PRIVATE CAPITAL MANAGEMENT

Q1 2022 Commentary

April 2022

"We may encounter many defeats, but we must not be defeated."
Maya Angelou

Q1 MARKET RECAP

Global equity and fixed income returns were largely negative in the first quarter as persistent inflation, rising interest rates, and Russia's invasion of Ukraine dominated headlines. The U.S. consumer continues to be well positioned and spent more on services and experiences than a year ago. Large cap stocks outperformed small cap, value outperformed growth, and U.S. outperformed international equities. Energy and utilities were the only positive sector performers, up 39% and 4.7% respectively.[1] Russian equity and bond investors faced large losses with the onset of war. Fortunately, the impact for most diversified investors was minimal as Russia did not represent a large share of global capital markets at the start of the year.[2] It continues to be a challenging environment for traditional fixed income; investment grade bonds recorded the worst start to the year since 1980 as interest rate expectations skewed to the upside. Interestingly, high yield bonds have outperformed investment grade bonds, indicating that the negative performance has been driven by rates rising rather than widening credit spreads.

Asset Class	Benchmark	March	Q1 2022	YTD
U.S. Large Cap Stocks	S&P 500 TR USD	3.7	-4.6	-4.6
U.S. Small & Micro Cap	Russell 2000 TR USD	1.2	-7.5	-7.5
Intl Dev Stocks	MSCI EAFE NR USD	0.6	-5.9	-5.9
Intl Dev Small & Micro Stocks	MSCI EAFE Small Cap NR USD	0.0	-8.5	-8.5
Emerging & Frontier Mkt Stocks	MSCI EM NR USD	-2.3	-7.0	-7.0
Global Stocks	MSCI ACWI NR USD	2.2	-5.4	-5.4
U.S. Municipal Bonds	Bloomberg Municipal TR USD	-2.3	-4.8	-4.8
U.S. Taxable Bonds	BBgBarc US Agg Bond TR USD	-2.8	-5.9	-5.9
U.S. High Yield Bonds	BBgBarc US Corporate High Yield TR USD	-1.2	-4.8	-4.8
U.S. Bank Loans	S&P/LSTA U.S. Leveraged Loan 100 TR USD	0.2	-0.2	-0.2
Intl Dev Bonds	S&P International Sov Ex-US Bond TR USD	-3.6	-7.1	-7.1
Emerging & Frontier Bonds	JPM EMBI Global Diversified TR USD	-0.9	-10.0	-10.0
U.S. REITs	MSCI US REIT NR USD	6.3	-4.3	-4.3
Ex U.S. Real Estate Securities	S&P Global Ex US REIT TR USD	3.6	-2.8	-2.8
Broad Commodity Futures	Bloomberg Commodity TR USD	8.7	25.6	25.6
Energy Partnerships	Alerian MLP TR USD	2.1	18.8	18.8
Gold	DJ Cmmdty Gold TR USD	2.7	6.6	6.6

Investor sentiment shifted quickly in the first quarter favoring high dividend paying equities in mature industries whose performance is positively correlated with rising rates (think energy and financials). Richly valued high growth equities are expected to face headwinds with higher discount rates in the future. In an unusual year where a 70% equity / 30% bond portfolio delivered a similar negative return to a 30% equity / 70% bond portfolio, many investors may be wondering what to do next.

