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Spectrum Investor® Quarterly Newsletter

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Newsletter Summary:

Federal Reserve Raises Rates to Combat Elevated Inflation
Stocks and Bonds Experience Quarterly Declines
Strong U.S. Consumer

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It has been a strenuous start to the year for stock and bond markets in 2022. Inflation has been one of the greatest challenges recently in an otherwise strong economy. Inflation was expected to cool off as the economy reopened. Instead, COVID variants continued to snarl supply chains. The Russian invasion of Ukraine also added inflationary pressures as both countries are important suppliers of commodities. In response to higher inflation, on March 16 the Federal Reserve announced faster interest rate hikes would be coming this year. Stocks and bonds are adjusting to the higher interest rate path and concerns of slower economic growth.

In spite of overall positive earnings growth, the S&P 500 US Large Cap Stock Index finished the first quarter down 4.6%. It was the first quarterly decline since the onset of COVID in spring of 2020. Through April 26, the index was down 12% and international stocks (MSCI EAFE) were down 12.7%. As a reminder, stock market declines of 10% or more are fairly common. In the 10 years ending April 26, the average annualized return of the S&P 500 was 13.8%. Six of the last 10 calendar years had declines of 10% or more.

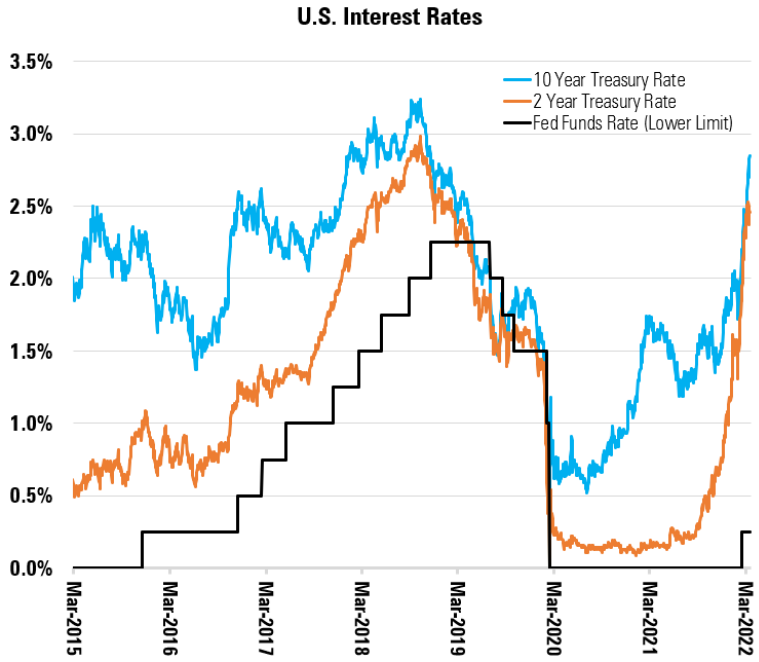
What has made this year unusual are bond market returns. The Bloomberg US Aggregate Bond Index was down 5.9% in the first quarter. It was the worst quarterly return for bonds since 1980. The chart to the right explains why. Bond prices fall when interest rates rise (and vice versa). The blue and orange lines show interest rates have risen very rapidly this year because of the change of plans from the Federal Reserve. (A year ago the Fed did not expect to raise rates until 2024.)

The silver lining is that just about everything looks more attractive than it did six months ago. At the end of September, the 2-Year US Treasury had a yield (interest rate) of just 0.28%. At the end of March it was exactly 2% higher at 2.28%, a much more appealing return for a lower risk investment. S&P 500 valuations have gotten cheaper with the price to earnings (PE) ratio near 18 for the first time since April of 2020. We think this makes for a good opportunity to adjust your portfolio if needed. Remember to think long-term and stay diversified.

The Federal Reserve: On March 16, the Fed raised the short-term Fed Funds rate from 0 to 0.25%. This is the black line in the chart to the right. By year end, the Fed is projecting it will have moved that rate to 1.9% through a series of future hikes. The 2 and 10-year treasury (orange and blue lines) have already moved above the year end target of 1.9%, indicating much of the pain for bonds may have already occurred.

