viewpointe A Horizon Trust & Investment Management Publication

HORIZON

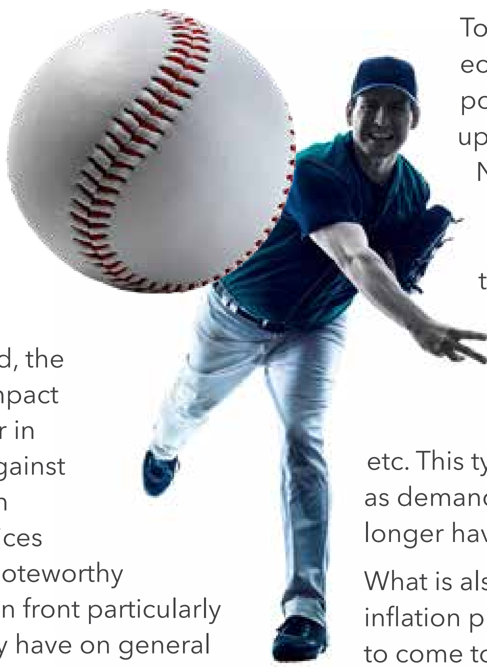
ISSUE NO. 76, SECOND QUARTER 2022

"The measure of who we are is what we do with what we have." -Vince Lombardi

Inflation has become a larger issue than what we had previously expected. While we had originally anticipated that inflationary forces would subside during the first half of the year, the Russian invasion of Ukraine significantly changed things. Recent increases in crude oil prices as well as prices of a number of other commodities has turned the pressure up on the inflation front. As a result, we had to adjust our economic and market forecasts. In this edition of Viewpointe, we discuss these adjustments. We also discuss the impact recent changes have had on our investment strategy. We conclude with a brief discussion regarding some items to consider when dealing with increased market volatility.

Economic Review - An Unexpected Curve Ball

Just when pandemic related concerns appeared to be settling down, things are flaring up on the geopolitical front. Russia's invasion of Ukraine has shaken global markets and elevated investor anxiety. A barrage of global sanctions, surging commodity prices, talk of nuclear escalation and scenes of modern-day warfare have shaken the economic landscape reverberating through both equity and fixed income markets.



While the impact of war on investment markets has historically been short lived, the present situation is unique given the impact it has had on the inflation front. The war in Ukraine and the retaliatory sanctions against Russia are resulting in price increases in several commodities. We have seen prices spike in nickel, wheat, corn, and most noteworthy crude oil. Developments on the inflation front particularly catch our interest given the impact they have on general economic conditions.

At the beginning of the year, we expected inflationary pressures to subside as bottlenecks cleared and consumer dollars moved away from goods purchases toward services purchases. While we had anticipated a soft first quarter resulting from the Omicron drag, we expected things to pick up in the second quarter before settling back to the pre-pandemic growth rate of 2%. Recent developments have placed downward pressure on our earlier forecasts.

To demonstrate why we now expect economic growth to soften, we start by pointing out that consumer spending makes up just about 70% of U.S. economic growth. Now let's talk about how recent gasoline price increases effect the average consumer. With consumers now having to pay significantly more to fill up their gas tank, they now have less money for other discretionary purchases. Less to spend on items such as retail goods, restaurant purchases, vacations, etc. This typically results in slower economic growth as demand drops for the items that consumers no longer have money to purchase.

What is also concerning are the limitations that inflation puts on the Federal Government's ability to come to the rescue. During the pandemic, the Government was able to stimulate consumer demand by providing assistance through stimulus checks and access to affordable credit. Ironically, this sort of stimulus has a tendency to fuel higher inflation. That is why inflation tends to be such a tricky nemesis.

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It not only results in a drag on economic growth, but also stands in the way of implementing policies to stimulate growth for fear of driving inflation higher.

