The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets — April 2022

From: *Philadelphia* Investment Management Group

OVERVIEW

- ***The Federal Reserve Has Begun to Raise Interest Rates to Combat Inflation.*** *More increases are expected throughout the balance of 2022, and the asset purchases to reduce the Fed's indebtedness will be outlined and commenced shortly.*

- ***Inflation Numbers Have Come in Higher Than Earlier Predicted.*** *The transitory nature for the duration of this period of inflation has been extended due to events such as the Russian-Ukraine war causing additional bottlenecks, with supply issues, among other concerns.*

- ***The Securities Markets, Both Stocks and Bonds, are Very Confused Due to the Many Current Events With Which We are Faced.*** *The volatility will wind down as these issues work themselves out and things start to fall into place.*

THE ECONOMY

In the previous market commentary, we reported on the Federal Reserve's intentions to combat the inflationary fear with higher interest rates and a significant reduction in its $9 Trillion asset portfolio. We have now seen an increase in interest rates, and as of the writing of this commentary, details are soon to be released outlining the amounts of securities allowed to mature in any month. So where does the economy go from here? There are as many different opinions on this as there are facts to consider. Even the Federal Reserve itself admits to the danger of setting policy based on forecasted economic and business developments. However, the Fed's feeling remains that inflation numbers will come down as supply chain problems ease and as more workers return to the labor market.

With regard to the supply problems, Russia and Ukraine are major suppliers of both food and energy. Adverse supply shocks, such as these, are stagflationary. They drive inflation up and real economic growth down. This is another example and a very important fact in the analysis of the demand/supply situation in the U.S.

The Fed also knows that too rapid a rise in interest rates and level of asset reduction increases the risk of recession, which it obviously would like to avoid. There is a broad range of potential outcomes and an unusually high degree of uncertainty.

In summary, and against the backdrop of known information, our belief is that the economy will survive these Fed initiatives and will slowly continue to move forward in a positive direction. Consumer finances appear to be in good shape, low inventories will slowly rebuild, and earnings growth remains solid. The pent-up demand occurring first from the COVID situation and now the Ukraine-Russian conflict will eventually right itself and business will be back to normal.

FINANCIAL MARKETS

EQUITIES

The first quarter of 2022 witnessed elevated market volatility with continued uncertainty over the war in Ukraine, tighter monetary policy and concerns about economic growth. Even before Russia invaded Ukraine, U.S. stocks were on a downward trend and interest rates had already started to rise. Major stock indexes suffered their worst performance in two years, dragging the S&P 500 down 4.60% over the past three months. The Dow Jones, NASDAQ and Russell 2000 index of small capitalization stocks lost 4.10%, 9.10% and 7.53%, respectively, during the same period.

	Equity Returns*			
Index	**Jan**	**Feb**	**Mar**	**1st Qtr**
S&P 500	-5.17%	-2.99%	3.71%	-4.60%
Dow	-3.24%	-3.29%	2.49%	-4.10%
NASDAQ	-8.98%	-3.43%	3.41%	-9.10%
Russell 2000	-9.63%	1.07%	1.24%	-7.53%

*Total: price change + reinvested dividends

What is in store for the equity markets as the year progresses is anyone's guess. Our view is that we will not enter a global, U.S. or European recession. The Fed continues to assert that it can raise interest rates and manage a soft landing. Further, household balance sheets remain strong, providing some cushion against the blow from higher borrowing costs and elevated inflation.

The following sector performance returns for the quarter tell a familiar tale during this period of inflation in the economy. Sectors selling at higher valuation levels came under attack more than others. While we recognize why sectors, such as Information Technology, Communication Services and Consumer Discretionary, had poorer performance with their larger valuation levels than other sectors, we nevertheless will maintain a weight in these attractive areas of the economy.

	S&P 500	
		Returns*
Sector	**Weight***	**1st Qtr**
• Energy	3.9%	39.03%
• Materials	2.6%	-2.37%
• Industrials	7.9%	-2.36%
• Cons. Discretionary	12.0%	-9.03%
• Consumer Staples	6.1%	-1.01%
• Health Care	13.6%	-2.58%
• Financials	11.1%	-1.48%
• Info Technology	28.0%	-8.36%
• Communication Svcs	9.4%	-11.92%
• Utilities	2.7%	4.77%
• Real Estate	2.7%	-6.22%

03/31/22
*Price + income
Source: S&P Dow Jones

In general, despite the negative equity performance in the past quarter, we will continue to focus on quality investments in these diversified sectors. As the various current events continue to influence the equity market, we are confident that as they get resolved, performance will come back into the equity marketplace.

FIXED INCOME

All fixed income categories fell in the first quarter as interest rates moved higher. The Federal Reserve raised short-term rates by 25 basis points in March for the first time since December 2018. The Bloomberg Aggregate bond index, a proxy for the U.S. bond market, fell 6.1%, the worst quarter in almost 40 years. In response to ongoing inflation, the Fed, in addition, concluded its tapering or asset purchases in March and underscored that subsequent 50-basis point hikes and an earlier start of runoff from the Fed's nearly $9 Trillion balance sheet will be necessary to combat inflation in the coming months.

One of the biggest concerns now, as evidenced by the very tight spread in yields between the two- and ten-year Treasuries, is with the slowdown in the U.S. economy, underscoring the delicate balance of policy decisions to curb inflation without leading to a U.S. recession. Central bankers are hoping that the strong job market will help them slow the economy without tipping it into an outright recession.

The bond market's returns, as reported below, show the effect on performance of the various bond groupings. As in the case of the equity discussion above, bond returns adjust very quickly to changes in inflation and the perception of Federal Reserve policy decisions. Across all bond maturity and quality areas, returns for the quarter were negative.

Fixed Income Returns

Index	**1st Qtr**
Corp/Govt	-6.43%
Int. Corp/Govt	-4.58%
Long Corp/Govt	-10.92%
U.S. Government	-5.56%
- Intermediate	-4.02%
- Long	-10.14%
Corporate	-7.74%
- Intermediate	-5.53%
- Long	-11.51%
- **Quality**	
- AAA	-8.49%
- AA	-7.50%
- A	-7.18%
- BBB	-8.21%
Municipal	-6.18%
- Intermediate	-4.44%
- Long	-7.45%

Source: ICE BofA

Concerns over higher interest rates and the Fed's pivot to a tighter monetary policy continued to produce headwinds as well for municipal bonds. The broad-based municipal market witnessed three straight months of losses. Compared to investment grade corporate debt, in spite of these losses, tax exempt paper had slightly better performance in the first quarter due to the subdued new issuance of bonds thus far in 2022.

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In conclusion, our strategy is to stay the course with a well-diversified, high quality equity portfolio, with short-to-intermediate high-grade bonds. With the glaring exception of inflation, the U.S. economy is performing well. The labor market is tight, incomes are growing, and household balance sheets are strong. While the increase in money supply was necessary by the Fed to combat the ill economic effects of the virus, the containment and reduction in this supply is an important tactic in the control of inflation and their target for a soft landing in the economy.

Philadelphia Investment Management Group
105 Clarke Avenue
Pocomoke City, MD 21851