Tempestuous Horizons

Q2 2022 Market Update

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"Our greatest glory is not in never falling, but in rising every time we fall." *Confucius*

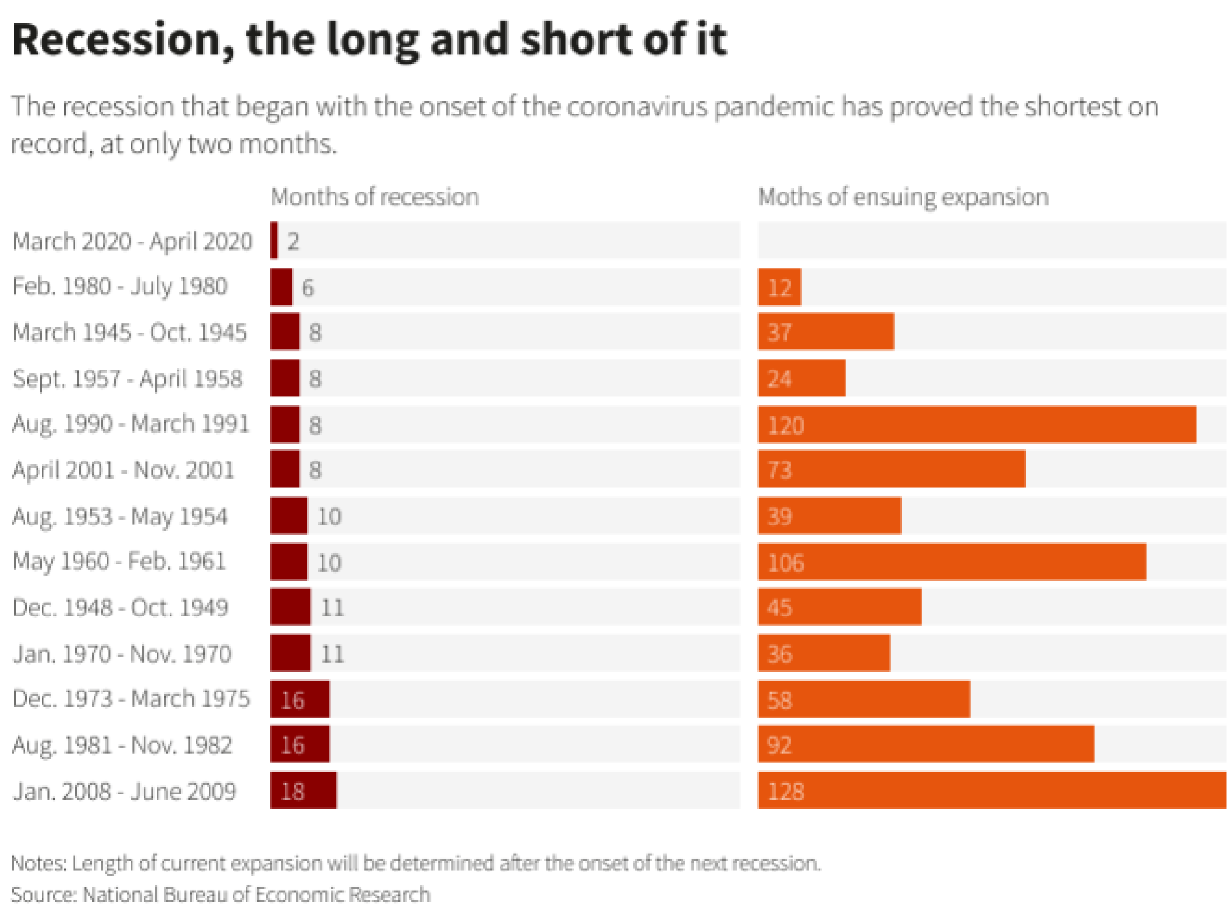
Without a doubt, what is happening in Ukraine is a tragedy and a reminder of the fragile balance of the World. Due to the continued conflict, sanctions, and inflation, we are revising down our 2022 market outlook from Moderately Bullish to Moderately Bearish. G Squared now feels we will have a recession in the next 18-24 months. This does not mean an automatic repeat of 2008. We may have a milder recession; however, we feel it's important to downshift into more defensive portfolio positions. Interest rates will still come up and the Fed hiking cycle looks to be 6-7 (or more!) rate hikes in 2022 putting further pressure on growth stocks and bonds. I hate shifting bearish, as I do firmly believe in the long term the USA will continue to grow and be a leading economy. We cannot ignore the continued pressure across multiple fronts (inflation, geopolitical risk, mid term elections, rate hiking cycle). We are more cautious now than we have been in years. We do feel there will be a short-term recovery in the markets when we get a resolution to the war in Ukraine, but that bounce may be short lived.