The Fed will announce its next rate hike on May 4. Markets are expecting it to be 0.50%. The key to that meeting isn't the hike itself, but any indication of changes to the year-end target. Fed Funds futures indicate the Fed Funds rate is more likely to end closer to 2.5% by year end (CME FedWatch Tool, 4/27/22).

About Inflation: Some inflation is good, but it can have negative effects if it is too high. For example, higher costs of materials can result in lower profit for businesses. Similarly, households have less for discretionary spending if necessities cost more. The latest CPI (Consumer Price Index) year over year change was 8.5% in March. It was the highest inflation reading since December 1981.



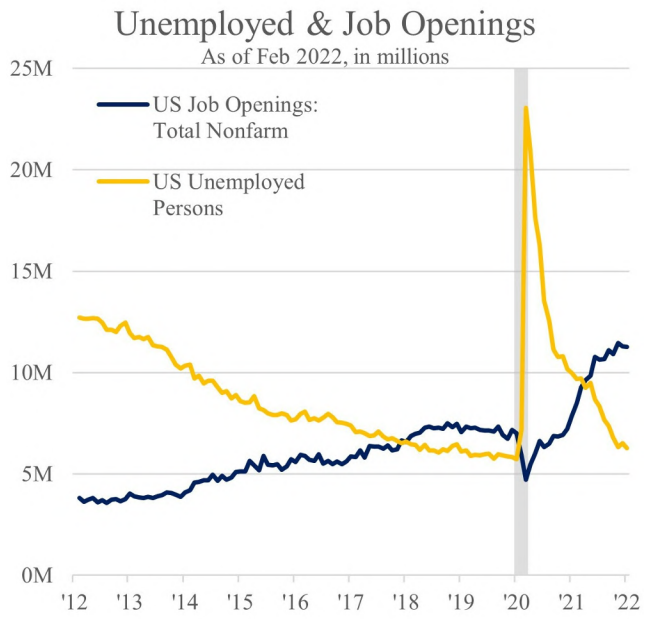
How does the Fed Impact Inflation? There is no magic wand, but by raising interest rates the Federal Reserve expects to decrease the amount of borrowing for purchases and investment. Ideally, that will lower overall demand closer to supply, stabilizing prices and lowering inflation. The risk is going too far and tipping the economy into recession.

Soft Landing: The goal of the Fed is a "soft landing": cool off the economy just enough to lower inflation, but not increase unemployment or hurt the overall economy. So far, most economists think that is possible, but acknowledge higher risks. The average forecast for economic growth in 2022 is 2.57% according to the April *WSJ* economic survey (based on Real GDP). The last two times the Federal Reserve raised rates by 2% in a 12 month period were 1994 and 2004-2005. In both instances, the S&P 500 declined over 5% early on but eventually finished up 1.32% in 1994 and up 6.32% from July 2004 to June 2005. Both times the economy kept growing and unemployment fell. It's not a promise of what is to come, but a reminder that market timing is extremely difficult.

Strong US Consumer: The US economy shrank 1.4% for the first quarter based on Real GDP (Gross Domestic Product after inflation). Year over year the economy grew by 3.6%. While the decline was a surprise, it was attributed to increased imports and declines in inventories, both of which signal strong demand from US consumers. Personal consumption is the largest part of the US economy and it expanded 2.7% in the first quarter. March unemployment of 3.6% was nearly the lowest in 50 years. The labor shortage situation has improved with 6.5 million more jobs added to the economy in the 12 months ending 3/31. As of February, there were still 11.3 million job openings, more than twice the number of unemployed people looking for work.

Quarterly Economic Update Continued

Jobs: Something to keep an eye on regarding the Fed's rate path and state of the economy is the jobs situation. Fed Chair Powell noted one path to a soft landing can be followed in the chart below. The hope is for job openings (blue) to decline toward the number of unemployed persons (yellow). That should help with the stressed labor market situation with employers fighting over a limited number of available workers. If the number of unemployed people starts to rise, the Fed may be less aggressive with its plans to fight inflation with higher rates. Keep in mind, this is expected to play out over several months into next year, rather than a matter of weeks.