We have not been faced with such a predicament since the period that spanned from 1965-1982. This period is referred to as "The Great Inflation." It spanned nearly two decades and contained a multitude of policy errors resulting in four economic recessions, two severe energy shortages, and the unprecedented peacetime implementation of wage and price controls. Eventually, the inflationary cycle was broken by a drastic tightening of monetary policy. Unfortunately, this tightening also resulted in a recession that lasted more than a year.

While we do believe there is cause for heightened caution given the current backdrop, we are optimistic that this time things can play out differently. First off, the Federal Reserve (Fed) made a lot of policy errors during The Great Inflation period. We are hopeful they learned from these mistakes and will be less likely to make them again, or at least not to the same degree. Also, it is important to note that unemployment was extremely elevated during that time period. The current strong employment situation provides a fair amount of cushion on the growth front. Another key differentiator is the U.S. was much more dependent upon foreign sourced energy back then. Today, we have a lot more control over energy prices by simply making adjustments on the domestic energy production front. Lastly, inflation levels are not anywhere near as high as the levels seen at the height of The Great Inflation. In addition, it is important to note that some of the current inflationary pressures were driven by pandemic related items that we expect to naturally fix themselves as the pandemic subsides.

In conclusion, while we have revised our growth expectations lower for this year, we still expect growth to remain in positive territory. This, however, depends on favorable outcomes on a number of fronts. First off, the Fed must navigate a tightening strategy that, while making progress against inflation, does not smother economic growth. Secondly, we must continue to see positive progress in terms of the pandemic that provides relief on the manufacturing capacity and delivery fronts. Also, progress on the pandemic front is necessary in order to see consumer purchases shift away from goods (where inflation has been hot) to services (where inflation has been subdued). Some additional items that we are monitoring closely that could potentially impact our forecast include the pace of de-globalization, covid related developments (particularly Asia), food supply issues (wheat and corn), debt default trends as interest rates rise and developments regarding China's stance on Ukraine.

Fixed Income Commentary - A Narrowing Path

In the previous edition of *Viewpointe*, we discussed our view that the Federal Reserve (Fed) was several months behind where we felt they should have been. We still view this to be the case and their path to avoid a policy error has narrowed further as a result of rising inflationary pressures. We still believe the Fed should have stopped purchasing fixed income securities on the open market and increased the Fed Funds Rate several months back when economic conditions were more favorable. This would have given them more runway to tighten monetary policy before facing conditions that we expect to be softer later in the year.

Regardless, that ship has sailed and we now have to deal with where things stand today. With that said, the Fed did finally increase the Fed Fund's Rate by .25% in March. With the first rate hike out of the way, the Fed is forecasting six more increases this year. In addition, it appears the Fed intends to start reducing the size of their balance sheet (wind down Quantitative Easing) as early as May. While Fed Chairman Powell downplayed the chance of a recession, it is hard to ignore what the yield curve is signaling. With the Fed's recent rate hike, all eyes are on the yield curve, which has been flattening for the past few months.

So, what does curve flattening mean? In this instance, we are referring to the U.S. Treasury yield curve. The Treasury yield curve simply charts the yields of U.S. Treasury bonds from the shortest term of one month going out to a 30-year maturity. A normal curve depicts an ascending line where the longer one ties up their money the more they earn in yield. When a shorter-term Treasury yields more than that of a longer maturity Treasury, it can be used as a signal that fixed income investors have concerns regarding future economic growth and/or inflation. It is oftentimes used as a signal that the Fed made a policy error by too aggressively increasing the Fed Funds Rate. Such a scenario is referred to as an "inversion" of the yield curve.

Fed Rate hikes are important since they have a direct impact on short-term interest rates. In other words, Fed rate hikes drive short-term rates higher. Intermediate and long-term rates on the other hand are impacted by market forces such as growth and inflation expectations. While short-term rates have been moving higher as a result of expectations of more hawkish Fed policy, intermediate and longer-term rates have increased at a more tempered pace. Ultimately, this has resulted in a "flattening" of the yield curve. We interpret the recent curve flattening as an indication that markets are not fully buying into the Fed's ability to get a full additional six hikes in prior to year-end. In short, the market is indicating the Fed may have to stop short of their current goal.

