



Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

First Quarter of 2022

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Executive Summary

- It was a disappointing quarter with global equity markets down across the board, suffering their worst and most volatile quarter in two years. The U.S. market ended the quarter down -5.3%, developed international market equities down -5.9%, and emerging markets lost -7.0%.
- The reasons for the downturn? Markets reacted to inflation surging to its highest level in four decades, the onset of Russia's war with Ukraine and its impact on supply chains and energy prices, and the Federal Reserve embarking on an interest rate increase plan whose pace investors are struggling to handicap.
- The Fed's abrupt change in strategy hit bond returns hard. The 10-year bond, the U.S. benchmark for fixed income, declined by -5.9%, its worse quarterly decline since 1980, showing how quickly the market reacted to this new stance.
- The only positive corner of the market was the commodities complex, with energy up a stunning +39% and the complex as a whole up almost +26% in the quarter due to sharply higher prices for energy and wheat following Russia's invasion of Ukraine. As a result, most ESG equity funds underperformed their standard counterparts because they are typically underweight conventional energy.
- Given the Fed's actions, our quarterly report focuses on monetary policy and frames out some of the implications of investing in what may be a new economic regime. As we argue, the coronavirus pandemic may mark the dividing line between the deflationary forces of the last 30 to 40 years and resurgent, and maybe even persistent, inflation. The Federal Reserve's main tool to fight inflation is its ability to raise interest rates, hence we look closely at investing in a secular rising interest rate environment.
- **Artemis strategy.** In the quarter, we made some equity moves, including reducing the growth tilt in all portfolios and trimming our overall technology disruption sleeve, while also introducing some clean technology exposure. As for fixed income, we became even more defensive and are holding cash (money market) as an allocation for the first time in years.

