May Investment Outlook 2022

KLINGENSTEIN FIELDS
ADVISORS

Gregory W. Golinski, CFA
Director of Analytics
Partner

Current Market Conditions

"A nickel ain't worth a dime anymore" - Yogi Berra

Heightened market volatility - most of it directionally downward – has been the result of an increasingly dangerous geopolitical environment and decidedly higher global inflation. The war in Ukraine, with its human devastation on continuous display, creates both humanitarian and economic concerns. Is global stability at risk? How threatened is economic growth? In financial markets, the focus on inflation persists. The latest data indicate prices have risen 8.5% over the past year. As a result, the Federal Reserve Board (Fed) is under increasing pressure to get inflation under control by raising short-term interest rates. Ideally, this should have the effect of tamping down speculation, slowing "hot" markets, such as housing, and limiting the possibility of a self-perpetuating wage/price spiral. We expect current forecasts for inflation and for the level of Federal Reserve (Fed) tightening activity to rise as monetary policy moves are subject to multi-year lags. Hence, the effects of the Fed's balance sheet ramp-up several years ago are still being felt. Similarly, it will take some time for the Fed's reduction of its assets to have full impact.

Fluctuating risk appetite buffering equities

Markets globally have been experiencing a fluctuating "risk on" and "risk off" cycle, driven by both geopolitical instabilities and concerns around the macro-economic environment. From the beginning of this year through mid-March, the S&P 500 declined approximately -12%, and then rallied back by about 11%. However, by the end of April, the market had once again traded off -13% from its 2022 starting point. In addition, the NASDAQ 100, which is widely considered a proxy for riskier but higher growth stocks, entered bear market territory, defined as a decline of over 20% from its peak. International markets have not fared any better, with both the MSCI EAFE (international developed markets) Index and the MSCI Emerging Markets Index both down -12% year to date.

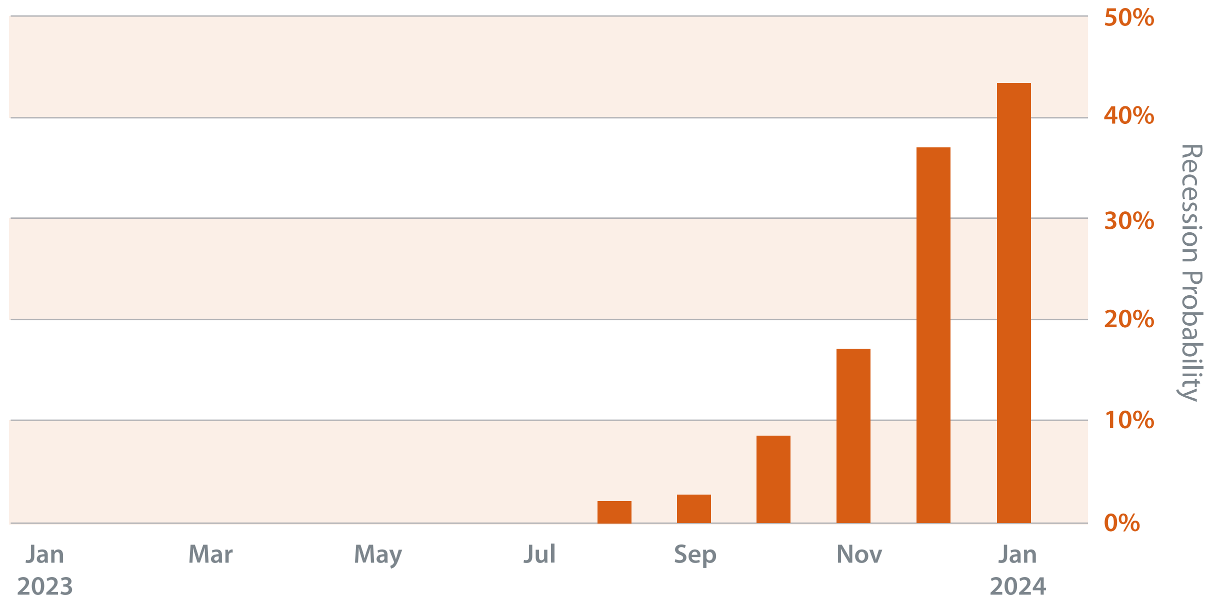
continued on page 2

Near-term recession risk still relatively low despite concerns

High current levels of inflation and rising short-term interest rates expose the economy to the possibility of a recession over the next few years. However, while the risk of recession has risen, we believe risks remain relatively low over the near-term. Concerns around inflation and geopolitics are offset by strong global economic growth, high levels of job creation, and generally positive measures of consumer net worth and spending. While the most recent GDP number came in unexpectedly negative, this reading was aberrant in that the negative figure was due more to "technical" factors related to inventory draw downs and imports, as opposed to spending.

While there are many models used to forecast potential recession risk, none of them are foolproof. In the chart below, we show one such model created by Bloomberg for the U.S. economy. This model does not see any chance of a recession in 2022 but predicts a 44% probability of recession by 2024. In Europe, the case for a recession is stronger, as the economic impact of the war in Ukraine is more acute given the geographic proximity to the hostilities and the heavy reliance on the combatants for energy and food commodities.

