ROSE CAPITAL ADVISORS

Rose Capital Advisors Market Commentary & Outlook

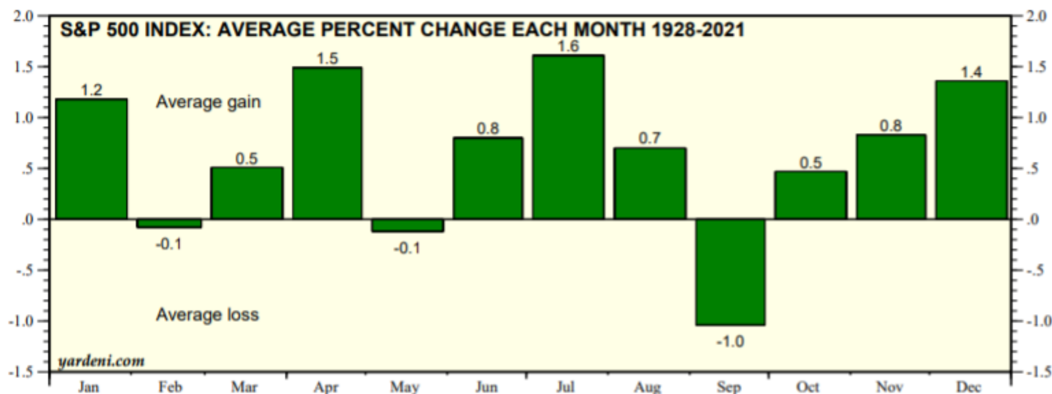
Q1 2022

Where We Are

With the unfolding of the Russo-Ukrainian crisis; the commencement of monetary policy interest rate tightening by the Federal Reserve; widespread concerns over shortage-induced price increases for energy and food; and further Covid-related lockdowns and restrictions in China, the month of March 2022 has produced a meaningful degree of fluctuation in financial market conditions. To cite just two examples: (i) after declining -3.0% on March 7, the S&P 500 rose +2.6% on March 9, for a total price swing of +5.6% in 48 hours; and (ii) the closing level of the VIX index (a popular measure of the stock market's expectation of volatility, based on S&P 500 index options) traced out a notably wide range during the month, from a zenith of 36.45 on March 7 to a nadir of 18.90 on March 29. Notwithstanding the news headlines inciting considerable moves in equities prices, bond yields, volatility readings, and currency exchange rates, the S&P 500's total five-week price change since its 4520.16 close on Thursday, February 24th — the day of Russia's invasion of Ukraine — amounted to a minuscule +0.2% through its Thursday, March 31st close of 4530.41.

In many respects, March's admixture of variability and quiescence has seemed to foreshadow and encompass the sometimes showery and windy, sometimes sunny and balmy days of April, as matchlessly described by William Shakespeare (1564–1616) in Act One of *The Two Gentlemen of Verona.* In his telling, "O, how this spring of love resembleth/The uncertain glory of an April day,/Which now shows all the beauty of the sun,/And by and by a cloud takes all away." Shakespeare appears to have had a special fondness for the year's fourth month (in Act One of *Midsummer Night's Dream*), "when wheat is green, when hawthorne buds appear") as no other month is mentioned half as often in his oeuvre as April.

As investors enter the fourth month of 2022, it can be seen in the nearby chart that *on average* over the 94 years from 1928 through 2021 inclusive, the month of April – with its historical +1.5% price return for the S&P 500 – places second best among the twelve months in the nine-plus decadal monthly performance ranking.



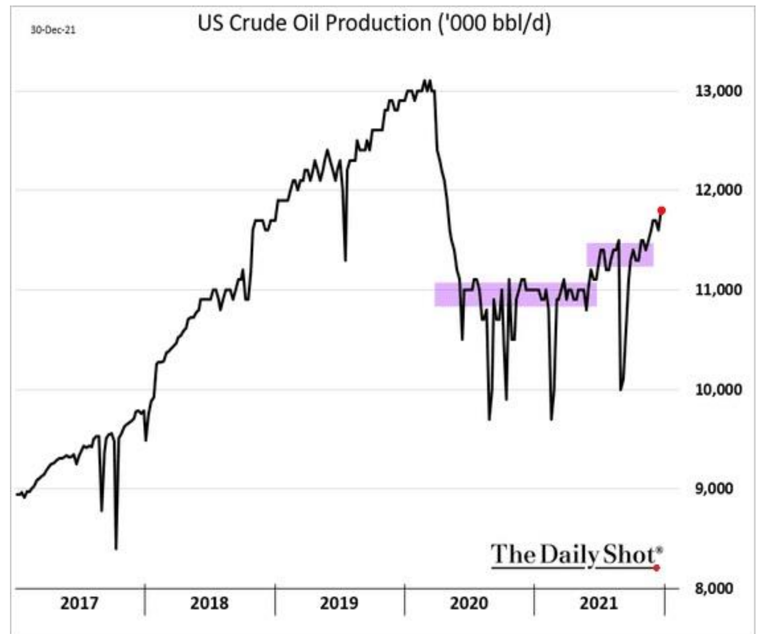
Source: Standard & Poor's and Haver Analytics.

And as highlighted in the nearby price performance table, in March, the S&P 500 rose +3.6%, following a -5.3% decline in January, and a fall of -3.1% in February, with the NASDAQ Composite rising +3.4% in March after declining -3.4% in February and falling -9.0% in January. After declining -9.7% in January, the Russell 2000 index of small- and mid-cap companies rose +1.0% in February and increased +1.1% in March.

Monthly and Year-to-Date Price Performance													
Index/Commodity	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	YTD (through 03/31)
S&P 500	-5.3%	-3.1%	+3.6%										-4.9%
Nasdaq Composite	-9.0%	-3.4%	+3.4%										-9.1%
Russell 2000	-9.7%	+1.0%	+1.1%										-7.8%
Gold	-1.8%	+5.8%	+2.6%										+6.7%
West Texas Int. Oil	+16.8%	+8.6%	+4.8%										+33.3%

Source: The Wall Street Journal, and Yahoo Finance.