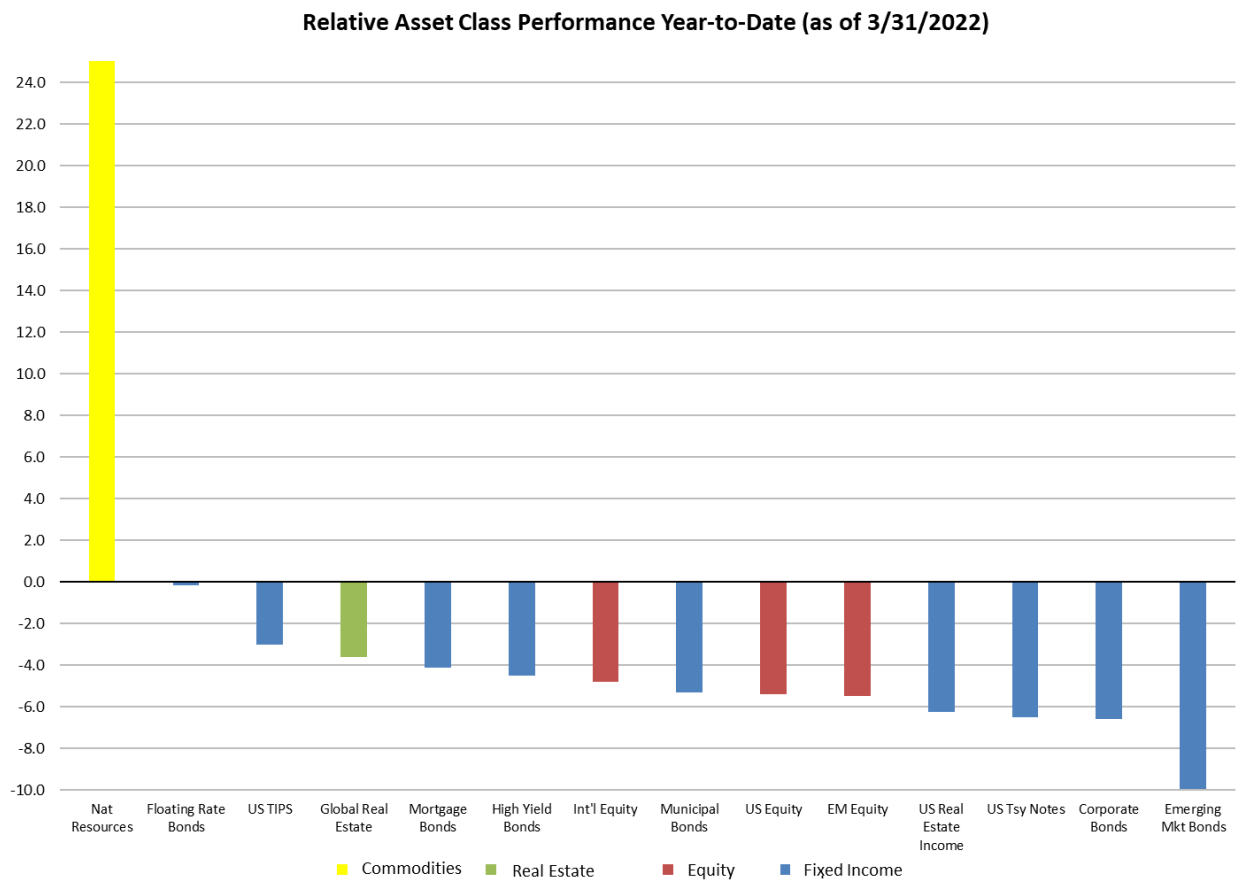


Markets in Review – Q1

It was a disappointing quarter with global equity markets down across the board, suffering their worst and most volatile quarter in two years. The U.S. market ended the quarter down -5.3%, developed market equities down -5.9%, and emerging markets lost -7.0%.

Markets reacted to inflation surging to its highest level in four decades, the onset of Russia’s war with Ukraine and its impact on supply chains and energy prices, and the Fed embarking on an interest rate increase plan whose pace investors are struggling to handicap. Indeed, one might argue the carnage could have been worse -- and almost was, except for a late-quarter rally. See Figure 1.

Figure 1. Asset Class Returns in USD for Q1 2022 (%)





The overall decline in the markets during the quarter masked some interesting divergences in outcomes. U.S. value stocks (-0.7% for the quarter) strongly outperformed growth stocks (-9.0%) with some eye-popping declines among shares of big technology companies who have been the biggest market leaders of the past decade. Meta (formerly Facebook), for example, had its worst quarter since its shares started trading publicly in 2012 and was one of the biggest losers within the S&P 500 during Q1, down -39%. Other former market leaders also struggled. Netflix Inc. lost -38% during the quarter, its worst period since 2012. PayPal Holdings also lost around -39%, its worst quarter on record, and Salesforce.com (-16%) finished its worst quarter since 2011.

Another divergence opened between environmental, social and governance (ESG) equity funds and their standard counterparts as the former typically hold a much lower allocation to conventional energy. With energy increasing by +39% in the quarter and almost every other sector in negative territory, it is no surprise that ESG funds sharply underperformed.

Finally, we also saw a divergence in emerging markets. Share prices in China were sharply lower, and shares in Hong Kong and Taiwan also fell. The number of Covid cases in Hong Kong and China spiked to their highest level in more than two years during the quarter, despite the Chinese government pursuing one of the world's strictest virus elimination policies. In contrast, Latin American markets all generated strong gains, led higher by Brazil. Also doing well were emerging market net commodity exporters, including Kuwait, Saudi Arabia, and South Africa. (Note: Russia was removed from the MSCI Emerging Markets Index on March 9, at a price that is effectively zero.)

Fixed income also had a very tough quarter with the U.S. benchmark for fixed income declining by -5.9%, its worst quarterly decline since 1980. (As will be discussed in more detail in the next section, most type of bonds do not provide protection in a sharply rising interest rate environment.) Central banks around the world, and the Federal Reserve in particular, became more "hawkish" (i.e., favoring monetary tightening) due to rising inflationary pressures; as a result, bond markets raced to price in this new stance. The U.S. Treasury market had one of its worst sell-offs on record with the 10-year yield moving from 1.51% to 2.35% and the two-year yield rising from 0.73% to 2.33%.

Other bond segments struggled as well. U.S. corporate bonds saw significantly negative returns (-7.7%), underperforming Treasuries, and municipal bond prices also reset down. The best segments of the fixed income universe were floating rate bonds and TIPS (Treasury inflation protected securities). Notably, these two segments are designed with protection during times of rising interest rates.



