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MARKET REVIEW
MAY 2022

SMB Trust Services

YIELD CURVE AND RECESSION RISK

A recession in the U.S. has not been a topic of focus for many investors over the last twelve months as last year the economy experienced the strongest rate of growth since 1984. However, expectations for a more aggressive Federal Reserve interest rate hike cycle and a brief U.S. Treasury yield curve inversion in early April have spurred discussions among investors and economists as to whether a recession is on the horizon. A *Wall Street Journal* survey in April of about 60 economists estimated a moderate 28% probability of a recession occurring in the next year. Meanwhile, Bloomberg economists' recession probability model, which is based on economic and market data, computes a 0% recession probability in the next 12 months and 33% recession probability in the next 24 months. The Bloomberg model accurately forecast the recessions in 2007-2009 and early 2000.

YIELD CURVE RECESSION SIGNAL

In a normal environment, the long end of the U.S. Treasury yield curve is largely controlled by market expectations for economic growth and inflation, while the short end is primarily driven by the Fed's interest rate policy. The yield curve is typically sloped upward since investors demand a higher yield on longer duration bonds to compensate them for the increased risk of higher interest rates and inflation over longer periods of time. Curve flattening can occur when the Fed raises rates to slow down the economy and restrain inflation. During rate hike cycles, the short end of the curve rises, while the long end may rise less or decline to reflect expectations for lower economic growth and inflation. Curve flattening during rate hike cycles sometimes results in a yield curve inversion, when short-term yields move above long-term yields. Yield curve inversions are a closely watched recession indicator because of their strong track record of preceding economic downturns. Prior to the pandemic, each of the last seven recessions since 1970 was preceded by an inversion in key parts of the yield curve. These recessions followed yield curve inversions by an unpredictable and varying time spanning, on average, between one and two years.

One of the most widely cited parts of the yield curve, the spread between the U.S. 2-year Treasury yield and 10-year Treasury yield, inverted briefly in early April. The 2-year/10-year curve quickly returned to positive territory and has remained positive since then. The duration and depth of curve inversions are important factors for assessing their recession signal. Brief and shallow inversions, such as in June 1998, can be a false recession signal, while longer and deeper inversions have been more dependable recession signals.

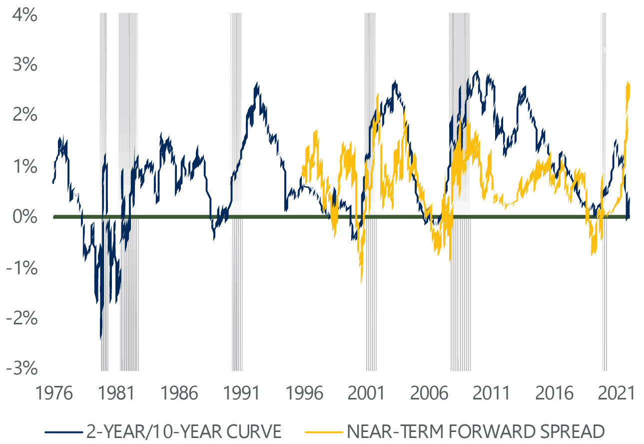
Not all parts of the yield curve are equally useful for signaling recessions. The 2-year/10-year curve inversion typically provides more lead time ahead of recessions than other parts of the curve which makes it a less timely indicator. For example, the 2-year/10-year curve inverted nearly two years before the 2007-2009 recession and 22 months before the S&P 500 peaked. The 3-month/10-year curve and the Fed's near-term forward spread may be more timely recession indicators since they both have inverted around five months closer to recessions on average than the 2-year/10-year curve. The 3-month/10-year curve and the Fed's near-term forward spread are both currently above 2% and are not signaling a recession in the near term.

The Fed's near-term forward spread measures the difference between the 3-month Treasury yield and investors' expectation of where the 3-month yield will be in 18 months, as measured by the 18-month forward rate on the 3-month Treasury Bill. This spread can be interpreted as investors' expected trajectory of the Fed's rate policy over the next year and a half. An inversion of this spread would be an indication that investors expect the Fed to cut rates within 18 months, likely due to an economic slowdown or recession. Research performed by Federal Reserve economists concluded the near-term forward spread has better predictive power for recessions than the 2-year/10-year spread. Fed Chair Jerome Powell suggested in March that he prefers the near-term forward spread for a yield curve measure of recession risk. Powell stated "…that's really what has 100% of the explanatory power of the yield curve. It makes sense. Because if it's inverted, that means the Fed's going to cut, which means the economy is weak." As seen in chart 1, the near-term forward spread's current level around 2.4% is the highest since late 2001 when the economy was exiting a recession.

