ASSET ALLOCATION PLAYBOOK

INTRODUCTION

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INTRODUCTION

Ashton Thomas Asset Allocation Team

MIKE SERIO CFA®, CAIA®, MBA

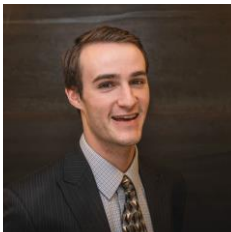
Director of Wealth Management

Mike is focused on ensuring access to high-quality advice for our advisors and their clients. He supports the Asset Allocation and Advanced Planning teams by weighing in on the financial markets and economy, investment due diligence processes, and overall plan development for the firm's top clients.

CLAUDIU BARBOS

Director of Fixed Income, Portfolio Manager

Claudiu directs the Asset Allocation Team and supports advisors through monitoring financial markets and economic data, interfacing with third-party money managers, and overseeing trading functions. He also writes commentary on the markets and economy for the firm.



KODI THRUSTON

Investment Analyst

Kodi assists the Asset Allocation team with research related to the financial markets, economy, and the firm's institutional asset managers. He also supports the firm's trading functions.

MACRO VIEW

The Paradigm Is Shifting

Of all the questions investors are dealing with at this time—and there are a lot, for sure—the overriding question is this: Can the Federal Reserve get monetary policy correct without causing a recession? The world hasn't seen this many disruptions in some time. The lingering effects of the pandemic, Russia's continued invasion of Ukraine, energy, metals, and agriculture prices spiking, supply chain bottlenecks, and the yield curve inversion are just some of the issues investors are facing at this time. The quarterly Playbook is written as a guide to help our advisors and clients navigate through times just like these.

One school of economic thought believes recessions are triggered by mismanaged Fed policy.[1,2] The stated goals of the Fed are "maximum employment", "stable prices," and "moderate long-term interest rates,"[3] the latter two being focused primarily on inflation control. Since the Great Financial Crises, the Fed zeroed in on full employment and price stability,[4] with an apparent emphasis on the former. At the time of this writing, the latest U.S. Unemployment Rate stood at 3.6%,[5] which is generally thought of as maximum employment, meaning nearly everyone who wants to be employed is. The more important figure is the participation rate which represents people in the labor force. That stood at 62.4%[4] as of March 2022, a level last seen in March 2020. Since consumer spending, which depends heavily on employment, is approximately 68% of the U.S. economy, [6] this would seem to bode well for markets.

The current employment picture and number of job openings[7] combined with the Fed's ongoing "loose" monetary policy would ordinary signal positive economic growth for the rest of 2022. However, the Fed has little choice but to raise interest rates and cut back on quantitative easing to fight the ongoing, non-transient inflation the economy is experiencing. While we believe the Fed is currently targeting a Personal Consumption Expenditures (PCE) Price Index of closer to 3%, the ex-food-and-energy number for this index came in at 5.4% as of February.[8] It is obvious to any Fed observer that it's time for the monetary policy brakes to be applied. To what extent, however, is yet to be determined.

1 https://www.politico.com/news/2022/03/29/federal-reserve-recession-inflation-rates-00021119
2 https://www.etftrends.com/2016/09/the-100-year-learning-curve-fed-policy-and-recessions/
3 https://crsreports.congress.gov/product/pdf/RL/RL30354/107, see "Summary"
4 https://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm
5 United States Labor Force Participation Rate - March 2022 Data - 1948-2021 Historical (tradingeconomics.com)
6 Shares of gross domestic product: Personal consumption expenditures (DPCERE1Q156NBEA) | FRED | St. Louis Fed (stlouisfed.org)
7 https://tradingeconomics.com/united-states/job-offers
8 https://www.bea.gov/news/2022/personal-income-and-outlays-february-2022

The Paradigm Is Shifting

While most market sectors and indices were negative in the first quarter,[9] we continue to forecast above-average market volatility. The war in the Ukraine brings much uncertainty as to the outcome and total economic and human toll. What we know is that economic sanctions along with the deglobalization of trade are longer term trends. First quarter corporate earnings are likely to come in on a positive note overall, but with possible continued inflation, those earnings will be worth less over time than in a disinflationary environment. Politically, it looks like corporate and personal taxes will rise eventually, as least in the short term, and the chance that inflation will remain with us for a while grows every week. As a result, we continue to believe that we are in the midst of a paradigm shift not seen in over 40 years. As a firm, we are advising active management within our diversified portfolios to increase probabilities of meeting client financial goals and managing risk appropriately.

