GM ADVISORY GROUP
WEALTH MANAGEMENT

investment perspectives

April | 2022

Q2 2022 MARKET OUTLOOK

Executive Summary

We entered 2022 with a positive outlook for risk assets because we believed that US growth would remain elevated, and that the inflation outlook would gradually improve. However, the war in Ukraine has exacerbated inflation risk and pulled forward recession risk, thereby warranting adjustments to portfolio positioning. The range of potential investment outcomes over the coming quarters has widened, and market volatility to persist. However, the US economy remains strong today, which could continue to power earnings and equity prices in the near term. We seek to balance a deteriorating medium-term outlook with a more constructive near-term outlook by favoring a more defensive strategy and maintaining a high cash balance to capitalize on opportunities as they surface.

First Quarter Review

Growth was strong, but inflation was stronger, driving higher volatility across asset classes.

- The US economy added another 2.5 million jobs in Q1 and has now fully recovered to its pre-pandemic high.
- Supply chain bottlenecks in the US improved, but commodity prices rose further as shortages persisted. The war in Ukraine exacerbated an already distorted inflation picture, facilitating a more hawkish Fed policy.
- This manifested in an inversion of the 2-10 yield curve, confirming the US economy's transition from mid cycle to late cycle.

Equities

Favor being underweight equities due to heightened inflation risks.

- Global equities declined **-5.4%** in Q1 while US equities performed about the same (**-5.3%**). Growth stocks (**-9.0%**) underperformed value stocks (**-0.7%**), and earlier stage growth stocks that are more sensitive to changes in interest rates were hit particularly hard—the Goldman Sachs Profitless Tech Index was down **-24.7%**.
- We believe the medium-term outlook for equities has soured as the US economy has transitioned to a late-cycle environment faster than we anticipated and upside risks to inflation have increased. However, a strong labor market and a corporate earnings reacceleration present upside risks to stocks in the coming quarters. A material improvement in the inflation outlook could also lengthen this economic expansion.
- We continue to favor US stocks versus international stocks because China is already in a recession, and risk of an imminent recession in Europe is now material.

Fixed Income

Favor remaining underweight fixed income until there is more clarity on the inflation outlook.

- The US Aggregate Bond Index fell **-5.9%** in Q1 and is in the middle of its second-worst peak-to-trough drawdown (**-11.1%**) in its history dating back to 1976.
- We continue to favor holding cash in lieu of fixed income until inflation begins to slow.

Commodities

Favor an overweight posture in commodities.

- Supply-demand imbalances persisted into Q1, propelling the Goldman Sachs Commodity Index (**+33.1%**) to its largest quarterly gain since 1990.
- We underappreciated the supply-side fundamentals and favored selling commodities too early (3Q21) as a result. We favor a neutral posture in broad commodities as a hedge against further inflation, with a particular emphasis on gold to hedge against stagflation risk.

Summary

Balance a deteriorating medium-term outlook with a still constructive near-term outlook. Hold cash.

- The economic cycle aged faster than we expected when we entered 2022. Absent a material improvement in the inflation outlook, the risk of entering a recession in 2023 is significant, which requires a more cautious approach.
- That said, the near-term outlook is more constructive given that the labor market remains strong. We will favor reducing risk as momentum in the labor market slows.
- We favor maintaining a high cash balance until it becomes clear that inflation has peaked.

POSITIONING HIGHLIGHTS:

UNDERWEIGHT	UNDERWEIGHT	OVERWEIGHT	OVERWEIGHT
Global Equities	Fixed Income	Commodities	Cash

Note: *This document, including important disclosures on Page 10, is meant to be read in its entirety.*

First Quarter Review

The US economy added 2.5 million jobs in Q1 as the labor force recovered to its pre-pandemic peak.

Inflation continued to rise beyond both our and consensus expectations, and the war in Ukraine has only muddied the inflation picture further. US CPI forecasts for 2022 have risen by +2.5% since the beginning of the year.

The Fed continued to convey a more aggressive path for tightening monetary policy. Currently, the market is anticipating 10 total rate hikes through the end of 2022, and the minutes from the March FOMC meeting indicate that the Fed will begin to reduce its balance sheet at a pace of up to 1.1% per month, slightly faster than the rate of reduction during the 2017–2019 period (0.8% per month).

Global equities were highly volatile and finished the quarter down **-5.4%**. Growth stocks, particularly those that are more vulnerable to rising rates and hedge fund crowding, performed extremely poorly. The Goldman Sachs Profitless Technology Index declined **-24.7%**, and some of the world's top growth equity hedge funds fell 30-40%.