Indeed, the only positive corner of the market this quarter was the commodities complex, up +25.5% due to sharply higher prices for energy and wheat following Russia’s invasion of Ukraine. The energy market alone returned a stunning +39% as Russian sanctions led to global supply imbalances. Of note is that other so-called real assets such as real estate did not provide inflation protection, nor did cryptocurrency (Bitcoin lost 15% during the quarter), as some have argued they would do. Gold, however, did outperform, and was up +8% in Q1.

Brave New World – Investing in a Rising Rate Environment

For the last 40 years, interest rates have been marching lower for a whole host of reasons including demographic shifts, the deflationary effects of technological change, and globalization, and the rise of “capital-lite” industries. All of these forces led to an enormous global surplus of savings putting downward pressure on interest rates – quite simply, governments and companies have not had to pay much in terms of interest to entice lenders to lend. See Figure 2.

Figure 2. Long-term Treasury Yield in Perspective



That world seems to be changing and these changes seem to be coming at a rapid pace. As a result, the investment environment today feels very different than it did just six months



ago. For one, the long glut of inexpensive labor that has kept prices and wages down for decades appears to be giving way to an era of worker shortages, and hence higher prices. The Russian invasion of Ukraine may be putting an end to globalization, which will only exacerbate the new trends. In effect, the coronavirus pandemic may mark the dividing line between the deflationary forces of the last 30 to 40 years and resurgent, and maybe even persistent, inflation.

It is admittedly early days to be claiming that we are in a whole new world, and there are many who argue that while current inflation is becoming more entrenched, it will begin to subside once economies normalize after the pandemic and supply chains return to pre-pandemic efficiency. If so, then governments may not need to raise interest rates very much in the end. But since we may be at an inflection point, it seems important to identify and consider the implications of investing in a secular rising rate environment as that may be exactly where we find ourselves.

So, what does a secular rising rate environment mean?

- 1. Bonds don't provide portfolio protection*

The most direct implication is what we all painfully felt during the first quarter of this year – that in a rising rate environment, most types of bonds don't act as a portfolio ballast. This is because as interest rates go up, bond prices decline. To understand why, assume you purchase a \$1,000 bond that pays 4% annual interest over its term. Now suppose interest rates rise and borrowers who are selling new bonds increase the interest rate they offer to 5% to induce sufficient lenders. All new lenders are going to want to purchase the new bonds that pay 5%, not the existing issues paying 4%. To entice new lenders to buy existing bonds, the price of the existing bonds must decline such that the effective yield on the existing bonds becomes equivalent to 5%.

- 2. We don't know how high rates may need to go*

Interest rates are currently rising in response to the Federal Reserve and other central banks raising short-term policy rates (e.g., the so-called Fed funds rate set by the Federal Reserve) to slow economic growth and inflationary pressures. No one knows how much interest rates are going to have to rise, which puts the Fed in a tricky spot as it attempts to cool the economy enough to bring down inflation, but not so much that it spurs a pullback in spending and increases unemployment.

