MORSE ASSET MANAGEMENT, INC.

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April 19, 2022

2022 Q1 Investment Commentary

Equity markets have continued to be volatile in 2022 as economic uncertainty has driven investor pessimism. Inflation continues to surge with new pressures triggered by the Russian invasion of Ukraine. The Federal Reserve began raising rates in March and has conceded to needing a more aggressive policy response to control prices. Economic data continues to be expansionary and the labor market robust but there is concern the current conditions will eventually lead to stagflation. Investor sentiment has fallen to extreme pessimism indicating markets are oversold. The weight of the evidence remains supportive but an improvement in inflation is needed for markets to break out of the current range.

Equities initially sold off in January, as valuation compressed following a jump in 10-year Treasury yields due to lingering inflation concerns. The 2021 fourth quarter earnings refocused investors on positive fundamental data, and the indices briefly recovered until February 10th, 2022, when the Consumer Price Index (CPI) surprised with the highest year over year inflation reading in over 40 years. A renewed selloff occurred, compounded by rising tensions in the Ukraine, ultimately establishing the lows on the day Russia began their invasion. Equity markets have since been range bound, which is characteristic of periods of increasing uncertainty due to the push and pull of offsetting bullish and bearish data and expectations.

Year to date, Energy and Utilities are the only sectors with positive returns followed by Consumer Staples, Financials and Materials. Consumer Discretionary, Tech and Communications were the worst performers. This reflects a flight to safety and a push into inflation beneficiaries. Valuation compression continued in the higher growth areas of the economy where valuations are now broadly below pre-COVID levels. Investor sentiment has also washed out to extreme pessimistic levels not seen since 2009 – a level which has historically preceded a rally. (Chart 1)

Russia's invasion of Ukraine and the geopolitical response has thrown the global pandemic recovery into doubt. Inflationary pressures caused by spikes in commodities quickly overwhelmed any relief from passing COVID disruptions. Together these countries are major global suppliers of oil, gas, wheat, and industrial and agricultural materials. Concerns quickly shifted from merely supply chain troubles to a European energy crisis, the loss of key global commodity sources and potential food shortages.

The Institute for Supply Management Purchasing Manager Indices (PMI) continue to indicate economic expansion, suggesting a near term risk of recession remains low. The Conference Board's Leading Economic Index (LEI) also remains broadly positive and is consistent with above-trend economic growth. Recent weakening in manufacturing has been offset by increases in service sectors. This reflects solid demand but shifting consumption away from durable goods to the service economy.

Inflation continues to weigh heavily on business and consumer sentiment. The March CPI data was encouraging despite the surging headline numbers. Core CPI (excluding food and energy) came in below expectations as reopening demand and supply chain issues diminished. Food and Energy prices surged due to the conflict between Russia and Ukraine.

There continues to be broad strength in the labor market. The unemployment rate fell to 3.62%, a post-pandemic low and just 15 bp above the pre-pandemic benchmark. The GDP of the U.S. is at a new high, more than 3% above its pre-pandemic level. This is perhaps the best single statistic showing the productivity-led post pandemic boom is still very much intact. (Chart 2)

Consumer activity has been resilient in the face of rising prices. According to the NY Fed's survey of consumer expectations, most households are responding to higher prices by raising their budgets, not by cutting discretionary spending. Year-ahead spending growth expectations jumped by 1.3% in March to 7.7%, the largest month-to-month increase in the survey's history.

The Federal Reserve has begun tightening monetary conditions, raising rates 25bp in March. More aggressive action is needed, as inflation continues surging, and they are now expected to deliver 50 bp rate hikes in both May and June with further hikes through year end. As a result, the 10-year Treasury yields have nearly doubled year to date to 2.9%. Despite this increase, the equity risk premium still favors an allocation to equities over bonds. Even with factoring in the more aggressive Fed policy, monetary conditions remain loose by historical standards. As long as the yield curve remains steep, there is room for rates to be raised without an inversion.

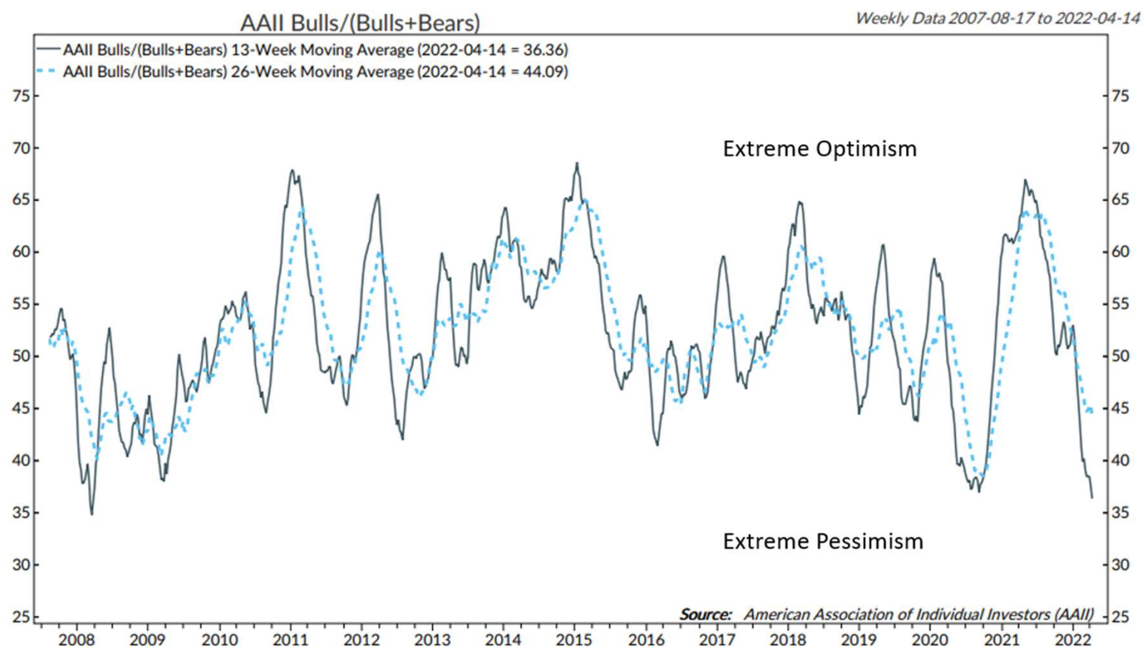
According to Factset's Earnings Insight on April 14th, the S&P 500 year-over-year earnings growth rate for the first quarter of 2022 is expected to be 5.1% and accelerating through year end. Projected earnings for the full calendar year are a healthy 10.2%. If equity prices remain subdued, the continued earnings growth will further improve valuations.

