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Economic and Market Outlook

March 31, 2022

War is Hell

If there is no Ukrainian strong army, there will be no Ukraine, and that will be the case when everyone will understand... it's not the war in Ukraine, it's the war in Europe. We are defending our country, our land. We are not attacking anyone, because that is immoral.

~ Volodymyr Zelensky, President of Ukraine

Section I. Introduction

The title of our report is actually a quote from General William Sherman of the Union Army toward the end of the Civil War, but the same could be said today. The images coming from Ukraine are horrific. The atrocities being committed by Putin and his army fill the nightly news. President Zelensky's quote above exhibits the threat that the West faces in maintaining a delicate balance in supporting Ukraine.

The world has faced many of these threats before. While we are repulsed by the current actions of Putin, it is our job in this space to help you understand the effects of such actions on the market using history as our guide.

Section II. Geopolitical Events

With geopolitical tensions such as what we are seeing in Russia and Ukraine, investors often wonder how the market takes such news. The markets are much like children – they don't like bad news, but they'll get over it.

A New York Times article from 2003 observed that "of the past 3,400 years, humans have been entirely at peace for 268 of them, or just 8% of recorded history". In other words, as much as we disdain war and conflict, it's happening all the time.

Let's take a look at more recent history. Chart #1 is from Vanguard and has a sample size of eight geopolitical events that they felt were important over the last sixty years. It shows that six months after the event, on average the market was up 5% and after a year the market was up 9%.

A more comprehensive report from LPL Research, S&P Dow Jones Indices, CFRA 1/6/20, points out that downturns have varied through history. For example, the S&P 500 dropped 25.8% over 22 days after Germany's attack on France in 1940, 11% the day after Pearl Harbor and 17% during the 1973 oil crisis.

These are the lows though, and a longer term perspective shows more.

Their study covers 21 "black swan" events over 80 years. They concluded the S&P 500 was on average down 6.5% in the 3 months following an armed conflict and up 13% one year after the conflict. Chart #2 shows the list of 21 events. The total average drawdown was 5%, and the average bottom occurred 22 days post conflict and it took 47 days on average to recover. The fact of the matter is that if you missed the news altogether, within a year it might be like it never even happened.

Section III. Inflation

Inflation continues to be an issue. The readings for inflation have continued to increase. Currently the Consumer Price Index (CPI) is 7.9% on an annual basis, and core CPI, which excludes food and energy, is at 6.4%. This is well above the Federal Reserve's 2% target. With the pandemic waning, consumers with cabin fever have spent some of their savings that they accumulated during the lockdown on travel and other services. Chart #3 is the personal savings rate for the U.S. After averaging about 7% from 2000 to 2019, it peaked in April 2020 at 33.7%, right after the beginning of the Covid-19 lockdowns. The reading for February 2022 is down to 6.4% meaning this pressure on inflation should begin to ease.

Energy has become a big contributor to inflation. We experience that every time we fill up the gas tank or pay our utility bill. Because of Germany's questionable decision in the past to become reliant on Russian energy, global supply has been greatly disrupted. Exploration, infrastructure, logistics and a qualified work force is a very capital intensive and time consuming endeavor. Unfortunately we can't just "turn on a spigot" and immediately increase global supply. This will further prolong the inflation problem.

The “ease” with which goods move around the world has been greatly impaired. The Federal Reserve probably chose the wrong word when they termed inflation “transitory” because that led people to believe it would only last a few months. Most of the inflation we are experiencing is a mismatch of supply and demand caused first by Covid-19 fears and lockdowns, then continuing supply chain issues and now the Ukrainian War. Factory shutdowns caused a shortage of semiconductors, food stuffs, lumber etc. At the same time, consumers flush with cash increased demand for these same goods. Manufacturing is complicated and factories can’t just start up on a dime. It takes time to hire and train workers.

Wages continue to rise in an effort to lure people back into the workforce. These wage increases will not roll back and it is unsure how much further they will need to rise.

Another problem for now is that rent increases due to increased home prices normally have an 18 month lag. This may also prolong inflationary pressures.

Other areas will eventually prove to be transitory but will take longer to work out than the Federal Reserve originally expected. Semiconductor chip shortages affect many parts of the economy from vehicles to technology. Bringing production to full capacity at factories is still difficult, creating shortages for many goods. The war in Ukraine creates the possibility of grain shortages next year. In addition, the lack of enough longshoremen and truck drivers is exacerbating the supply chain situation.

