PDS WEALTH MANAGEMENT

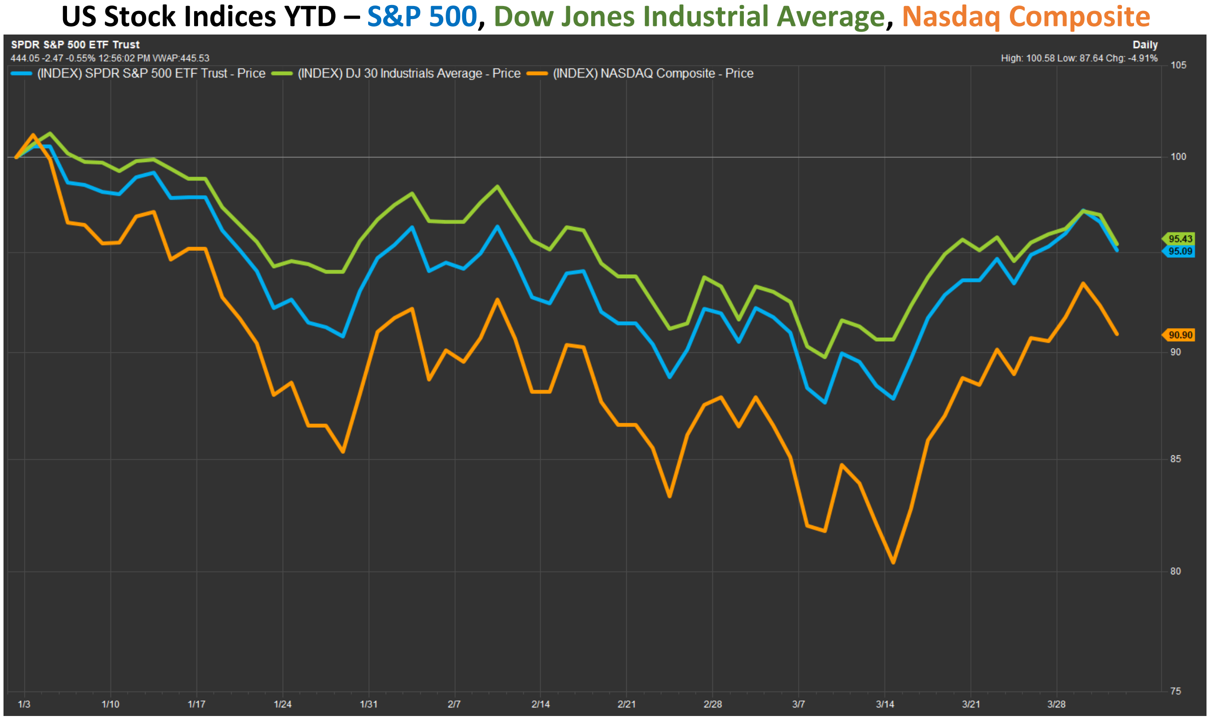
Quarterly Investment Report – Q1 2022

At the beginning of the year, our only prediction was that 2022 would not be uneventful. So far that is looking prescient as we exit a first quarter in which Russia invaded Ukraine, the US Federal Reserve Bank raised interest rates, and global financial markets swung wildly. While the domestic economy remains strong and unemployment low, inflation readings are high and persistent, leading to calls for interest rate hikes to go further and faster. Several economies outside the US, particularly in Europe and China, are also showing signs of slowing. These issues, and many more highlighted below, have our attention and are keeping us on our toes as we trek further into 2022.

Markets Review

Stocks

US Stock Indices YTD – S&P 500, Dow Jones Industrial Average, Nasdaq Composite



Source: FactSet

Stocks were under pressure for most of the first quarter, though they managed to rebound in the final two weeks of March. For Q1 overall, the S&P 500 fell 5%, the Dow Jones Industrial Average dropped 4.6%, and the Nasdaq declined 9%. At their recent lows in mid-March, those indices were off 13%, 10%, and 19%, respectively, from their early January highs. Frequent readers of this quarterly report would know that the average intra-year decline in stocks has averaged 14% over the last 40 years, roughly in-line with what we have seen thus far in 2022.