Over the course of March, West Texas Intermediate crude oil prices rose +4.8%, from $95.72 per barrel on February 28th to $100.28 per barrel on March 31st. The global oil *demand* side continues to reflect momentum in the global economy, fuel shortages, currently low levels of inventories and spare capacity, and precautionary buying, while on the *supply* side: (i) the Russia-Ukraine conflict has exposed significant actual and potential supply disruptions; (ii) several nations, especially the U.S. and including certain allies, have launched the release of crude oil from their respective Strategic Petroleum Reserves; (iii) Iran continues with the nuclear talks begun on November 29th, which could in theory increase the supply of Iranian oil officially entering global oil markets if economic sanctions on Iran are relaxed; (iv) facing pressure from investors to moderate growth and address their emissions amid concerns about increasing regulations and climate change, large U.S. and European oil companies have continued to spend sparingly to boost production, even as certain major oil companies have halted and/or completely exited their Russian activity; (v) consolidating U.S. shale producers have exercised financial probity; have not excessively increased output in reaction to higher crude prices (as shown in the nearby chart); have followed production discipline and exerted capital spending restraint; and (vi) following the 27th OPEC and non-OPEC ministerial meeting (via videoconference) on Thursday, March 31st, the group (which includes Saudi Arabia, Russia, the United Arab Emirates, Kuwait, Iraq, and other countries) agreed to slightly augment their pace of monthly output increases to an agreed pace of 432,000 barrels per day from May 1st. The 28th OPEC+ Ministerial Meeting is scheduled for Thursday, May 5th.



During March, the U.S. dollar rose +1.61% versus the DXY index, comprised of six major currencies (the Euro, Japanese yen, British pound, Canadian dollar, Swiss franc, and Swedish krona). On March 31st, the DXY index was 98.31, up +2.4% from its close of 95.97 on December 31st, 2021.

Despite being somewhat challenged by competition from higher short-term interest rates over the course of the past month, the daily spot gold price (as logged by USA Gold) closed at $1,949.20 per troy ounce on March 31st, up +2.6% during March and up +6.7% from its close of $1,795.00 per troy ounce on January 31st.

In the accompanying table, March month-end closing yield levels are shown for 2-year, 10-year, and 30-year U.S. Treasury securities, and these monthly data are used to compute the year-to-date 2022 yield level changes (expressed in basis points), also highlighted nearby.

2022 Month-End Treasury Securities Closing Yield Levels												
Security	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
2-Year	1.18%	1.44%	2.28%									
10-Year	1.79%	1.83%	2.32%									
30-Year	2.11%	2.17%	2.44%									

Source: The Wall Street Journal, and Yahoo Finance.

Month-to-Month 2022 Yield Level Changes (in Basis Points)												
Security	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
2-Year	+45	+26	+84									
10-Year	+27	+4	+49									
30-Year	+21	+6	+27									

Source: The Wall Street Journal, and Yahoo Finance.

For 2-year U.S. Treasury securities, after rising 45 basis points in January, 26 basis points in February, and 84 basis points in March, yields reached 2.28% at month-end where they are up 155 basis points (1.55%) since their closing level of 0.73% on December 31st, 2021. Financial market participants have begun increasingly pricing an even faster pace of policy interest rate increases in 2022 (with 2-year U.S. Treasury yields rising), even as they have simultaneously been expressing concerns that removing monetary accommodation too quickly might actually slow economic growth (with 10-year U.S. Treasury yields and 30-year U.S. Treasury yields rising at a considerably less rapid rate).

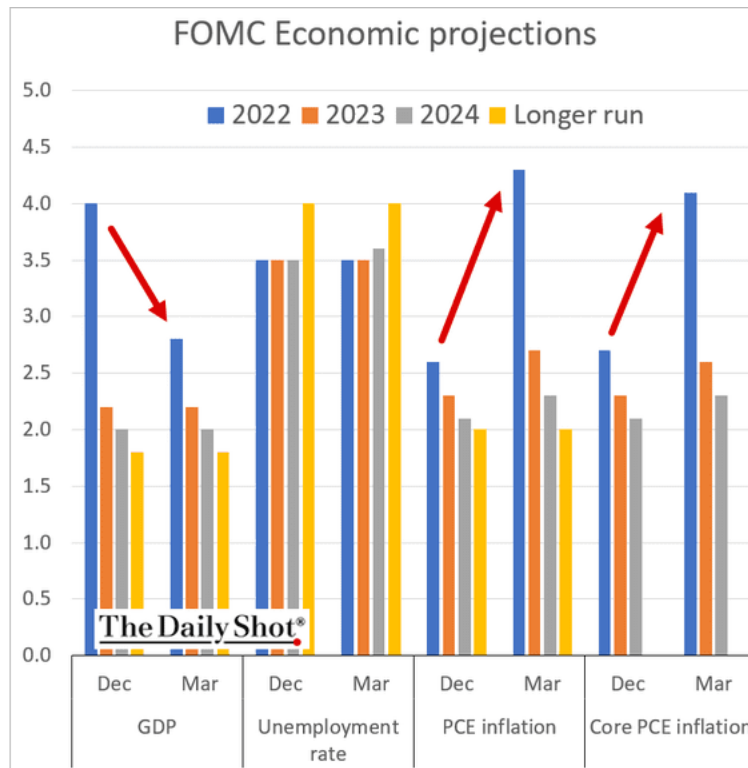
For 10-year U.S. Treasury securities, after rising 27 basis points in January, rising four basis points in February, and rising 49 basis points in March, yields reached 2.32% at the end of March, where they are up 80 basis points (0.80%) since their closing level of 1.52% on December 31st, 2021.

For 30-year U.S. Treasury securities, after increasing 21 basis points in January, rising six basis points in February, and rising by 27 basis points (0.27%) in March, yields reached 2.44% at the end of March, where they are up 54 basis points (0.54%) since their closing level of 1.90% on December 31st, 2021.

The following paragraphs review several of the factors likely to exert meaningful influence on financial asset prices.

<u>Factors Likely to Exert Significant Influence on Financial Asset Prices</u>

1. **Likelihood of Slower Economic Growth and Higher PCE Inflation:** Four times a year, the Federal Reserve's policymaking body — the Federal Open Market Committee (FOMC) — releases a summary of Federal Reserve Board members' and Federal Reserve Bank presidents' economic projections, under their individual assumptions of projected appropriate monetary policy, for: (i) GDP growth; (ii) the unemployment rate; (iii) headline and core (excluding food and energy prices) Personal Consumption Expenditures (PCE) inflation; and (iv) the appropriate monetary policy fed funds target interest rate. According to the Federal Reserve, "appropriate monetary policy" is considered to be the future path of policies that each participant deems most likely to foster outcomes for economic activity and inflation that best satisfy his or her individual interpretation of the Fed's statutory mandate "to promote maximum employment and price stability." The projections furnish information on the values that participants consider to be most likely to prevail in the current year, in the two succeeding years, and over the longer run. Following its two-day meeting on March 15-16, the FOMC issued its revised Summary of Economic Projections (SEP), in effect updating the SEP issued at the conclusion of the FOMC meeting of December 14-15, 2021.