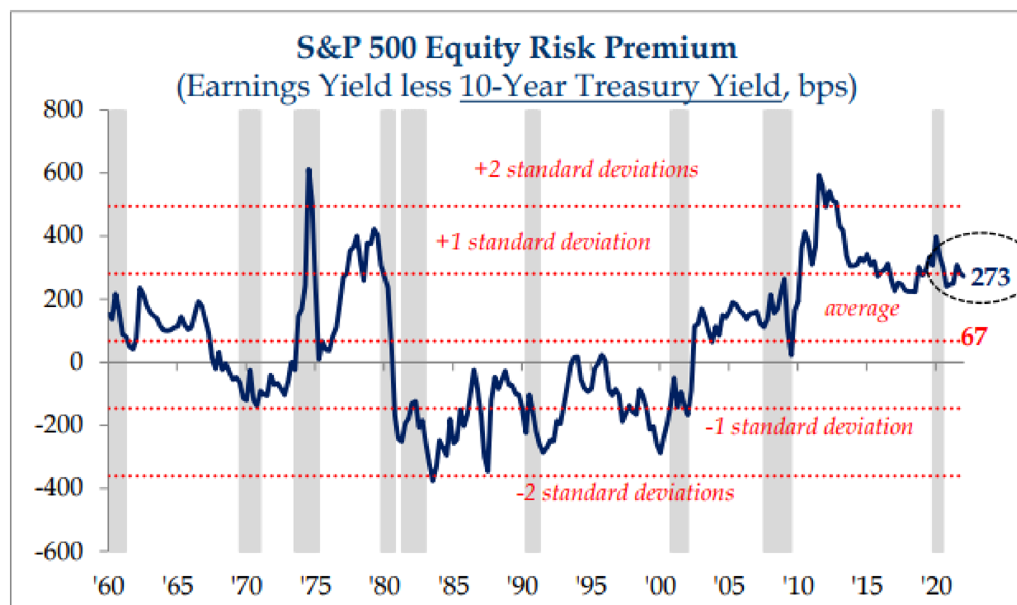
Given that we will probably see more volatility this year, we believe the outsized returns we experienced from the bottom of the pandemic market two years ago are not sustainable going forward. As markets never go straight up (or straight down), patience could be the operative attitude. As Warren Buffett wrote, "The stock market is a device to transfer money from the impatient to the patient."[10] Let us all remember that investing is a journey.

9 https://www.msn.com/en-us/money/news/stocks-just-posted-worst-quarter-since-covid-market-crash-e2-80-94but-buffetts-new-favorite-sector-logged-meteoric-ascent/ar-AAVJtXp

10 https://www.forbes.com/sites/investor/2018/01/30/winning-in-the-market-with-the-patience-of-the-wright-brothers-and-warren-buffett/?sh=15ab485b633b

The Case for Shorter Duration Equities

EQUITY RISK PREMIUM STILL SUPPORTIVE OF EQUITIES



Source: Strategas

When one undertakes the long and arduous process of working toward and earning a Chartered Financial Analyst (CFA) designation, two theoretical topics among many are required understanding. The first is the concept of *equity risk premium* or, more simply put, how much additional return stocks must produce to compensate an investor for moving from bonds to stocks. This is the earmark of *risk aversion*.

Presently, with stock markets off their all-time highs, the equity risk premium is more attractive than it had been even three months ago. Although not a good timing tool, this is telling us that valuations are more attractive than they were going into the new year. Although there is always the risk of an exogenous shock collapsing markets, we think at present there is a relatively low risk of significant market drawdowns. Future stock market returns compared to bonds look somewhat attractive at this point.

The Case for Shorter Duration Equities

HOW SENSITIVE YOUR STOCKS ARE TO RATES WILL SOON BE CLEAR

Higher share prices relative to earnings explain half the returns of the S&P 500 over 10 years. That proportion rises to 60% for the technology-heavy Nasdaq as Alphabet, Meta Platforms and Amazon.com left "old economy" banks and utilities in the dust…Sector averages are misleading, however. Within tech, the implied duration of Amazon and Netflix is above 23 years, whereas International Business Machines and Intel are closer to the market average and Hewlett-Packard Enterprise, a laptop and printer maker, ranks near the bottom at less than 14 years.

