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FIDUCIARY PULSE

1st Quarter 2022: Financial Markets Rattled by Russian Invasion, Inflation Pressures Rise, and The Federal Reserve Takes Steps Towards Monetary Normalization

By Clark Kendall

The Quarter In Brief

Financial markets abhor uncertainty, and Russia's invasion of Ukraine added new uncertainties to a market already wavering from accelerating inflation and the prospect of higher interest rates. After a year of strong economic growth and solid stock market returns, heightened inflation and the unclear pace of monetary policy tightening triggered market volatility right from the start of the new year. The potential of rising interest rates propelled bond yields higher and hurt stock valuations, especially the previously high-flying, high-growth technology names.

Stock market weakness continued into February as investors worried that the Fed's slow response would lead them to address high inflation with more rate hikes than investors initially anticipated. When Fed Chair Jerome Powell announced plans to shrink the Fed's balance sheet, the fears of a more aggressive monetary policy grew.

Financial markets were roiled by the lead-up to the Russian invasion of Ukraine, with prices becoming more volatile as investors reacted to the building tensions on the Russian-Ukrainian border and momentary glimpses of a potential diplomatic solution. Stocks slumped on news that hostilities had started as investors assessed the global economic impact of the invasion and the economic sanctions that followed. The flight to safety sent bond yields lower, halting, at least temporarily, the march toward higher yields.

In the final month of the first quarter, stocks

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continued to be volatile as intensifying hostilities in Ukraine added to inflation and supply-chain concerns. However, by mid-March, stocks staged a strong turnaround that reversed much of the quarter-to-date declines as investors welcomed the clarity on monetary policy following the Federal Open Market Committee's March meeting and encouraging economic data.

Overlooked by these headline concerns, corporate profits for the fourth quarter exceeded market expectations. With 95% of S&P 500 constituent companies reporting, 76% reported a positive earnings surprise, posting an average earnings growth rate of 30.7% in the fourth quarter. This earnings momentum may likely moderate in the first quarter to a 4.6% increase and 8.5% for the full year.

The U.S. Economy

In the fourth quarter, the U.S. economy grew at a robust annualized rate of 6.9%, led by strong retail sales, services, and exports. The economy overcame several substantial headwinds, including a surge in Omicron infections, accelerating inflation, continued bottlenecks in the global supply chain, a labor shortage, and the anticipation of a tighter monetary policy.

The solid economic performance in the fourth quarter helped drive the unemployment rate from 4.8% in September to 3.9% in December, a favorable trend that carried over into the first quarter of 2022, with the unemployment rate falling further to 3.8% in February.

The first quarter's economic expansion is likely to be modest due to the drag of Omicron, but the Ukrainian invasion may further dent economic growth. The Federal Reserve Bank of Atlanta, which attempts to track GDP growth in real-time, reported that its "GDP Now" forecasting model lowered its nearly 2.0% Q1 GDP pre-invasion annualized growth rate estimate to 1.3% as of March 31, 2022.

The Atlanta Fed is not alone. In one survey of economists two weeks after the invasion, findings lowered the average of 14 earlier forecasts by 0.3 percentage points. The first and second quarters felt the most significant impact of the projected economic deceleration before stabilizing in the year's final two quarters.

Elevated inflation was a dominant concern throughout the quarter. The cost of consumer goods jumped 7.9% year-over-year in February, the most significant increase since July 1981. This boost comes atop year-over-year increases in the Consumer Price Index of 7.5% in January and 7.0% in December 2021.

With lower economic projections ahead, the Fed set upon a new course in its monetary policy with the end of asset purchases and the implementation of a 0.25% interest rate hike, the first such increase since 2018. The Fed also signaled the possibility of a total of seven quarter-point rate hikes this year and three or four next year to combat inflation and its intention to announce a plan for reducing its $9 trillion balance sheet.

In the quarter to come, economic growth will be challenging in an uncertain geopolitical landscape, further interest rate hikes, the persistence of elevated inflation, and supply-chain stresses.

Global Economic Health

The impact of war in Europe has led to downward revisions in the 2022 growth estimates for major global economies. Further supply chain disruptions and more significant inflationary pressures are likely to weigh upon economic activity.

