EAMON
CAPITAL MANAGEMENT

FIRST QUARTER 2022 COMMENTARY

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Quarterly Recap

After a relatively calm 2021, instability was front and center in the first quarter of 2022, as inflation surged to 40-year highs, the Federal Reserve signaled its intent to raise interest rates faster than previously thought, and Russia proceeded with a full-scale military invasion of Ukraine. These factors fueled a selloff and pushed stocks lower during the first three months of the year.

Broad market volatility began to pick up during the first few days of 2022 as inflation readings hit multi-decade highs, confirming price pressures were still accelerating. This prompted multiple Federal Reserve officials to signal that interest rates will rise faster than markets had previously thought, including a possible rate hike in March. The prospect of sooner-than-expected interest rate hikes weighed on the sectors with the highest valuations, specifically growth-oriented technology stocks.

In late January at the FOMC meeting, Fed Chair Powell clearly signaled that the Fed would be raising rates at the next meeting (in March) confirming to investors interest rates were going to rise much more quickly than had been assumed a few months prior. As a result, the S&P 500 Index ended January with the worst monthly return since March 2020 (the onset of the pandemic).

To begin February, volatility remained elevated with the market's primary concern shifting from monetary policy to geopolitics as Russia amassed troops on the Ukrainian border prompting the United States and other Western countries to warn of an imminent invasion of the sovereign nation. The rising threat of a major military conflict in Europe, for the first time in decades, further weighed on broad stock performance throughout the month. This significant uncertainty, combined with continued high inflation readings and intermittent warnings about future interest rate increases from Federal Reserve (Fed) officials, kept markets bumpy into March and to end the quarter.

Economy

Geopolitical

The humanitarian crisis of invasion of Ukraine is still unfolding. While inflation and the Fed are primary sources of economic uncertainty, the war is a significant source of financial and geopolitical instability.

Russia is the world's second largest crude oil exporter and supplies one-third of Europe's energy needs. The war has spurred a rapid rise in energy prices, stoking inflationary pressure for the rest of the world.

The war's longer-term economic impact could depend on how much the West ratchets up sanctions. The Fed's decision-making process could become more complex if the conflict and economic sanctions cause a meaningful slowdown in global growth. For now, we believe the Fed will implement a series of measured rate hikes followed by shrinking of its own balance sheet to help rein in inflation.

Inflation

US inflation accelerated sharply over the quarter, led by significant increases in the price of energy, food and housing. In January and February the monthly Consumer Price Index (CPI) increased 0.6% and 0.8%. During February, in annual terms, headline inflation registered 7.9%, representing the fastest pace in nearly 40 years and the fifth consecutive month of inflation readings above 6.0%. A Bloomberg survey of economists forecast annualized headline inflation may peak around 8% soon, as the spikes in the price of energy and other commodities arising from Russia's invasion of Ukraine are reflected. Headline inflation is then expected to gradually decline toward the end of the second quarter as high readings from early 2021 are removed from annual calculations.

Unemployment

The US employment data showed solid improvement during the first quarter of 2022, in contrast to the relatively mixed picture in late 2021. Nonfarm payrolls added 431,000 jobs in March. Despite being below expectations, it was accompanied by upward revisions to 504,000 and 750,000 jobs added in January and February. The revision for February was the strongest jobs improvement since September 2020. The unemployment rate declined 0.3% to 3.6% at the end of 2021, moving closer to the pre-pandemic level of 3.5% in February 2020. Average hourly earnings remained elevated at 5.6% annually, while the labor force participation rate ticked higher to 62.4%, remaining 1 percentage point lower than before the pandemic.

Fed/Rates

To protect the economy's long-term health, the Fed has become more determined to raise interest rates to fight against higher prices. The Fed's aggressive tone caught some investors off guard and renewed worries that central bankers won't be able to tame inflation without stalling economic growth.

During its March meeting and as expected by the market, the Federal Open Market Committee (FOMC) increased its federal funds rate 25 bps to 0.25%-0.50%. Later in the month, Chair Powell indicated the FOMC may move more aggressively by raising the federal funds rate by more than 25 bps at each consecutive meeting raising investor expectations for rate hikes in the order of 50 bps, an action not seen since 2000. By the end of the quarter, fed funds futures contracts were pricing in roughly 75-100 bps in rate hikes over two of the Fed's upcoming meetings in May and June.

