QUARTERLY MARKET OUTLOOK

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2022 SECOND QUARTER OUTLOOK

Volatility Springs Higher

At-A-Glance

The S&P 500, Dow industrials and NASDAQ 100 went into a correction during the first quarter of 2022, falling more than 10% from their respective peaks.

The benchmark 10-year Treasury yield jumped from around 1.5% early this year to over 2.3% at one point in the first quarter.

Inflation in February was 7.9% year-over-year, a level not seen in 40 years, driven by a surge in commodities, a strong labor market and supply-side disruptions caused by the pandemic.

We are watching for a potentially more hawkish Fed as inflation persists.

The Fed lowered its forecasts for 2022 real Gross Domestic Product (GDP) to 2.8% due to the impacts caused by the war in Ukraine. We think real GDP could be lower than this but do not expect a recession, or two negative quarters of GDP growth. First quarter economic growth may be negative, however.

The wildcard is more fiscal stimulus to unclog supply chain bottlenecks.

Special Note from the Cetera Investment Management Team:

In parts of this outlook we will focus on the economic and market implications of the Russian invasion of Ukraine. While the human toll of this humanitarian crisis is high and cannot be discounted, we believe it is our job to focus on the impact this crisis has on global markets and set aside our emotions in the commentary. Our hearts go out to those impacted from this war, including those here at home with loved ones in Ukraine. We hope the war ends soon.

Overview

We had been expecting volatility for over a year and it finally arrived in the first quarter. While we didn't predict a war in Ukraine, we thought valuations in both bonds and stocks were relatively high and the U.S. Federal Reserve (Fed) could potentially raise interest rates and stop its bond-buying program faster than investors expected. The war in Ukraine has possibly delayed the Fed's actions and maybe even softened them, but a hawkish Fed remains a risk to markets. Overall, the impact of the war on financial markets will be tied to higher commodity prices caused by sanctions. Russia and Ukraine are a small part of the global economy but export a lot of oil, gas and wheat.

The global economy will normalize this year after a bumpy couple of years, crashing in 2020 and rebounding in 2021. We think economic growth expectations for the United States could come in below forecasts due to Omicron overhangs, lingering supply-side disruptions, inflation and maybe even a hawkish Fed later in the year. However, we do not anticipate a recession, or two quarters of negative GDP growth. We expect inflation to moderate in the second half of 2022 but remain above trend. Labor inflation may be less transitory than many believe.

On the bright side, the equity and bond valuations we just mentioned are improving and there are potentially many more opportunities in both securities. While large cap U.S. equity valuations remain elevated relative to historical standards—they are lower than last year—smaller companies have valuations far below their recent past and international stocks are below their 15-year averages.

Bond yields have risen sharply in some cases, reducing the interest rate risks many were worried about to an extent. Rising rates are still a risk in our view. Credit spreads have widened, offering more yield for investment-grade corporate bonds and high-yield corporate bonds. A modest amount of inflation can be healthy for corporate issuers and default rates are projected to be very low this year.

We want to reiterate our recommendation to diversify across asset classes, sectors and countries, while adhering to long-term risk and return objectives. Your financial professional can help you stay on track and keep focused on your personalized long-term plans, helping you navigate the next phase of this economic recovery.

