PrivateWealth Partners, LLC

FIRST QUARTER 2022 REVIEW

Dear Friend,

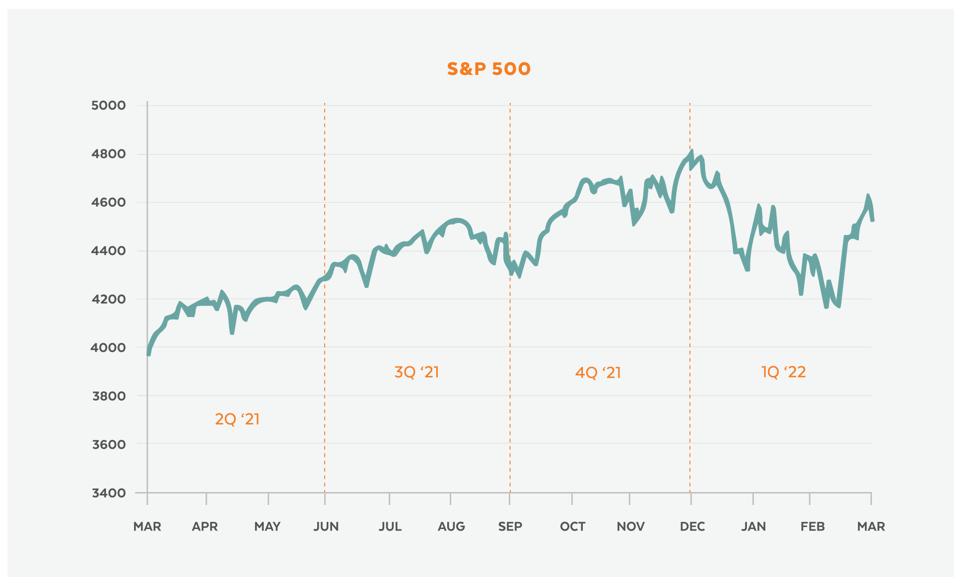
April 11, 2022

Stocks started the new year on a volatile note. Persistent inflationary pressures amidst a strong jobs recovery have pushed the Federal Reserve to adopt a more hawkish monetary policy stance, and Russia's needless war continues to disrupt commodity markets while weighing heavily on sentiment. U.S. and global stocks spent the first half of Q1 pricing-in these variables—from January 1 to the invasion on February 24, the S&P 500 declined -11.3%.

As we noted in our intra-quarter February 25 letter, however, equities have a tendency to bounce back once a conflict breaks out. Historically, this recovery happens not because armed combat is bullish, but because fighting ends the uncertainty surrounding a possible war. Markets can then weigh the downstream effects of the conflict and associated economic sanctions, to determine whether these effects might be significant enough to trigger a global recession.

From the February 24 invasion to the end of the quarter, all 11 S&P 500 sectors moved higher and the broad index rallied +7.4%. The sharp correction and partial recovery in the first three months of 2022 left the S&P 500 index down -4.6% for the quarter, a reasonably modest decline, especially considering the U.S. stock market's strong performance cumulatively across 2019, 2020 and 2021 (90+% in gains).

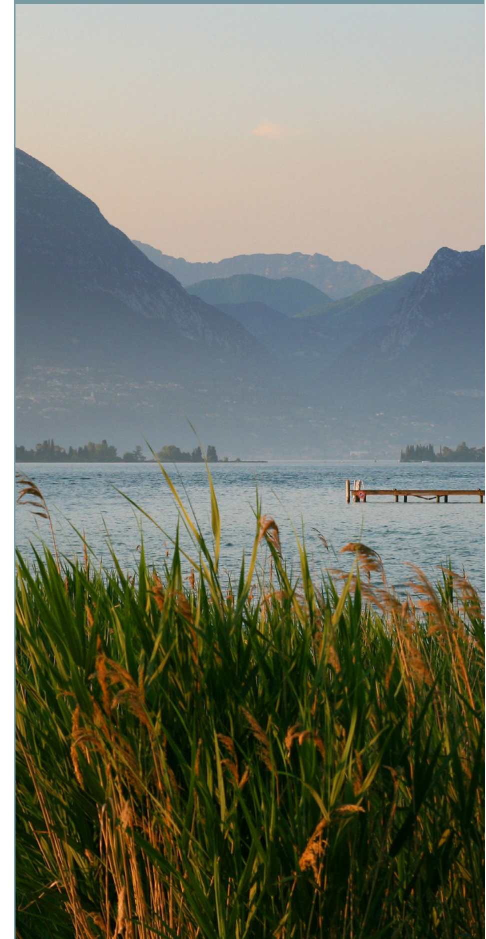
THE S&P 500 OVER THE PAST YEAR



Source: Strategas Research

"The intelligent investor is a realist who sells to optimists and buys from pessimists."

\- BENJAMIN GRAHAM



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Growth stocks rallied starting in mid-March, but investors clearly favored value stocks amidst the heightened volatility, with value outperforming growth by an +8.4% margin for the quarter. The S&P Energy sector posted sizable gains (+39%) as oil prices surged above $100 a barrel and the earnings outlook for the energy complex greatly improved. Shortly after the war broke out, crude oil prices traded as high as $133 a barrel but have since hovered around the $100 a barrel mark. On the negative side, Technology (-8.4%), Consumer Discretionary (-9.0%) and Communication Services (-11.9%) were among the hardest hit. These latter sectors have relatively higher valuations.

Private Wealth Partners continues to believe the risk of a recession and bear market in 2022 is lower than what is largely circulated in the media. But we also believe investors should brace for more market volatility and the possibility that this correction could continue, as some of the strong forces that have driven the market higher are now headwinds. Going back to 1928, the average peak-to-trough pullback in a given year was -16.3%, and corrections frequently span months. More choppiness seems likely ahead.

From an investment strategy standpoint, however, certain areas of the U.S. equity market remain attractive. The U.S. has less exposure to Russia than almost every major economy, employment data is accelerating (supporting incomes and consumption), corporations continue to invest in software and IT, and households (in aggregate) have experienced a sharp increase in wealth over the past few years. Consensus estimates have the U.S. economy growing 3+% in 2022.

U.S. stocks also continue to look attractive relative to bonds. The rising rate environment has bond prices in decline—according to the April 1, 2022 Morningstar Market Update, Q1 2022 was the worst quarter for bonds in 20 years, with long-term core bonds returning -11.3%. Because inflation remains high, the real rates on bonds (which are nominal bond yields minus the inflation rate) are also locked in negative territory. As of this writing, the 10-year U.S. Treasury bond yield is at 2.75%, up from 1.44% just three months ago.

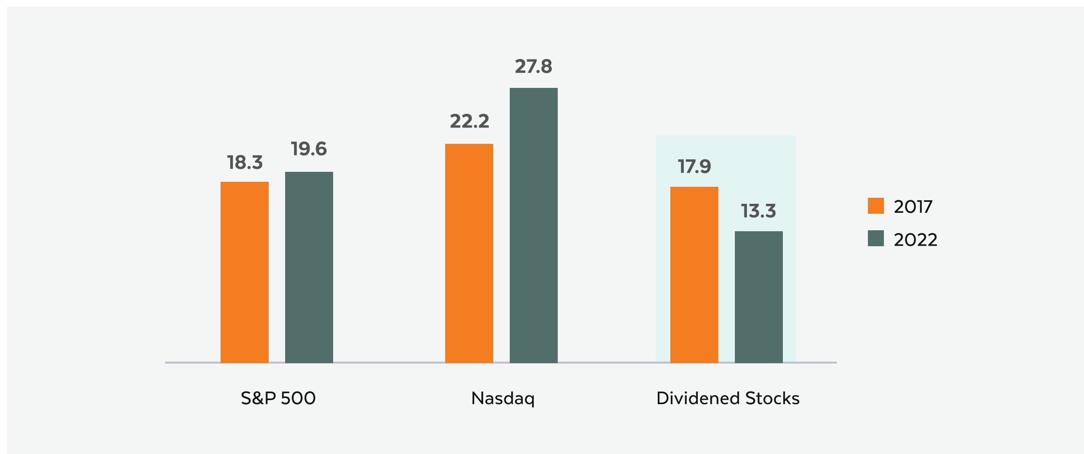
Private Wealth Partners is underweight bonds and the credit market, and we are favoring U.S. equities with an overweight to high quality dividend growth stocks. We explain this positioning below, and share some economic insights later in the review.

HIGH-QUALITY DIVIDEND GROWTH STOCKS IN THE CURRENT ENVIRONMENT

Focusing on quality, cash flow, growing earnings, and dividends can help buffer an investment portfolio against market turbulence. Dividend stocks in particular look compelling in the current economic climate. Historically, dividend stocks are less sensitive to interest rate risk and inflation, and they currently offer relatively attractive valuations.

While stocks in general have become pricier over the past five years, high dividend paying stocks are actually trading at more attractive valuations today compared to 2017 (see chart on the next page).

FORWARD P/E RATIOS OF THE S&P 500, NASDAQ, AND DIVIDEND STOCKS



Source: Blackrock

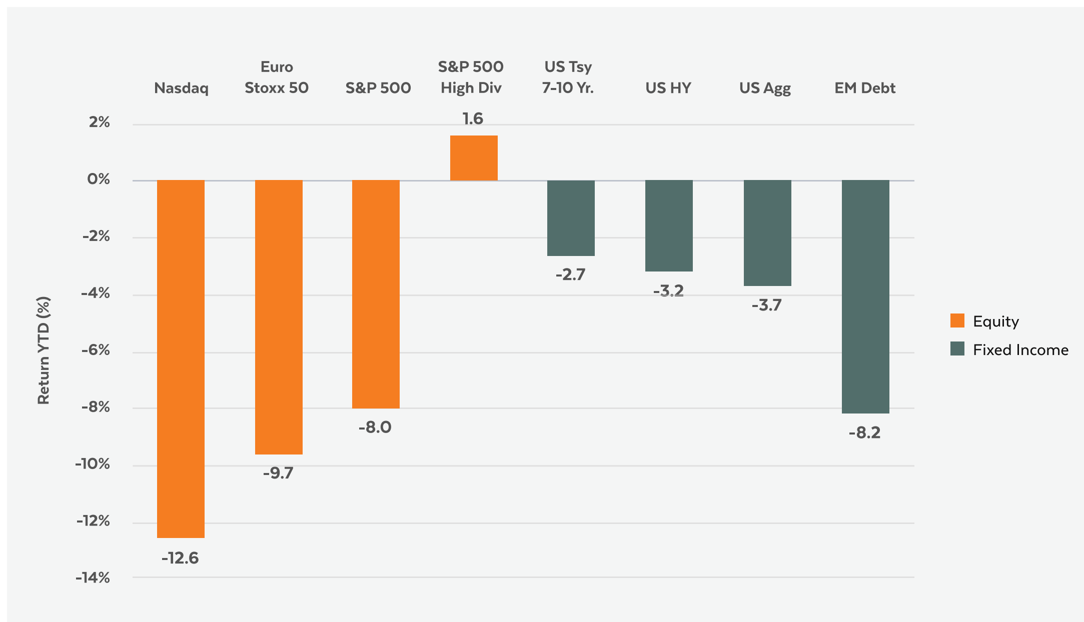
Goldman Sachs also notes that a portfolio of sector-neutral high dividend yield stocks currently trades at a -26% P/E valuation discount to the S&P 500, which is well below the long-term average of -12%.

Dividend stocks have also performed well during periods of elevated inflation and rising interest rates, which aptly describes the current setup in the U.S. economy. Our research indicates that when inflation runs in the 5% to 7% range—which is basically where it is now—a strategy of owning the top dividend payers has outperformed the broad S&P 500 index historically. Private Wealth Partners is actively pursuing dividend payers in more recession-resistant areas of the market, which we believe will serve as a hedge against volatility.

Rising interest rates have also historically impacted dividend stocks less than other categories of stocks. For example, over the past year, the Nasdaq 100 returns have been more tightly correlated to interest rate returns (10-year U.S. Treasury bond) than usual, which helps explain why growth stocks may continue to struggle as bond prices fall. Conversely, dividend stocks (S&P 500 High Dividend Index) have been negatively correlated to bond prices and interest rate returns over the past few years, arguably making dividend stocks a diversification hedge in a rising rate environment.

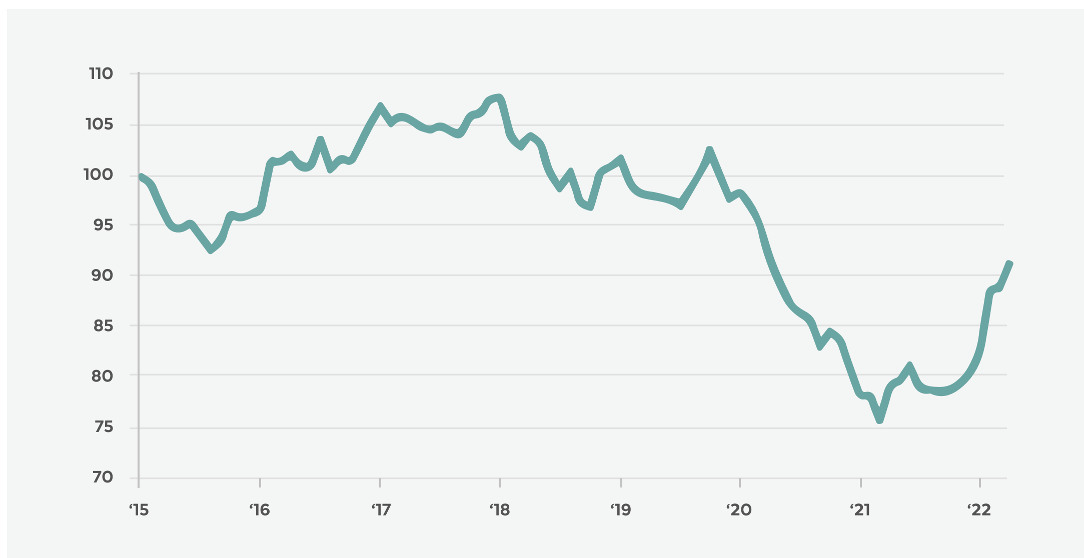
Dividend stocks' performance has held up in 2022 so far, consistent with the historical patterns described above. As you can see in the two charts on the next page, S&P 500 dividend stocks have outperformed while other asset classes and categories of stocks have fallen:

ASSET CLASS RETURNS IN JANUARY - FEBRUARY 2022



Source: Blackrock

S&P 500 DIVIDEND PAYERS RELATIVE TO NON-PAYERS



Source: Strategas Research

The case for positioning in dividend payers is strong, but 2022 also presents an environment where rising input costs could impact dividend programs. In fourth quarter 2021 earnings calls, corporate management teams discussed rising input costs as a headwind to margins, but the overarching takeaway was that corporations believed their investments in their employees would ultimately yield stronger growth and that, in many cases, they could use pricing power as a core strategy for margin protection.

In our research, we see logical reasons for why inflation can actually be supportive of raising nominal S&P 500 dividends. Interestingly, Goldman Sachs actually raised its forward S&P 500 index dividend estimates in early March (post-Ukraine invasion), while at the same time forecasting well over $1 trillion in corporate buybacks. Private Wealth Partners will be monitoring whether wage inflation ultimately proves a stronger headwind to margins than companies expect, which could force some companies to cut back on buybacks and ultimately dividend programs.

ECONOMIC OVERVIEW

From 2009 to 2019, consumer price inflation (CPI) in the U.S. averaged 1.77%. In February 2022, inflation was running at 7.9% with few signs of abating quickly, marking the highest year-over-year pace of inflation since January 1982. The producer price index, which measures input costs to businesses, is even higher.

Inflation is not just limited to food and energy. CPI is rising in virtually all categories, from goods to services to home prices and rent. The pandemic and related fiscal policies were no doubt the initial drivers of elevated inflation as consumers spent extra dollars on goods rather than services like dining out, travel and hospitality. The resulting supply-chain problems included factory closures, labor shortages, and shipping bottlenecks which all came together to cause rising goods inflation. These inflationary pressures were poised to at least partially resolve themselves in the first half of 2022. Then Russia invaded Ukraine.

In the wake of the war, commodity prices have surged across many different categories, like oil, natural gas, palladium, wheat, and fertilizer. Shortages of some commodities and rising prices across the board have already begun to reverberate across the global economy, leading to even more inflationary pressures and supply chain issues. As the conflict wears on and more sanctions appear likely, commodity supplies will remain tight and inflationary pressures on the real economy will probably remain elevated.

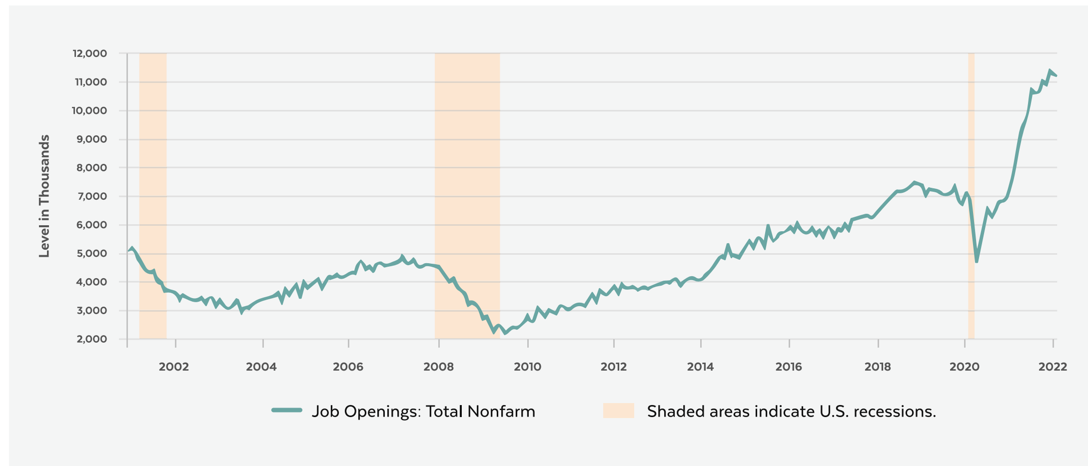
This environment has reset interest rate expectations higher and has arguably contributed to volatility in the stock market. The Federal Reserve raised the benchmark fed funds rate by a quarter point at their March meeting, but Chairman Jerome Powell and other Fed governors have indicated the Fed's willingness to be more aggressive—suggesting half-percentage point increases are on the table. Fed Governor Lael Brainard, who is awaiting Senate confirmation to serve as the Fed's vice chairwoman, said recently that the central bank will start reducing its balance sheet "at a rapid pace as soon as its May meeting," which notably drove selling pressure in the stock market in the days following her comments.

The U.S. economy faces plenty of headwinds, but a balanced view should also acknowledge solid economic fundamentals that signal more growth ahead.

In the latest jobs numbers release in March, U.S. employers added 431,000 jobs with particularly strong hiring in services industries like restaurants and retail. The Labor Department also said that hiring in January and February was stronger than initially reported, signaling that the jobs market is better than most appreciate.

The latest release was the 11th straight month where job gains totaled more than 400,000, which marks the longest stretch of consecutive gains dating back to 1939. The unemployment rate fell to 3.6%, which now puts it very close to its pre-pandemic level of 3.5% (which is also a 50-year low). As the chart below shows, there are a historically high number of jobs available in the U.S. economy.

JOB OPENINGS IN THE U.S., 2001 - PRESENT

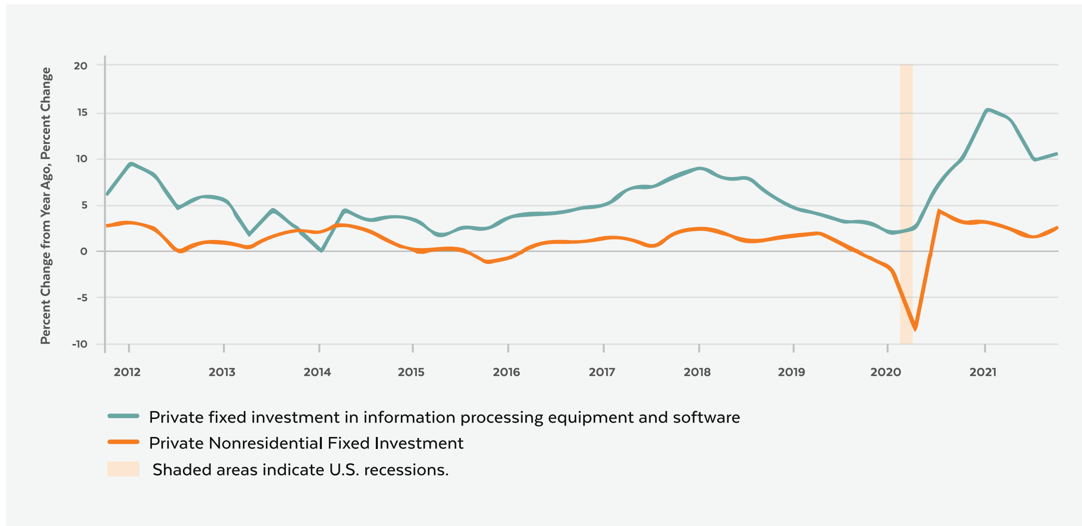


Source: Federal Reserve Bank of St. Louis

U.S. corporations are also flush with cash and have been investing at a solid clip. Private nonresidential fixed investment – a proxy for business investment – jumped 7.4% in 2021, even when adjusting for inflation. This uptick in business spending marked the fastest rate of increase since 2012.

Perhaps not surprisingly, U.S. businesses spent the most on software and information-processing (blue line in the chart on the next page), as the need to 'digitize' business operations was catalyzed during the pandemic and is bound to grow as remote work becomes the norm. Spending in this area of IT rose a stout 14% in 2021. The trend of ramping up business investment looks poised to continue: manufacturing firms surveyed by the Institute for Supply Management said they plan to increase investment by 7.7% in 2022, and services firms – which comprise a majority of the U.S. economy – expect a 10.3% increase.

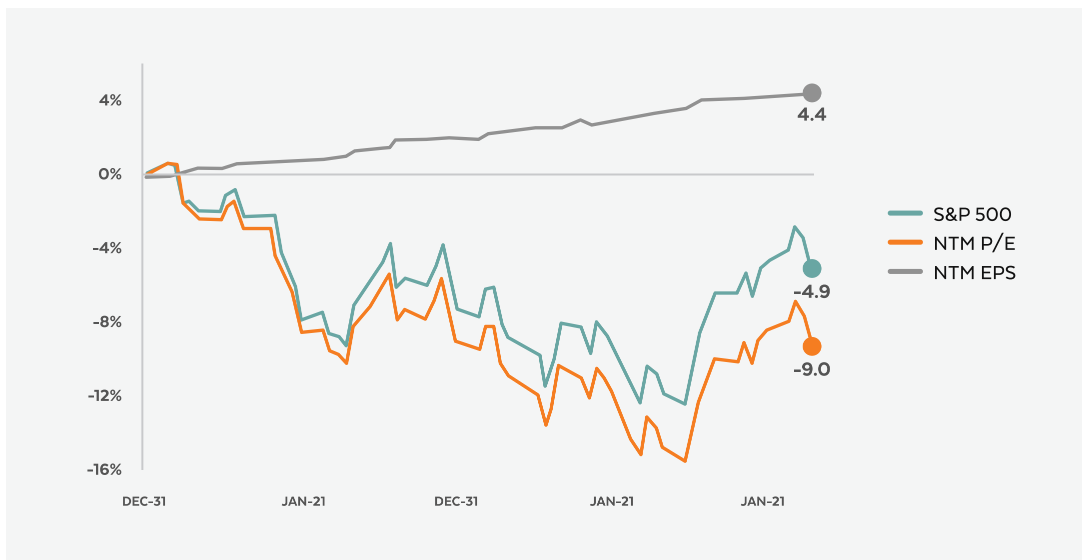
BUSINESS INVESTMENT ON THE RISE, PARTICULARLY IN SOFTWARE AND IT



Source: Federal Reserve Bank of St. Louis

Finally, the earnings outlook for American corporations remains positive for 2022. Though analysts decreased earnings estimates in aggregate for Q1 2022, they also raised earnings-per-share (EPS) estimates for the balance of the year. According to Credit Suisse, forward 12-month EPS estimates increased by 4.4% in the first quarter. Credit Suisse also notes that while earnings estimates were rising, stock prices were falling (see chart below), which caused the forward 12-month P/E ratio for the S&P 500 to fall from 21.3x to 19.5x during the first three months.

PERCENT CHANGE IN S&P 500 INDEX, EPS AND P/E RATIO (YEAR-TO-DATE)



Source: Credit Suisse

CONCLUSION

Investors are weighing a laundry list of unknowns in the current environment—how quickly the Fed will raise rates, whether and when inflation will moderate, how long Russia's war will continue, whether the war escalates and turns global, and whether the pandemic is truly over. Our base assumption is that equity market volatility will continue as these questions continue to weigh on sentiment.

At the same time, history reminds us that diversified, high-quality portfolios can be resilient in the face of headwinds. While inflation and higher interest rates are likely to pressure valuations in certain areas of the stock market, we believe this will lead to greater dispersions among equity market segments and an increased need for active managers to migrate to higher quality companies. Our focus in the first half of 2022 is to own highly profitable companies with strong cash flows and solid dividend growth.

Finally, as a quick housekeeping note, Private Wealth Partners' new Form ADV, Brochure, Brochure supplements, and Form CRS for 2022 are available for clients upon request. You can also visit our website, www.pwpart.com, to download these forms.

If you have any questions about this review or your investment portfolio, please do not hesitate to reach out to us. We hope you have a wonderful spring season, and as always, we thank you for your support and for your continued confidence.

Sincerely,

Kenneth F. Siebel | William F. Dagley | David P. Wong

Elyse Gottschalk | Richard G. Kuchen | James Lenczowski

Jason M. Saxon | Chris Greene | Katrina Sutherland

Vickie Marinovich

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