The key concern for inflation is persistent price hikes. The good news is that Industrial Production plus Productivity gains thanks to technology will eventually lead to disinflation. In addition, the Producer Price Index (PPI) is beginning to reflect some moderation. That is why we believe inflation will not be a long term problem but it will last longer than Federal Reserve first believed. Some of the current elevated inflation rate is transitory, based on supply chain shortages. Inflation due to wage hikes is appearing to stick for the long term.

Section IV. The Federal Reserve and Interest Rates

Because of inflation the financial media has become more focused on interest rates. We have been spoiled by ultra-low rates during the pandemic. Historically, rising interest rates accompany a strengthening economy. Chart #4 shows rate hike and rate cut cycles since 1989. The market rose 80% of the time during rate hike cycles and only 67% of the time during rate cut cycles. Ken Fisher of Fisher Investments points out in his February 18th, 2022 newsletter that stocks and interest rates have a slightly positive

correlation, meaning rising rates usually mean rising stocks. In addition, the ultra-low rates we have experienced have hurt savers and retirees.

The Federal Reserve has adjusted monetary policy. Federal Reserve Chairman Jerome Powell stated at his latest press conference that the committee will stop adding to the Fed balance sheet in March and raise the Fed Funds rate by a quarter-point to... a quarter-point. In addition, the 2-year Treasury yield is about 2.1% meaning the market has already priced in seven more quarter-point rate hikes. The 10-year Treasury yield has risen to around 2.35%. This is also a reflection that long term inflation expectations are not elevated.

We still believe the rise in rates will continue. Historically, the stock market will climb until a third rate hike. After that, things can get bumpy if they have to continue to fight inflation. A 2.5% 10-year Treasury note yield is still very low historically and there are other factors that still exist that should limit the climb moving forward. Japan has been a net seller of U.S. Treasuries for the last 5 years. Japan may become a net buyer of U.S. Treasuries because of the eventual rise in rates. This is because the eventual rise in the 10-year bond yield combined with currency hedging costs collapsing makes the U.S. 10-year bond much more attractive to Japan than Japan's 0.24% 10-year yield.

In addition, rates in most European 10-year bonds remain low, making the U.S. 10-year bond more attractive to international investors. The U.K. 10-year yields 1.65%. The German 10-year yields 0.53%. France 10-year yields 0.98%. Italian 10-year yields 2.05%. Swiss 10-year yields 0.51%. This compares to our 2.35% 10-year yield.

Section V. The Recession Model

As we have discussed in past reports, earnings and the economy are the true long term influences on the stock market. Recessions are the major reason we experience corrections of more than 10%. Corrections of less than 10% are just part of normal volatility and can happen multiple times each year.

We have developed what we view as a recession indicator which tracks 5 data sets on a monthly basis. If 3 of the 5 indicators are negative and the S&P 500 is below its 40 week moving average, it is a very strong indication that a recession is near or may already be underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of February, the unemployment rate was 3.8% and the 12

month moving average was 4.98%. By being below the moving average this indicator is positive.

Indicator number two is represented in Chart #5. This represents the year over year percentage change of Advance Real Retail and Food Service Sales. This is one method to measure the strength of the consumer. As you can see, the Covid-19 shut down had a major effect on this index in early 2020. Re-opening is also having a major effect. This indicator bottomed in April 2020 at -20.2% and had recent high of 45.2% in April 2021. Currently the reading is 9.0% for February, so this indicator is positive. Any reading above 0 is positive. The reading is also normalizing which should relieve some inflation pressure.

Indicator number three is represented in Chart #6. This shows the year over year change in Industrial Production. This indicator bottomed in April 2020 at -16.3%. This indicator is positive and increasing. It currently sits at 7.5% for February 2022. This number improving could also help lower inflation.

For indicator number four (Chart #7), we look at Total Nonfarm Payrolls divided by the Civilian Labor Force Level on a year over year percentage change basis. This indicator has moderated because of the difficulty companies are having hiring in the last couple of months caused by the Delta and Omicron variants and stands at 2.32%. A zero reading represents neutral therefore this indicator is still positive.

Indicator number five (Chart #8) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year over year percentage basis. Once again, this indicator bottomed back in April 2020 at -7.69%. Currently the reading is only 0.0%, so this indicator is neutral and reflects how the Delta and Omicron variants have elongated the economic recovery in the last few months.

