FIRST QUARTER REVIEW

The first quarter of 2022 will probably be remembered for two seminal events: the Federal Reserve's pivot from quantitative easing to quantitative tightening, and the start of hostilities in Ukraine. While either of these events in and of itself would probably give the markets pause, the combination resulted in a 4.6% decline for the S&P 500. The NASDAQ lost 8.9%.

As expected, in mid-March the Federal Open Market Committee (FOMC) raised its federal funds target rate by one quarter of a percentage point to 0.25%-0.50%. At the same time, the Committee unveiled economic projections with sharply higher inflation and federal funds expectations, while lowering anticipated economic growth for 2022. The numbers were in sharp contrast to those released in December when Omicron, rather than Ukraine, topped the list of worries.

The war in Europe, which so far has proven to be a stalemate and is unlikely to be resolved any time soon, has disrupted activity on a number of fronts. These include upheavals in the markets for energy, food grains, and a number of key materials, all the while further disrupting already stretched global supply chains.

Inflation in the U.S. and in Europe is now above 8%, a 40-year high and well in excess of what was expected as recently as December. More troubling, especially in the U.S., are signs that the underlying drivers of inflation have broadened from goods to services, exacerbated by tight labor market conditions. Inflation psychology has shifted significantly, and while longer-term inflation expectations have not yet become unhinged, they are increasingly at risk of doing so.

The Federal Reserve, now finding itself well behind the curve, has given clear signals that it is shifting to a more aggressive tightening mode, to include more rapid and larger rate hikes as well as balance sheet runoff. The U.S. consumer is still in good shape, but recent wage gains have been overtaken by inflation. Most analysts are still forecasting decent economic and corporate profit growth, both this year and next. We question, however, whether these projections will be realized, given tightening monetary policies, continued conflict, and emerging weakness in other parts of the world. Mortgage rates in excess of 5% are already having an effect on the U.S. housing market.

We ended our January letter with this sentence: "As a practical matter, this outlook requires increased allocations to defensive quality equities and higher cash cushions." We continue to believe this is the case today.

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