MARKET UPDATE

Economic Market Update – First Quarter, 2022

April 19, 2022

- Historic weakness across all asset classes in Q1 2022
- Recession concerns may be overstated
- Inflation and geopolitical concerns may make markets uncertain

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With the first quarter of 2022 now behind us, most investors must be thinking "good riddance". Looking into the rearview mirror, the picture is ugly – Q1 2022 was the worst quarter for performance across traditional asset classes since 1981. The start to the year brought the highest inflation in 40 years, the most significant armed conflict in Europe since the end of WWII, and the first of what are expected to be many rate hikes from the Federal Reserve. The combined weight of these developments was too much for markets to bear, dampening investor sentiment and leaving few places to hide absent commodities. U.S. stocks, U.S. Treasuries, corporate bonds, developed international stocks, and emerging market stocks all lost at least 3.5% for the first time since the third quarter of 1981. Broad weakness across the range of asset classes is historically abnormal; typically risk-off assets like U.S. Treasuries rally during weakness in risk-on assets like stocks. In the first quarter of 2022, however, inflation concerns and clear signaling from the Fed that a number of rate hikes would be coming over the course of the year combined to push up yields, with the much followed 10-year U.S. Treasury yield hitting the highest level since May of 2019. Seemingly more troubling, as plastered across the financial news media recently, is the rise in the 2-year U.S. Treasury yield, which as of this writing is slightly above that of the 10-year. This phenomenon, known as a yield curve inversion, is a much-ballyhooed indicator of future recessions. The quarter saw falling asset prices, high inflation, a spike in geopolitical risk, and a yield curve inversion. Does this mean that investors are only in for more pain ahead in the months to come? Perhaps not, if history is any guide.

Below we will explore why the inversion of the 2-10 yield curve may not be the reliable predictor of recession that many claim, identify some metrics that will likely provide a better early recession warning in the current environment, and examine why an inverted yield curve should not be taken as a sign to sell out of stocks.

Recessions are clearly one of the biggest risks to stock prices, so assessing near-term recession risk is a natural place to start for any analysis. The recent yield curve inversion has been splashed around the headlines as an omen of an impending recession – and, on the surface, rightfully so, given that the yield curve has indeed inverted prior to every recession since the U.S. went off the gold standard. A more in-depth examination, however, shows that the story is not so simple. To start, let's examine the inversion of the 2-10 spread, the spread most often heralded as a recession indictor. While it is true that the 2-10 spread has inverted prior to each recession, there have been times when the 2-10 spread has gone negative without seeing a subsequent recession. This means that the indicator has on occasion produced false positives.

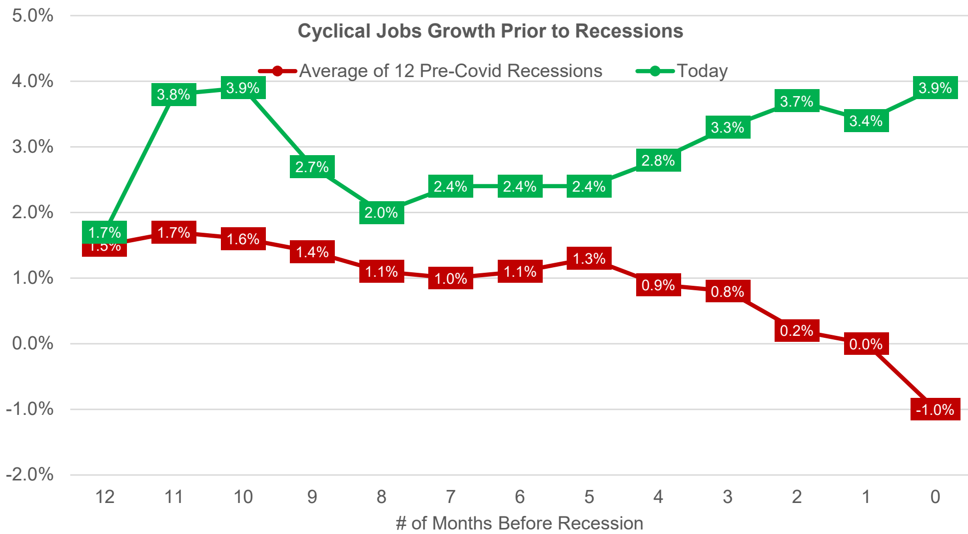
Aware of the reputation of the 2-10 spread as an omniscient predictor of recessions, the Fed has recently published a detailed examination. In short, it finds statistically significant evidence that any perceived relationship between the 2-10 spread and future recessions is spurious, likely the result of "reverse causality".[1] More importantly, they identify the spread that actually does provide a near-term signal about the trajectory of the economy: the spread between 3-month and

