HB RETIREMENT®

FINANCIAL MARKET SNAPSHOT

April 20, 2022

First Quarter Recap

The first quarter of 2022 proved to be very challenging for financial markets. In fact, it was the worst quarterly performance for both stocks and bonds since Q1 of 2020, the infamous Covid lockdown quarter.

Investor concerns that lead to the market pullback included a spike in January's daily Covid cases, continued supply chain constrains, persistently high inflation, geopolitical and economic uncertainties raised by the Russian invasion of Ukraine, and heightened worries that a quicker pace of interest rate hikes needed to combat inflation could potentially result in a Fed policy mistake. This myriad of concerns caused investors to reassess risk and reduce global growth rates, prompting a sharp sell-off in equity markets during the quarter. As a result, the S&P 500 declined 4.6% in Q1, while the Nasdaq fell 8.9% and the Dow Jones Industrial Average dropped 4.1%.

Fixed income securities – which have historically provided more of a safety haven during volatile time periods – were not immune to the selloff either. In fact, the Bloomberg U.S. Aggregate Bond Index declined 5.9% in Q1 and recorded its worst quarterly performance since late 1980, and its third-worst quarter since the index's inception. In March alone, the bond index dropped 2.8%, recording its worst monthly performance since July 2003. The Bloomberg U.S. Municipal Bond Index realized similar results, falling 6.2% over the quarter. At the same time, the annual inflation rate – as measured by the CPI – continued to climbing sequentially higher in each month throughout the quarter, recording a 40-year high reading in March of +8.5%. Consequently, even holding cash resulted in a significant erosion of future purchasing power.

Table 1: Notable Returns / Yields / Spreads. Data as of March 31, 2022.
Source: Morningstar
Note: BBG Barc = Bloomberg Barclays; 10Yr Treasury Yield figures as of the end of the month/quarter

	Ticker	Q2-21	Q3-21	Q4-21	Q1-22
S&P 500 Total Return Index	SPXT	8.5%	0.6%	11.0%	-4.6%
Russell 1000 Growth Index	RLG	11.9%	1.2%	11.6%	-9.04%
Russell 1000 Value Index	RLV	5.2%	-0.8%	7.8%	-0.74%
MSCI EAFE Index	MXEA	5.4%	-0.3%	2.7%	-5.91%
MSCI Emerging Markets Index	MXEF	5.1%	-8.0%	-1.4%	-6.97%
BBG Barc. US Agg Bond Index	LBUSTRUU	1.8%	0.1%	0.0%	-5.93%
10-Year Treasury Yield	USGG10YR	1.47%	1.49%	1.51%	2.32%

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So how have economic forecasts changed since the beginning of the year?

The war in Ukraine and spiking inflation has significantly changed economist and investor expectations over the past three months. At the start of the year, markets were expecting the FOMC would raise its targeted Fed Funds interest rate by roughly three 25 basis point rate hikes for all of 2022. Additionally, economists surveyed in December were expecting inflation to peak sometime in Q1 and for the U.S. economy to expand by 3.9% in 2022.

However, continued supply chain constraints coupled with the impact that the war in Ukraine is having on commodity prices has caused economists to extend their timeline for when peak inflation might occur and reduce their economic growth forecasts. Higher and more persistent inflation has also caused the Fed to become more hawkish. Consequently, the U.S. futures market currently appears to be pricing in between eight and nine rate hikes (25bps) in 2022, implying that Federal Funds Rate could approach 2.75%, or more, by year end. As a result, economists have been reducing their 2022 GDP growth forecasts and are now expecting the U.S. economy will grow by 3.3%, a reduction of 60 basis points.

Things are significantly more precarious in Europe and the likelihood of recession in that zone has materially increased since the beginning of the year. We note that Russia supplies about two-thirds of Germany's natural gas, half of its coal and roughly a third of its oil. Several other countries in the Eurozone are similarly dependent on Russian energy supplies. Due to these factors, we believe that Europe's macro risk profile has significantly increased due to the possibility that escalated tensions in the region could result in a major reduction of Russian energy supplies to countries throughout the European Union.

