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Newsletter and Capital Markets Review

April - (Mid)May 2022

April ended and May began with such volatility, testing then breaking support levels, that we decided to hold the newsletter to mid-month and watch a bit longer because the story was clearly only half-told. We use, as does most of Wall Street, terms like "headwinds" to describe challenges to forward progress. What we are increasingly appreciating is that these "winds" are not just slowing the inexorable climb higher that markets have enjoyed since 2009 – they are pushing us off course and even backward. It is more and more apparent to us that we are headed into an equity bear market, and likely one in fixed income at the same time. Through May 13th prices for the S&P 500 have fallen 15.6%, the NASDAQ Composite 24.5% and the Bloomberg Barclays US Aggregate Bond Total Return Index 9.7%.

It may be more appropriate to describe the troubles we face as a cyclone rather than a headwind because they are not exclusively coming from one direction and they are far from steady-state.

1. *Inflation – Energy, Commodities, Housing*
2. *Reduction in monetary expansion*
3. *Rising interest rates*
4. *Widening US High Yield interest rate spreads*
5. *Full, although declining, equity market valuations*
6. *Corporate earnings are still growing but the pace is slowing*
7. *Negative real wage growth*
8. *Consumer sentiment – lowest since August 2011*
9. *Supply chain issues*
10. *Slowing home sales*
11. *Waning fiscal stimulus*
12. *Geopolitical flash points*

To round it out to a baker's dozen, we should also consider the effects of the growing climate crisis and the ongoing pandemic.

What is deeply concerning about marketplace reactions is that many of these considerations are not reversals but only changes in the rate of change. For instance, the broad US money supply (M2) has grown 41% over the past two years. We are not seeing the money supply now shrink. We are seeing the rate of increase decelerate, but still be positive. Similarly, the Fed is tapering asset purchases (not wholesale dumping existing holdings) with the goal of beginning to shrink the balance sheet. The Fed is raising policy rates methodically as well. Neither policy alone is a dramatic reversal. The only thing that makes this situation somewhat unique and more consequential is that both actions did not occur simultaneously after the previous three bond buying programs since the Financial Crisis.

There are also numbers within the numbers that point to emerging concerns that are still out over the horizon. For instance, producer price inflation is higher than consumer price inflation, which is likely signaling weaker earnings to come. To carry the wind analogy past its sell-by date, we could be blown into a perfect storm where our baker's dozen of winds interact and reinforce each other and intensify the bear market and an increasingly likely economic recession.

The catalyst to mark the bottom in asset prices does not appear to be imminent, and our sense is that it may take several more quarters before the capital markets attempt to hold high(er) ground again. As an example, a change in US Fed monetary policy, either pausing the rise in policy rates or leveling off on the taper of its balance sheet could prove to be a trigger for asset prices to climb. Or, it may ultimately be that valuations ease to levels that become historically attractive, corporate earnings begin to accelerate, or equity investors simply become exhausted. One measure of market exhaustion depicted on the accompanying chart is the percentage of S&P 500 index member stocks selling below their long-term trends, in this case the 200-day moving average. Approximately 32% of the S&P 500 companies are trading above their long-term trend lines and over the past twenty years it appears that the percentage needs to reach 20% or less for the market to ultimately bottom. At the same time, we are watchful for so-called "value traps" – prices have been falling, which makes stocks look historically more attractive when considering financial performance ratios like Price-to-Earnings. But, the many challenges we outlined could conspire to subsequently hit financial performance and make those companies expensive again even at a new lower price. We would not rule out another bear market rally like we experienced in March, but for now, we see further downside risk and maintain high cash levels that we established in January.