Russia Invades Ukraine: The invasion of Ukraine is a humanitarian disaster and a tragedy. The people of Ukraine have shown courage and resilience in defending their homeland. While it impacts no one more than them, this war is having an impact on the global inflation. Russia and Ukraine are important suppliers of natural resources. For example, Russia typically provides 40% of Europe's natural gas supply. Either by way of sanction or choice, Europeans are looking elsewhere for gas. The US is sending record amounts of natural gas to Europe, pushing US natural gas prices to 13-year highs as of April 19 (CNBC, 4/19/22). For more on the impacts on commodity prices, see the chart on page 4.

Keep in mind that this uncertainty will continue to influence the inflation situation for the world, particularly in food and energy. It goes without saying that a peaceful and swift resolution would be beneficial to everyone. At the moment however, there is little evidence that a conclusion in on the near-term horizon.

China: The Omicron wave has made its way to China and they are attempting to fight back with fresh lockdowns. Here are a few key points to consider:

1. Death rates are low - a good sign that other countries will not follow suit in new lockdown measures.

2. This will result in prolonged supply chain issues - China exports are 12% of global trade. The current lockdown includes Shanghai, the world's busiest port.

3. China lockdowns are providing temporary relief to energy prices - China is the world's largest importer of oil.

4. The Chinese government is expected to attempt offsetting economic damage from lockdowns with stimulus plans - China is the world's second largest economy.

Year to Date Performance: It is important to remember that stocks have done really well leading into 2022. The table below shows double digit annualized returns for nearly every category over the last three years. Optimism related to the economic reopening lead to the highest stock valuations since the late 1990s. In part we would consider this is a reset of expectations. As we mentioned earlier, the S&P 500 PE Ratio at 18x as of late April is much more in line with historic norms compared to the 22x PE ratio we saw in 2020.

Another key point to note is S&P 500 corporate earnings are still rising. Earnings likely rose by 6% for the first quarter and are expected to rise 11% for the full year 2022 (FactSet Earnings Insight, 4/22/22).

Rising interest rates tend to hurt stocks with high valuations more. That is one reason why value categories (purple and orange) have held up better this year compared to growth (red and yellow). Value stocks have lower valuations compared to growth. Similarly for bond investors, short duration bonds are less impacted by rising rates.

Think like Warren Buffett: On April 30 we will once again attend the Berkshire Hathaway shareholder meeting for our 17th consecutive year. Last year Warren said stock market volatility is like your neighbor constantly peering over the fence and asking you how much your house is worth. Pay less attention to current prices and more attention to owning a portfolio you feel comfortable with in the long run. As always we are happy to help.

Spectrum Investor® Update
as of March 31, 2022

Morningstar Category Averages	1st Qtr	1 Year	3 Year
Intermediate-Core Bond	-5.89%	-4.43%	**1.67%**
Allocation 50%-70% Equity	-4.63%	4.55%	9.85%
Large Cap Value	-0.19%	12.90%	13.55%
Large Cap Blend	-5.23%	12.10%	16.78%
Large Cap Growth	-10.76%	5.75%	**18.74%**
Mid Cap Value	-0.86%	10.87%	13.61%
Mid Cap Blend	-5.05%	5.63%	13.50%
Mid Cap Growth	-12.35%	-4.00%	15.34%
Small Cap Value	-2.01%	6.19%	13.19%
Small Cap Blend	-6.27%	1.13%	12.35%
Small Cap Growth	**-12.78%**	**-9.02%**	13.87%
Foreign Large Cap Blend	-7.05%	-1.61%	7.23%
Real Estate	-5.09%	21.77%	10.99%
Natural Resources	**8.48%**	**25.31%**	18.43%

Source: Morningstar, 3 yr return is annualized. Morningstar classifies categories by underlying holdings and then calculates the average performance of the category. Past performance is not an indication of future results. Returns in Blue = Best, Returns in Red = Worst. Please see Benchmark Disclosures on pg. 4.

