First Quarter 2022 – Investment Commentary

WEST SHORE BANK

As a kid we used to play a game in the school yard called Pile On. If you had the football, you were running for your life because you knew once you were caught every kid piled on you until you gave up the football. This past quarter it seemed as though the U.S. economy was the kid holding the football. Entering the year, markets were dealing with the supply-chain crisis and rising inflation, next came the rapid rise and spread of Omicron, followed by the Federal Reserve (Fed) policy pivot, and then the Russian invasion of Ukraine. All of these issues raised the overall level of uncertainty and, as you know, markets do not react kindly to elevated uncertainty.

Stock markets were under pressure for most of the quarter but quite surprisingly amongst all these headwinds somehow mustered a strong relief rally to close the quarter. Volatility was high as stock markets moved into and out of correction territory a couple of times and a few markets moved into and out of bear market territory as well, including the tech-heavy NASDAQ index. From its most recent high, a "correction" is a decrease equal to or greater than a -10% decline and a "bear market" is a decrease equal to or greater than a -20% decline.

Table 1 – Stock Index Total Returns – as of March 31, 2022

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Dow Jones Industrial	2.49	-4.10	-4.10	7.11	12.57	13.40	12.77
S&P 500	3.71	-4.60	-4.60	15.65	18.92	15.99	14.64
S&P 400	1.38	-4.88	-4.88	4.59	14.14	11.10	12.20
MSCI Developed	0.64	-5.91	-5.91	1.16	7.78	6.72	6.27
MSCI Emerging	-2.26	-6.97	-6.97	-11.37	4.94	5.98	3.36
Russell 2000	1.24	-7.53	-7.53	-5.79	11.74	9.74	11.04
NASDAQ	3.48	-8.95	-8.95	8.06	23.57	20.31	17.77

Unlike stocks, there was no relief rally for bonds which posted historic negative total returns for the quarter as yields shot up sharply across the yield curve. The 2-Year treasury yield went from 0.73% to 2.29% and the 10-Year treasury yield went from 1.51% to 2.32%. Bond market volatility was extremely high as yields frequently swung wildly intraday as well as from one day to the next. Bond market participants are struggling to figure out just how far behind the curve the Fed is on getting inflation under control and rightfully so. All of the pressure within the bond market rests at the doorstep of the Fed whose credibility is once again being widely called into question.

Table 2 – Bond Index Total Returns – as of March 31, 2022

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Bloomberg Inter Gov't/Credit	-2.45	-4.51	-4.51	-4.10	1.50	1.81	1.85
Bloomberg High Yield	-1.15	-4.84	-4.84	-0.66	4.58	4.69	5.75
Bloomberg Aggregate	-2.78	-5.93	-5.93	-4.15	1.69	2.14	2.24
Bloomberg Municipal	-3.24	-6.23	-6.23	-4.47	1.53	2.52	2.88

Inflation began ramping up in February 2021 and at the time economists and market analysts were split on whether the rise would be transitory or persistent. The Fed remained in the transitory camp for most of 2021 even though they had to upwardly revise their 2021 PCE inflation forecast four times from +1.8% to +5.3%. It wasn't until the November 2021 Consumer Price Index (CPI) posted a near forty-year high, a twelve-month reading of +6.8%, when the Fed capitulated that inflation was indeed not "transitory."

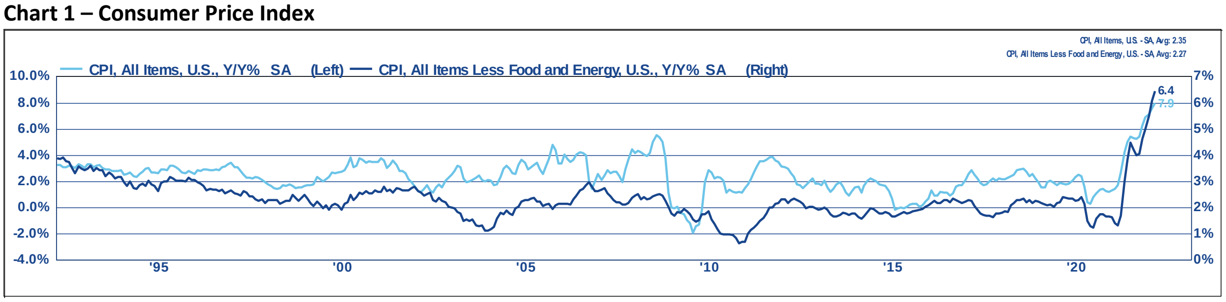
Shortly thereafter at the December 2021 FOMC meeting, the Fed promptly did a complete 180-degree turn on monetary policy signaling their intent to accelerate both the unwinding of the bond purchase program and raising short-term rates. Moreover, they also announced their intention to begin meaningful discussions on unwinding their $8.9 trillion balance sheet. The Fed's monetary policy path projections have changed significantly over the last nine months, especially in the last three months.