Market/Performance

Equity

All major equity indices posted negative returns for the first quarter, with the S&P 500 Index -4.6% and the Russell 1000 Index -5.1% seeing mild losses compared to the Nasdaq Index -15.0% and Russell 2000 Growth Index -12.6%. Elevated volatility, geopolitical uncertainty, and rapidly rising interest rates caused investors to flee richly valued, growth-oriented tech stocks and rotate to more fairly valued sectors of the market.

By market capitalization, large-cap stocks outperformed small-cap stocks as a result of the heightened geopolitical uncertainty and rising interest rate environment. Small-cap stocks typically are less financially healthy and hold more debt on their balance sheets. Therefore, prolonged elevated inflation, i.e., higher input costs, combined with supply-chain bottlenecks and rising interest rates are a perfect storm chipping away at the financial health of these smaller companies. As such, investors flocked to the relative safety of large-cap during the rise in volatility over the course of the quarter.

From an investment style standpoint, value massively outperformed growth as shown by the Russell 1000 Value Index -0.7% and Russell 1000 Growth Index -9.0%. Investors fled growth-oriented, high-P/E technology stocks for sectors more focused on quality with current profitability.

On a sector level, Energy was the clear standout receiving a strong tailwind due to the surge in oil and natural gas prices in response to the Russia-Ukraine war. Utilities, a historically defensive sector, posted a small positive return as investors rotated to defensive sectors in response to elevated market volatility and geopolitical uncertainty. Financials, negative on an absolute basis, and beating on a relative basis, benefitted from rates moving higher while facing selling pressure in the face of uncertainty with Russia-Ukraine.

Internationally, foreign markets declined as well. Geopolitical uncertainty hit foreign markets particularly hard and erased what was a somewhat positive performance profile to start the year. Emerging markets lagged its developed markets counterparts due to a stronger U.S. dollar and rising geopolitical risks.

Fixed Income

During the first quarter, bond bonds had their worst performance in 40 years with major bond indices posting negative returns. Yields increased at their fastest pace in years, further flattening the yield curve, and inverting some segments, as investors considered an accelerated pace of Fed rate tightening, including 50-bp rate hikes for 2022. Over the quarter, 2-year UST yields rose from 0.73% to 2.33%, 10-year UST yields rose from 1.52% to 2.33% and 30-year UST yields rose from 1.90% to 2.44%. Emerging market bonds, both USD-denominated and those denominated in foreign currency, widened as well.

From a security level perspective, shorter maturity bonds, i.e., shorter duration, outperformed longer maturity bonds due their sensitivity to rising interest rates. Bond prices have an inverse relationship to interest rates so as yields increase prices fall. Corporate bond spreads widened over the quarter, a negative for the securities. However, their lower-quality, high yield (below investment-grade) counterparts outperformed due to their low correlation with the U.S. Treasury curve. Outside of the U.S., emerging-market bonds experienced heavy selling as geopolitical uncertainty put hefty pressure on this part of the market. U.S. dollar-denominated bonds underperformed their local currency counterparts due their direct exposure to Fed activity, through movements in the U.S. dollar and domestic interest rates, versus those issued in their country's home currency.

Outlook

We do believe volatility will remain elevated in the coming months and to end the year but there are bright spots on the horizon. We do expect equity markets to end the year higher with bond markets gaining steam as growth and inflation show signs of slowing later in the year and into 2023.

For stocks, company fundamentals remain healthy, the consumer is strong despite mounting inflation, and monetary policy is still relatively loose compared to historical standards. As of the writing of this commentary, the S&P 500 Index forward 12-month P/E ratio was 17.6, below the five-year average of 18.6. However, it still remains above the longer-term averages: 10-year (16.9), 15-year (15.5), 20-year (15.5), and 25-year (16.5). While we are closer to the bottom versus the start of the year, and selling might continue, we do not expect it to remain there very long as many investors are waiting to jump in near these discounted levels.

For bonds, severe periods of dislocation as seen thus far in 2022 can be followed by strong reversals to the upside in the next calendar year. We can point to examples in 2008, 2013 and 2017. However, the biggest difference relates to how much of the dislocation was due to corporate spread widening relative to an overall increase in the interest rate levels, i.e., risk-free interest rates (U.S. Treasury). While the current environment is not as severe as 2008 from a spread widening perspective, where spread levels pushed past 2000 basis point (+20%), there has been modest widening during this period of rising interest rates leading us to see the potential for a reversal at some point.

