

Quarter-In-Review – If someone had told you at the end of last year a war would breakout in Europe, oil prices would surge to over \$120/barrel, and that inflation and interest rates would shoot higher, you’d have penciled in double-digit percentage equity declines for the quarter. As it turns out, losses by quarter-end were surprisingly modest, ranging from -4.6% to -7.5% for the main indexes. Granted, if you dig a bit beneath the surface, it’s easy to find segments of the market that were hammered. Speculative growth stocks were hit hard with losses approaching -30%, while Chinese internet stocks were down roughly -25%. But value stocks, which had been left for dead after 2020, held up reasonably well. The small-cap value index dipped -2.5% and large-cap value was down only -0.1%. It helped that the energy and utility sectors, traditional value type holdings, gained +39% and +5% respectively.

It was also a tough quarter for bonds. Rising inflation and the prospect of a more aggressive Federal Reserve meant yields increased across the curve with 10-year and 2-year Treasury yields up 0.82% and 1.59% respectively. This translated into losses in all sectors of fixed income, with intermediate-term Treasury bonds losing -6.4% for the quarter and short-term bonds dipping -3.4%. Other bond sectors also struggled. Investment grade corporate bonds were hit with an -8.4% loss, emerging market bonds were down -9.7%, and even TIPS lost -3.1%.

Prediction Gone Awry – If you follow the markets for any length of time at all, you are familiar with the routine around every year-end. Investment firms publish their outlooks for the coming year that delicately balance the pros and cons and what it means for the markets. We read a number of them each year and are even guilty of publishing our own. One thing that stands out from all the letters last year (ours included!!) was the utter omission of any discussion of a war in Europe. It goes to show that crystal balls are always cloudy, even at the best of times. Clearly the events in Ukraine are tragic on a human level, but they are also likely to have long running consequences for a global economy that was just starting to get back on its feet after the COVID shock.

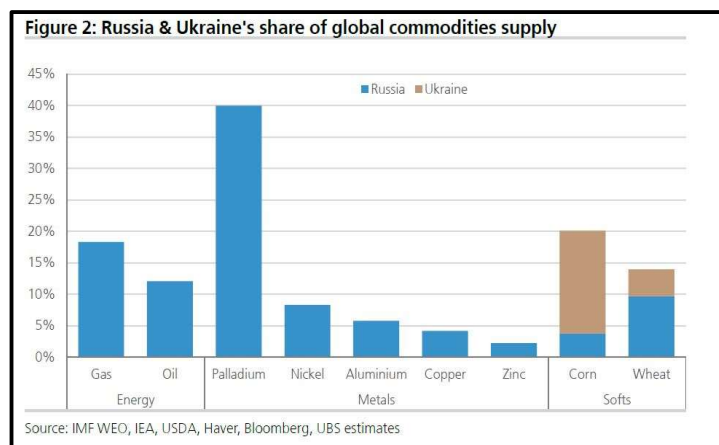
Market Benchmarks			
Market Indices	YTD	3-Yr An	5-Yr An
S&P 500 Index	-4.6%	+18.7%	+15.8%
Russell 2000	-7.5%	+11.6%	+9.7%
Global Equities	-5.5%	+13.8%	+11.6%
Int'l Index (EAFE)	-6.5%	+7.4%	+6.5%
Emerging Mkts	-6.3%	+5.4%	+5.7%
Other Indicators	3/31/22	12/31/21	12/31/20
Fed Funds Rate	0.25%-0.5%	0%-0.25%	0%-0.25%
2-Year Treasury	2.32%	0.73%	0.12%
10-Year Treasury	2.33%	1.51%	0.92%
S&P 500 P/E Ratio*	19.5	21.2	22.3
Crude Oil	\$101.20	\$75.45	\$48.45
Core Inflation	5.4%	4.7%	1.4%

*Forward 12-month operating earnings per S&P

The Post COVID Economy – At the beginning of this year it was clear that large parts of the global economy were moving on from COVID. Mask mandates were falling by the wayside, roads and airports seemed back to normal (if not abnormally busy), and families were making plans for summer vacations. This didn’t mean COVID had disappeared, only that economic life was getting back to normal. In Europe in particular, case counts were on the rise due to the new BA.2 subvariant. This new COVID strain appears to be much more infectious than Omicron, but the symptoms appear mild, especially in the vaccinated. And that is the key point – widespread vaccine distribution is allowing the global economy to heal. Prior to the conflict in Ukraine, global trade was picking up, consumers were spending, and housing was booming. If we look at the data in the U.S., growth in the fourth quarter last year was a robust +6.9%. Consumers played a key role in this jump, and as you can see from the chart at the top of the next page, consumers accumulated over \$2 trillion of excess savings during the pandemic months that are still finding their way

back into the economy. Combine this with a robust jobs market that is driving wage gains, particularly at the lower income brackets, and the economic fundamentals in the U.S. at the beginning of 2022 were robust.