***The Wall Street Journal*, March 21, 2022**

Source: Strategas

Another theoretical concept a CFA candidate needs to master is *duration*. We can simplify the definition as this: "The number of years required to receive the present value of future payments, both interest and principal, from a bond. The concept of duration is used to relate the sensitivity of bond price changes to changes in interest rates."[1] Although this concept is generally applied to bonds, it can also be thought of when investing in equities.

Since approximately 1995, technology stocks have outpaced all other sectors of the S&P 500.[2] One characteristic of this sector is that cash flow to investors, whether those flows come in the form of retained earnings or dividends, are sometimes enjoyed well into the future. Think of the income these growth stocks produce as analogous to long-term, 30-year bonds. When interest rates are falling or we are in a disinflationary (falling inflation) environment, long-term bond returns are attractive.

1 https://financial-dictionary.thefreedictionary.com/Duration
2 https://tinyurl.com/3dx46awc (Source: Yahoo Finance; URL shortened)

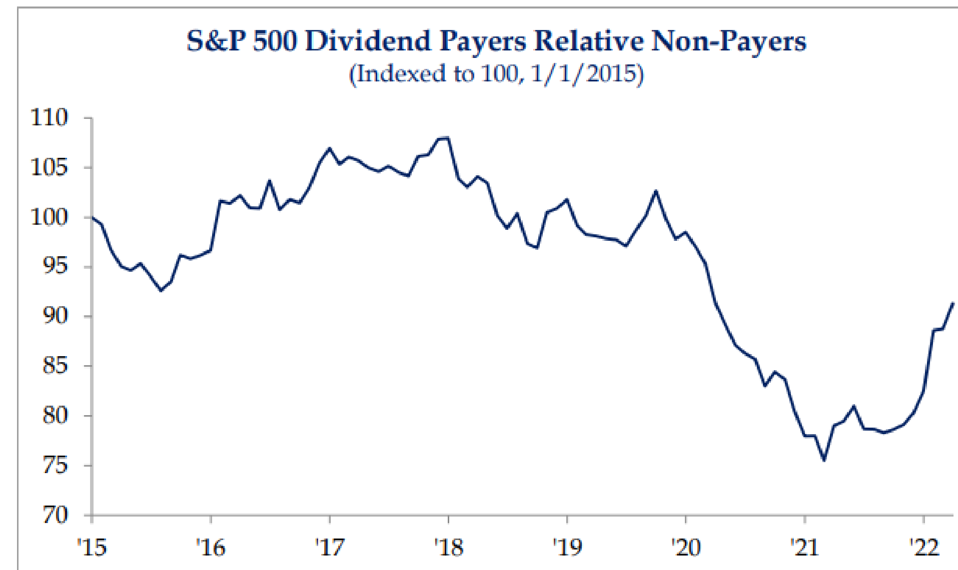
The Case for Shorter Duration Equities

After inflation and interest rates started to fall in the 1980s,[3] the economy has generally enjoyed good times. Since the great financial crises, the world's central banks have given investors artificially low, and even negative, interest rates. As the money supply kept growing and rates stayed low, this gave us another acronym: TINA, meaning There Is No Alternative. The rates found in bond—or lack thereof—made the risk premium for stocks very low, especially for long-duration, technology issues. Some of these companies made up for no earnings or dividends by essentially saying to investors, "When we have earnings, that means we are running out of new ideas."

Contrast that environment with the present. Inflation is now less transitory than the Fed thought and short-term rates, the traditional habitat of the central bank, are rising to cool the economy. The Fed is now more concerned about inflation than employment. Intermediate-term rates are also up, as the Fed is discontinuing its aggressive quantitative easing (QE). We believe it is important to remember that we are on the verge of what is possibly the single most important change in the financial markets in more than a decade: the QE era is coming to an end.

With rates rising we believe the better alternative to long-duration bonds and tech stocks are shorter duration, "old economy" value stocks. One measurement of this segment is stocks which pay dividends which generally are shorter duration issues. As can be seen here, dividend payers have looked strong year to date.