The impact of the war on Germany's economy has already been significant. As a result, economists have reduced the country's 2022 GDP forecast from 4.1% to about 2.2%, and additional downward revisions may be needed. Scores of German companies – including BMW, BASF and ThyssenKrupp – have warned that their earnings will be negatively impacted while many others declined even to offer a prediction. Consequently, we believe that many European-based companies could experience significant negative earnings revisions over the next several quarters.

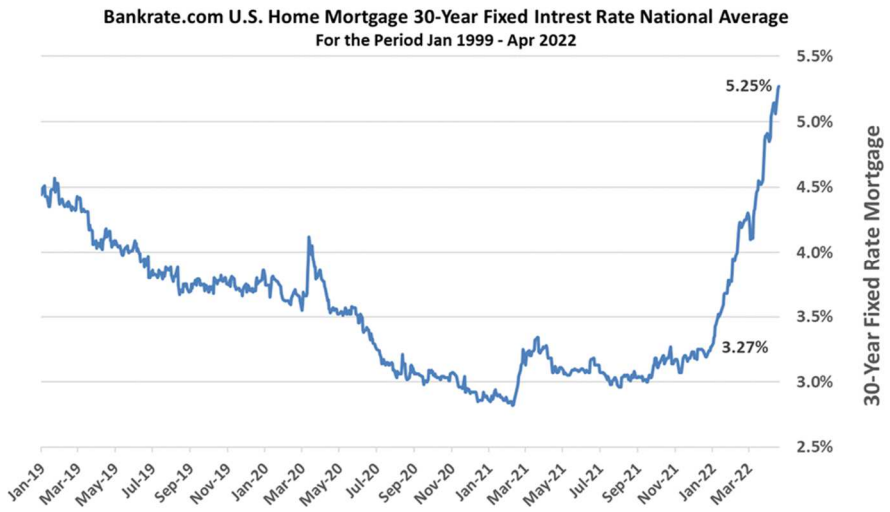
Evolving Federal Reserve Guidance and Expectations

The first 25 basis point hike occurred during the March 16th FOMC meeting with unanimous consent by all voting members, aside from St. Louis Fed President Bullard, who wanted to raise rates by 50 basis points. During Powell's press conference that followed the meeting, he noted that the Fed could start reducing the size of the holdings on its balance sheet as soon as May. Over the last two years, bond buying has pushed the Fed's balance sheet to just shy of $9 trillion versus the pre-Covid level of about $4 trillion in assets.

Its last balance sheet reduction, from 2017-19, saw the Fed allow a set level of proceeds from maturing bonds to roll off each month while reinvesting the rest. At time of his comments, Powell's seemed to indicate this time will be more aggressive than the $50 billion a month the Fed used in the prior case.

The FOMC provided some additional clarity on April 6th following the release of the minutes from its mid-March policy meeting. The minutes revealed that policymakers were prepared to reduce the central bank's balance sheet by $95 billion per month, more than what appeared to be the consensus expectation of around $80 billion – as the market sold off on the news. The minutes also confirmed that officials were prepared to raise rates by 50 basis points (0.50%) at their upcoming May meeting – which is essentially inline with the market's current consensus expectation. As of March 8, the fixed income futures markets were predicting that the most likely scenario was for the federal funds target range to hit 2.50% to 2.75% by the end of the year – well above its current target rate of 0.50%.

In a speech to the National Association for Business Economics, Chair Powell said that, if necessary, the central bank would be open to raising rates by a comparatively aggressive half-point at multiple Fed meetings. Powell's comments spawn some additional market angst given that the Fed hasn't increased its benchmark rate by a half-point since May 2000. Powell's comments also signaled that higher rates were on the way for mortgages, auto loans, credit cards and other consumer and business borrowing. In fact, mortgage rates advanced throughout the quarter to the highest levels in more than three years, according to the Freddie Mac Primary Market Mortgage Survey. As the chart below shows, fixed-rates have risen roughly 2.0 percentage points since the beginning of the year, to roughly 5.25%, the sharpest three month increase since May 1994.



