Q1 2022 Quarterly Economic Review

By Hancock Whitney Asset Management
April 2022

Challenges Trigger a Rocky Start to 2022

By David Lundgren, CFA EVP, Chief Investment Officer & Executive Director

Index Return Summary as of 3-31-2022										
Index Name	**1Q 2022**	**Mar-22**	**Feb-22**	**Jan-22**	**4Q 2021**	**3Q 2021**	**Year to date**	**Last 12 months**	**Last 3 Years***	**Last 5 Years***
Equity										
S&P 500	**-4.6%**	3.7%	-3.0%	-5.2%	11.0%	0.6%	-4.6%	15.6%	18.9%	16.0%
Dow Jones Industrial Average	**-4.1%**	2.5%	-3.3%	-3.2%	7.9%	-1.5%	-4.1%	7.1%	12.6%	13.4%
S&P MidCap 400	**-4.9%**	1.4%	1.1%	-7.2%	8.0%	-1.8%	-4.9%	4.6%	14.1%	11.1%
S&P SmallCap 600	**-5.6%**	0.4%	1.4%	-7.3%	5.6%	-2.8%	-5.6%	1.2%	13.6%	10.9%
MSCI Europe, Australasia and the Far East (EAFE)	**-5.9%**	0.6%	-1.8%	-4.8%	2.7%	-0.4%	-5.9%	1.2%	7.8%	6.7%
MSCI All Country World Index (ACWI)	**-5.4%**	2.2%	-2.6%	-4.9%	6.7%	-1.1%	-5.4%	7.3%	13.8%	11.6%
Equity Satellites										
MSCI Emerging Markets (EM)	**-7.0%**	-2.3%	-3.0%	-1.9%	-1.3%	-8.1%	-7.0%	-11.4%	4.9%	6.0%
MSCI World Ex USA Small Cap	**-7.1%**	0.6%	-0.9%	-6.8%	0.4%	0.8%	-7.1%	-1.3%	10.0%	8.2%
MSCI Frontier Markets	**-7.9%**	-0.1%	-4.4%	-3.5%	0.7%	3.4%	-7.9%	9.4%	7.3%	6.0%
Bloomberg Commodity	**25.5%**	8.6%	6.2%	8.8%	-1.6%	6.6%	25.5%	49.3%	16.1%	9.0%
MSCI US Real Estate Investment Trusts (REIT)	**-4.1%**	6.5%	-3.2%	-6.9%	16.3%	1.0%	-4.1%	26.2%	11.1%	9.6%
Alerian Master Limited Partnership (MLP) Infrastructure	**19.3%**	1.9%	5.3%	11.1%	0.9%	-6.3%	19.3%	37.9%	1.5%	-1.1%
Fixed Income										
FTSE World Government Bond Index (WGBI)	**-6.5%**	-3.4%	-1.1%	-2.1%	-1.1%	-1.2%	-6.5%	-7.7%	-0.1%	1.3%
Bloomberg Barclays U.S. Intermediate Aggregate Bond	**-4.7%**	-2.5%	-0.8%	-1.5%	-0.5%	0.0%	-4.7%	-4.4%	1.2%	1.7%
Bloomberg Barclays Municipal 1-10Y Blend 1-12Y	**-4.8%**	-2.3%	-0.3%	-2.2%	0.2%	0.0%	-4.8%	-4.0%	1.0%	1.8%
Bloomberg Barclays US Corporate High Yield	**-4.8%**	-1.1%	-1.0%	-2.7%	0.7%	0.9%	-4.8%	-0.7%	4.6%	4.7%
Bloomberg Barclays US Universal	**-10.0%**	-0.9%	-6.5%	-2.8%	-0.4%	-0.7%	-10.0%	-7.4%	0.0%	1.7%
JPMorgan Emerging Market Bond Index (EMBI)	**-6.1%**	-2.7%	-1.4%	-2.2%	0.0%	0.1%	-6.1%	-4.2%	1.9%	2.3%
* Annualized										
Source: Morningstar										

After a very solid year for equity markets in 2021, stock stumbled out the gate in 2022 producing negative results for most major indices for the quarter. After dealing with the pandemic for most of the last two years, it appeared we were turning a corner on COVID, at least here in the United States, and then a new challenge emerged as on February 24th, Russia invaded Ukraine. As a human tragedy was unfolding with significant loss of life and millions forced from their homes, markets and economies had yet another new challenge to face. Many equity investors rushed to the sidelines until greater certainty could be achieved leading to increased volatility and the first market correction (decline of more than 10%) for the S&P 500 since March 2020.

Most of the developed world united and issued sanctions to punish Russia economically for their actions. While these sanctions caused significant financial stress on the Russian economy, markets and currency, the rest of the world felt reverberations as well. While Russia's share of global GDP is only about 3%, they are a significant exporter of natural gas, oil, minerals and agricultural products. Disruption in the energy markets as a result of sanctions led to a surge in the price of oil and many other commodities. Prior to the invasion, inflation was running at levels not experienced in almost 40 years. The recent surge in energy prices further exacerbated existing inflation problems reducing consumer purchasing power and in turn threatened to derail economic growth here in the U.S. and abroad.

Generally bonds are considered a safe haven during times of market stress, but this quarter was clearly an exception. Surging broad based inflation, tight labor markets, nagging supply chain bottlenecks and increasingly aggressive Federal Reserve rate hike expectations combined to drive the sharpest quarterly decline in U.S. Treasury returns since the U.S. Treasury index inception in 1973. The broad based investment grade Bloomberg U.S. Aggregate Bond Index declined -5.9% for the quarter, marking the second worst quarter since the index's inception in 1976. Tough policy guidance by Federal Reserve policymakers amid soaring inflation played the major role in the quarter's rise in interest rates. The Fed spent the first two months of the quarter completing the wind down of its pandemic related quantitative easing (QE) program and then in March the Fed policy committee voted to raise overnight rates by 0.25% as expected. Fed Chairman Jay Powell's pointedly hawkish rhetoric in his March post meeting commentary caught investors by surprise as he stated rate hikes are on the table at each of the remaining six meetings of 2022. Powell assured listeners the U.S. economy is solid and can handle higher rates. Again the fixed income markets heard Chairman Powell's message and traded rates sharply higher in response. It's very interesting though that in the weeks following the Fed's launch of an expected string of Fed Funds rate increases, U.S. Equity markets rallied sharply, suggesting markets are encouraged by the Fed's determination to address its inflation challenge in a deliberate and aggressive manner.

