Avantia

June 30, 2022

Quarterly Market Review

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Driving over a mountain pass in the middle of winter can be a dangerous undertaking! Picture this: You're on a family trip to go skiing and must make it through the pass despite there being a snowstorm. The roads are icy, temperatures are below freezing, and snow is falling thick and fast. Your headlights reflect off the snow in the darkness, nearly blinding you and bringing the visibility close to zero. As you drive higher into the mountains, the conditions continue to worsen and tension builds. While it may seem optimal to turn around now, we must remember why we are here in the first place. Your partner is in the passenger seat and the children are in the back seat, excited for the day. The coffee next to you is hot, and the skiing conditions promise to be absolutely stunning for your annual family ski trip to Crystal Mountain. Sure, the roads are dangerous and should be taken seriously, but you have studded tires with excellent traction, you are driving with care, and should something happen, you are prepared with blankets, food, and cell phones. Plus, other family members are in other cars near you on the road.

After a few stellar runs down the mountain, you realize how worth it the long and difficult journey was. The kids are happy, as you finally get to enjoy some peace by the warm fire.

Investing in challenging markets is much like this. We know there are risks and we build a portfolio to be well positioned in markets like today. We look for opportunities to add value and stick to our plan, knowing that the returns and risks of the equity market are worth it over the long run. A steady hand at the wheel will help avoid the pitfalls of novice investors.

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Markets

Asset Class Views:

As fears around inflation, interest rates, and recession expectations drive markets, some asset classes are likely to fair better than others given the long time horizon that equity investors enjoy. We see opportunity in the equity markets by being overweight value relative to growth and leaning into international markets. We see less opportunity within inflation protected fixed income, which does poorly when actual inflation turns out to be either equal or less than inflation expectations. We see this as being fully priced in and the opportunity in inflation-protected bonds has played out, so we return to neutral weight there. Duration (term) is still likely to underperform so we remain short duration across bond portfolios. With volatility high, options markets are yielding higher than average premiums, and investors with experience with this asset class can benefit.

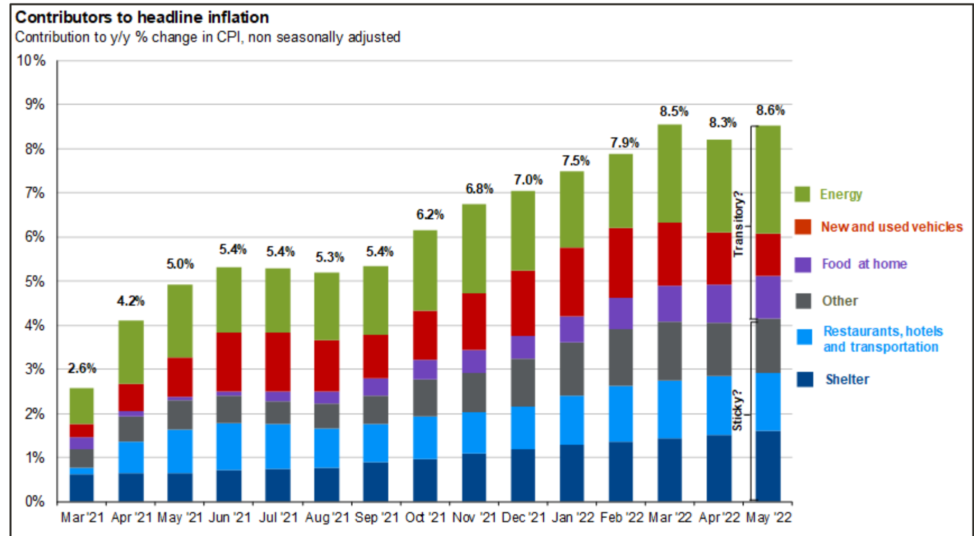
Figure 1(Sources: J.P. Morgan, Vanguard, Bank of New York Mellon, Russell)

Opportunity Set		Detail	Outlook	Conviction
Major Asset Classes		Public Equity	↗	
		Real Assets	↘	
		Fixed Income - Inflation Protected	→	
		Fixed Income - Nominal	→	
Factors		Value	↗	
		Small Cap	↗	
		Term	↘	
		Credit	↗	
Preference by Asset Class	Public Equity	U.S.	↗	
		International	↗	
		Emerging Markets	↗	
	Fixed Income	U.S. Treasuries	→	
		Municipal - High Quality	↗	
		Municipal - Credit	↗	
		Corporate - High Quality	↗	
		Corporate - Credit	↗	
		Cash - USD	↗	
	Real Assets	Real Estate	→	
		Master Limited Partnerships	→	
		Gold	→	
		Bitcoin	→	

