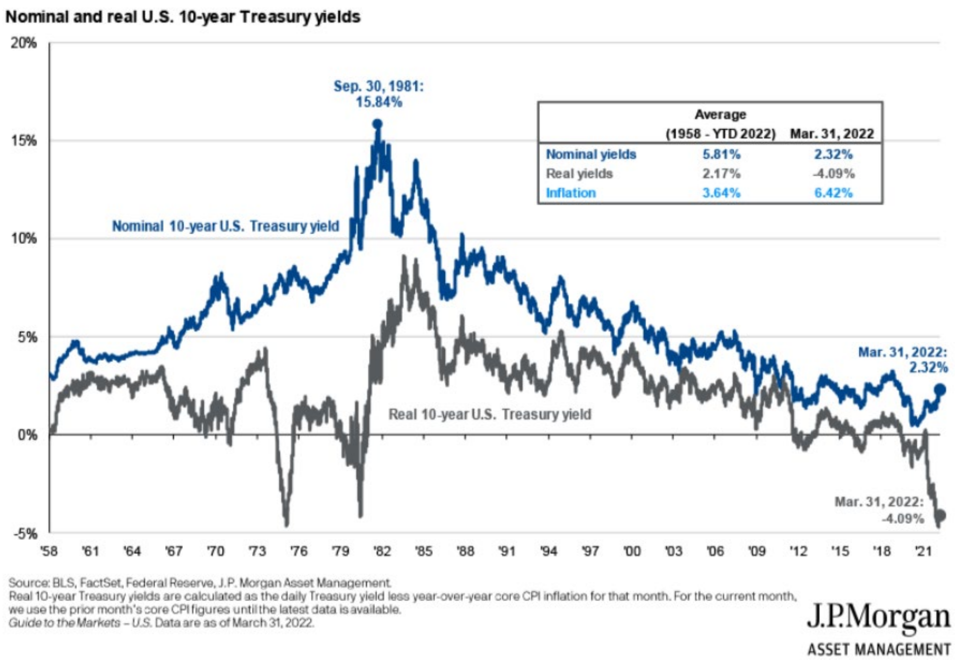
Figure 1. S&P 500 at Inflection Points – Bull and Bear Markets, 1996 to Date



Equity and fixed income markets – along with consumers and the media – have begun to recognize that inflation is here to stay. The inflation in progress in the wake of the easy monetary policy and aggressive fiscal stimulus associated with the COVID pandemic has been exacerbated by the impact of the war in Ukraine on food and energy prices and the effects of China's "zero COVID" policy on the availability of goods ranging from clothes and supplements to electronic components. As a result, inflation hit a 40-year high – an eye-popping 8.5% -- in the US last month.

Despite the first quarter sell-off, financial markets have yet to close the gap between inflation expectations and reality as evidenced by real interest rates at a level last seen in 1981 (see Figure 2, below). Either nominal rates will rise to reflect the surge in inflation, inflation will retreat, or we will see some combination of the two (as we expect). After largely ignoring rapidly rising inflation through 2021, bond yields surged in the first quarter, indicating a shift in sentiment. Fiscal spending also looks set to moderate following the flood of pandemic-induced spending over the past two years. As a result, economic activity and earnings will slow in the coming months.

Figure 2. Nominal and Real 10-Year Treasury Yields, 1958-March 31, 2022



First Quarter Market Review 2022

Commodities (+25.73%) and value stocks (energy +38.51%) were the bright spots in the first quarter. Overall, global equities (MSCI ACWI) fell 5.65%, a decline that was *surpassed by* the 5.86% decrease in the US Aggregate Fixed Income index. US stocks (S&P 500 –4.6%; US total stock market index –5.45%) outperformed non-US stocks (MSCI ACWI Ex-USA –6.27%), with emerging markets (-7.79%) again lagging developed markets. Value dramatically outperformed growth and blend across market capitalizations in the first quarter, and although both declined, large cap stocks outperformed small (see Figure 4, page 3).

Recent excess performance notwithstanding, the longer-term performance gap, current valuations, and the economic backdrop continue to favor the economically sensitive sectors represented in the value category (see Figure 5, page 4).