2-year Treasuries, which the Fed terms as the "near-term forward spread". Not only does the Fed find that this spread contains statistically significant information about future recession risk, the interpretation of it as such is much more logical.[2] The near-term forward spread is, in theory, the market's expectations for interest rates over the course of the next 18 months. When this spread inverts, the market is predicting that the Federal Reserve will have to cut rates in the near-term, which it does to stimulate the economy during recessions. At the start of the year, both the 2-10 spread and the near-term spread were around 75 basis points. The 2-10 spread declined significantly during Q1, but the near-term forward spread went in the opposite direction, and is now over 2%. Given the statistical evidence of the near-term spread as a much more precise indictor of recession risk, the current level should ease concerns that a recession is imminent.

This view is further supported by the current state of the labor market. Prior to past recessions, the labor market has seen a significant deterioration in cyclical jobs growth (with "cyclical" jobs defined as those in construction and manufacturing). Currently, cyclical jobs growth is actually still accelerating, and is well above the levels seen prior to previous recessions. Additionally, the current ratio of open jobs per unemployed person is at all all-time high, with nearly two available jobs currently for every one person unemployed. Given that consumer consumption is the main driving force of the U.S. economy, it is difficult to envision the economy falling into recession during the tightest labor market in history. Add to the mix that household balance sheets are the healthiest they have been in decades and picturing a recession in the near-term becomes even more difficult. Once the near-term forward spread, state of the labor market, and health of household balance sheets are taken into account, the risk of recession signaled by an inversion of the 2-10 spread is likely overstated. Moving forward, we will be closely monitoring each additional indicator to assess recession risk, but none are currently cause for immediate concern.

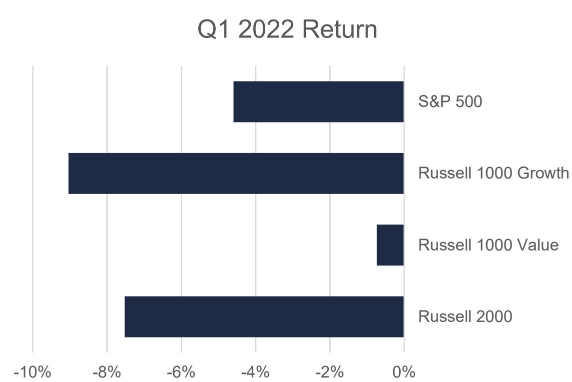
[1]Eric C. Engstrom and Steven A. Sharpe, "(Don't Fear) The Yield Curve, Reprise".

[2]Ibid.



