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MARKET REVIEW
FEBRUARY 2022

SMB Trust Services

FED'S HAWKISH PIVOT

The hawkish tone of the Federal Reserve's December policy-setting meeting minutes, which were released on January 5th, rattled financial markets in in the first month of the year. The U.S. 10-year Treasury yield rose to a two-year high near 1.9% in the weeks following the release of the minutes, while the S&P 500 fell nearly 10%. The December minutes noted that Fed officials believed it may be appropriate to raise interest rates "sooner or at a faster pace than participants had earlier anticipated" given the tightening labor market and stubbornly high inflation. Public comments from multiple Fed officials in the days following the minutes' release provided further evidence that policymakers were contemplating hiking rates in 2022 at a significantly faster pace compared to their outlook just a few months ago.

INTEREST RATE HIKES

While the Fed's meeting in late January did not include any monetary policy changes, it set the stage for rate hikes to begin in short order. Fed Chair Jerome Powell said in his press conference that "the Committee is of a mind to raise the fed funds rate at the March meeting." Powell also remarked that the Fed is "willing to move sooner" and "perhaps faster" than the previous rate hike cycle from 2015 to 2018 since the economy is stronger, inflation is higher, and the employment market is tighter. This suggests the Fed's pace of raising rates this year could be faster than the 0.25% per quarter hike cadence in 2017 and 2018. As seen in Chart 1, pricing in federal funds futures markets in recent days indicates investors expect at least six 0.25% rate hikes this year, up from expectations in September for one hike this year.

Six quarter-point rate hikes this year is not a forgone conclusion, however, as Fed officials may feel less urgency to raise rates if inflation moderates as expected. The median estimate from a recent Bloomberg survey of 39 economists shows year-over-year inflation is projected to moderate to under 3.0% by the end of this year. Expectations for cooler inflation are in large part driven by projected improvements in labor supply and supply chain disruptions. Many economists also expect a reversal of the year-over-year base effects which amplified inflation readings for most of 2021. Fed Chairman Powell noted in his January post-meeting press conference, however, that inflation could surprise to the upside in coming months given the COVID-19 Omicron variant and tense geopolitical situation in eastern Europe.

Throughout 2021, supply chain issues and worker absenteeism due to COVID-19 prevented many U.S. businesses from boosting production to meet elevated demand. This dynamic clearly contributed to outsized inflationary pressures, but production headwinds may lessen in the coming months. As seen in Chart 2, the ISM Manufacturing Supplier Deliveries index, a measure of delivery delays, fell in January to its lowest level since November 2020, which suggests supply chain issues are improving. Similarly, the ISM Services Supplier Deliveries index has also declined in recent months. According to the U.S. Census Bureau's Household Pulse Survey, a record 8.75 million Americans missed work in early January because they had COVID-19 or someone in their home had the virus, up from 2.96 million in early December. Declining infections in the U.S. may lead to fewer worker absences related to COVID-19 and spur further recovery in labor force participation as pandemic concerns ease.

Tighter financial conditions are another factor that could help cool inflation since they can act as a substitute for rate hikes. In a 2016 speech about the pause in the Fed's rate hike cycle, Fed Vice Chair Lael Brainard said "over the past year and a half, the United States has experienced a tightening of financial conditions that is the equivalent of an additional increase of over 75 basis points in the federal funds rate." Bloomberg economists estimate that the right mix of tighter financial conditions could have the same impact on slowing GDP growth this year as a 0.5% rate hike in March. The Fed may feel less pressure to hike rates six or more times this year if financial conditions tighten enough to slow the economy and inflation.

