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Investment Market Review
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The war in Ukraine and inflation sent markets lower over the first three months of the year. The world watched in horror as Russian troops invaded Ukraine. Russia's attempt to topple the government in Kyiv was met with stiff resistance by the Ukrainians. Many anticipated that the military operation would be swift as the outnumbered Ukrainian forces would be overpowered by the Russian military. Yet, the war continues on without a clear path toward de-escalation.

Countries around the world imposed significant sanctions on Russia following the invasion of Ukraine. The sanctions targeted Russian oil, banking, airlines, and oligarchs and were designed to cripple the Russian economy and reduce funding for the military campaign.

The conflict in Ukraine has exacerbated the already existing inflationary pressures in the economy. Sanctions against Russia, which is one of the largest producers of oil in the world, caused oil prices to surge to over $120 per barrel in March, an increase of more than 100% over the last year. Rising oil prices pushed the national average price of gasoline to an all-time record of over $4.00 a gallon.

In addition to rising oil and gas prices and the massive government stimulus programs in 2021, lingering supply chain constraints have held inflation at generational highs. Inflation, as measured by the Consumer Price Index (CPI), increased 8.5% in March, the highest reading since 1981. Inflation has now been above the 50-year average of 3.9% for 12 straight months.

As expected, the Fed raised the federal funds rate by ¼ point at its March meeting in an attempt to bring inflation under control. The market is now projecting nine or more ¼ point rate hikes from the Fed in 2022, with growing expectations that they will raise rates by ½ point at one or more of the upcoming meetings. In addition to raising interest rates, the Fed also ended its fourth round of quantitative easing (QE4) that began in March 2020. Over the 24 months that QE4 was in existence, the Fed purchased a staggering $4.8 trillion of treasuries, mortgage-backed securities, and other loans in an attempt to support the economy through the pandemic. As QE4 comes to an end, the size of the Fed's balance sheet will shrink, serving as another tool to help tame inflation.

As the Fed starts raising interest rates and inflation remains high, bond yields have started to rise. After spending much of 2020 and 2021 between 0.5% and 1.5%, the yield on the 10-year Treasury bond reached 2.3% in March. While bond yields are still low by historical standards, they are approaching levels last seen in 2018. Rising rates will filter through the economy and result in higher mortgage rates and business financing costs.

All but two sectors in the S&P 500 fell during the first quarter. The energy sector, supported by rising oil prices, posted a market leading 39% gain for the quarter. Utilities were the only other sector in the index to record positive growth for the quarter with a more modest 4.8% return.

Value stocks outperformed growth stocks by a significant margin during the quarter. Our research indicates that value stocks tend to perform better than growth stocks during periods of high and rising inflation. That is exactly what we have experienced over the last couple of quarters.

A change in market leadership is evident when we examine the broad factors that drive market performance. In 2020, momentum stocks were the best performing group in the market (+30%) while value stocks were laggards (-0.2%). Momentum stocks are those that have outperformed over the past 6 to 12 months. In 2021 value stocks took over the top spot with a return of 29% and momentum stocks returned 13%. So far this year, stocks that fall in the defensive category are the only group that has posted positive returns, while momentum, small cap, and cyclical stocks are all down more than 7%.

As we have noted over the last few quarters, we remain laser focused on the trend in inflation. As such, we continue to search for companies that will thrive in a high inflation environment. That is not to say that we are abandoning our focus on quality growth companies. Rather, we are seeking to add some exposure to those segments of the market that will perform best should inflation remain elevated for longer than expected. As a hallmark of our investment strategy, our client portfolios hold high quality securities with strong safety profiles. During this period of ongoing volatility, we are even more cognizant of the need for defensiveness and safety.