Pavlic Investment Advisors

Client Review & Outlook

1st Quarter, 2022

Dear Client,

After a banner performance year last year, 2022 has started off with market volatility that we haven't seen in two years-since the beginning of the COVID lockdowns. This recent volatility had been driven by three main factors: the Russia/Ukraine geopolitical conflict, the exacerbated inflation problem stemming from higher food and energy prices, and a Federal Reserve that remains on its monetary tightening schedule after having been extremely accommodative due to COVID-related economic fears. With inflation touching ~8.0% levels as of the latest readings, there is no question the Fed is "behind the curve" having just begun to raise interest rates. We are not envious of the Federal Reserve's mandate to tame inflation without pushing the US economy into recession. This is like trying to land a B-52 bomber on a moving aircraft carrier. Although historically there have been interest rate rising regimes that haven't led to a recession, during these time periods, the Fed was fighting *future* (anticipated) inflation. Today, inflation has already reared its ugly head. If you are sensing that we are growing more cautious, you are correct, we have taken a more cautious stance with your portfolios after a sharp run up in stocks that occurred at the end of the first quarter.

We remain committed to protecting your capital on the downside while also capturing the upside potential when the markets rally. Owning high quality growing companies at reasonable valuations is the foundation of our strategy. Although a down quarter is never enjoyable for us or you, we protected more than the overall market during a down quarter. Our core equity portfolio was down only -5.0% 1Q22, beating 2 and matching 2 major market indices: the NASDAQ (-9.1%), the Russel 2000 (-7.8%), the Dow Jones (-4.6%) and the S&P 500 (-5.0%). We accomplished this performance through three main factors. First, holding both CyrusOne and Cerner both under contract to be bought out. Second, we made sure our clients owned stocks that will continue to benefit from rising commodity inflation such as Archer Daniels Midland and Dow Chemical. And third, we held on to existing positions, like L3Harris Technologies (a defense contractor) that outperform during geopolitical conflicts. Performance drags in the quarter included Facebook and PayPal; however, our outperformers outweighed our detractors causing our portfolios to decline far less than some indices and in-line with the others.

PIA & Stock Index Performance

	Full year 2021	1Q 2022
PIA US Equity Strategy	**+25.0%**	**-5.0%**
S&P 500 Index	+26.9%	-5.0%
Dow Jones Index	+20.2%	-4.6%
NASDAQ Index	+20.8%	-9.1%
Russell 2000 Index	+15.0%	-7.8%
S&P 500 Value	+25.5%	-0.6%
S&P 500 Growth	+25.1%	-7.6%
PIA US REIT Strategy	**n/a**	**-4.1%**
US REIT Index	n/a	-6.6%

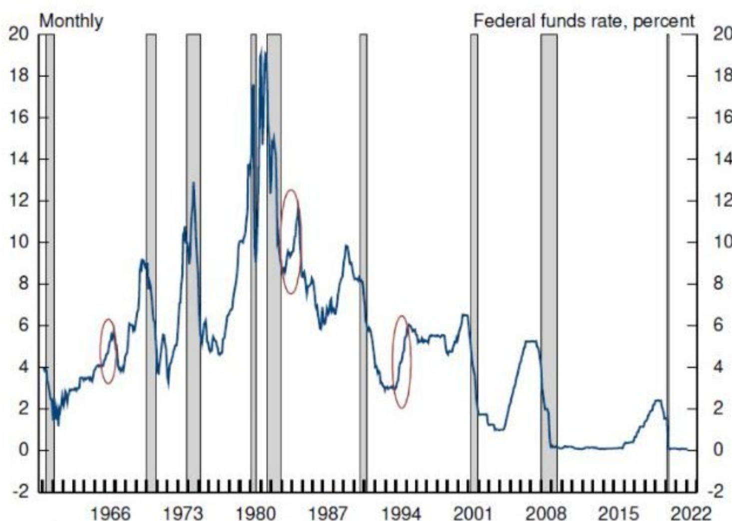
Note: Past performance is not indicative of future results.