CHART 1

U.S. TREASURY YIELD CURVE

10-YR MINUS 2-YR & NEAR-TERM FORWARD SPREAD*

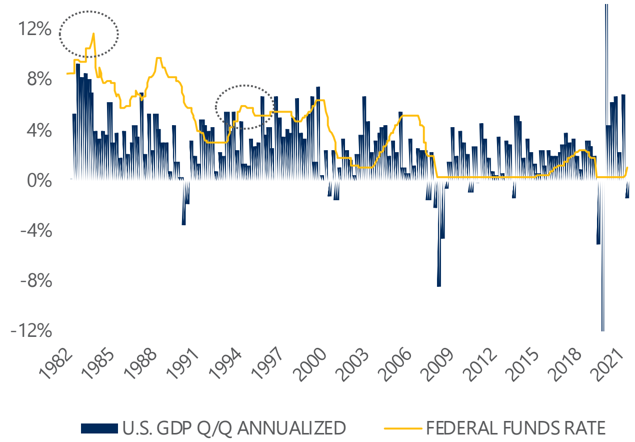


Source: Bloomberg. *The near-term forward spread measures the difference between the 3-month U.S. T-bill yield and the 18-month forward rate on the 3-month U.S. T-bill. Past performance does not guarantee future results.

CHART 2

SOFT LANDINGS AND HARD LANDINGS

U.S. GDP GROWTH & FED POLICY RATE



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

WHAT ABOUT A SOFT LANDING?

Some Fed officials including Fed Chair Powell and former Fed Chair and current Treasury Secretary, Janet Yellen, believe the central bank could engineer a so-called "soft landing." This term describes a scenario in which the Fed's policy rate is raised just enough to prevent the economy from overheating, but not high enough to cause a recession. This contrasts with a "hard landing," when the pace and magnitude of rate hikes lead to a contraction of economic growth. Historically, soft landings have been a tricky task, but there are several examples from the mid-1960s, mid-1980s, and mid-1990s (see chart 2).

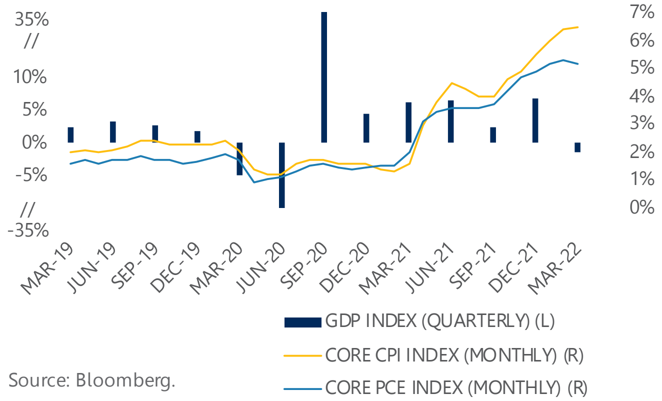
One of the biggest current concerns for Fed Chair Powell and his FOMC colleagues is the potential for an overheated labor market and increasingly larger wage gains to drive overall inflation higher. The only time-tested way to cool a jobs market that is too strong for its own good is to weaken demand. The Federal Reserve's only proven tool to reduce demand is to hike interest rates high enough to curtail consumer and business spending. As annual U.S. consumer inflation has surpassed 8.0% in recent months, the million-dollar question is: How high will Fed officials need to hike rates to bring inflation down closer to their 2.0% target over a full economic cycle?

Over a multi-year horizon, it seems reasonable to expect the Fed will likely need to lift its policy rate considerably higher than the previous rate hike cycle (which peaked at a range of 2.25% to 2.50% in December 2018). This is because the real economy remains on decent footing despite excessive inflation. The relative health of U.S. consumer and corporate balance sheets and the potential for a release of pent-up pandemic demand for travel and leisure underscores a solid economic backdrop. After U.S. GDP grew 5.7% in real terms in 2021, the U.S. economy unexpectedly contracted at an annualized rate of 1.4% in the first quarter. The headline number was a bit misleading, however, as it was weighed down by a larger-than-usual trade deficit, lower inventory growth, and less government spending. Real final sales to domestic purchases (a measure of core demand which strips out foreign trade and inventory components) increased at an annualized rate of 3.7% in the period following a 2.5% gain in the fourth quarter. Of course, a potential escalation of the war in Ukraine or a drawn-out period of COVID-19 lockdowns in China could short-circuit the U.S. economy.