DOW: 34,678
NASDAQ: 14,221
S&P 500: 4,530
10 Yr T-Note: 2.32%
Inflation Rate: 8.5% (3/22)
Unemployment Rate: 3.6%

Data as of 3/31/22 unless otherwise noted. The Dow Jones Industrial Average is comprised of 30 stocks that are major factors in their industries and widely held by individuals and institutional investors. The S&P 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The NASDAQ Composite Index measures all NASDAQ domestic and non-U.S. based common stocks listed on The NASDAQ Stock Market. Barrel of Oil: West Texas Intermediate. Inflation Rate: CPI. The market value, the last sale price multiplied by total shares outstanding, is calculated throughout the trading day, and is related to the total value of the Index. Indices cannot be invested into directly.

To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

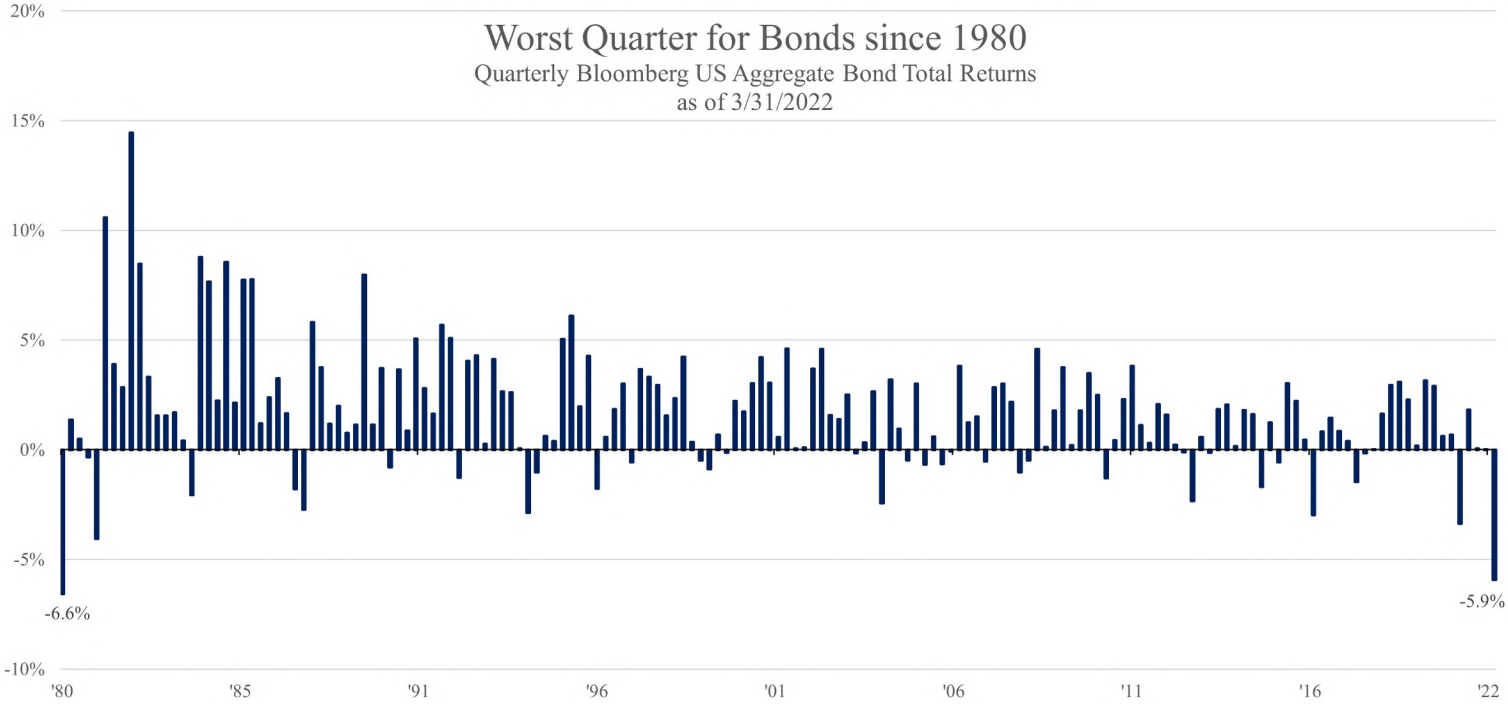
S&P 500 Index at Inflection Points: The chart below illustrates the performance history of the S&P 500 from 12/31/96 to 3/31/22. As of 3/23/20, the S&P had dropped 34% from its high, but recovered, ending 2020 up 18%. The following year the S&P rose another 28%. In the first quarter of 2022, the S&P 500 is down 4.6%. As of 3/31/22, the 10-year treasury rate rose to 2.3%, compared to the dividend yield of the S&P 500 at 1.5%. While the current yield on bonds has risen over the dividend yield of stocks, we continue to suggest slightly over-weighting stocks.