MIXED ECONOMIC SIGNALS

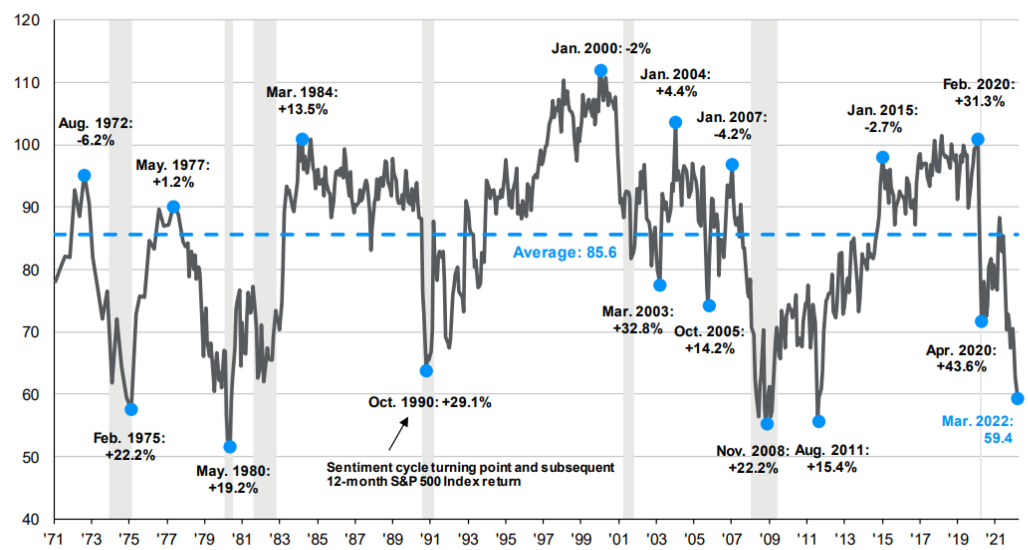
At year-end 2021, the global economy was growing at an above average pace. Supply chain woes, labor availability, and rising input costs were strong headwinds, but corporations had been able to pass on higher

[1] Morningstar Advisor Workstation. Data as of 3/31/2022
[2] iShares by Blackrock. 2021 Annual Report for iShares MSCI ACWI ETF. Total Russian equity capitalization estimated to be less than .4% of global stock market. Total Russian bond market capitalization to be less than .5% of global bond market capitalization using data provided by the 2021 SIFMA Capital Markets Fact Book, and estimates provided by the Central Bank of Russia. Bondholder data is not detailed by investor type.

costs to consumers largely maintaining profit margins. Inflation was rising, but at a decelerating pace and future inflation expectations were manageable. This narrative changed as Russia invaded Ukraine prompting price spikes in oil markets, wheat, and various precious metals. Countries that are heavy importers of these commodities are seeing growth estimates slashed as the cost of living has risen dramatically. German economic advisors recently cut GDP growth forecasts to 1.8% from 4.6% in 2022, anticipating worsening economic conditions due to the war in Ukraine.[3] Fortunately, with a lower dependence on energy imports, the U.S. appears to be faring better. The national unemployment rate sits below 4%, ISM services and manufacturing data remains in expansionary territory, jobs openings remain plentiful, debt service payments are historically low, and household net worth is close to an all-time high.

Yet, consumer sentiment continues to decline. The University of Michigan sentiment survey has been steadily declining since April 2021 as survey respondents remain concerned about inflation and continued fears about COVID-19. As lower income households spend more of their wages on gasoline, the near 20% spike[4] in fuel costs since the war began is expected to result in lower discretionary spending for this demographic.

Consumer Sentiment Index and subsequent 12-month S&P 500 returns



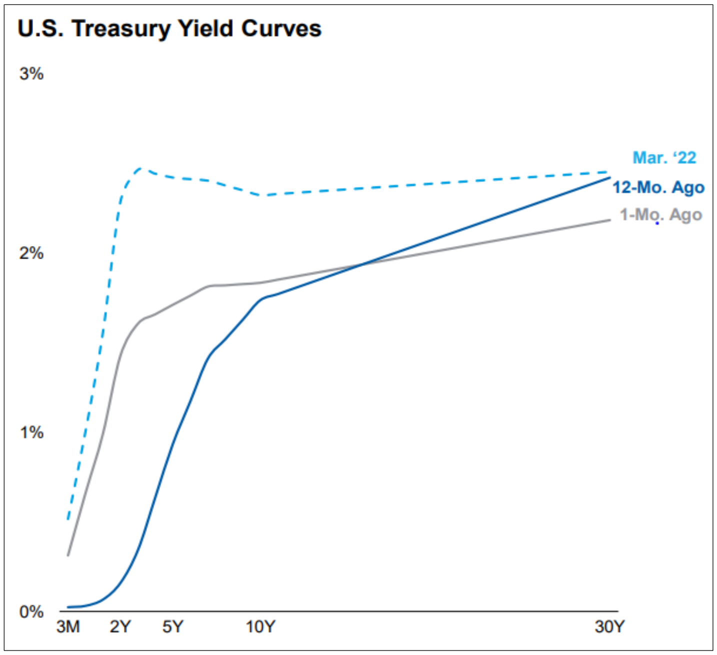
Source: FactSet, Standard & Poor's, University of Michigan, J.P. Morgan Asset Management.

