Market Summary

U.S. Equity Markets	1Q'22	1 Year	3 Years	5 Years	10 Years
S&P 500	-4.6%	15.7%	18.9%	16.0%	14.6%
Russell 1000 Growth	-9.0%	15.0%	23.6%	20.9%	17.0%
Russell 1000 Value	-0.7%	11.7%	13.0%	10.3%	11.7%
Russell 2000	-7.5%	-5.8%	11.7%	9.7%	11.0%
Russell 2000 Growth	-12.6%	-14.3%	9.9%	10.3%	11.2%
Russell 2000 Value	-2.4%	3.3%	12.7%	8.6%	10.5%

Top/Bottom Sectors	1Q'22	1 Year
Energy	39.0%	64.4%
Utilities	4.7%	19.9%
Cons. Staples	-1.0%	16.1%
Comm. Services	-11.9%	-0.9%
Cons. Discretionary	-9.1%	9.7%
Info. Technology	-8.4%	20.9%

Price Comparison (in USD)	Mar. 31, 2022	Mar. 31, 2021
Oil (WTI spot)	$100.53	$59.19
Natural Gas	$5.64	$2.61
Gold	$1,949	$1,713
Fed Funds Rate	0.38%	0.13%
10-Yr Treasury	2.35%	1.74%
VIX	20.56	19.40

Non-US Equity Markets (in USD)	1Q'22	1 Year	3 Years	5 Years	10 Years
MSCI AC World Ex U.S.	-5.4%	-1.5%	7.5%	6.8%	5.6%
MSCI EAFE (Developed)	-5.9%	1.2%	7.8%	6.7%	6.3%
MSCI Emerging Markets	-7.0%	-11.4%	4.9%	6.0%	3.4%

Non-US Regions (in USD)	1Q'22	1 Year
Developed Americas	5.1%	21.2%
Developed Asia	-3.0%	-2.8%
Developed Europe	-7.3%	4.2%

Non-US Regions (in USD)	1Q'22	1 Year
Emerging Americas	27.5%	24.3%
Emerging Asia	-8.6%	-15.0%
Emerging EMEA	0.5%	9.8%

Source: MSCI, S&P Global, FTSE Russell; Refinitiv, St. Louis Federal Reserve Bank

Market Review:

The Santa Claus rally at the end of last year was the last blast before a winter chill cooled off a hot stock market. Stock prices began to sink right from the first trading day of the quarter. At the low for the quarter the S&P 500 Index closed almost 14% below its high water mark. But one could contend a bear market has already occurred since 62% of S&P 500 constituents have had a drawdown of -20% or greater. That statistic jumps to 78% of constituents with a -15% or greater dip. The small cap index officially made it into bear market territory, 21% below its peak. While large cap U.S. value stocks were largely unchanged at the aggregate, their brethren in the growth index did not fare as well. Similarly, small cap growth stocks fell more than value ones. This was especially true for those companies with very high price/earnings ratios or with no earnings at all. Within the U.S., companies in the most expensive decile underperformed the least expensive by a wide margin. At the aggregate, non-U.S. stock returns were roughly in line with the U.S., but dispersion was quite wide. Commodity prices extended their rally with the war in Ukraine and the sanctions imposed on Russia. As a general rule, companies benefiting from higher commodity prices saw the value of their stock appreciate notably.

Market Outlook:

The global economic discussion at present revolves around inflation, central bank tightening, and the impact of war in Europe. Supply has been unable to match voracious demand leading to inflationary pressures. Central bankers appear to be behind the curve as inflation has been more persistent than expected. Inflation due to supply shocks tends to be transitory, but removing excess liquidity in the system to blunt demand is the current goal of monetary policy. Expect most central bankers to maintain their stance toward becoming less accommodative despite the risk that war in Europe could yield even more supply disruption. A flattening yield curve is causing some angst but strong employment and the reservoir of excess liquidity accumulated over the past two years meaningfully lessen the risk of a global recession. The European economy is most exposed to disruption given their dependence on Russia for energy and their trading relationship with a slowing Chinese economy putting them at the highest risk of recession if either situation deteriorates further. U.S. stock valuations have moderated substantially in the past year, but with rising interest rates and inflation there could be pressure for a further reset. That could be accomplished with high enough earnings growth to lower valuations while stock prices stagnate or stock prices

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(Continued from page 1)

could fall to a level where valuations are more historically aligned with higher interest rates. 2022 is likely to have a little bit of both. S&P 500 earnings are currently expected to increase by more than 9% in 2022 and those expectations are still rising. They have actually risen another 2% during the quarter despite worries of an imminent recession and fallout from a European war. Projections for next year's earnings have moved up in lockstep. Since the majority of stocks have already experienced a bear market, one at the aggregate probably is not overdue barring a recession. But keep in mind that the aggregate index is a composite of many individual companies whose fortunes can vary widely and volatility can provide opportunity.