Recession Probability Rises Sharply in Late-2023

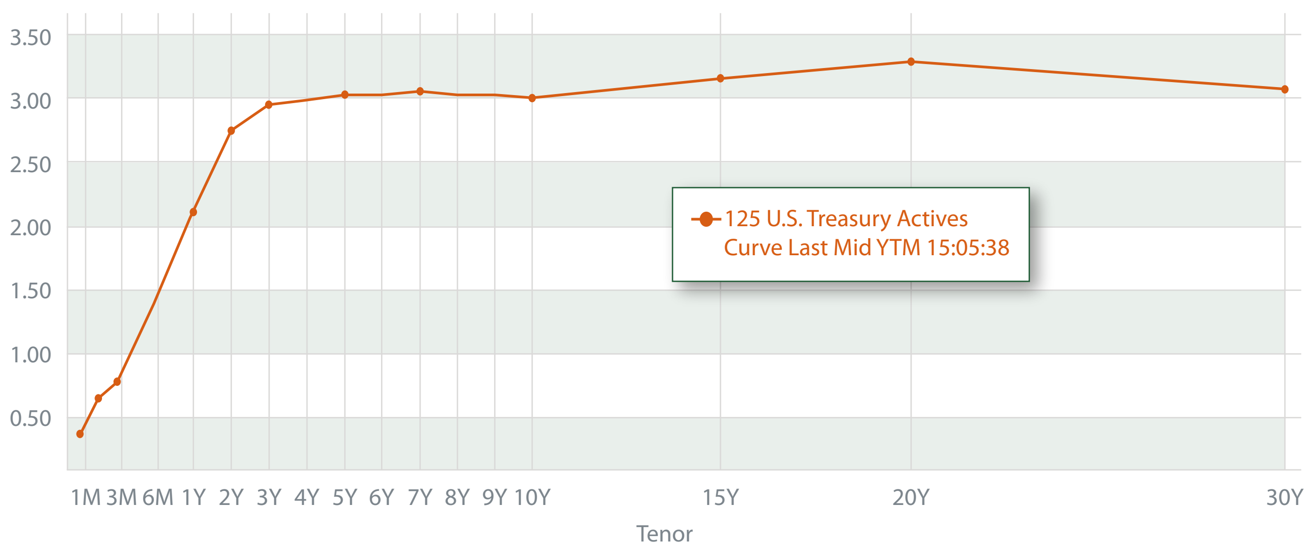


Source: Bloomberg Economics. Note: Each bar on this chart represents the outcome of the model associated with the time-horizon, i.e. the Jan. 2024 bar reflects the predicted probability for a recession occurring within 22 months

continued on page 3

Recession watchers often look to the yield curve, shown below. The yield curve is the chart of interest rates corresponding to different maturity periods of U.S. Treasury bonds. The relationship between the yield curve and recessions stems from the observation that when nearer-term rates are higher than longer-term rates (called a yield curve inversion), it is an indication that investors are more pessimistic about the future than the present. Currently there is ambiguity with this measure, although the difference between the 3-month and 10-year periods the Fed pays closest attention to does not signal a significant recession risk in the near term.

US Treasury Yield Curve



Curve Id	1M	3M	2Y	5Y	10Y	20Y	30Y
I25	0.380	0.787	2.728	3.012	2.997	3.281	3.065

Source: Bloomberg

continued on page 4

May Investment Outlook 2022

Investment Approach and Strategy

Equity valuations have compressed but not equally across the board

Despite the recent volatility, risk assets have not moved in lockstep. According to a study by Credit Suisse, the most expensive stocks in the market (i.e. the ones with the highest price/earnings (P/E) multiples) have seen their P/Es decline much more significantly than those of other cohorts and are now more in line with their longer-term averages.

This suggests a re-rating of long duration growth equities has taken place. Investors are no longer willing to bid up high revenue growth stocks without meaningful profitability generation. The recent focus has been on quality securities whose earnings are stable and may often provide a compelling dividend yield. Additionally, the recent volatility provides opportunities to invest in attractive growth managers and individual stocks that up to now have looked relatively unattractive due to high valuations.

Interest rates have risen in anticipation of the Fed's moves. While this has resulted in a welcome improvement to the interest earned on short-term balances, we still do not think rates have risen enough to offer an attractive substitute for risk assets like equities.

Things we are watching

The key factors we are watching remain global geopolitical stability and inflation risk. While inflation is currently high, and expectations for medium term inflation have risen, we still expect inflation to fall over the course of the next year. The keys to this view of declining inflation are the remediation of supply chain problems, oil prices falling back to levels more in line with their production costs, and actions by the Fed to slow inflation.

As part of this action to slow inflation, on May 4th, the Fed announced an interest rate hike of 0.5%, which was widely expected. The Fed also discussed the initial plans for reducing the amount of bonds it holds in reserve. These bonds were accumulated as a way to support the economy in prior times of crises, such as the pandemic and financial crisis. Reducing these reserves, and thus withdrawing liquidity from financial markets, is another method to fight inflation by increasing pressure on the economy's brakes.

All these factors will also distill into the U.S. mid-term elections held later this year. Governmental agencies like the Fed are often reticent to take actions that could be perceived as political, so they tend to stay a bit more accommodative than they might otherwise be. This tendency can be supportive of financial markets. Finally, the outcome of the war in Ukraine remains uncertain and recent worries over Vladimir Putin's health further cloud the picture.

.