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD	2007 - 2021 Ann.	2007 - 2021 Vol.
EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Cash 1.8%	Large Cap 31.5%	Small Cap 20.0%	REITs 41.3%	Comdty. 18.4%	Large Cap 10.6%	REITs 23.2%
Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Fixed Income 0.0%	REITs 28.7%	EM Equity 18.7%	Large Cap 28.7%	Cash 0.2%	Small Cap 8.7%	EM Equity 22.9%
DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	REITs -4.0%	Small Cap 25.5%	Large Cap 18.4%	Comdty. 27.1%	Fixed Income -10.3%	REITs 7.5%	Small Cap 22.5%
Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	High Yield -4.1%	DM Equity 22.7%	Asset Alloc. 10.6%	Small Cap 14.8%	Asset Alloc. -14.6%	High Yield 6.6%	Comdty. 19.1%
Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Large Cap -4.4%	Asset Alloc. 19.5%	DM Equity 8.3%	Asset Alloc. 13.5%	High Yield -16.9%	Asset Alloc. 6.1%	DM Equity 18.9%
Large Cap 5.5%	Comdty. -35.6%	Large Cap 25.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	Asset Alloc. -5.8%	EM Equity 18.9%	Fixed Income 7.5%	DM Equity 11.8%	EM Equity -17.5%	EM Equity 4.8%	Large Cap 16.9%
Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	Small Cap -11.0%	High Yield 12.6%	High Yield 7.0%	High Yield 1.0%	REITs -19.2%	DM Equity 4.1%	High Yield 12.2%
High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Comdty. -11.2%	Fixed Income 8.7%	Cash 0.5%	Cash 0.0%	DM Equity -19.3%	Fixed Income 4.1%	Asset Alloc. 11.7%
Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	DM Equity -13.4%	Comdty. 7.7%	Comdty. -3.1%	Fixed Income -1.5%	Large Cap -20.0%	Cash 0.8%	Fixed Income 3.3%
REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -14.2%	Cash 2.2%	REITs -5.1%	EM Equity -2.2%	Small Cap -23.4%	Comdty. -2.6%	Cash 0.7%

Market Commentary:

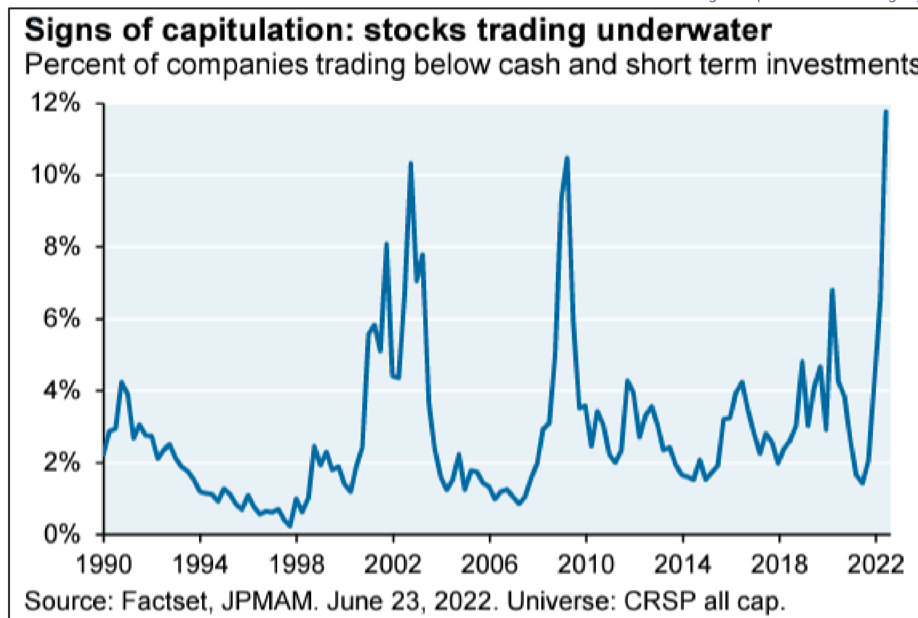
Figure 2(Sources: J.P. Morgan)