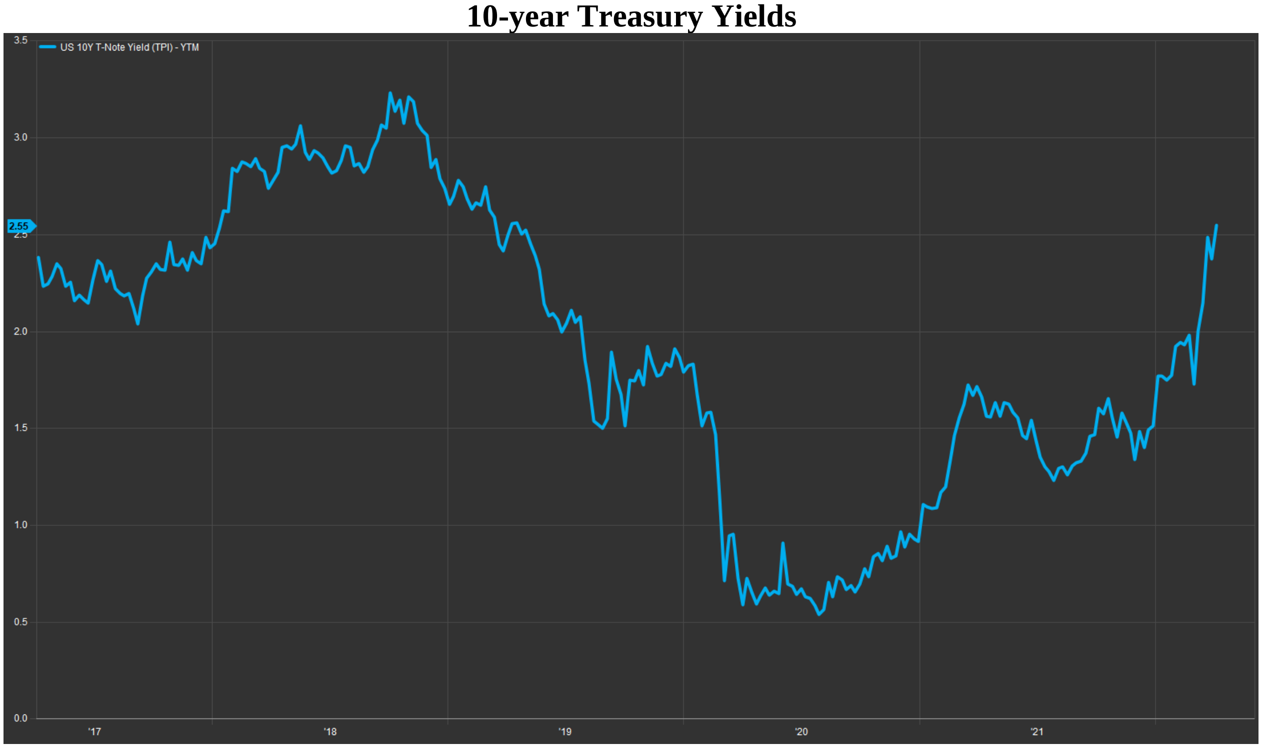
The energy sector was the standout performer in Q1 with a +38% gain – not surprising given the >35% increase in oil prices. Utilities were the only other sector to post a positive quarterly return with a +4% gain. The worst performing sectors were Communication Services, with a 12% slide, Consumer Discretionary (-9.5%), and Technology (-8.6%). Healthcare, Materials, Financials, Industrials, and Staples all lost between 1-3%.

The small-cap Russell 2000 Index ended Q1 with a 7.5% drop while international markets, as measured by the FTSE All-World ex-US Index, declined 6%. Emerging market indexes, some with exposure to Russia, fell slightly more than their developed market peers.

Bonds

Contrary to recent periods of equity market disruptions, fixed income investments did not offer a refuge during the volatile first quarter as bond prices were under pressure and yields rose. There was notable pressure in shorter-dated (<10-year) maturities – 2-year Treasury Note yields rose from ~0.75% to 2.3% and the 5-year Note yield roughly doubled to ~2.4%. The yield on the 10-year Treasury Note began the year at 1.5% and breached 2.5% in the final days of the quarter. The upward trend continues in April with the 10-year yielding 2.64%. The Bloomberg Barclays US Aggregate Bond Index fell 6% in Q1, suffering its worst decline since 1980.