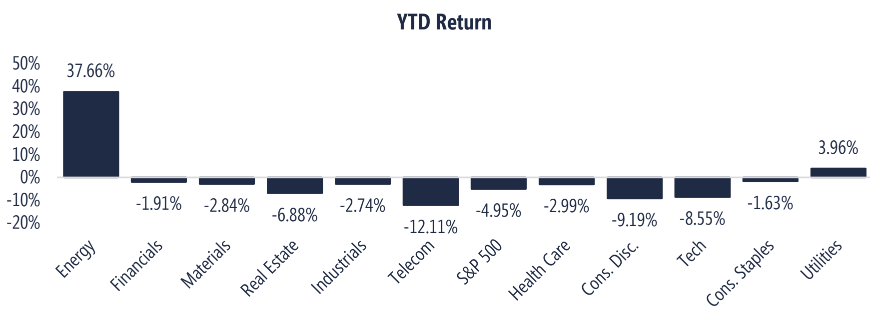
While taken as a whole, returns were disappointing across assets in Q1, and the quarter ended with some positive momentum, particularly for stocks. The S&P 500 was down 12.5% for the quarter through early March, but rallied substantially into quarter-end, easing some of the pain. After a historically poor quarter for cross-asset performance, the question naturally arises – is the recent rally a mere respite before more pain ahead, the proverbial "dead cat bounce"? Or might investors see brighter days ahead? Given the concern over the shape of the yield curve that has dominated coverage of financial markets in recent days, it is instructive to examine the performance of the S&P 500 around previous yield curve inversions. Even if you disagree with the Fed's assessment that an inversion of the 2-10 spread provides little information about future recession risk, such an inversion historically has not signaled that forward equity market returns were likely to be negative. While the number of cases is somewhat limited, since 1976 when the 2-10 spread has inverted for the first time without having been negative at any point in the prior 6 months, the S&P 500 has been positive 67% of the time 6 months later with an average return of 3.81%.[3] The numbers are even stronger over longer time horizons, with the S&P 500 positive 83% of the time 1 year, 18 months, and 2 years after a 2-10 inversion, with average returns of 13.40%, 18.54%, and 18.98% respectively.[4]

U.S. Equity Markets



After a tumultuous ride, the bellwether for U.S. stock returns, the S&P 500, finished the quarter down 4.60%.[5] As typically occurs in down markets, small-cap stocks underperformed their large-cap peers in Q1, with the Russell 2000 Index losing -7.52% for the quarter. U.S. equity performance continued to vary widely by style, with value significantly outpacing growth despite a strong rally in the latter style to close out the quarter. Prior to

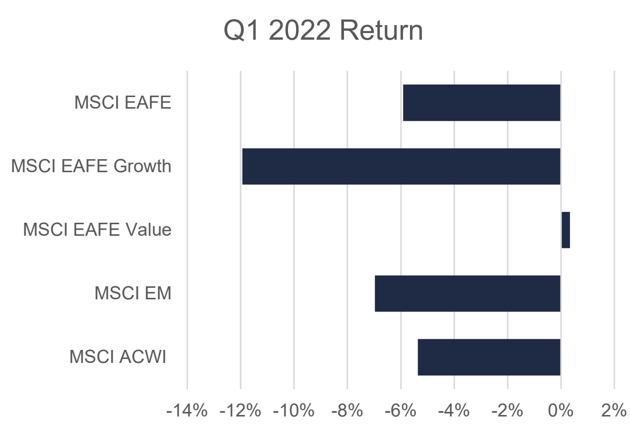
[3]Rob Hanna, "Yield Curve Inversions and SPX Returns." Quantifiable Edges.
[4]Ibid.
[5]All returns are total returns unless otherwise stated; international returns are net returns is USD.



March 14, large-cap value was ahead of large-cap growth by the largest margin since the bursting of the tech bubble in Q1 2001. A rally in the mega-cap stocks that bore the brunt of the pain early in the quarter reduced this margin considerably, but value still ended the quarter well ahead of growth across the cap spectrum. The Russell 1000 Value Index, which comprises both large- and mid-cap firms, fell just -0.74% for the quarter vs. the -9.04% return of the Russell 1000 Growth Index. The value style led in small-cap as well, with the Russell 2000 Value Index returning -2.40% vs. the Russell 2000 Growth Index's return of -12.63% on the quarter. As expected when the divergence between growth and value is so wide, performance varied widely across sectors and industries in the first quarter as well. A mix of cyclical and defensive value stocks were the leaders on the quarter. Energy stocks were by far the best performers, as oil prices continued their march higher that began in 2021, ending the quarter up 37.66%. The only other sector to finish the quarter in the green was Utilities, a traditional defensive safe haven, which notched a gain of 3.96% in Q1. The other sectors in the S&P 500 that finished the quarter ahead of the broad index were a mix of cyclical and defensive names as well, with Consumer Staples, Financials, Industrials, Staples, and Health Care all down less than the index as a whole. Cyclical growth names bore the brunt of the pain, with Communication Services, Consumer Discretionary, and Information Technology all laggards on the quarter, each finishing down at least -8% despite the rally they experienced into the end of March. The much-watched FANMAG[6] complex of mega-cap stocks was down by as much as 18.5%, but participated in the late rally to close the quarter down only 7.3%.

