Situation analysis

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April 15, 2022

Q1 performance: Unprecedented and unwelcome, but not alarming

Since the launch of the MSCI Emerging Markets Index in 1988, six major market indices have never all had a simultaneously negative quarterly return — until now. In the first quarter of 2022, investment-grade taxable and municipal bonds, U.S. stocks, measured by the S&P 500 index, developed foreign stocks (MSCI EAFE Index), emerging foreign stocks (MSCI Emerging Markets Index) and U.S. real estate investment trusts (REITs — Dow Jones U.S. Select REIT Index) all posted losses, ranging from a -3.7% loss for REITs to a -6.9% loss for emerging markets stocks. Additionally, bonds posted their worst total return ever over the time horizon we reviewed, with high-quality taxable and municipal bonds losing -5.9% and -6.2%, respectively, worse than the "mere" -4.6% dip for the S&P 500.

As investors, we must consider the odds of this pattern continuing and steps we can take to manage risk and reward in this unique environment.

A confluence of unique events to kick off 2022 pressured global stocks and bonds. First was the U.S. Federal Reserve's (Fed) pivot to fight inflation by ending its asset purchase program and raising interest rates. By the end of the quarter, market prices reflected more than seven interest rate increases of 0.25% each in 2022. This pressured bond prices as a group and depressed investor sentiment for lower-quality bonds, further lowering investor returns. This event also hit investor sentiment for equities, with prices relative to expected earnings falling in the quarter. Higher prices from the Russia/Ukraine conflict increased investor fears of diminished profit margins, leading to further declines in sentiment measures. For now, there is little change in earnings expectations for 2022 as the U.S. economy recovers from the Omicron variant of the coronavirus, the labor market remains strong and business activity grows.

Six major asset classes declining in the same quarter has never happened dating to 1988. However, in eight instances, five of the six experienced negative total returns (first quarter 1990, first quarter 2005, second and third quarters 2008, second quarter 2013, fourth quarter 2016, first quarter 2018 and first quarter 2020) This only happened back-to-back once, in 2008, as we battled the global financial crisis. The other periods generally saw some recovery, with the average next quarter return for most asset classes in positive territory. Emerging markets and REITs were exceptions due to large outlier negative returns during the 2008-2009 financial crisis, which also reduced the average subsequent quarterly returns for all asset classes.

 Important disclosures provided on page 3.

Asset classes under pressure

	1Q 2022 return	Average return for 8 selected quarters*	Worst return of 8 selected quarters*
Bloomberg Aggregate Bond Index	-5.93%	-0.80%	-2.98%
Bloomberg Municipal Bonds Index	-6.23%	-1.31%	-3.62%
S&P 500 Index	-4.60%	-3.73%	-19.60%
MSCI EAFE Index	-5.79%	-8.47%	-22.72%
MSCI Emerging Markets Index	-6.92%	-8.38%	-26.86%
Dow Jones U.S. Select REIT Index	-3.71%	-6.65%	-28.52%

*Average and worst calculations include eight quarters where five of the six asset classes posted negative returns: 1Q 1990, 1Q 2005, 2Q and 3Q 2008, 2Q 2013, 4Q 2016 and 1Q 2018.
Source: U.S. Bank analysis, Factset data: Data period: January 1, 1988, to March 31, 2022.

While history provides us some guide to what the future may hold, we must consider the differences in this market and economic environment and how best to position portfolios. The Fed is on a path to raise interest rates to battle inflation. Inflation pressures appear likely to remain above average for much of the year due to supply constraints on labor, energy, raw materials and semiconductors. The economy is reopening from coronavirus-induced shutdowns, and we see evidence of pent-up demand for leisure travel and services. However, higher prices may present a challenge to business profit margins, because companies must raise prices to compensate for higher wages and raw materials costs. Limitations on corporate pricing power could damage earnings prospects.

Given this confluence of uncertainty and the challenge of higher interest rates and above-average inflation, we prefer strategies with rising cash flows and rising income streams. Global infrastructure and bank loans are two investment strategies that meet these criteria. Global infrastructure comprises sectors such as utilities, transportation, energy storage, cell towers and data centers. Bank loans are loans to lower-quality companies where the income paid adjusts based on changes in short-term lending rates. Global infrastructure investments generally provided positive performance in the first quarter, with the Dow Jones Brookfield Global Infrastructure Index gaining 3.2%. Bank loans saw solid though slightly negative performance; the S&P/LSTA U.S. Leveraged Loan 100 Index lost 0.2%.

Coincidence of poor performance is unusual across major fixed income, equity and real asset classes. However, the occurrence does not portend a difficult future. It is important to understand the current and possible future market conditions to best position portfolios for these challenging environments. For now, the economic backdrop is one of slower but still positive growth and above-average inflation. Given this environment, we are tilting portfolios toward strategies with cash flows that benefit from inflation, including global infrastructure and bank loans. As market conditions evolve, we will update portfolio strategies and share our perspective.

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Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. International investing involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments. Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in fixed income securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Investment in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in high yield bonds offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a bond issuer's ability to make principal and interest payments. The municipal bond market is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issues of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes, but may be subject to the federal alternative minimum tax (AMT), state and local taxes. There are special risks associated with investments in real assets such as commodities and real estate securities. For commodities, risks may include market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates and risks related to renting properties (such as rental defaults).

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