The markets are currently processing a lot. The biggest driver of volatility is the latest inflation prints - Inflation came down then back up for the previous two months (Figure 2). Markets are hoping to see a lower inflation print which will signal a peak in inflation. When inflation peaks, it nearly always signals a bottom in the stock market. As inflation falls and rates rise, real rates will turn positive and positive real rates is a "normal" condition. The last decade or so has not been normal at all. However, few are talking about this due to food and energy inflation is still being high. Furthermore, core inflation is falling, shipping costs are falling, and supply chains are breaking loose (which is a good thing). Store inventories are incredibly high, and they are trying to clear product off their shelves with sales and discounts. That being said, a lot of products are pandemic specific, and as demand slows for these products, excess inventory is natural and discounts will follow, which drives down inflation numbers. For example, home office furniture has slowed, as workers now need suits and ties as office work returns. However, with shipping rates falling, and other supply chain items loosening up, inflation is likely to continue falling. Food and energy are, however, heavily impacted by the war in Ukraine.

If the war in Ukraine were to end today (unlikely), then headline inflation would fall more rapidly. There is support politically in Europe that may very well lead to the end of the war in Ukraine, but it could equally result in a more catastrophic incursion more broadly in Europe. For example, Germany activated the second phase of its three-stage emergency plan for a natural gas supply. Germany is reaching dangerous levels of energy shortage. Germany's new Chancellor will need to find a way out from under the shadow of Angela Merkle. Separately, Lithuania recently blocked all rail supplies going from mainland Russia through Lithuania to Kaliningrad, a Russian city on the Baltic Sea. Finally, Finland and Sweden have been encouraged to join NATO as soon as possible and Turkey seems to support this. Europe is starting to unite against Russia. If Europe unites against Russia to push them out of Ukraine, energy prices will plummet and food prices will slowly begin to correct. We have removed our overweight to energy.

Figure 3(Sources: J.P. Morgan)



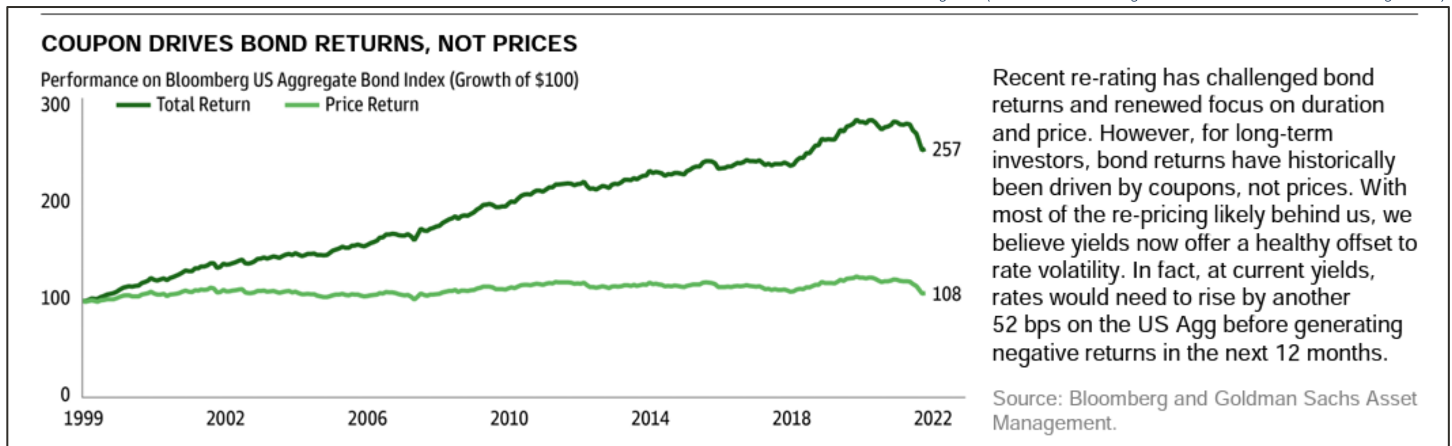
What does this mean for markets? The items discussed would slow the rate increases that the market currently has priced in. As of this writing, markets are giving an 86% chance of the Fed raising rates by 75 basis points, which is a lower chance than it was a week ago (97%). Rate increases would still continue, just at a potentially slower pace. Stocks trade on expectations and due to a more positive outlook, stocks would likely reverse if we saw the inflation and rate expectations change. This is also in line with what historically happens when inflation has peaked. Growth stocks will

continue to face headwinds, though not as much as before. Value will continue to outperform as both earnings and multiples expand. Small cap stocks tend to have higher borrowing costs compared to large cap stocks, along with more leverage. Rising rates in general are tough on small cap relative to large cap. Another capitulation metric worth mentioning is the "underwater" percentage. Currently, with the all-cap universe of stocks, the percentage of companies trading below the value of the cash and short-term investments on their balance sheets has never been higher in over 30 years (Figure 3). This has been a good signal of a bottom in the past. Are we at the bottom? Probably not just yet, but we seem to be very close, and we rather catch the upswing than miss it as the first part of it generally happens very quickly.

