



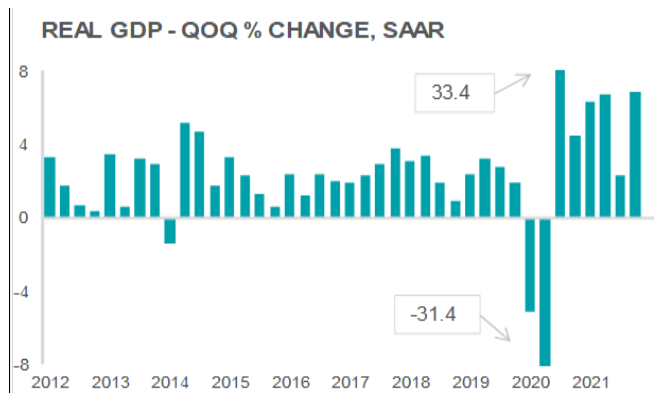
Investor Concerns and Looking Ahead

After a sizzling 2021 and a roaring 4th quarter, equity markets began 2022 on a distinct down-note. Recovery from the COVID pandemic provided blue skies for two years of solid equity gains, but storm clouds were brewing on the horizon. Increased inflation caused interest rates to drift higher during the fourth quarter of 2021, and that rise began to accelerate in the new year, precipitating a sharp decline in equities, even before any official rate hikes by the Federal Reserve. Adding to the downdraft was a slump in economic activity from a resurgent COVID virus around the world, and then the onset of war in Europe as Russia invaded Ukraine. By their mid-March lows, the S&P 500 had entered correction territory with a decline of over 10%, and the NASDAQ Composite was in a bear market with a decline of more than 20% from its high.

Nevertheless, by the end of March, equity markets were proving the old adage that “the market climbs a wall of worry” by staging an 8% rebound in the S&P 500. The NASDAQ recovered nearly 14% of its value in the last half of March. So why this unexpected advance in the face of seemingly dire news? The answers lie beneath the surface.

The Economy

Preliminary estimates of GDP growth for the first quarter of 2022 suggest a marked slowdown to a little over 1% after a heady pace of over 5% in 2021. Despite this slowdown, jobs made steady gains and the unemployment rate declined to 3.6%, although this measure also reflects a significant drop in the number of people actually wanting employment – part of the COVID-era phenomenon known as the “Great Resignation.” Overall, these numbers still reflect fundamental strength in the US economy.



GDP growth likely shrank to about 1.3% annualized for the first quarter of '22.

While inflation raced ahead in the first quarter of '22, the Fed entered the year fully intent on quelling surging prices. The Fed's collapsing of interest rates in early 2020 and expansion of securities purchases in the open market (a.k.a., quantitative easing) to combat the economic impact of the pandemic closures certainly contributed to inflationary pressures. However, supply chain restrictions and other dislocations also played a significant role in boosting near-term inflation. The Russian invasion of Ukraine, in particular, disrupted energy flows and sent oil prices rocketing higher as the west imposed economic sanctions against the Putin regime. This took a bite out of family budgets as well as adding to inflationary

pressures. However, the resulting increased risk of supply-driven recession was also reason for the Fed to potentially moderate its planned tightening schedule, which provided some positive lift to equity markets. In addition, the on-again, off-again peace talks between Russia and Ukraine gave some reason for optimism that the war would end early. Russian violations of cease-fires agreements, however, tended to dispel that hope as signs of atrocities were reported.

The fact that inventory shortages continue to plague merchants around the world indicates supply chain issues remain a very real part of the inflation problem, and this offers some hope that price pressures could moderate as the global economy continues to come back online. However, China's draconian resort to renewed lockdowns in response to the Omicron variant underscored again

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the fragility of the global supply chain and its impact far beyond the local economies. China's close relationship with Russia also raises concerns about the possibility of escalating geo-political tensions and economic disruption. For now, China seems to be walking a fine line to avoid that outcome.