It was a similar story in Europe and Japan, but the one exception to this constructive backdrop was China. As we discussed last quarter, China



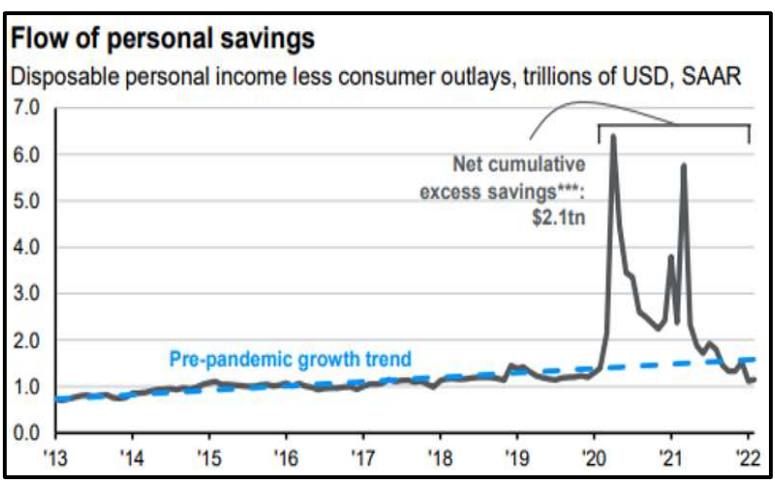
is sticking to their ‘zero COVID’ policy, and a recent surge in infections has led to broad countermeasures. For example, the Chinese government is in the process of testing 25 million citizens in Shanghai. The immediate consequence is a continuation of the supply disruptions that have plagued the global economy for the last two

years. As you can clearly see from the chart at the bottom of the page, shipping delays are a significant problem. But on balance, the economic fundamentals looked decent at the beginning of the year. If anything, things were too hot, with inflation at levels we hadn’t seen since the 1980’s. Then in late February Russia invaded Ukraine and the situation got complicated.

The Economic Consequences of War – Both Russia and Ukraine have intricate relationships with the global economy despite the fact that together they account for just 2% of global GDP. Recent estimates think the on-going conflict could knock \$1 trillion off the value of the world economy this year and add 3% to global inflation. But as we explore below, the impact will not be evenly distributed.

The key dynamic at work is that both Russia and Ukraine are the key suppliers of certain raw commodities, as you can see from the chart on page 1. And the more you dig into the supply situation, the more nuances emerge. For example, Ukraine produces roughly half the world’s neon, a key component in the production of computer chips. Obviously, this production has ceased for the foreseeable future.

The speed and scope of the backlash against Russia is unprecedented, basically cutting them off from the global trading system for all but key energy exports. And energy is proving the most immediate problem, particularly in Europe. As you can see from the chart at the top of the next page, Europe relies heavily on energy imports, with 30% of their oil and 40% of their natural gas needs coming from Russia. Germany in particular is heavily reliant on Russian natural gas, and there are no good substitutes over the short-term. It isn’t just increased costs. Germany and Austria are already developing plans to ration natural gas usage for major industrial



Secondly, the sensitivity of the U.S. economy to rising energy costs is far less than it once was. As you can see from the chart at the bottom of page 3, the energy burden in the U.S. stands at just 4.4%, close to all-time lows. This means that higher prices do not have the same impact they once did (you can also see how Europe’s ratio is near an all-time high). In other words, economic growth in the U.S. is unlikely to deteriorate significantly due to the conflict in Ukraine.

But other regions are not so lucky. Take the issue of food supplies. As you can see from the chart at the top of page 4, a large number of lower income countries rely on wheat from either Russia or Ukraine. Combine this with soaring fertilizer costs, and not only are food prices soaring in some countries that can least afford it, but there is also the risk of outright shortages. Already governments in Sri Lanka and Peru are dealing with social unrest while Egypt has asked the IMF for help. And sadly, there is no easy fix for this – Ukraine’s summer harvest will obviously be poor, putting further pressure on supplies. The key point is that the supply issues that plagued the global economy during the COVID crisis are being amplified by the Russian/Ukrainian conflict. Some countries such as the U.S., Canada, and Brazil are relatively insulated, but others are much more vulnerable.

