Forza Investment Advisory, LLC

Strengthening Our Clients' Financial Lives

FROM THE DESK OF BOB CENTRELLA, CFA ***April 8, 2022***

Usually I like to open my letter with some witty repartee and I was going to make some reference to the Oscar's "slap" heard round the world. But this quarter did not have much to be happy about given the Russian invasion of Ukraine, continuing (but lessening) Covid infections and record inflation to name a few negatives. So the real slap in the face was that the first quarter of 2022 was our worst quarter since Q1-2020, the beginning of Covid. The market started the year heading down on inflation and Fed rate hike fears and never quite got going. It took a March rally from the depths to bring the S&P 500 return to -4.61% for the quarter as the market hit a low of -13% during early March when the Russian invasion of Ukraine heated up. The Nasdaq actually declined over 20% from its peak, signalling a bear market decline. Here's a negative alert – I apologize but when you look at your statement you will see negative signs in the return column. There weren't many places to hide unless you were an energy, commodity or utility fund. And the bond market offered no protection as prices dropped causing the Barclays Bond Aggregate to drop -5.85% in Q1. More on bonds later. During the quarter, we were more busy than normal on the trading side as we rotated out of some positions and into others that we thought would be better suited for the volatile environment while still offering good upside. I anticipate the rest of this year may offer more of the same.

There were some positive returns this quarter but largely it was a difficult period to make money unless you were in commodities. Below is a list of various assets classes price changes (not total return) for the quarter.

Asset Class	Return%	Asset Class	Return %	Asset Class	Return%
Nymex Nat Gas	51.3%	S&P Financials	-1.9%	7-10 Yr UST	-6.55%
Nymes Gasoline	43.1%	S&P Health Care	-3.0%	SP REIT	-6.9%
SP 500 Energy	37.7%	Nikkei 225	-3.4%	Russell 2000	-7.8%
Nymex Crude	33.3%	Dow Jones Avg	-4.6%	SP Info Tech	-8.6%
Wheat	30.5%	Bitcoin	-4.5%	I-sh Corp Bond	-8.7%
Bloombg Commodity	25.5%	S&P 500	-4.95%	Nasdaq	-9.1%
Brazil Index	14.5%	SP MidCap 400	-5.2%	SP Cons Cyclical	-9.2%
Silver	7.7%	Ishares Nat Muni	-5.7%	German DAX	-9.3%
Gold	6.7%	SP Sm Cap 600	-5.9%	Shanghai Comp	-10.7%
US Dollar Index	1.8%	VG Tot Intl Bond	-4.9%	I-Sh 20 Yr UST	-10.9%
S&P Cons Staples	-1.6%	STOXX Euro 600	-6.6%	Ether	-12.3%

Natural gas jumped 51%, oil prices +33%, Wheat +30.5%, and corn, cotton, soybens all rose above 20% --- hence, inflation. Among traditional assets Gold rose 6.7% and Silver +7.7%. Bitcoin fell 4.5%.

Capitalization and Style: The S&P 500 dropped -4.95% while the Dow fell -4.57% and the Nasdaq -9%. Soaring interest rates hurt Growth stocks. Value did much better than Growth overall with Large Value -.60% outperforming Large Growth -8.6% while Smallcap 600 Value -1.83% bested Small Growth -9.73%. Similary MC Value -.63% outperformed MC Growth -9%.

Sector Analysis: Energy +38% by far led S&P sectors with Utilities +4% the only other positive sector. Other top sectors were Consuner Staples -1.6%, Financials -1.9% and healthcare -3%. Om the downside the weakest sectors were Communication Services -12.1%, Consumer Cyclical -9.2% and Technology -8.6%.

KEY ISSUES

As we head into the 2nd quarter and rest of the year let's look at the key issues. I'll start with the Russian invasion of Ukraine since it does not look like this will be resolved anytime soon and it is difficult to handicap as to the effect on markets. One thing for sure is Russian sanctions will continue to stoke oil/gas inflation. But the ongoing war can have unforseen consequences and remains a key geopolitacal risk. Here are my TOP 10 key non-geopolitical issues:

1. Current economic data shows the economy is strong but the surge in inflation is likely to weigh on economic growth and slow corporate earnings. GDP rose 5.5% in 2021 and the Fed estimates it to grow 2.8% this year. Solid growth but down from the 4% level it predicted in December.
2. The upcoming Q1 earnings season will see a focus on wage increases, expenses and margins. As of now earnings are expected to grow about 5% from last year. That is quite a slowdown from over 20% growth last quarter albeit against a covid-tarnished year before. Will slowing eps growth be enough to inspire markets?
3. Inflation is here and not going away anytime soon. Rising prices are everywhere with CPI and PPI price inflation near 8% year to year. We used to only read about this in 3rd world countries. Skyrocketing commodity costs and rising energy costs are leading the way from gas at the pump to oil/gas needed to run homes and businesses. Without getting political, I believe the current administration's abrupt denunciation of fossil fuels has really hurt us all. And supply chain disruptions around the world (especially China) are still driving costs higher. To attack inflation, the Federal Reserve is finally getting aggressive…
4. The Fed is embarking on a rate rise and stimulus tightening program to combat inflation. The Fed raised rates .25% at the end of March for the first time since December 2018. It has signalled that it will raise rates 6 more times this year and estimates call for the Fed Funds rate to end the year from 2.25% to 2.75%. In addition the Fed will begin running off its $9 Trillion balance sheet of treasury and mortgage securities. This is a sharp reversal from its purchases of securities to provide liquidity. Basically, the Fed waited too long and now will be playing catch-up. As a result…
5. Yields are rising fast! The 2Yr and 3Yr Treasury yields have risen the most in 2022 while inversions are now taking place in certain areas with longer term yields below short-term yields. Historically a prolonged inversion of yields has signalled an oncoming recession in the next 1-2 years. Below is a chart of the 2-YR to show how fast yields have risen. The Yield is up 2.2% since June 2021 to 2.6%.

UST 2YR Yield

6. Bonds had been in a bullish pattern since the early 1980's. As proof the 5.85% decline in bond returns in Q1 was the worst since Sept 30, 1980! The rapid rise in yields has already baked in a lot of the Fed increases over coming months. Higher yields could cause a rotation from equities to bonds but I think we might still need rates well over 3%.
7. Back on the positive side, the labor market is strong. We've had 11 straight months of 400K+ job gains, the longest sine 1939! The 3.6% unemployment rate is near the February 2020 pre-pandemic low of 3.5%. Wage force participation is up , wages are rising and consumers are flush with cash…but… it's still not enough to keep up with inflation.
8. Markets actually do well during rate hike periods because it usually coincides with a strong economy. The market rose during 4 of the last 5 hike cycles with the S&P gaining 63%, The Dow 59% and the Nasdaq 103%.

Rate Cut Cycle Start	Rate Cut Cycle End	DJIA	S&P 500	Nasdaq Composite
5/31/1989	2/3/1994	60.0%	50.0%	78.8%
7/5/1995	3/24/1997	49.6%	44.5%	31.9%
9/28/1998	6/29/1999	33.4%	28.9%	51.9%
1/2/2001	6/29/2004	-2.2%	-11.5%	-11.2%
9/17/2007	12/15/2008	-36.1%	-41.2%	-41.6%
7/31/2019	1/14/2022*	33.5%	56.2%	81.9%
Average %		23.0%	21.2%	32.0%
Median %		33.4%	36.7%	41.9%
Source: Dow Jones Market Data				

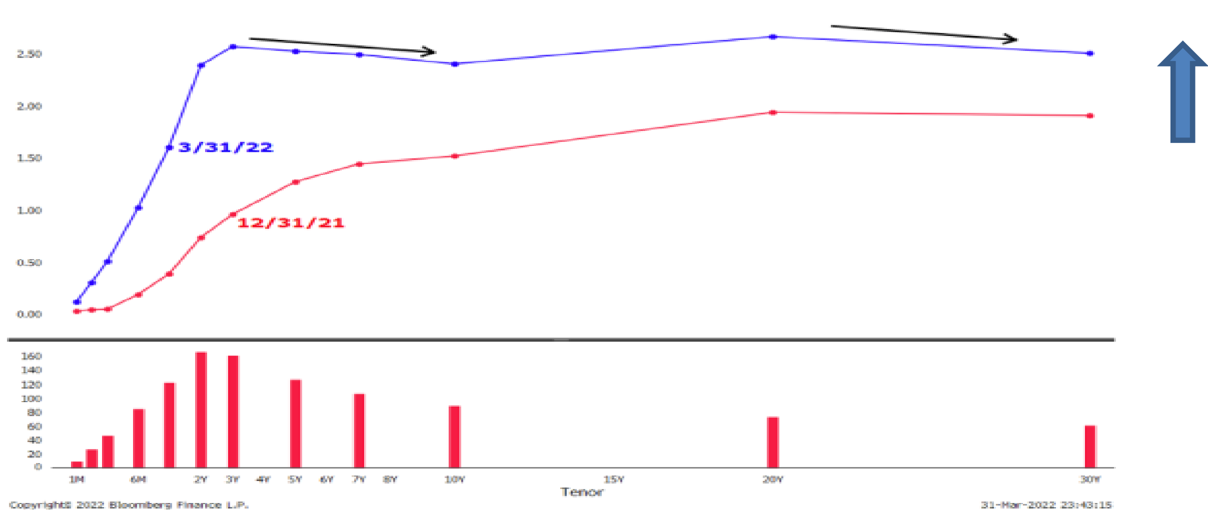
Rate Hike Cycle Start	Rate Hike Cycle End	DJIA	S&P 500	Nasdaq Composite
2/3/1994	7/5/1995	16.3%	13.8%	18.1%
3/24/1997	9/28/1998	17.4%	32.6%	40.0%
6/29/1999	1/2/2001	-1.6%	-5.0%	-13.3%
6/29/2004	9/17/2007	28.7%	30.0%	26.9%
12/15/2008	7/31/2019	213.7%	243.1%	442.0%
Average %		54.9%	62.9%	102.7%
Median %		17.4%	30.0%	26.9%
Source: Dow Jones Market Data				

9. On a seasonality basis, since 1950 April is the best month for stocks and has risen 15 of the last 16 years. So we got that going for us!