Table 3 – Federal Reserve Economic Projections for Fed Funds Rate and PCE Inflation

FOMC Meeting	2022 Fed Funds Rate Projection	# of expected hikes	2022 PCE Inflation Projection	2023 Fed Funds Rate Projection	# of expected hikes	2023 PCE Inflation Projection
June-21	0.25%	None	2.1%	0.75%	2	2.2%
Sept-21	0.50%	1	2.2%	1.25%	3	2.2%
Dec -21	1.00%	3	2.6%	1.75%	3	2.3%
Mar-22	2.00%	6-7	4.3%	3.00%	3-4	2.7%

The Fed's policy tone has also shifted and is much more aggressive towards dealing with inflation. In answering questions at the March 2022 FOMC press conference, on numerous occasions Fed Chair Jay Powell made it abundantly clear that the Committee was committed to fulfilling its obligation to restore price stability and would use every policy tool available to do so. Herein lies the uncertainty for bond and stock markets.

Chart 1 – Consumer Price Index

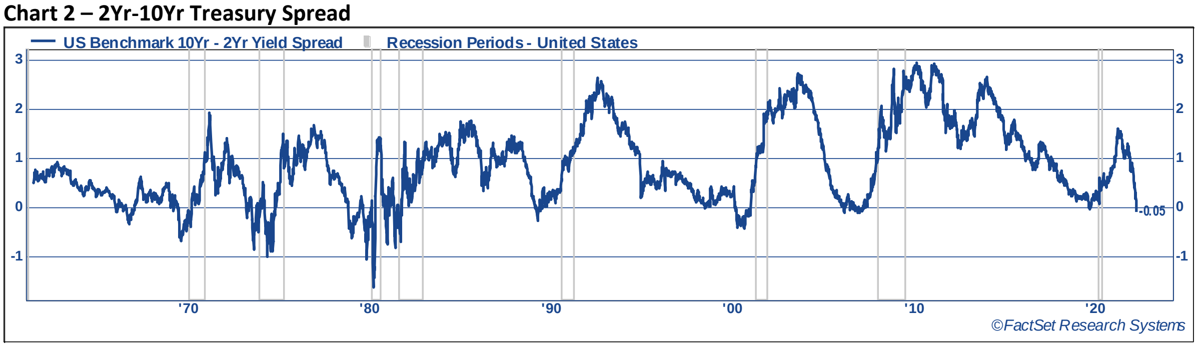


For the stock market, the concern is the Fed will overstep on policy and raise rates too much. Instead of having a soft economic landing, the economy will be pushed into recession. There is already heightened concern inflation is crimping household budgets. Rising prices function as a tax on consumers and could lead to slower growth. Additionally, there is rising concern that higher wages and overall input costs are going to put a dent in corporate margins and lower profitability. So far, margins and earnings have held up well as cost pressures have been offset by price increases and cost saving initiatives. Over the next few quarters, we anticipate downward revisions to corporate earnings growth estimates.

For the bond market, it is trying to figure out if rates need to go higher than the Fed's projected neutral rate of 2.4% to curtail inflation and this is the reason bond market has had so much volatility. If rates do need to go higher than the neutral rate, is it 3.0%, 3.5%, 4.0% or higher? The neutral rate is the rate that is neither accommodative or restrictive and one that fosters full employment and price stability. While the bond market is floundering trying to figure out Fed monetary policy, it is also signaling pending economic weakness as the yield curve inverted.

Historically, the bond market has been a harbinger of expected economic activity and an inverted yield curve has been a consistent and reliable indicator of recessions. Only once has an inverted yield curve not been followed by a recession and that was back in the 1960s. As the chart below shows, the yield curve recently inverted as the spread between 2-Year and 10-Year treasury bond turned negative. An inverted curve is when the 2-Yr treasury yield is higher than the 10-Year treasury yield. The bond market is in the Fed policy misstep camp.

Chart 2 – 2Yr-10Yr Treasury Spread



Meaning, because the Fed was slow in dealing with inflation, they will need to raise rates faster and higher in order to corral inflation and doing so will likely lead to an economic downturn. Elevated inflation is not going away anytime soon as the Ukraine conflict has thrown another wrench in the supply chain wheel.

Quite often when highlighting risks to an economy, pundits, including this one, may use the generic catchall phrase "geopolitical risk" when there is a conflict in the world that is simmering. In last quarter's commentary, we did just that due to the rhetoric related to Russia amassing additional forces on the Ukrainian border. In no way did we imagine this simmer would boil into the hellish fire of war.