10-year Treasury Yields



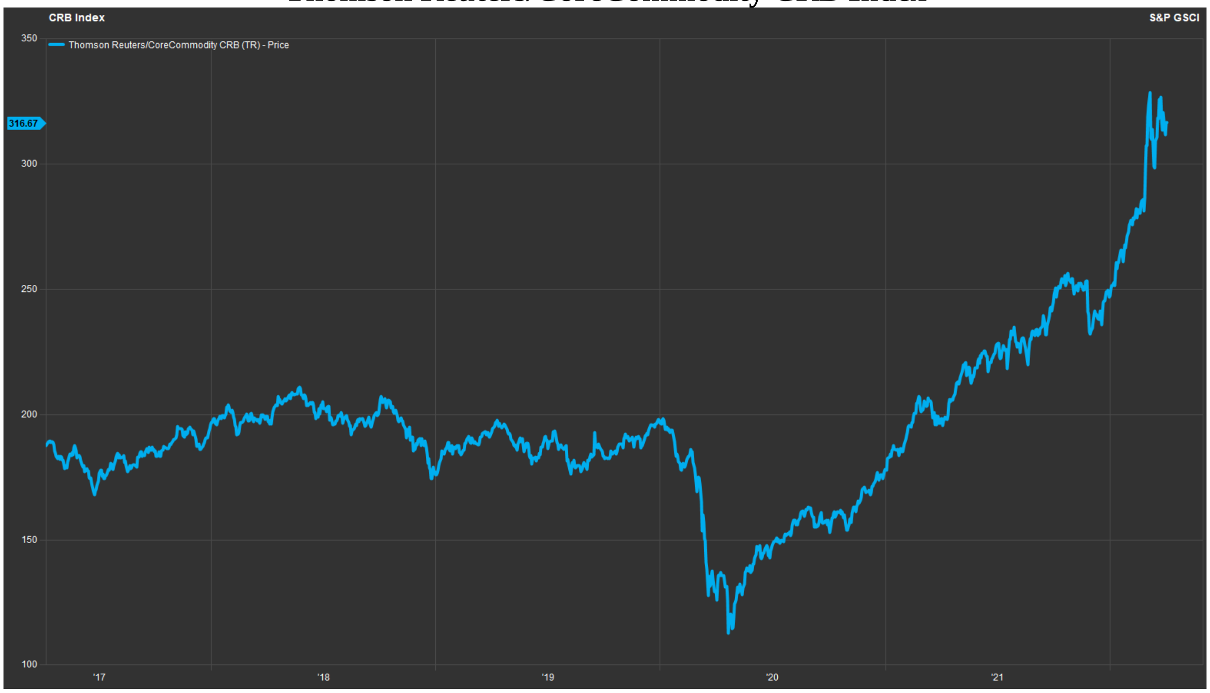
Source: FactSet

The S&P 500 Investment Grade Corporate Bond Index fell 7% in Q1 and currently yields 3.6% with a duration of 7.6 years. The S&P 500 High Yield Corporate Bond Index declined 6% in Q1 and currently yields 5%. On a positive note, spreads of corporate bonds compared to treasury bonds remain below historical averages, indicating the market views corporate balance sheets as healthy, for now at least.

Commodities

For this edition of our quarterly report, we thought it worth mentioning the commodities markets. The Russian aggression in Ukraine has put meaningful upside pressure on oil and gas prices, as well as some agricultural and metals products. Russia supplies much of Europe's energy needs and both countries contribute a significant percentage of agricultural products to global markets. The prospects of shortages from a lack of near-term alternative supply sources has led to price spikes across many commodities. The below chart of the Thomson Reuters/CoreCommodity CRB Index shows a near tripling off the March 2020 lows.