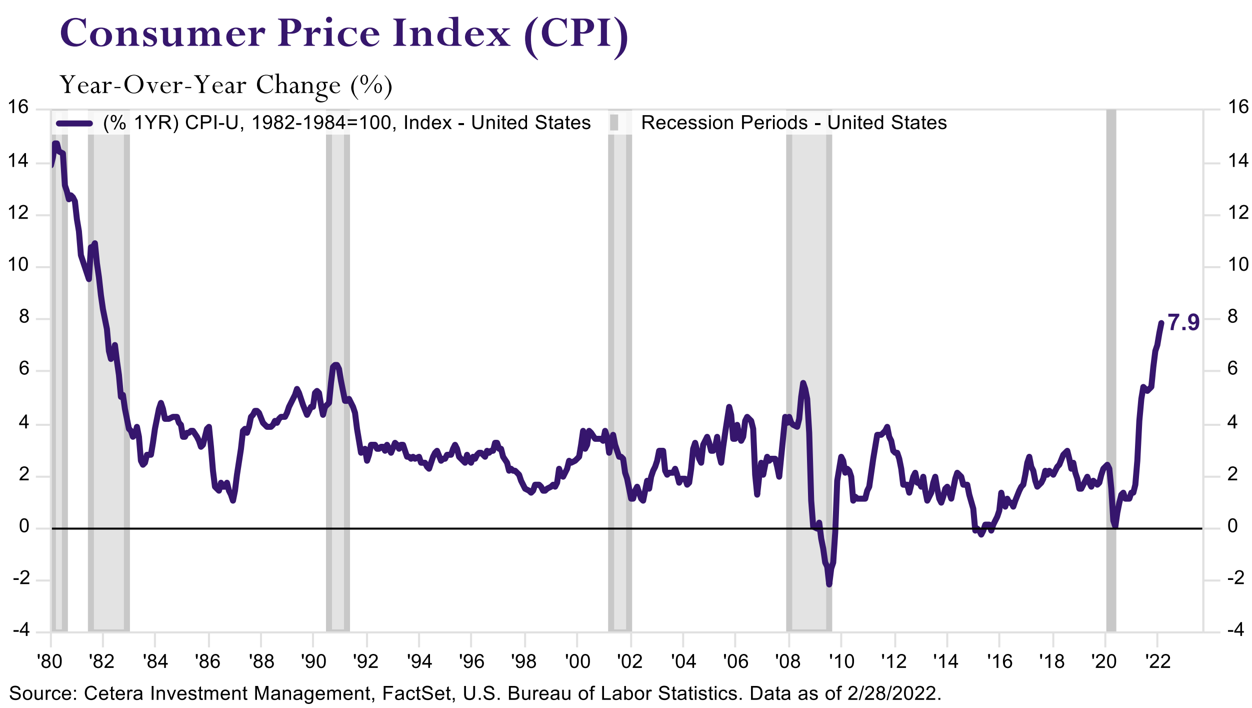
Global Economy

Before we discuss the current inflationary shock, it is important to summarize past shocks because it explains the Fed's predicament and what it might be forced to do later in the year. We have said in past outlooks that as the pandemic fades, investors will shift focus to the Fed removing accommodative policies. We even created a Fed-O-Meter to track the Fed relative to what the data is telling us. The Fed is tasked with a dual mandate of keeping prices stable (consistent with a 2% annual inflation target) and full employment. Higher interest rates can keep inflation in line with the target, but can hurt economic growth and thus employment. The Fed's job is a balancing act.

How Did the Fed Get So Far Behind on Inflation?

When the Fed started raising rates after the financial crisis in 2015, the unemployment rate was around 5% and the inflation rate, as measured by the Consumer Price Index(CPI), was a measly 0.1% (2015 annual rate). In contrast, before this recent 0.25% Fed Funds rate hike, the Fed was still easing monetary conditions by buying long-term bonds with a zero interest-rate policy, while staring at an unemployment rate under 4% and a February CPI print of 7.9% as seen in **Figure 1** below (the highest in 40 years).

Figure 1: Consumer Price Index



Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics. Data as of 2/28/2022.