Currently four of the five indicators are positive but the S&P 500 Index is 0.41% below its forty week moving average after bottoming at -6.08% in the recent correction. Even though the S&P 500 is below its forty week moving average this model does not give any recession warning signs because 4 of 5 indicators are still positive. We will be closely monitoring these indicators in the coming months.

The above indicators are only updated on a monthly basis. To offset this situation we also track two other indicators. They are both indicators that are updated more frequently (on a weekly or daily basis) and we consider them as early recession indicators. Both are somewhat volatile so we track three month moving averages.

These two indicators are separate and independent of the first five and either one can indicate the possibility of recession on its own.

The first one is the Aruoba-Diebold-Scotti Business Conditions Index which is updated on a daily basis and published by the Philadelphia Federal Reserve. The 91 day moving average, after pulling back two reports ago to 0.05, rebounded and went to 0.49 at the last report to 0.63 currently. The divining line for entering and exiting recessions is -0.8.

The second indicator for recessions is the Chicago Fed Business Activity Index. It is reported weekly and the divining line for entering recessions is -0.7. The three month moving average slightly weakened and sits at 0.35.

In summary, the two “early warning signs” are not predicting recession at this time, and have remain steady or improved in the last three months.

Section VI. Market Psychology

For decades we have measured market psychology using price and volume data in the short and long term from the Dow Jones Industrial Average as well as a 17 week moving average of advancing and declining stocks on the New York Stock Exchange.

Currently most of the price/volume indicators remain positive, but 5 of the 12 are starting to flash yellow. This is reflective of the recent correction in the 10% range. These are normal and part of market volatility.

Our advance/decline line has dipped slightly below 46%, once again reflective of the recent pullback. Our model that measures the first and second derivative on price and volume is currently neutral but looking like it will likely improve. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data.

Section VII. The Economy

Indexes that measure manufacturing data have continued to have strong readings. The Philly Fed Manufacturing Index hit a nearly 50 year high in April 2021 with a reading of 50.2 (0 is the line for growth or contraction). The reading for March 2022 was a still positive 27.4. The Empire State Manufacturing Index hit a high in July 2021 of 43 (0). March's reading was a disappointing at -11.8 and may be weather related (Northeast snow storms). The national ISM manufacturing index remained elevated at

58.6% in March and the ISM services index is at 56.5% (above 50 is considered growth, above 55 is considered exceptional growth). Multiple Wall Street and Federal Reserve predictions for GDP have been lowered because of the war in Ukraine and inflation for 2022. GDPNow currently estimates GDP at 1.3% annualized for the first quarter. These economic indicators paint a bit of an opaque picture moving forward.

Section VIII. Conclusion

We believe that the Federal Reserve will patiently be data dependent to determine their path for fighting inflation. As pointed out, while headlines seem to make investors nervous about the situation in Ukraine, history shows that “black swan” events have minimal long term impact. Economic data for the most part remains strong which keeps us cautiously optimistic we can avoid a recession while the Fed fights inflation.

It can seem like a very treacherous period to be invested in the market. Not only do we have a global conflict that’s erupting, but we also have other deep concerns like inflation and the impact of rising interest rates.

In times like these, it is important to take a macro perspective of the environment and not get myopic with your portfolio decisions, especially when it comes to long-term investing.

We hope this report finds you in good spirits and good health!

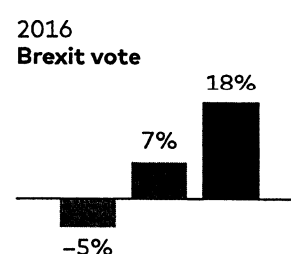
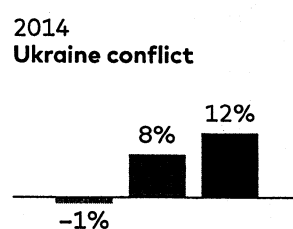
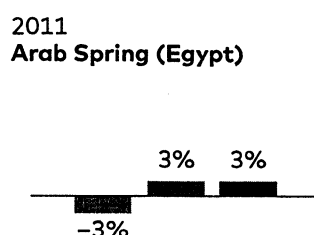
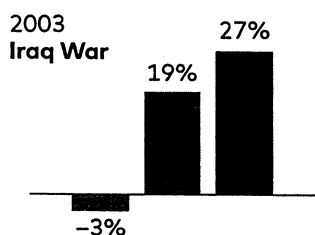
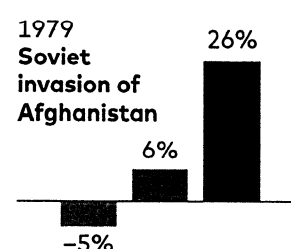
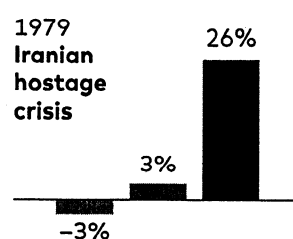
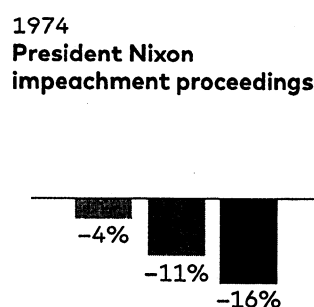
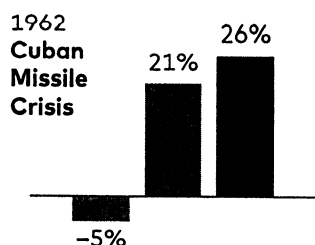
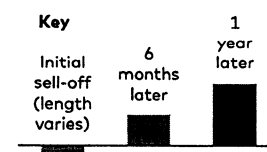
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Geopolitical sell-offs are typically short-lived