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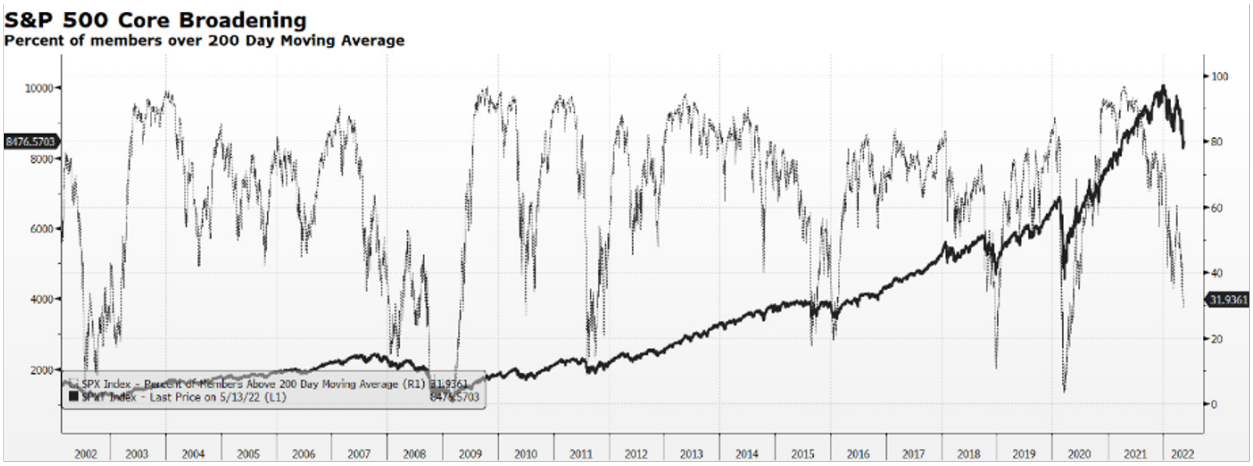

[chart and data courtesy S&P, Bloomberg LP © 2022]

Portfolio Positioning

Earlier in the quarter, we took steps to reduce our exposure to equity risk as the capital markets digested their nearly unprecedented run- up since the pandemic nadir in March of 2020. Our feeling has been that signals of transient inflation are becoming more systemic and, combined with a regime change from the Federal Reserve from stimulating to tightening, the short-term prospects for equities are less attractive. Since that time markets took a brief respite and even rallied a bit before continuing to grind and sometimes lurch lower. We subsequently took a further incremental step away from equities in both US and foreign markets as we look for the catalyst that will define the bottom of this downward trajectory, the recent bear market rally in US equities notwithstanding. Within our ETF models, we made the shift primarily in US large cap growth and in Developed Europe equities, and in our ESG models through core and growth-biased large cap equities and broad international equities. All proceeeds were committed to cash and cash equivalents for the moment.This further reinforces our underweight allocation to equities overall as well as keeping a modest underweight in fixed income, with cash now even more overweight. Within global equities, we materially lowered US exposure, kept an underweight in Emerging Markets, and established an underweight with respect to Eurozone stocks while continuing an underweight in Japan. Within fixed income, we are overweight in the US with a preference for mortgages investment grade corporate credit. We have little to no exposure to non-US fixed income except through Green Bonds in our ESG series portfolios. All portfolios holding fixed income maintain lower duration than the benchmark.

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Risk Outlook

- **Inflation** – What once was episodic is being reinforced by ongoing and new challenges turning small concentrations of inflation into a system-wide problem. Price rises are becoming more prevalent across the economy, and the Russia-Ukraine conflict just adds insult to injury as energy markets ran up to levels not seen since the bubble preceding the Financial Crisis. In many regards it is surprising, maybe even astonishing, that inflation has not been more of a concern for years now. We are more than a decade in to post-Crisis easy monetary policy and a booming stock market only briefly interrupted by the pandemic and now inflation, the Fed and the Russia-Ukraine conflict. The coordinated government response to the economic damage of the pandemic was massive. Had all of that stimulus settled into the "real" economy, inflation would be on a tear. We believe that the capital markets have served as a pressure relief valve, with stimulus settling out of the real economy and into the markets inflating asset prices. Correlation does not equal causation, but there seems to be a relationship of some sort between the magnitude of the stimulus and the increase in aggregate value in just the public markets. The challenge now is distinguishing between inflationary hotspots with very clear causal links and pathways to resolution, and more systemic inflation with no focused direct causes and therefore no clear tools for fixing. We have seen spikes in prices of building materials and scarcity of new cars for purchase as examples. But, while we cannot discount those observations entirely, we principally see them as graphic examples of how interdependent world economies and supply chains are and how fragile they were with just-in-time inventory management. While investors have extolled just-in-time since Toyota popularized it, it introduced an inelasticity into global supply chains that was not capable of absorbing the blow of COVID. We liken this to everyone on the highway cruising at 70 Mph riding bumber-to-bumper and doorhandle-to-doorhandle. It works fine until somebody swerves or stamps on their brakes. This was further exacerbated by climate-related issues with beetle infestation and fire affecting Western timber stocks and storms knocking petro-chemical production capacity off line among several other challenges. The results were issues such as a microchip shortage affecting the ability of factories to finish automobiles for delivery. We believe as major parts of the global economy get back in order that the current focused situations like cars, appliances, chips and building supplies will self-correct, but by then it may be too late as inflation becomes widespread and entrenched. The global sanctions regime surrounding Russia will also play in, challenging energy markets and holders of Russia debt, which will almost certainly add volatility to the inflation situation. In the meantime, as investors and market watchers, we are looking at the confluence of business practices that are not sustainable, resilient or adaptive and externalities like global health, territorial conflict and climate change which can and will disrupt businesses and markets again.