The economic repercussions of Russia's invasion of Ukraine are widespread. Commodities prices, from oil and agricultural products to natural gas and base metals, may stay elevated for the foreseeable future. This sustained elevation may be due to the combination of sanctions, the destruction of infrastructure, and supply uncertainty, resulting from the disruption of supply chains, as land- and sea-based trade routes have become impeded or completely closed down.

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While the measure of the invasion's economic impact remains fluid and imprecise, according to the Economist Intelligence Unit (EIU), a British-based economic research and analytics group, economic growth in Europe may slow down by nearly 50% from a pre-war estimate of 3.9% to about 2.0%. The impact on eurozone countries may be less severe, with estimates revised from 4.0% to 3.7%. EIU also projects that global growth will be shaved by 0.5 percentage points, from 3.9% to 3.4%.

The United Kingdom is facing a similar outlook. The British Chamber of Commerce downgraded its forecast for economic growth in 2022, reducing its initial 4.2% growth projection to 3.6% in the wake of the Russian invasion. The Japanese economy saw a steep

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MARKET INDEX	Y-T-D % CHANGE	Q1 % CHANGE	Q4 % CHANGE
DJIA	-4.57%	-4.57%	+7.37%
NASDAQ	-9.10%	-9.10%	+8.28%
S&P 500	-4.95%	-4.95%	+10.65%
BOND YIELD	**3/31 RATE**	**1 MO AGO**	**1 YR AGO**
10 YR TREASURY	2.33%	1.84%	1.75%

Sources: Wall Street Journal, March 31, 2022, Treasury.gov (Bond Yield)

The market indexes discussed are unmanaged and generally considered representative of their respective markets. Individuals cannot directly invest in unmanaged indexes. Past performance does not guarantee future results. U.S. Treasury Notes are guaranteed by the federal government as to the timely payment of principal and interest. However, if you sell a Treasury Note prior to maturity, it may be worth more or less than the original price paid.

slowdown in the first quarter due to a surge in Omicron infections. A Reuters poll of analysts lowered their median Q1 GDP annualized growth rate from 4.5% to 0.4%. Japan's economy may remain under pressure as a declining yen has exacerbated rising energy and commodity prices. Finally, China set its 2022 growth rate target at 5.5%, the lowest in more than 25 years. Even this modest goal may be challenging to reach amid struggles to manage a surge in COVID-19 infections that have led to shutdowns of cities and factories and regulatory pressures in its property and technology sectors.

The MSCI-EAFE Index, which tracks developed overseas markets, slid 6.61% in Q1, while emerging markets, as measured by the MSCI-EM (Emerging Markets) Index, fell 7.32%.

Looking Back, Looking Forward

Blindsided by one of the "known unknowns" that are always lurking in the background and can upset existing market narratives, markets reacted to Q1's rising inflation. Investor expectations coming into 2022 were modest – economic growth may come slowly but remain solid, and stocks were forecast to rise, though not at the pace of 2021.

> So, as investors look forward, they may see three significant headwinds for the market: inflation, higher interest rates, and potentially wider geopolitical issues.

In the new year, investors were fully aware that inflation was proving more durable than "transitory" and that interest rates could head higher. Yet, it was only upon the turn of a calendar page that investors seemingly contemplated what that potentially meant, i.e., a more aggressive Fed, a slowdown in corporate earnings growth, and a devaluing of high-growth companies whose earnings may be in the distant future.

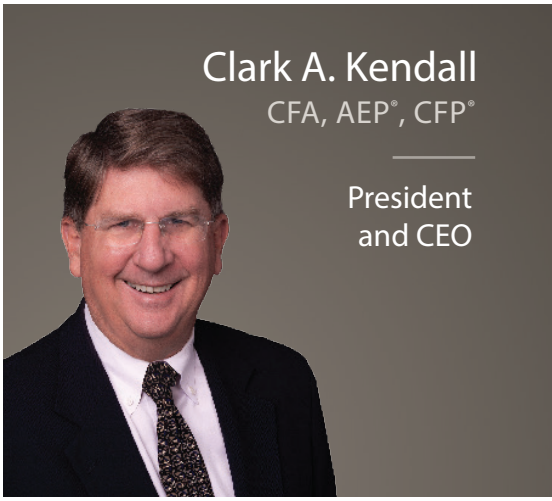
In one respect, the market correction in the first quarter (defined as a decline of 10-20% from recent market highs) shouldn't have come as a surprise to experienced investors since there have been 27 such declines since World War II, with the last one occurring in 2018. By historical standards, a correction was overdue. Past corrections have had an average decline of 13.7% and last for about four months (not including corrections that turn into bear markets, i.e., a decline of 20% or more). Nevertheless, historical performance is only a guide, not a guarantee of the future. So, as investors look forward, they may see three significant headwinds for the market: inflation, higher interest rates, and potentially wider geopolitical issues.