Thomson Reuters/CoreCommodity CRB Index

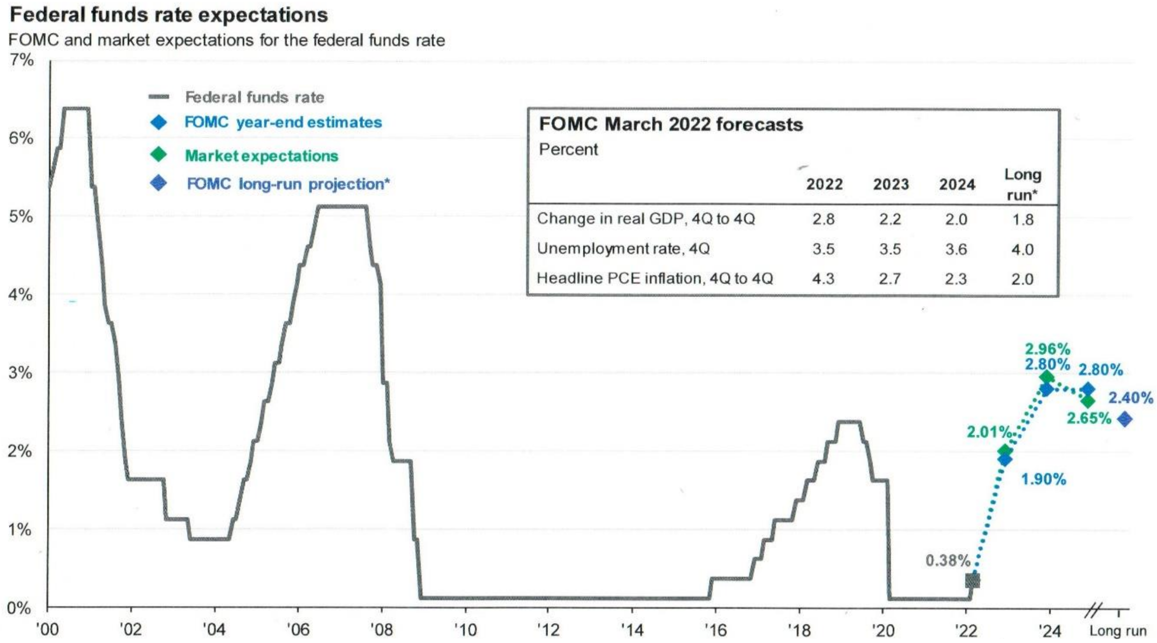


Source: FactSet

Economic Review

The most anticipated economic event in the US in the first quarter was the Federal Reserve Bank's interest rate hike and termination of its bond buying program. On March 16, the Fed raised the overnight lending rate by 25 basis points to 0.5%. There was some speculation that a 50bp increase was in the offing, but Russia's invasion of Ukraine injected enough uncertainty to warrant a less disruptive, smaller hike. Expectations are growing for 50bp rate hikes out of the next several Fed meetings. Markets are currently pricing in a Fed Funds rate of ~2% at year-end 2022 and ~3% at the end of 2023.