Can the Fed Arrest the Rise of Inflation?

Monetary policy is a blunt instrument that can be used to slow the demand part of the inflation equation. By raising interest rates it makes it more expensive to buy things on credit and by reducing balance sheets it removes some of the available liquidity chasing too few goods. It also has a psychological effect making consumers of goods and investors more cautious in their spending habits. Household debt service relative to disposable income is close to an all-time low and household cash balances are 3.5 times higher than before the pandemic. Corporate cash on hand is 65% higher. Bank loan growth has not been overly robust in this expansion. A series of 0.25% rate hikes will likely dampen the competitive instincts of homebuyers but current rates are a long way from being tight. Draining some liquidity out of the system is likely to be a key tool, but like "quantitative easing" was an experiment so too is "quantitative tightening". Some of the heavy lifting may already be in process. Case in point, M2 money supply growth and the federal budget surplus have an imperfect but meaningful relationship to inflation with about a 12-month lead time. Annual real M2 growth topped out at 25% a year ago and has since fallen to 5%. Similarly, the annual federal deficit to GDP ratio also peaked last March and has been cut in half over the past year. Legislative gridlock in this case may be helpful in moderating inflation because of the difficulty in passing new deficit spending programs. We believe the supply side of equation, which the Fed does not control, is just as important. We address some of these supply side issues in the following sections.

A Look Behind the Inflation Curtain: Wages

Scarce labor in the face of rising demand is part of the inflation equation. For a variety of reasons many workers have chosen to not re-enter the workforce. Active workers have been re-evaluating work and life in light of their pricing power in the job market. As a result wages[1] are 12% higher today than they were in the month before the pandemic. But the U.S. labor force has grown in the last four months at an annualized rate of 4.5%, compared to 0.5% in the previous twelve months. Maybe all of those baby boomers that "retired" but did not start taking social security are deciding to "unretire". If Tom Brady can do it so can they. Ironically, higher interest rates, a stock market that no longer goes up every month, and recession uncertainty may be a catalyst for them to re-enter the workforce. The pool of workers now sits at less than 1% below where it was at in February 2020, right before lockdowns decimated the job market. After month-over-month wage growth topped out in December at an annualized rate of 9%, it slowed to 5.5% in January, then to 3.6% in February, a short but significant slowdown. In the most recent NFIB Small Business Survey the percentage of businesses expecting to hire more employees dropped to 19% from a peak of 32% reached in August. That level is actually about equal to survey responses prior to the pandemic. Granted the response rate for businesses with unfilled jobs is still elevated and job openings reported by the Bureau of Labor Statistics are still close to record levels, so it is too early to call all clear on a wage price spiral. But underlying trends offer some hope that we have seen the worst and the labor mismatch has a chance of resolving.

A Look Behind the Inflation Curtain: Supply Chains

Globalization of supply chains over the past couple of decades has been a strong disinflationary force so it should not be too much of a surprise that when links in the chain break it can have an inflationary effect. Especially when monetary and fiscal policy is putting cash in consumers hands that pumps up demand. Delivery times lengthen, inventories run low, and price rises as a result. Delays sparked by Covid-19 have highlighted the downside to "just in time" production. There is a growing call for bringing supply closer to home, which will at best remove some of the deflationary tailwind we have enjoyed by shifting production to low-cost locations and at worst might prove to be an inflationary underpinning for prices over a period of years. In the near-term, it is best to watch for signs of supply catching up with demand to assess the impact on present inflationary pressures. Most data still indicate a mismatch, but there are some signs that things are not getting worse and are in some cases improving. The ISM supply managers surveys for both manufacturers and non-manufacturers show wait times for supplier deliveries are still elevated, but they are well off their highs. Importers are finding ways to address port bottlenecks. During the 2020 pandemic lockdowns U.S. imports ran well below trend accumulating a deficit of $190 billion in real terms to trend. In 2021 that deficit flipped to a surplus to trend and is currently running more than 7% above trend and has recouped almost 50% of