- **Rates** – More rate increases are coming from the Fed, although the slope of that increase is uncertain given competing forces like inflation, energy prices, and war. Even a slight normalization of the rate environment could have profound effects in fixed income markets, severely dragging down assets like 30-year Treasury Bonds which are normally seen as safe harbors from risk. Global financial instability may actually moderate that some as the US T Bond is the world's mattress for protecting personal, sovereign and corporate wealth, which will pin down rates to some degree. Wall Street has been cautioning about the risk of rising rates since the end of the Financial Crisis in 2009, but we have yet to actually have to live with those risks because a slow grind recovery followed by a series of crises including COVID have conspired to hold central bank policy where it has been – accommodative. We can observe that rising rates, which are now upon us, are not welcome in markets that have enjoyed easy money for more than a decade now. This compels us to think about risk in globally diversified portfolios differently, where the traditionally more conservative parts of asset allocations may actually represent more material risk in the nearer term.

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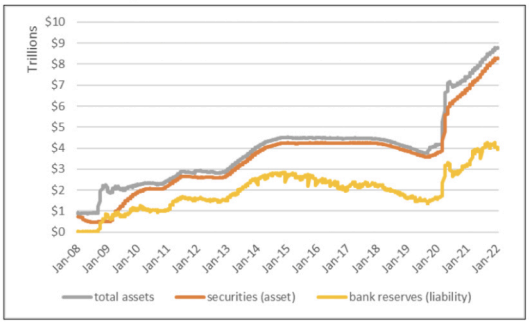
Risk Outlook [cont'd]

- **The National Balance Sheet** – Continuing on the related themes of inflation and rates, the Federal Reserve has started winding down the extraordinary measures they have been taking through asset purchases. That has a couple implications – one is telling the markets that the training wheels can come off. The Fed feels like their additional help is no longer as needed. That is positive in tone which should be good for market sentiment, but offset by the disappointment of losing a major bond investor. This does mean a more orderly bond market where institutional investors are not competing with the government for bond inventory. Again, this is good, but it also means less liquidity. This is a slow turn of the battleship of state. They are not really shrinking the balance sheet. Just growing it less fast, so most of the market reaction will be sentiment-driven rather than based on real stresses from lower liquidity.

Figure 1. Federal Reserve Balance Sheet



Source: Federal Reserve.

- **COVID-19** – We are now looking at the global transition of SARS CoV-2 and COVID-19 from pandemic to endemic, and what that means for progress and prosperity in developed and developing economies. Vaccine deployment continues and close on its heels the promise of new therapies in pill form that may make addressing severe illness as simple for COVID as Tamiflu does for influenza. New strains of the virus may contest the efficacy of those vaccines, but after two years the world has become more adaptive to the challenge and the need to hit the "off switch" on the world economy is far less than the early stages when the virus represented all danger with no defense. As we have previously expressed, the global community remains vulnerable to a have/have-not dichotomy based on access to virus-fighting resources. Indications are that pricing will be calibrated according to economic capacity, which is a promising development that may help to reduce the gap between developed and developing nations in the same way COVAX is working to do so through access to vaccinations. With these developments we may be less than a year away from COVID no longer being a meaningful factor in global economies.

