Market Commentary

First Quarter 2022

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The first quarter of 2022 was marked by significant volatility in financial markets. The positive news of COVID transitioning from pandemic to endemic was overshadowed by the Russian invasion of Ukraine along with reports of persistently high inflation. After declining for most of the first two months of the quarter, stocks bounced back in March, reducing the decline for the full quarter. US stocks, as measured by the benchmark S&P 500, declined 4.6% on a total return basis in the first quarter. This was the first negative calendar quarter since the first quarter of 2020 during the onset of the COVID-19 pandemic.

Fixed income yields spiked higher across the maturity spectrum as the Fed clarified its intent to raise rates in a methodical fashion over the next 18-24 months. We have long opined the Fed was behind the curve on raising rates; a situation exacerbated by the Russian invasion of Ukraine, which will increase inflationary pressures. Russia and Ukraine are both key producers of many commodities, particularly energy and wheat. Disruptions in supplies of these and other commodities will put further upward pressure on prices for consumers. If the Fed follows through with its current plan of seven quarter-point rate increases during 2022, with three or four more hikes in 2023, it will bring the Federal Funds rate to 2.875%. Under nearly every scenario we can envision, this would still leave Fed Funds below the expected inflation rate two years hence. By maintaining crisis level monetary policy long after the crisis had abated, the Fed made their task far more difficult, in our opinion. In a potential admission of their tardiness, Chairman Powell noted in a March 21st speech, *"if we conclude that it is appropriate to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings, we will do so."* We interpret that comment to mean the Fed is considering 50 basis point hikes at one or more meetings, potentially starting with the May meeting. While markets may react negatively in the short-term to larger than expected moves, we believe it is prudent to quickly move away from crisis-era interest rates. The 10-year note ended the quarter at 2.34%, significantly higher than the 1.51% yield on December 31, but down from the 2.50% reached during the last week in March. The last time the benchmark Treasury yield was above 2% was mid-2019. We have expected yields at the longer-end of the yield curve to drift higher and would not be surprised to see the 10-year yield move to a range of 2.50%-3.00% in the coming months in the absence of further exogenous shocks.

The price for benchmark West Texas Intermediate began 2022 at $75.44 and moved steadily higher to approximately $90 per barrel when the Russian invasion of Ukraine caused a spike to a 14-year high of $130 in early March, before pulling back to end the quarter at $100.28 per barrel. The 33% price increase during the quarter increased inflationary pressures and crimped consumer spending on discretionary items. We went back to our research from 2008 when oil prices last spiked this dramatically and noted we had written at the time, "the world does not 'work' with oil prices over $125 for an extended period of time." We still believe this to be true. Demand destruction begins when oil crosses $100 per barrel as consumers look to cut back on consumption by driving less and altering other behaviors. The inflation pressures of the past year along with increased energy demand as the world rebounds from the COVID pandemic combined to move our estimate of fair value for oil to approximately $70-90 per barrel. The current excess to that range is almost solely due to investor uncertainty from the actions in Ukraine and sanctions against Russia.

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Economic and Market Outlook

While COVID-19 has thankfully lessened as an economic concern, inflation and the invasion of Ukraine are at the forefront of investor concerns. In our prior Market Commentary, we explained how inflation had been allowed to run so high via huge increases in the monetary supply and extremely low interest rates which encouraged spending. As pandemic era fiscal policy was removed, we expected the slowdown in monetary growth to lead to a steady decline in inflation. The Federal Reserve's dual actions of raising interest rates and reducing its prodigious balance sheet would also assist in tempering consumer demand. These positive actions are countered by the Russian attacks on Ukraine which put significant upward pressures on pricing for many commodities.

Final real GDP growth for 2021 came in at 5.7%. This was below the 6.6% estimate at mid-year as the economy slowed in the latter months due to continued supply chain disruptions and the large uptick in COVID cases in the fourth quarter. Despite the slower than expected growth in the second half of the year, 2021 saw the fastest real GDP growth since 1984. 2022 growth is estimated at 2.5-3.0%, although inflationary pressures, continued supply chain issues, and the uncertainty due to the Ukraine invasion could cause growth to come in below this range.