Inflation pushed interest rates higher and bond prices lower. The US Aggregate Bond Index fell **-5.9%** during Q1 and currently trades **-11.1%** from its high, its worst drawdown since 1980. Long-term treasuries have fallen **-18.7%** year-to-date (YTD).

Broad commodities gained **+33.1%** in Q1, their strongest quarter since 1990. Performance was driven by supply–demand imbalances that had been persistent entering 2022, and then worsened following Russia's invasion of Ukraine (since Feb. 24, the day of invasion, US natural gas prices have risen by **+53.4%**). Gold was up **+7.6%**, but rising rates and anchored long-term inflation expectations have prevented gold from breaking out.

MARKET REPORT CARD – March 31, 2022

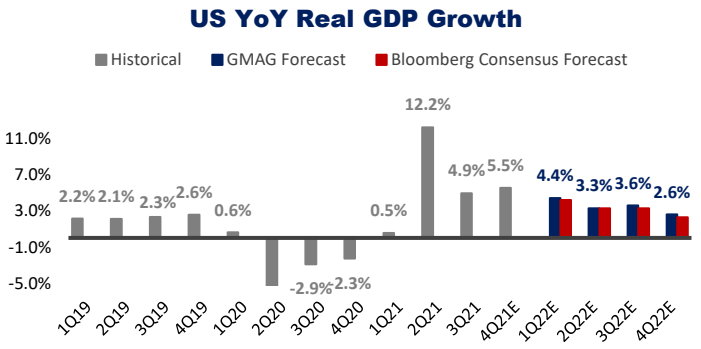
Performance Reported in US Dollars	2022	Trailing 6 Months	Trailing Year
Equities			
Global (MSCI All World Equity Index)	-5.4%	+1.0%	+7.3%
United States (Russell 3000 Index)	-5.3%	+3.5%	+11.9%
International Developed (MSCI EAFE Index)	-5.9%	-3.4%	+1.2%
Emerging Markets (MSCI EM Index)	-7.0%	-8.2%	-11.4%
Bloomberg Barclays US Aggregate Bond Index	-5.9%	-5.9%	-4.2%
Long-Term Treasuries (Barclays 20+ Year)	-11.0%	-7.9%	-1.1%
Investment-Grade Bonds (Barclays US Corp)	-7.7%	-7.5%	-4.2%
High-Yield Bonds (Barclays US HY Corp)	-4.8%	-4.2%	-0.7%
Commodities (S&P GSCI Index)	+33.1%	+35.1%	+64.6%
Crude Oil (S&P Crude Oil Index)	+40.8%	+44.8%	+86.8%
Gold (LBMA Gold PM Price Index)	+7.6%	+11.4%	+14.9%
Hedge Funds (HFRX Global Hedge Fund Index)	-1.4%	-1.3%	+1.0%

Source: Bloomberg, GMAG Research

Data Check: Growth forecasts are revised lower as inflation eats into Real GDP. The US economy remains hot today, but risk of recession in 2023 has increased.

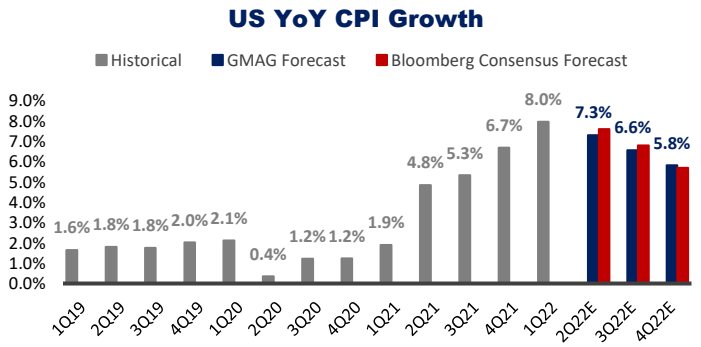
Entering 2022, we expected that financial markets would endure higher volatility as the Fed would begin its path toward policy tightening. However, we also believed equities would continue to grind higher as the economy would expand (albeit at a slower pace than in 2021), and inflation would reach its illusory peak during the first quarter. Three-and-a-half months into the new year, our optimism has faded somewhat, and here's why:

Figure 1: We expect growth to decelerate but remain elevated.