- **China and Russia** – One of our long-term risk themes continues to be our focus on Chinese Communist Party actions which have not materially shifted for the better in the COVID era. From aggression in the Asia-Pacific region to military tension along the border with India to suppression of Hong Kong citizens' rights and the interests of the Uighur population and the lack of contrition for their early role in failing to stop COVID-19 in its tracks, all may contribute to China-directed backlash or retaliation. There does seem to be regional coherency in the response as nearly all Pacific nations have aligned with the US against Chinese aggression. From lack of respect for intellectual property rights to involvement in global criminal drug trafficking to financial crimes and human rights abuses bordering on genocide, the country is finding it harder to get the global community to look the other way. We view this as a risk to investment in China and investment in companies reliant on a Chinese supply chain, but likely bullish for other parts of the Asia Pacific interested in usurping China's role as the manufacturing floor for the world. Meanwhile Russia continues to operate from other pages in the same playbook, manipulating natural gas markets in Europe and staging a full invasion of the sovereign nation of Ukraine. This is disrupting agricultural markets as the invasion interrupts Ukraine's ability to produce and provide agricultural products, and the global sanctions against Russia in response severely limit their own access to markets, effectively taking two consequential producers out of global markets. North America is food-independent, but because of the interconnectedness of global commodity markets, this kind of disruption may compound inflationary pressures in food.

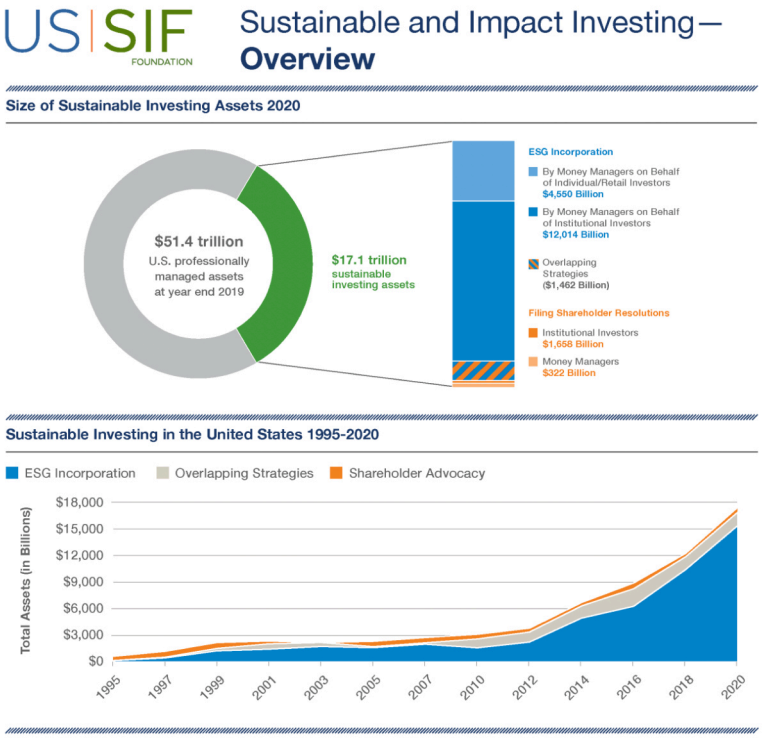
ESG Considerations - Inflation and Housing

Even taking market performance out of the equation for the moment, the rise in assets committed to ESG investments has been striking. We are waiting for more current figures, but with the recent sharp pullback in capital markets it is actually not unreasonable to look at pre-pandemic figures. According to the USSIF Foundation 2020 Report on US Sustainable and Impact Investing Trends, of an estimated $51.4 trillion in professionally managed assets just in the United States, $17.1 trillion involved some degree of ESG inclusion, be that incorporation into investment decision making or some level of engagement and advocacy on ESG issues based on managed assets. That puts the figure at 1 of every 3 professionally managed dollars. There are very few things one can point to in the capital markets where that high a percentage of investors is practicing some version of the same thing.

That 1-in-3 ratio may be wildly overstated, but even heavily discounted, ESG-involved assets now number in the trillions with a 'T'. It is no longer niche and it is no longer being ignored. Whereas not long ago a financial services firm was an outlier if it even discussed much less practiced ESG, today a firm would stick out for not having at least a thoughtful position statement on the subject.