Last quarter, we ended our Review and Outlook with a quote: *"Plan Ahead. It wasn't raining when Noah built the Ark."* During the first quarter, it started to rain. However, the important thing is that we stuck to the individualized investment plans we have in place with you. For clients that had excess cash in accounts, we were able to invest in high quality companies at much lower prices such as medical device maker Stryker (SYK), Zebra Technologies (ZBRA) and cell tower operator Crown Castle (CCI) which is benefitting from the continued expansion of 5G infrastructure for cell phones. We didn't panic sell at the bottom no matter how grim the headlines were, and ultimately stocks recovered from -13.0% mid-quarter to end the quarter only -5.0% as measured by the S&P 500. That said, we do not believe we are out of the woods yet. We remain committed to our forecast of a 10-20% correction in 2022, but we also recognize the risks of recession are rising for 2023, especially if the Fed can't land its plane.

Stock Market Review

The Federal Reserve & its Inflation Problem. The central bank of the United States is the Federal Reserve. They control the money supply and are charged with a dual mandate: keep employment high and keep inflation low. We ended the first quarter with unemployment at 3.7%--a near record low. There are also 1.7 job openings for every American citizen looking for work. For highly skilled labor, this ratio is even wider, which has in turn led to significantly upward pressure on wages. The Fed is succeeding at its first objective--keeping employment high—and one could make a fair argument they are succeeding too well with the upward pressure we've seen on wages.

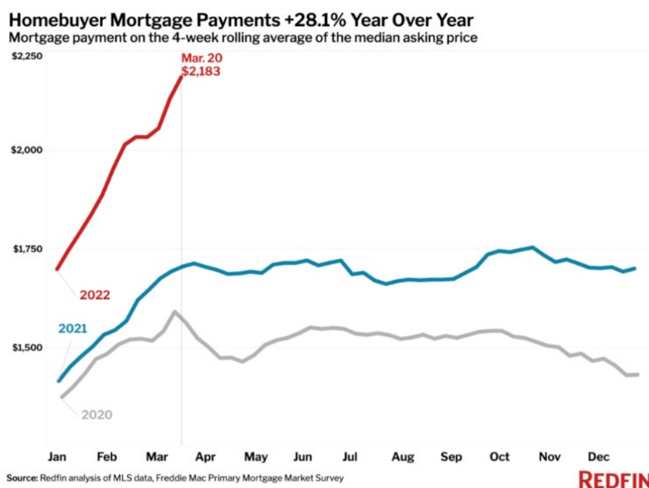
The Federal Reserve is however, clearly failing at its second objective, keeping inflation low. The latest inflation reading came in at +7.9% year-over-year, well over the Fed's +2.0% long term inflation target. The Russia/Ukraine conflict added to already high energy prices, particularly for Europe which sources 35% of its oil from Russia. In the US, we historically have imported only ~3% of our oil from Russia. However, the economy is more global than ever, and if Europe needs to replace 35% of its oil, supply must come from somewhere else (including the US). Reduced supply and rapidly increased demand have driven oil and gas prices to new highs, which in turn has put a dent in consumer confidence. Last quarter, we thought inflation would come down to +4.0% by the end of 2022—we now think we will end the year at +6.0%, still well above the target of +2.0%.

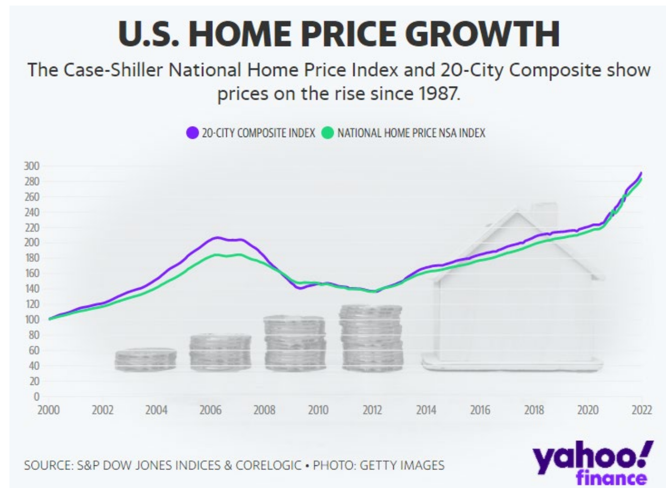


Note: The shaded bars indicate periods of business recession as defined by the National Bureau of Economic Research (NBER): December 1969 to November 1970, November 1973 to March 1975, January 1980 to July 1980, July 1981 to November 1982, July 1990 to March 1991, March 2001 to November 2001, December 2007 to June 2009, and February 2020 to April 2020.
Source: Federal Reseve Board, Statistical Release H.15, "Selected Interest Rates".