The nearby chart displays the median economic projections of FOMC members, with the median representing the middle projection when the projections are arranged from lowest to highest. Projections of change in U.S. real GDP, and for both measures of Personal Consumption Expenditures inflation, represent percent changes from the fourth quarter of the prior year to the fourth quarter of the year indicated. Reflecting some degree of disruption to consumer spending and industrial output from higher energy prices and the Omicron variant of the coronavirus; a lesser degree of fiscal stimulus from the federal government; tightening monetary policy conditions; and heightened geopolitical uncertainties' effects on household and business sentiment, as of March, real GDP is projected to grow +2.8% in 2022, down from +4.0% in the FOMC's December projection. The median projection of 2023 GDP growth is +2.2% and +2.0% in 2024, unchanged from December's projections.

As of mid-March, the average civilian unemployment is projected to be 3.5% in 4Q22 (unchanged from the December projection), 3.5% in 4Q23 (unchanged from the December projection), and 3.6% in 4Q24 (up +0.1 percentage point from the December projection).

Reflecting ongoing supply chain disruptions, tight labor supply, and elevated price increases for food, energy, electricity, and shelter, Headline Personal Consumption Expenditures inflation is projected to be +4.3% in 2022, +2.7% in 2023, and +2.3% in 2024, up from December projections of +2.6% for 2022, +2.3% for 2023, and +2.1% for 2024. Core (ex food and energy) PCE inflation is projected to be +4.1% in 2022, +2.6% in 2023, and +2.3% in 2024, up from December projections of +2.7% for 2022, +2.3% for 2023, and +2.1% for 2024.

As a result of these lowered economic growth projections and increased inflation projections, as of March the value of the midpoint of the projected appropriate target range for the federal funds rate — not shown in the nearby chart — is 1.875% for the end of calendar year 2022, 2.750% for the end of calendar 2023, and 2.750% for the end of calendar 2024, up from December's projections of 0.875% for the end of calendar year 2022, 1.625% for the end of calendar 2023, and 2.125% for the end of calendar 2024.

To our way of thinking — as discussed in greater detail within the Portfolio Positioning section at the end of this *Commentary* — within a balanced equities exposure of approximately equal weighting to Growth, Value, and Defensive sectors, investors will want to focus on price-making rather than price-taking companies that can maintain or increase profit margins, companies that can flourish in a rising interest rate environment, and companies that benefit from higher levels in the general price index.

2. **Consumer Inflation Expectations:** Launched in 2013, the New York Federal Reserve Bank's Survey of Consumer Expectations (SCE) is a monthly, nationally representative, internet-based survey of a rotating panel of approximately 1300 heads of household. The survey seeks responses to expectations about economic outcomes related to inflation, the labor market, and household finance, together with subjective expectations for variables including not only future inflation but also data on the individual's forecast uncertainty. The survey tracks respondents' age, income, education, homeownership status, employment history, region, and level of numeracy. Respondents participate in the survey for up to 12 months, with a roughly equal number rotating in and out of the survey each month. In contrast to similar surveys that are based on repeated cross sections with a different set of respondents in each survey, the SCE's approach enables observation of changes in expectations and behavior of the same respondent over time.

According to the New York Fed's SCE, over the past two years, consumers have begun to expect short-term and intermediate-term inflation to behave differently in the post pandemic era than in the immediately preceding years. As shown in the nearby chart of one-year and three-year inflation expectations, in response to rising rates of consumer price inflation in 2021, survey respondents have increased their *one-year inflation expectations* from a 2015–2020 range of +2.5–3.0% to +6.0% as of February 2022. At the same time, respondents' *three-year inflation expectations*, having essentially fluctuated within a +2.5–3.0% channel for 2014 through 2020, in 2021 have risen somewhat less dramatically, reaching +3.8% as of February 2022.

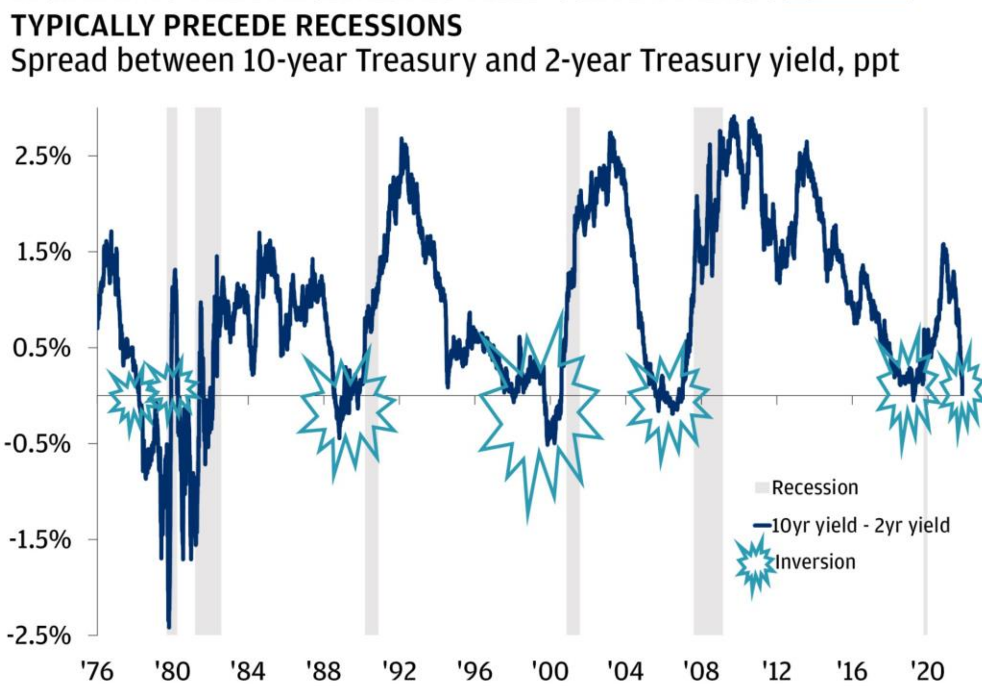
Investors and policymakers are monitoring these readings of short-term and longer-term inflation expectations to ascertain whether high near-term inflation becomes embedded into longer-term inflation expectations. Such an outcome could potentially add to wage pressures and thereby render inflation more persistent. In response, it is likely that monetary policy would have to become even more restrictive via meaningfully higher interest rates, exerting downward pressure not only on the general price level, but also on the real economy. We would view a sustained move upward in three-year inflation expectations as a warning sign of notably tighter monetary policy.