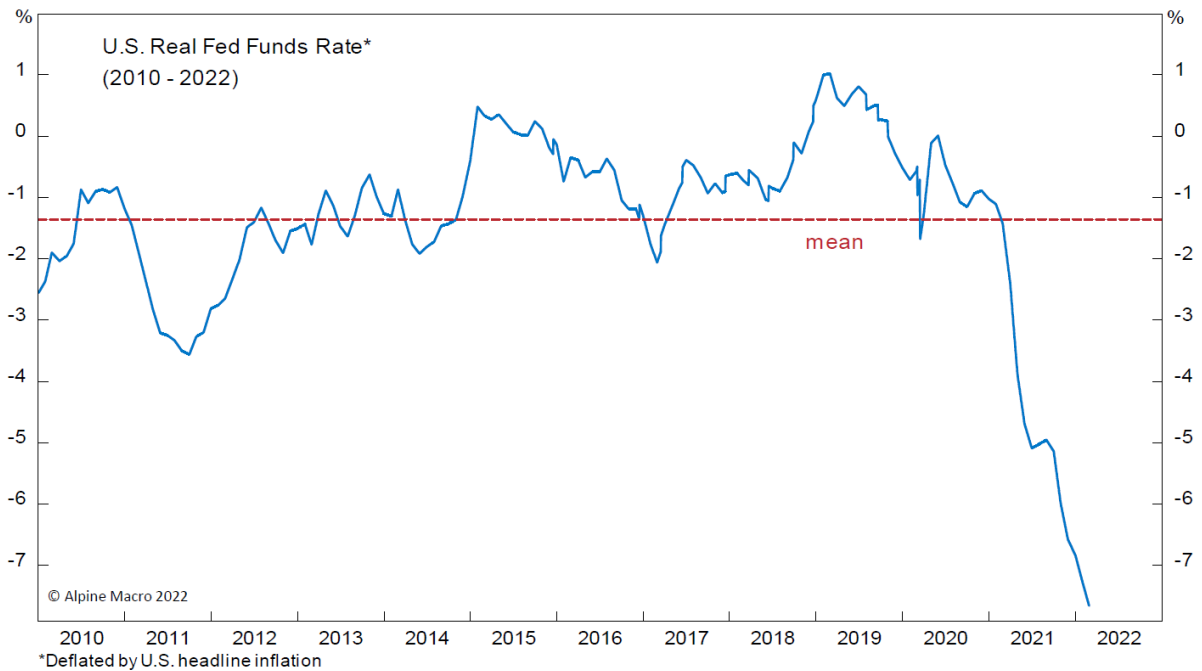


One school of thought argues that current inflation is largely the product of excess demand due to over-stimulating the economy during the pandemic and that the Federal Reserve has been too slow to respond. Indeed, a mere glance at the chart below (Figure 3) shows the real (after-inflation) short-term interest rate is currently a stunning -7%, and clearly suggests that if inflation doesn't dissipate soon, the Fed is going to have to very aggressively raise rates.

Other experts believe that current inflation is still largely due to supply-side shocks – the pandemic and now the Russia/Ukraine war – that have had and continue to have damaging effects on supply chains, labor supply, and energy supply.

Which of these is the only or the primary cause of inflation leads to different solutions. If you believe inflation is primarily a demand-side problem, then the fix is to jack up interest rates to discourage consumption. If inflation is primarily a product of supply-side constraints, then fixing the ports, providing incentives to get folks back to work, and increasing energy supply will work better. In the supply-side situation, inflation should trend lower without significant or prolonged central bank actions and a resulting economic slowdown.

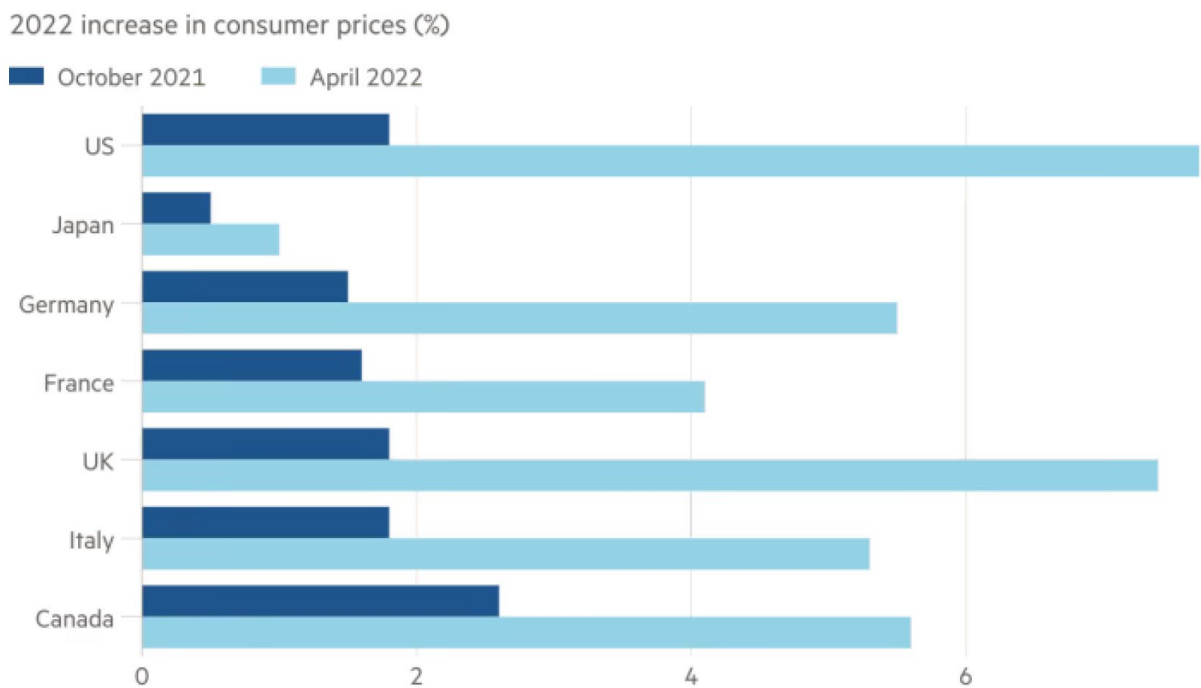
Figure 3. Real Fed Funds Rate in the U.S.