The level of intensity around ESG, both broadly and in very specific areas like diversity, equity and inclusion (DEI) is high, and now we have come to the point where the press are asking hard questions, regulators are deciding whether existing rules are sufficient to control for exaggerated or incorrect conclusions and claims, and think tanks and universities, data companies and analysts are building rubrics for consistent, detailed analysis. But, the person on the street is probably asking the most essential question underpinning all of that serious examination – if so much money is oriented around environmental, societal and good governance practices, why aren't things better?

What it comes down to is an overly broad definition of "ESG" and exceedingly loose standards for what qualifies. That is actually ok. Saying "I invest in ESG" is like saying "I invest in the market". True, but very non-specific. We have been saying for a number of years that we would go through a wave of market adoption where the participants and options would explode, and they have. Early on, there was a small community of serious practitioners and a similarly small community of investors committed to them. Within that community there was a fairly coherent if somewhat informal conception of what ESG was, with very few marginal participants.



[Chart from US SIF Foundation Trends Report, 2020]

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ESG Considerations [cont'd]

Is there such as thing as too much choice?

Today a very high percentage of investment firms have something on offer with an ESG label. We have not observed a lot of examples of firms being outright mendacious about their ESG claims, but because "ESG" is such a broad umbrella term it means everything and nothing at the same time. Firms might be using simple scoring methodologies, or they might be using exhaustive research-driven fundamental analysis. They might be looking for a single defining sustainability characteristic or they might be seeking a comprehensive application of the UN Sustainable Development Goals. As we have written in the past, we lean away from simple score-based processes because they tend to miss consequential details about investments or may average away what otherwise would be disqualifying controversies because of the smoothing effects of scores. Similarly, we tend to avoid investments that play on specific ESG themes but do not embrace most or all of the major factors, such as a portfolio that highlights DEI but does not take into account environmental or human rights concerns. All these options will fall inside the big tent, but the devil, and the opportunity, is in the detail.

All other things being equal, what do we want to see addressed in the construction of ESG portfolios? Ideas like justice, equal access, sustainability, and regeneration:

- ***Access to nutrition***
- ***Access to education***
- ***Access to health care***
- ***Economic opportunity and empowerment***
- ***Human rights and dignity***
- ***Safe workplaces***
- ***Ethical business and financial practices***
- ***Resource efficiency***
- ***Clean water and sanitation***
- ***Housing***
- ***Diversity and equity***
- ***Climate change***
- ***Biodiversity***
- ***Conflict minerals***
- ***Genocide***

We look at it from a process point of view. Different managers view these themes and candidate securities through different lenses and with differing priorities. What we seek are managers that consistently examine most or all of these themes in their own ways and will be able to enter into robust discussions about what they own and why according to those themes. We might disagree in some cases, but we can acknowledge the reasoning and that the risk or opportunity is observed and addressed.

All of that being said, we do use some passive instruments in our ESG portfolios that are more formulaic in their construction and do not always reach what we consider to be best practice. In the years that the ESG marketplace has been developing we have had to deal with challenges of scarcity. In the beginning it was a sheer lack of options that covered global markets. We simply could not cover every interesting or necessary asset class with a high quality ESG solution because they simply did not yet exist. More recently, our need for low cost, liquid exchange traded funds as tactical trading instruments in our asset allocations has compelled us to accept more mechanistic and formula-based investment options. Yes they meet the baseline criteria for comprehensive integration of ESG factors, but fundamental discretion and reasoning at the security-by-security level is not present. This too is starting to improve as a next generation of so-called active ETFs come into the market where we get the benefit of the trading and liquidity of an ETF but with the deeply fundamental portfolio construction techniques of a mutual fund or separately managed account.