3. **Path and Magnitude of Monetary Policy Rate Hikes:** The February Consumer Price Index rose +0.8% month-over-month and +7.9% year-over-year, and the February Producer Price Index increased +0.8% month-over-month and +10.0% year-over-year — for both indices, the fastest pace in four decades. In a March 21 speech to the National Bureau of Business Economics, Federal Reserve Chair Jerome H. Powell — noting the very strong labor market; the previously hoped-for “transitory” supply side price relief not yet coming to pass; the Ukraine war-induced oil and gas price spike; and other commodity disruptions — indicated that the Fed is prepared to more quickly withdraw support from the economy if necessary to suppress high rates of inflation. Chair Powell also left the possibility of 50-basis point hikes on the table for coming FOMC meetings. As a result, even though the FOMC had raised policy interest rates by 0.25% (25 basis points) on March 16, and had forecast six increases of similar size by yearend 2022, fed funds futures markets have begun to price in a potentially more restrictive stance. As shown in the nearby chart as of mid-March, financial markets were pricing in an additional eight to nine policy rate hikes through the end of the year. Such a course of acceleration in rate hikes — as fed funds futures are now indicating — would imply a rise in the fed funds target rate to the 2.25–2.50% range or above by year end. To bring inflation under control in past Fed tightening cycles has usually required a target fed funds rate *above* the inflation rate. In our opinion, investors, corporate managers, and consumers should thus expand their consideration of considerably more rate hikes than reflected in current market pricing.

Investors need to be vigilant as to the potentially deleterious effects of rising interest rates on: (i) bond prices (because if interest rates increase, investors will no longer prefer the lower fixed interest paid by a bond, resulting in a decline in its price); and (ii) equity prices, since such tightened conditions can cause a slowdown or even a contraction in economic growth, lowering corporate profits and the earnings multiple applied to such earnings. It is also important to keep in mind that the Federal Reserve has already announced plans — possibly commencing as early as the next FOMC meeting scheduled for May 3-4 — to begin reducing its massive portfolio holdings of U.S. Treasury and mortgage-backed bonds (which as of September 29, 2021 amounted to $8.5 trillion). This process — also known as Quantitative Tightening — takes place by allowing securities to mature, by not reinvesting coupon inflows, or even by active sales from the portfolio — which has the effect of creating further upward pressure on borrowing costs and mortgage interest rates.

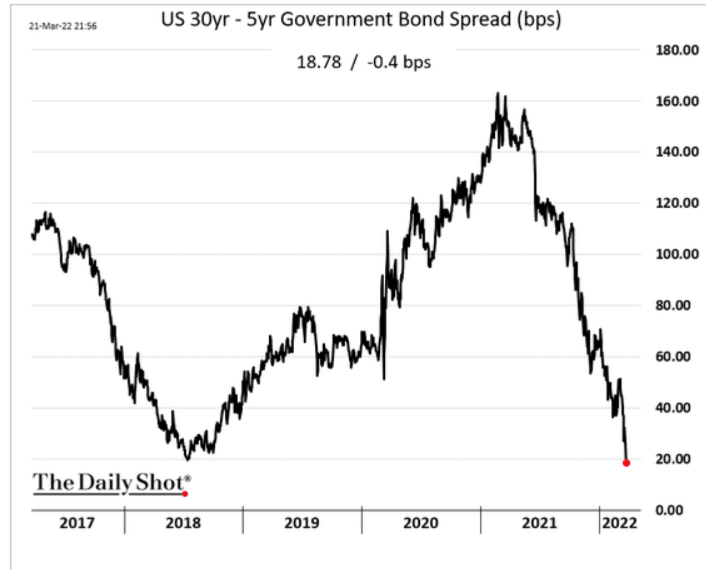
Selectivity and discernment are called for in such an environment, since rising interest rates tend to be a positive influence on financial institutions' share prices while generally effectuating detrimental consequences on P/E multiples and on intermediate- and long-term fixed income securities prices.

4. **U.S. Treasury 10 year-2 year Interest Rate Spread:** As generally defined, the phrase U.S. Treasury "yield curve" refers to the relationship between the short- and long-term interest rates of bills, notes, and bonds issued by the U.S. Treasury. Under normal conditions, debt with longer maturities typically carries higher interest rates than nearer-term issues. An inverted yield curve is considered unusual — when short-term U.S. Treasury securities have higher yields than long-term U.S. Treasury securities — and in the past, has been viewed as a reasonably reliable though not 100% perfect predictor of a pending economic recession. Traditionally, higher short-term interest rates have been an indicator of tightening monetary policy, and when combined with an unsettled economic outlook has prompted investors to buy intermediate- and or long-term bonds and drive down yields. An inverted yield curve in U.S. Treasuries is considered to have predicted every recession since 1955, with only one false signal during that time (in 1998). Although it is possible to experience a yield curve inversion without an ensuing recession, no recession since 1955 has occurred without an inverted yield curve. The nearby chart shows the seven 10-year-2 year yield curve inversions and the six succeeding recessions.



Source: Bloomberg Finance L.P. Data as of March 29, 2022.

Structural factors, the shape, character, and length of economic expansions, the Fed's portfolio holdings, and foreign capital flows into or out of U.S. Treasury securities can influence the depth and duration of inverted yield curves. While some analysts prefer to focus on the difference between three-month and 10-year U.S. Treasury yields, and others prefer the 30 year-5 year spread or the 10 year-3 year spread, owing to its wide public attention and media usage, we have tended to focus on the U.S. Treasury 10 year-2 year yield curve difference. In the nearby charts, it can be seen that the 30 year-5 year spread, the 10 year-2 year spread, and the 10 year-3 year spread tend to follow similar patterns, with the 10 year-3 year spread having already having inverted (with 3-year U.S. Treasury yields 5.19 basis points (-0.0519%) *below* 10-year U.S. Treasury yields as of the third week of March, and the 10 year-2 year having inverted on an intraday basis on Wednesday, March 30th and during the day as well as at the close of trading on Friday, April 1st.