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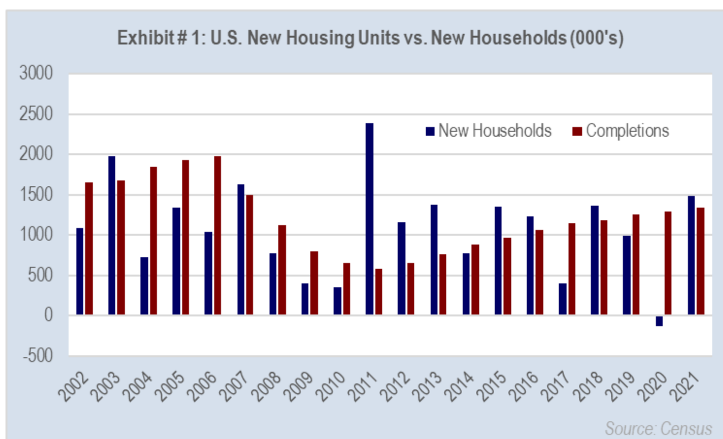
the 2020 deficit. At the current pace all of that deficit will have been offset by October. Another errant link in the chain was trucks to transport those containers arriving at ports. One of the commonly cited complaints was a lack of drivers. The most recent data shows employment in the general freight trucking industry 3.6% above pre-pandemic levels and growing at a 6% annualized pace. Yes, clogged supply chains are still a problem, but progress seems to be headed in the right direction. The issues only need to lessen from extremes to relieve a bit of the upward pressure on prices.

A Look Behind the Inflation Curtain: Raw Materials

The spike in raw materials prices is mainly a supply-demand phenomenon. Rising energy prices are a flashpoint because they are the most visible. Industrial metals, building materials, agricultural prices, etc. have also been volatile. The demand side is easy to understand. As more goods are consumed the demand for the raw materials to make them also rises. The supply side of the equation is a bit more nuanced. The old adage that “the cure for high energy prices is high energy prices” was true because higher prices stimulated more drilling, which increased supply. Normally, when the global economy accelerates energy prices rise to equilibrium where supply and demand are balanced. In the current global expansion demand has outstripped supply for a variety of reasons. The transition to green energy was never going to be smooth and this rough patch was exacerbated by war and tariffs. However, we suspect the old adage will still hold true in a way. Higher prices will hasten the move to greener sources of energy as they become cost competitive, stimulate more supply via additional drilling or more Saudi oil on the market, and support a return to some of old conservation practices of the 1970’s. Food inflation is another matter. Production is not as easily increased and much of it is dependent on global weather patterns. Take wheat for example. In the early part of the last decade supply outstripped demand. Global wheat harvested increased 15% in the five years ended 2017, while consumption only rose 9%. But in three of the last four years consumption has outstripped supply, rising 6% versus 2%. This depleted the ending inventory carried over into the next year and reduced the margin for error in the coming production season. Layer on top of that a multi-year drought in South America, floods in the primary growing region in Australia, and war between Russia and Ukraine, which collectively account for 26% of wheat exports, and a price spike is inevitable. But it only takes one year of bumper crops to reverse that rise. Metals and building materials industries tend to go through boom-bust cycles. You could probably even say the same about semiconductors. New capacity , prompted by increasing prices, is expensive and takes time to add production. Therefore, prices swings tend to be longer in duration. This time around companies have been slow to add capacity because of past experience with the cycle. However, capital investment announcements have ramped up in most of these industries and some relief may be felt. It is natural to project the latest price move into the future with commodities, but raw materials prices are by nature cyclical.

A Look Behind the Inflation Curtain: Shelter

The cost of shelter is more than 30% of the Consumer Price Index. Since it is such a large portion of consumer outlays it is good that it tends to be more stable than the commodity and supply chain-driven components. But this stability and outsized impact also makes the current rise in the cost of shelter one of the more concerning aspects of the present situation. The 20-year average annual increase for CPI-rent is 3.0% and 2.6% for owners’ equivalent rent [owners’ equivalent rent is an estimate of what a homeowner would pay if they rented the house they own]. For most of the pandemic period increases for both of these inputs were pretty subdued at 2% or less. About the time the eviction moratorium ended both metrics accelerated and are now running at an annualized 3-month rate of 5.9% for rent and 5.1% for owners’ equivalent rent. So some of the current above trend growth may be a catch-up for the previous stagnation that landlords experienced. Real estate bulls like to point to under building as a reason for house prices and rents to rise. In 2021 there was a deficit of total housing units completed (1,340,000) relative to new households created (1,480,000) (see Exhibit #1). But over the last ten years there has been a surplus of completions to household formation of 541,000 units. In 2020 there were 1,287,000 housing units completed when the number of households shrunk by 128,000. The most recent data for



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housing starts is the highest it has been since 2006. However, rental vacancy rates have fallen to levels last seen in 1984. The history of this component is for short, sharp peaks and troughs. We wonder if this time around it will be more of the same.