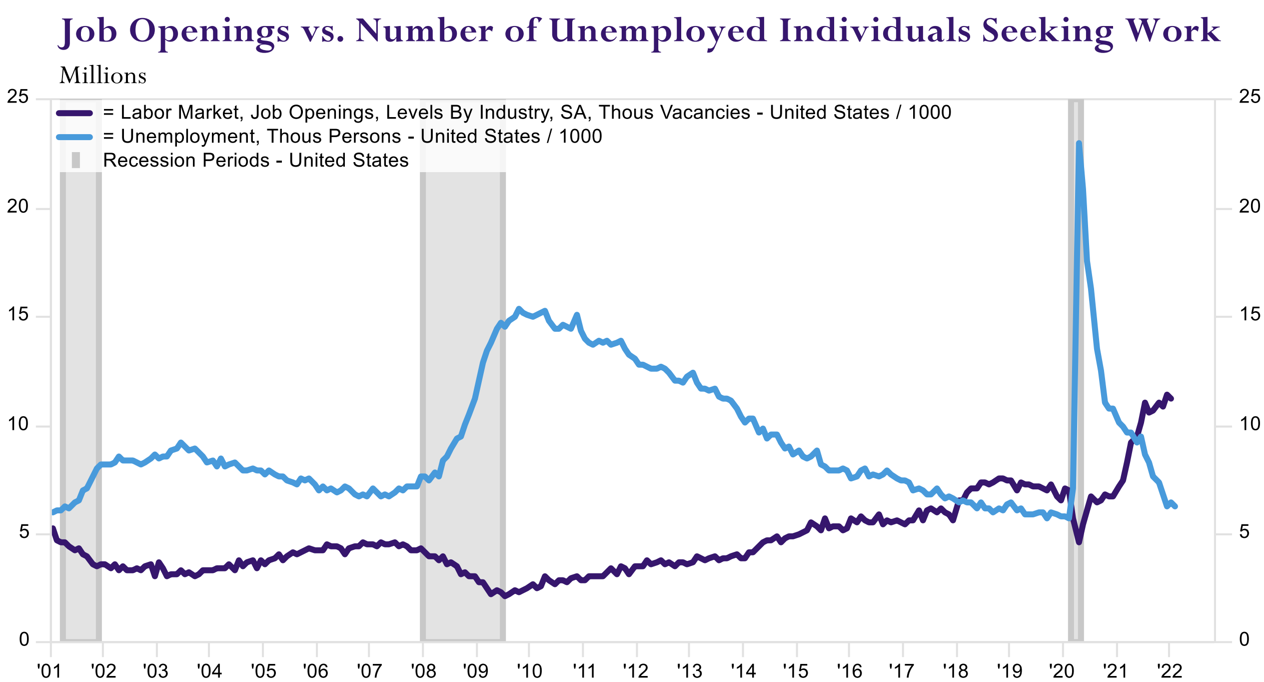
Prior to the Russian invasion of Ukraine on February 24, the Fed seemed to finally have an action plan on how to tame rising inflation. In 2021, the Fed had erred on the side of caution and just watched inflation run hot as supply-side disruptions caused by a ship stuck in the Suez Canal in spring, Hurricane Ida in the fall and the

Omicron variant in the winter clouded its view of inflationary buildup. In addition, the Fed sat tight as it awaited more clarity around what congress would do regarding a stimulus package earlier in 2021. A $1.9 trillion relief bill was signed into law last spring, followed by $1.2 trillion infrastructure bill in the fall.

Inflationary pressures were starting to build as the Fed was on pause. Americans were prepared for the much-awaited reopening of their local economies due to easing of COVID restrictions. In the summer, airline tickets, rental cars, hotels and used cars all saw huge price increases as demand far outpaced supply. Not all of these increases could be attributed to supply-side disruptions caused by shipping constraints. Something else was also brewing in labor markets.

Labor shortages, especially in the service industry, were forcing companies to compete for workers. Companies offered signing bonuses to restaurant workers and others in the service industry to compete. When extended unemployment benefits rolled off in the fall, there was a spike in labor force participation, but the gap between the number of job openings and the number of unemployed workers remained at all-time highs. For many reasons, including COVID worries, childcare issues and early retirement, workers dropped out of the work force and did not return. This shortage was already becoming an issue before the pandemic started, as the number of jobs was already exceeding those looking for work. The pandemic only exacerbated the problem as seen in **Figure 2**. There are currently 4.75 million more job openings in the U.S. than unemployed individuals looking for work.

Figure 2: More Jobs than People Looking for Work



Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics. Data as of 1/31/2022.

Early this year, the Fed finally had the relatively unclouded inflation picture it was seeking in order to raise interest rates and stop buying longer maturity bonds. The Fed had been buying these bonds to maintain lower long-term yields, which elevated asset valuations, including housing and the stock market.

Coming out the pandemic the Fed did not want to disrupt the labor market recovery and was willing to let inflation run hotter because of "transitory" forces that they believed would eventually diminish. The problem is that more inflationary forces continued to emerge, and wage inflation may not be as temporary as was anticipated. Now the Fed is playing catch-up and may be forced to combat inflation at a faster pace at the expense of economic growth and the labor market. This bring us to the newest inflationary shock.