Source: Bankrate.com

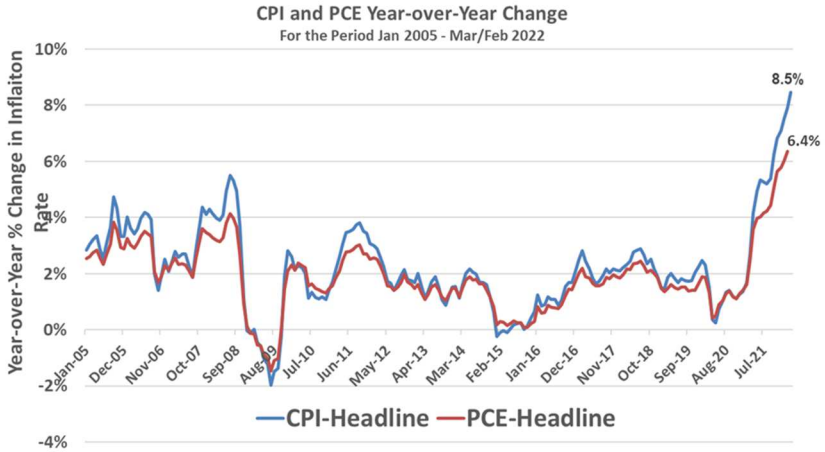
Federal Reserve policy and the situation in Ukraine continued to loom large over sentiment throughout the month of March. Stocks pulled back sharply on April 5th after Fed Governor Lael Brainard, widely considered among the most dovish policymakers, promised in a speech that the Fed would start to "reduce [its] balance sheet at a rapid pace as soon as our May meeting." Later that day, Federal Reserve Bank of Kansas City President Esther George told Bloomberg that there was "no question" that the Fed had to act rapidly to quell inflation. The following day, Federal Reserve Bank of St. Louis President James Bullard said that the central bank is behind on its mission to tame inflation and will likely have to act fairly forcefully to get price pressures under control.

In short, while the Fed has been transparent, the news trickle has exacerbated concerns about the central bank is behind the curve with respect in taking steps to control inflation and might potentially make a policy mistake that could send the economy into a recession, which would lower earnings prospects in general and further drag down equity valuations. Consequently, growth-stocks continued to be pressured throughout the quarter by the rapid rise in rates.

U.S. Inflation Quickens to 8.5%, Ratcheting Up Pressure on Fed

U.S. consumer prices rose in March by the most since late 1981, underscoring the painfully high cost of living and reinforcing pressure on the Federal Reserve to raise interest rates even more aggressively. The consumer price index increased 8.5% from a year earlier following a 7.9% annual gain in February, Labor Department data on April 12th. The widely followed inflation gauge rose 1.2% from a month earlier, the biggest gain since 2005. Excluding volatile food and energy components, core prices increased 0.3% from a month earlier and 6.5% from a year ago, due in large part to the biggest drop in used vehicle prices since 1969 and a deceleration in price growth in other merchandise categories.

Source: Bureau of Labor Statistics and Bureau of Economic Analysis

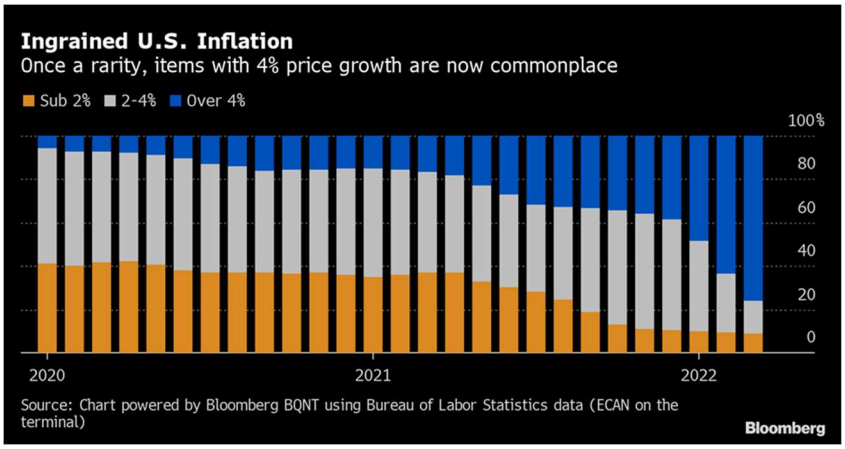


Used car prices, which had been a driver of higher goods inflation for months, were down 3.8% in March, the second straight monthly decline. New car prices, meanwhile, rose slightly. Gasoline costs drove half of the monthly increase, while food was also a sizable contributor, as Americans paid more for vegetables, meats and dairy products.