Internationally, as the risk of a broader war increases, stocks in the region will fall. When the war in Ukraine ends, a massive rally will likely take place over the course of a few days, followed by higher volatility as the news is digested. Emerging markets will perform similarly in terms of direction, but with a muted level of volatility the farther they are, economically, from Ukraine.

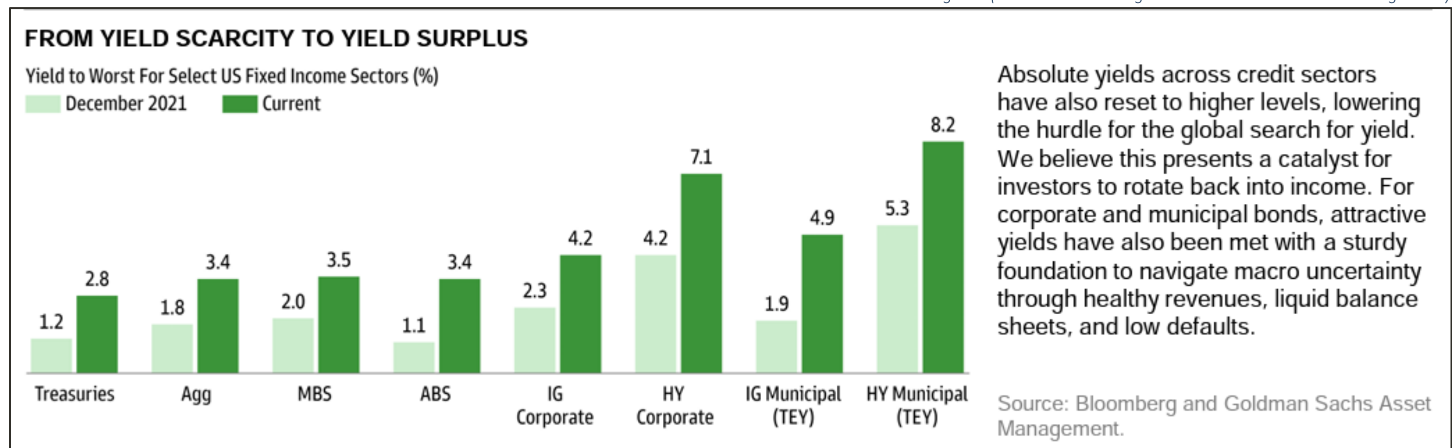
Within fixed income, as inflation decreases, for a while, we are likely to see rates rise. This will increase the long-term return of fixed income and hurt the short-term return. To manage this, we will continue to shorten bond duration within client portfolios. As a data point, the Taxable Equivalent Yield (TEY) on high yield munis is 8.2% now. It was 5.3% in December. Investment grade municipal bonds are at 4.9%, compared to 1.9% in December. Markets are pricing in another 3% increase in the fed funds rate by the end of this year. It's reasonable to expect that at a duration of 4 years, about 2/3rds of that rate increase will be evident. In sum, rates will go up, prices will go down, and bond portfolio performance will be down in 2022. However, the true source of performance in fixed income is the yield, not the price (Figure 4). Bonds mature at par, stocks have no such mechanism.