The backdrop is a difficult one as the Fed tries to reverse many of its extraordinary pandemic related policies and move back to a more neutral position while navigating a 'soft landing' for the economy. While 1Q22 is likely to be a downbeat correction to the overly robust 4Q21, likely in a 1.5-2.0% Q/Q AR, we continue to expect 2022 as a whole to exhibit solid growth around 3.0%, as the U.S. economy inevitably slows toward long-term norms.

Below are additional highlights of the quarter and in the pages to follow the Hancock Whitney Asset Management team discusses other noteworthy events in more detail. We hope you enjoy this review and as always please reach out to any Hancock Whitney associate to discuss your personal financial situation.

Ukraine

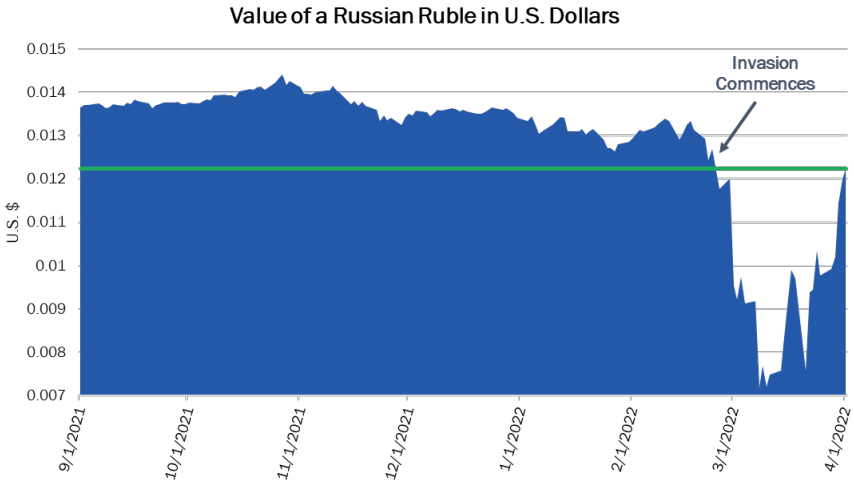
By Stephen Morgan, SVP, Investment Director – Wealth Portfolio Management

- Undoubtedly, the Russian invasion of Ukraine has been the geopolitical story of the quarter and most probably of the year and possibly the decade. The military action has disrupted global trade dynamics, inspired new sanctions regimes, re-awoken nuclear fears, and inspired significant shifts in government policy including a newly invigorated commitment to the North Atlantic Treaty Organization (NATO).
- The military evolution of the invasion has been surprising to many observers. What was widely considered the world's second most powerful military has been fought to a standstill, hobbled by logistics issues that have created shortages of ammunition and fuel in the invasionary force. Early Russian advances from the north toward the Ukrainian capital of Kyiv have been repelled with Russian forces withdrawing in order to concentrate on regions in the west and south of Ukraine where Russia has seen greater success. Despite setbacks on the ground, Russia has continued a program of bombardments across Ukraine, including targets in far west close to Lviv and the border of Poland, a NATO member who has served as both an exit point for refugees and an entry point for military aid to Ukraine.
- Russian advances from Crimea in the south of Ukraine and from separatist regions in Donbass in Ukraine's east have made somewhat better gains than those in the north, though fighting in the region remains brutal. The important port city of Mariupol on the Sea of Azov has emerged as a center of the war's humanitarian crisis as the city, including civilian housing, hospitals and shelters, has been reduced to rubble while thousands of civilians have been forcibly relocated into Russia.

Red shading indicates (roughly) areas under control of Russian forces.
(Source: iStock/PeterHermesFurian with alterations to show current situation by our author based on information from the Institute for the Study of War and The Associated Press.

- Even in the south, Russia's advance west toward Mykolaiv, headquarters of the Ukrainian navy, and the critical port of Odessa appears to have halted with troops moving to fortify the separatist Donbass region around Donetsk and Luhansk and the land corridor connecting it to Crimea.
- The United Nations estimates that more than 4 million people, about 10% of Ukraine's population, have fled to country due to the conflict and almost 25% of Ukraine's population have been displaced from their homes.
- A broad coalition of nations have imposed sanctions on Russia in response to the invasion, significantly curtailing Russian access to global funding and markets. The sanctions regime includes seizure of assets of both the Russian government and individual elites and is already hobbling the country's economy. Notably, the United States and its allies have revoked Russian "most favored nation" status (under various terms) while restricting imports of many Russian goods. Russia has also seen several of its most important financial institutions cut off from the SWIFT messaging system which enables cross-border transfer of funds between banks. In addition to official sanctions, many corporations including McDonald's, Coca-Cola, and Goldman Sachs have moved to curtail their Russian dealings beyond what may be demanded by governmental edict. The effects of the sanctions are likely to impact the Russian economy for years to come even if a quick resolution of hostilities were to arise.

- While the U.S. and Canada have announced a ban of Russian energy imports, the situation in Europe is more complicated as Russia provides a significant portion of the fossil fuel supply to the region. Nations across the continent have announced initiatives to curtail their dependence on Russian fuel. Poland has taken an especially aggressive stance with a plan to eliminate import of Russian oil by the end of the year while Germany has signed deal to receive liquefied natural gas (LNG) from other suppliers including the U.S. which has moved to authorize increased LNG export capacity.
- In the meantime, the Kremlin has demanded that payments for natural gas exports be made in Russian rubles, boosting demand for the currency in global markets. At least in part as a result of that strategy, the ruble has recovered from a significant drop that occurred at the outset of hostilities and the sanctions that followed. While this partially offsets the impact of sanctions, allowing Russia to conduct trade with non-sanctioning nations at more favorable terms, it is in our analysis only a bandage on the wounds inflicted by the global financial isolation being imposed on the country.



- U.S. President Joe Biden, meanwhile, has announced releases of crude supply from the Strategic Petroleum Reserve, most recently a million barrel a day release to continue for 180 days, representing a 30% drawdown in the reserve in an effort to contain spiking energy prices especially in the gasoline markets ahead of mid-term elections.
- While the energy markets remain a prime example, the Russian incursion into Ukraine has birthed uncertainty across a broad range of commodities markets including industrial metals and agricultural goods. Russia and Ukraine combined represent about a third of the global wheat and corn export markets and about half of the sunflower oil trade. We expect that there will be significant shortages in those goods as we move forward, potentially fomenting unrest in nations like Egypt dependent on those supplies.
- We continue to believe that a treaty guaranteeing that Ukraine will be officially neutral and not pursue NATO membership along with making territorial concessions to Russia is most probable outcome. There remains, though, significant possibility of other outcomes. Ukraine has, for example, said that it will not concede areas in the Donbass as part of ongoing peace negotiations.

