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Q1 2022 Market Commentary

Produced by our Portfolio Management Team, Affinity Investment Advisors, LLC

Capital Markets Review

While there is always uncertainty when investing in risk assets, 2022 can perhaps be characterized as particularly challenging. There are several positive and negative countervailing forces present in the economy and capital markets. From a positive perspective, interest rates are still historically low, consumer demand appears reasonably strong given the pent up, post pandemic demand, and U.S. corporations – especially banks – generally possess strong balance sheets. While consensus earnings growth for S&P 500 companies for Q1 2022 is estimated be a modest 4.9%, EPS estimates for calendar year 2022 have been revised higher to 9.1%.

Challenges to the market include very high inflation rates and a more hawkish Federal Reserve, a flattening yield curve, decelerating growth in 2022, and the conflict in Ukraine and its impact on the economy and markets.

Equity Market Review

After a robust equity market in 2021 with the S&P 500 Index rising 28.7%, the U.S. equity markets traded lower in the 1st quarter of 2022. The S&P 500 Index declined -4.60% during the first three months of the year. Several factors pressured stock prices during the quarter. The Russian invasion of Ukraine exacerbated already high commodity prices. The most obvious impact has been on oil prices, which impacts virtually every segment of the economy. However, other products, such as nitrogen fertilizers, are produced in Ukraine and likely portend further price hikes. The continued increases in inflation in the U.S. have forced the Federal Reserve to assume a more hawkish posture. The Fed is expected to raise the Federal Funds Rate to nearly 2% in 2022, and then still higher in 2023. Historically, such monetary policy actions have a negative impact on stock prices, and the most recent quarter was no different.

It is interesting to note, however, that there was significant dispersion across styles and sectors during the 1st quarter. Growth stocks, represented by the Russell 1000 Growth Index, declined -9.04%. Meanwhile, value stocks, represented by the Russell 1000 Value Index, fell only -0.74%. However, as the table below shows, growth stocks still hold a significant advantage over value stocks over the trailing 3-, 5-, and 10-year periods.

Performance Results	Q1 2022	1 Year	3 Years	5 Years	10 Years
Russell 1000 Growth Index	-9.04%	14.98%	23.60%	20.89%	17.04%
Russell 1000 Value Index	-0.74%	11.67%	13.02%	10.29%	11.70%

All data as of 3-31-2022; Source: FTSE Russell

The outperformance of value stocks in the 1st quarter was driven by large differences in sector returns. As the table below shows, some of the largest traditional growth sectors by weight, such as Communication Services, Consumer Discretionary and Technology, represented the three worst performing categories during the period by declining -11.3%, -9.0% and -8.7%, respectively. Conversely, sectors with larger relative weights in the value indices, such as Energy and Financials, outperformed the broad market.

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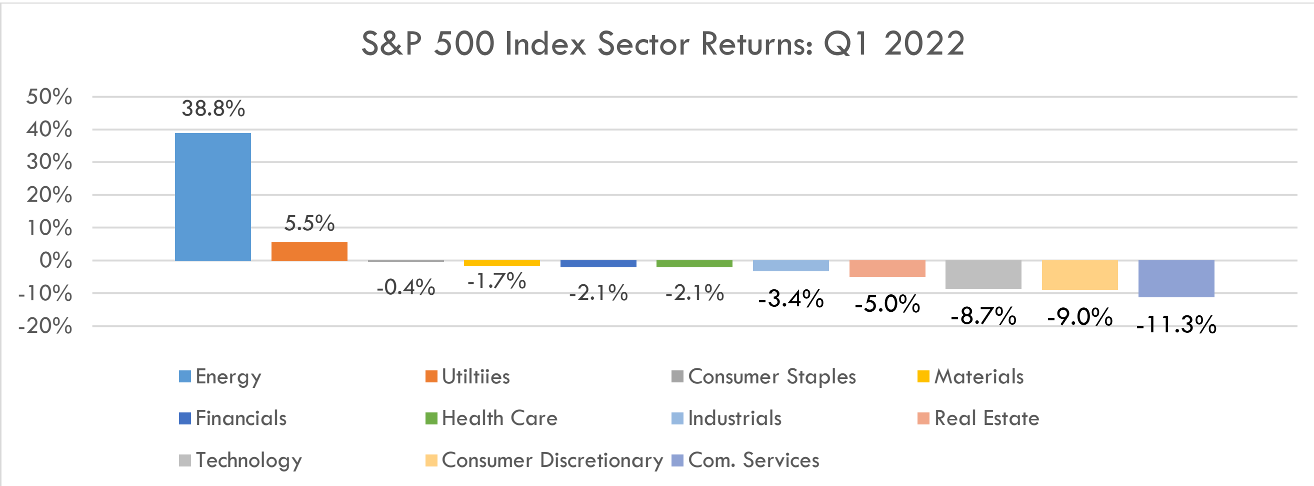


