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Market Overview

During the first quarter of 2022, the stock market[1] experienced sharp volatility driven by increasing Treasury yields and the Russia-Ukraine conflict. The S&P 500 was down 4.6% during the quarter The Dow Jones Industrial Average[2] fell 4.1%, while the Nasdaq[3] declined 8.9%. However, as the quarter came to a close, the major indices bounced off their lows from late February and mid-March.

In the first quarter, energy was the best performing equity sector. Along with rising energy prices, grain, fertilizer, and metals prices jumped sharply as the Ukraine-Russian hostilities threatened those countries' production and distribution of those commodities. Oil and gas exports from Russia were partially interrupted through sanctions, causing a near historic rise in oil and gas prices. Along with the growing uncertainty around Federal Reserve policy, these events caused wild daily gyrations in market prices.

Ten-year Treasury bond yields rose strongly during the quarter from 1.7% to 2.3%, resulting in an unaccustomed, sizable 5.9% decline in the U.S. Aggregate Bond Index[4]. Sharply rising consumer prices and investor uncertainties over the pace of the Federal Reserve's hiking of the Federal funds rate were mainly to blame.

International markets have continued their underperformance relative to the U.S. equity market as the dollar continued its advance. The MSCI World Index[5] is down 5.3% vs the S&P which is down 4.6%.

Mark L. Blom, CFP® — Thomas Steffanci, PhD — Kirk Masci

U.S. Equity Returns Table
Source: Tamarac

Index	Q1 2022 Returns	2021 Returns
Dow Jones	-4.10%	20.95%
S&P 500	-4.60%	28.7%
NASDAQ	-8.95%	22.18%
Russell 2000	-7.53%	14.82%
MSCI World	-5.26%	19.04%

U.S. Treasury Yield Table
Source: Treasury

	3/2022	3/2021	3/2020
3 month	.52%	0.03%	0.11%
2 year	2.28%	0.16%	0.23%
5 year	2.42%	0.92%	0.37%
10 year	2.32%	1.74%	0.70%
30 year	2.49%	2.41%	1.35%

Other Indices Table
Source: Morningstar

	Q1 2022 Returns	2021 Returns
Gold (GLD)	5.67%	-4.15%
Brent Oil (BNO)	43.14%	62.34%
U.S. Dollar Index (UUP)	2.61%	5.73%
Int'l Equity Markets (EFA)	-6.46%	11.46%
Emerging Equity Markets (EEM)	-7.57%	-3.62%

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GRACE'S CORNER: Staff Update

It is my pleasure to introduce Kirk Masci. Kirk joined BFSG in early February. He obtained his bachelor and master degrees in finance at the University of Arizona. Prior to joining us, he worked in wealth management at a national brokerage firm. His responsibilities at BFSG include investment research and portfolio management. Kirk is also a Chartered Financial Analyst™ Level 2 candidate. Welcome Kirk!

Grace Lau, CFA® - Managing Principal

Have Stock Prices and Bond Yields Discounted the Fed?

Record market volatility, rapid repricing of Federal Reserve (the "Fed") tightening expectations, and surging inflation were the footprints of the first quarter. The resulting retreat in equity prices and surging bond yields were worsened by the Russian invasion of Ukraine.

In that environment, the S&P 500 dropped 13% from its closing peak to trough, with the Nasdaq suffering a 20% decline. European and Chinese stock indices fell 15% and 28%, respectively. But other things of importance were occurring around the March 8 closing stock market lows. Oil prices peaked at $125/bbl, gold prices topped at $2,043/oz, and the VIX, the "Fear Gauge" Index, also reached its peak. So, there were factors at work reaching unsustainable levels at the time of the stock markets' rout.

The subsequent equity market rally from deeply oversold levels was swift, sharp, and unexpected, with the S&P 500 rising 10% and the Nasdaq ahead by 15%.

Bond yields rose while all this was occurring. Two-year Treasury yields rose from 1.65% in early March to 2.33% at month's end, and 10-year yields increased from 1.95% to 2.35%. The takeaway is that the surge in oil prices and the Russian-Ukraine hostilities were the dominant narratives that impacted equity market movements in the first quarter. If market fears of a more hawkish Fed was the market driver, the sharp stock market rally toward the end of the quarter likely would not have happened, with the bond markets still in the midst of discounting more aggressive Fed policy. The stock market appears to be over the angst of aggressive Fed tightening. In fact, *both* markets now may be pricing (via the Federal funds futures market) a policy of declining rates late next year from an anticipated recession brought on by an overzealous Federal Reserve.

But the markets still must deal with the uncertainties of the Russian-Ukraine conflict with its impact on commodity inflation, and the risk of unanticipated shortfalls in corporate earnings. Financial markets can deal with, and price in, risk. What they can't measure is geo-political uncertainty. That is the 2022-2023 wild card.

So far, corporate earnings have held up well despite supply chain entanglements, and rising input prices and labor costs. Though analysts' 2022-2023 earnings and revenue expectations have been marked down over the past several months according to FactSet, consensus earnings for 2022 are for an 8½% gain with revenue growth at 8%, and 6% and 4%, respectively for 2023. Those expectations would reduce the S&P P/E ratio[6] to 18.8 based on 2022 earnings estimates. That would be lower than the February 2020 pre-pandemic level of 19.2x and level with the past five-year average.

In the environment of rising interest rates, elevated commodity and oil prices, and geo-political uncertainties, portfolio allocations to sectors such as industrials, materials, and energy are attractive, taking advantage of rising economic and the infrastructure buildout. Dominant companies that can post revenue and earnings gains benefiting from the surge in web and cloud storage are also attractive. More defensive sectors such as utilities and consumer staples with above average dividend yields can provide a solid anchor to a portfolio. Fixed income allocations should emphasize limited maturity floating rate bonds and collateralized loan funds which offer lower volatility and attractive yields.

Thomas J. Steffanci, PhD - Senior Portfolio Manager

Disclosures

1. The S&P 500 is designed to be a leading indicator of U.S. equities and is commonly used as a proxy for the U.S. stock market.
2. The Dow Jones Industrial Average (DJIA) is a price-weighted measurement stock market index of 30 prominent companies listed on stock exchanges in the United States.
3. The Nasdaq Composite is a stock market index that includes almost all stocks listed on the Nasdaq stock market and is heavily weighted towards companies in the information technology sector.
4. The Barclays Aggregate Bond Index is a broad-based index used as a proxy for the U.S. bond market.. Total return quoted.
5. The MSCI World is a market cap weighted stock market index of 1,546 companies throughout the world.
6. The price-to-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings (EPS) and is one of the most widely-used valuation measures for stocks.

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