Fed futures markets currently project a policy rate of between 2.75% and 3.00% by the end of 2022. If monthly consumer inflation begins to stabilize in the summer and the rate of year-over-year inflation declines, Fed policymakers could end up not hiking rates quite as high as these expectations over the next eight months. This scenario could allow Fed officials to pause their rate hike campaign (most likely in the first half of 2023) to determine if financial conditions have been sufficiently tightened to subdue inflation. Given the current mix of strong demand and constrained supply, it seems likely the Fed may have to eventually resume its rate hikes after a pause. Although a "hard landing" over the next 12 months seems unlikely, a second round of rate hikes in 2023 could ultimately prevent policymakers from achieving an historically elusive "soft landing."

ECONOMY

GDP AND CONSUMER PRICES
MARCH 2019 THROUGH MARCH 2022



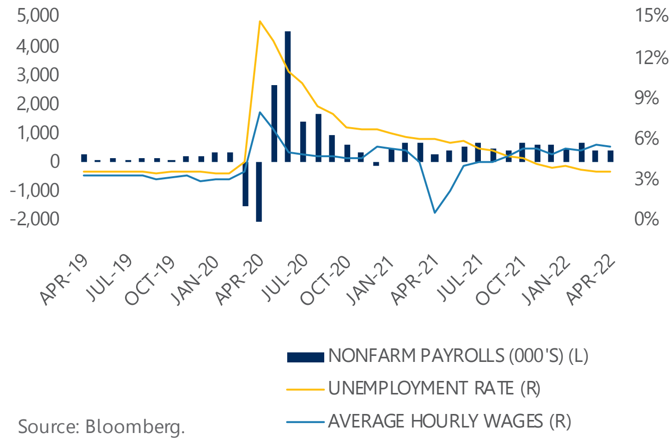
Source: Bloomberg.

U.S. economic growth contracted in the first quarter by an annualized rate of -1.4%, marking the first contraction since the onset of the pandemic. This growth rate fell short of the 1.5% median economists' estimate compiled by Bloomberg.

The Core Consumer Price Index, which excludes the volatile food and energy prices, was up 6.5% in March from the same period a year ago. Shelter costs remain the largest contributor to higher inflation.

The Fed's preferred measure of inflation, the Core Personal Consumption Expenditures Price Index, climbed to 5.2% in March. Fed Chairman Jerome Powell acknowledged heightened inflation but mentioned a larger rate increase of 0.75% is not being considered.

LABOR MARKET
APRIL 2019 THROUGH APRIL 2022



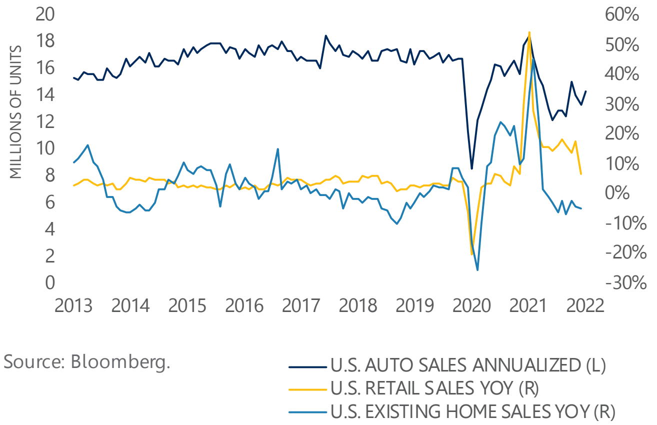
Source: Bloomberg.

Strong U.S. job growth continued in April as nonfarm payrolls increased by 428,000, beating economists' estimate of 380,000. Despite the economic contraction in the first quarter, the U.S. added an average of roughly 518,000 jobs per month this year.

Job gains were widespread across all industries. The leisure and hospitality industry was the strongest with 78,000 jobs added. The manufacturing industry added 55,000 jobs.