Historically, investors have done well adding risk during periods of declining consumer sentiment as it typically coincides with economic pullbacks and lower equity valuations. Our current environment appears different as low absolute consumer sentiment readings are observed alongside above average stock market valuations and positive, albeit declining, economic growth.

WATCHING THE CURVE

Historically, when the difference between the 10-year U.S. Treasury yield minus the 2-year U.S. Treasury yield goes negative, it has been a useful indicator of an impending recession. This is known as an inverted yield curve and it happened briefly in the first quarter of 2022. The curve inversion was largely due to a swift rise in short term interest rates reflecting changing inflation expectations and the Federal Reserve's plan to hike the fed funds rate. To be clear, an inversion does not cause a recession, but the two have historically been highly correlated.

[3] https://www.sachverstaendigenrat-wirtschaft.de/en/media/details/russias-war-of-aggression-against-ukraine-and-energy-prices-drastically-worsen-the-economic-outlook.html. Accessed 4/9/2022.
[4] U.S. Energy Information Administration. https://www.eia.gov/petroleum/gasdiesel/. Accessed 4/10/2022.



Source: Eaton Vance Monthly Market Monitor. Factset, Morningstar as of 3/31/2022

An inverted yield curve indicates that market participants believe future growth will slow down and longer-term interest rates will fall. In our current inflationary environment, an inverted curve puts the Federal Reserve in a predicament; it will be increasingly difficult for the Fed to pursue an aggressive monetary tightening policy to combat inflation without increasing recession risks as financial conditions tighten. There is a growing number of forecasters suggesting the 2-10 U.S. Treasury yield spread has lost is predictive power. These economists argue that long-term rates would be materially higher without massive quantitative easing post pandemic. If so, the curve would not be inverted in a normal environment giving the Federal Reserve plenty of room to raise short term rates. While tempting to believe this argument, liquidity conditions are the main driver of the yield curve, and bond market participants are discounting tightening liquidity and increasing odds of a slowing economy.

The market is braced for higher fed funds rates, but how much higher? Looking at futures contracts, we can observe the probability assigned to fed funds rate ranges at future Federal Reserve meetings. At quarter end, market participants now assign the highest probability (38%) that the fed funds rate will be in the range of 2.50-2.75% by the December 2022 Fed meeting.[5] Despite high and rising inflation numbers, market participants believe the fed funds rate will reach its peak in Q2 2023 at a range of 3.00-3.25%.[6]

FIXED INCOME – A LOOK UNDER THE HOOD

Negative year-to-date performance for fixed income can be largely attributed to a recent increase in rates rather than a deterioration in credit quality. Recall that bonds accrue interest daily and typically pay coupons on a semi-annual basis. Q1 bond price declines will be partially offset by interest income contractually obligated to be paid to bond holders for the remainder of the year. In addition, fixed income portfolio managers have been reinvesting maturing bonds in higher yielding securities, which we (and they) anticipate will improve future returns. Selling out of bonds now to avoid future losses might seem like a tempting strategy but, as with equities, it will require a great deal of luck to get the timing right on reentry.

What is a bond investor to do in this environment? Our strategy is to favor active managers with shorter than benchmark duration. This helps mitigate interest rate risk on the portfolio. Secondly, active managers with more flexible mandates can, for example, allocate to Treasury Inflation Protected Securities, high yield bonds, and floating rate loans which could outperform nominal bonds in a rising rate environment. Historically, fixed income as an asset class exhibits around ⅓ the risk of an equity portfolio and provides diversification. With global growth decelerating, we do not recommend selling an asset that is negatively correlated (relative) to equities.