DIVIDEND PAYERS MAKING A SIGNIFICANT COMEBACK



Source: Strategas

3 https://www.thebalance.com/u-s-inflation-rate-history-by-year-and-forecast-3306093

STRATEGY & OPPORTUNITY

The Case for Shorter Duration Equities

The conclusion is this: as long as inflation remains in the system and the Fed is in a tightening mode, value stocks should continue to outperform growth stocks. Investing legend Marty Zweig's "don't fight the Fed"[4] policy remains true to this day. This applies in both easing and tightening regimes.

4 https://www.investing.com/analysis/dont-fight-the-fed-200621963

Is the End of the 60/40 Portfolio Near?

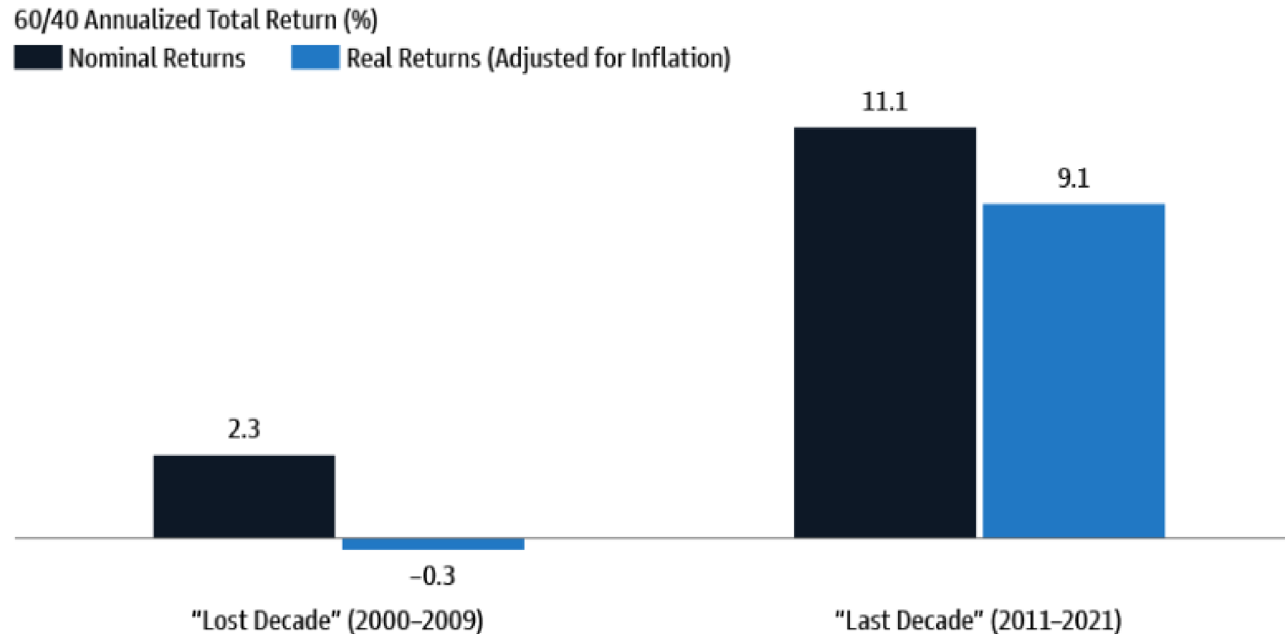
Historically, optimized 60/40 portfolios—those comprised of 60% equity and 40% fixed income weightings—have generally met client planning needs over time while staying within their defined risk-weighted boundaries. Since the end of the COVID-19 pandemic, we find both advisors and clients questioning the efficacy of these more "traditional" asset allocation models in the face of current market conditions.

History tells us there have been a number of rolling "lost-decade" periods where returns for these "optimized" asset-allocated models were, in effect, zero or near zero. The cycle investors have just experienced gave us above-normal growth in an environment of relatively low inflation. This was an attractive environment for returns in both equities and fixed income. With the consensus expectations of lower economic growth and inflation not seen in 40 years telling us the investment paradigm has shifted, the growth/inflation mix investors are presently facing is not conducive to attractive returns. Additionally, "stagflation" (low growth with high inflation) concerns are becoming more worthy of consideration.