Chart #1

5% Average total return 6 months from event

9% Average total return 1 year from event

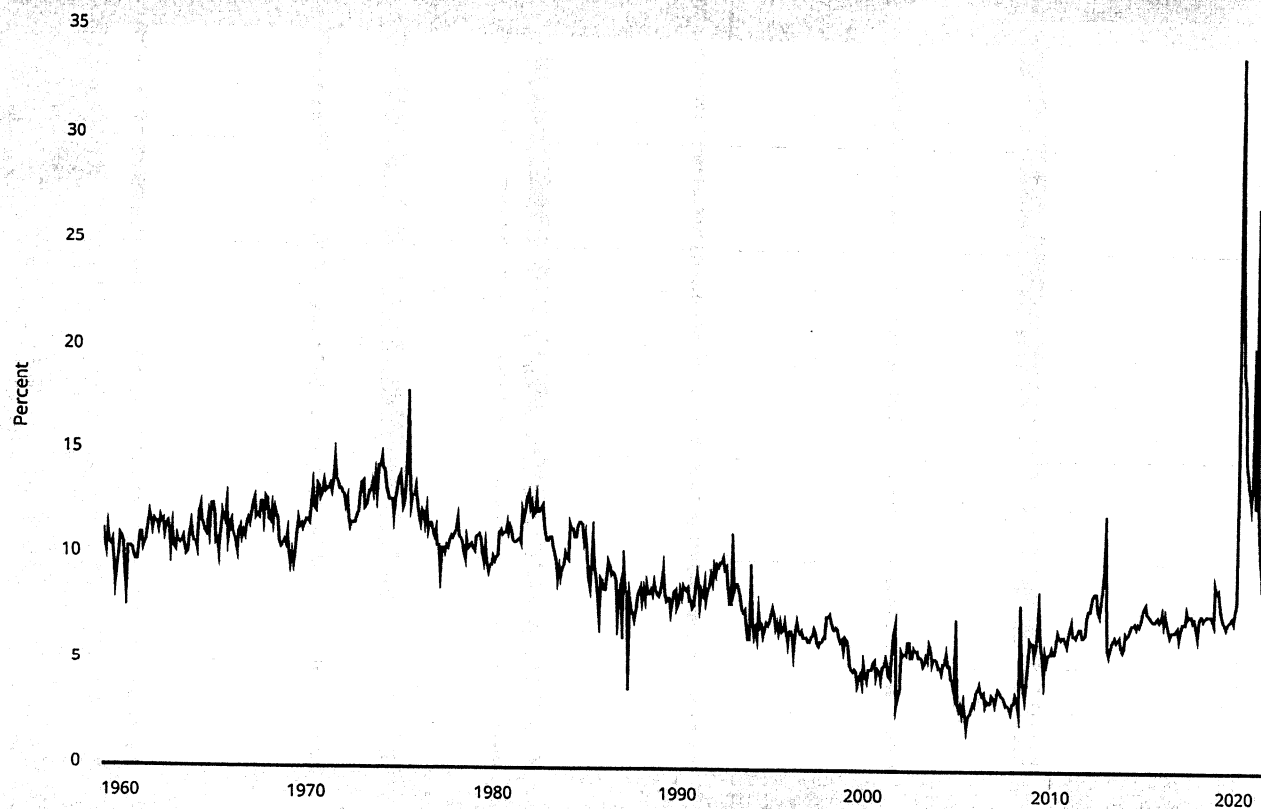


Geopolitical Events And Stock Market Reactions

Chart #2

Market Shock Events	Event Date	S&P 500 Index		Calendar Days To	
		One-Day	Total Drawdown	Bottom	Recovery
Iranian General Killed In Airstrike	1/3/2020	-0.7%	7	7	7
Saudi Aramco Drone Strike	9/14/2019	-0.3%	-4.0%	19	41
North Korea Missile Crisis	7/28/2017	-0.1%	-1.5%	14	36
Bombing of Syria	4/7/2017	-0.1%	-1.2%	7	18
Boston Marathon Bombing	4/15/2013	-2.3%	-3.0%	4	15
London Subway Bombing	7/5/2005	0.9%	0.0%	1	4
Madrid Bombing	3/11/2004	-1.5%	-2.9%	14	20
U.S. Terrorist Attacks	9/11/2001	-4.9%	-11.6%	11	31
Iraq's Invasion of Kuwait	8/2/1990	-1.1%	-16.9%	71	189
Reagan Shooting	3/30/1981	-0.3%	-0.3%	1	2
Yom Kippur War	10/6/1973	0.3%	-0.6%	5	6
Munich Olympics	9/5/1972	-0.3%	-4.3%	42	57
Tet Offensive	1/30/1968	-0.5%	-6.0%	36	65
Six-Day War	6/5/1967	-1.5%	-1.5%	1	2
Gulf of Tonkin Incident	8/2/1964	-0.2%	-2.2%	25	41
Kennedy Assassination	11/22/1963	-2.8%	-2.8%	1	1
Cuban Missile Crisis	10/16/1962	-0.3%	-6.6%	8	18
Suez Crisis	10/29/1956	0.3%	-1.5%	3	4
Hungarian Uprising	10/23/1956	-0.2%	-0.8%	3	4
N. Korean Invades S. Korea	6/25/1950	-5.4%	-12.9%	23	82
Pearl Harbor Attack	12/7/1941	-3.8%	-19.8%	143	307
Average		-1.2%	-5.0%	22	47

Source—LPL Research, S&P Dow Jones Indices, CFRA 1/6/20

FRED — Personal Saving Rate


Shaded areas indicate U.S. recessions.