The Markets

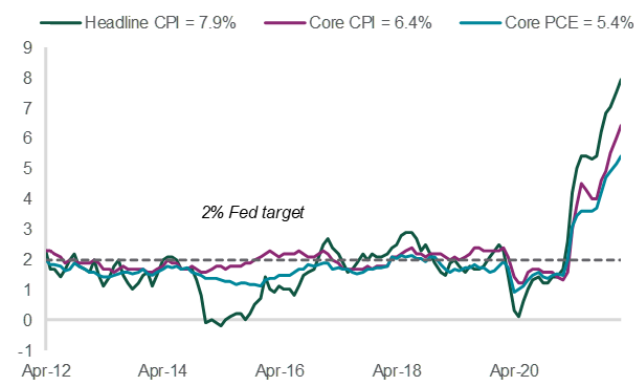
After posting a 29% gain for 2021 and a remarkable 18% gain in the COVID-plagued 2020, it was not surprising that the S&P 500 might take a breather in the new year. In particular, it was the darlings of the pandemic that began to show weakness first, perhaps on elevated valuations. As interest rates began to climb, the discounted present value of future earnings for such companies began to fall, and the market resumed its sporadic rotation out of growth stocks and into the more stodgy, income-oriented value companies. While the S&P 500 fell 4.6% by the end of the first quarter, the Russell 1000 Growth Index dropped at twice that pace, down 9.04%. At one point during the quarter, the tech-heavy NASDAQ plunged more than 20% from its highs. The Russell 1000 Value Index, however, was almost flat for the quarter with a decline of only 0.74%. Value stocks outpaced Growth shares by almost eight percentage points – an impressive reversal from prior years when Growth stocks led the way.

While large-cap, U.S. companies were the best performers (down about 5%), their mid- and small-cap cousins trailed close behind with returns of -5.7% and -7.5% respectively, as measured by the Russell indices. However, the divergence between Growth and Value styles was not limited to the large companies. The same trends were evident among small- and mid-cap stocks as well, with very wide disparities between Growth and Value.

Despite the war in Europe and renewed lockdowns in China, international markets were also close behind US stocks in their march lower. The MSCI EAFE Index (Europe, Australia, Far East) declined 5.8%, while emerging market stocks fell 7%.

While bonds are typically the safe haven when stocks are falling, it was the rise in rates (and, therefore, decline in bond values) that precipitated the stock selloff. The yield on two-year Treasuries more than tripled during the first quarter, from 0.75% to 2.38%, while the yield on five-year bonds doubled from 1.27% to 2.51%. That sharp increase in yields reflected the surging expectations for rate hikes by the Federal Reserve through the remainder of the year. The Fed itself has set expectations for as many as seven or eight 25 basis point rate hikes, and possibly moving rates higher by 50 basis points at a time. Such aggressive increases make it a challenging time to own bonds.

Consumer Price Index – Percentage Changes Year-over-Year



CPI: Consumer Price Index, PCE: Personal Consumption Expenditures
Source: Northern Trust, information as of 2/28/2022.

Already, the rise in rates caused declines in bond indices that match the fall in stocks. For the first quarter, the Bloomberg US Aggregate Bond Index lost nearly 6% of its value (more than the S&P 500). The comparable index of tax-free bonds similarly fell 6.2%.

Uncertainties Ahead

Looking forward, the path of interest rates will be an important near-term factor for the direction of equity prices, and as the Fed pushes rates higher, the shape of the yield curve will get more attention. Already, the yield on short-term rates is essentially equal to those of longer-term rates. An environment in which short rates are higher than long rates, called an inverted yield curve, is sometimes (but not always) a signal of an approaching recession. It will be important not to overestimate the significance of such market signals, and instead to remember that markets are forward-looking and quickly price in expectations for the year ahead. Similarly, short-term developments in geo-politics and the COVID virus can spook markets and send stocks falling, but it is the longer-term fundamentals that will ultimately push markets higher.

Investment markets are inherently volatile, but that is no reason to worry. It is because of that riskiness that long-term investors are handsomely rewarded. Various sectors and asset classes will move in and out of favor, but a broadly and globally diversified portfolio of stocks and bonds remains the best way to navigate turbulent markets. Also, sticking with one's long-term objectives and avoiding the temptation to outguess the markets is the surest path to success. Your CNB Wealth Management advisors are available to answer your questions and provide the portfolio management and planning guidance to help you achieve that success.