Volatility Accompanies Uncertainty in Equities Markets

By Martin Sirera, CFA, SVP, Equity Product Management, Investment Director

As the world became a more volatile place in the first quarter of 2022, equity markets reflected that volatility and in the face of a number of rising risks, equity investors elected to retreat a bit, driving prices lower across a broad spectrum of equity market segments. Some optimism took hold in the final two weeks of the quarter igniting a moderately robust rally going into quarter-end. That rally however, was not enough to pull markets out of the red. The S&P 500 Index posted the first quarterly loss since the near calamity in the first quarter of 2020. Across the globe, the same mood was evident and equity markets declined in sync. At its low point in mid-March, the S&P 500 was off more than twelve percent, indicative of the intense feeling of risk-avoidance that investors in general were experiencing to that point.

Within the U.S., the long-term trend of Large Cap outperformance continued with both the S&P Mid Cap 400 and Small Cap 600 Indexes ending the quarter with bigger declines than the S&P 500. On the other hand, the other predominant long-term trend – that of Growth outperformance over Value – certainly hit a major roadblock, if not came to an end. Outside the U.S., all of the major regional and broad-based indexes underperformed the S&P 500. The uplift going into the end of the quarter indicates that weary, and wary, equity investors are searching for sources of optimism and finding them in some places.

Increasing Risks

The list of risks that are bedeviling equity investors late is full and in some cases, those individual risks are growing. The lists include geopolitical, fundamental and economic risks. Most prominent among them all is inflation. The destruction of purchasing power and the erosion of disposable income that the current spike in inflation has produced is a genuine threat. It threatens not only the sense of optimism that has been lifting equity prices ever higher since the pandemic low on February 23, 2020, but also in a very real and direct way threatens the health and well-being of households and business in the U.S.

The rally in stock prices that took hold in mid-March was almost certainly entirely due to a sense of relief that the U.S. Federal Reserve Bank and its Fed Open Market Committee (FOMC) had finally initiated the battle to tamper inflationary pressures. While many believe the Fed should have raised rates sooner, the announcement that the Fed would increase the overnight Fed Funds rate was met with a positive reaction that carried through to nearly the end of the month.

Investors have been focused on inflation for two clear reasons. First, of course, is the destructive nature of inflation alluded to above. As noted in the Economic Review, real wages (i.e., pay raises adjusted for the higher costs of living) have declined. In an environment of nearly full employment, employees are thus unable to enjoy the fruits of the higher demand for their services. This can be a real headwind to discretionary consumer spending. Secondly, even in this full-employment environment, the battle to arrest inflation carries its own risk, which has been magnified by the FOMC's arguably delayed reaction. In the past, an overly-aggressive Fed has sometimes been a catalyst, or at least a contributor to the ignition of an economic contraction as it continues to fight price increases even as the negative effects of those price increases take hold. The conflicting signals emanating from different maturity-segments of U.S. Treasury Yield Curve indicates that expectations for future growth are a bit unsettled in investors' minds.

Although the launch of an unprovoked war by Russia on its neighbor, Ukraine, dominates the daily news headlines, by itself it comes in no higher than second on the list. The main worry for markets are the derivative effects of the war: exacerbation of other problems that already existed like adding a few more percentage points to already astronomically high commodity price increases over the last 2 – 3 years. Those concerns merely compound the inflation concern, which already existed. Moreover, Eastern Europe is not the only cause for concern about global affairs. The growing unease in the western Pacific region, specifically the area of the Taiwan Strait and the South China Sea, should have everyone's interest heightened. China's dictator, Xi Jinping, seems to be building up to a bolder expression of mainland China's claim that Taiwan is its sovereign territory. The potential for a spark in that region grows constantly.

A few other risks are on investors' minds and deserve mention. Although the pandemic feels like it is in the rear-view mirror here in the U.S., there are problems in other places. China, for one, is currently pressing lockdowns in major parts of the country, most notable, the megalopolis of the Yangtze River Delta region, home to Shanghai. In that particular case, China's contribution to supply chain issues may not abate as fast as the world needs.

Beyond those items, businesses are still being confronted with ever-higher input costs. And while current profit margins are very healthy, they happen to be historically high. Input costs pressures (including employment cost pressures) threaten these very comfortable margin levels. Proposals of tax increases add to those concerns. And finally, the level of publicly held U.S. government debt is at a level previously unheard of: at or above 100% of annual Gross Domestic Product. A high debt burden is a threat to long-run economic growth.

Reasons For Oprimism

Despite the market's focus on risks in the first quarter, the picture is not entirely bleak. Weighing against those rising risks are a number of meaningful signs of improvement in the domestic economy. At nearly full employment, the U.S. economy is poised to transition smoothly out of the booming 2021 pandemic-rebound into a period of slow-to-moderate growth that could coax inflation down from its 5-decade highs. Concomitantly, receding virus threats to economic activity also provide an opportunity for consumers to expand their discretionary spending.

Outside the consumer segment, businesses have been keeping up a robust level of investment spending growth. Capital expenditures have been growing and business surveys generally show a willingness or intent to continue

that. Capex is a very important contributor to short-term and long-term economic growth and business profits. With this and other aspects of the current expansion in mind, analysts have been increasing their estimates for S&P 500 Sales growth. At the start of the year, the street estimated that Sales would increase about 6.8% in the full calendar year. Now, three months in, that estimate has risen to over 9%. Should those expectations be met or exceeded, aspect would provide solid support to equity prices.