Source: U.S. Bureau of Economic Analysis

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Chart #4

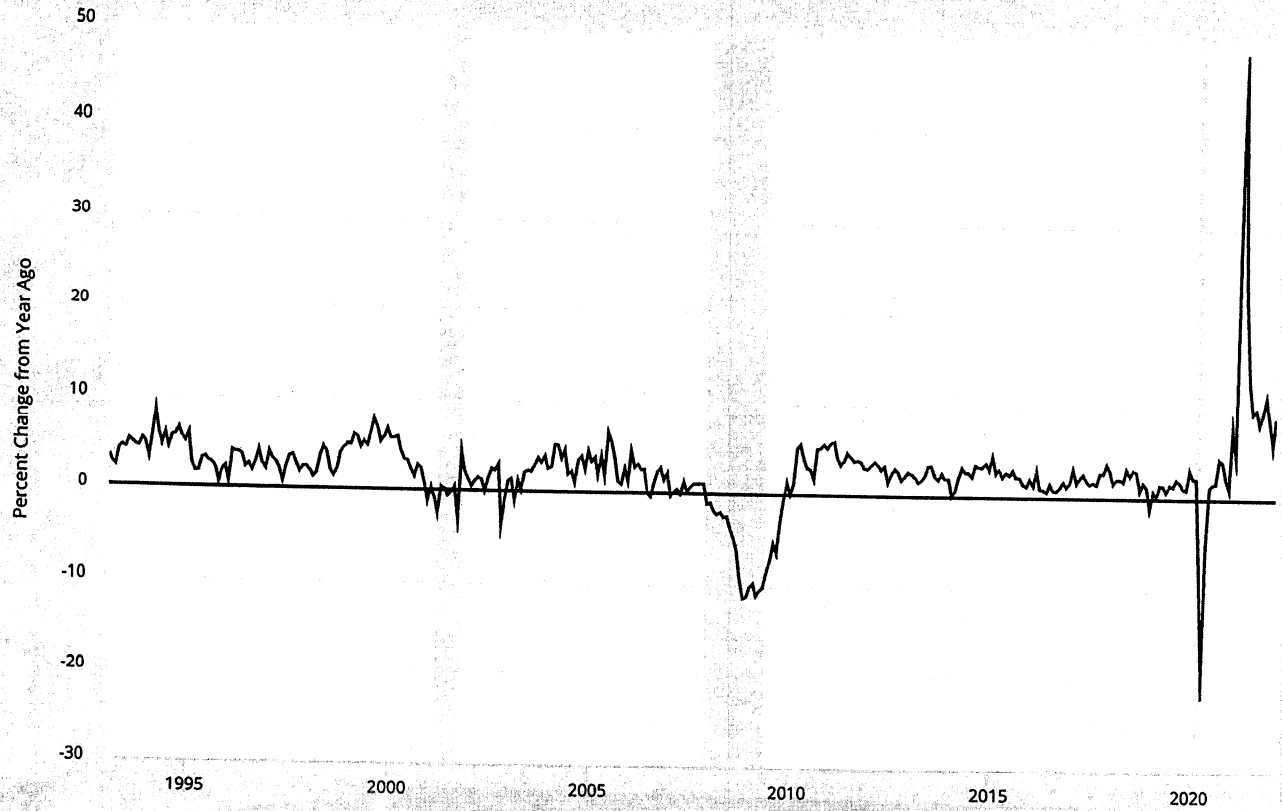
Rate Cut Cycle Start	Rate Cut Cycle End	DJIA	S&P 500	Nasdaq Composite
5/31/1989	2/3/1994	60.0%	50.0%	78.8%
7/5/1995	3/24/1997	49.6%	44.5%	31.9%
9/28/1998	6/29/1999	33.4%	28.9%	51.9%
1/2/2001	6/29/2004	-2.2%	-11.5%	-11.2%
9/17/2007	12/15/2008	-36.1%	-41.2%	-41.6%
7/31/2019	1/14/2022*	33.5%	56.2%	81.9%
Average %		23.0%	21.2%	32.0%
Median %		33.4%	36.7%	41.9%

Source: Dow Jones Market Data

Rate Hike Cycle Start	Rate Hike Cycle End	DJIA	S&P 500	Nasdaq Composite
2/3/1994	7/5/1995	16.3%	13.8%	18.1%
3/24/1997	9/28/1998	17.4%	32.6%	40.0%
6/29/1999	1/2/2001	-1.6%	-5.0%	-13.3%
6/29/2004	9/17/2007	28.7%	30.0%	26.9%
12/15/2008	7/31/2019	213.7%	243.1%	442.0%
Average %		54.9%	62.9%	102.7%
Median %		17.4%	30.0%	26.9%