Larry Summers, a former Treasury secretary and now Harvard University professor, is a key proponent of demand-induced inflation explanation, and he has been critical of the Biden Administration’s \$1.9 trillion coronavirus relief bill passed in the spring of 2021. In his view, it was too much money following on the heels of other stimulus programs and is now leading to a wage-price spiral. In such a spiral, workers win higher wages to keep up with rising prices, and then those higher wages prompt firms to raise prices further. The demand-wage school of thought argues that Fed will have to raise rates aggressively to choke off demand and break this dynamic. This is increasingly the view of the International Monetary Fund (IMF) as well, which just published rather startling new estimates for global inflation in 2022 that marks a sea change in the estimates they published just six months ago. See Figure 4.

Figure 4. IMF Inflation Forecasts – October 2021 versus April 2022



Source: IMF



3. Housing market appreciation is set to slow

Another implication of a rising rate environment is that interest rate sensitive sectors are going to feel the pinch early. The residential real estate market is one such sector with mortgage rates now topping 5% for a 30-year fixed rate mortgage. As one (real estate agent) client told us, every one percentage point rise in mortgage rates knocks \$100k off what a buyer can borrow (on a \$1.0M initial mortgage) and still have the same monthly mortgage payment.

Before anyone panics about carnage in the housing market as happened in 2008, there are a couple of key differences from conditions at that time compared to today. For one, many developed countries are suffering a structural shortage of homes to buy as the industry failed to build sufficient homes relative to demand over the last decade. Second, lending standards have been tighter over the last decade with many fewer sub-prime mortgages so higher interest rates shouldn't be as destabilizing as they were in 2008. But higher mortgage rates will have some impact and are already starting to do so in some of the more expensive coastal markets. (And homebuilders' stock prices are off almost 40% year to date.) Of course, much will depend on how high rates move.

4. Equity returns may also suffer

Bill Dudley, former president of the New York Federal Reserve, recently said: "It's hard to know how much the U.S. Federal Reserve will need to do to get inflation under control. But one thing is certain: to be effective, it has to inflict more losses on stock and bond investors than it has so far." We agree, because tightening monetary policy stops inflation by destroying jobs, lowering investment, and frankly, making people poorer. In summary, shrinking liquidity, peaking economic growth, and rising interest rates cannot be a good story for equities, especially when P/E multiples for the key indices remain high.

5. We may see a recession

But what really makes stocks correct is a recession. The stock market often holds up well in the early stages of a Fed tightening cycle, only keeling over once higher interest rates have shown signs of weighing on the economy and recession is looming. What Dudley and others are saying is that the Fed will be forced to push the economy into recession to stop inflation. Not everyone agrees with this point of view, but the odds are increasing. Recessions are extremely difficult to predict -- and we are no sages -- but the more inflation



becomes entrenched, the more likely one becomes, and this is a very tough balancing act and a challenging position for the Fed.