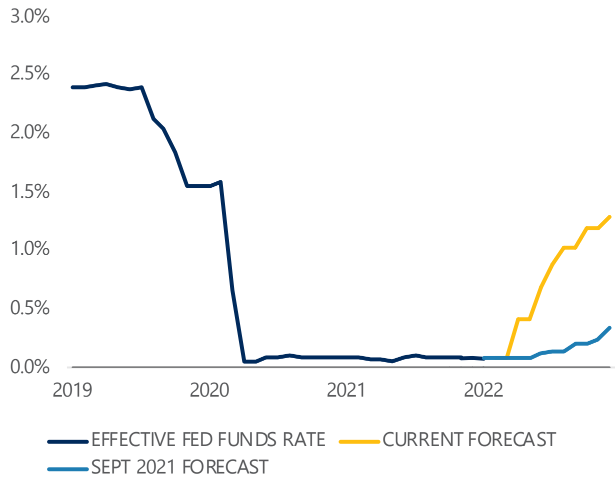
BALANCE SHEET NORMALIZATION

In December, the Fed accelerated its efforts to wind down emergency-era balance sheet expansion by doubling the rate at which it was tapering bond purchases to $30 billion per month. At the updated pace, asset purchases will conclude in March rather than in the summer as originally planned at the Fed's November meeting. At its January meeting, the Fed reasserted its plan to end asset purchases in early March and released an addendum on the principles for

CHART 1

FED'S HAWKISH PIVOT

FED FUNDS RATE, 2022 MARKET FORECAST



Source: Federal Reserve Bank of St. Louis & Bloomberg.
Past performance does not guarantee future results.

CHART 2

EASING SUPPLY CHAIN DISRUPTIONS

ISM MANUFACTURING & SERVICES BUSINESS SUPPLIER DELIVERIES

Source: Bloomberg.
Past performance does not guarantee future results.

balance sheet normalization. The addendum signaled the central bank's plans to begin reducing the size of its balance sheet this year after rate hikes begin. It further conveyed a preference for passive reduction by not reinvesting the proceeds from maturing U.S. Treasuries and agency mortgage-backed securities, instead of outright security sales. Similar to rate hikes, Powell said the Fed is willing to move sooner and faster with reducing its balance sheet than the last cycle in 2017 to 2018.

POTENTIAL IMPACT ON ECONOMY AND EQUITY MARKETS

History suggests the initial set of Fed rate hikes and steps toward balance sheet reduction are unlikely to significantly constrain U.S. GDP growth or cause a bear market in U.S. stocks. Because monetary policy has a lagged effect, an initial rate hike in March may not impact the economy until the second half of this year or later. Even with 1.00% or more of rate hikes in 2022, the inflation-adjusted (or real) fed funds rate would likely remain well within negative territory. Historically, economic slowdowns precipitated by Federal Reserve interest rate hike campaigns have not materialized when the real fed funds rate is below 2.0%. Using year-over-year core personal consumption expenditures (PCE), the Fed's preferred measure of inflation, the real fed funds rate is currently -4.6%. This compares to -0.9% at the beginning of the 2015-2018 rate hike cycle and -1.0% when policymakers began to raise rates in the 2004-2006 cycle. In February 1994, the real fed funds rate was +1.0%, when then-Federal Reserve Chair Alan Greenspan and his colleagues began the 1994-1995 rate hike cycle.

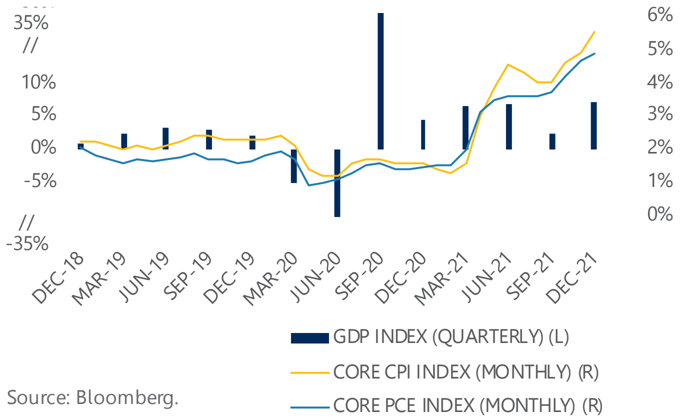
Additionally, Fed policymakers have signaled a low terminal policy rate. This is the level at which Federal Open Market Committee (FOMC) participants project the rate hike cycle will conclude. It is also the theoretical "neutral" level of interest rates at which economic growth is neither constrained nor boosted. The median estimate of the 18 FOMC participants for the "longer run" federal funds rate in the December 2021 Summary of Economic Projections was 2.50%. Even if year-over-year inflation stabilized to its pre-pandemic range of 1.5% to 2.0%, a nominal fed funds rate of 2.50% would imply an inflation-adjusted policy rate range of 0.5% to 1.0%. This outcome would not be considered restrictive compared to history.