Source: Dow Jones Market Data

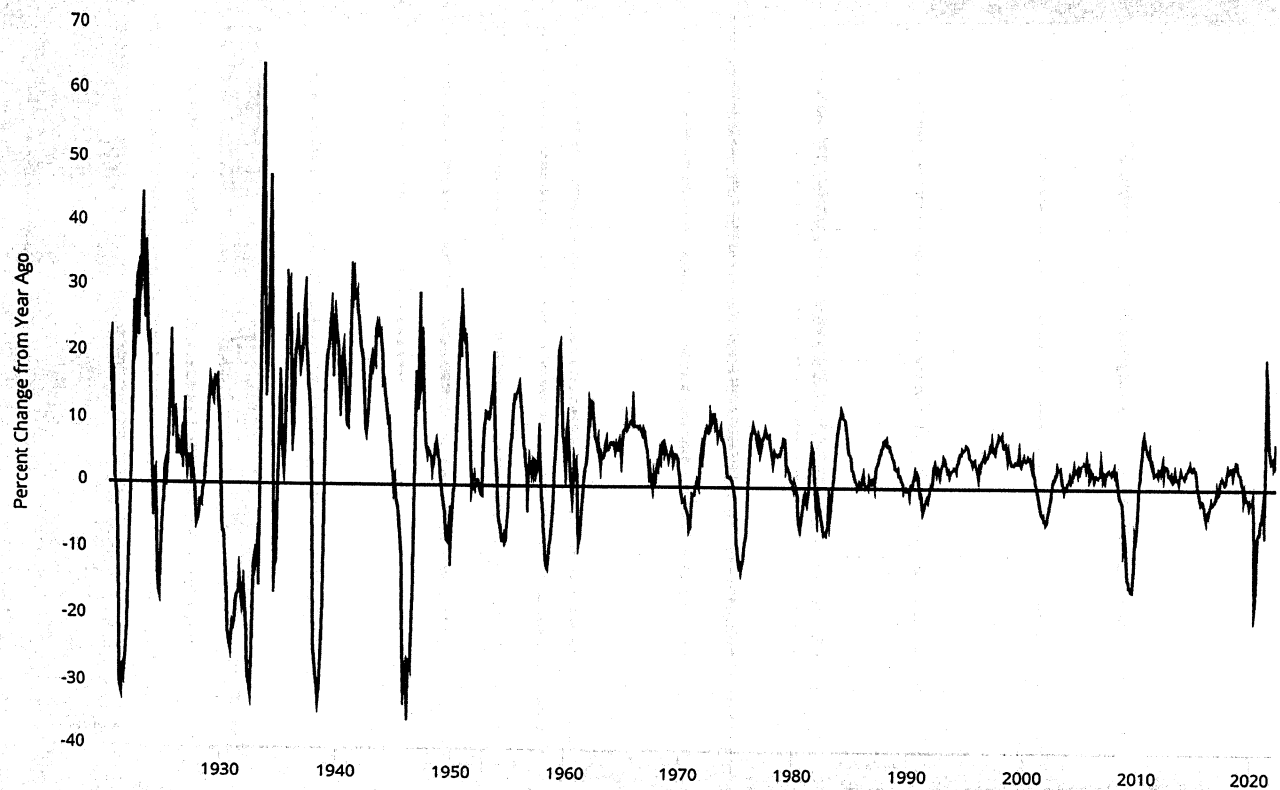
Chart #5

FRED — Advance Real Retail and Food Services Sales