While a tighter monetary policy is the Fed's primary tool in fighting inflation, its ability to dampen inflation over the near- to intermediate-term may be limited since higher interest rates take time to work through the economic system. Also, a tighter monetary policy will do very little to solve current supply chain problems – a significant contributor to rising prices. While higher rates may be effective for lowering inflation longer term, it may come at a short-term cost to investors. Higher interest rates, along with any shrinking of the Fed's balance sheet, may reduce liquidity in the markets, which may put some downward pressure on stocks.

The wild card seems to be what Russia does next, which could be as disparate as agreeing to a withdrawal from Ukraine with a promise to respect Ukraine's territorial integrity to invading additional countries and ratcheting up tensions with the West. A peaceful resolution to the Ukraine crisis may be met with deep relief by investors, potentially allowing markets to rally and return the focus to economic fundamentals, like GDP growth, inflation, and corporate profits.

A widening of tensions may prove problematic to the financial markets and the economy, especially if they involve Russia taking steps that violate the borders of NATO countries or if China pursues an invasion of Taiwan.

We've seen markets unsettled by war in the past. They tend to regain their balance in a relatively short period. However, the conflict in Ukraine is very different from more recent wars, which is why the market's near-term prospects may first and foremost turn on the outcome of events in Eastern Europe.



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Retirement Preparation Mistakes

By Carol Petrov

Why are they made again and again?

Much is out there about the classic financial mistakes that plague start-ups, family businesses, corporations, and charities. Aside from these blunders, some classic financial missteps plague individuals, or as we say the Middle-Class Millionaire.

Calling them "mistakes" may be a bit harsh, as not all of them represent errors in judgment. Yet whether they result from ignorance or fate, we need to be aware of them as we prepare for and enter retirement

Timing Social Security.

As Social Security benefits rise about 8% for every year you delay receiving them, waiting a few years to apply for benefits can position you for higher retirement income. Filing for your monthly benefits before you reach Social Security's Full Retirement Age (FRA) can mean comparatively smaller monthly payments.

Managing medical bills.

Medicare will not pay for everything. Unless there's a change in how the program works, you may have a number of out-of-pocket costs, including dental, and vision.

Underestimating longevity.

Actuaries at the Social Security Administration project that around a third of today's 65-year-olds will live to age 90, with about one in seven living 95 years or longer.

The prospect of a 20- or 30-year retirement is not unreasonable, yet there is still a lingering cultural assumption that our retirements might duplicate the relatively brief ones of our parents.

Withdrawing strategies.

You may have heard of the "4% rule," a guideline stating that you should take out only about 4% of your retirement savings annually. Some retirees try to abide by it.

So, why do others withdraw 7% or 8% a year? In the first phase of retirement, people tend to live it up; more free time naturally promotes new ventures and adventures and an inclination to live a bit more lavishly.

Talking About Taxes.

It can be a good idea to have both taxable and tax-advantaged accounts in retirement. Assuming your retirement will be long, you may want to assign this or that investment to its "preferred domain."

What does that mean? It means the taxable or tax-advantaged account that may be most appropriate for it as you pursue a better after-tax return for the whole portfolio.

Retiring with debts.

Some find it harder to preserve (or accumulate) wealth when you are handing portions of it to creditors.

Putting college costs before retirement costs.

There is no "financial aid" program for retirement. There are no "retirement loans." Your children have their whole financial lives ahead of them.

Retiring with no investment strategy.

> "It can be a good idea to have both taxable and tax-advantaged accounts in retirement.

Expect that retirement will have a few surprises; the absence of a strategy can leave people without guidance when those surprises happen.

These are some of the classic retirement mistakes.

Why not attempt to avoid them? Take a little time to review and refine your retirement strategy with an advisor here at Kendall Capital.