Source: Bloomberg, GMAG Research

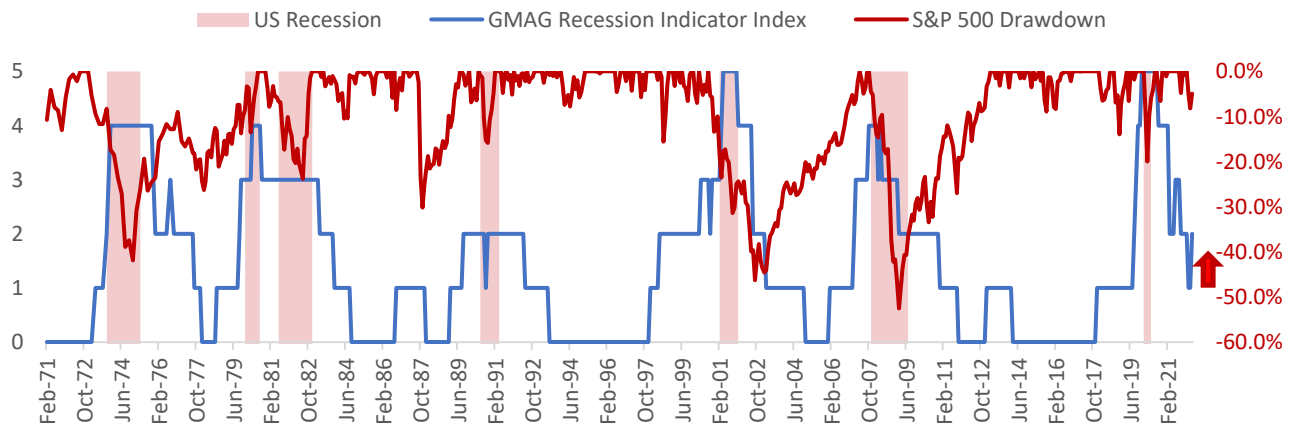
Figure 2: We also expect inflation to decelerate but remain elevated.



Source: Bloomberg, GMAG Research

- The US economy matured faster than we anticipated. The jobs we expected to gain back over the next 6-12 months came back in just one quarter, bringing the US labor market back to its pre-pandemic peak in very short order. This is good for the economy today, but it reduces the slack that is needed to power future growth.
- The war in Ukraine is devastating from a humane perspective, but it has also exacerbated inflation risks, as it threatens to further complicate supply issues that could send energy and food prices higher through the remainder of the year.
- Surging inflation has forced the Fed to grow increasingly hawkish, manifesting in downward revisions to economic growth and an inversion of the 2-10 yield curve, triggering the second of our five recession signals. This is consequential because historically, recession risk is material when at least 2 of our 5 signals have triggered (see **Figure 3**). Also, mortgage rates have risen above 5% for the first time since 2011. This will likely slow housing demand, which is a key cog in the economic machine, presenting an additional threat to economic growth.
- Economies abroad face even more acute challenges. The risk that Europe enters a recession in 2022 is material because the nation-block faces greater uncertainty regarding energy prices. Eurozone inflation expectations have risen by **+4.0%** since December, whereas growth expectations have been revised down by **-1.3%**.

Figure 3: 2 of our 5 recession indicators have now triggered, signaling that the risk of a US recession in the next 12 months is material.

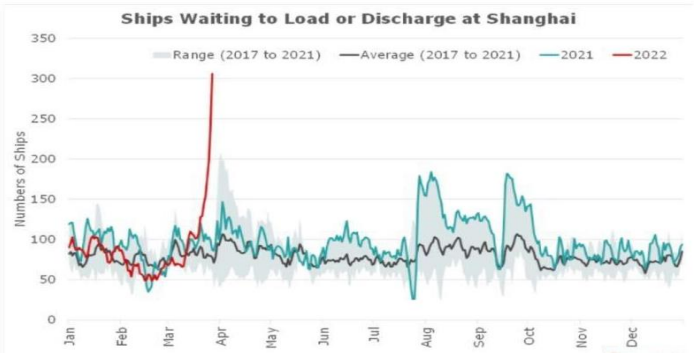


Source: Bloomberg, GMAG Research

Data Check: Continued…

- China has effectively been in a recession since the middle of last year as the country's zero-tolerance COVID-19 policy combined with its unwillingness to administer an mRNA vaccine has resulted in rolling lockdowns that constrained economic activity. The country is currently in its largest lockdown yet, and frustration is mounting as some citizens are finding it difficult to access food. The lockdowns have also increased congestion at the port of Shanghai (see **Figure 4**), which doesn't bode well for supply chains considering that it ships more volume than any other port in the world.

Figure 4: Container ships are piling up at the port of Shanghai.



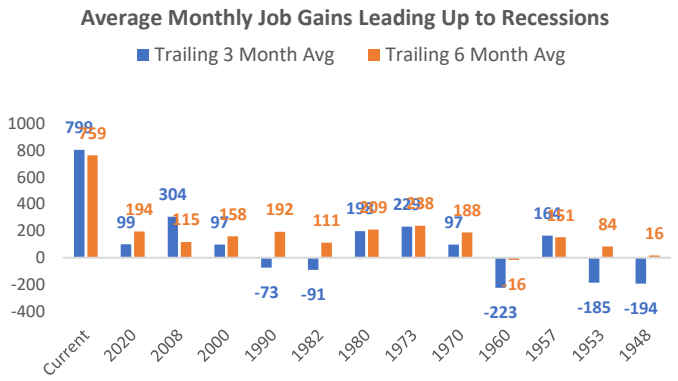
Source: VesselsValue

However, it's not all doom and gloom…

Although risk of a US recession is rising, there are reasons to be optimistic in the near term.