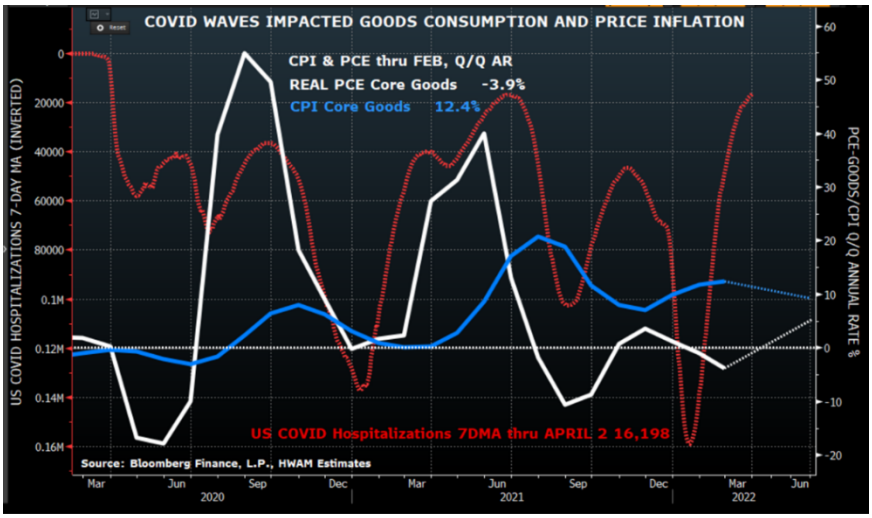
An Unclear Path Ahead

Equity markets continue to be in a transitional phase. The road ahead is by no means clear of obstacles that threaten the markets' sense of equilibrium. Inflationary pressures are high and appear to be rising still. Global unrest is the daily news providers' bread-and-butter. The fiscal affairs of the Federal Government are messy and seem to be getting messier. That said, consumer and business spending and investment in a full employment economy are a solid source of strength. Should the complete ending of pandemic threats domestically materialize sooner rather than later, a mild growth surge may follow. Yet markets are still overvalued. In this unclear and uncertain environment, a neutral posture relative to equity exposure and a sense of caution remains the best approach.

The Improving U.S. Economic Outlook is Disrupted by Inflation and the Ukrainian Invasion

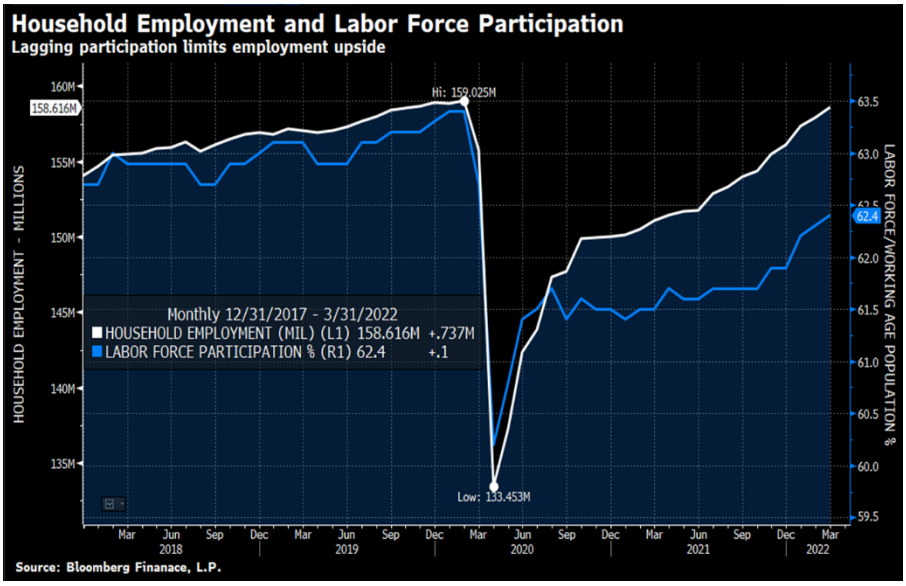
By Paul Teten, CFA, SVP, Chief Investment Strategist & Investment Director

As the first quarter opened the U.S. economy was riding a wave of strong growth in 2021 but suffering indigestion from an Omicron-impacted consumer spending pause late in the year. The full-tilt manufacturing sector over-built inventory, driving super strong 4Q21 Real GDP growth of 6.9% Q/Q annual rate, which led to moderating production schedules in 1Q22 to get back in sync. The most relevant domestic theme in the quarter was the disappearance of Omicron and emptying of COVID hospital beds, which fell to the lowest levels since the early days of the pandemic. Inflation continued to be a nagging worry, the supply chain doggedly disrupted, goading the Federal Reserve to guide expectations for rising short-term interest rates in increasingly aggressive language. The Russian invasion of Ukraine on February 24 was a very cold shower for dismayed Western democracies which had grown complacent through 77 years of crisis remediation by the U.N. Security Council, ironically chaired by Russia this year. Russian President Vladimir Putin has managed to unify the NATO alliance to an extent unimaginable before the hostilities commenced, at the cost of extensive sanctions and further disruption to the global supply chain, primarily impacting energy markets. As the quarter concluded, U.S. labor markets impressed with a sustained run of very strong payroll growth, a return to full employment and expanding labor force participation, the key building block of sustainable growth. Tentative signs also surfaced that the anticipated reacceleration of consumer spending is gathering steam, as well as some easing in the consumer goods logjam at U.S. ports. While 1Q22 is likely to be a downbeat correction to the overly robust 4Q21, likely in a 1.5-2.0% Q/Q AR, we continue to expect 2022 as a whole to exhibit solid growth around 3.0%, as the U.S. economy inevitably slows toward long-term norms.



U.S. COVID hospitalizations have fallen to the lowest levels since the early days of the pandemic, heralding the likelihood of accelerating economic activity in the months ahead. The Russian war in Ukraine has been extremely distracting, but the sense of Russian miscalculation is growing as the initial objective of a quick capture of Kyiv has faltered. The conflict is beginning to look more like a long war than a short battle, sometimes characterized as a quagmire. The risk that the violence escalates beyond Ukraine's borders is not