The Current Transitory Inflationary Shock – Energy and Food

The Russian invasion of Ukraine caused both energy and food prices to surge. The problem with higher energy prices is that it doesn't just show up at the gas pump. Higher energy prices flow into pretty much everything we buy because shipping costs and production costs become more expensive. This impacts everything from food to services and travel.

Some of the energy shock could be mitigated as output lost from the sanctions put on Russian oil can be made up over time as OPEC nations and our own oil producers increase production. The news is worse for European economies because 40% of natural gas imports are sourced from Russia. Natural gas prices are more regional and not global, like oil, because natural gas is harder to transport, usually requiring pipelines or liquification facilities. The good news for the United States is that we are a large natural gas producer and domestic natural gas prices are keeping stable and relatively low compared with the rest of the world.

On the food front, Ukraine, nicknamed the "breadbasket of Europe," and Russia combine to provide about 30% of the world's wheat production. The war has drastically reduced production and shipping from these areas, sending global food prices sharply higher.

With food and energy representing about 13% and 7% of CPI respectively, this once again leaves the Fed with a clouded picture of inflation, as it is unknowable how long this war will last and how soon commodity production can be brought back online. However, the Fed can't afford to wait anymore. Inflation is at 40-year highs and is hurting Americans' purchasing power. It needs to act but will continue to lean on the cautious side for now. Looking at the latest Federal Open Market Committee (FOMC) summary of economic projections by the Fed, the Fed Funds rate is expected to rise to the 1.75% to 2.0% range. That's equivalent to seven 0.25% rate hikes by year-end.

Economic Growth

Russia is a small part of the global economy, as discussed in a recent commentary, so the direct impact of sanctions on Russia's economy to global GDP will be minimal. A reduction in economic growth projections will be dependent on the impact of sanctions on inflation and how the global banks respond. As such, GDP growth expectations have been lowered for the year. We expect the United States' real GDP to be around 0.3% lower due to the sanctions and higher oil prices caused by the war. The Atlanta Fed's GDPNow, which estimates inflation adjusted GDP in real time, estimated first quarter 2022 real GDP growth to be around 2% prior to the war. Their projections did fall below zero but are currently about 1.3% as of March 17. In the Fed's December Federal Open Market Committee (FOMC) meeting, the members median projection for real GDP growth in 2022 was 4%. In the most recent meeting, they lowered this projection to 2.8%. While we don't anticipate a recession or two quarters of negative real GDP growth this year, it is possible we could see a negative first quarter as the economy still had the Omicron virus overhang and the initial shock of high energy prices, which should abate later in the year. We believe real GDP growth is likely to come in below consensus this year, maybe in the 2%-3% range.

Our Chartbook gauges the risk of recession and that risk is currently at a low level, although the trend is negative. Economic data is weakening from high levels. Notable metrics may be consumer sentiment, which is falling dramatically, and the Treasury yield curve. The spread between the two-year Treasury Yield and 10-year Treasury yield is narrowing and under 0.3%. When this spread becomes negative, it could signal a recession ahead as bond markets are telling us that short-term growth is higher than long-term growth. We view this metric with caution because the Fed is heavily influencing the curve and pushing short-term yield higher with expectations of rate hikes.

In Asia, Japan is seeing some inflation, but it is still under 1% and below its target of 2%. As such, the Bank of Japan will likely keep its interest rates where they are and close to zero. The bank is also resolute in keeping a 0.25% cap on its 10-year bond yields. It pledged to buy unlimited Japanese Government Bonds to keep this cap and keep borrowing costs low, although it is currently tapering its corporate bond purchases. Going further west, China is curtailing its credit creation, which will slow its property and export sectors. President Xi will break the pattern of Chinese presidents not serving more than two terms and will run for another term. China has been focusing on long-term goals and has been willing to sacrifice short-term growth recently. It is also dealing with population growth headwinds and its population could even decline in 2022. London-based economic research firm Capital Economics estimates 2022 GDP growth in Japan and China to be 3.3% and 3%, respectively.