Figure 3. Global Equity, Fixed Income, and Real Assets Performance (Percent Change), 1Q 2022

		1Q2022	2022 YTD	Last 12 Months	Last 24 Months Annualized
Equities	**Global**	-5.65	-5.65	6.80	28.58
	US Equities	-5.45	-5.45	11.67	34.80
	US Large Cap	-5.15	-5.15	13.18	34.76
	US Mid Cap	-6.32	-6.32	8.83	36.27
	US Small Cap	-5.74	-5.74	0.67	37.47
	Non-US Equities	-6.27	-6.27	-2.66	20.59
	Non-US Developed Markets	-6.77	-6.77	0.21	20.45
	Non-US Emerging Markets	-7.79	-7.79	-13.03	16.95
Fixed Income	**US Aggregate**	-5.86	-5.86	-4.18	-1.77
	US Treasuries (Intermediate)	-5.31	-5.31	-4.97	-3.69
	Municipals (Intermediate)	-7.53	-7.53	-5.97	-0.74
	Investment Grade Corporate	-7.47	-7.47	-4.36	2.19
	US Corporate High Yield	-4.53	-4.53	-1.21	8.39
	Bank Loan	-0.48	-0.48	1.37	6.54
	Emerging Markets	-9.17	-9.17	-6.33	4.06
Real Assets	**Commodities**	25.73	25.73	57.95	51.48
	Energy (Oil/Gas)	38.51	38.51	78.44	98.16
	Energy Pipelines (MLPs)	24.89	24.89	41.57	69.38
	Precious Metals	6.41	6.41	9.71	12.88
	Industrial Metals	17.16	17.16	38.82	44.65
	Agriculture	10.79	10.79	29.29	24.50
	REITs (Real Estate)	-5.97	-5.97	21.45	28.74

Source: Morningstar Direct as of 3/31/2022

Note: Coloring is relative. Deeper green indicates higher relative return, deeper red indications lower relative return.

Figure 4. Morningstar Style Box Analysis, 1Q 2022

Q1 2022

	Value	Blend	Growth
Large	1.63	-5.99	-13.55
Mid	4.85	-5.13	-16.01
Small	1.80	-6.23	-13.37

1Y

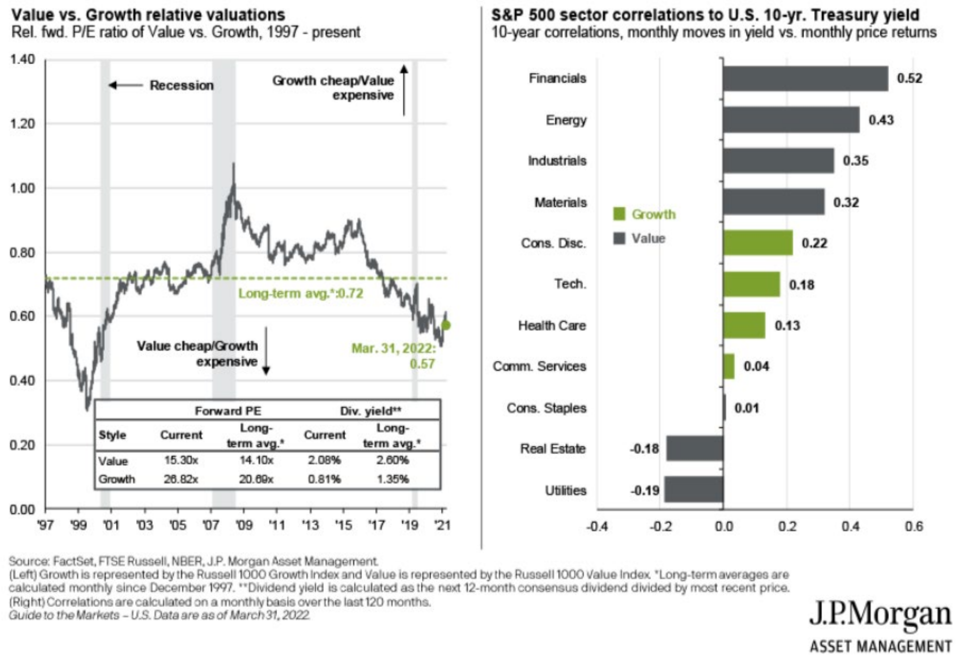
	Value	Blend	Growth
Large	12.12	16.10	5.79
Mid	15.42	11.44	-1.85
Small	10.50	-1.00	-13.87

3Y

	Value	Blend	Growth
Large	11.82	19.70	19.01
Mid	12.96	15.87	16.62
Small	13.06	10.88	9.56

Source: Morningstar Direct, Morningstar Indexes. Data as of March 31, 2022.