The war in Ukraine, which started in late February, led to a spike in energy prices on fears that cutting off Russian oil and gas would stretch an already tight supply. The CPI report showed that energy prices rose 11% in March from the prior month, the most since 2005, while gasoline prices jumped 18.3%, the largest gain since 2009. That said, gas prices have started to decline in recent weeks, in part because of sinking demand in China where several major cities are under strict Covid lockdowns. If sustained, the drop suggests that energy prices will have less of an impact on inflation in April.

The report showed goods inflation stayed elevated, while services continued to advance. On a year-over-year basis, goods inflation excluding food, energy and used vehicles rose 8.1% in March, the most since 1981. Services costs increased 5.1% from a year ago, the biggest advance since 1991. Airline fares rose a record 10.7% in March from a month earlier. Shelter costs, which include rents and hotel stays, rose 0.5% for a second month. Prices for household furnishings and supplies rose 1% from February after outsize gains in recent months. The index for furnishings and operations jumped 10.1% from a year earlier, the most since 1975.

The March CPI reading represents what many economists expect to be the peak of the current inflationary period, capturing the impact of soaring food and energy prices after Russia's invasion of Ukraine.

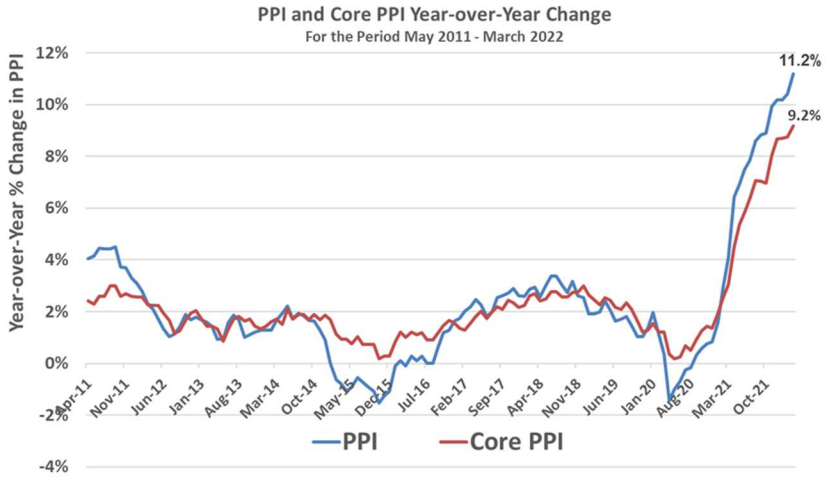


Source: Bloomberg

U.S. inflation didn't just reach a fresh four-decades high of 8.5% in March, it also got wider. An analysis of diffusion indexes for consumer prices shows that 76% of the goods and services measured by the Bureau of Labor Statistics saw gains of at least 4% from a year earlier. That's up from two-thirds in February, and less than 5% at the end of 2019, before the pandemic. Last month, only 2% of items in the index saw a decline in prices, including smartphones and TVs.

Producer Prices in U.S. Surge Most on Record, Topping Estimates

Prices paid to U.S. producers jumped in March from a year ago by the most in records back to 2010, topping all estimates and underscoring persistent early-stage inflationary pressures that risk feeding through to consumers. The producer price index for final demand increased 11.2% from March of last year and 1.4% from the prior month, according to Labor Department data released April 13th. The data showed upward pressures intensifying amid soaring food and energy prices. The worrisome price trends have been reaggravated since Russia's invasion of Ukraine in late February. Supply-chain snarls likely worsened into April amid China's lockdowns, suggesting wholesale inflation could be slow to recede even as energy prices have retreated, keeping the Federal Reserve firmly committed to rate hikes this year. The monthly gain was broad across categories and also the largest on record.



Source: Bureau of Labor Statistics

Excluding the volatile food and energy components, the core PPI increased 1.0% from a month earlier and was up 9.2% from a year ago. That stands in contrast to the latest consumer price report which showed a softening in the pace of core inflation.

The PPI data showed prices for transportation and warehousing services spiked a record 5.5% in March. The increase was driven by higher truck transportation of freight costs and airfares.