BCA Research's U.S. Investment Strategy recently decomposed Federal Reserve rate hike cycles since 1960 into four phases based on whether the FOMC is hiking or cutting rates and the position of the policy rate relative to estimated equilibrium. The analysis showed that nonfarm payrolls, GDP and S&P 500 earnings expectations all grew at their fastest rates during periods when the Federal Reserve is hiking rates, but has not yet made policy tight. The report highlights that S&P 500 earnings typically grow at a strong clip and price multiples are relatively steady in the beginning phases of a Fed rate hike cycle. In the most recent cycle, the S&P 500 achieved a respectable annualized total return of 9.2% from January 1, 2016 through December 31, 2018. Over this same period, S&P 500 earnings grew at an annualized rate of 11.1%. In the 2004-2006 rate hike cycle, the S&P 500's annualized total return was 7.5% and its earnings expanded at an annualized clip of 14.3%.

In the last six months, drastic improvements in the labor market and a sharp rise in inflation have clearly shifted the policy inclinations of Federal Reserve officials from ultra-accommodative to a much more neutral stance. Although the direction for policy is hawkish, the trajectory of the Fed's rate hike campaign could be less steep than many market participants expect given the likelihood that inflation stabilizes in the second half of 2022. Despite recent market volatility, historical precedent suggests that concerns about the initial phase of rate hikes significantly impairing domestic GDP growth or S&P 500 earnings in 2022 and 2023 will likely prove to be overstated.

ECONOMY

GDP AND CONSUMER PRICES
DECEMBER 2018 THROUGH DECEMBER 2021



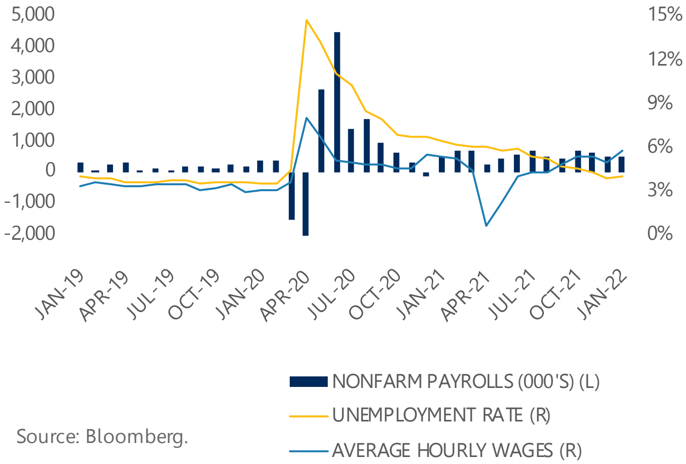
Source: Bloomberg.

The U.S. economy bounced back strong in the fourth quarter with GDP accelerating at an annualized pace of 6.9% and growing 5.7% in 2021. Consumer and business spending were the primary driving forces behind a level of growth not seen since 1984.

In December, inflation accelerated to a multi-decade high as the Core Consumer Price Index (CPI) increased 5.5%, driven by rising shelter costs and prices for used and new vehicles.

The Federal Reserve's preferred measure of inflation, the Core Personal Consumption Expenditures (PCE) index, which excludes volatile food and energy costs, rose 4.9% in 2021, well above the Fed's 2% target rate.