The Federal Reserve must now act and raise rates to combat inflation. It began by reversing its bond buying program and increased the Federal Funds rate by 0.25% during the first quarter. The forecast for future rate increases is for six more 0.25% hikes which would put us just over 2.0% at year end. This is a very aggressive pace, and if followed, will increase the odds of a recession in 2023. The chart to the left shows an 80-year history of the Federal Funds Rate. Historically, there is a 12–24-month lag between when the Federal Reserve begins its interest rate rising trajectory (blue line) and a recession (shaded grey area).

What does this mean for mortgage rates and housing? The shape of the yield curve determines the interest rates at which the consumer can borrow to purchase goods. The most important and often debt financed items consumers buy are homes and cars. A general rule of thumb for a 30-year fixed rate mortgage for a high credit quality borrower (740+) is to add 2.0% to the current 10-year US Treasury rate. During the quarter, the 10-year US treasury rate moved from 1.63% to 2.33%, an increase of 0.70%. As a result, the average 30-year fixed rate conventional mortgage has risen from sub-3.0% two years ago to 4.75% today. Said another way, the average monthly interest cost on a traditional 30-year mortgage has increased by over 65%, with 30% of the increase coming in just the last quarter alone. Additionally, the Case-Schiller home index was up mid-double digits last year and was up 35% over the trailing two years (see charts on next page). Rates up 65% combined with home prices up 35% over the last two years has been a double whammy for first time home buyers. Existing homeowners are enjoying ~15%/year increases in their home values which has helped offset the frustrations of rising inflation. While real estate remains a great inflation hedge, home prices cannot continue to rise at these rates. We expect them to slow to rates that are in the low single digits (historical averages) as the consumer runs out of buying power from both higher prices and higher interest rates.





The good news for 2022: GDP, Corporate Earnings, and the US Consumer. The US consumer remains flush with cash—the Congressional Budget Office estimates that American consumers still have $2.3 trillion more in liquid cash savings than they otherwise would have if the pandemic hadn't curbed spending and Congress hadn't doled out numerous stimulus checks to both consumers and businesses. Combine that with the enormous wealth effect on consumers who own their own homes, and you have a tremendous positive wealth effect. Despite new variants continuing to emerge, COVID feels like a rear-view mirror event and even consumers that have largely stayed at home over the last two years are antsy to get out. All this is positive for economic growth as the consumer drives the demand side of the equation. It is also the primary reason we should see positive GDP growth of +3.0% this year. A recession is defined by two successive negative quarters of negative GDP growth and we do not except them in 2022.

The question then becomes, at what point does the consumers excess cash savings run low? How quickly will inflation eat away at the consumer's pocketbooks? When will we start to see it translate into lower earnings for the companies that we invest in? The latest published earnings reports remained strong for our companies. We will be closely watching for any cracks in the armor at the end of April when companies report their first quarter results. Consumer confidence just started showing signs of faltering in the first quarter, but it isn't because unemployment is rising—a typical leading recessionary indicator. With a strong consumer, strong corporate profits, still positive, albeit lower GDP, we remain confident that a recession will not transpire in 2022. However, we do see risks emerging that will make for a more turbulent landscape in 2023.

A quick note on Schwab trade confirmations. After every trade we make in your account, even if it is for only one share of stock, Schwab will send you a trade confirmation either through email or a letter via the USPS. This is different from our prior custodian, Fiduciary Partners, which only sent quarterly statements, and as a result, some clients have commented that "we are doing a lot more trading." We continue to manage your portfolios in the same way we always have, however, now with the trade confirmations, you now receive a "notice" of even the smallest tweaks to your portfolios. The Schwab platform allows us to be more nimble and more exact with our desired portfolio weights which is a benefit to our clients. If you prefer paperless, we can help you with that, and if you prefer to unsubscribe from paperless, we can help with that too. We cannot turn these off for you, but we can walk you through it on the Schwab website.