In Europe, the European Central Bank (ECB) projects that real GDP growth in 2022 will be 3.7%, down from 4.2%. They increased inflation projections for the year to 5.1%, then falling to 2.1% in 2023 and 1.9% in 2024. Concerned about record inflation (5.8% in February), the ECB moved up the timetable on ending its bond-buying program and is expected to start raising interest rates soon. Rates may increase by 0.5% by year-end after over a decade of no rate hikes. ECB President Christine Lagarde sounded a lot like Fed Chair Jerome Powell in that she assured everyone that the central bank is “data-dependent” and would reverse course if needed. She also deferred to policymakers in responding to the war in Ukraine rather than addressing any impacts caused by the war using monetary policy.

More Stimulus?

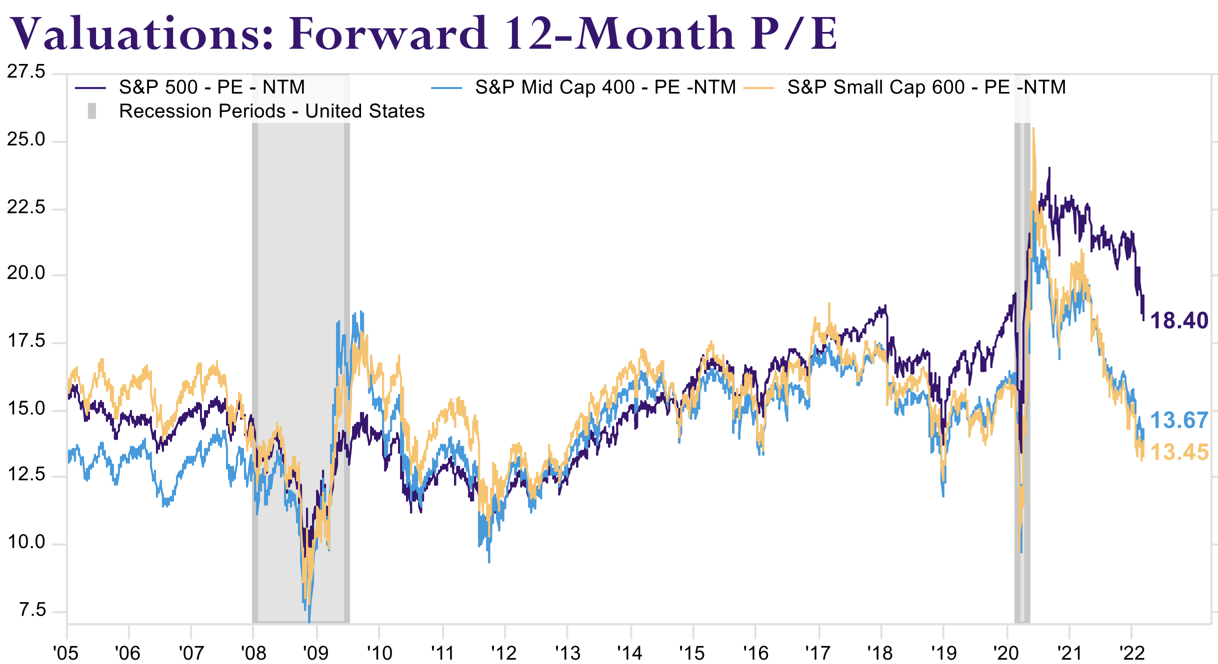
As Lagarde implied, more fiscal stimulus could be a potential wildcard, and not just in Europe. There is increased talk about the Biden Administration rebooting a version of its Build Back Better plan. President Biden recently mentioned the rebranded plan as Building a Better America in his State of the Union address. To offset high gas prices, a stimulus bill could be proposed to help struggling Americans. This introduces unpredictability, because while stimulus could be a tailwind for the economy once again, its impact on inflation would be a concern. Adding more stimulus on top of high inflation could amplify the issue, so addressing inflation in any potential bill would be paramount. Proposals could be geared at unclogging ports and shipping lanes to address this issue.