Our base case is that the U.S. will not fall into a recession in the near term. The momentum in the economy, consumer and labor markets are strong enough to survive near term negative pressures. The key to a soft landing will be how long inflation remains at an extreme. We are maintaining a defensive posture, balancing between high-quality growth at reasonable prices, stable businesses, and inflation beneficiaries. Our playbook continues to focus on significant secular, cyclical and structural trends, and persistent above-average growth potential. We will continue adjusting portfolio risk according to the prevailing market environment.

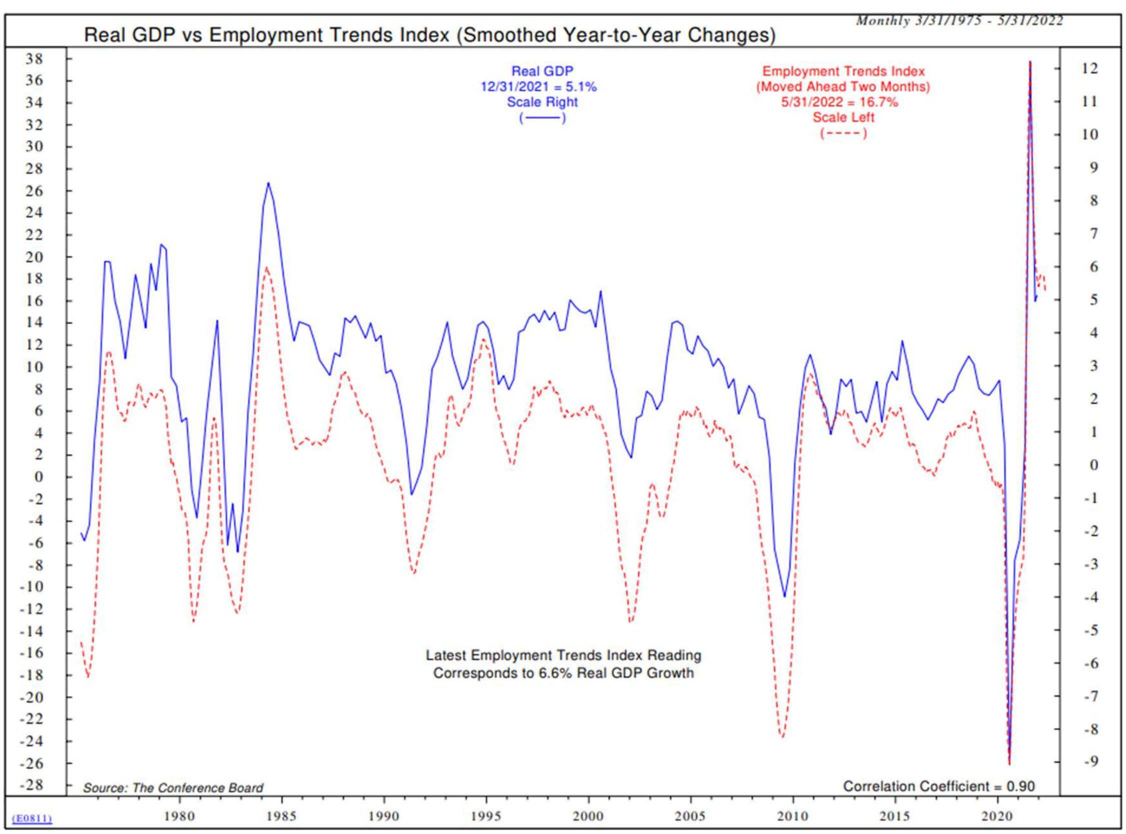
Morse Asset Management Investment Team

Robert B. Morse, Jian Wang, James Cushing

1.


AAII Bulls/(Bulls+Bears)
Weekly Data 2007-08-17 to 2022-04-14
AAII Bulls/(Bulls+Bears) 13-Week Moving Average (2022-04-14 = 36.36)
AAII Bulls/(Bulls+Bears) 26-Week Moving Average (2022-04-14 = 44.09)
Extreme Optimism
Extreme Pessimism
Source: American Association of Individual Investors (AAII)

2.


Real GDP vs Employment Trends Index (Smoothed Year-to-Year Changes)
Monthly 3/31/1975 - 5/31/2022
Real GDP
12/31/2021 = 5.1%
Scale Right
Employment Trends Index
(Moved Ahead Two Months)
5/31/2022 = 16.7%
Scale Left
Latest Employment Trends Index Reading
Corresponds to 6.6% Real GDP Growth
Source: The Conference Board
Correlation Coefficient = 0.90
(E0811)