The unemployment rate remained at a pandemic low of 3.6%. The participation rate stood at 62.2%, just 1.2% lower than the pre-pandemic level in February of 2020.

HOUSING, AUTO AND RETAIL SALES
APRIL 2013 THROUGH APRIL 2022



Source: Bloomberg.

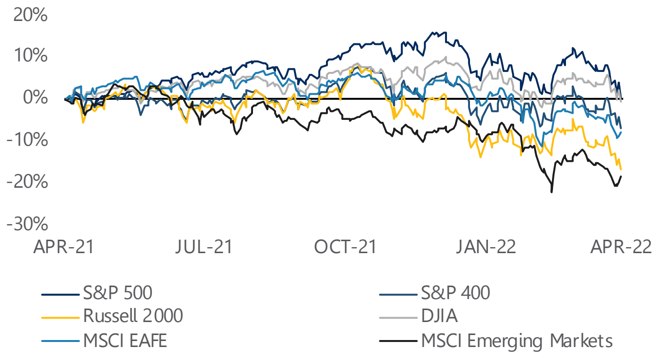
U.S. vehicle sales rose to a seasonally adjusted annualized rate of 14.29 million units in April. Vehicle production is still constrained due to an undersupply of parts including semiconductors.

U.S. retail sales growth slowed to 6.6% in March from nearly 18% growth in February. Consumers cut back on spending at electronics and appliance stores and sporting goods stores. Spending at gasoline stores remained high amid rising gas prices.

Existing home sales were down 4.5% in March from a year ago and fell 2.7% from the previous month. The housing market has slowed from extraordinary activity last year amid the spike in mortgage rates which are at their highest level in over 10 years from the record low last year.

EQUITY

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

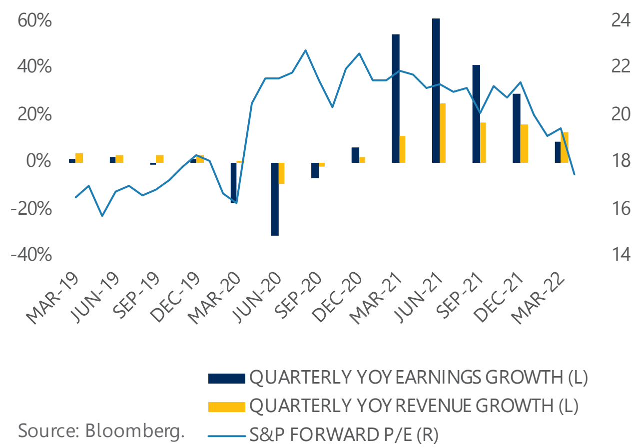


Source: Bloomberg. Past performance is no guarantee of future results.

U.S. equities fell sharply in April. Concerns about a more aggressive pace of Fed rate hikes, COVID-19 lockdowns in China, and ongoing war in Ukraine weighed on equity markets. The S&P 500's 8.72% decline was the index's largest monthly loss since the start of the pandemic and third largest monthly decline since the Global Financial Crisis. The technology-heavy Nasdaq fared even worse with a 13.24% monthly decline which sent it into a bear market.

The MSCI EAFE index fell 6.38% in April, but most of the loss was due to the U.S. dollar strengthening. The index only fell 1.30% in local currency terms.

S&P 500 YOY EARNINGS & REVENUE GROWTH
BY QUARTER, MARCH 2019 THROUGH APRIL 2022



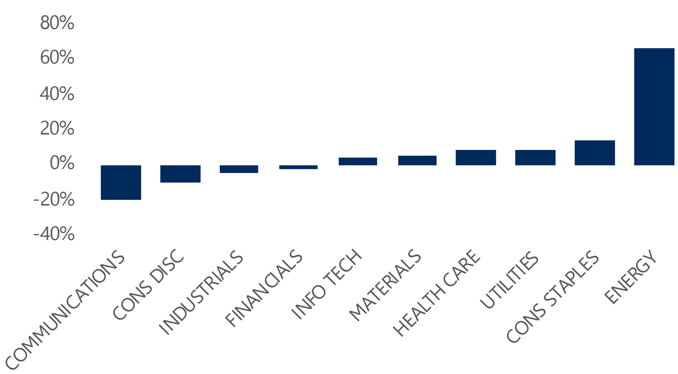
Source: Bloomberg.