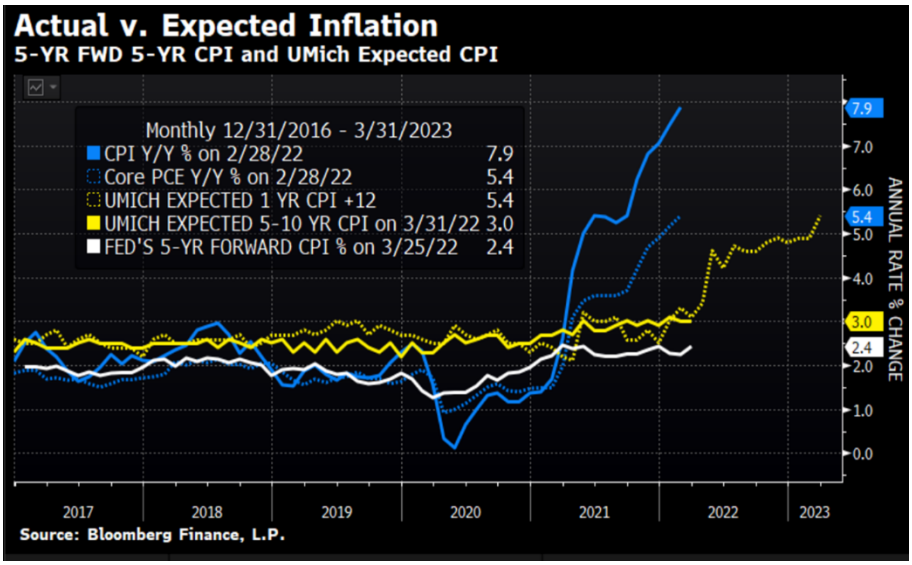
miniscule, but at this writing it appears Russia's objectives are shifting toward consolidating gains in the eastern Donbas region, establishing a fortified land bridge to the Crimean Peninsula and the Black Sea. That conquest in itself would capture a naval advantage worthy of Putin's dreams of empire. Our assessment is that the Ukrainian conflict and its captivation of public attention will likely diminish in the months ahead, notwithstanding weekly reminders at the gas pump, as the fully employed U.S. economy reaches for maximum productivity and output. The growth phase ahead is likely to see resurgent consumer spending, continuing capital investment in productivity-enhancing technologies, and with supply chain logistics improving, domestically at least, the beginning of moderation in consumer goods inflation.



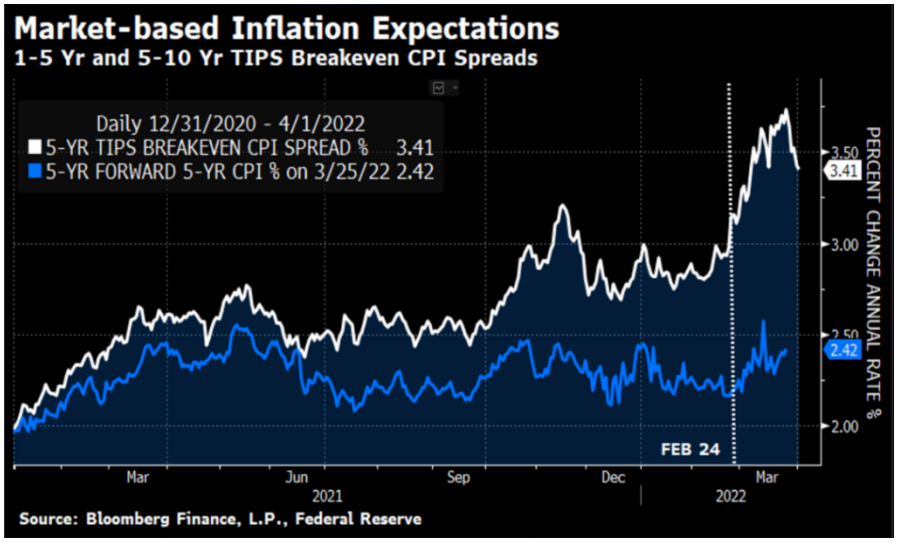
Household employment, a broader survey than non-farm payrolls which includes small business and entrepreneurial activity, grew by 737,000 in March, continuing a remarkable string of increases averaging 845,000 per month over the last five months. Total household employment clocks in a mere 200,000 under the February 2020 peak, so it's a fair statement to say the U.S. has achieved full employment. Other aspects of U.S. labor market conditions that reflect a fully employed economy include a 3.6% U3 unemployment rate, only 0.1% higher than the pre-pandemic peak, achieved as the civilian labor force grew by 2.8 million over the last six months, reflecting very strong employment opportunity. Of the marginally attached work force, including part-time and discouraged workers, all cohorts have returned to pre-pandemic levels, represented by the U6 unemployment rate falling to 6.9%, which, like the U3, sits only 0.1% above the 2020 low point. In support of improved logistics in the supply chain for consumer goods, transport and warehousing payroll growth is accelerating and growing at an 8.5% pace this year, compared to 4.8% overall. Labor utilization, reflected in the aggregate hours worked series and a key Real GDP proxy, has grown at an astonishingly consistent 4.6% rate over the last year. Continued robust employment growth, the foundation of economic opportunity, is unlikely to continue at recent rates as the U.S. economy hits the constraints of full employment. The only route forward to continue strong employment gains is expanding labor force participation, relatively anemic so far this cycle, but showing signs of improvement lately. Attracting part-timers, discouraged workers, retirees, teenagers, de-activated veterans and others into the labor force will be key to expanding national income and investment going forward.

The U.S. economy is ideally situated to fulfill employment opportunity and attract a growing labor force, with a high and unprecedented level of job openings over 11 million. In contrast, unemployment has fallen to 5.95 million, only 230,000 above the February 2020 low point. Our assessment is that unemployment has hit the practical floor and that the remaining idled workers have skill, health and/or educational challenges that make

them difficult to bring on board. Thus the 11 million job openings are focused intently on the marginally attached and potential workers referenced above. The gap between job openings and unemployment represents astounding opportunity in the U.S. economy. An extremely high percentage of the unemployed, running 13-15% in recent months, are job leavers who are looking for a better job, a characteristic of strong upward job mobility. The competition for these workers is intense and has resulted in the strongest wage gains in decades, averaging 5-6% over the last year.



The unfortunate qualifier of strong wage growth is that galloping inflation has erased it entirely and real wage growth has shrunk by 2% over the last year. That's the crux of the case for the Federal Reserve to coax inflation trends lower, the sooner the better and preferably without crippling the economy in the process. The Fed is confronting a daunting high-wire act, however our assessment is that there is a credible plausibility they will be successful. Our hypothesis has been that the global supply chain would slowly normalized this year, an expectation supported by strong hiring in the transport sector and falling container shipping rates, down 20% since last fall. China is a key player in the global supply chain and is struggling with COVID lockdowns. Violence in Ukraine has disrupted the energy and agricultural commodity markets. Both are detours to progress in the near-term but not likely to persist long-term. The University of Michigan consumer sentiment survey reports an expectation that the Consumer Price Index (CPI) will grow 5.4% in the year ahead, meaning that the last 12 months CPI increase of 7.9% is expected to begin to moderate significantly in the interim. We are encouraged by the steadfastness displayed in longer-term expectations for inflation, with the U. Mich 5-10 Yr. expected inflation measure and the Fed's market-based 5-10 Yr. measure projecting future inflation in a 2.5%-3.0% range, well anchored to the Fed's long-term inflation goals. While the Fed's preferred inflation gauge, the core personal consumption expenditures deflator, excluding food and energy prices, has grown a marginally less threatening 5.4% over the last year, it's undeniable that soaring food and energy prices are highly disruptive to consumer spending and hiring incentives. The U.S. economy will benefit enormously from an expected retreat in those volatile prices, which we expect to develop as the crisis in Eastern Europe passes in the months ahead.