S&P 500 Index at Inflection Points

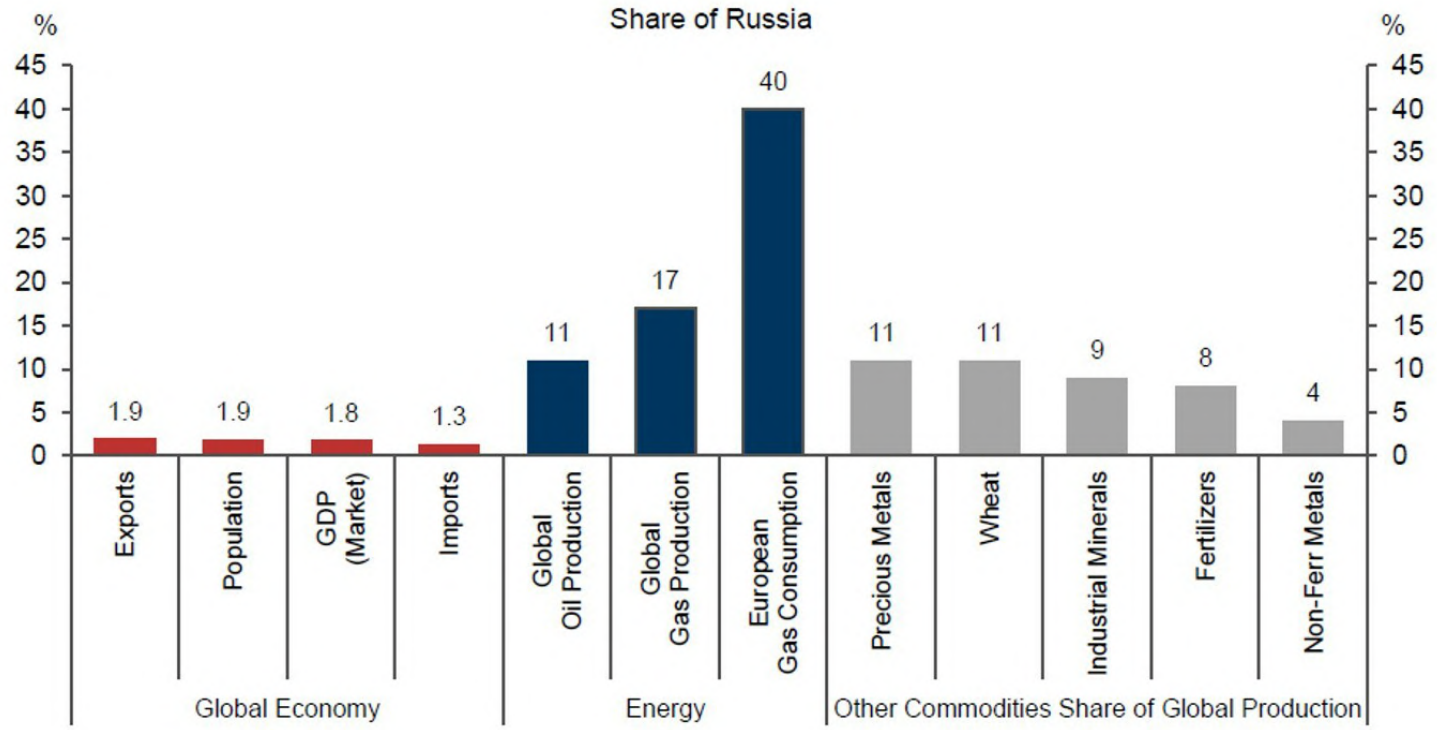
Characteristic	3/24/2000	10/9/2007	2/19/2020	3/31/2022
Index Level	1,527	1,565	3,386	4,530
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	19.5x
Dividend Yield	1.4%	1.9%	1.9%	1.5%
10-yr. Treasury	6.2%	4.7%	1.6%	2.3%