21-Mar-22 21:56
US 30yr - 5yr Government Bond Spread (bps)
18.78 / -0.4 bps
180.00
160.00
140.00
120.00
100.00
80.00
60.00
40.00
20.00
0.00
The Daily Shot®
2017
2018
2019
2020
2021
2022

29-Mar-22
US 10yr - 2yr Government Bond Spread (bps)
2.4 / -10.1 bps
180.0
160.0
140.0
120.0
100.0
80.0
60.0
40.0
20.0
0.0
-20.0
The Daily Shot®
2017
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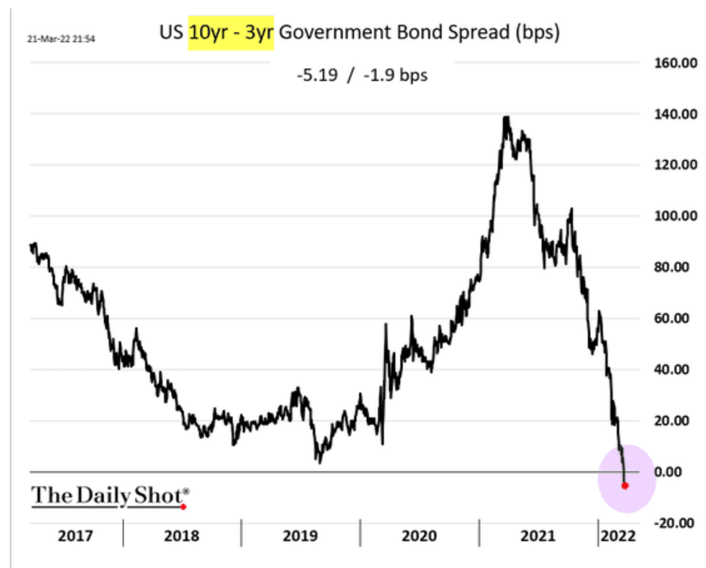
21-Mar-22 21:54
US 10yr - 3yr Government Bond Spread (bps)
-5.19 / -1.9 bps
160.00
140.00
120.00
100.00
80.00
60.00
40.00
20.00
0.00
-20.00
The Daily Shot®
2017
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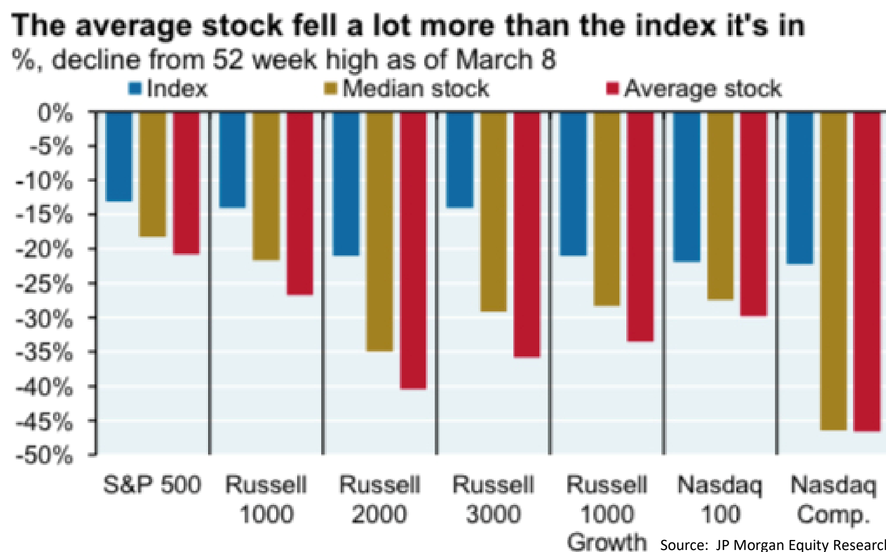
Important caveats to keep in mind include the fact that: (i) the slope of the yield curve has become so well publicized and closely monitored that its forecasting efficacy may have been somewhat diminished; (ii) financial market participants have differing opinions over the predictive accuracy of deep versus shallow yield curve inversions; and most importantly, (iii) the timing between a yield curve inversion and a recession can vary considerably. The chart shows that the 10 year-2 year government bond spread has declined from 160 basis points (1.60%) in 1Q21 to 79 basis points (0.79%) on December 31, and 14.56 basis points as of the third week in March. Such movement calls for positioning portfolios and allocating assets to defend against, and where possible, benefit from, an economic recession — even though it bears repeating that the time interval between a yield curve inversion and the onset of a recession can vary greatly, *if in fact a recession does occur.*

5. **Beneath-the-Surface Stock Price Erosion:** On March 8, the S&P 500 index closed at 4170.70, representing a year-to-date decline of -12.5% (and a price weakness of -13.0% versus its 52-week closing high of 4796.56, reached on January 3, 2022). As shown in the far-left panel of the nearby chart, as of that March 8 nadir for the S&P 500 index as a whole, *the average stock* in the S&P 500 was down even more from its 52-week high (at -21%).



Source: JP Morgan Equity Research

The chart also shows that for many other equity indices, the *average stock* deterioration versus its 52-week high was even more widespread: (i) for the Russell 1000, -26%; (ii) for the Russell 2000, -41%; (iii) for the Russell 3000, -36%; (iv) for the Russell 1000 Growth index, -34%; (v) for the Nasdaq 100 (representing 100 of the largest non-financial companies listed on the Nasdaq stock market), -30%; and (vi) for the Nasdaq Composite index (consisting of 2,485 securities as of December 31, 2000), -46%.

In our opinion, bullish and bearish inferences can be drawn from this intra-index price enfeeblement. Bullish securities analysts and investment strategists point to the fact that a fair amount of substantial price damage has already occurred at a deeper level than reflected merely in the respective indices, in the process diminishing the speculative spirits that had been so generously encountered in the equities sphere. At the same time, those adopting a bearish interpretation cite such price erosion as shown in the chart as simply the initial stages of more widespread price weakness ahead.

To our way of thinking, both points of view have a considerable degree of validity, and it is important to recognize that while some of the speculative froth has abated in equities pricing, many sectors' and companies' valuations remain high on a historical basis. In such a context, we reiterate our emphasis on discipline and discernment in emphasizing quality and long-term staying power in portfolio construction.

6. **Implications of the Russian Invasion of Ukraine:** Reflecting increased equity, bond, and foreign exchange volatility and heightened anxiety since the February 24 Russian invasion of Ukraine, financial markets, global economic data, and worldwide public opinion have been highly sensitive to mainstream and web-based news accounts of the conflict. It is fair to say that the first weeks of the incursion have not unfolded as Russia had anticipated. Despite intensive, profligate shelling attacks and bombardment, Ukraine has — to some degree bolstered by shipments of air-defense and antitank weapons, intelligence sharing, and other aid — inflicted significant military casualties on the invading Russian forces. The horrific wartime conditions have led to severe shortages of food, water, and medicine in many parts of the country and have caused several million Ukrainian refugees to flee into neighboring countries.

By the fourth week of March after more than a month of fighting, possible outcomes have remained difficult to predict, ranging from: (i) de-escalation and ceasefire; to (ii) an entrenched conflict and a lengthy war of attrition; to (iii) a serious spillover into a much wider conflict involving many more nations. Financial and commodity asset prices have thus far been significantly driven by reports of bargaining positions, governmental pronouncements, potential cease-fire discussions, and frequently, the next-day repudiation thereof. More intensive cyberwarfare attacks on local and intercontinental resources have remained a constant threat; senior NATO officials have warned Russia against the use of chemical, biological, radiologic, or nuclear weapons; and a significant unknown remains as to what specific threshold(s) would prompt further escalation and more direct confrontation with the NATO alliance.