First quarter earnings reporting season is winding down with 437 S&P 500 companies reporting results. S&P 500 earnings are on pace for 9.30% growth compared to analysts' initial projection for 5.19% growth. Cyclical and commodity-driven sectors such as energy, materials, and industrials are reporting the strongest earnings growth.

Excluding financials, S&P 500 earnings are on pace for 18.45% growth. The financials sector is experiencing negative earnings growth this quarter largely due to tough year-over-year comparisons. Banks releasing loan loss reserves drove very strong earnings growth last year.

S&P 500 operating margins are on track for a small year-over-year increase to 15.65% despite inflation causing higher input costs for some companies.

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



Source: Bloomberg.

Equity market weakness was widespread across most sectors. The traditionally defensive consumer staples sector was the only sector with positive performance in the month.

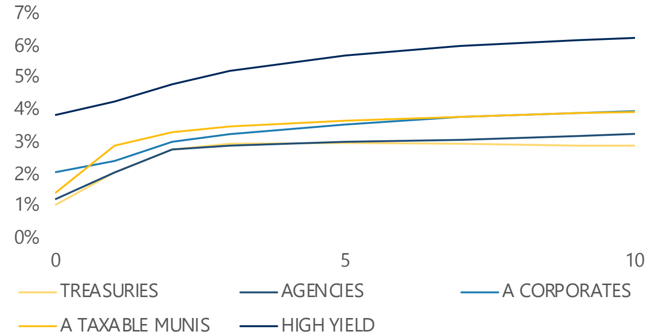
Higher growth stocks in the consumer discretionary, technology, and communications sectors experienced the most selling pressure. These three sectors each declined over 10% in the month. The S&P 500 Growth index fell 12.48% in the month, while the S&P 500 Value index was down 4.86%.

The energy sector finally cooled off with a modest 1.54% monthly decline after gaining 35.49% in the first quarter. Crude oil prices remained volatile in April but finished higher for a fifth consecutive month.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF APRIL 2022



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

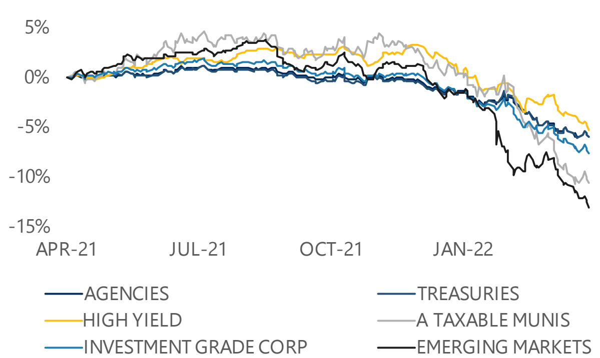
The U.S. Treasury curved shifted significantly upward in April and steepened in response to a more aggressive Federal Reserve policy outlook. Fed funds futures as of April 30 indicate investors expect the Fed's policy rate will reach 2.86% by year end compared to a projection of 2.39% only a month earlier.

Yields on the 2-year U.S. Treasury note rose 0.38% in April to finish the month at 2.72%, while yields on the 10-year note climbed 0.59% to 2.94%. Both maturities closed the month at their highest levels since the second half of 2018.

The yield spread between single A-rated corporate bonds and U.S. Treasuries at the 2-year maturity mark is noticeably tight at 0.21%.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

APRIL 2021 THROUGH APRIL 2022



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

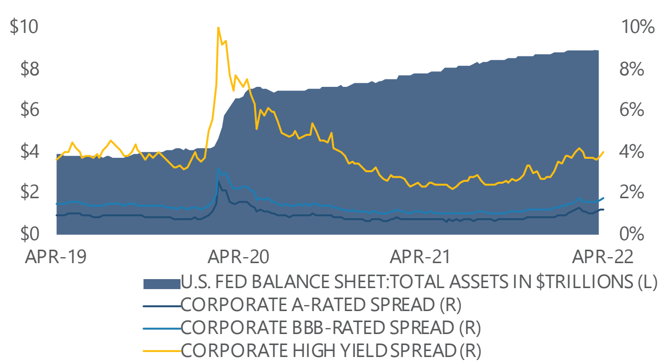
Increased expectations for higher rates led every bond segment to post a negative 12-month return of at least 5.2%, as shown in the accompanying chart. In broad terms, the shorter the duration of fixed income portfolios the better positioned they were over the previous 12 months.