With elevated valuations of both stocks and bonds—which, in spite of recent market volatility, remain closer to all-time highs than "selloff" territory—Ashton Thomas continually seeks to identify strategies which could effectively meet clients' financial goals. As the following chart shows, the returns of a 60/40 portfolio post-Great-Financial-Crises have been generally attractive. The question we are asking now is what are the chances that this trend will continue in light of higher inflation, rising interest rates, and other present and potential future economic trends?

Is the End of the 60/40 Portfolio Near?

There have been a number of lost decades since 1871—the most recent of which occurred in the first decade of this century—where traditional long-only, 60/40 portfolios have had a negative real return when factoring in inflation. These periods are shown below in the shaded sections.



Source: Goldman Sachs Asset Management and Bloomberg. As of 8/31/21. "Lost Decade" refers to 1/1/2000-12/31/2009. "Last Decade" refers to 9/1/2011-8/31/2021.

Source: https://www.gsam.com/content/gsam/us/en/advisors/market-insights/gsam-connect/2021/is-the-60-40-dead.html

Current valuations for equities (as measured by the Shiller P/E Ratio) and bonds (as measured by the nominal 10-year Treasury bond yield) are similar to eras preceding lost decades. Although valuations are not the be-all and end-all of investing, they do act as "speed limits" longer term. Eventually, mean reversion of valuations occurs after periods of investing/return extremes. One could argue that is where we are presently. Valuations alone have a mixed track record in forecasting returns if economic conditions, such as low inflation and high growth, remain supportive.

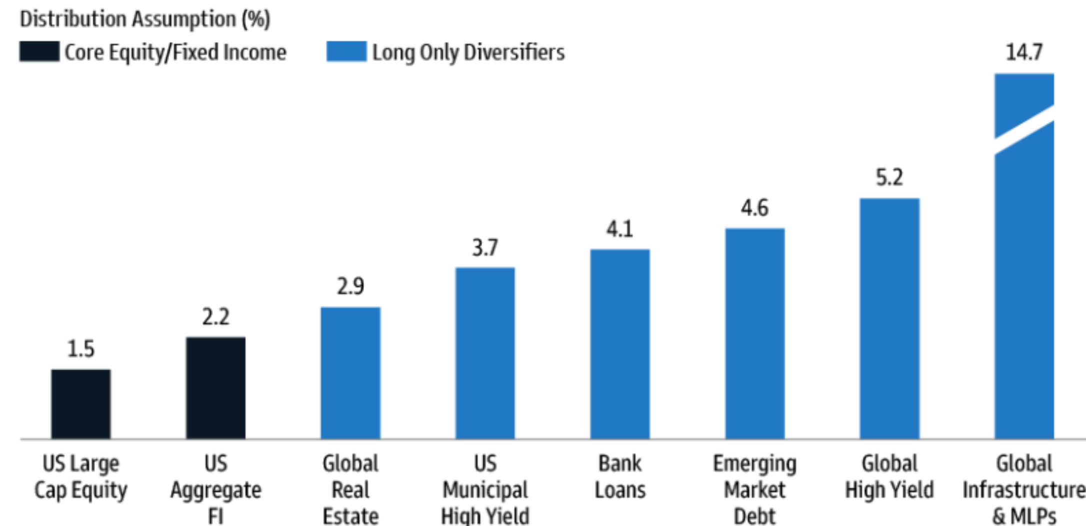
However, at times like this, they eventually become the defining factor for longer-term market returns.

Is the End of the 60/40 Portfolio Near?

Some investment professionals are beginning to advocate for abandoning the balanced portfolio approach—such as that reflected in a 60/40 portfolio for a moderate investor with a longer time horizon—altogether. We believe it is premature to draw that conclusion absent a more extreme long-term scenario, either in the economy or the global financial markets.

Here some trends which, if they continue to play out, may suggest this approach deserves at least some consideration:

- Correlation of equity and bond prices may run higher than usual due to rising inflation.
- If the premium equites return over bonds for a given period remains positive, this approach could make sense. In an environment of rising rates and somewhat stable corporate profits, this could play out.
- Increased inflation makes historical risk measures for bonds, at least those from the past few decades, inaccurate and unpredictable. This makes owning bonds with higher risk profiles (and therefore higher coupon rates) less attractive.
- Although cash yields are still low, they are becoming more attractive relative to bond yields. The premium for owning bonds is decreasing as interest rates rise.