Source: Federal Reserve Bank of St. Louis

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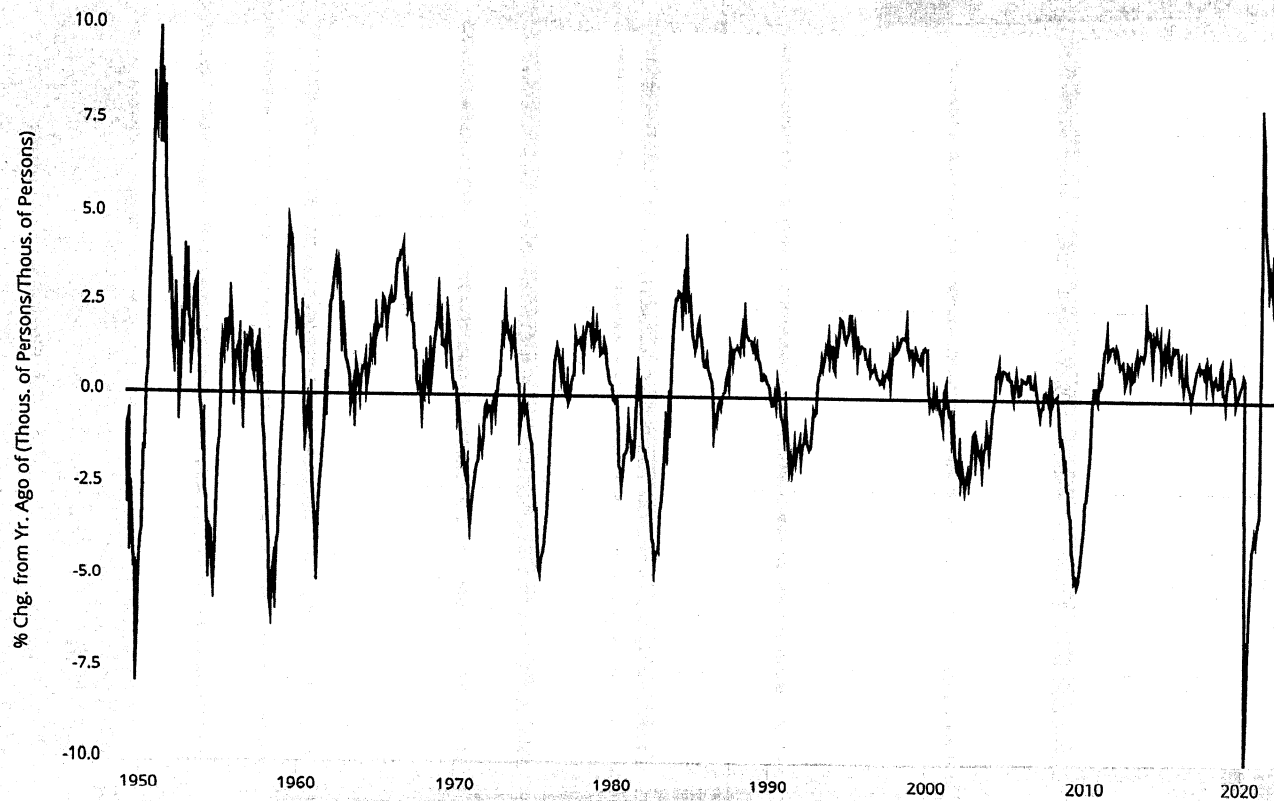
Chart #6