- Despite surging inflation, even the lowest income consumers in the US remain in relatively healthy financial shape. Click here to view our US Household Pulse Monitor.
- The US labor market is very strong. In the past 5 US recessions, on average, the S&P 500 has peaked 3 months prior to the labor market peak. The current velocity of job gains is multiples greater than that experienced leading up to previous recessions (see **Figure 5**), implying that a US recession is unlikely imminent.

Figure 5: The US labor market is significantly hotter than those that have historically preceded recessions.

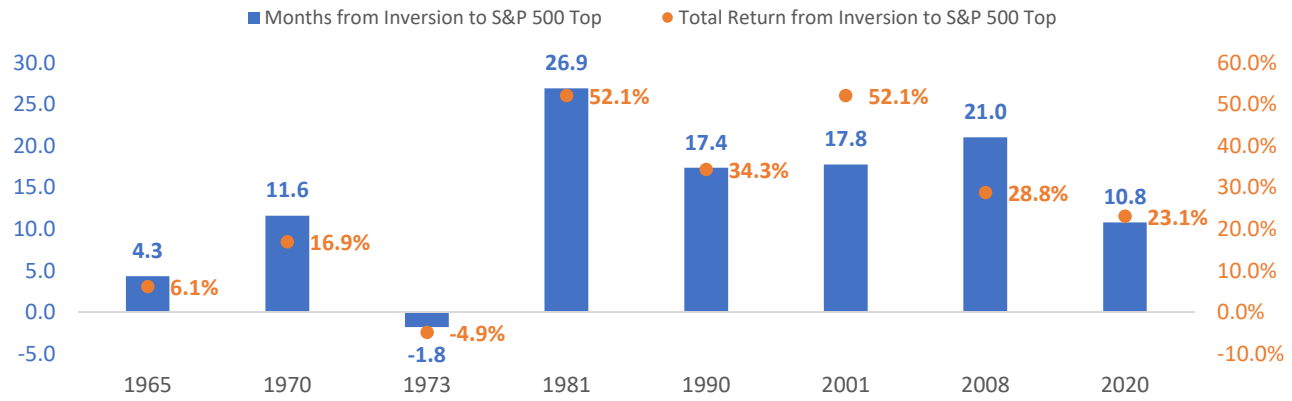


Source: Bloomberg, GMAG Research

- Although the yield curve has inverted, this alone is not a panic button signal. Historically, yield curve inversion has preceded the peak in the S&P 500 by an average of 14 months, and the average return from the time of the inversion to the equity market peak has been **+26.0%** (see **Figure 6**). This time around, the time from inversion to the market will depend highly on the path of inflation.
- Notwithstanding congestion at the Shanghai port, US supply chain bottlenecks are showing signs of reduced stress, as the Goldman Sachs Supply Chain Bottleneck Index has declined from 10 to 6.

We believe it is risky to be too defensive while the labor market is this hot, and we seek to balance a worsening medium-term outlook with a more constructive near-term outlook.

Figure 6: Historically, an inverted yield curve has preceded the S&P 500 peak by an average of 14 months.



Source: Bloomberg, GMAG Research

Investment Outlook

Global Equities

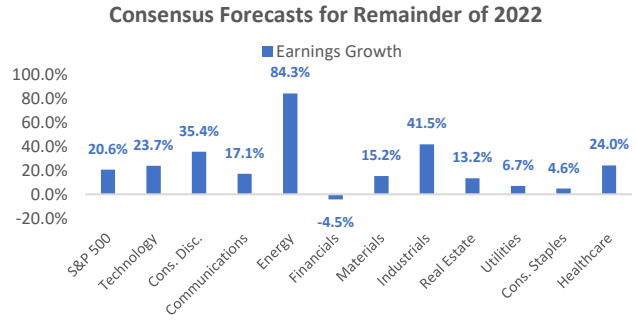
We favor being underweight equities because recession risk has increased.

We favor transitioning to an underweight posture in equities because (1) the US economy has transitioned into a late-cycle environment and (2) we expect growth to decelerate for the remainder of 2022. However, we don't believe it is prudent to shift to a max defensive posture until we see momentum in the labor market begin to fade. There are multiple factors that could power earnings and equity prices higher in the next 6-12 months.

We expect corporate profits to remain strong.

Corporate earnings are expected to reaccelerate through the remainder of 2022 (**Figure 7**). In aggregate, corporations have been able to pass on higher input costs to consumers and we expect that to remain the case in the near term. Although higher commodity prices combined with rising wage inflation will eat into corporate profit margins, the impact that this will have on asset prices in the next 6–12 months may be overestimated.

Figure 7: Earnings are expected to remain strong through the remainder of 2022.

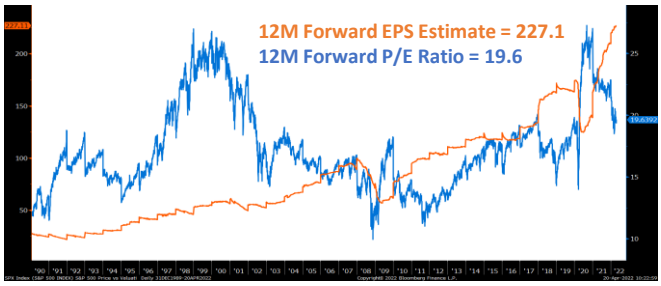


Source: Bloomberg, GMAG Research

Valuations are neither cheap nor expensive.

The forward price-to-earnings multiple on the S&P 500 is currently 19.4 (**Figure 8**), which ranks in the 78th percentile of observations dating back to 1990. Although we wouldn't refer to US stocks as cheap, we wouldn't say they are very expensive either.

Figure 8: S&P 500 valuations are neither cheap nor expensive, and earnings growth remains strong for now.

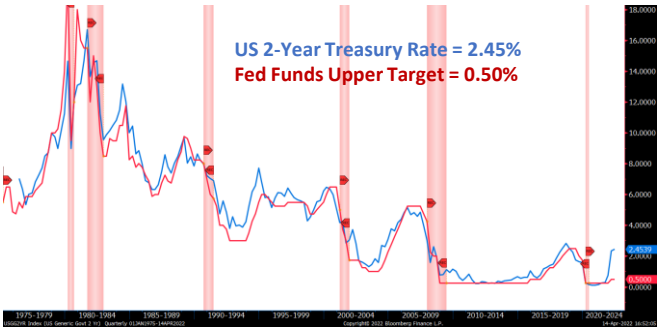


Source: Bloomberg

The Fed has considerable room to ease monetary policy through forward guidance if inflation surprises to the downside.

Although the Fed has only raised interest rates once, the market has already priced in 10 additional rate hikes (see **Figure 9**) over the next 12 months. Therefore, the Fed is in a position where it can ease monetary conditions simply by reducing its guidance. The Fed cannot do this with inflation running as hot as it is today, but if inflation slows faster than expected, that would likely push interest rates lower, steepen the yield curve, and lengthen this economic expansion. We believe this scenario is less likely but presents an upside risk to stocks, nonetheless.

Figure 9: Although the Fed has only made 1 rate hike, the market has already priced in 10 rate hikes, providing the Fed with the ability to ease monetary conditions via forward guidance.

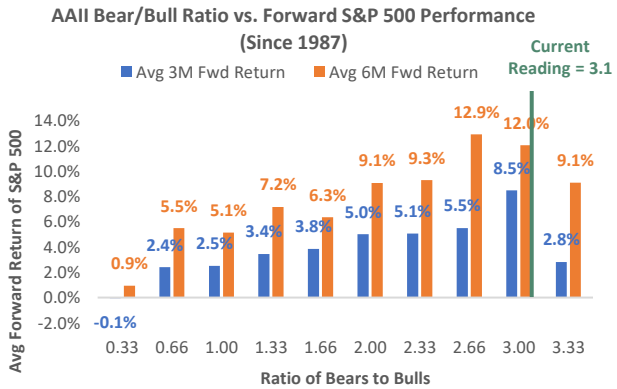


Source: Bloomberg

Pessimism is near an all-time high.

In the most recent AAII Investor Sentiment Survey, the ratio of bears to bulls was 3.1, which ranks in the 99.5th percentile of readings since the survey was created in 1987. Historically, levels of extreme pessimism have been followed by strong equity performance (**Figure 10**).

Figure 10: Sentiment is at an extremely low level, which has historically preceded strong equity market returns.



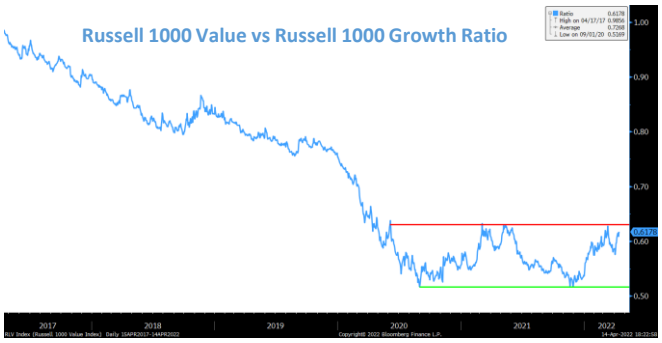
Source: Bloomberg, GMAG Research

Continue to favor growth within equities for now.