Per the National Bureau of Economic Research (NBER) there are multiple ways for a recession to get started. Below are their 6 potential drivers of a recession, they probably sound very familiar:

1.) A Sudden Economic Shock
2.) Excessive Debt
3.) Asset Bubbles
4.) Too Much Inflation
5.) Too much Deflation
6.) Technological Change

The business cycle and recessions go hand in hand. During economic expansion the economy sees healthy sustainable growth. Over time, lender encourage consumers to take on debt and irrational exuberance starts to bubble asset prices. As this expansion ages, asset values & debt go up. At a certain point this destabilizes markets from expansion to contraction and the bubble bursts causing growth to contract and economic recession. It’s a tried-and-true cycle that has been happening for hundreds of years. Per the NBER, since 1945 the average recession lasted 11 months, prior to that period it was an average of 21.6 months with the Great Depression. In the last 30+ years we have had 4 recessions:

- Gulf war Recession: July 1990- March 1991, short 8 months
- Dot Com Recession: March 2001- November 2001, short 9 months
- The Great Recession: December 2007- June 2009, long 18 months
- COVID-19 Recession: Feb 2020- April 2020, Blink and you missed it 2 months short



A War by Any Other Name

Conflict and wars historically have less of an economic effect than you may anticipate. Nevertheless, you cannot be agnostic to the lasting scars that will remain when we get a resolution. The Western world will be (rightfully!) furious about the invasion and highly unlikely to reduce sanctions right away. Our concern is the world will shrink, taking Russia supply & demand out of most of the developed world, as well as continuing to pressure supply chains especially with some precious metals and minerals that Russia has a high market share in. It's estimated that Russia produces about 10% of the World's oil supply, 13% of the World's fertilizer production (potash, phosphate and nitrogen), 10% of the US aluminum import volumes, and 37% of the World's Palladium production. Western sanctions may push Russia to pivoting to India and China as closer trading partners. India has signaled that it is willing and happy to buy discounted crude oil from Russia, and China has not waivered in its support of Russia through this war.

Figure 2: Russia's share of global minerals reserves, 2021

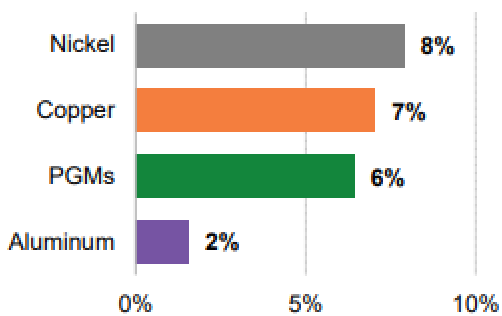
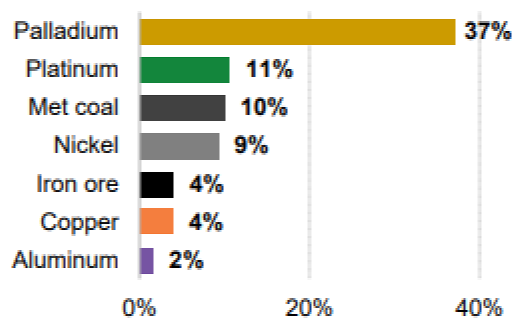


Figure 3: Share of Russia in global mined production, 2021



Source: USGS, BloombergNEF. Note: PGM is platinum group metals and includes estimates for platinum and palladium. Met coal refers to metallurgical coal and figures refer to 2020 data.