FRED — Industrial Production: Total Index

Source: Board of Governors of the Federal Reserve System (US)

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Chart #7

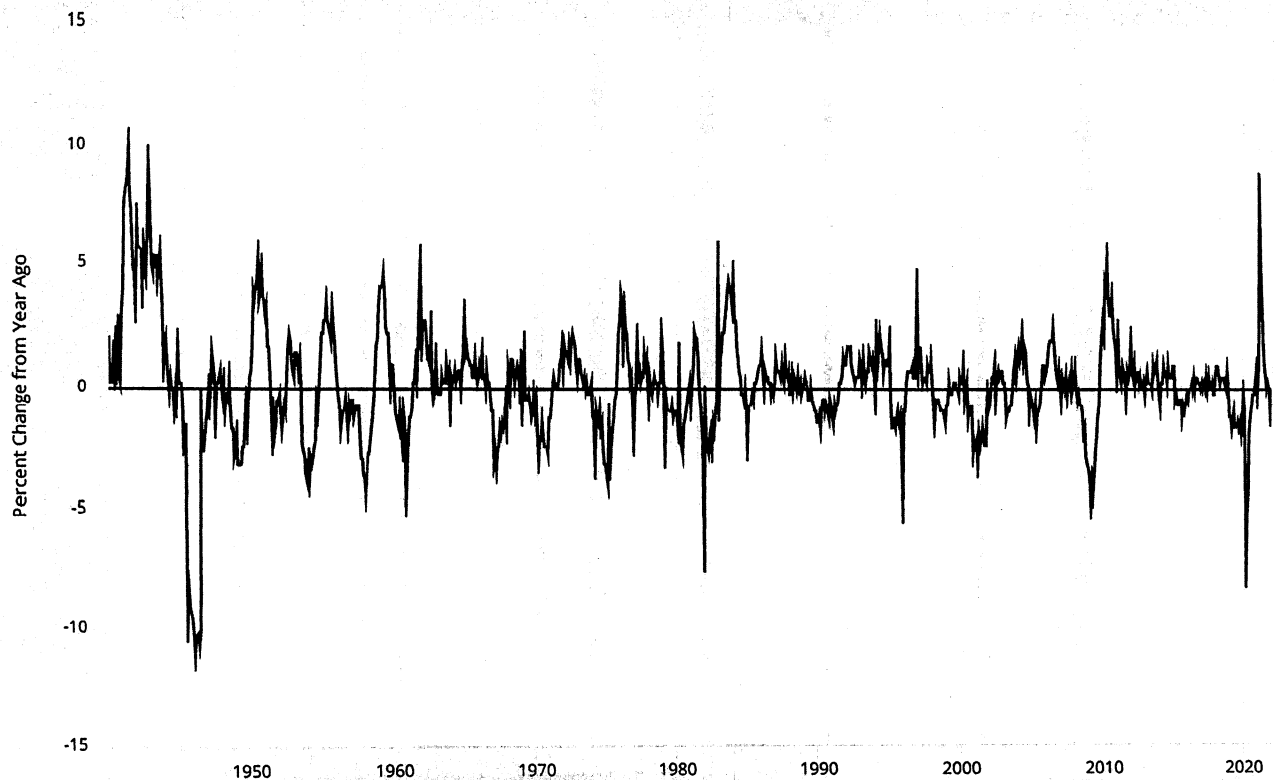
FRED — All Employees, Total Nonfarm/Civilian Labor Force Level

Shaded areas indicate U.S. recessions.

Source: U.S. Bureau of Labor Statistics

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Chart #8

FRED — Average Weekly Hours of Production and Nonsupervisory Employees, Manufacturing

Shaded areas indicate U.S. recessions.

Source: U.S. Bureau of Labor Statistics

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