Prices of goods climbed 2.3% in March for a second month. More than half of the increase was due to a 5.7% jump in energy prices. The cost of services, meanwhile, advanced 0.9% after a 0.3% rise in February. More than 40% of the gain in services costs reflected higher margins in trade that includes wholesalers and retailers.

Costs of processed goods for intermediate demand, which reflect prices earlier in the production pipeline, increased 2.1% from a month earlier. More than 60% of the broad advance was due to energy, particularly jet fuel. Compared with a year earlier, the measure was up 21.7%.

The war in Ukraine, which started in late February, led to a spike in energy prices on fears that cutting off Russian oil and gas would limit supply. Crude oil prices have since retreated on concerns pandemic-related lockdowns in China will limit demand. The risk is that the increase in input costs for producers will be passed on, at least partially, to consumers as firms try to protect margins.

Sanctions Slowly having an Impact: Russia Ruled in Potential Default Over Ruble Payment on Bonds

Russia has been ruled in potential default by a derivatives panel after breaching the terms of its bonds, bringing holders of insurance contracts on the debt one step closer to a payout. On April 20th, the Credit Derivatives Determinations Committee ruled that a "potential failure-to-pay event" occurred for credit-default swaps when Russia made two dollar-bond payments in rubles after foreign banks declined to process U.S. currency transfers.

Russia could still avert a default if it pays bondholders in dollars before a 30-day grace period ends. The payment issue is just one example of the fallout from the sanctions imposed on the country because of its invasion of Ukraine. The extensive restrictions have cut it off from the financial system and complicated transactions that were previously executed smoothly and with little attention.

That means for now, Russia is on the brink of its first default on external debt in more than a century. The clock is ticking on the grace period, which runs to May 4th, before the sovereign is likely to be officially declared in default. Holders of the swaps can then start the process of getting paid on contracts covering about $40 billion of debt.

The official default declaration would traditionally be made by ratings firms, but all have withdrawn coverage of Russia to comply with a European Union ban. However, S&P Global Ratings took the step of cutting the government to "selective default" before its exit. Moody's Investors Service then said Russia's ruble payments on the dollar bonds would be "considered a default" if the situation isn't remedied within the grace period. It noted that the comments didn't constitute a credit rating shift. Meanwhile, Russia's finance ministry has argued that it's fulfilled its debt obligations. It's blamed the U.S. and others for blocking payments to creditors, and threatened legal action.

Second Quarter Outlook

Please keep in mind that this year will likely continue to be very volatile as markets navigate rising commodity prices and economic growth shocks while simultaneously shifting to a higher yield environment. Fundamentals, quality, and valuations remain key considerations for portfolio positioning. For Q2, we continue to monitor the changing global risk environment and believe that our allocation balances inflation protection with the prospects of reduced economic growth, creating a framework that reflects cyclical and defensive exposures while also having some balance between value and growth.

Lastly, and perhaps most importantly, at HB Retirement, we remain committed to our disciplined and repeatable investment process, which is based both on top-down, macro analysis coupled with bottom-up, fundamental research. As such, we intend to follow the data and adjust our outlook and portfolios accordingly. Consequently, at the present time, we are staying the course with regard to the asset allocation—favoring value over growth. Unprecedented times such as these not only validate but mandate a disciplined investment process!

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There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

Stock investing involves risk including loss of principle.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Precious metal investing involves greater fluctuation and potential for losses.

Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

High yield/junk bonds (grade BB or below) are not investment grade securities and are subject to higher interest rate, credit, and illiquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

The MSCI EAFE Index is a free float –adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

The MSCI EM (Emerging Markets) Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of the emerging market countries of the Americas, Europe, the Middle East, Africa and Asia.

The S&P 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing the major sectors of the U.S. economy.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment grade fixed-rate bond market, including both government and corporate bonds.

Except for the historical information contained in this report, certain matters are forward-looking statements or projections that are dependent upon risks and uncertainties, including but not limited to such factors and considerations such as general market volatility, global economic risk, geopolitical risk, currency risk and other country-specific factors, fiscal and monetary policy, the level of interest rates, security-specific risks, and historical market segment or sector performance relationships as they relate to the business and economic cycle.

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