LABOR MARKET
JANUARY 2019 THROUGH JANUARY 2022



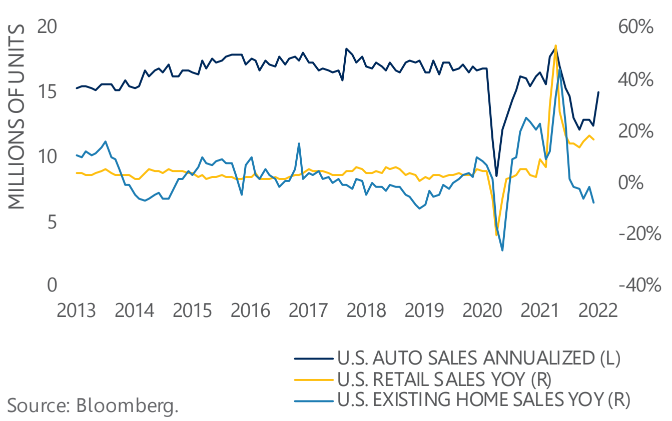
Source: Bloomberg.

The first jobs report of 2022 was a massive surprise as the U.S. added 467,000 jobs in January, well above economists' estimate for 150,000. Additionally, the December and November job gains were both revised higher, going from 199,000 to 510,000, and 249,000 to 647,000, respectively.

Despite the early-January surge in COVID-19 cases, the leisure and hospitality industries contributed the most job gains, primarily in food services and drinking places; however, employment in these industries is still down roughly 10% since February 2020.

The unemployment rate ticked up slightly to 4.0% largely due to increased participation, and average hourly earnings rose 5.7%. The participation rate inched higher to 62.2%, just 1.2% below pre-pandemic levels.

HOUSING, AUTO AND RETAIL SALES
JANUARY 2013 THROUGH JANUARY 2022



Source: Bloomberg.

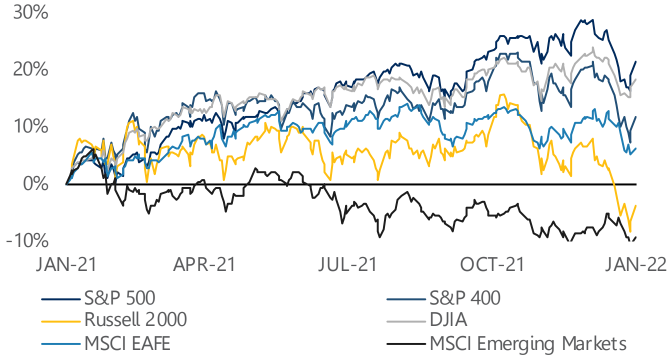
Production bottlenecks and supply shortages seemed to be less of a constraint for vehicles in January as U.S. sales rose to 15.0 million units on a seasonally adjusted annual rate, a staggering 20% jump from the prior month. Economists' consensus forecast was for an increase to 12.7 million.

U.S. retail sales growth slowed to 16.9% in December, down from 18.2% growth in November. Consumer spending was curbed due to higher prices, which drove December's 1.9% monthly decline.

Existing home sales declined 7.1% on a year-over-year basis in December, the first decline over the last three months. Despite the slight pullback, the 6.12 million existing home sales in 2021 were an 8.5% increase from the prior year.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS
PRICE APPRECIATION, JANUARY 2021 THROUGH JANUARY 2022