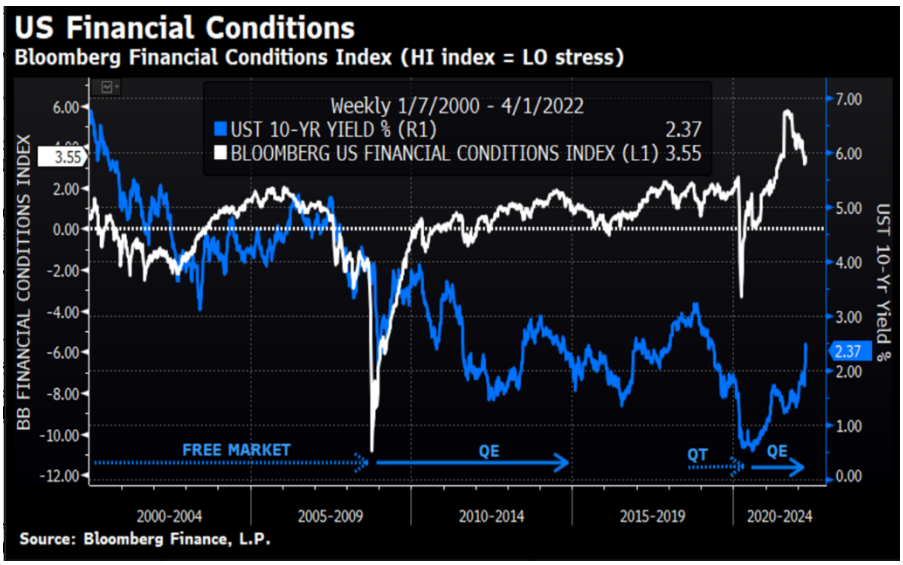


The contrast between market-based measures of expected inflation over the next 5 years and subsequent 5 years is telling. The spread between 5-Yr. Treasury Inflation Protected Securities (TIPS) and nominal Treasury 5-Yr. notes, reflecting an implied CPI rate over the 5 year period, rose from 2% to 3% in 2021 as last year's inflation surge began to impact future expectations. The 5-Yr. TIPS spread jumped further to 3.75% following the Russian invasion on February 24, projecting expected

disruption to energy and agricultural markets. Growing sentiment that the U.S. embargo of Russian oil will be ineffective in limiting Russian exports, and the Biden Administrations move recently to release 1 million barrels of oil daily from the Strategic Petroleum Reserve through year-end, brought oil prices down from the $120/bbl level to $99/bbl last week. Wheat is a major Ukrainian export, the price of which spiked sharply on the invasion, almost doubling, but which has retraced 60% of the post invasion spike in the last half of March. Those retreats in key commodity prices are reflected in the 5-Yr. TIPS spread dropping back to 3.41% at quarter-end. It's also worth noting that the 5-Yr. TIPS spread at 3.41%, driven by bond market participants placing bets on future inflation rates, is a long way down from the last 12 months' CPI at 7.9%. Market bets are pointing to the likelihood that recent CPI trends are at peak levels. And in that context, it's remarkable that the 5-10 Yr. TIPS spread continues fairly tightly in a 2.0-2.5% range.

There are several risks to our constructive view of solid economic growth in the U.S. this year, 3%-ish Real GDP growth trends, against market expectations around 2.6%, as expressed in the Bloomberg Survey; accompanied by cresting and moderating inflation in the second half. Prominent among them is continuing disruption to global markets from the Russian aggression, the outcome to which is exceptionally difficult to handicap. The market preference of course is over sooner rather than later. We expect it's a safe assumption that the vast majority of Americans admire the heroic resistance of the Ukrainians and pray for their success. The longer that takes the higher the cost to be borne, but the benefits are also immeasurable for an outcome that includes an energized NATO alliance, a weakened and perhaps re-directed Russia, and a more circumspect and perhaps less hegemonic China. We are also monitoring the possibility that the severe disruption to the energy markets from the war, intersecting with poor political prospects for the Biden Administration's congressional agenda, may coerce more realistic energy policies and regulation, promoting better domestic supply and infrastructure development to export liquefied natural gas to Europe.

Other risks include a possible resurgent COVID variant, which once again could be disruptive to consumer behavior. We don't rate that risk as particularly pressing, but who knows? Economically, the key risk is inadequate incentives for expansion of labor force participation, meaning high inflation that absorbs wage gains and income. Our expectation is that the Fed's monetary policy of raising the Fed Funds rate to the 2.5-3.0% range by mid-2023 is the right call, and will constitute a return to equilibrium policy, neither too loose nor too tight. The Fed's goal of returning core inflation to that same range is likely to get an assist from an improving supply chain, important signals for which are already flashing positive, as discussed earlier herein. The expected result is an inflation-adjusted Fed Funds rate around zero, which we assess as a neutral rate. Longer-term interest rates will probably rise modestly higher, finally rewarding savers who have subsidized the U.S. recovery from the 2008 collapse and the COVID lockdowns.