Equity Markets

The S&P 500 started 2022 only 200 points away from 5,000, but with all the uncertainty around Omicron and then the Russian invasion of Ukraine, the index was down to just 200 points above 4,000 by mid-March, representing a decline of approximately 13% from the early January record high. A lot of the pullback was led by growth sectors that did well coming out of the pandemic, while value-oriented sectors fared much better. Smaller capitalization stocks still fell in tandem with their larger counterparts though. Developed international and emerging markets also declined, seemingly in line with U.S. large cap stocks. The path down wasn’t smooth; valuations were elevated entering 2022 and we had been expecting volatility since the second half of last year. The average daily trading range of the S&P 500 was under 1% last year. Year-to-date, that range has doubled and is close to 2%. We haven’t had a trading range this wide since the first quarter of 2020 when it was 2.58%.

The silver lining in this stock market correction is that valuations are now better. While earnings have been great, investors had been bidding up the price to buy into stocks and thus their future earnings streams. At year end, the S&P 500 had a trailing price-to-earnings ratio of 25.2. This was in the 92nd percentile over the last 15 years and had only been higher 8% of the time. As of February 28, the S&P 500 price-to-earnings (P/E) ratio was 21.3 and in the 88th percentile. This is still high relative to recent history but closer to the 15-year average of 18.5. Valuations in mid cap and small cap are looking attractive from a historical perspective. These valuations are well below their average and in single-digit percentiles. You can see the fall in forward P/E ratios in **Figure 3**. These are based on the future 12-month earnings rather than the past 12 months we have been discussing. Regardless what metric you prefer, valuations are getting better. International markets are also below their long-term averages. You can see a more detail on this on page 6 of our Chartbook.

Figure 3: Valuations



Source: Cetera Investment Management, FactSet, Standard & Poor's. Data as of 3/11/2022.

Future company earnings still look good, too. Earnings growth will slow to more pedestrian levels, as last year the growth rate was extraordinary because it was coming out of very low earnings levels caused by the pandemic. Earnings growth should stabilize this year in the mid-single digits, as currently forecasted by FactSet Research. We believe that the service area of the economy will continue to recover and outpace the goods-driven sector that did so well at the start of the recovery. We think service-oriented companies will continue to outperform and that value will continue to outperform growth this year. This is also a longer-term trend as growth has outperformed value for over a decade. We also expect smaller cap stocks to rebound and lead larger cap stocks eventually. While long-term trends can be hard to time, we expect these trends to take hold over time. However, one should not abandon growth stocks.

Fixed Income

Volatility isn't limited to stocks, either. Bond markets have also been volatile although volatility looks different in bond markets. The yield on the 10-year Treasury bond started 2022 around 1.5% and climbed to over 2.1% as the Fed got the clarity it was looking for to start removing accommodation. The war in Ukraine spooked investors and the flight to safety bid up bond prices and lowered yields back down to around 1.7%. Bond prices move inversely to bond yields. After investors had time to assess the war and become comfortable with financial markets and the reduced possibilities of escalation, bond yields went back up to the 2% range. These may seem like small moves, but if we simplify the math, the 10-year Treasury bond has approximately a 10-year duration. This means a 1% move in yields equates to a 10% move in price. So, these 0.3% moves in yield resulted in around 3% swings in the prices of longer-term bonds. Not a lot for stock investors, but that's high volatility for bond investors, considering inflation is already eating into their purchasing power. With the move up in yields, the Bloomberg Aggregate bond index is now down around -5% year-to-date. This broad index has a duration close to seven years now because the Treasury department issued a lot of long-term debt to finance all the stimulus money. The index which tries to replicate the entire bond market had to add more long-term U.S. treasuries.

Now that we have explained duration in simple terms, we can add another twist to the equation that bond investors are grappling with. Yields don't move evenly along the yield curve. If we look at Treasury bonds with different maturities and durations, like three months, two years, five years, 10 years and 30 years, their yields don't move up or down in unison. With the Fed making its intentions to raise short-term interest rates the shorter maturity bonds move up in yields and thus down in price. Longer maturity bonds are less impacted by these actions by the Fed and more influenced by long-term growth prospects and inflation. As we mentioned earlier, the Fed tries to control the long end of this curve by buying and selling bonds it owns, but its influence is not as direct. As such, the spread between the two-year Treasury and 10-year Treasury has been contracting over the past year. Around a year ago it was around 1.6% and by mid-March the spread was under 0.3%. When this spread inverts, and the two-year yield is greater than the 10-year yield, this can signal a recession is coming. Investors view this as long-term growth prospects being less than short-term growth prospects. In **Figure 4**, you can see the sharp move up in two-year yields and this jump has not been matched by longer maturity bonds.