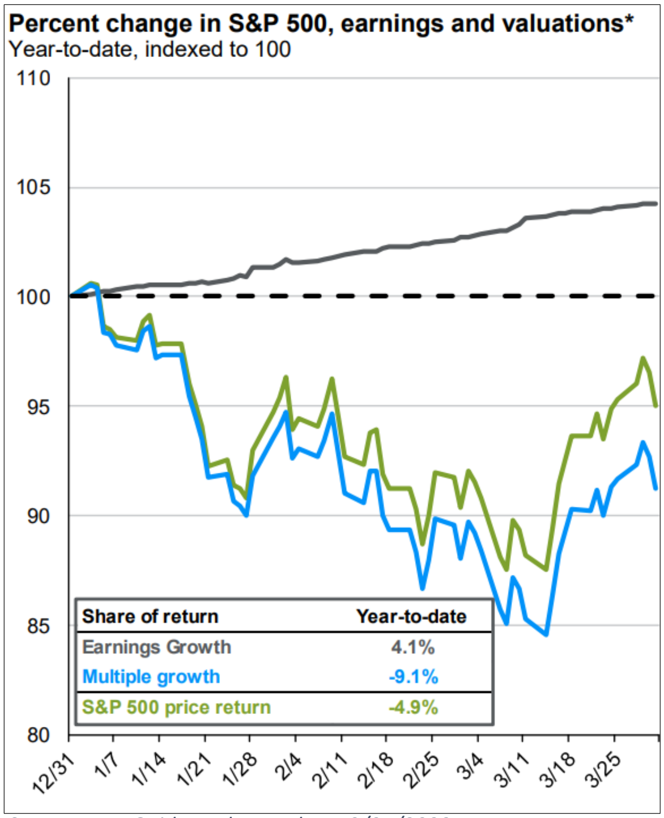
[5] CME Fed Watch Tool. https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html. Accessed 4/10/2022.

[6] Federal Reserve Bank of Atlanta. Market Probability Tracker. https://www.atlantafed.org/cenfis/market-probability-tracker. Accessed 4/10/2022.

CORPORATE EARNINGS HOLDING STRONG

As illustrated in the chart to the right, earnings growth estimates increased throughout the quarter (gray line) while the multiple paid for earnings declined (blue line) and stock prices fell (green line). This leaves us with better equity valuations entering the second quarter. Actual S&P 500 earnings growth exceeded estimates by 6.5% over the past 10 years so it is possible earnings surprises will move Q1 earnings growth higher than forecasted.

Revenue expectations remain strong as well. Analysts are forecasting a greater than 10% year-over-year growth in Q1. Net profit margins are under pressure as most sectors except for energy, industrials, materials, and utilities are expected to post lower year-over-year profit margins. Despite rising rates, bank earnings may face headings from rising loan loss reserves.[7]



Source: JPM Guide to the Markets. 3/31/2022

WHERE TO GO FROM HERE

Our hearts go out to those who have lost their livelihoods and loved ones in Ukraine. History has shown time and time again that corporate earnings growth (and stock performance) endures during war and geopolitical conflicts. At the same time, our global economy is wading through the most pronounced inflation spike in the last 40 years. What are some actionable steps investors can make in these challenging times?

1) Revisit your financial plan and do a reality check. Were you spending above your means during above average return years?
2) Think like an equity investor in your bond portfolio. Lower prices and higher yields provide a more attractive time to add to your investment.
3) Consider implementing alternative strategies that can complement your traditional stock and bond holdings.

Your PCM advisor is here to help you navigate these challenging times. Thank you for your continued trust.

Sincerely,
The Private Capital Management Team

[7] Factset. Earnings Insights by John Butters. https://insight.factset.com/sp-500-likely-to-report-earnings-growth-of-more-than-10-for-fifth-straight-quarter. Accessed 4/9/2022.