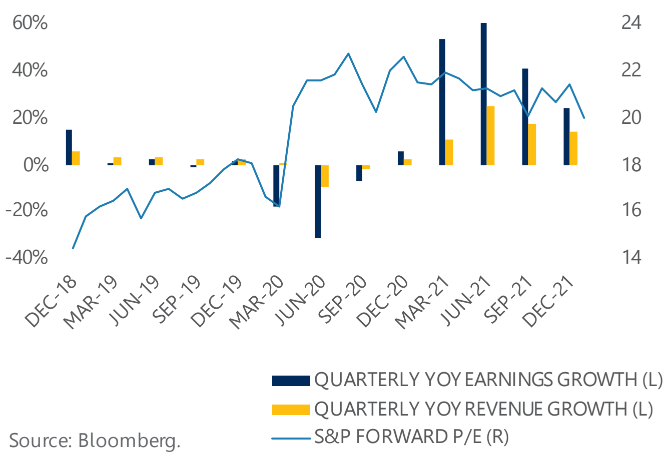
Source: Bloomberg. Past performance is no guarantee of future results.

Equity markets got off to a rough start in the new year due to the Federal Reserve's hawkish pivot to accelerate monetary policy tightening and rising bond yields. The Russell 2000 and technology-heavy Nasdaq indexes experienced the steepest sell-offs with both indexes falling into correction territory and ending the month down 9.63% and 8.96%, respectively.

The S&P 500 fared better with a 5.17% decline, but still posted its worst monthly performance since March 2020.

Equity indexes recovered some of their losses late in the month as a strong start to fourth quarter earnings reporting season helped investor sentiment.

S&P 500 YOY EARNINGS & REVENUE GROWTH
BY QUARTER, DECEMBER 2018 THROUGH JANUARY 2022

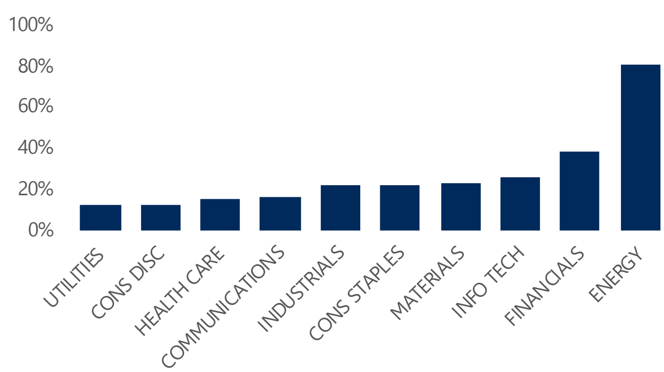


Source: Bloomberg.

Over half of the companies in the S&P 500 index have reported fourth quarter earnings. Around 75% of the S&P 500 companies to report thus far have exceeded analysts' earnings estimates, which is slightly below the five-year average beat rate of 76%. S&P 500 earnings are on pace for 26.37% growth compared to analysts' initial projection for 19.84% growth.

The S&P 500's net profit margin is on track for a second consecutive quarterly decline to 13.00%. Higher input costs amid strong inflation are weighing on margins for some companies. During third quarter earnings conference calls, 305 S&P 500 companies mentioned inflation, which was the highest number in at least a decade.

S&P 500 SECTORS 12-MONTH PRICE RETURNS
JANUARY 2021 THROUGH JANUARY 2022



Source: Bloomberg.

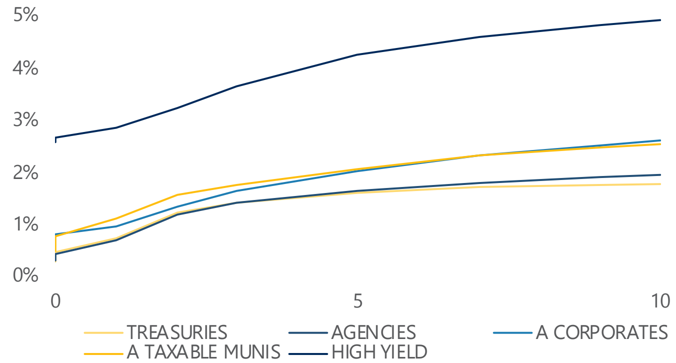
Growth leaning sectors, such as technology and consumer discretionary, were among the worst performing sectors in the month as higher valuation stocks experienced the most selling pressure from the rise in interest rates.