10. I need a top 10 and I want to keep it positive so … *the 2016 Italian Barbareso is a magnificant vintage* and still available now. It's considered the baby sister of the Barolo but this vintage could be one of its best ever. Buy all you can and stock up. Oh, and the 2015 & 2016 Brunellos are also a top notch vintages as well so buy some of those too while at your favorite wine store. 2017 not so good so Impress your friends by picking the others off the wine list if you see them.

BONDS

As mentioned earlier, bonds had their worst quarter since 1980. Below is a chart of the change in the Yield Curve since the end of 2021. Note that there has been a big jump in rates (about 1% across the curve) and that there are some inversions along the curve as well where short term rates are higher than long term. The 1% change in rates on a 10-yr bond would equate to about a 7-8% loss in value, explaining why Q1 was such a bad quarter of bonds. Remember yields and prices have an inverse relationship. As yields rise, prices decline causing a loss in value. On the plus side, current yields are becoming attractive and you can now get a 2.5% return for holding a bond a couple years. Some may argue that bond yields are already reflecting multiple rate increases by the Fed and now might be a good time to buy. I recommend laddering yields and maturities here over a period up to a few years. As bonds mature you can reinvest at potentially higher yields. Muni bond spreads to treasuries are also getting attractive so buying munis here using a similar strategy can generate some return.



EQUITIES

We've seen a massive rotation mostly out of Growth stocks and into Value stocks and defensive stocks such as Healthcare and Consumer Staples. The trade is getting a bit "crowded" and valuations are not as attractive as before, but could continue if markets remain volitile. High PE multiple growth stocks tend to struggle as rates rise (basically the higher yield discounts their future earnings to a lower value) while stocks with higher dividends and defensive characteristics gain momentum. On occasion, growth stocks will get oversold and investors rotate into them for a while. So, you can either try to (A) time the rotation (very difficult) or (B) own both styles of stocks for the long haul. I tend to favor plan-B but also with a little of A involved. Over time, I believe owning a blend of these stocks is the best strategy. At the beginning of the year I stated that we favor

owning both Value stocks and GARP (Growth at a Reasonable Price) and still do. US-based Small and Midcap stocks (favoring value oriented) should also be a part of the portfolio.

For the next month we will be going through Q1 earnings season. Investors will pay close attention to company comments on expenses and margins due to inflation as well as supply constraints and demand. Another possible headwind not being talked about is the value of the dollar which has been strong of late and up 8% from a year ago. This will hurt foreign earnings translated back to the dollar. Earnings growth for the S&P 500 is expected to rise 5-6% for the quarter, a sharp slowdown but now against normalized comps. For Q2-Q4 earnings growth is estimated at 5.8%, 10.3% amd 9.6% for full year growth at 9.5%. Valuation puts the S&P at 19.5x forward earnings, slightly above the 5-yr (18.6x) and 10-yr (16.8x) averages. If stocks do hit these levels of growth with similar valuation, then in theory stock prices could rise with the earnings growth.

International stocks continue to underwhelm and given the ongoing war in Ukraine and their exposure to Russian oil and commodities, I recommend being underweight overall. There are pockets of strength such as Brazil and Canada (oil and commodities) but I still prefer to own US companies with smaller exposure to international stocks.

FINAL THOUGHTS

You may have noticed that I have barely talked about the Covid pandemic. It is still a risk out there but seems to be better adapted to by countries and people. Much of the population has at least either had it, been vaccinated or both. It seems the severity is lessening although there are still many cases. The other issues I listed are more in the forefront with the pandemic a secondary but still major issue. A new outbreak in China can have supply chain implications again. But I am hopeful that the covid issue for the market is less of a risk than in the past, especially as we have warm weather on the way.

In summary, **I believe that equities can still provide positive gains as the year progresses**. With 2022 earnings expected to grow about 9.5%, if stocks can grow with earnings then you are looking at potential 15% gain in prices from here given the Q1 loss. With rates expected to rise however, it is likely that those stock gains could be discounted down to a lower level. So on the positive side I give stocks a return potential of 5-15% through year end. On the flip side, there is some risk that the Fed overshoots and can throw us into a recession in 2023 but even that should be a mild one if it happens. Still, prices could decline based on that scenario if it becomes more likely. Right now, I assign a about a 33% probablility of that happening based on the Fed's history. I'm a little more positive on bonds (up to a couple years maturity) here to generate some return if held to maturity. But again I favor laddering maturities to take advantage of rising rates.

Enjoy the Spring and change in the weather. Been a bit cold and wet here in the northeast. As always, feel free to drop me a note for discussion.

Bob