



BANK OF MILLBROOK TRUST AND INVESTMENT SERVICES

REVIEW AND OUTLOOK

PUBLICATION 56

APRIL 2022

“Without courage we cannot practice any other virtue with consistency. We can’t be kind, true, merciful, generous, or honest.”

- Maya Angelou

When looking at the investments and portfolios we manage for our clients many things are factored into our decision making. First and foremost, are our clients’ objectives and tolerance with risk. We strive to balance the allocation of portfolios to reflect what best suits each client. Often when our clients are not comfortable with a high level of risk, we purchase bonds or other fixed income securities to help offset the risk of stocks or equities.

In the past two months, the world has gone topsy-turvy. The investment decision-making process has become particularly difficult with factors such as runaway inflation, a war in Europe, mid-term elections, and to name a few. When filtering out all of this noise, we take comfort in the fact that we focus on quality investments that have historically demonstrated their ability to weather the test of time.

The chart below illustrates historical annualized returns from 3 different snapshots in time. On the right is 1928 to 2019. On the left is more recent; 2010 to 2019, which was a period of high growth and low interest rates. The center illustrates 1970 to 2019 when growth was slow and yields were high. This was a period of time that bears many similarities to our current situation, and we believe this trend will continue. We look forward to taking advantage of higher bond yields, and continue our conviction with quality stocks.

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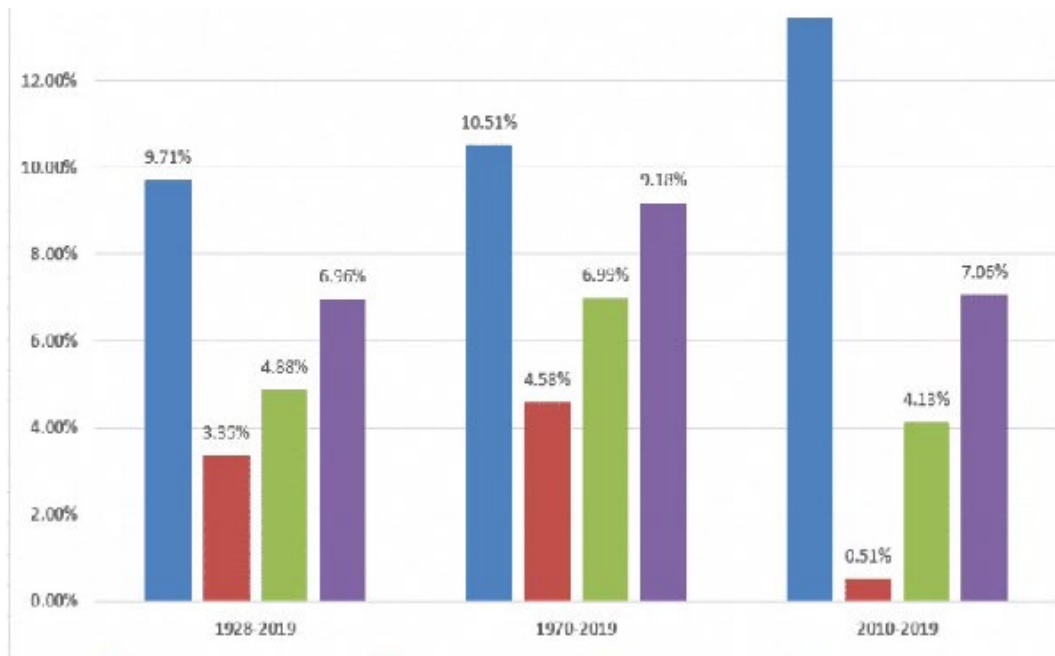
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The enclosed newsletter outlines the challenges facing the Federal Reserve in terms of taming inflation. We are all feeling the sting of higher prices, particularly in food and energy, and bringing down those inflationary trends is not an easy task. Our economy is currently strong and unemployment is at a very low 3.6%. To bring down inflation requires aggressive “tightening” by the Federal Reserve which results in higher interest rates. The purpose of higher rates is to slow down the economy, in turn stemming inflation. Unfortunately, recession is often a by-product of such “tightening”.

Interest rates have risen very quickly in the past 3 months. At the end of December, the 10-year Treasury yield was at 1.51%. Today it is at 2.83%. This has had a negative effect on the bond market.

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ECONOMIC OUTLOOK

Summary

Unlike some Central Banks, the Federal Reserve has a dual mandate – promoting maximum employment and price stability. To that end, there have been few points in history where the labor market has been as hot as it is today. Headline statistics reflect a 3.6% unemployment rate, and weekly initial jobless claims reached as low as 166k recently – both at or below the lowest levels in the past 50 years.

At the same time, inflation is at the highest levels in 40 years for reasons beyond having a tight labor market (e.g. supply chain disruptions, stimulus, Russia.) Yes, wages have been increasing but they are not the root cause. In fact, they are failing to keep up with the current pace of inflation which ultimately translates into less purchasing power for consumers. Fortunately, the booming labor market allows the Fed to be heavy handed, at least in the short term, in using its “tools” such as rate hikes and reducing its balance sheet (aka Quantitative Tightening, or QT) to fight stubborn inflation.

The Fed only officially started their rate hiking cycle in March. However, due to forward guidance and effective communication by Chairman Jay Powell and other Federal Reserve’s Open Market Committee (FOMC) board members, many projected rate hikes have already been priced in to the market. This, in effect, has implemented those rate hikes in advance. Furthermore, since their most recent meeting, Fed members have upped the ante and started to prepare investors for 50 basis point (bp) hikes at the May and June meetings followed by 25 bp hikes in all remaining meetings during 2022. Add in QT starting in May and the Fed is seemingly doing all it can to reel in inflation.