Figure 4(Sources: Bloomberg and Goldman Sachs Asset Management)

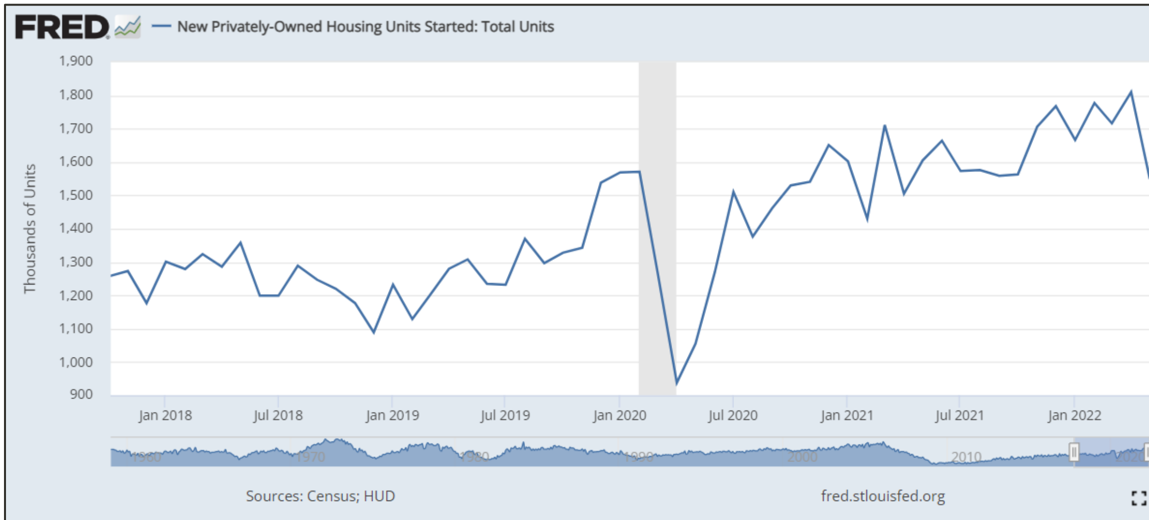


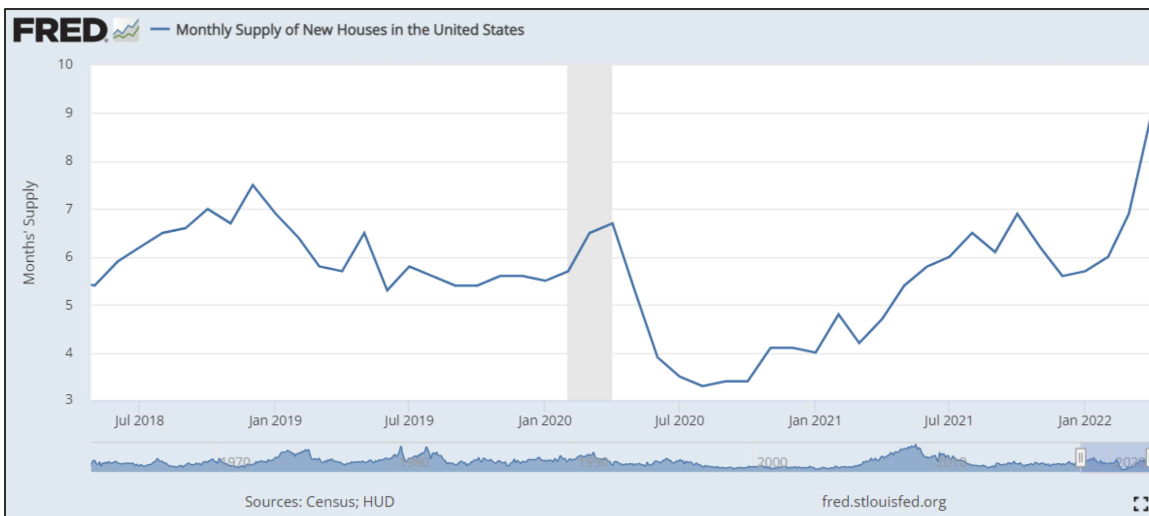
Credit is likely to continue to outperform investment grade in fixed income markets. Broadly speaking, tax revenue is up and municipalities are well capitalized. Corporates continue to see increased earnings and have large cash reserves. The banking sector has virtually zero stress in the system. Thus, defaults remain low in an environment when rates are higher (Figure 5).