International Equity Markets

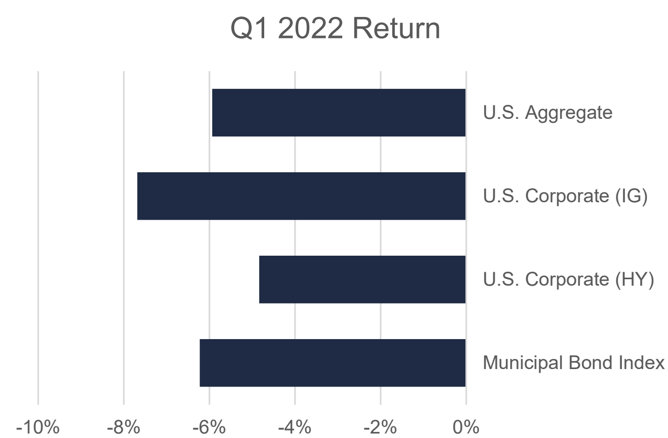
International equities lagged U.S. stocks slightly in Q1, with a clear split between resource-exporting and resource-dependent countries and regions. The MSCI EAFE Index of major developed international equity markets lost -5.91% for the quarter as a whole. The growth/value trend was present internationally as well, with the MSCI EAFE Growth Index returning -11.94% vs. a gain of 0.33% for the MSCI EAFE Value Index. Resource-exporting areas like the U.K., Canada, and Asia



[6]Facebook, Apple, Netfix, Microsoft, Amazon, and Alphabet (Google).

Pacific ex. Japan were positive on the quarter while resource dependent areas like Japan and Europe ex. U.K., the region most exposed to a disruption in energy flows from Russia and Ukraine, were negative. The divergence in performance between commodity producers and nations reliant on importing natural resources was even starker in emerging markets. Every Latin American market, a region highly dependent on the export of commodities, finished the quarter in the green. Major oil producers, like the United Arab Emirates and Qatar, also saw significant gains, as did South Africa, a major producer of both agricultural commodities and minerals. On the other side of the equation, big importers of natural resources experienced significant declines. China, the biggest country in the MSCI EM Index at just under 32%, fell -14.19% in Q1. The next two largest countries in the index, Taiwan and South Korea, suffered significant declines as well, down -6.58% and -9.57% respectively. **Summing up equity markets globally for the quarter, the MSCI ACWI Index, a proxy for the global stock market, lost -5.36% in Q1.**