Inflation - Transitory Factors vs. Supply Shocks – While some countries may be insulated from the immediate impact of the war, everyone is struggling with the inflationary consequences. Before the conflict in Ukraine there was a general view that the price shocks from COVID would start to abate as 2022 progressed. This looks less likely now. Depending on the measure, inflation was running between 5.4% and 6.4% in March, well above the Fed’s target of 2%. Part of this surge is still due to the one-time



shock from COVID. For example, new car supply has been dented due to a chip shortage, and both new and used car prices have surged. However, it's tough to extrapolate the roughly +60% year-over-year gain in used car prices going forward. This is the essence of the transitory inflation argument. And there are still merits to it. Consumer spending is starting to rotate from goods to services, and this should take the pressure off inflation in certain sectors. And that is certainly what investors are focusing on. Long-term inflation expectations priced into the market are only modestly above 2% (chart at the bottom of page 4). However, the inflation trends over the next few months are cloudy at best. The surge in energy costs is likely to permeate through the economy, as are the price increases in things like wheat, corn, etc. It is quite possible that these increases offset whatever benefit we get from the transitory factors becoming less important, leaving us with an inflation picture that remains too hot in 2022.

On a Tightening Path – Before we delve into the details of central bank policy, we should step back for a minute and acknowledge that policy settings in most countries are still at emergency levels. Zero interest rates and massive asset purchases on the part of global central banks were policies meant for the COVID crisis, soaring unemployment, and fears of deep recessions and deflation. They are unquestionably inconsistent with the world today that is characterized by full employment levels (at least in North America), percolating inflation, and supply shocks. In light of this it seems only natural that the Federal Reserve is on a path towards normalizing policy. They hiked rates by a quarter point in March and have communicated that half-point hikes are likely in May and June. In total the Fed thinks they will get the overnight Fed Funds rate to roughly 2.5% by the end of this year. Just as importantly, they plan to start shrinking the size of their massive \$9 trillion balance sheet, possibly by roughly \$1 trillion over the next year.

How big of a challenge will higher rates be for the global economy? In truth no one can be quite sure, but first and foremost we should acknowledge that monetary policy is simply moving from ultra-easy to just easy. It won't be until 2023 that policy could get tight. Throughout much of the 2000's the yield on the 10-year Treasury averaged

Europe's Energy Shortfall			
	Produces	Consumes	Net
Oil (bbl/day)	3.6mm	15.0mm	(11.4mm)
Gas (cu/year)	230bn	560bn	(330bn)
Coal (tons/year)	475mm	950mm	(475mm)

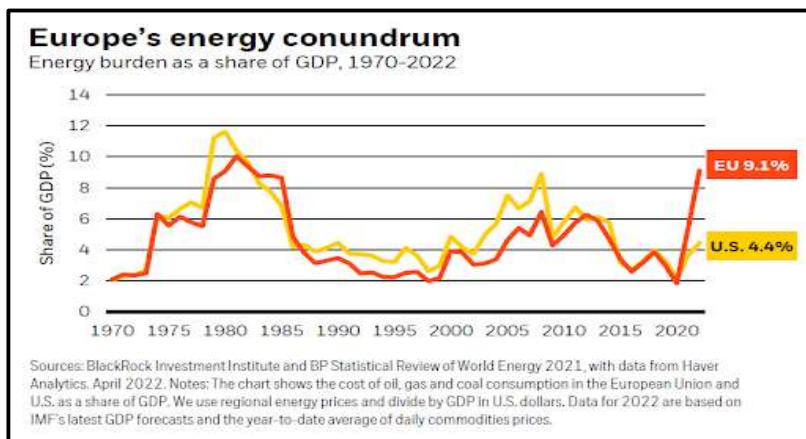
Source: Bloomberg

around 4% and mortgage rates were in the 6% range. Today's rates of 2.3% and 4.7% respectively don't seem too onerous. Given the strength of the consumer it's reasonable to think that the real economy can deal with tighter policy in 2022.

The one immediate wildcard is residential real estate. Affordability has become challenging in many markets due to high prices and rising rates. Will 5% mortgage rates crash the housing market? It seems unlikely. For one thing, inventory levels remain very tight in many markets, which should limit price declines. Secondly, underwriting standards never really got stupid the way they did in the 2004 to 2007 period, implying that we are unlikely to see distressed sellers/lenders emerge in the months to come. Maybe higher rates combined with low inventories means the market becomes moribund for a prolonged period. Time will tell. But higher rates work through the system in two ways. The first is through the real economy as we have discussed. However, rates also impact the financial markets, and this path is possibly even more important than the real economy in today's world of hyper-financialization.