Carol Petrov
CFP®

Vice President and Senior Relationship Manager

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How Market Cycles Can Impact Retirements

By Brian Mattox

Sequence of returns can play a role in your overall portfolio.

A thoughtful retirement strategy helps Middle-Class Millionaires pursue their many retirement goals. That strategy must consider many factors, and here are just a few: income needs, the order of withdrawals from taxable and tax-advantaged retirement accounts, the income tax implications of those withdrawals, and sequence of return risk.

Just what is the sequence of return risk?

In brief, it is the risk that market declines in the early years of retirement, combined with steady withdrawals, could reduce your portfolio's outlook.

A recent CNBC article mentioned how sequence of return risk can affect retirement accounts. It used a 20-year example – someone retiring in 2000 with $1 million in an account tracking the returns of the S&P 500, making withdrawals of $40,000 a year that increased 2% annually in view of inflation.

In 2000, a bear market began. The 37% pullback for the S&P 500 that occurred in 2000-02 would have reduced the $1 million account to about $470,000 by January 1, 2020, the end of the 20-year period. The balance reflects the annual withdrawals of $40,000 and the 2009-20 bull market.

Now, if the order of yearly returns were flipped, the portfolio would show much different performance. At the end of the 20-year period, the retiree would have had more than $2.3 million in that account after the exact same schedule of income distributions.

It's critical to point out that investing involves risk, and past performance does not guarantee future results.

The return and principal value of stock prices will fluctuate as market conditions change. And shares, when sold, may be worth more or less than their original cost.

The S&P 500 Composite Index is an unmanaged index that is considered representative of the overall U.S. stock market. Individuals cannot invest directly in an index, and index performance is not indicative of the past performance of a particular investment.

In retirement, it is vital to address risk and volatility.

You have less time and may have fewer opportunities to rebuild your savings. Fortunately, there are ways to address the challenge of sequence of return risk and manage your portfolio risk while looking for opportunities.

> "A thoughtful retirement strategy helps Middle-Class Millionaires pursue their many retirement goals.

Brian Mattox
CAIA

Chief Investment Officer, Vice President

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Major Risks to Family Wealth

By Jason Tkach

Protect your family assets for future generations. All too often, family wealth fails to last.

One generation builds a business—or even a fortune— lost in the ensuing decades. Why does it happen, again and again? Often, middle-class millionaire families fall prey to serious money blunders, making classic mistakes, or not recognizing changing times.

This article is for informational purposes only and is not a replacement for real-life advice. Make sure to consult legal and tax professionals before modifying your overall estate strategy.

Procrastination.

This is not just a matter of failing to create a strategy but also failing to respond to acknowledged financial weaknesses.

As a hypothetical example, say there is a multimillionaire named Alan. The designated beneficiary of Alan's six-figure savings account is no longer alive. He realizes he should name another beneficiary, but he never gets around to it. His schedule is busy, and updating that beneficiary form is inconvenient. Alan forgets about it and moves on with his life.

However, this can cause significant headaches for those left behind. If the account lacks a payable-on-death (POD) beneficiary, those assets may end up subject to probate. Using our example above, Alan's heirs may discover other lingering financial matters that required attention regarding his retirement accounts, real estate holdings, and other investment accounts.

Minimal or absent estate management.

Every year, some multimillionaires die without leaving any instructions for distributing their wealth. These people are not just rock stars and actors but also small business owners and entrepreneurs. According to a recent Caring.com survey, 58% of Americans have no estate preparations in place, not even a will.

Anyone reliant on a will alone may risk handing the destiny of their wealth over to a probate judge.

The multimillionaire who has a child with special needs, a family history of Alzheimer's or Parkinson's, or a former spouse or estranged children may need a greater degree of estate management. If they want to endow charities or give grandkids an excellent start in life, the same idea applies. Business ownership calls for coordinated estate management with consideration for business succession.

A finely crafted estate strategy has the potential to perpetuate and enhance family wealth for decades, and perhaps, generations. Without it, heirs may have to deal with probate and a painful opportunity cost—the lost potential for tax-advantaged growth and compounding of those assets.

The lack of a "family office."