How this crisis unfolds may dictate the course of our economy as well as the stock market. Below we summarize our best and worst case as well as our highest probability outcome as of 3/25/22:

1. **Best Case:** Russia and Ukraine reach a ceasefire agreement swiftly. This agreement will splinter Ukraine into Western/Eastern states with Russia claiming the Donbas Region. Sanctions stay harsh, though may ease end of 2022, however, not expected immediately.
2. **Highest Probability Case:** Ukraine does not negotiate or surrender. Conflict drags on like a Vietnam or Afgahinstan. Western Sanctions stay harsh and do not ease, NATO build up, high tensions continue.
3. **Worst Case:** NATO involvement, Nuclear war, Nuclear plant meltdown, or Chemical War. Becomes WWIII.

Even in our best-case scenario, at this time, we feel that severe sanctions will continue for the near future. Removing Russia from the market shrinks the world as well as keep commodity prices high. Russia most likely leans into China and India to buy oil & gas, and Europe is faced with a recession due to rising cost pressure and inflation; this eventually leads to US recession as well.

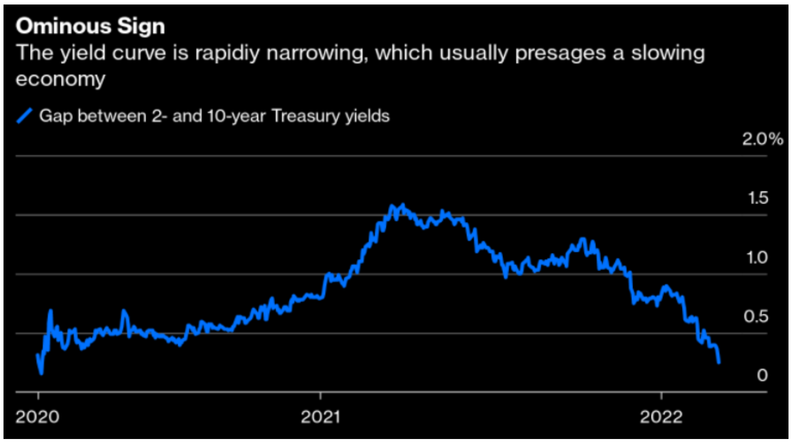
Recession 101

A recession is defined by two successive quarters of Negative GDP growth. By the time we have hit a recession definition, the recession has been felt by the markets and consumers for months. The stock market is also considered a leading indicator of recessions, so markets tend to fall before the recession hits. Many of the traditional signals in the Leading Economic Indicators (LEI) Index are measured monthly or quarterly and are slower to manifest. Below is a snapshot of February's LEI Index Data per Bloomberg LP, as you can see holding steady for now through February.