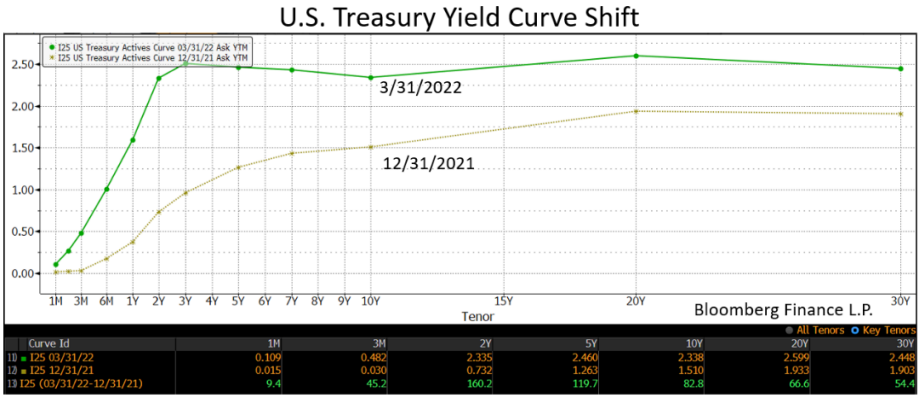
There is a lot of anxiety in the markets over the Fed's monetary policy reversal and fear that the Fed will overdo it and cripple the economy. Many point to the relatively flat yield curve, evidenced by the lack of much yield spread between Treasury 2-Yr. and 10-Yr. notes, which last week closed at -0.08%, a mildly inverted curve. We don't place much weight on that concern and assess the Treasury bond market as highly manipulated, and over-valued, by the Fed's bond buying programs in recent years, known as quantitative easing (QE). We are encouraged instead by the Fed's recent focus on liquidity signals from the money markets, relatively un-manipulated; and the very positive spread between 3-Mo. Treasury discount bills and 18-Mo. T- Bills, closing last week at a wide 2.69% spread, indicating a low level of liquidity stress. Similarly, we are guided by the Bloomberg Financial Conditions Index, which models a variety of liquidity measures and credit risk metrics, and which currently indicates a very low level of financial stress in the U.S. economy. The Index has declined modestly in recent months from very high levels as inflation surged and

markets were disrupted by the Russian war, but remains substantially above peak levels in 2000 and 2006. Note that the Index fell sharply in August 2007 through the zero line, when commercial paper markets first sniffed out the coming carnage in sub-prime mortgages. The stock market peaked two months later. The current signal confirms our assessment that the U.S. economy is on solid footing, with healthy private sector balance sheets, strong opportunity and productivity, and low recession risk in our foreseeable future.

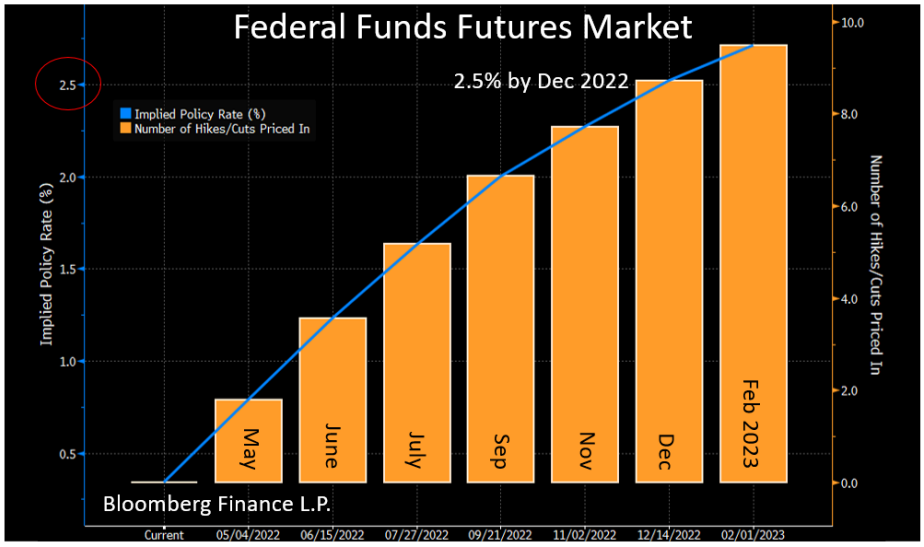
A Perfect Storm in the Bond Markets

By Jeffery Tanguis, SVP, Director of Fixed Income, Investment Director

A Perfect Storm of events led to the worst quarter on record for U.S. Treasury securities and the second worst for the broader U.S. investment grade fixed income markets. Surging broad based inflation, tight labor markets, nagging supply chain bottlenecks and increasingly aggressive Federal Reserve rate hike expectations combined to drive the sharpest quarterly decline in U.S. Treasury returns since the index inception in 1973. For 1Q2022 the Bloomberg U.S. Treasury Index declined -5.58%. The broad based investment grade Bloomberg U.S. Aggregate Bond Index declined -5.93% for the quarter, marking the second worst since inception in 1976. Interest rates across the curve began their ascent straight away on January 1st and trended consistently higher pausing only for two weeks in late February on safe haven demand spawned by the Russia/Ukraine conflict.



While Treasury rates rose across the curve during 1Q2022, the most dramatic moves occurred in the U.S. Treasury 2 year maturity where yields are most sensitive to anticipated Federal Reserve policy action. The Treasury 2 year yield rose +160 basis points to 2.34% during the quarter. The Treasury 10 year rose +83 basis points, also to 2.34%. The 30 year Treasury bond yield rose +54 basis points to 2.45%. Grabbing headlines and generating debate during the quarter was the "flat" yield curve as evidenced by the Treasury 2 yr./10 yr. yield differential. The yield curve slope is currently flirting with inversion having crashed from 78 basis points to 0 basis points at quarter end.



Tough policy guidance by Federal Reserve policymakers amid soaring inflation played the major role in the quarter's rise in interest rates. The Federal Reserve met twice during the quarter, in January and March. At each meeting, and any other opportunity, Chairman Powell sounded a progressively louder alarm about rising inflation, telegraphed the need for more aggressive policy action and worked to convince the markets the Fed will eventually curb inflation. As was expected the January meeting yielded no policy action. The Fed spent the first two months of the quarter completing the wind down of its pandemic related quantitative easing (QE) program. The QE program officially

ended in early March thus opening the door for rate hikes as well as the reverse program of quantitative tightening (QT). In the lead up to the March meeting Chairman Powell all but guaranteed a 25 basis point rate hike so little seemed left to investor's imagination. Interest rates rose into the March meeting as some investors speculated the Fed might surprise the markets with a 50 basis point hike. The Fed policy committee voted 8 to 1 to raise 25 basis points as expected. Powell later hinted he would have preferred a 50 basis point hike were it not for the global economic uncertainty wrought by the Russia / Ukraine conflict. The Russian conflict complicates the Fed's task as war and its related sanctions have exacerbated inflation further and elevated European growth concerns. Powell's use of hawkish rhetoric in his March post meeting commentary caught investors by surprise. Powell flatly stated rate hikes are on the table at each of the remaining 6 meetings of 2022 and 50 basis point hikes are possible. In conjunction an updated survey of committee rate expectations (the DOT PLOT) showed a similar rate path. The DOT PLOT further revealed the committee was prepared to raise rates to "neutral" or beyond in 2023. The Fed views the "neutral" rate currently to be in the 2.40% range for the federal funds target. The Fed's sense of urgency was unmistakable. The markets braced for higher rates. In late March in a speech to the National Association for Business Economics Powell upped his ante again by saying he intends to take interest rates "expeditiously" to neutral levels and even beyond if necessary to curb inflation. He was also ready to back multiple 50 basis point increases starting in May "if necessary". Powell assured listeners the U.S. economy is solid and can handle higher rates. Again the fixed income markets heard Chairman Powell's message and traded rates sharply higher in response.