What's it All Mean for the Markets? – Markets have thrived the last couple years on the combination of massive fiscal spending and ultra-loose monetary policy. Both trends are unlikely to repeat going forward, but we shouldn't get overly cautious just yet. The fallout from the mid-term elections is likely to be gridlock until 2024 – no new stimulus plans but also no tightening in fiscal spending. And while rates are headed higher, monetary policy isn't going to become restrictive this year. The Fed isn't taking the punch bowl – it's more like they are handing out lite beer instead of tequila shots!!

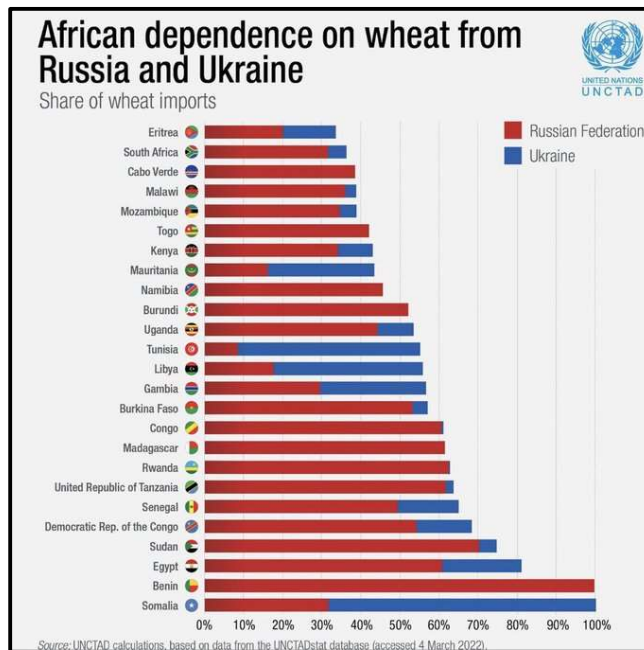
Let's address the outlook for fixed income first. As we noted earlier, hostilities in Ukraine and continued supply chain disruptions in China means inflation is unlikely to moderate significantly this year. Also, the Fed's move to raise rates and reduce the size of their balance sheet should pressure longer-term yields the rest of this year. We have positioned our bond portfolio for rising rates by holding bonds with relatively short maturities that have reduced sensitivity to rising rates. Today you can earn upwards of 3% in bonds maturing in less than



two years, and while there is the risk of some price depreciation over the short-term, the high starting yields will go a long way towards offsetting this. But it is going to be tough to make money in bonds over the next few months. They still serve a purpose as a hedge against recession in 2023 or 2024, but we shouldn't expect much on the fixed income side of things for the rest of this year.

As for equities, it remains a mixed bag. As we discussed last quarter, we remain worried about the high valuation/momentum segments of the market. They were hit hard in the first quarter, but valuations in many aggressive growth sectors remain lofty. Historically, when interest rates increase the price/earnings (PE) ratio for the broad market falls. The good news is that earnings growth typically more than offsets the contraction in PE multiples. The challenge for the speculative areas of the market is that often times there are no earnings to play the offsetting role. Not a good combination, and needless to say, we have lower exposure here. We are also nervous about the economic situation in Europe as any energy supply disruptions could trigger recession. Granted, European stocks are about as cheap as they have been in years relative to U.S. equities, but the uncertainty is simply too high to make us want to reverse our underweight allocation.

We remain relatively constructive on the prospects in the U.S., particularly for the more value orientated sectors. We think earnings growth this year can offset the headwinds from higher interest rates, and mid-single digit earnings projections for this year might even be on the



low side. This implies modest returns for stocks over the next twelve months but returns that nonetheless beat those offered in the fixed income world. We think the value segments of the market can avoid some of the PE multiple contraction we expect for the broad market simply because their current valuations are cheap relative to history. Currently we're overweight value and underweight growth in both our active and passive strategies.

Looking Ahead – As we noted at the outset of this piece, given what has gone on globally the last three months, the sell-off in

the equity markets has been relatively subdued, at least outside of the momentum/speculative favorites of the last few years. Investors are essentially betting that global growth should persist in 2022 despite the shocks. At the broad level we think this is true, although there will be nuances at the regional and sector levels. What has changed is that the combination of the hostilities in Ukraine and China's renewed lockdowns means price pressures could persist for longer than originally expected. This will translate into sticky inflation and a more aggressive response by central bankers, particularly in the U.S. The pressure on yields should continue for a while longer, and this is likely to cap returns in the fixed income market and certain sectors of the equity market. However, we think the economic fundamentals, particularly in the U.S., are robust enough to withstand the rise in rates and that the fears of pending recession are overblown, at least for now.



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