We continue to favor growth stocks given our belief that economic activity will slow because revenue and profits of growth stocks are generally less volatile than those of cyclical stocks.

However, value stocks have outperformed growth stocks in 2022 as inflation has accelerated beyond consensus expectations. This outperformance has caused market participants to speculate whether we're headed into a regime shift where value stocks will begin to outperform growth stocks over a sustained period. Although we remain open-minded about this possibility, it is not our base case. In our view, value's recent outperformance simply reflects reversion to the mean following nearly two years of growth outperformance from the onset of the pandemic. From the pre-pandemic peak on February 19 through December 2021, the Russell 1000 Growth Index outperformed the Russell 1000 Value Index by **+34.7%**. Three-and a-half months into 2022, that gap has since closed to **+13.3%**. If inflation has legs, value's outperformance will persist, and this value-to-growth ratio will break out (to the upside) of the range shown in **Figure 11**.

Figure 11: Russell 1000 Value vs. Russell 1000 Growth Ratio

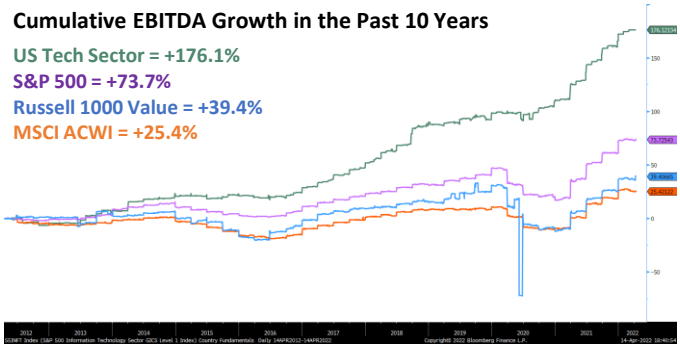


Source: Bloomberg

We would interpret such a move as a signal that inflation's run is not done yet, and we would favor tactically reducing our equity exposure altogether, as well as our growth tilt within equities, in favor of a more neutral style bias.

From a long-term investment perspective (3-5 years) we continue to favor growth stocks, particularly those in the US technology sector, as the demand for computing power and software intensifies. **Figure 12** illustrates the magnitude by which the US technology sector has compounded operating profits relative to the broader equity market during the past decade. We favor longer term investments in thematic positions that we expect to benefit from a continuation of this secular trend as software and artificial intelligence continue to "eat the world."

Figure 12: The US tech sector has grown operating profit at a much faster pace than the broader equity market in the past decade.

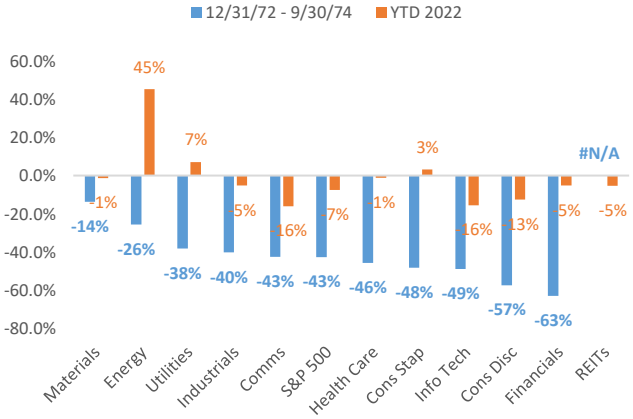


Source: Bloomberg

What a sustained inflationary period might mean for growth stocks.

Many market participants believe the closest analog to the current environment is 1973, which is the last time US inflation became unanchored and led to an economic recession. During that time, equity sectors with revenues positively correlated to inflation, such as materials and energy stocks, outperformed sectors that are negatively correlated to inflation. Such sectors include bond proxies, like REITs and utilities, as well as companies that trade at higher valuation multiples, like technology and consumer discretionary stocks. We are certainly seeing some parallels in the current environment (**Figure 13**). However, if the market believed that rates are going to rise materially from here, it is unlikely that utilities and REITs would be performing as well as they have recently.

Figure 13: S&P 500 sector performance during the 1973 recession relative to today.