These Fed “tools” work by slowing the money supply and liquidity in the economy. Higher interest rates promote saving and less spending/borrowing - for example, 30 year fixed

mortgage rates are now approaching 5%. As people spend less, the overall level of economic activity/demand slows. Less demand generally translates to lower prices – but it typically comes at the cost of GDP growth.

Pre-Russia/Ukraine, we were already starting to see signs of slower economic consumption. Retail Sales for February came in below expectations, especially when removing automobiles. Monthly durable goods and factory orders were negative. ISM new orders declined sharply to its lowest levels since the pandemic. Given the complexities of the global economy, and recent geo-political tensions, the Fed is walking a wire to get control of inflation while providing a soft landing for the economy.

Positives

The labor force is increasing at the same time unemployment is decreasing

ISM Manufacturing and Services remain in expansionary territory

Though still elevated, Core PCE came in slightly below expectations

Negatives

4Q21 GDP growth was revised lower by 0.1%

Personal consumption for 4Q21 was revised lower by 0.6%

ISM Prices Paid for March jumped 11.5 points



EQUITY OUTLOOK

Summary

Domestic equity markets rebounded in March after finishing the first two months of the year in negative territory. Large growth stocks, which had led the declines, also drove the recovery as represented by the Russell 1000 Growth Index's 3.9% climb in March. The Russell 1000 Value, by contrast, finished the month higher by 2.8%. The 3.7% rally in the S&P 500 Index was far stronger than the 0.7% bump in the developed international MSCI EAFE Index and the 2.3% decline of MSCI Emerging Markets Index.

Issues plaguing capital markets were little changed during the month of March. Russia has indicated their intention to shift strategy in Ukraine. That along with ongoing negotiations may reduce the risk of greater Western involvement to some degree but the potential for escalation remains. Inflation tensions remain elevated but there has been some hope the Federal Reserve may be able to engineer a soft landing. Supply chains remain congested but each passing month gets us closer to the end of this crisis.

All in all, the rebound off lows of early March seems a bit premature given the level of risk and uncertainty in the near term. Stocks are likely to remain volatile over the coming

months and a retest of the recent market lows is quite likely. In April, the market's focus will also shift to corporate earnings. Earning results should be solid in aggregate but we are also likely to see greater dispersion of results as inflationary pressures and supply chain issues disproportionately impact certain companies and industries.

Positives

Covid no longer impacting markets

Equity fundamentals

Negatives

Inflation and the Fed's increasingly hawkish tone

Supply chain and labor shortages

Yield curve inversion



FIXED INCOME OUTLOOK

Summary

Beyond the human tragedy, the war in Ukraine continues to create vast uncertainties in the outlook for the economy, inflation and the financial markets. Usually when geopolitical tensions arise there is a flight to safety where investors soak up high quality U.S. Treasury bonds. This is especially true when there is concern that any sort of confrontation will slow global trade and economic growth. While we believed this would happen again, this playbook is being discarded as investors focus on the extraordinarily elevated level of inflation and the Fed's response, rather than the potential economic fallout.

Regardless of the conflict, the Federal Reserve's Open Market Committee remains steadfastly committed to the removal of the accommodative monetary policy put in place to combat the economic fallout from the pandemic. They took their first step toward this with a 25 basis point (bp) increase in the Fed Funds rate at their mid-March meeting. With the next meeting in early May, Fed officials have now been publically discussing the need to be more aggressive in an effort to combat inflation. These comments are then taken as policy with the market moving in advance and in effect doing the tightening work for the Fed. The next rate hike or two will now likely be in 50 bps increments and they will begin to reduce their balance sheet holdings by this summer.

Reflecting an abrupt repricing of monetary policy, the 2-year Treasury note increased an astonishing 90 bps during March to end at 2.34%. At this level, the market is pricing in 2% of additional rate hikes this year to go on top of the one seen so far. Recall that a mere six months ago the Fed was not expected to increase the overnight rate at all in 2022. The 3-year Treasury note increased by about the same amount and at 2.51% became the peak of the curve out to 10 years as that note only increased 51 bps to end at 2.34%. The 20-year bond became the absolute highest yield along the curve at 2.60%, which was 15 bps higher than the 30-year bond.

Similar to January and February, credit spreads moved sharply wider during the first half of March, but then rallied and ended

tighter for the month. Even with better performance from investment-grade corporate bonds, the major fixed-income benchmarks had their second to worst monthly return in the past 30 years. For example, the Bloomberg Intermediate Government/Credit Index had a return of -2.45%, which brought the quarterly return to its absolute worst over that same period at -4.51%. Barring an extremely unlikely plunge in yields across the curve, fixed-income investors are likely to experience their first ever back-to-back negative return calendar years. The good news is that the pain should be mostly behind us and investors can now earn much higher yields on new funds or the reinvestment of cash flows and maturities. While we acknowledge that longer maturity yields can move somewhat higher due to the Fed and inflationary uncertainties, the inversion of the curve tells us that sharp increases like we have seen are unlikely to be repeated.

Positives

Demand for safety investments as global economic uncertainties increase

Short maturity yields already reflect multiple 50 bp Fed rate increases

Negatives

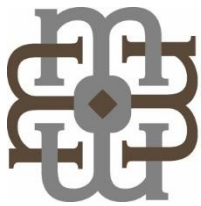
Russia's invasion will exacerbate inflationary pressures

Balance sheet reductions could pressure yields

Unknowns

Resolution of Russia's invasion of Ukraine

Foreign demand for U.S. debt



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