Figure 4: Two-Year Treasury Yield

Source: Cetera Investment Management, FactSet. Data as of 3/11/2022.

Moving down the credit spectrum and into corporate bonds, investors can get more yield for taking on additional credit risk of default and downgrades. Yields of investment-grade corporate bonds have also risen. The effective yield has gone from under 2% last summer to close to 3.5% currently on the ICE BofA US Corporate Index, an index traced by the Federal Reserve Bank of St. Louis. Likewise, the effective yield on the ICE BofA US High yield index climbed from under 4% last summer to close to 6% right now. The more credit risk investors take the more correlated to equities the bonds become. The good news is that default rates are supposed to be very low this year and modest amounts of inflation can be good for corporate bond issuers as they can raise profit margins and their debt becomes worth less in real terms. Inflation makes debt more manageable because the debt is not inflation adjusted. Fundamentals are good for corporate credit.

With this backdrop in the bond market, we recommend diversification across the yield curve and across different credit qualities. Overall, we recommend being underweight benchmark duration and limiting exposure to what the Fed has been buying and could possibly be selling in the future. The Fed has been buying predominantly long-dated Treasury bonds and mortgage-backed securities. If the Fed stops buying these bonds, the demand for the bonds may fall, driving rates higher. We like corporate bond fundamentals including high yield bonds, but we limit exposure to the highest yielding bonds as they offer less diversification from equities. When constructing a bond portfolio, your financial professional can help you build a portfolio that suites your specific goals and objectives.

The Bottom Line

The Fed will be a major influence on markets as it starts to withdraw stimulus by raising short-term rates and stopping its long-term bond purchases. The pace at which it does this and how it telegraphs this to markets will be important. While the Fed has been cautious up to this point, they indicated increased urgency to combat inflation during the March FOMC meeting. Inflation risks are growing and the Fed might need to act quicker and more decisively than investors are prepared. We will continue to watch the data and listen to what Fed officials are saying for clues.

The global economy will be coming off a volatile couple of years. 2020 was a year of massive declines in GDP and 2021 was a year of strong growth rates driven by the recovery. 2022 will likely be more in line with historical GDP growth rates. First-quarter real GDP growth might be negative, but again, we don’t expect a recession, or two consecutive quarters of negative GDP growth. We also continue to watch policy makers closely as the possibility of more stimulus and would change projections.

With the stock market correction, valuations, or P/E multiples, are better and earnings are projected to be healthy this year. This could be a good backdrop for stocks as local economies, especially larger cities, fully reopen from COVID restrictions. We continue to expect value-oriented stocks and the service-oriented sectors to resume their rebound.

The credit cycle is possibly in its early mid-cycle, which is good for corporate bonds. Default rates are expected to be very low this year and modest amounts of inflation can help high-yield issuers. However, with more credit risk comes more market volatility, so we recommend sticking to long-term risk and return objectives when adding credit to your portfolio. Equity volatility should remain elevated this year, so balancing that out with high-quality bonds is still prudent. Being underweight duration, or having less interest rate sensitivity than the aggregate bond benchmark, may be a good plan of action. As yields rise, there may be opportunities to add more duration to portfolios.

As always, count on your financial professional to help you stay on track and keep your sights on your long-term goals.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary
The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Dow Jones Industrial Average is a price-weighted average of 30 U.S. blue-chip stocks traded on the New York Stock Exchange and NASDAQ. The index covers all industries except transportation, real estate and utilities.

The NASDAQ Composite Index includes all domestic and international based common type stocks listed on The NASDAQ Stock Market. The NASDAQ Composite Index includes over 2,500 companies, spanning all 11 sector groups.

The ICE BofA US Corporate Index tracks the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market. Securities must have an investment grade rating and an investment grade rated country of risk. Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of $250 million.

The ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. To qualify for inclusion in the index, securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch) and an investment grade rated country of risk. Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of $100 million.