Figure 5. Value versus Growth and Sector Earnings Correlation to Real GDP, 1Q 2022



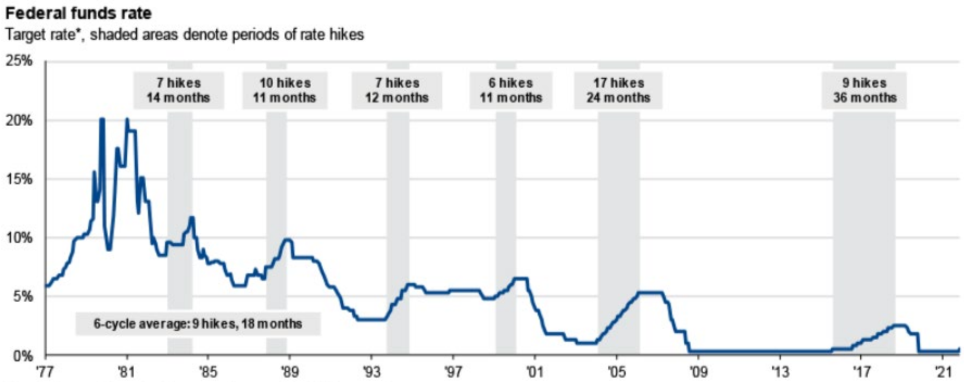
Outlook – How quickly will growth slow?

Now that expectations for higher inflation have been acknowledged and interest rates are rising rapidly, the question becomes, "how quickly will economic and earnings growth slow and what impact will it have on the equity market?". We do not know how quickly the Fed will raise rates or how rapidly the economy will slow – and we are not alone. World Bank Chief Economist Carmen Reinhart recently said the global economy is passing through a period of "exceptional uncertainty" and added that she would not rule out further downgrades to the outlook following a recent reduction in the World Bank's estimate for global growth in 2022 to 3.2% from 4.1% in January. At the same time, the Fed has not ruled out 75 bps increases in the Fed Funds rate at upcoming meetings.

Figure 6, page 5 shows the historical impact of Fed rate hikes on equity market returns. Although equity market returns are unlikely to come close to the extraordinary increases we have seen in recent years, we take comfort in the fact that the average S&P 500 return in the past six rate hiking cycles was +5.8%.

Despite the first quarter sell-off, equity markets remain expensive. Corporate profits recovered sharply in 2021 and further – albeit slowing – gains are now being reported. Both revenues and margins expanded rapidly in 2021 (see Figure 7, page 5). With inflation accelerating pricing power will become increasingly important in 2022. Industries able to pass on raw material and labor cost increases and those able to quickly implement technology changes to improve efficiency will fare far better than those unable to do so.

Figure 6. Historical Impact of Fed Tightening, 1977 to Date



Market reaction during previous rate hiking cycles

	May 1983 – Jul. 1984	Mar. 1988 – Feb. 1989	Feb. 1994 – Feb. 1995	Jun. 1999 – May 2000	Jun. 2004 – Jun. 2006	Dec. 2015 – Dec. 2018	Mar. 2022 – Present	Avg. of past 6 rate hiking cycles
Yield change (bps)								
Federal funds rate	313	325	300	175	425	200	25	290
2-year Treasury	311	227	305	121	238	165	43	228
10-year Treasury	274	91	185	50	52	49	17	117
S&P 500 return	-9.6%	6.8%	-2.1%	8.5%	12.0%	19.0%	6.3%	5.8%
U.S. dollar	10.4%	1.7%	-4.7%	3.4%	-5.8%	-1.4%	-0.6%	0.6%

Source: FactSet, Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management.
S&P 500 returns are price returns and do not include reinvestment of dividends. Averages do not include the current cycle. Current cycle begins on March 16, 2022. *Between 1979 and 1982, the FOMC changed its approach to monetary policy, focusing on the money supply, rather than the federal funds rate. In the fall of 1982, however, the Federal Reserve shifted back to its approach of targeting the "price" rather than the "quantity" of money. Thus, because the federal funds rate was not the FOMC's key policy tool, we exclude increases in the federal funds rate between 1979 to 1982 in our analysis of rate hike cycles.
Guide to the Markets – U.S. Data are as of March 31, 2022.

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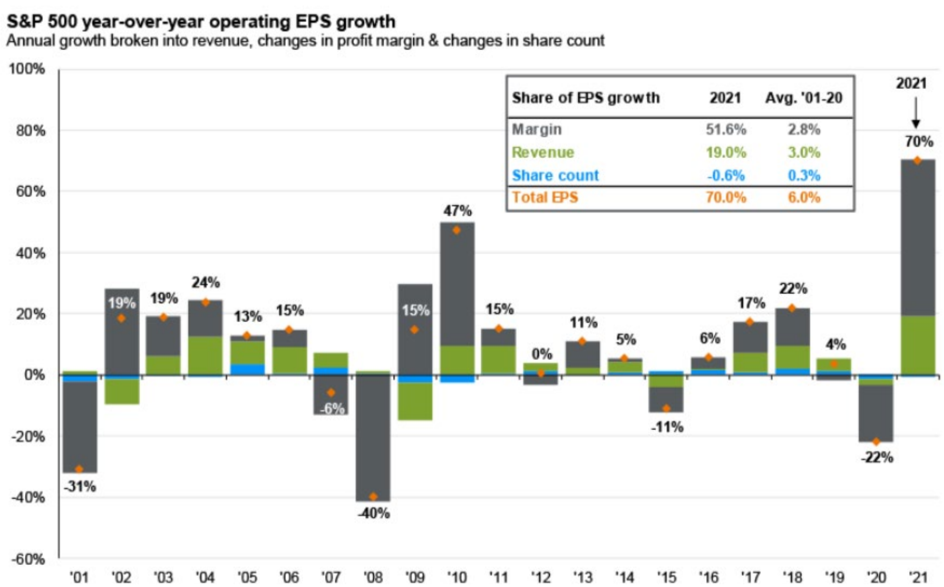
Figure 7. S&P 500 Earnings Growth, 2001-2021