Source: Compustat, FactSet, Federal Reserve, Refinitiv, Standard & Poor's, J.P. Morgan Asset Management. Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat. Forward price to earnings ratio is a bottom-up calculation based on IBES estimates and FactSet estimates since January 2022. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns. The S&P 500 Index is a market capitalization-weighted index composed of the 500 most widely held stocks whose assets and/or revenue are based in the US. Guide to the Markets – U.S. Data as of 3/31/2022.

Worst Quarter for Bonds since 1980: Rising rates hurt bond prices to start 2022. As bonds started the year at historically low yields, the total return for bonds is more sensitive to price changes due to rising rates.



Russia's Importance to the Global Economy: While Russia does not have a major share of the global economy, it is a major exporter of commodities, particularly energy. The importance of Russia to energy markets resulted in a rise in oil prices, with US Crude rising over $116 for the first time since 2008 (*WSJ*, 3/3/22).



Source: IMF, Goldman Sachs Global Investment Research

Benchmark Disclosures

Morningstar Category Averages: *Morningstar classifies mutual funds into peer groups based on their holdings. The Category Average calculates the average return of mutual funds that fall within the category during the given time period. The following indexes and their definitions provide an approximate description of the type of investments held by mutual funds in each respective Morningstar Category. One cannot invest directly in an index or category average.* ***Intermediate-Term Bonds: Bloomberg US Agg Bond Index****–Measures the performance of investment grade, US dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS, ABS and CMBS.* ***Allocation 50%-70% Equity****–These funds invest in both stocks and bonds and maintain a relatively higher position in stocks. These funds typically have 50%-70% of assets in equities and the remainder in fixed income and cash.* ***Large Cap Value: S&P 500 Value Index****–Measures the performance of value stocks of the S&P 500 index by dividing into growth and value segments by using three factors: sales growth, the ratio of earnings change to price and momentum.* ***Large Cap Blend: S&P 500 Index****–A market capitalization-weighted index composed of the 500 most widely held stocks whose assets and/or revenue are based in the US.* ***Large Cap Growth: S&P 500 Growth Index****–Measures the performance of growth stocks drawn from the S&P 500 index by dividing it into growth and value segments by using three factors: sales growth, the ratio of earnings change to price and momentum.* ***Mid Cap Value/Mid Cap Growth: S&P MidCap 400 Index****–A market cap weighted index that covers the complete market cap for the S&P 400 Index. All S&P 400 index stocks are represented in both and/or each Growth and Value index.* ***Mid Cap Blend: S&P MidCap 400 Index****–Measures the performance of mid-sized US companies, reflecting the distinctive risk and return characteristics of this market segment.* ***Small Cap Value: Russell 2000 Value Index****–Measures the performance of small-cap value segment of Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.* ***Small Cap Blend: Russell 2000 Index****–Measures the performance of the small-cap segment of the US equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.* ***Foreign Large Cap Blend: MSCI EAFE NR Index****–This Europe, Australasia, and Far East index is a market-capitalization-weighted index of 21 non-US, developed country indexes.* ***Small Cap Growth: Russell 2000 Growth Index****–Measures the performance of small-cap growth segment of Russell 2000 companies with higher price-to-value ratios and higher forecasted growth values.* ***Real Estate: DJ US Select REIT Index****–Measures the performance of publicly traded real estate trusts (REITs) and REIT-like securities to serve as proxy for direct real estate investment.* ***Natural Resources: S&P North American Natural Resources Index****– Measures the performance of US traded securities classified by the Global Industry Classification Standard (GICS) as energy and materials excluding the chemicals industry and steel but including energy companies, forestry services, producers of pulp and paper and plantations. Past performance is no guarantee of future results. This report is for informational purposes only and should not be construed as a recommendation or solicitation to buy or sell any security, policy or investment.* ***PE Ratio*** *is the measure of the share price relative to the annual net income earned by the firm per share.*