In January, S&P 500 Value's 6.75% outperformance versus S&P 500 Growth was value's largest monthly outperformance since the dot-com bubble burst in 2000. Higher oil prices and bond yields contributed to energy and financials being the only sectors with positive returns in the month. The price of West Texas Intermediate (WTI) crude oil jumped 17% in January to $88 per barrel for the first time since October 2014 amid geopolitical tension in Europe and expectations for strong demand and tight supply.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF JANUARY 2022



Source: Bloomberg. Past performance is no guarantee of future results.

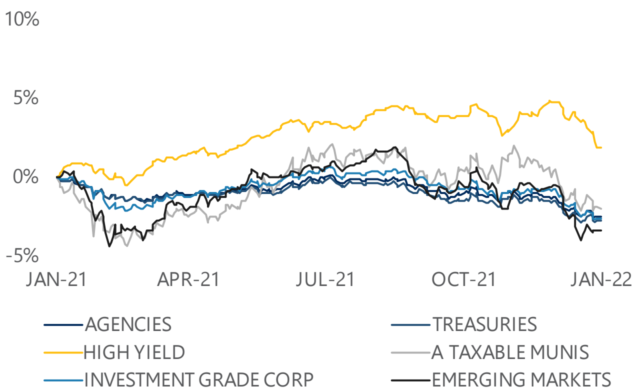
In January, the U.S. Treasury curve shifted significantly higher and flattened in response to a more aggressive Federal Reserve policy outlook. According to Bloomberg's U.S. interest rate probability model, money market futures as of January 31 projected the Fed's policy rate will be 1.23% at the end of 2022 compared to projections of 0.83% only a month earlier.

Yields on the 2-year U.S. Treasury note rose 0.45% in January to finish the month at 1.22%, while yields on the 10-year note climbed 0.27% to 1.79%. Both maturities closed the month at their highest levels since January 2020.

The yield spread between single A-rated corporate bonds and U.S. Treasuries at the 2-year maturity mark noticeably tightened to 0.12% by month's end.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

JANUARY 2021 THROUGH JANUARY 2022



Source: Bloomberg. Past performance is no guarantee of future results.

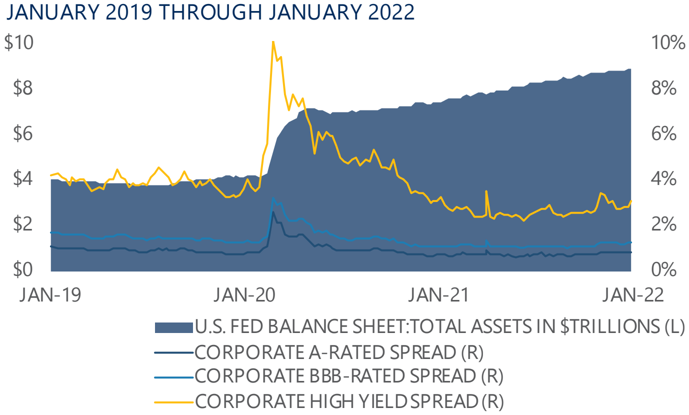
Increased expectations for higher rates led every bond segment. except high yield, to post a negative 12-month return, as shown in the accompanying chart. In broad terms, portfolios with more exposure to shorter duration and lower credit quality areas of the market were among the best positioned over the previous 12 months.

Domestic high yield corporate bonds significantly outperformed emerging market bonds despite both segments exhibiting similar credit quality. Relative dollar strength in the past 12 months has contributed to the considerable performance difference.

Above-trend economic growth, an accommodative policy backdrop and a larger coupon cushion have enabled lower quality domestic bond segments to outperform their higher quality counterparts over the last 12 months.

FED BALANCE SHEET EXPANSION AND CREDIT SPREADS

JANUARY 2019 THROUGH JANUARY 2022



Source: Bloomberg.