Among a range of outcomes, in its initial phases the conflict has led to: (i) much-stricter-than expected financial sanctions imposed by a newly cohesive European Union, the United Kingdom, the United States, and several other nations on the Russian government, central bank, companies, and specific individuals; (ii) export and import limits or outright bans on trade, capital flows, and commercial activity; (iii) neutral, abstaining, or Russia-leaning pronouncements or activity by China, India, and certain other countries; (iv) severe disruptions to many global supply and demand channels for energy, industrial and precious metals, agricultural commodities, livestock, conventional and hybrid seeds, fertilizer, and numerous components of and final outputs of manufactured goods; (v) disruption to the deeply-intertwined and critically important global ecosystem of semiconductor chip design, software tools, production equipment, and fabrication facilities; and (vi) significant “flight-to-safety” capital flows out of perceived high-risk currencies and assets, thence into perceived low-risk currencies and assets.

Faced with such a challenging set of background conditions, we believe it is prudent for investors to carefully consider the historically inflationary conditions that follow wartime activity. In addition to the inestimable human suffering, the tragic loss of life, and the enormous physical and psychological damage wreaked upon global confidence and economic activity, financial market participants may anticipate a heightened degree of concern about inflation and the resultant hawkish rhetoric and actions by central bankers in the U.S., Canada, the United Kingdom, and Australia. At the same time, Western European authorities are likely to be seeking to provide stimulus to counterbalance the negative economic and societal fallout in Europe from the conflict. Revenue, profitability, and employment levels of many multinational enterprises may be harmed, even as post-conflict, significant flows of capital and goods will be required for infrastructure reconstruction and the remediation of water, air, and ground pollution in the military theater.

PORTFOLIO POSITIONING

Rose Capital Advisors

Portfolio Positioning Strategies:

Following the S&P 500's well above-average total return performance of +31.5% in 2019, +18.4% in 2020, and +28.7% in 2021, and in the current environment of: (i) monetary policy transition; (ii) slowing yet still above-average economic expansion; and (iii) upwardly-trending inflation, we believe that careful thought, planning, and attention needs to be devoted to the investor's most appropriate forms and vehicles for implementing the fundamental elements of Asset Allocation and Investment Strategy, which include:

i. **Diversification:** while it does not by any means guarantee a profit or ensure against a loss, diversification means including low- and negatively-correlated investment exposures that truly counterbalance price movements in other assets, particularly during times of great financial stress and/or rising financial asset volatility;

ii. **Rebalancing:** which encompasses judiciously using concepts of reversion to the mean and market price dislocations to *trim exposures to assets that have grown to represent too large a portion of the overall portfolio*, while at the same time, *adding exposures to high-quality assets that have fallen out of investor favor* and suffered significant, though deemed not permanent, price declines versus intrinsic value;

iii. **Risk Management:** which involves recognizing when markets have become consumed by unrealistic expectations, meme securities, excessive speculation, momentum plays, "story stocks," and information overload — a situation that has pertained at various times in recent experience to a number of companies in certain parts of the cryptocurrency realm and the technology spectrum — and understanding the degree of liquidity, the true pricing realism, and the appropriate roles of short-term liquid securities, real assets, financial assets, and alternative assets during intervals of geopolitical disturbance and especially, in decades-long (or longer) regimes of inflation, stagflation, deflation, monetary disruptions, and currency resets;

iv. **Reinvestment:** which encompasses knowing when to emphasize and trade off income return versus capital growth, all the while keeping in mind the critical importance of discipline, equanimity, patience, perspective, cost consciousness, tax awareness, and longevity in capturing and compounding dividend, coupon, rental, maturing securities, and other forms of incoming capital flows; and

v. **Asset Protection and Husbandry:** which encompass considerations of current and likely future income, wealth, and capital gains taxation at the state, local, federal, and possibly international level; estate planning; relevant insurance design and structuring; cybersecurity shielding; portfolio monitoring and reporting; administrative expenses; forms, frequency, and means of asset access; and asset custody.

Portfolio Positioning Principles:

With roughly equal weightings to Growth, to Value, and to Defensive-style rubrics, we continue to allocate an important exposure to equities, with prudent shifts between styles, sectors, geographies, and — where appropriate from a cost, timing, tax, liquidity, and size standpoint — public versus private markets. Expressed below are a number of themes that we believe should be taken into consideration over the next few years in selecting asset categories, asset classes, asset managers, sectors, companies, and security types:

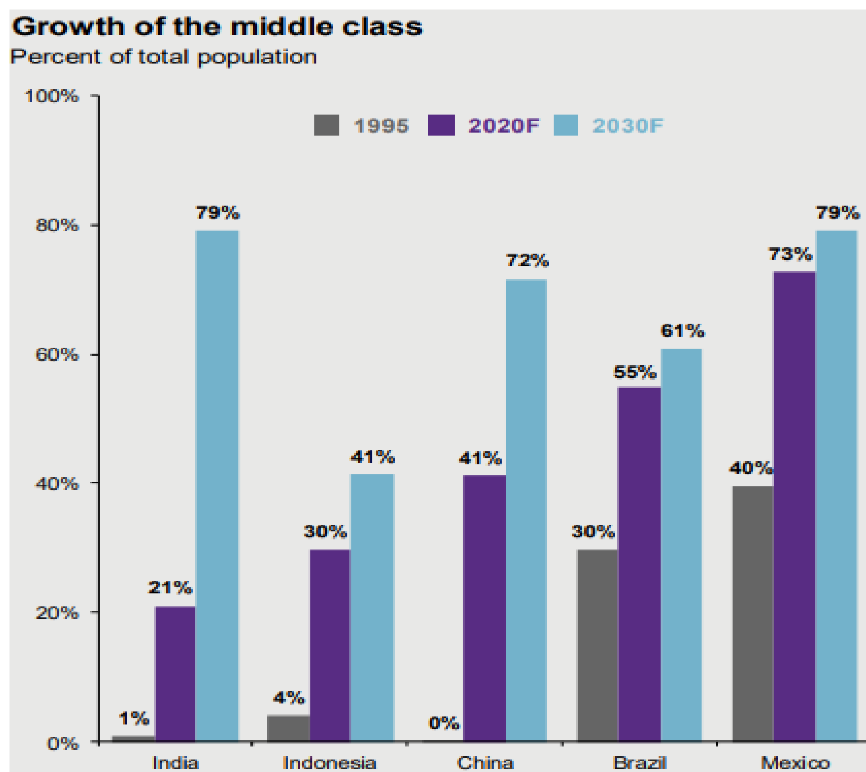
PORTFOLIO POSITIONING

i. **Paying Attention to the Value of Money**: Taking advantage of (rather than being taken advantage by) the consequences of money printing, internal and external currency debasement, government debt monetization, and the 'Modern Monetary Theory' approach that to some degree in the pandemic-response era was pursued by the Authorities — within shifting money and credit cycles — to service America's massive *explicit* government and corporate indebtedness and the enormous *implicit* obligations of pension and healthcare promises;