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.

As expected, the two highest quality bond segments in the accompanying chart, Treasuries and Agencies, have held up best in the first four months of 2022 as bond prices continue to fall at a historic pace.

FED BALANCE SHEET EXPANSION AND CREDIT SPREADS

APRIL 2019 THROUGH APRIL 2022



Source: Bloomberg.

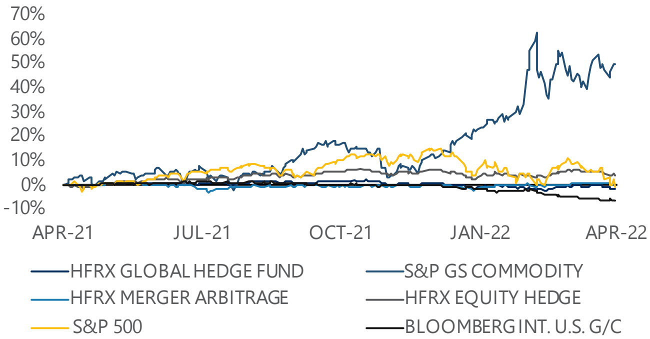
The Fed's balance sheet expanded by roughly 112% during the pandemic to $8.9 trillion in April from $4.2 trillion in February 2020. The Fed announced at their May 3-4 meeting that they will begin reducing their balance sheet size in June.

According to the Fed's projections, their balance sheet will be reduced by $522.5 billion this year to roughly $8.375 trillion, a modest 5.87% decrease. In 2023, the balance sheet is projected to be reduced by $1.14 trillion to around $7.235 trillion, a 13.6% decrease.

U.S. corporate high yield, BBB-rated, and single A-rated credit spreads have been steadily widening since August of 2021. U.S. corporate BBB-rated, and single A-rated credit spreads are once again wider than their pre-pandemic levels.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS
APRIL 2021 THROUGH APRIL 2022



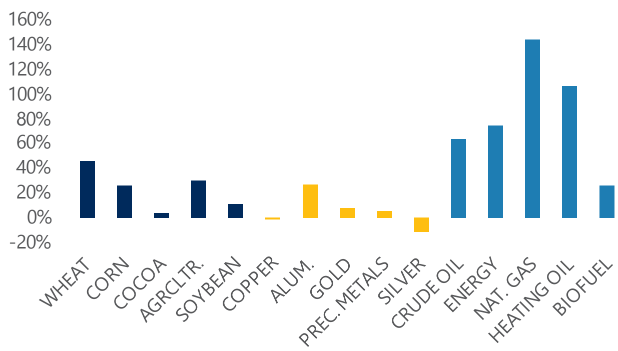
Source: Bloomberg. Past performance is no guarantee of future results.

The S&P GSCI Index, a broad measure of price performance in commodity markets, surged 34.85% in the first four months of 2022 driven by sharp gains in crude oil, natural gas, corn, and wheat.

The year-to-date price performance gap between commodities and other major asset classes is glaring. The S&P 500 and Bloomberg Intermediate U.S. Government/Credit Bond Index have declined 12.92% and 6.42%, respectively, thus far in 2022.

The HFRX Global Hedge Fund (HFRXGL) Index, a broad measure of investable hedge fund strategies, fell 0.90% in April compared to the S&P 500's 8.72% monthly decline. The HFRX Macro/CTA Index, which is comprised of short-term trend-following strategies and is a component of the HFRXGL Index, gained 1.90% in April.

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



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

U.S. natural gas futures climbed 28.3% in April as lower domestic inventories, expectations of hotter temperatures in the southern U.S., and strong European demand boosted prices.

Prices of copper and aluminum fell substantially in April amid rolling COVID-19 lockdowns in major Chinese population centers. The risks lockdowns pose for short-term global manufacturing demand weighed on most industrial metals during the month.

Corn prices climbed 9.2% in April to reach a 10-year high. Cold and rainy April weather in key corn-producing states including Indiana, Illinois, and Iowa drove concerns that a slow start for the U.S. planting season could reduce yields later this year.

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NOT A DEPOSIT	NOT FDIC INSURED	MAY LOSE VALUE	NOT BANK GUARANTEED
NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY			