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SUMMARY

- The Fed is using three monetary tools to combat inflation.
- Markets are now anticipating as many as nine rate hikes.
- We think stocks are still expected to outperform bonds.

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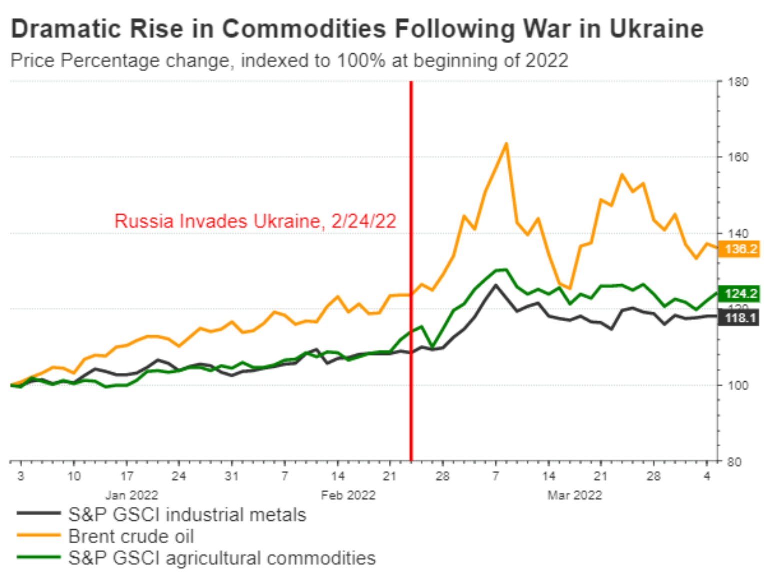
The Rule of Three

Three Fed Responses to Inflation, Three Possible Market Outcomes: How We Are Dimensioning the Macro Risks to Stocks This Year

As we laid out in last week's *Quarterly Commentary*, markets witnessed several major macro events in the first quarter; some expected and some not. These included rapid economic recovery from COVID-19 dislocation and geo-political conflicts (Russia/Ukraine and China). Unfavorable resolution of any or all of these raise the risk of high inflation becoming structural.

Central bankers, governments and markets have a handful of tools at their disposal to try and avoid runaway inflation. Since the economic impact associated with each tool varies, the process will look more like a feedback loop, with each financial constituent interpreting the other's actions and reacting in real time. This feedback loop is likely to lead to elevated uncertainty, hence the analogy in our 2022 Outlook of market volatility reminiscent of riding a mechanical bull.

In our *2022 Outlook*, we listed high inflation, which caused the Fed to tighten faster than expected, as one of the major risks to the market this year. At the time, we believed that inflation would peak in '22, but had not anticipated war in the region of some of the world's largest producers of energy and agricultural commodities (see chart, left). Today's *Weekly* represents an attempt to update our views regarding inflation and Fed Policy in light of the war in Ukraine, and to provide a series of scenarios of what we think are the likely Fed actions and stock market outcomes.



Source: Refinitiv Datastream / Fathom Consulting, RiverFront data daily as of 04.06.2022. Chart shown for illustrative purposes only.

The Fed's Toolkit to Affect Demand Through Interest Rates: The Fed has a variety of tools at their disposal to alter the level and path of inflation; three of these were used in the first quarter to combat inflation that remains too high for policymakers, consumers, and investors:

1. **Adjusting the Short-Term Funds Rate:** Fed increased the target range by 0.25%.

2. **Quantitative Tapering/Tightening:** Fed further slowed purchases of bonds and signaled they will be starting to reduce the size of the balance sheet as early as May.

3. **Signal Future Rate Increases:** Fed increased their expectations from three to as many as 8-9 rate hikes in 2022.

Each of these three actions has the goal of curbing inflation, though the Fed must rely on the response of consumers, corporations, and governments for their monetary policy to be successful. For example, when determining production targets, companies must consider the cost of input and the cost of financing. With inflation increasing input costs, incentives must exist to increase the supply of goods, which lowers prices, or for innovative solutions to reduce other costs. The major areas for longer-term innovation appear to be in global shipping/logistics alongside alternative sources of energy. Innovations in either of these areas should reduce the cost of getting goods to consumers, though clean energy will take longer to affect prices, in our view.

The Fed's guidance has been particularly important to Chairman Powell and has arguably been the most important of the three tools so far. Although they have only increased rates a single time, Chairman Powell's signal regarding future rate hikes has pushed 2-year Treasury note yields to 2.5% over the same period. Thus, the bond market has already largely anticipated the full 2022 guidance. In addition, interest rates of all maturities have risen significantly, causing the worst start to any year for the Bloomberg Global Aggregate Bond Index since its creation in 1990. For consumers, this is evident in 30-year mortgage rates, which have risen from below 4% to above 5%. When combined with high oil prices, this rise in rates reflects a much more restrictive policy than a 0.25% Fed hike would suggest.

Process Over Prediction: Three Scenarios of How This Might Play Out Over 2022

At RiverFront, our portfolio strategy relies less on trying to predict the future, and more on our process of preparing ahead of time to understand possible outcomes and their implications. Our discipline uses historical data combined with experience to determine which scenario the market is trending towards, and then seeks to dynamically adjust portfolio positioning accordingly.

The good news is that for now, longer-term views of inflation reflected in both economist surveys and long-term bond yields are still muted, meaning investors believe supply-side solutions to inflation will alleviate the problem in the long run. We believe there are three outcomes related to inflation; we consider our base case to be the most likely outcome, but we admit that the situation is fluid.

Pessimistic Outcome: Fed stomps the brakes, sending the economy into recession: the Fed comes to believe that the risk of runaway inflation exceeds the risk of wealth destruction due to overseas geopolitical issues and/or COVID-19, and thus applies overly aggressive tightening measures that exceed current market expectations.

Base Outcome: Fed achieves moderation; markets slow but remain positive: the Fed tightens enough to have a positive impact on inflation while not upsetting the economy's measured economic growth. We think this should be good for stocks.

Optimistic Outcome: Inflation subsides as high prices quell demand and spur supply: the Fed believes that market forces will correct inflation long term, and that their current interest rate targets are either enough or

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more than needed to combat inflation. This is our most optimistic scenario for stocks. Below is a table of key issues and how they might play out:

	Pessimistic Case	Base Case	Optimistic Case
Geopolitical Conflict	Conflict re-escalates and China and Saudi Arabia join Russia's side. This combination could control critical shipping lanes and the supply of electronics and oil.	Ukrainian conflict resolves in a stalemate – geopolitical tensions ease but restructuring of global supply chain is minimal.	Ukrainian conflict fully re-engages NATO, and trade deals are made that help create alternate commodity and supply chain hubs; Latin America, Southeast Asia and Northwest Africa are all candidates.
COVID-19 Recovery	A new variant emerges that restarts lockdown either everywhere or in critical supply chain areas and growth regions; stagflation becomes likely.	COVID-19 continues its current trajectory of being more contagious and less lethal. Supply chains resume full capacity, which helps relieve inflation by the end of 2023.	Inflation cools because of slowing Chinese demand considering their Zero-Tolerance COVID-19 Policy. Longer term, high prices increase supply and create an ideal environment of moderate inflation.

In the **Pessimistic Case,** very few asset classes perform well – commodities and cash will be notable exceptions, much like the most recent quarter, although more protracted. Fixed income will lose its status as a safe asset. Finding uncorrelated assets will be critical. Tactical shifts will be necessary to protect against a recession.

In the **Base Case**, we believe stock returns will be more muted than what we have come to expect over the last few years, but still better than bonds. We would continue to advocate for strategic purchases of corporate bonds with shorter maturities, bank loans and high-yield bonds, as well as covered call strategies (see *Weekly View*, 7/19/21, for more information on our views of covered call strategies).

The **Optimistic Case** is a higher return version of our Base Case. In this scenario, we believe the covered calls and high yield strategies will meaningfully underperform value-oriented equity strategies, although they will perform much better than core fixed income.

The common takeaway across all scenarios is that we think equities should continue to protect portfolios against inflation better than bonds, and that we believe covered calls are likely a great strategy for downside defense and income until interest rates rise. Value-oriented equities should perform well, as should commodity-oriented countries, in our view. We believe Fixed Income strategy should focus on shorter duration credit.

Implications for Different Investor Outcomes

- **Accumulate:** 'Accumulate' investors will face emotional challenges in the pessimistic-case outcome as the value of their portfolios may fall. However, dollar cost averaging through a period of sideways or down markets will be helpful for long term returns and maintaining a long-term outlook will be especially important in our view. The base and optimistic scenarios should work out well for accumulate investors, but they might want to consider raising the equity portions of their portfolios since low interest rates lead to low returns for fixed income and cash long term.
- **Sustain: '**Sustain' investors will initially struggle with the pessimistic-case outcome because the downside defense characteristics of bonds will not work as expected. We believe these investors should gradually accumulate Treasuries and Fixed Income as yields rise. As yields go up, we believe the protection potential offered by bonds will increase. To the extent that Sustain investors own longer maturity bonds, the rising interest rate environment will be challenging, but the base and optimistic-case outcomes will support the stock portions of their portfolios and high-quality equities should provide growing dividend income, in our view.

- **Distribute:** While total returns will be lower in the pessimistic case scenario for all the outcomes, 'distribute' strategies will be able to re-invest in higher yielding assets in the pessimistic-case scenario. In the base case, using the covered call and high yield strategies might be helpful for income. The optimistic case presents challenges on the income side for distribute investors since yields will likely compress and the portfolio will not produce sufficient income. In this scenario higher stock weightings and systematic withdraws are required to supplement cashflow requirements, in our view.

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Standard & Poor's (S&P) 500 Index TR USD (Large Cap) measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Bloomberg US Aggregate Bond Index TR USD (Fixed Income Investment Grade) is an unmanaged index that covers the investment grade fixed rate bond market with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. The issues must be rated investment grade, be publicly traded, and meet certain maturity and issue size requirements.

Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

An option is a contract sold by one party to another that gives the buyer the right, but not the obligation, to buy (call) or sell (put) a stock at an agreed upon price within a certain period or on a specific date. A covered call option involves holding a long position in a particular asset, in this case U.S. common equities, and writing a call option on that same asset with the goal of realizing additional income from the option premium. Certain ETFs use a covered call strategy. By selling covered call options, the fund limits its opportunity to profit from an increase in the price of the underlying index above the exercise price, but continues to bear the risk of a decline in the index. A liquid market may not exist for options held by the fund. While the fund receives premiums for writing the call options, the price it realizes from the exercise of an option could be substantially below the indices current market price.

In a rising interest rate environment, the value of fixed-income securities generally declines.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero).

Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

Buying commodities allows for a source of diversification for those sophisticated persons who wish to add this asset class to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any commodity purchase represents a transaction in a non-income-producing asset and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.

For each outcome category (accumulate, sustain, and distribute) RiverFront's portfolio management team has assigned one or more RiverFront product(s) based on their assessment of the product's investment objective as it relates to a typical client's return and risk objectives when seeking investment outcomes of accumulating wealth, sustaining wealth and distributing wealth. The team has also designated RiverFront product alternatives for those clients looking to take more or less risk with the outcome category. The 'more aggressive' (or more risk) alternatives will generally have greater equity and international exposure as well as longer time horizon targets, while those designated as 'more conservative' (or less *risk) will have fewer equities, a lower exposure to international and shorter time horizon targets. Since the risk assessments are dependent on the outcome category selected, RiverFront products may fall in multiple categories. All investments carry a risk of loss and there is no guarantee that an investment product or strategy will meet its stated objectives.*

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