Source: Variant Perception, Bloomberg, GMAG Research

We would be surprised if the tech sector performs as poorly as it did on a relative basis during the next recession, considering the relative efficiency of the tech sector today. Since 1990, the operating margin for the US tech sector has increased from 9.5% to 26.3%. Except for financials, no other S&P 500

sector has expanded its operating margin by more than +6% over that time. Gavin Baker, one of the thought leaders in consumer and technology investing, explains why tech, particularly software companies, are now better equipped to deal with inflation than they were in the 70s in this interview titled "There is no playbook."

Still waiting for an opportunity to add to China stocks.

As mentioned previously, China has effectively been in a recession since August. The most recent Caixin Manufacturing and Services PMI readings came in at 48.1 and 42.0, respectively—any reading below 50 indicates a contraction. We believe the Chinese government would like to increase stimulus to boost economic activity but is concerned that any stimulus would be inefficient so long as the country remains hampered by COVID-19. When China turns the corner with respect to COVID-19, we expect stimulus to increase and economic activity to pick up, at which point, there should be an opportunity to buy Chinese stocks that have fallen materially out of favor. Although the S&P 500 is only **-8.4%** off its high, the MSCI China and CSI China Internet Index are trading **-45%** and **-70%** from their respective highs (see **Figure 14**) and have wiped out most of the gains accumulated during the past 10 years.

Figure 14: Broad China and China internet stocks have fallen -45% and -70%, respectively.

Source: Bloomberg

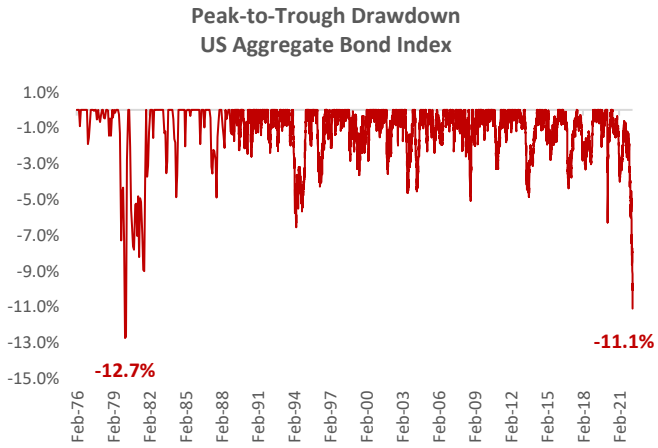
Although it has been rare for international economies to accelerate while the US is slowing, COVID-19 has desynchronized the global economy to some extent. As a result, there could be a material divergence in economic growth in the next year or two that is led by China, which would favor a larger allocation to emerging market equities.

Fixed Income

Favor remaining underweight fixed income until inflation peaks.

Rising inflation expectations combined with hawkish Fed monetary policy have caused bonds to sell off drastically in 2022. Currently, the US Aggregate Bond Index (Agg Index) is down **-11.1%** from its high, which is the second worst drawdown in history since its inception in 1976 (see **Figure 15**).

Figure 15: The US Aggregate Bond Index is in the middle of its worst drawdown since 1980.



Source: Bloomberg, GMAG Research

It appears the bond market anticipated a less aggressive plan for balance sheet reduction than what was communicated in the minutes from the March FOMC meeting. On April 4 (the day before the minutes were released), Vice Chair of the Federal Reserve Lael Brainard, communicated that the Fed's plans for policy tightening would include "rapid" balance sheet reduction. Since then, the Agg Index has sold off **-3.5%**, and long-term bonds have led the rout in a disproportionate fashion, falling **-8.8%**. Further, 10-year and 30-year treasury yields each rose by **0.52%**, whereas the 2-year treasury yield increased by only **+0.15%**, dramatically steepening the yield curve (see **Figure 16**).

Figure 16: The 2-10 yield curve inverted, and then subsequently steepened to a spread of about +40 basis points.

Source: Bloomberg

Although the curve is no longer inverted, we expect it will continue to flatten (and eventually reinvert) from here. We believe the hawkish rhetoric from the Fed was simply a catalyst for the yield curve to bounce following a period where it headed straight down for 3 consecutive months. Our base expectation is that this is not the start of trend reversal where long-term yields become unanchored.

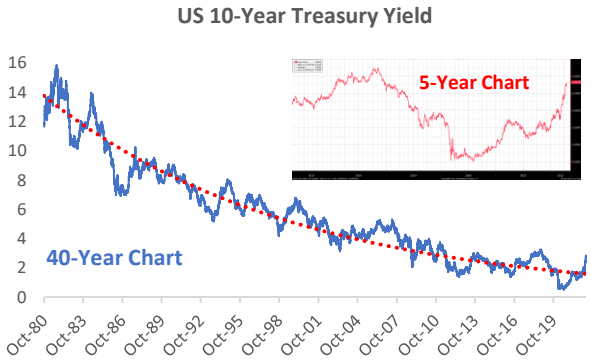
Is the bond bull market over?