ii. **Concentrating on "All-Weather" Sectors and Companies**: Seeking investments with balance and flexibility, that are able to thrive regardless of: which political persuasion informs the thinking and policies of the White House, Congress, the judiciary, the state legislatures, and relevant domestic and international regulatory authorities; evolving Environmental, Social, and Governance (ESG) priorities and values; wealth distribution initiatives and public health conditions; episodes of geopolitical tension (such as have especially pertained in recent weeks), entente, and detente; and wider socioeconomic trends;

iii. **Distinguishing Between Temporary and Permanent Change**: Focusing on the commercial and financial implications of new social and political power structures, alliances, and global associations; new energy sources and resources; new trade channels; new on- and offshoring structures; new cost, logistical, supply-chain, and transportation modalities, new "WFH" and "WFA" (Work From Home and Work From Anywhere) employment methods; and new business models, pathways, digitalizations, and forms of person-to-person and business-to-business work, leisure, learning, and wellness activity;

iv. **Taking Advantage of Demographic Tailwinds**: Through U.S. and select non-U.S. companies, recognizing shifts in consumer and business preferences and gaining exposure to, and meeting the rising needs, aspirations, and appropriate spending power of, the expanding global middle class, (Please see the nearby chart for data on the past and projected growth of the middle class as a percent of the total inhabitants in five large population countries – India, Indonesia, China, Brazil, and Mexico);



Source: Brookings Institution, J.P. Morgan Asset Management.

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v. **Comprehending and Verifying Past Success**: Emphasizing companies and sectors that have demonstrated successful track records and past experience in: competitive preeminence; abundant free cash flow generation; capital allocation skill; balance sheet strength; risk management; sustainably defendable business models; and the ability to sustain high multiyear returns on equity (derived from revenue growth and favorable margin preservation, rather than through disproportionately high levels of leverage) meaningfully above the companies' and sectors' weighted average cost of capital; and

vi. **Identifying Innovative and Disruptive Technology Hegemons**: Selectively and with discernment, focusing on technology enablers, disrupters, and dominators in such fields as diagnostics, biotechnology, and therapeutics based on CRISPR (Clustered Regularly Interspaced Short Palindromic Repeats), weight management and wellbeing, public health, medical nutrition, regenerative medicine, artificial intelligence, data analytics, machine learning, 5G cellular network technology, the Internet of Things, infrastructure, robotics, retraining, quantum computing, battery inventions, alternative energy, virtual reality and augmented reality devices, hypersonic aviation, electric vehicles, and cybersecurity, while not least, also taking account of the Environmental, Social, and Governance (ESG) risks, aspirations, and initiatives of companies in these and other fields.

Portfolio Positioning Tactics:

1. **Keeping Things in Perspective**: Many of the overarching themes and conditions that influence our intermediate- and long-term asset allocation and investment strategy emphasize the need to recognize that the concepts and implementation methods intended to achieve safety, balance, purchasing power protection, diversification, and liquidity are likely to face evolving (and sometimes, rapidly shifting) taxation regimes, regulatory architectures, social priorities, geopolitical power relationships, price level changes, demographic trends, indebtedness levels, technological penetration and usages, financial structures, currency systems, and importantly, perceptions of the definition, role, degree of physicality, embodiment, and value of money itself.

2. **Flexibility versus Conviction in Formulating Investment Thinking**: In seeking to determine when to adhere to, and when to lean against, prevailing consensus views (such views may sometimes be pejoratively referred to as "groupthink"), it is important to critically question the soundness and durability of the reasoning and assumptions underlying a given investment framework and positioning at any point in time. While it at times may not make sense to hold out-of-consensus views — often expressed as "fighting the tape," — at other times — especially at major cyclical or secular turning points (at a significant asset top, *when reality is finally found to fall short of prevailing overly optimistic expectations*, or a major asset bottom, *when reality is shown to be worth considerably more than prevailing overly pessimistic expectations*), the rewards of implementing a contrarian stance can be quite meaningful.

3. **Enhancing and Preserving**: Even with some of the speculative fervor having already diminished in certain areas of the financial realm, we still confess to a degree of unease over numerous lingering manifestations of investor exuberance, and the popularity of certain securities and sectors considered to be "forever holdings" — our short-term inclination at this juncture is to take note of the Federal Reserve's explicit policy measures to rein in inflation, while taking advantage of episodes of asset price strength to continue the course of upgrading positions — offloading lower-quality, higher-risk assets and with timing and price discipline, adding to attractively-priced, higher-quality assets on equity market pullbacks.

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It is worth keeping in mind that the average year includes three separate -5% or more pullbacks for the S&P 500, with only one taking place in 2021 (and one greater than -10% correction having taken place thus far in 2022). With the cessation of Federal Reserve asset purchases under way and Quantitative Tightening (Federal Reserve balance sheet reduction) about to commence; slowing growth in China; and in view of our expectation of bouts of increased asset price volatility in the months ahead, prudence counsels being vigilantly aware of the narrow market breadth, along with the meaningful price erosion beneath the surface of the Russell 2000, Nasdaq Composite, and even the S&P 500 indices, while seeking to take advantage of such retrenchments as a key element influencing significant new capital commitments.

4. **Equity Emphases and De-emphases**: In the current conditions of rising U.S. Treasury interest rates, particularly at the short end of the maturity spectrum, to us it appears likely that cash-generating, financially-stable companies with robust growth prospects, which are able to operate and thrive against a distinctly unsettled geopolitical backdrop and in the digital sphere as they continue to enhance their business models, deserve to retain some degree of a valuation premium. Within equities: (i) we prefer to gradually shift emphasis from Growth sectors, companies, and managers towards the inclusion of select Value and Defensive sectors, companies, and managers (with a focus on energy, industrials, select financials, materials, Covid-recovery, reopening, and consumer staples sectors, and a concomitant de-emphasis on companies and sectors dependent on access to low-cost energy); (ii) we continue to counsel very selectively adding small- and mid-cap companies (or investment managers specializing in and with good track records in this space) to our primary emphasis on large-capitalization enterprises; and (iii) for the time being, while we continue to prefer a tactical overweighting to U.S. domestic equities — with pullbacks such as those encountered in early March viewed as an opportunity to sensibly add equities, particularly those sectors and companies likely to thrive in a less-predictable economic environment — we also espouse holding (or gradually building) relatively modest allocations to global leaders listed in international markets.