6. The classic 60/40 portfolio will disappoint?

The finance literature is once again replete with predictions that the trusted 60% equity and 40% fixed income portfolio is dead. We are not so sure. Wall Street loves to belittle the 60/40 portfolio as it offers them the opportunity to showcase all sorts of alternatives such as tail risk hedges, various hedge fund strategies, private lending, and the like. If history is any guide, most of these will disappoint, except for the fees generated for the providers.

Simpler investments such as commodities and gold, which might provide some protection against inflation over a decade, are already up a lot because of the current inflation. Stocks may not be pristine, but in our view they are better than most alternatives at this stage. Moreover, if interest rates continue to increase over the next year or two and inflation peaks, fixed income will start delivering decent returns again.

In summary

The key issue is that prevailing view of the last year that inflation was transitory, due largely to covid-induced supply disruptions, has been put to bed. The new prevailing view is that while supply disruptions are a driver of inflation, so too is the consumer spending boom, which hasn't let up, and new complications piling on from Russia's invasion of Ukraine. With both supply-push and demand-pull inflation comingled, the Fed is dealing with a highly complex situation in the near term.

Artemis Strategy

So what to do? The current market is not for the meek, but that doesn't mean freezing in place. We leaned into growth when the pandemic hit and this strategy paid off well. But as we have written before, growth stocks tend to lose some of their attractiveness in a rising rate environment, especially those that are richly valued. As such (and since early last year), we have been steadily rebalancing our growth / value mix to be more neutral (i.e., similar in weights), and we made more progress in January and February. Our portfolios still have a bit of a growth tilt (owing to the technology disruption sleeve that we also reduced) but much less than even a year ago.

In addition to trimming our overall technology disruption exposure, we also swapped out of the early all-in-one technology disruption fund we invested in to introduce exposure to



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emerging clean technologies. We have been wanting to do this for some time now, but many of the options were too expensive until recently. We also think the timing is good as the Russia/Ukraine war has laid bare the flawed strategy of remaining dependent on fossil fuels. Please see the addendum to this report to learn more about the fund we selected.

As for fixed income, we have been more aggressive as it became clear that bonds were going to be in trouble in this environment. To mitigate some losses, we have been selling corporate bonds and holding the proceeds in cash. This is an atypical move for us and we don't expect to hold the cash for long, but it's painfully obvious that cash is earning more than fixed income at the moment. Bond rates are resetting at a record pace in anticipation of the Federal Reserve's actions, so we believe certain segments of the bond market will regain their appeal for people with cash to put to work.

We sold out of our real estate income fund and moved these proceeds into an investment-grade floating rate fund. This fund won't earn a lot but should hold its own as the rate it pays "floats" higher when rates rise.

Finally, we remain optimistic on the long-term prospects of the market and global economy. Corporations continue to post solid earnings, innovation and technological advancements are progressing, and the consumer has proven resilient over time. As such, we are still fully exposed to the equity market, albeit more defensively as we are all long-term investors, but we have notably become very defensive at the moment.



Market Index Descriptions (for Figure 1)

Equities:

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **FTSE Emerging Markets All Capitalization China A Inclusion (net)** is a market cap-weighted index representing the performance of large-, mid- and small-capitalization stocks in emerging markets.

Fixed Income:

The **Bank of America Merrill Lynch U.S. Treasuries 7-10 Year** measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years.

The **Bank of America Merrill Lynch U.S. GNMA Mortgage Backed Securities Index** is a market cap-weighted index, including generic-coupon Ginnie Mae mortgages, with at least of \$150 million principal amounts outstanding.

The **Barclays Capital 1-15 Year Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities having at least one year and less than 15 years remaining term to maturity.

The **Bank of America Merrill Lynch U.S. Corporate 5-7 Year** measures the performance of U.S. dollar denominated investment grade rated corporate debt having at least five years and less than seven years remaining term to maturity.

The **J.P. Morgan Emerging Market Bond Global Core** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.



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The **Bloomberg Barclays U.S. Treasury U.S. TIPS** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.

The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **S&P Global REIT Index** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade-rated corporate debt publicly issued in the U.S. domestic market with a maturity of at least one year remaining.

The **S&P/LSTA U.S. Leveraged Loan 100** reflects the performance of the largest facilities in the leveraged loan market.