Although the secular trend in bond yields has flattened out—we would expect this as yields approach the zero-bound—it continues to make lower lows and lower highs (see **Figure 17**), and therefore, the bond bull market remains intact.

Yields can continue to rise so long as inflation is accelerating. However, we anticipate that the 2018 peak in the 10-year yield of around 3.25% will serve as a point of resistance if the 10-year can get there (currently, it is trading at 2.89%).

Nonetheless, inflation does present an upside risk to bond yields. We favor remaining underweight fixed income and do not prefer increasing exposure to this asset class until we see evidence that inflation is subsiding. Until then, we favor holding cash in lieu of bonds.

Figure 17: Despite the recent rise in interest rates, we remain in a secular bond bull market for now.



Source: Bloomberg

Commodities

Favor being overweight commodities, with a particular emphasis on gold.

We believe commodity prices can continue to run hot as the war in Ukraine exacerbates existing commodity supply shortages.

To recap, in 3Q21, we favored reducing exposure to commodities because we believed that the recovery phase of the economic expansion was over and that demand would peak on a rate-of-change basis.

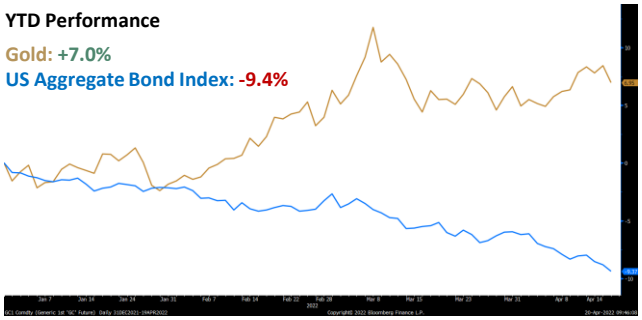
However, following a modest **+6.8%** gain in the back half of 2021, broad commodities soared **+33.1%** in the first quarter as oil and gas supplies struggled to keep up with demand. In hindsight, we underestimated the impact that the supply-side issues facing the energy market would have on oil and gas prices. On top of this, the war in Ukraine now poses an additional threat to inflation because it has the potential to exacerbate imbalances in the food and energy supply in a couple of ways:

1. Ukraine accounts for 8% of the world's wheat exports, and the war directly threatens this supply if Ukrainian farmers are unable to plant.
2. Western sanctions on Russian energy exports have caused the price of natural gas to go parabolic. Not only does this increase the price of utility bills, but it also indirectly increases the price of food. Why? Because crops need fertilizer, and fertilizer needs natural gas. Tune in to the 15-minute mark of this podcast to hear why David Friedberg believes this could lead to widespread famine in developing nations by year-end.

Although commodity prices have already risen sharply, we believe it is risky to abstain from this asset class given the likelihood that inflation will remain sticky throughout the remainder of 2022. Within commodities, we particularly favor gold because it can serve as a hedge against slowing growth and/or rising inflation. Given that stagflation (growth ↓, inflation ↑) poses a material threat to investment portfolios, we believe an allocation to gold is prudent in the current environment.

Relative to bonds, gold has been the defensive asset of choice in 2022. YTD, gold has gained **+7.0%** whereas US bonds have fallen **-9.4%** (**Figure 18**).

Figure 18: Gold has materially outperformed bonds in 2022.



Source: Bloomberg

When inflation begins to slow, it will likely happen alongside slowing growth, which is an environment we refer to as disinflation, or in rare cases, deflation if inflation is negative. In such a scenario, we would expect bonds to outperform gold, although both assets generally perform well in that type of regime.

Conclusion

Our medium-term outlook for the US economy is less optimistic than it was entering this year because (1) labor slack has diminished materially—2.5 million jobs were added in just three months—and (2) the war in Ukraine has increased upside risks to inflation. The US economy is now in a late-cycle environment, and the risk of entering a recession in the next 18 months is material.

However, there are reasons to remain more optimistic in the near term while labor market momentum is strong, and sentiment is perhaps overly pessimistic. Furthermore, if inflationary pressures begin to wane, it could allow the Fed to reduce its hawkish guidance, which would likely improve market sentiment and could also lengthen the economic expansion.

We favor balancing a deteriorating medium-term outlook with a more constructive near-term outlook by being mildly underweight equities. We also favor maintaining a high cash balance in lieu of fixed income until it becomes clear that the illusory inflation peak is in. Last, we favor being overweight commodities, particularly gold to hedge against the risk that the global economy enters a stagflationary recession.

Please call us at any time to discuss our market views and how they are affecting your individual asset allocation. We will keep you apprised of any important developments.

Sincerely,

gmag

Please see below for important disclosures.

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