Investor rate expectations experienced a seismic shift during the quarter. Bond investors began the calendar year expecting only 3 Fed rate hikes of 25 basis points each during 2022. The futures market now anticipate 9 to 10 rate hikes in 2022 thereby reaching the Fed's "neutral" level by mid-December 2022.

The credit markets in 1Q2022 were not immune to the volatile interest rate environment. Intermediate corporate bond spreads trended wider from the start of the new year. The Russia/Ukraine conflict ushered in even more investor caution. Bargain hunters began to emerge in mid-March after intermediate term corporate spreads had nearly doubled from their 2021 yearend levels. Corporate bonds spent the final 2 weeks of the quarter enjoying a strong rebound but it was too little and too late. For the quarter the Bloomberg Intermediate Investment Grade Corporate Index recorded a -5.25% total return. The intermediate term investment grade corporate bond index spread to Treasuries ended higher by 24 basis points to finish at +92 basis points. The U.S. Corporate High Yield market fared slightly better than investment grade credit thanks to the heavy influence of hydrocarbon based energy companies in the index. The Bloomberg U.S. Corporate High Yield Index suffered a -4.84% total return for the quarter while high yield spreads to Treasuries finisher the quarter +42 basis points wider to +325.

Policy and Politics

By Stephen Morgan, SVP, Investment Director – Wealth Portfolio Management

- Congress pushed through the omnibus spending bill that authorizes Federal spending for the 2022 fiscal year. After months of delays and deal making, the $1.5 trillion package saw relatively quick passage by bipartisan majorities once it was introduced in the House of Representatives early Wednesday morning. Passage came ahead of the Friday, March 11 deadline to avert a government shutdown, the legislation could not be signed into law by President Joe Biden until early the week of March 14. Thus, Congress also passed a final Continuing Resolution that sustained government funding until March 15 by which time the president had signed the bill.
- The package provides $730 billion in non-defense spending and $782 billion in defense spending. Both those represent about $42 billion in increases over the prior year, representing a 6.7% increase in non-defense spending and a 5.6% increase in defense spending. The bill provides $13.6 billion in military and humanitarian aid for Ukraine, per the White House's request. However, another administration request for additional COVID-19 funding was cut from the final version of the bill. Legislators have made movement to provide a scaled-back version of that spending separately. Planned spending for border wall construction—which Democrats had tried to remove—remains in the budget.
- Amid a backlog of tax returns and taxpayer inquiries, the budget also provides a 6% boost for the IRS, including $225 million to fund services to taxpayers.
- The administration released its $5.8 trillion budget proposal for fiscal year 2023 in late March. The proposal includes increases in defense spending along with additional funding for domestic law enforcement. It largely avoids specific requests for items in President Biden's marquee Build Back Better program, creating

instead a deficit neutral reserve fund as a placeholder for a future spending agreement between the White House and Congress. On the taxation side, the proposal includes increased taxes on the wealthy including a tax on unrealized capital gains. West Virginia Senator Joe Manchin, a leading Democrat, has already expressed opposition to the unrealized gain tax. The administration estimates that the budget proposal would reduce the deficit by about $1 trillion over the next 10 years. It is important to note that the proposal is just that—a proposal—and the eventual budget ratified by Congress could look significantly different, especially if mid-term elections shift the balance of power in the legislature.

- President Biden gave his first State of the Union Address to joint houses of Congress on the evening of March 1. The speech opened, unsurprisingly, on the unfolding crisis in Ukraine and the American response during which the President was able to engineer a rare bipartisan standing ovation in honor of the Ukrainian ambassador who was in the audience. He turned then to domestic issues and touted a number of items in his social agenda under the rebranded "Building a Better America" title. He also signaled a shift in the government's COVID stance, saying the virus "no longer needs to control our lives"
- Democrats failed in their attempts to enact significant voting right reform in the quarter, though efforts continue.
- President Biden nominated Ketanji Brown Jackson to fill the Supreme Court seat opened by the retirement of Justice Stephen Breyer. The Senate Judiciary Committee split evenly on a party line after its hearings. Despite the lack of recommendation from the committee, the full Senate was able to take up on the nomination on the floor and she was confirmed 53 -47 with three Republicans joining Democrats in supporting her appointment to the court.
- Democratic Senator Ben Ray Luján of New Mexico suffered a stroke early in the quarter, temporarily eliminating his party's ability to make a majority vote in that chamber. He has, however, since recovered allowing Democrats to push certain actions on a party-line with the Vice President acting as the tie-breaker.
- The president's nominations for senior positions at the Federal Reserve were temporarily blocked in the face of Republican opposition. However, Sarah Bloom Raskin who was particularly controversial due to her previously stated views on the role of banks in confronting climate change, asked to have her nomination withdrawn. With that, the remainder of the slate was freed to move ahead.
- On a related front, the Environmental Protection Agency announced a proposed new rule that would cut pollution from heavy vehicles like busses and trucks. The rule focuses on nitrogen oxides which are linked to asthma and other lung conditions and would see those emissions slashed by as much as 90% from new vehicles by 2031. It will also set updated greenhouse gas standards for certain vehicles. This is the first of a three-pronged set of rule proposals the EPA plans, with later prongs focused on medium-duty vehicles and greenhouse gas emissions from heavy duty vehicles.
- Meanwhile, the Securities Exchange Commission announced its long-awaited rules proposals for environmental and climate-change disclosures for public companies. The proposed rules would require publicly traded companies to include risks related to climate-change and environmental policy/sentiment in their filings and to provide statistics about various types of emissions. Once officially published, the proposals will have a period of public commentary before being finalized.
- The SEC also voted 3-1 to propose a rule that would limit the safe harbor for forward-looking statements and the use of projections by SPACs, require additional disclosures, and make companies acquired by SPACs liable for misrepresentations or omissions in merger documents filed with the agency.
- The Senate has enacted a version of the America Competes Act (which goes by many names including the U.S. Innovation and Competition Act) which would provide financial support for U.S. silicon chip manufacturing as well as other initiatives targeted at Chinese competiveness. The move allows the bill to go into conference committee where a final version can be drafted.

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