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.
EPS levels are based on annual operating earnings per share. Percentages may not sum due to rounding. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of March 31, 2022.

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Investors should remain prepared for choppiness and consolidation as we move through this period of extreme uncertainty. The risks that could emerge in coming months include:

- Surging energy (gasoline, diesel, jet fuel) prices as the summer travel season kicks off,

- Dislocations in consumer spending as rapidly rising inflation influences the spending decisions of a generation that has never experienced it,
- Global food shortages in the wake of the removal of Russian and Ukrainian grain from the market and fertilizer shortages culling crops elsewhere, and
- The emergence of a new more virulent and vaccine resistant COVID variant.

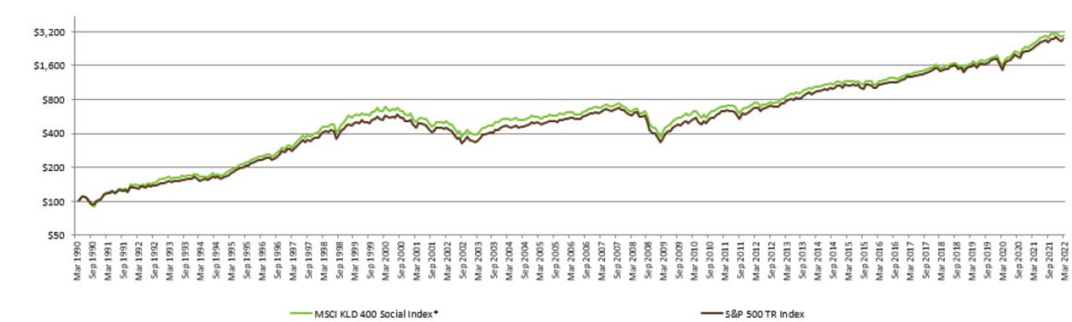
Investors who stay on course amid market volatility and conflicting prognostications, maintaining well-diversified portfolios geared toward achieving their long-term objectives, will continue to be rewarded.

Achieving Long-Term Investment and Impact Objectives

The shift into sustainable, responsible, and impact (SRI) investments continues. As of December 2021, assets under management at global exchange-traded "sustainable" funds that publicly set environmental, social, and governance (ESG) investment objectives amounted to more than $2.7 trillion; 81% were in European based funds, and 13% in U.S. based funds. In the fourth quarter of 2021 alone, $143 billion in new capital flowed into these ESG funds. Not surprisingly, following years of excess performance, as shown in Figure 8, the MSCI KLD 400 index underperformed the S&P 500 index in the first quarter amid surging prices for fossil fuels and other commodities. This setback notwithstanding, the sustained, consistent performance of this standard SRI/ESG benchmark over time supports our view that strategies incorporating environmental, social and governance (ESG) factors – with an eye toward making the world a better place – and mainstream financial returns can be achieved simultaneously.

As always, everything we do at First Affirmative is driven by our dedication to enabling advisors to deliver financial results to clients and belief in the power of capital to bring about lasting environmental and social change. Our new, innovative Values-Aligned Direct Index Solution (VADIS) and Sustainable Managed Mutual Fund and Multi-Manager Investment Solutions are built to enable clients to achieve their financial goals over the long term, along with their individual environmental, social, governance, ethical, and values-based objectives. Each portfolio is carefully constructed to be well diversified across assets, sectors, geographies, securities, and management styles –– and designed to weather periods of uncertainty and volatility.

Figure 8. MSCI KLD 400 vs S&P 500 Indices, March 31, 2022



Annualized Return Since 5/1/90:	MSCI KLD 400 Social Index*	S&P 500 TR Index
	11.83%	10.82%

Source: Morningstar. *Data prior to 9/1/2010 is that of the MSCI KLD 400 Social Index GR, while data since 9/1/2010 is that of the MSCI KLD 400 Social Index NR. Indexes are unmanaged groups of securities. Index performance does not include the impact of cash, fees, or transaction costs. Investors cannot invest directly in indexes but may purchase mutual funds or other investment products designed to track the performance of various indices.

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