It is our view the selling in both stocks and bonds is overdone given strong corporate fundamentals, healthy consumer balance sheets, and a Federal Reserve determined to slow inflation. We would expect stocks to perform well over the next 12-18 months assuming no surprises from the Federal Reserve or a significant escalation in the Russia-Ukraine war. Further, we do not expect rates to move much higher from here providing support for bonds with investors earning a much higher level of yield relative to six months ago. On average, higher yield levels have almost a perfect correlation to higher overall bond returns when looking out five years- this is good news for patient bond holders. However, we do see this as a fluid outlook due to the many exogenous variables weighing on investor sentiment and are remaining flexible with our short-term investment strategy.

Returns as of 3.31.22

				Trailing (Annualized)		
	MAR %	QTD %	YTD %	1-Yr %	3-Yrs %	5-Yrs %
Blended Benchmarks[2]						
90% Equity / 10% Bonds	1.7	-5.5	-5.5	3.0	12.1	9.8
80% Equity / 20% Bonds	1.4	-5.4	-5.4	3.5	11.7	9.7
70% Equity / 30% Bonds	0.7	-5.5	-5.5	2.1	10.2	8.5
60% Equity / 40% Bonds	**0.3**	**-5.6**	**-5.6**	**1.3**	**9.3**	**7.8**
50% Equity / 50% Bonds	-0.2	-5.5	-5.5	0.8	8.2	7.1
100% Bonds	-2.3	-5.6	-5.6	-4.3	1.3	1.7
U.S. Large Cap Equity						
S&P 500 Index	**3.7**	**-4.6**	**-4.6**	**15.6**	**18.9**	**16.0**
DJ Industrial Average Index	**2.5**	**-4.1**	**-4.1**	**7.1**	**12.6**	**13.4**
Russell 1000 Index	**3.4**	**-5.1**	**-5.1**	**13.3**	**18.7**	**15.8**
Russell 1000 Growth Index	3.9	-9.0	-9.0	15.0	23.6	20.9
Russell 1000 Value Index	2.8	-0.7	-0.7	11.7	13.0	10.3
U.S. Mid Cap Equity						
Russell Mid Cap Index	**2.6**	**-5.7**	**-5.7**	**6.9**	**14.9**	**12.6**
Russell Mid Cap Growth Index	1.6	-12.6	-12.6	-0.9	14.8	15.1
Russell Mid Cap Value Index	3.0	-1.8	-1.8	11.5	13.7	10.0
U.S. Small Cap Equity						
Russell 2000 Index	**1.2**	**-7.5**	**-7.5**	**-5.8**	**11.7**	**9.7**
Russell 2000 Growth Index	0.5	-12.6	-12.6	-14.3	9.9	10.3
Russell 2000 Value Index	2.0	-2.4	-2.4	3.3	12.7	8.6
International & Emerging Market Equity						
MSCI EAFE Index	**0.6**	**-5.9**	**-5.9**	**1.2**	**7.8**	**6.7**
MSCI EAFE Growth Index	0.6	-11.9	-11.9	-1.5	9.8	8.9
MSCI EAFE Value Index	0.7	0.3	0.3	3.6	5.2	4.2
MSCI Emerging Markets Index	**-2.3**	**-7.0**	**-7.0**	**-11.4**	**4.9**	**6.0**
MSCI ACWI ex. U.S. Small Cap	1.0	-6.5	-6.5	0.0	10.2	7.9
Fixed Income (U.S. & Emerging)						
Bloomberg US Agg. Bond Index	**-2.8**	**-5.9**	**-5.9**	**-4.2**	**1.7**	**2.1**
Bloomberg US Agg Int. Bond Index	-2.5	-4.7	-4.7	-4.4	1.2	1.7
Bloomberg US Int. Corporate Index	-2.3	-5.1	-5.1	-4.1	2.1	2.5
Bloomberg US Long Corporate Index	-2.8	-11.4	-11.4	-4.3	4.6	4.9
ICE BofA US High Yield Corp Index	**-0.9**	**-4.5**	**-4.5**	**-0.3**	**4.4**	**4.6**
Bloomberg US TIPS Index	-1.9	-3.0	-3.0	4.3	6.2	4.4
JPM EMBI Global Diversified Index	-0.9	-10.0	-10.0	-7.4	0.0	1.7
JPM GBI-EM Global Diversified Index	-1.5	-6.5	-6.5	-8.5	-1.1	0.2

[1] Source: Morningstar

[2] Source: BridgeFT

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