This runs the risk of turning into a high stakes game of chicken if the Fed continues to hike, driving short-term rates higher, while intermediate and long-term rates go up by a lesser degree. The risk is the yield curve inverts at certain points. Of particular importance is an inversion between two-year and ten-year Treasury yields. An inversion between two-year and ten-year Treasury yields has been utilized as a pretty accurate indicator of a recession on average 12 months out. Since 1978, there have been six recessions according to the National Bureau of Economic Research. On average, the yield curve inverted 12 months before these recessions occurred.

Despite the strong correlation of an inversion being followed by a recession there are those that argue that this time may be different. One argument is the hurdle for an inversion is much lower in a low-rate environment and that it just takes more time for intermediate and long-rates to adjust. Another is that while an inversion may take place in coming months, it will be short-lived since all the Fed has to do is sell some longer dated bonds from their balance sheet to drive rates up in that space. (Prices down/ yields up.) Lastly, some blame the subdued increase in intermediate and long-term rates on increased demand from foreign investors who are not necessarily making a call on U.S. economic growth, or on inflation.

Ultimately, we expect an aggressive Fed in the short term, but a Fed that tempers their approach as negative economic and market impacts start to develop. We expect intermediate and long-term rates to move higher in coming months giving the Fed a little more space to hike the Fed Funds Rate. Regardless, we do not expect the Fed to get six more hikes in this year. We are in the four to five hike camp with the expectation that those hikes, combined with a natural deceleration in inflation, will provide the Fed with enough room to temper their approach before smothering economic growth. While we acknowledge the risks are high, we are keeping our fingers crossed on a soft landing. Of course, this forecast is subject to change in coming months and will have to be monitored closely. Unfortunately, the Fed has been known to overshoot and, in this instance, they will be left with very little room to re-stimulate in the event they go too far.

Equity Commentary -
Losing the "Fed Put"

At the beginning of the year, we were of the opinion that equity market returns would be harder to come by than in 2021. Thus far, that prediction appears to be accurate with equity returns in negative territory. To a large degree we attribute this to the loss of what has been referred to as the "Fed Put." The "Fed Put" is a spin-off from what is referred to as a put option contract. A put option contract gives the purchaser of the contract the option to sell a specified amount of a stock at a predetermined price on a set date. Ultimately, the put option provides downside protection in the event the named stock trades below the price set in the contract. In other words, the contract provides a form of insurance against losses beyond the contract price by allowing the holder the ability to still sell at the contract price.

The "Fed Put" essentially is the pattern of accommodative Federal Reserve policy that has oftentimes followed poor equity market returns. In other words, it is the expectation that if things get too bad in the stock markets the Fed will implement accommodative policy to help prop prices up. While this has been recognized as a safety net dating back to the late '90s, there is concern things have changed due to current inflation levels. Many investors fear that inflation will prevent the Fed from being able to implement the accommodative policies they have implemented in the past that directly benefited stock prices.

This fear has forced many investors to rethink the underlying profitability of their stock positions. Low rates have resulted in cheap financing for the last several years. This access to cheap credit helped a number of companies stay in business despite the fact they produced little or no earnings. In a cheap credit environment, investors are able to focus more on future profit potential and less on a company's short-term profitability. Rising financing costs force investors to reevaluate this view and focus more attention on short-term prospects. Suddenly, those companies that were heavily reliant upon cheap financing are no longer as attractive and their stock prices have to be adjusted to incorporate an increase in short-term risk. We view this repricing of short-term risk as a significant driver of recent stock market weakness.

As a result, we have seen a direct shift in leadership in the equity space. Suddenly the sleepy dividend payers that have shown solid long-term profitability trends have taken the leadership role away from up-and-coming technology stocks that were trading at high valuations based upon future growth expectations.