Decades ago, the wealthiest American households included offices: a staff of handpicked financial professionals who supervised a family's entire financial life. While traditional "family offices" have disappeared, the concept is as relevant as ever. Today, select wealth management firms emulate this model: in an ongoing relationship distinguished by personal and responsive service, they consult families about investments, provide reports, and assist in decision-making. If your financial picture has become far too complex to address on your own, this could be a wise choice for your family.

Technological flaws.

Hackers can hijack email and social media accounts and send phony messages to banks, brokerages, and financial professionals to authorize asset transfers. Social media can help you build your business, but it can also expose you to identity thieves seeking to steal both digital and tangible assets.

Sometimes a business or family installs a security system that proves problematic—so much so that it's silenced half the time. Unscrupulous people have ways of learning about that, and they may be only one or two degrees separated from you.

No long-term strategy in place.

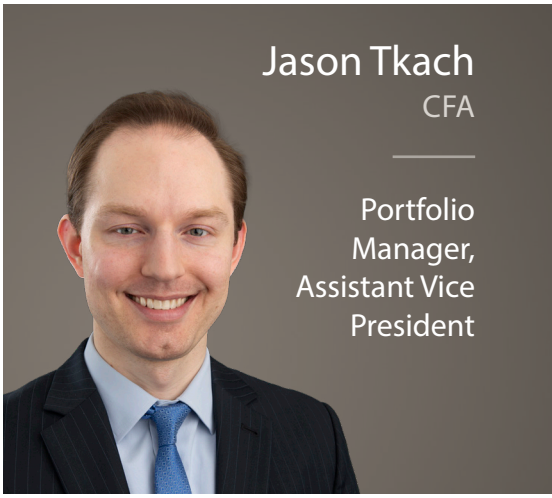
When a family wants to sustain wealth for decades to come, heirs will want to understand the how and why, and be on the same page. If family communication about wealth tends to be more opaque than transparent, then that communication may adequately explain the mechanics and purpose of the strategy.

No decision-making process.

In some high-net-worth families, financial decision-making is vertical and top-down. Parents or grandparents may make decisions in private, and it may be years before heirs learn about those decisions or fully understand them. When heirs do become decision-makers, it is usually upon the death of the elders.

Horizontal decision-making can help multiple generations commit to the guidance of family wealth. Financial professionals can help a family make these decisions with an awareness of different communication styles. In-depth conversations are essential; good estate managers recognize that silence does not necessarily mean agreement.

You may attempt to reduce these risks to family wealth (and others) in collaboration with your financial advisor at Kendall Capital and legal professionals. It is never too early to begin.



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Is Inflation Peaking?

By Zemin Zhu

One lesser-known indicator is called the Baltic Dry Index.

We know our middle-class millionaire clients see it in prices at the grocery store and the gas station and feel it in their monthly budget. So why don't the financial markets seem too concerned about inflation?

Remember, financial markets are considered "discounting mechanisms," meaning they are looking six- to nine-months into the future.

And by June 2022, the financial markets expect that inflation will lower than today.

One lesser-known indicator helps support that forecast is called the Baltic Dry Index. It measures the cost of transporting raw materials, such as coal and steel. The index has been trending lower for several weeks, which in the past has suggested that prices may be more manageable in the months ahead.

No indicator is fool-proof.

That's why the Baltic Dry Index is just one of the many indicators that our professionals follow when watching inflation. They also keep a close eye on the Fed, which is responsible for controlling inflation.

With the economy improving, the Federal Reserve has indicated it will be tapering bond purchases this month. That may help with inflation. The Fed also has prepared the markets for higher interest rates in 2022. That, too, may help.

For now, it's important to understand that Inflation can influence interest rates, which often play a role in how a portfolio is constructed. At Kendall Capital we are keenly focused on what's next for inflation to determine if any portfolio changes are appropriate in the future.

"Remember, financial markets are considered "discounting mechanisms," meaning they are looking six- to nine-months into the future.

Zemin Zhu
FRM

Portfolio Manager

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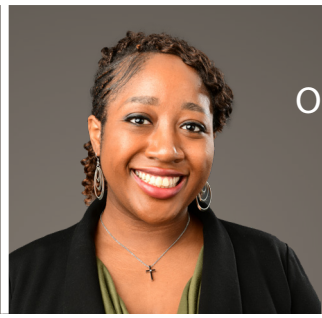

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