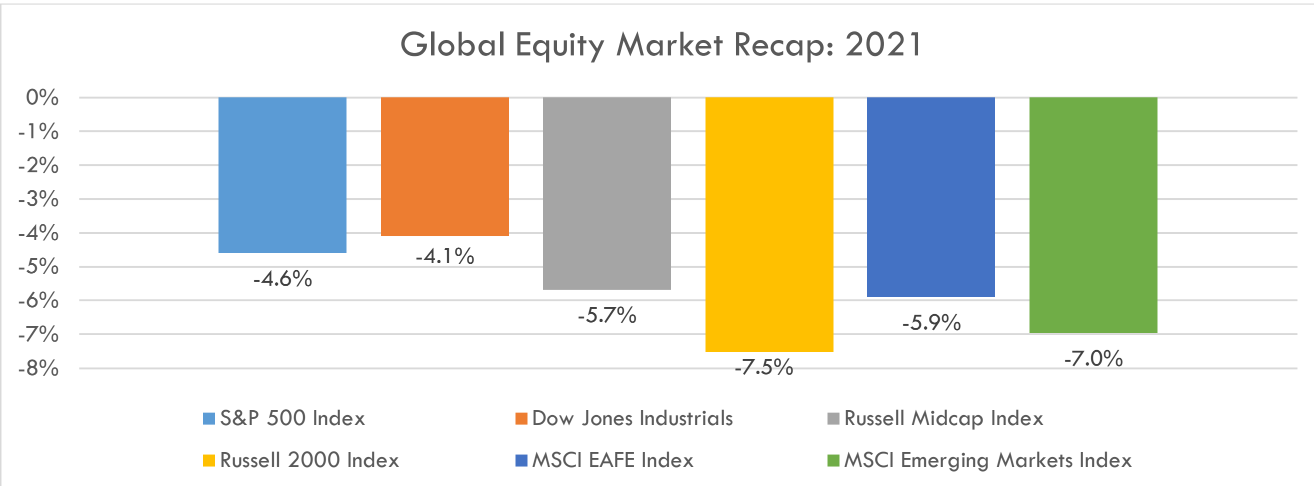
We mentioned in the last quarterly commentary that the outperformance of value stocks relative to growth stocks has been considerably more profound in the U.S. small cap market. Similar to the large cap universe, small cap value stocks dramatically outperformed growth stocks in the 1st quarter. During the period the Russell 2000 Value Index declined -2.40% while the Russell 2000 Growth Index fell -12.63%; in a technical sense, this was a formal "correction" for small cap growth companies. Unlike the large cap space, the rotation into small cap value stocks at the expense of small cap growth stocks has been on-going. The table below shows stronger relative performance for the Russell 2000 Value Index over the trailing one- and three-year periods.

Performance Results	Q1 2022	1 Year	3 Years	5 Years	10 Years
Russell 2000 Growth Index	-12.63%	-14.33%	9.88%	10.33%	11.21%
Russell 2000 Value Index	-2.40%	3.32%	12.73%	8.57%	10.54%

All data as of 3-31-2022; Source: FTSE Russell

Negative returns are generally associated with a "risk-off" investment environment, and this was true of the 1st quarter. As the chart below demonstrates, larger capitalization stocks performed better than mid cap and small cap stocks, and developed equity market indices, such as the S&P 500 Index and the MSCI EAFE Index, outperformed developing markets, such as the MSCI Emerging Markets Index.

Within emerging markets, returns were highly disparate. Not surprisingly, the MSCI Emerging Markets EMEA Index, which includes Russia and Poland, declined -13.67%. Other regions were also weak, including the MSCI Emerging Markets Asia Index which fell -8.69%. Meanwhile, markets which are more levered to commodities, such as the MSCI Emerging Markets Latin America Index and MSCI Canada Index, posted positive returns of 27.26% and 4.58%, respectively. Clearly the rise in energy prices helped elevate the performance of energy related markets and investment products, such as the Alerian MLP ETF, which catapulted 19.01% higher during the quarter.



Fixed Income Markets Review

Interest rates increased in 2021, and this trend continued into 2022. During the 1st quarter, the 10-Year U.S. Treasury yield rose from 1.52% to 2.32%, negatively impacting bond prices. The chart below shows the rise in rates since the middle of 2020. It is interesting to note that at 2.32%, the yield on the 10-Year U.S. Treasury is still well below its most recent high of 3.23% in October of 2018; and that the general increase in yields from mid-2016 to late 2018 did not derail the economy or most asset prices. From June 30, 2016 to October 31, 2018, the S&P 500 Index rose more than 36% (cumulative).