Source: Morningstar, Goldman Sachs Asset Management. Distribution rates generally represent the asset-weighted median 12-month yield of representative Morningstar peer groups through 12/31/2020. Please see end disclosures for asset class definitions and important disclosures. **Past performance does not guarantee future results, which may vary.**

While there was little benefit to owning bonds in a balanced portfolio during the "lost" decades, abandoning a balanced portfolio may be premature. If however, an investor believes that is truly a paradigm shift, investors need to look at other more untraditional options. However, if one believes 1) there is merit to the "lost decade" theory, 2) there is real concern we may be on the verge of experiencing such a period of time, 3) and one is concerned about potential impacts on a traditionally allocated portfolio as a result of these factors, it may become advisable to consider a modest increase in equity exposure to reach stated return goals.

Source: https://www.gsam.com/content/gsam/us/en/advisors/market-insights/gsam-connect/2021/is-the-60-40-dead.html

Is the End of the 60/40 Portfolio Near?

The main concern at present in our view duration risk. Duration, in the financial lexicon, is the number of years it takes to receive the stated value of a bond in terms of interest and principal.[1] This measure can, in theory, be applied to any investment. In general, the longer the duration of future cash flows from an investment, the more volatile and risky the investment or asset class. In consideration of where we are at present, Goldman Sachs believes that duration risk in 60/40 portfolios is at all-time highs. We do not think this observation is commonly known or understood by investors.

Thirty years ago, the financial instruments available for inclusion in an investor's portfolio were U.S. stocks, developed international stocks, U.S. bonds, and cash equivalents and some mutual fund derivations thereof. With the democratization of the financial services industry, we now have many more vehicles and solutions to incorporate in a wealth management strategy.

In general, those looking to mitigate risk and increase returns should be employing asset classes which have some of the following characteristics:

- **Illiquidity:** This usually comes with more and unique types of risk, but illiquidity premiums are still found in the private equity and debt markets. This is not a solution for clients with short-term cash flow needs, and lockups can be long and unnecessarily onerous.
- **Leverage:** Both explicit and implicit leverage can add to returns, especially when costs are low. However, as we learned in the Great Financial Crises, tail risk increases when leverage is used (think Lehman and AIG), and there is always the issue of forced margin calls in extreme situations.
- **Market Timing:** Although this is a difficult exercise to master, we have found some institutional managers who have added value on the margin. Besides capturing positive and negative momentum, successful market timing needs to anticipate reversals.
- **Diversification:** This is well known and documented in the average college Finance textbook. Diversification can occur across not only stocks and bonds, but via real assets, through private assets, by regions, by styles, and through diversity of credit quality. There is almost always a bull market present somewhere. While this may not "right the ship" in a down year for a major asset class, it could help "steady the ship" when the waters are troubled.

1 https://financial-dictionary.thefreedictionary.com/Duration

Is the End of the 60/40 Portfolio Near?