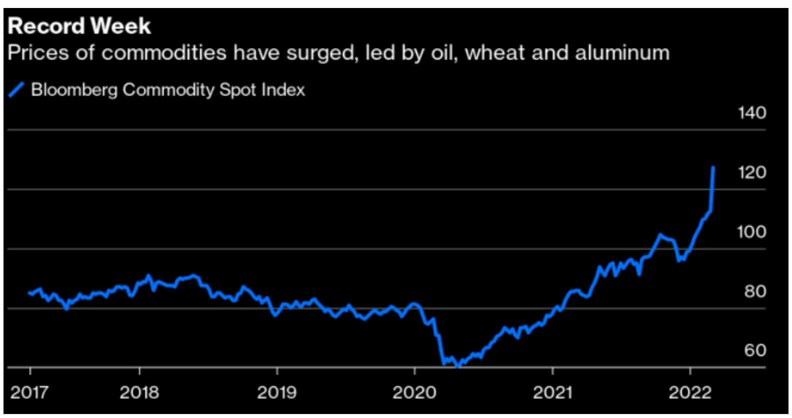
	Feb. 2022	Jan. 2022	Dec. 2021	Nov. 2021	Oct. 2021	Sept. 2021
Leading index	119.9	119.5	120.1	119.2	118.3	117.6
Monthly change	0.3%	-0.5%	0.8%	0.8%	0.6%	0.2%
Diffusion index	70.0	30.0	75.0	70.0	80.0	55.0
6-mo. diffusion index	70.0	70.0	90.0	70.0	60.0	70.0
Net Contributions to Leading Index						
Average workweek	0.17%	-0.11%	0.00%	0.06%	-0.06%	0.00%
Jobless claims	0.14%	-0.31%	0.23%	0.24%	0.26%	0.05%
Consumer goods orders	0.01%	-0.09%	0.10%	-0.02%	0.03%	-0.03%
ISM New Orders	0.13%	0.05%	0.12%	0.13%	0.11%	0.19%
Orders Nondef Cap Gds ex air	0.02%	0.00%	0.00%	-0.02%	0.01%	0.04%
Building permits	-0.06%	0.02%	0.29%	0.12%	0.13%	-0.25%
Stock prices	-0.13%	-0.09%	0.01%	0.19%	0.01%	-0.01%
Leading Credit index	0.06%	-0.01%	0.05%	0.08%	0.14%	0.14%
Interest rate spread	0.23%	0.21%	0.17%	0.18%	0.19%	0.16%
Avg. consumer expectations	-0.14%	-0.15%	-0.09%	-0.12%	-0.13%	-0.09%

Other signals we are watching are the yield curve to invert specifically the 2-Year and 5-Year spreads relative to the 10-Year spread. When you are getting just as much yield on a shorter-term bond than a 10 or 30-Year bond, typically that signals concern on the economy. The Unemployment rate is one we are watching carefully as well, as when unemployment bottoms out that tends to signal the start of a more difficult economic time period with a slack labor market. Unemployment is currently 3.8% and historically low, we have not seen this start to trend up yet but feel it may be coming. The top recession indicators are:

Recession Indicator	Signal	Trend
Inverted Yield Curve	Partially inverted	Narrowing and worsening
Declines in Consumer Confidence	Yes	Dropping since late 2021
Sudden Stock Market Declines	Yes	Indexes down -10% to -20%
Drop in the LEI	Partially	Jan Negative, Feb Positive
Rising Unemployment	No, but may be bottoming	Sideways, look for bottom



As commodity prices are skyrocketing simultaneously the bond yield curve is flattening, and an inverted yield curve is a strong signal for recession. Recent events have spiked yields towards end of March and curve has continued to flatten and yields spike up.



