Market Update
First Quarter 2022

The Ascent of Uncertainty

After ending last year at record highs despite growing concerns regarding inflation and increasing Omicron-led covid cases, US equity markets finally took a breather giving back ***approximately 4.6%*** in the first quarter of 2022. In and of itself, this retracement would seem reasonable given the markets impressive run off pandemic lows two years ago. However, it clearly does not tell the entire story of the new year. During the quarter, the S&P 500 fell by as much as 12.5% as uncertainties circling the economy and markets grew both in intensity and number with Russia's invasion of the sovereign state of Ukraine. The events of the past month have shifted the global investment landscape and investors will need to take note moving forward.

While we certainly hope for a quick resolution for the sake of the Ukrainian people, the conflict in Eastern Europe is now creating lasting impacts on the global economy in addition to the immediate shocks. The near-term strains are clear with large numbers of Ukrainians fleeing to the safety of neighboring countries coupled with rising prices across numerous commodities. Longer-term impacts are less obvious today but bear watching from changing governmental spending priorities to the redrawing of partnerships and alliances. A deeper look into our expanded thoughts can be found in a recent update titled 'The Debate Over Guns or Butter Returns'. One of the most critical measures taken has been Russia's removal from the global banking system and further isolation through a variety of sanctions.

The restrictions enacted by the US and allies opposed to Russia's aggression will accelerate the de-globalization trend already occurring across the global economy. The world has undeniably become more interconnected over recent decades driven by a range of factors including enhanced technology and communication capabilities, improved and lower-cost transportation and relative peace. And while overall global output and trade have continued to increase, the share of cross border trades between nations has been in steady decline for quite some time. This adjustment has been the result of more natural occurrences such as growing middle classes in emerging markets once sought after for low-cost labor now becoming bigger consumers themselves – leading to more import and less exports.

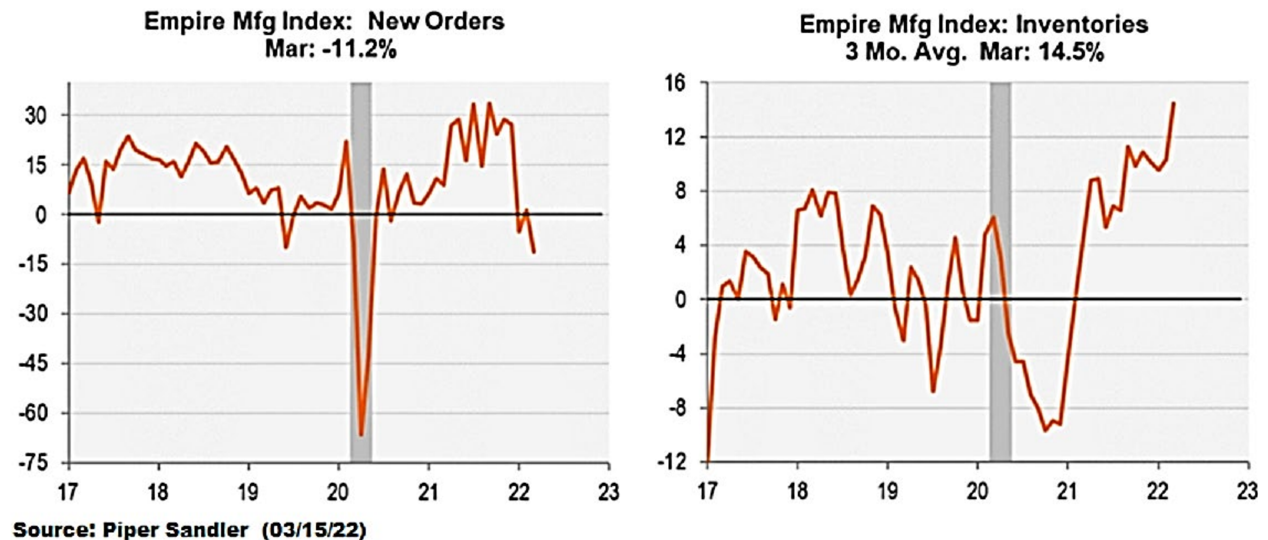
More recently, de-globalization has been hastened by elements from rising trade tensions and tariffs to the Covid pandemic exposing an assortment of supply chain issues. The isolation of

Russia is the newest source expanding this movement which is likely to increase populism leading countries to shift priorities inward to protect themselves should these 'weapons' ever be pointed in their direction. Global trade will continue to rise on an absolute basis but the evolving landscape will create new winners and losers as global supply chains rebalance.

Inflation anxieties boiled over in the first quarter for investors and the Fed alike. While some inflation is good in that it can drive business investment, too much too fast can alter consumer behaviors. The dramatic monetary and fiscal stimulus necessary to get us through the worst of the pandemic ultimately created flush consumers and disrupted supply chains resulting in demand that far outstripped supply. Furthering the issue, is the new impact of the war on myriad commodity prices as well as ongoing, though sporadic Covid outbreaks.

The Federal Reserve had been signaling its intentions to end its easy money policy and finally began its campaign against inflation in March by raising the target range for the fed funds rate by 25 basis points to 0.25%-0.50%. It also signaled its future intentions for six more rate hikes this year with four additional hikes next year. The biggest unknown for investors is whether central bankers will be able to engineer a so-called soft landing using rates to slow the economy without overshooting and causing a recession.

Even before the Fed began its tightening cycle, higher prices were already slowing growth both here and abroad. Early in pandemic with consumers at home, we overspent on "goods" stocking our individual shelves and finally finishing long overdue home improvement projects. With easing restrictions and reopenings, demand has slowly been shifting to services and experiences such as eating out at restaurants, attending concerts and vacation travel. This change in behavior is giving inventories a chance to 'catch-up' which also helps alleviate price pressures. As the charts here show, this is already underway. The Empire State Manufacturing Index is a monthly survey of manufactures that summarizes general business conditions in New York state.



As you can see, new orders (demand) have been falling while inventories (supply) have been on the rise. There is certainly still volatility within these regional data sets across but economic dislocations are generally moving in the right direction and closer to equilibrium.

In our opinion, the pace of corporate earnings growth is also set to slow along with economy. During periods of slowing growth, our experience shows that investors gravitate towards those areas of the market that can still produce solid increases in earnings. Additionally, a more normalized rate environment could make it difficult for those companies that relied upon near zero borrowing costs to remain afloat. Scarcity of growth is typically good for growth stocks but now will also be significantly more challenging for those business that cannot expand for the first time in a long time due to higher rates.

Markets hate uncertainty. Today, the investment backdrop is littered with these unknowns. We expect inflation pressures to ease over the medium-term as the Federal Reserve further slows demand via higher interest rates. Slowing does not mean negative and strong wages, rising labor participation and solid productivity gains all point to healthy underlying fundamentals. Global events will take longer to resolve and until investors have more clarity elevated volatility is likely to stay with us. While challenging, these periods also create opportunities for active investors as volatility often leads to the mispricing of assets. Our dual concentrated investment approach gives us the capability to benefit in this setting where what you choose to avoid is just as important and rewarding as what you choose to own.

As always, thank you for reading and please do not hesitate to reach out to us if we can assist you with achieving your investment goals in any way.

Kindest Regards,

Jeff Travis, CFA
Oak Associates, ltd.

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