Rate Expectations

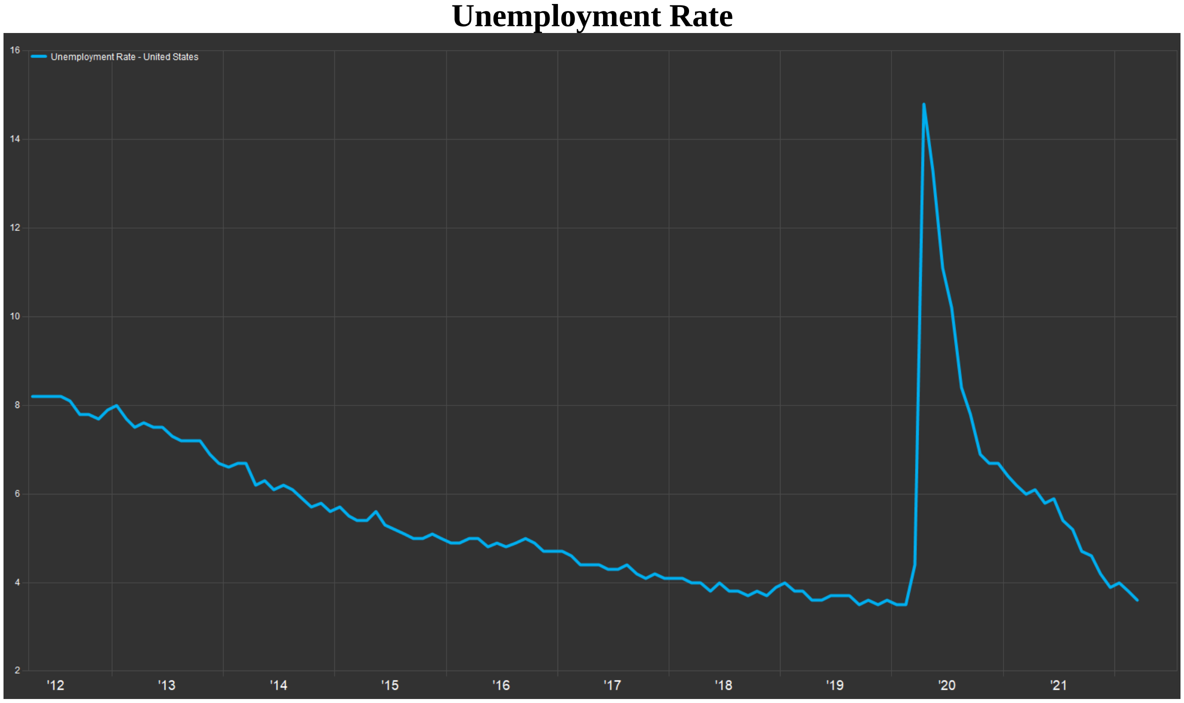


Source: JP Morgan

Employment

The March reading of US unemployment, reported on April 1, came in at 3.6%, just a hair's breadth away from pre-COVID levels of 3.5% and down from 4% at the beginning of the year. Growth in payrolls was robust throughout the first quarter and demand for labor remains strong, as evidenced by over 11.2 million job openings reported in the latest JOLTS survey from February.

Unemployment Rate



Source: FactSet

Inflation

The headline inflation reports from January, February, and March showed headline prices rising between 7-8% year over year, and around +6% excluding food and energy. For years the Fed struggled to get inflation to their 2% target. Now we are reminded of the phrase "be careful what you wish for, because you may just get it." The Fed has a delicate task ahead – curb inflation while avoiding a recession.

Headline CPI Change Y/Y

Source: Factset

Outlook

As we move further into 2022, we have answers to some of our past questions and some new ones. Below is a non-exhaustive list of issues that currently have our attention:

Geopolitics/Global Issues

- Does the war in Ukraine come to an end? If so, when and how? If not, does it spill over into other geographies and draw in other countries/NATO?
- Is China emboldened by Russia's aggression or has the international sanctions regime caused them to re-think their plans for Taiwan? Do China/Russia ties become stronger or weaker?
- COVID continues to linger in some parts of the world and cause havoc on supply chains, especially in China. Do new variants continue to emerge or does the world learn to live with the virus? Does China depart from its zero-COVID policy?
- This one is always a concern in the modern era - when, where, and who will the next cyberattack target?

Economic

- Now that the Fed has ended its quantitative easing program and embarked on a rate hiking cycle, how high and how fast will they go? Will it be enough to rein in inflation without tipping the economy into recession – a soft-landing?
- How fast will the Fed reduce their sizable ($8.9 trillion) balance sheet? What effect will it have on the yield curve, which some claim is currently signaling a recession is on the horizon?
- The war in Ukraine appears to be having a deleterious effect on European economies, does that weakness spread overseas?

Corporate Fundamentals

- Corporate earnings estimates remain a bright spot and have provided some support to equity markets, but are those estimates at risk of coming down?
- Can consumers and companies manage the spike in oil and other commodity prices?
- Will rising interest rates put pressure on sectors like housing and autos? (Mortgage applications are down >40% vs 2021)
- Will labor shortages persist and wage gains continue to lag headline inflation?

Domestic Political

- US midterm elections will be held on November 8; do Republicans take back either house?
- Are Biden and the Democrats able to pass further stimulus, raise taxes, or any part of the Build Back Better agenda?

All the best for Q2!

Paul Spencer, CFA®

Director