Nonetheless, the increase in rates pushed most bond categories lower. The broad Bloomberg U.S. Aggregate Index declined -5.93% during the quarter. This represented a return better than the Bloomberg U.S. Agg Credit-Long Index which fell a whopping -11.23% and the Bloomberg U.S. Agg

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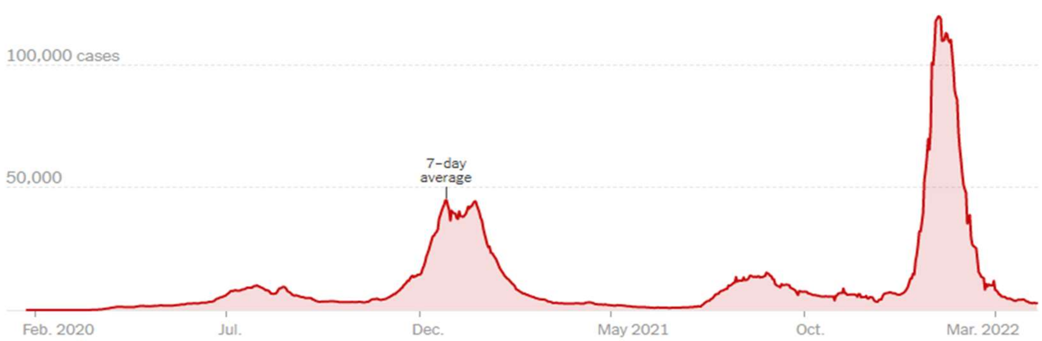
Government Treasury-Long Index which declined -10.58%. Interestingly, credit spreads remained relatively tight during the general decline in asset prices. The ICE BofA U.S. High Yield Spread, which measures the difference in yields between below investment grade corporate bonds (S&P BB or lower) and U.S. Treasury securities, edged slightly above 4% in mid-March. As the chart below shows, the spread is still quite tight and does not portend near term challenges in the credit markets. While high yield bonds were negative in the 1st quarter, they did outperform other fixed income categories by declining less (the Bloomberg U.S. Agg Corporate High Yield Index declined -4.84% for the quarter).

Capital Markets Outlook

Perhaps one of the most positive factors underlying the economy and capital markets is the pandemic's current status. New Covid-19 cases have dropped dramatically, as have hospitalizations and related deaths. The chart below shows the enormous decline in cases, which certainly has positive implications for growth. While this is good news, we of course cannot predict the future variants that may arise.



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Speaking of growth, according to the Conference Board, U.S. Real GDP growth is estimated to come in at 3.0% for calendar year 2022. This is a decline from the strong GDP growth of 5.7% in 2021, but higher than the growth rate of 2.3% in 2019. Rising/high commodity prices will likely hinder growth: the Conference Board estimates that at $125 per barrel of oil, GDP growth will be reduced by approximately -0.5% for the year. The drag on GDP growth will be higher or lower depending on the ultimate level of commodity prices. Nonetheless, economic expansion of this magnitude should translate into respectable revenue and earnings growth for most U.S. companies. As mentioned in the commentary's opening, EPS estimates for 2022 have been revised higher to 9.1%.

Regarding valuations, the market's decline from the early January highs has improved the attractiveness of stocks – at least from a valuation perspective. The forward P/E ratio for the S&P 500 Index stands at 19.5x earnings. This metric is down from late 2020 through much of 2021 when forward P/Es were around 22x to 23x earnings. Forward P/Es are more attractive as one slides down the market capitalization spectrum: for S&P 400 Mid Cap stocks the forward P/E is 14.4x earnings and it is 13.8x earnings for S&P 600 Small Cap stocks. We believe small and mid cap equities continue to offer better value relative to large cap equities, and international stocks appear more attractive relative to domestic stocks. With respect to style, despite the more recent rotation into value-oriented stocks, we continue to believe that value equities are more attractive relative to growth equities.

While there are positive factors surrounding the economy and market fundamentals, several key risks exist. First, while the conditions involving Covid-19 have greatly improved, new variants could emerge and the impact of such developments on the economy is uncertain. Second, the Federal Reserve has altered its posture and is now poised to tighten short term rates for the first time since the pandemic began. Clearly, the Fed's objective is to contain and reduce the 7.9% inflation rate which has reached 40 year highs. One current benefit for the Fed is that the second pillar of their dual mission is to maximize employment, and the job front is fairly strong. Many estimates call for inflation to peak over the next several months before moderating.

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One important consequence of rising short term interest rates is its impact on the yield curve. The chart above shows that inversions (in the case of the chart above that means the 2-year yield is higher than the 10 year yield) often lead to economic downturns. However, it is also noteworthy that such inversions generally precede recessions by months, not weeks. Whether or not an economic recession emerges will depend on many factors, including the level of inflation and the concomitant extent to which the Fed tightens, fiscal policy, and geopolitical events such as the war in Ukraine. In our view, given the strength of the U.S. economy and fundamentals and our view that inflation will taper off later this year, it seems less likely that a recession is imminent.

Finally, it is worth mentioning that this is a year when mid-term elections will occur in the U.S. Historically, it is characteristic for stock prices to show weakness through the first three quarters of the year. Often, when uncertainty surrounding the elections begins to evaporate, the equity markets respond positively. We thank our clients for your continued support and welcome any comments or questions.

Sources: Federal Reserve Bank of St. Louis; FTSE Russell; MSCI; S&P Dow Jones; Bureau of Labor Statistics; and Refinitiv.

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