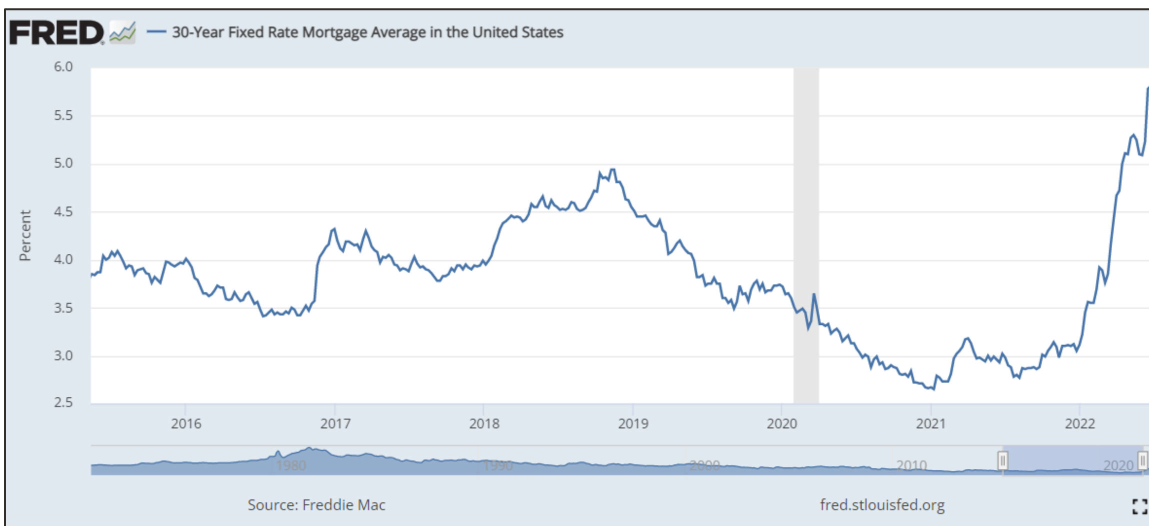
Figure 5(Sources: Bloomberg and Goldman Sachs Asset Management)



Real assets are likely to struggle in our current environment. As rates rise, real estate tends to struggle as the cost of debt increases. Thus, yields in this area will fall as rates rise unless rent inflation can keep pace. That is looking increasingly unlikely as builders have potentially overbuilt. Demand for housing may be decreasing, as mortgage rates have rapidly risen, though still historically low.





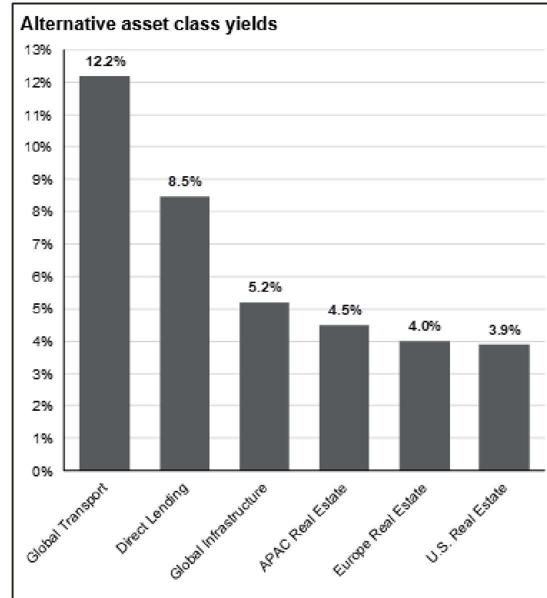


Real estate is an effective inflation hedge, due to the natural inflation hedge provided by debt financing. However, as inflation falls, this benefit will be muted. Additionally, as rates increase, investors can find higher yield in lower risk assets such as investment grade fixed income. For comparison, consider that Investment grade corporates yield is 4.2%, the TEY on IG Munis is 4.9% and the yield on US REITs is 3.9%.

In times like these, investors have a higher propensity to capitulate. While most investors know they should be long-term investors, they are often short-sighted in their execution. Part of this is driven by evolution, and part is a function of proximity bias. Evolution has rewarded us for avoiding danger. Proximity bias causes

us to give greater decision weight to events that have occurred most recently. However, an optimal approach can be witnessed regularly in professional real estate investors. These investors typically have very low levels of cash (about 3% of their balance sheet), and nearly everything else they own is focused on real estate. The real estate is highly leveraged, with one notable exception, their own home. Real estate investors essentially build a moat around their lives and protect their lifestyle by removing risk and adding highly confident sources of income to fund their lives. Once that is established, they take increasingly large bets on development projects because they can now sustain failures and reap the rewards of a risk. At Avantia, we take a similar approach. We build robust financial structures through asset location, understanding the entire balance sheet and income sources (current and future), and build an asset allocation to provide the essential protection needed to support the family's lifestyle, and then allocate excess resources to riskier assets in a thoughtful manner.

Figure 9(Sources: J.P. Morgan)



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