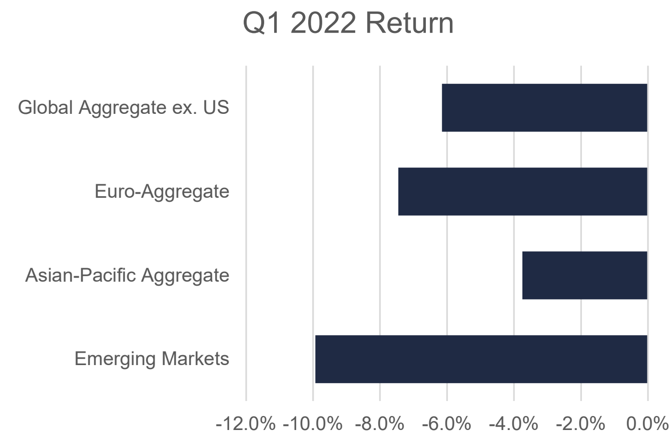
U.S. Fixed Income Markets



Fixed income returns were historically poor in the first quarter of 2022. Broadly speaking, fixed income suffered the worst start to a year on record and fell by the most in a single quarter since Q3 1980. Fears that the Russian invasion of Ukraine would only serve to exacerbate inflationary pressure already hitting 40-year highs and clear signals from the Fed that a hawkish shift was increasingly likely in an effort to combat high inflation combined to put upward pressure on yields during the quarter. The yield on the 10-year U.S. Treasury, which began the year at 1.51%, finished the quarter at 2.34%. The yield on the 2-year U.S. Treasury experienced an even more meteoric rise, starting the year at 0.73% and finishing the quarter at 2.33%, just a basis point under the 10-year. The broad increase in rates across the various tenors of the yield curve weighed heavily on bonds prices, leaving all major areas of the fixed income market in the red at the end of Q1. The Bloomberg U.S. Aggregate Bond Index, a broad measure of the performance of investment-grade fixed income markets in the U.S., fell -5.93% in Q1. Investment-grade corporate bonds were down even more on the quarter as credits spreads widened as well, finishing down -7.69%. High yield corporate bonds, which provide better protection from rising rates than their investment-grade counterparts due to their higher coupons, posted slightly better returns, finishing the quarter only down 4.84%. Despite generationally high inflation prints, TIPS lost ground during the quarter as well, with the Bloomberg US Treasury Inflation Protection Notes Index down -3.02%. Municipal bonds also struggled, with the Bloomberg

Municipal Bond Index falling -6.23% on the quarter. Floating rate bonds, which have interest payments that adjust to the prevailing interest rate environment, offered the most protection from the upward pressure in yields, with the Credit Suisse Leverage Loan Index retreating only 0.10% for Q1.

International Fixed Income Markets



International fixed income performance broadly lagged the U.S. on the quarter. The Bloomberg Global Aggregate ex. U.S. Bond Index, a proxy for the global investment-grade credit universe outside of the United States, lost -6.15% in Q1. Asia-Pacific lost -3.75%. Europe was the laggard, down -7.46% for the quarter. Emerging market bonds struggled as well in US dollar terms, with the JPMorgan Global Core Emerging Market Bond Index declining -9.93% on the quarter. Performance was significantly better in local currencies terms, down only -2.14% for Q1.

Cross-asset returns were historically poor in Q1 2022, leaving investors with few places to hide. Volatility will likely remain high in the near-term as the Fed is poised to enter a sustained hiking cycle to combat inflationary pressure not seen since the 1980s and geopolitical uncertainty remains elevated at a level not seen for decades. While further geopolitical shocks are a wild card that could bring additional turmoil to markets, evidence suggests that the risk of recession over the next 12 months remains low. As of now, we doubt that an inversion of the 2-10 spread is a harbinger of an imminent recession given that the near-term forward spread, which is the spread found by Federal Reserve researchers to provide statistically significant information about future recession risk, remains extremely steep. The tightness of the labor market, with nearly two open jobs for every unemployed person, further reinforces this view. Rising rates will present a challenge to fixed income returns in the short-run, but reinvestment of interest makes up a significant amount of fixed income total return, so in the longer-term higher rates will ultimately be beneficial to fixed income investors, despite the volatility rising rates bring in the short-term. Equity returns can also be strong from here. As discussed, equity returns have historically been strongly positive in the year after an initial 2-10 yield curve inversion. **The current consensus expectation for 2022 U.S. GDP growth is 3.5%. and the strong economic growth environment combined with the historic strength in the labor market create a solid economic backdrop for equities through the remainder of the year.**

We remain committed to focusing on your long-term financial goals and priorities and constructing portfolios designed to reach those goals while minimizing risk. As always, our clients' interests always come first, and our goal is to continue to separate the signal from the noise and focus on what truly matters to the economy and markets to help you achieve your investment goals. Should you wish to have a more in-depth conversation about the current environment and its impact on your portfolio and long-term financial plan, please reach out to your Fulton team.

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Matthew is a portfolio manager and leads the investment strategy group for Fulton Private Bank and Fulton Financial Advisors. He was a National Merit Scholar at the University of Chicago, where he graduated with a B.A. in Political Science. He is a Chartered Financial Analyst (CFA®) charterholder and is a member of the CFA® Institute and the CFA® Society of Philadelphia.

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