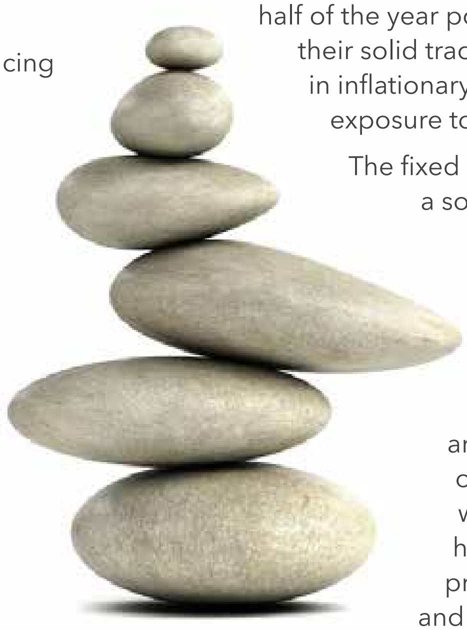
While equities have traded lower in general, the brunt of the losses has taken place amongst growth focused stocks. In many instances, these were the same names that were the top performers during the second half of 2020 and the first three quarters of 2021. We do expect this trend to continue based upon our expectation that interest rates will continue to move higher. We are not alone in our assessment. We are seeing numerous signs of expectations of slower growth on the horizon.

A good example can be found when reviewing the recent downward trend in earnings per share expectations. Another example can be found in recent downward revisions of year-end S&P 500 targets that place the average year-end target return for the S&P 500 at 3% for the calendar year.

In conclusion, rising borrowing costs have hurt growth focused stocks, particularly those that were highly dependent upon access to cheap credit. When rates rise, future growth is discounted, reducing what investors are willing to pay for these stocks. While stock markets are down on a year-to-date basis we are not confident we have experienced the bottom. There are several indicators that we utilize to help identify a market low. As of now several of these indicators are signaling that we are not quite there yet. In addition, despite some upward momentum, we are seeing few indications of a durable rally at the present time. With that said, market direction does have a tendency to change in a hurry and as a result we remain optimistic that conditions will improve before year-end, and we can finish the year in positive territory.

Asset Allocation - Patiently Waiting

While we had originally intended on rebalancing our model portfolios in January, we decided to hold off given the increase in market volatility and downward pressure in both the equity and fixed income spaces. Sitting on a little extra cash from year-end capital gains distributions served us well, as both the equity and fixed income markets demonstrated widespread weakness. With that said, there were a handful of times that we considered rebalancing during the latter half of the quarter, but ultimately decided to wait until more signs of a bottom developed. It is our expectation that these signs are likely to develop during the second quarter.



When we do rebalance, it is our intention to maintain an overweight in U.S. large-cap stocks. While we had kicked around the idea of increasing our exposure to developed international stocks, recent events in Ukraine have changed our mind. Growing expectations of a recession in much of Europe and a strengthening U.S. dollar make a good argument to stick with U.S. stocks. Within the U.S. stock space, we continue to favor large-cap names and shift more attention to dividend paying stocks within this space. With that said, we do see second half of the year potential in small-cap U.S. stocks, given their solid track record of attractive performance in inflationary environments and their having less exposure to foreign revenue sources.

The fixed income mutual fund space experienced a soft start to the year given the material increase in interest rates. These rate increases placed significant downward pressure on fixed income security market values. The good news is fund portfolio yields are rising as fund managers are able to invest liquid assets in some of the highest yielding investments that we have seen in quite some time. These higher yields should provide better protection against further rate increases and a more attractive future income stream.

In our individual stock model portfolio, we replaced two individual stock names in order to reduce our exposure to both the information technology and consumer discretionary sectors. We took the proceeds from these sales and invested in a U.S. Large-Cap Stock ETF that is focused on companies that have followed a managed-dividends policy focused on consistently increasing dividends over time. This move was aimed at increasing our exposure to dividend paying stocks versus the growth focused names that have been under downward pressure.