With the on-going human suffering and loss of life in Ukraine, it seems thoughtless to note that this conflict has and will have serious ramifications for the global economy. This is because Russia, and to a lesser extent Ukraine, play an integral role in producing many grain, energy, and metal commodities and any sustained loss of production will adversely affect global supply. Unfortunately, the Ukraine conflict is not the only headline event that will likely constrain already limited supply.

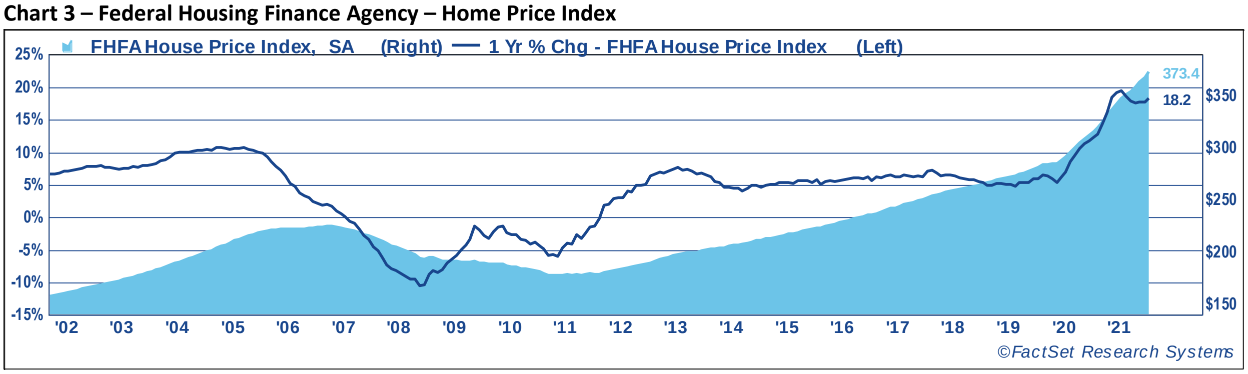
Keeping with the Pile On theme, in March China abruptly locked down several provinces to control the spread of COVID. The lockdowns could have serious implications for U.S. tech companies as one province is a major hub for tech suppliers and a prolonged shutdown of manufacturing operations could cause major supply disruptions. With the global supply chain already in disarray, further meaningful disruptions on the production of vital goods will serve to intensify supply bottlenecks and sustain the worst inflation in four decades.

Because the supply chain has been and is in such disarray, the Fed's only alternative is to lessen healthy consumer and business demand and to do so they will have to tighten financial conditions via monetary policy. The good news is (yes, there is good news) that as the Fed begins to tackle inflation, it does so with the U.S. economy in a position of strength for underlying economic fundamentals are solid. The labor market is historically strong, housing fundamentals remain robust, retail sales remain resilient, consumer and business balance sheets are in decent shape and overall confidence levels, while down, are near historical averages.

The labor market has strengthened of late as weekly initial unemployment claims continue to drop and reached a level of 187,000 in March, which is the lowest reading since September 6, 1969. This statistic is just one indication of labor market strength. Over the past six months, monthly job gains have averaged 583,000 per month. Over the past year, average hourly wages have grown +5.0%, and for each unemployed person, there are 1.8 jobs currently available. Even Federal Reserve Chair Jay Powell noted in a recent statement that "in many ways, this may be the tightest labor market ever."

Housing has been a major contributor to economic growth especially coming directly out of the COVID lockdown era. While housing data has cooled off a bit, the underlying fundamentals remain good as inventory levels are muted, home builder confidence is high, demand is strong, and annual home price gains have persisted at a vigorous mid-to-high teen percentage pace, although we do expect home price percentage gains to decelerate as housing affordability is strained due to these prices gains and higher mortgage rates.

Chart 3 – Federal Housing Finance Agency – Home Price Index



In March, the Fed lowered forecasted 2022 U.S. economy growth to 2.8% from 4.0% last December. The consensus Wall Street 2022growth forecast has also been lowered to 3.5% growth from their December forecast of 4.0%. Going forward, expect downward revisions to economic and earnings growth and continued elevated volatility within stock and bond markets. The challenges surrounding the supply chain, inflation, the Ukrainian conflict, and the Fed will pressure markets until there is more clarity on their resolution.

The self-fulfilling prophecy of inflation has taken root. The dramatic and historic rise in bond yields last quarter clearly indicates the bond market believes the Fed is behind the curve on the inflation fighting front. The Fed’s notion of a soft economic landing will be transitory. We continue to employ a defensive tactical strategy favoring a modest underweight to stocks and a shortening of bond duration to limit interest rate risk.

Prepared by Perry Adams – SVP & Director – West Shore Bank Wealth Management – April 6, 2022

Sources: FactSet, The Federal Reserve, U.S. Department of Labor, U.S. Bureau of Economic Analysis, Federal Housing Finance Agency