5. **Focus on Strength and Quality**: Our long-term equity portfolio weightings continue to emphasize asset managers, sectors, and specific companies that can benefit from the major sustained trends of the 2020-2030 decade, including: (i) incremental growth in a wide range of economic circumstances; (ii) a focus on economic and infrastructure repair, digitalization, e-commerce, personal wellness, safety, domesticity, home improvement, and sustainable consumer demand; and (iii) advantageous capture of benefits from onshoring, supply chain redesign, and deglobalization as important drivers of capital spending and disruptive innovation. At the company level in equities, as mentioned above in "Comprehending and Verifying Past Success," we emphasize identifying and building long-term exposure to firms possessing fortress-like, cash-rich balance sheets, prudence in balance sheet utilization, limited debt, consistency and durability of positive free cash flow generation, dividend strength, and competitive business models with abiding competitive advantages (high barriers to entry, low threat of substitute products, and enduring pricing power vis-à-vis suppliers and/or customers) that over a long time frame can generate high returns on equity through revenue growth and sustainable profit margins, rather than through unhealthily high levels of leverage.

PORTFOLIO POSITIONING

6. **Balancing Growth and Value Sectors**: At its closing level of 2791.44 on Thursday, March 31st, the price return of the Russell 1000 Growth index (symbol RLG, and including companies in sectors such as technology, healthcare, and communication services) was (according to *The Wall Street Journal*) down -9.2% from its December 31,2021 closing level of 3074.99, while the price return of the Russell 1000 Value index (symbol RLV, and including companies in sectors such as financial, real estate, energy, utility, and industrial businesses) was, at its closing level of 1642.89 on Thursday, March 31st (according to *The Wall Street Journal*), down -0.8% from its December 31,2021 closing level of 1655.73. This 8.4 percentage point (8.4%) Value minus Growth returns differential appears to argue for continuing a degree of balanced exposure in selected Value sectors, companies, and managers as well as in selected Growth sectors, companies, and managers. As this process continues, it is worth keeping in mind that *true value investing represents identifying and owning assets that are trading for less than they are actually worth, not assets that are merely inexpensive*. Many superficially inexpensive assets may very well be inexpensive for a reason, and can very well remain so or deteriorate further.

7. **Fixed Income Securities**: Reflecting their largest quarterly price declines in more than three decades, U.S. Treasury bond prices year-to-date through March 31st have declined -2.6% in the 1-3 year maturity range, -6.5% in the 7-10 year maturity range, and -10.9% in the above 20-year maturity range. Even though yield movements have ascended in the past month, they appear likely to exhibit further increases over the course of the coming months. And outside the United States, as shown in the nearby chart, according to Bloomberg in late-March, a dramatically lower total of $2.7 trillion (down from $18 trillion in early 2021) was outstanding in global negative-yielding sovereign — and some corporate — debt outstanding). We continue a preference for issuers at the high-quality end of the rating spectrum, both in taxable investment grade and high-yield bonds and in tax-exempt bonds (where we see some pockets of value on a taxable equivalent basis. We view fixed income securities as continuing to be subject to price risk due to our expectation of higher yields as 2022 progresses, and thus we prefer maturities and durations along the short-to-intermediate portion of the yield curve spectrum.

PORTFOLIO POSITIONING

8. **U.S. Dollar Outlook**: After declining -9.9% in 2017, appreciating +4.4% in 2018, marginally gaining +0.4% in 2019, and declining -3.4% in 2020, the DXY U.S. dollar index measured versus a basket of six major currencies — the euro, Japanese yen, Swedish krona, British pound, Canadian dollar, and Swiss franc — had as of its market close of 95.97 on December 31st, appreciated +6.7% in 2021. On Thursday, March 31st, the DXY U.S. dollar index had appreciated +2.4% year-to-date, closing at 98.31. Over the next few quarters, given our expectations of the Federal Reserve: (i) stepping up the pace of its projected policy interest rate increases; and (ii) commencing the process of reducing the size of its portfolio of U.S. Treasury and mortgage-backed securities, we believe the U.S. dollar may rise relative to major currencies including the euro and Japanese yen.

8. **Alternative Investments and Real Assets**: In alternative investments, we continue our multi-quarter focus that has for some time emphasized exposure to: (i) commodities and real-asset sectors of the economy including industrial metals, agriculture, and materials, (ii) gold and/or gold mining ETFs/shares (particularly those miners with reserves in stable geographic locations, capital discipline, and cash flow growth); (iii) high-quality master limited partnerships with strong business models and sustainable dividend-paying capacity; (iv) select investments in private credit and private real estate; (v) and opportunistic strategies that are positioned to selectively derive meaningful value from dislocations created by geopolitical disorder and/or potentially injurious mutations of the coronavirus, as well as the economic and profits recuperation therefrom.

David Martin Darst, CFA
Senior Investment Advisor
Dynasty Financial Partners

INVESTMENT STRATEGY THEMES FOR 2022

Rose Capital Advisors

To reiterate our Investment Strategy Themes for 2022, we are including them below, adorned by the 27 flags flown by the United States of America in the 245 years since our nation's founding. In preparing Portfolio Positioning Strategies, Portfolio Positioning Principles, and Portfolio Positioning Tactics for 2022, we again respectfully pay tribute to the oft-quoted observation of the 34th U.S. President (and Five-Star General) Dwight David Eisenhower (1890-1969) that "plans are useless, but planning is indispensable." With this wisdom in mind, our 2022 Investment Planning approach reflects and encompasses the following themes:

1. **Growing but Slowing** GDP as provided by the IMF (est. approximately +4.0%) and corporate profits as provided by FactSet (est. approximately +10%)
2. **Transitioning** to a decidedly less stimulative monetary and fiscal policy backdrop
3. **Fluctuating** financial asset prices in conditions featuring shifting performance leadership and increased equity (VIX), bond (MOVE), and currency (VXY) volatility
4. **Differentiating** with emphasis on greater discernment and selectivity in asset classes, managers, sectors, and companies
5. **Challenging** — in an environment of elevated valuations, the easy money has likely been made, with the recent significant upward and downward moves in individual securities prices not a usual characteristic of bull markets

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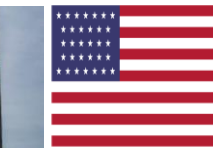
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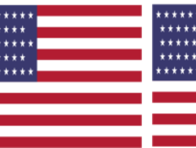
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