Opportunities in the individual fixed income space improved during the first quarter. We were able to identify a number of short-term corporate bonds that offered yields in excess of 2%. We are also starting to see some more attractive opportunities in the certificate of deposit space as rates in this area are also starting to adjust to the higher rate environment. We expect this trend to continue in coming months and plan on taking advantage of opportunities in this space as they present themselves.

Financial Planning - Market Volatility

Conventional wisdom says that what goes up must come down. However, even if you view market volatility as a normal occurrence, it can be tough to handle when your money is at stake. Though there is no foolproof way to handle the ups and downs of the stock market, the following common-sense tips can help.

Don't put your eggs all in one basket.
Diversifying your investment portfolio is one of the key tools for trying to manage market volatility. Asset classes often perform differently under various market conditions. Therefore, spreading your assets across a variety of investments such as stocks, bonds, and cash alternatives has the potential to help reduce your overall risk. Ideally, a decline in one type of asset will be balanced out by a gain in another, though diversification will not eliminate the possibility of market loss.

One way to diversify your portfolio is through asset allocation. Asset allocation involves identifying the asset classes that are appropriate for you and allocating a certain percentage of your investment dollars to each class (e.g., 70% to stocks, 20% to bonds, 10% to cash alternatives). Completing a client investment profile (CIP) worksheet with your Horizon Trust & Investment Management Relationship Manager can be a very helpful exercise. This worksheet can help you determine which asset allocation model is the best fit for you based on your investment objectives, risk tolerance and time horizon.

Focus on the forest, not on the trees.
As the market goes up and down, it is easy to become too focused on day-to-day returns. Instead, keep your eyes on your long-term investing goals and your overall portfolio. Although only you can decide how much investment risk you can handle. If you still have years to invest, do not overestimate the effect of short-term price fluctuations on your portfolio.

Look before you leap.
When the market goes down and investment losses pile up, you may be tempted to pull out of the stock market altogether and look for less volatile investments. The modest returns that typically accompany low-risk investments may seem attractive when more risky investments are posting negative returns. However, before you leap into a different investment strategy, make sure you are doing it for the right reasons. How you choose to invest your money should be consistent with your goals and time horizon.

A recent study from Putnam Investments highlights the importance of staying invested. The study showed that if you owned the S&P 500 Index from 12/31/06 through 12/31/21, your annualized total return was 10.66%. However, if you had missed the market's ten best days for that period, your annualized return dropped dramatically to 5.05%.

Look for the silver lining.
A down market, like every cloud, has a silver lining. The silver lining of a down market is the opportunity to buy shares of stock at lower prices. One of the ways you can do this is by using dollar-cost averaging. With dollar-cost averaging, you do not try to "time the market" by buying shares at the moment when the price is lowest. In fact, you do not worry about price at all. Instead, you invest a specific amount of money at regular intervals over time. When the price is higher, your investment dollars buy fewer shares of an investment, but when the price is lower, the same dollar amount will buy you more shares. A workplace savings plan, such as a 401(k) plan in which the same amount is deducted from each paycheck and invested through the plan, is one of the most well-known examples of dollar-cost averaging in action.

Although dollar-cost averaging will not guarantee you a profit or avoid a loss, a regular fixed dollar investment may result in a lower average price per share over time, assuming you continue to invest through all types of market conditions.

Don't count your chickens before they hatch.
As the market recovers from a down cycle, elation quickly sets in. If the upswing lasts long enough, it is easy to believe that investing in the stock market is a sure thing, but of course, it never is. As many investors have learned the hard way, becoming overly optimistic about investing during the good times can be as detrimental as worrying too much during the bad times. The right approach during all kinds of markets is to be realistic. Have a plan, stick with it, and strike a comfortable balance between risk and return.