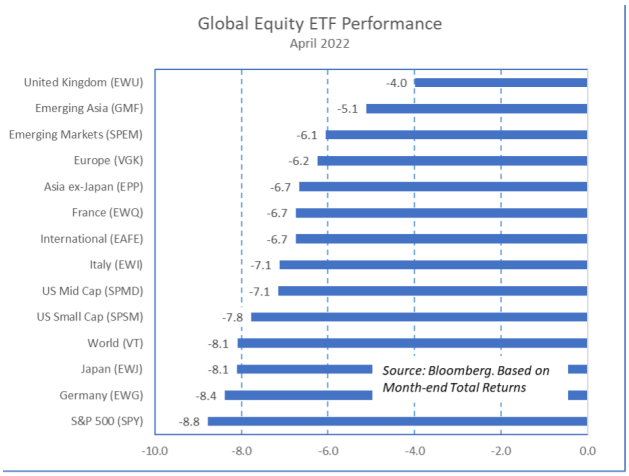
It is all ESG, but it is not all oriented to material and measurable positive change in the areas outlined above. It is not as easy a box to check as a decade or more ago when one could count the available and investable options in the dozens. The free market has responded to the tremendous upwelling of interest in ESG by giving us an exceptional array of choices that should mean there is something to satisfy any investor's interest, but that investor must do (or have a trusted advisor do) the work to select wisely if change is what is sought. To torture another metaphor as we head into the hotter weather, it is all ice cream. What flavor or flavors do you want? Hard or soft serve? Toppings? Dish or cone? Organic? Vegan, even? It requires two kinds of work to get your dessert – take the time to know and articulate what is important to you, and do the research to be sure what you select satisfies those expectations. And remember to tip your server.

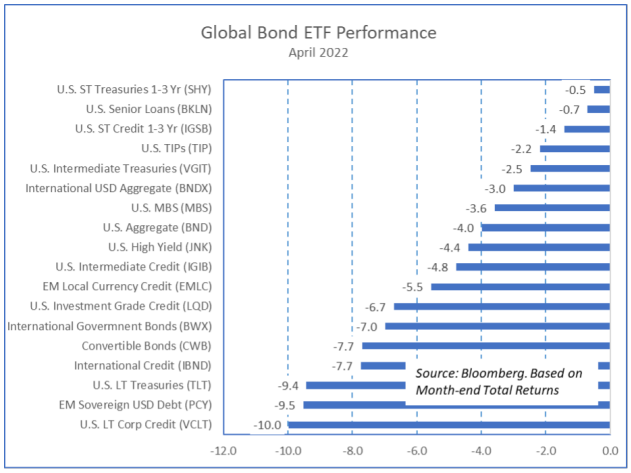
April 2022 Capital Market Review

No refuge. Inflation, rate increases, global conflict, supply chain disruptions, and the ongoing presence of COVID cast a long shadow over the markets. Listed markets were uniformly bad in April, shrugging off the (limited) March rally and continuing their downward trajectory. Maybe of the greatest concern is that the long term bonds of US companies did even worse than their shares of stock. We have been saying for a while now that bonds are not the safe harbor they once were in an asset allocation, and this was painfully illustrated again for the month.

Equity Markets

The dispersion between best and worst returns in global equity markets has narrowed some to less than 5% as compared to the prior month's 10+%, but entirely on the negative side of the ledger. Technology and innovation were the major casualties, which shows through in which markets got hit hardest – US (SPY), Germany (EWG), and Japan (EWJ). The Russia/Ukraine conflict continues to weigh on Europe from national security fears to disrupted energy and food markets to digesting the effects of the sanctions regime erected around Russia (and Belarus). This has played itself out in the price of carbon where oil and natural gas continue to hold at levels not seen since before the Financial Crisis. OPEC could intervene, but they have no reason to as long as the checks continue to clear. China's zero-COVID policy also continues to show cracks, resulting in shutdowns in factory and port cities which have further aggravated global supply chains that still see China as the world's manufacturing floor.





Bond Markets

Equities and bonds traded places, with the spread between best and worst contracting in equities but blowing out in fixed income. The difference in returns between the US Short Term Treasury (SHY) and the Long Term US Corporate Bond (VCLT) expanded to 9.5%, with everything posting negative. The "safe" Treasury equivalent (TLT) did barely better than a half a percent improvement in return over the corporate option. Treasury Inflation Protected Securities (TIP) provided some respite falling "only" 2.2%, showing that the inflation hedge could only deliver a less worse outcome in the current economic and rates environment. The mattress-stuffing option (cash) outperformed, although even that story has no happy ending because those dollars which are paying very little interest are losing actual purchasing power at more than 8% per year right now thanks to inflation.

The returns cited reflect total return performance of exchange traded funds listed in the corresponding bar charts

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