There are many who see the flattening yield curve, with shorter-term maturities yielding nearly the same as longer maturities, a very tight labor market, and a Federal Reserve ramping up for rapid interest rate increases foretelling a recession. We look at companies' very strong balance sheets along with a consumer that is still willing and able to spend countering these headwinds. While we do not see the makings of a recession during 2022, we acknowledge the combination of aggressive Fed tightening and the uncertainties of the Russian invasion of Ukraine, increase the chances of policy mistakes that could further crimp economic growth. Growth will clearly slow meaningfully in the US during 2022 and 2023, but we currently believe the odds of a recession are less than 50%.

Portfolio Positioning

Tandem used the volatility in equity prices to selectively add to equities during the quarter, reducing fixed income positions in many cases. With our long-term philosophy to sell what looks expensive and buy discounted securities, we reversed our movements from 2021 where we were trimming rising equities and buying fixed income. While interest rates have moved up meaningfully on a percentage basis, they remain close to generational lows on an absolute basis. We wrote in our last commentary,
"*It would not take a large increase in interest rates to wipe out a year or two of long-term bonds' coupon payments*." We did not know how accurate and timely that statement would be. With the upwards move in interest rates during the first quarter, 10-year Treasury notes saw a principal loss of approximately 7.5%. The knee-jerk reaction by investors to the Fed's stated policy changes has disrupted traditional fixed income investing and made portfolio asset allocation more challenging. Historically, fixed income would serve as a counterbalance to equities in portfolios. During times of equity declines, bonds would hold their value or even rise slightly in some circumstances. This has not been the case for the past several months, causing some to question why they should hold any fixed income.

Tandem has long believed in holding balanced portfolios with the actual proportion of equities and fixed income set on an individual basis based on several factors including years to retirement, personal risk tolerance, and ability to withstand fluctuations in price. With interest rates coming off all-time lows, fixed income - particularly maturities of more than three years or so – have significantly more risk than

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historically. While we have kept maturities shorter than index benchmarks, we are considering shortening the weighted maturities even further. With an extremely flattish yield curve, investors gain little by extending maturities much beyond two to three years. If rates continue to rise, maturing bonds can be rolled into new ones with higher coupon rates.

Equities continue to get cheaper as the combination of rising earnings and declining prices lower earnings multiples to levels not seen in a few years. Earnings estimates for the S&P 500 have remained fairly steady for 2022, with current expectations for an increase in the high single digits versus 2021. The March 31 valuation of the S&P 500 is approximately 20x forward (2022 estimates) earnings on the S&P 500. While slightly higher than historical averages, it is still meaningfully below the levels reached in 2020 and 2021. Rising fixed income yields could eventually make bonds more attractive relative to equities, but we remind you of the need to not only earn solid risk-adjusted returns, but also the need to stay ahead of inflation. There are few better inflation hedges than equities in our opinion, mainly due to companies' ability to raise prices to maintain margins in most circumstances.

Conclusion

The sharp increase in volatility over the past few months has spooked investors after equities moved higher in a nearly straight line for the prior 21 months. Principal declines in fixed income, coming simultaneously with equity price declines, intensifies investor angst. Long-time readers of our missives will know we always counsel to never make rash or emotional judgements when markets are moving rapidly in either direction. Rather, we use price dislocations to make changes to portfolios where warranted – usually on the asset allocation level, rather than individual securities. The activities in Ukraine, inflationary pressures, and the Fed's quest to lower inflation while not slowing the economy so much it slips into a recession are the key drivers of financial markets thus far in 2022. Corporate earnings and profit margins are key as we move through 2022. Please let us know if you have any specific questions or concerns about your investments. As always, we request that you inform us of any significant changes in your financial situation.

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