We would like to reiterate that we are not day traders—we are long term investors. We are also not asleep at the wheel—when we see stocks that go parabolic to the upside we trim or exit like we did this quarter with agricultural commodities producer Archer Daniels Midland (ADM) and defense contractor L3Harris Technologies (LHX). When we see attractive entry points in stocks we like, such as Zebra Technologies (ZBRA) or Stryker (SYK), we buy them. High quality names that we have owned for many years such as Apple and Microsoft where the fundamental thesis hasn't changed (or has only gotten better), we continue to hold despite recent volatility. We do not want to

generate unnecessary capital gains taxes for our clients, but we also feel that we have a duty to be nimble in volatile markets in order to continue to drive investment performance.

Bond Market Review

Interest rates rose during the quarter and short-term rates rose more than long-term rates. This latter phenomena is called yield curve flattening. The 10-year US Treasury yield (which we view this as the "risk-free" rate of return) started the year at 1.51% and ended the quarter at 2.33%, an increase of 82 basis points. The shorter end of the yield curve has risen even more meaningfully, which put near term pricing pressure on several of our variable rate bond positions. Several of our clients have asked us about this decline in market value of the variable rate bond positions, and we remind them that we hold all bonds to maturity and on the maturity date, we will receive our $100/bond back. Bond investor statements may show a market value loss, but a much higher than anticipated yield. The yield calculation includes the price recovery that will be earned by holding the bond until maturity. We will hold the bond to maturity, get our $100/bond back, and collect on average 3-4% interest over the life of the bond. These bonds are not beating the rate of inflation currently, but they are much more lucrative than holding cash in a checking account earning approximately zero percent interest.

Secondly, and more importantly, because we structure bond portfolios with 10% of the bond portfolio maturing each year, it gives us a forced (and zero transaction fee) opportunity every year to either buy bonds 10 years out on the maturity ladder or rebalance into stocks if stocks have fallen in price. The good news with rising rates is that many of the investment grade bonds 10 years out are now offering yields in excess of 4.5%, much higher than we've seen in the last few years. Investors who want to live off a fixed income coupon stream, we can now redeploy the 2022 maturities into much higher yielding bonds instruments than we could before.

2022 Market Outlook

Over half of all stocks are in a bear market, i.e., have declined more than 20%. By market cap, the broader market indices are down much less because the larger market cap names, like Apple and Microsoft, have continued to perform significantly "less bad" than the average stock. We continue to own larger positions of these bellwether stocks because they are offering the downside protection we would expect them to provide. Stocks will move on both fundamentals and investor sentiment shifts. And while the sentiment shifted a lot in the first quarter, fundamentals including earnings and cash flow growth matter the most in the long term. Companies like Apple and Microsoft continue to offer incredibly strong cash flows at reasonable valuations.

Cyclical value stocks have had very strong appreciation since the COVID vaccines came out in November of 2020. Historically when recessions arrive, cyclical value stocks are punished the most (like we last saw during the COVID downturn.) As we view the risks of recession increasing for 2023, we are tilting our portfolio back to more high quality growth-oriented companies. We will continue to maintain a barbell approach between growth and value, with our primary focus investing in sustainable growth companies whose stock prices trade at reasonable valuations.

We ended the quarter with the highest average cash position we have had in a while due to our belief that we will see more volatility over the course of the year. The Federal Reserve hiking rates and inflation has been exacerbated by the Ukraine war's impact on energy prices. That said, our target Buy list of companies has never been longer—we are looking to make entry points at better prices with the hopes of holding the positions for many years to come. Although tactically we hold higher cash today, we always believe an investor with a greater than a 5-year time horizon should remain strategically fully invested in stocks for the long term. Stock market corrections are inevitable--we should not fear them but acknowledge that we have lived through many and will experience many more together over the years. We strive to benefit from these opportunities as much as we can.

"The stock market is the only market in the world where when things go on sale,
all the customers run out of the store." *--Cullen Roche*