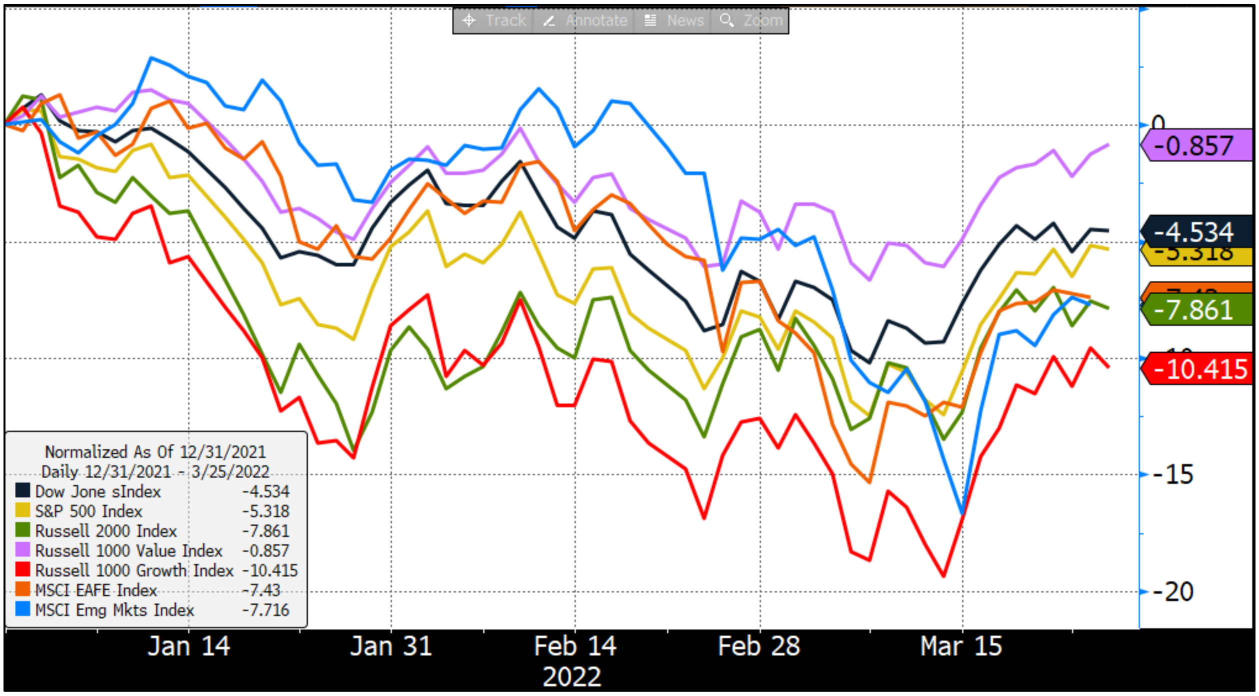
Commodity Price YTD Increase (through 3/11/22)

- WTI Crude Oil: +45.37%
- Gasoline +48.62%
- LME Aluminum +24.06%
- LME Nickel +131.41%
- Corn +28.87%
- Soybeans +27.24%
- Wheat +41.42%

Market Movements

As of the time of writing this on March 25th, on the next page is a chart of the major indexes Year-To-Date performance. You will see most markets entered a bear market off their highs (a movement of greater than -20%) including the tech heavy growth index, small caps, and emerging markets. We have seen a nice bounce here in March to help stabilize short term performance. Typically, we would be buyers of dips as we prefer to *buy low, sell high*, however, we are concerned with how those pockets of the markets will perform as we hit a more difficult economic stretch. Right now, we are recommending value stocks; quality stocks that are not overpriced and have strong cash flows and balance sheets with the ability to weather more difficult conditions.

YTD Chart, Major Stock Market Indexes Performance. (% Normalized)



Predicting the markets is often rife with errors. The multitude of factors that go into short term projections make it almost impossible to get it correct consistently. That is why we preach staying the course, as often the storm passes quickly, and markets rebound faster than anticipated. You have seen this play out in late March, with most indexes rapidly rallying 5-7% from their lows. We are not advocating selling everything, that is not a prudent strategy. We are advocating ensuring you are in the more defensive parts of the market, have ample liquidity on hand and are mentally ready for a more difficult market. Understanding your risk exposure is key. Short term pullbacks and stress may be more frequent and more violent than the last 2 years. With all this doom and gloom, it may turn out to be less bad than we are forecasting. Many variables could change over the course of the next few months. Inflation, in our opinion, is not going away any time soon and this was the deciding factor for us on why we have transitioned moderately bearish. Once we see signs that inflation is easing, earnings are resilient, and unemployment is stable we will most likely be recommending moving back into an equity overweight. How your portfolio should be adjusted depends on many factors unique to you: what is your time horizon? Are you living off your assets or need funds? What is your risk tolerance? For those with a long-term perspective, we do feel this will be but a speedbump in the road. Markets always recover. Even when it feels the world is about to fall apart, somehow, we have managed to keep society duct-taped together for thousands of years and I am confident we will soldier on.