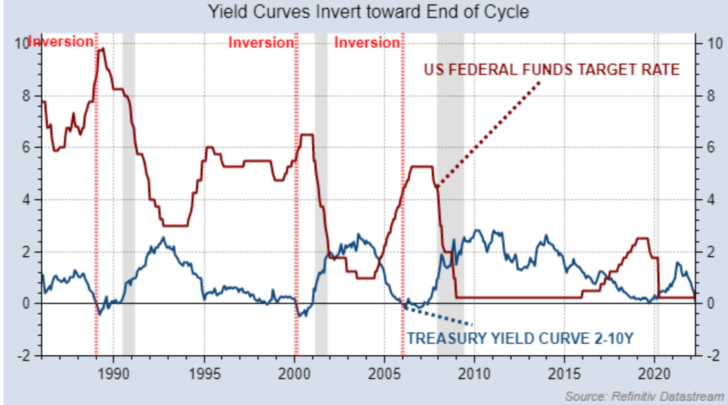
The "R" Word:

With war in Europe disrupting the global flow of goods and services added to existing supply bottlenecks, rising interest rates, and slower Chinese growth has some investors starting to ponder the possibility of a U.S. recession, the "R" word. This fear is exacerbated by the middle part of the yield curve turning negative (the yield on 5yr Treasury bonds exceeds that of the 10yr) in the later half of March. Negative yield curves historically have often been precursors to recessions. The theory is that bond investors are telling us that the Fed has gone too far in raising rates and they believe the result will be a recession. However, that scenario describes a condition at the end of a tightening cycle rather than the beginning. So what is the bond market trying to tell us? Is this time different? That phase is most often uttered right before the market proves once again that it repeats. But much about the bond market has been different this time since central banks started their experiment with quantitative easing. With such a large buyer, that is now turning into a seller, could there be some distortion in yield curves? Fed holdings of Treasury notes started to shrink in the middle of February, about the same time as the middle part of the yield curve accelerated toward negative territory. Concurrently the Treasury was selling 50% more 5-year notes than 10-year notes. This is actually not that abnormal, but a large buyer leaving the market coupled with uneven supply could lead to distortion. Economic indicators are slipping back from extreme highs but many are still quite positive relative to long-term averages. They are exceeding expectations at the rate slightly better than earlier in the year demonstrating some positive momentum. Job openings are still at record highs and workers are beginning to re-enter the workforce to fill them. Inflation may be pushing some of those that left the workforce to return. As higher prices run down excess accumulated savings and feelings of uncertainty build the renewed expansion in the workforce may be an indication of a mind shift. Yes, consumer sentiment has soured but it is not matched by consumer action. Excluding motor vehicles, retail sales are still running well ahead of the trendline and slow motor vehicle sales are not for lack of demand. Rising mortgage rates will be a headwind for residential construction. But household formation and employment growth are likely to keep some wind in the sails. House prices are frothy but housing dynamics are very different from 2008.

Fed Funds lift-off and Stocks:

Full blown bear markets are often the result of Fed tightening cycles gone too far, pushing the U.S. economy into recession. Therefore, it is a natural reaction for investors to get skittish when the Fed starts to tighten. But the peaks of the last three tightening cycles that ended in recession were at 5.25% in 2006, 6.5% in 2000, and 9.8% in 1989 (see Exhibit #2). The current estimated neutral rate is around 2.5%, so it would take another nine 0.25% hikes just to get to neutral. Yet investors sold stocks on the first hike. Historically that is not all that uncommon. Of the last seven cycles four of them saw a negative price move in the three months following the first rate hike, but all but one of them recovered into positive territory by the end of twelve months. The average price change over that twelve month period was 6.1%. Returns during Fed tightening cycles are not exceptionally high, but they tend to climb the wall of worry.

Exhibit #2: Fed Tightening Cycle vs. Yield Curve
Yield Curves Invert toward End of Cycle



Conclusion

Given rising interest rates, inflation, and ongoing supply disruptions, the likelihood of a corporate earnings recession has increased from earlier in the year. Currently, 1Q'22 revenues for the S&P 500 are forecast to be up 11% while earnings are only projected to rise 6%, indicating noticeable margin compression. The large amount of liquidity still in the system and a robust labor market lessen the risk of a downturn in corporate earnings and the economy but risks are rising and will possibly continue in that direction for the foreseeable future.

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