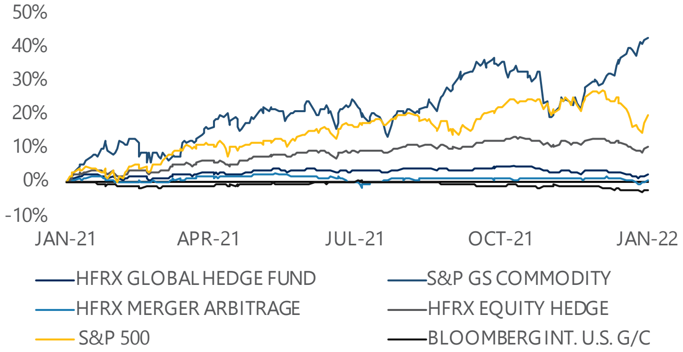
The Federal Reserve's balance sheet has expanded by roughly 112% during the pandemic to $8.9 trillion in January from $4.2 trillion in February 2020.

Federal Reserve Chairman Jerome Powell indicated in his press conference following the January 25-26 Federal Open Market Committee (FOMC) meeting policymakers "...(have) reaffirmed their plan as announced in December, to end asset purchases in early March." Powell cited labor market improvements and elevated inflation as the main reasons to remove "sustained high levels of monetary support."

U.S. corporate high yield, BBB-rated, and single A-rated credit spreads have widened modestly in recent months, and remain significantly lower than their widest levels at the start of the COVID-19 pandemic.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS
JANUARY 2021 THROUGH JANUARY 2022



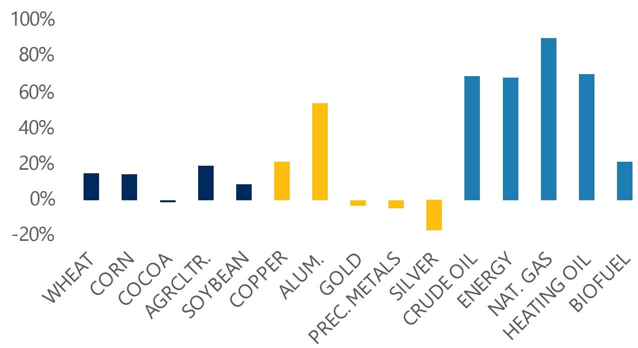
Source: Bloomberg. Past performance is no guarantee of future results.

The S&P GSCI, a broad commodities index, outpaced the S&P 500 by 16.33% in January. According to Bloomberg data, this was the largest one-month performance difference in favor of the S&P GSCI since June 2008. Low inventories, supply bottlenecks, elevated inflation and strong GDP growth have been broadly supportive of commodity prices.

The HFRX Global Hedge Fund Index declined 1.47% in January, holding up better than the S&P 500's 5.17% drop and matching the Bloomberg Intermediate Government/Credit Index's monthly return.

The HFRX Equity Hedge Index dropped 2.12% in January as declines in fundamental growth and value strategies more than offset gains by market neutral managers. The HFRX Merger Arbitrage Index fell 0.74% during the month.

COMMODITIES, 12-MONTH SPOT RETURNS
JANUARY 2021 THROUGH JANUARY 2022



Source: Bloomberg. Past performance is no guarantee of future results.

U.S. West Texas Intermediate (WTI) crude oil futures surged 17.2% in January to $88.15 per barrel following a 13.6% advance in December. Escalating tensions between Russia and Ukraine combined with expectations for modest production increases by OPEC and its allies have put significant upward pressure on most energy commodities in recent months.

Dry conditions in South America and concerns that the Russia-Ukraine military standoff could disrupt global wheat supplies pushed the S&P GSCI Agriculture Index higher by 4.4% in January.

Gold prices declined 1.8% in January, as building expectations for U.S. Federal Reserve interest rate hikes diluted the precious metal's appeal as a safe haven asset and inflation hedge.

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