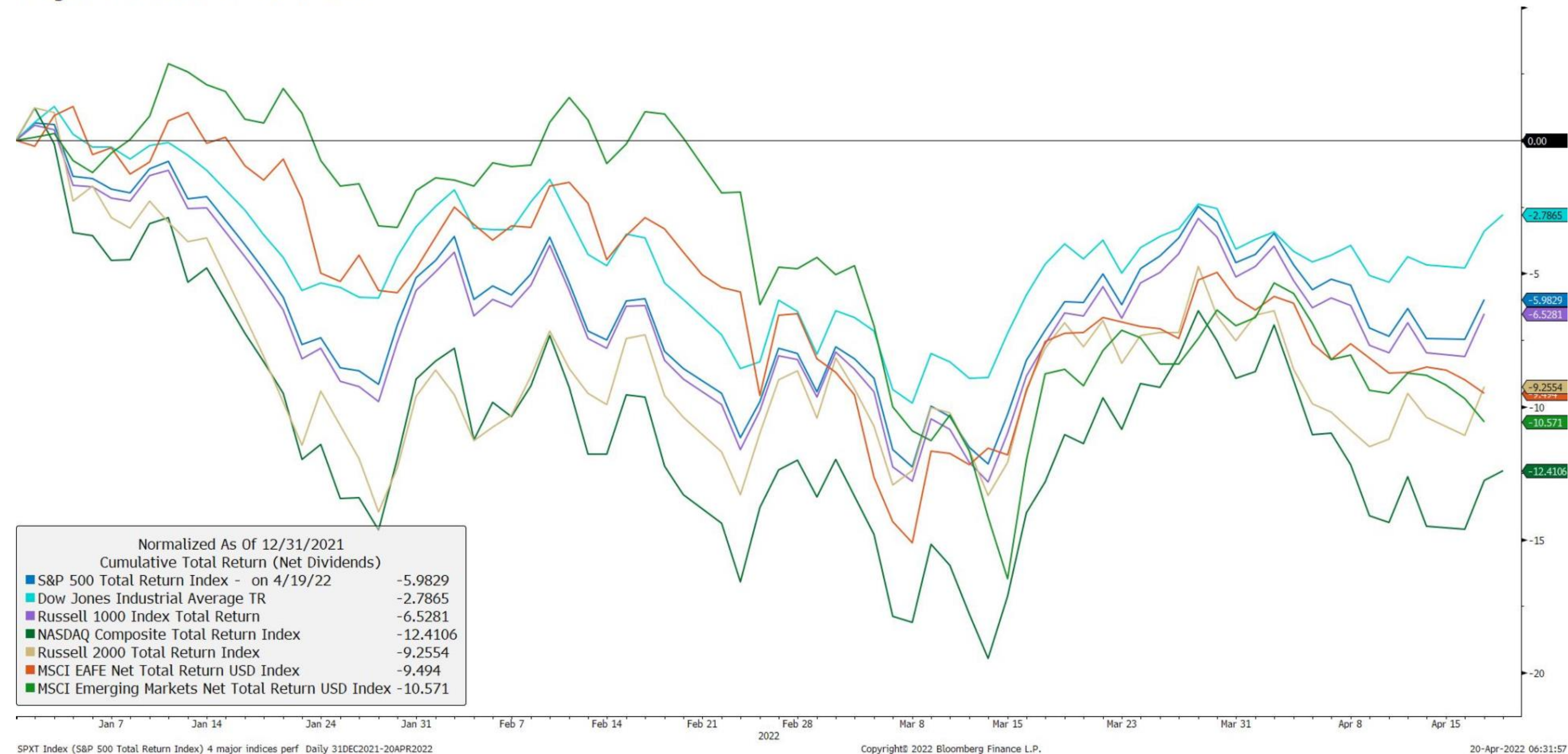
- **Dynamic Risk Management:** Volatility targeting and momentum managers can reduce risk in a portfolio without market timing. However, when market dynamics are showing sharp reversals, these strategies have shown themselves to be less effective.
- **Option Overlays:** Strategies that aim to benefit from dislocations can enhance income and mitigate tail risk when properly employed. The complexities and cost of these strategies should not be overlooked by any means. This is not a viable approach for everyone and is certainly not something one should apply to an entire portfolio.
- **Commodities:** Investing in a "real asset" is much different than using the futures market. Looking at the efficacy of commodities longer term, there are long cycles where commodities investing can present opportunities for both enhanced return and reduced risk. However, commodities prices and markets operate far differently than stocks and bonds and carry their own unique set of risks which should be properly understood and considered.

As we continue to study various investment approaches discussed in the wealth management community and attempt to bring you our well-formed thinking on these strategies, your advisor and the Ashton Thomas Asset Allocation Team will endeavor to communicate our findings for your consideration, as we have done here. No single strategy or approach is appropriate or applicable for every client. This is why we work hard collectively to understand your financial needs, as well as current trends and thinking in our industry. It is our consistent aim to employ effective investment tools, insight, and resources aimed at helping each client achieve their financial goals over time.

TLDR[1]

We've been speaking of some of the disparity in the market for the last year with many macro indicators showing high valuations in general and some of the pandemic justification for tech stocks starting to wear off. The quarter had the potential to make things spectacular for stock pickers in the right names and possibly miserable for equity managers in the wrong names or even sectors. Diversification, in the same light, was either correct or incorrect, but with such wide disparity in returns across several areas of the market, it may have helped smooth the ride. The market is in an early phase of consolidation and many long-term trends are overshadowed by short-term, amplified noise.

Major Index Performance



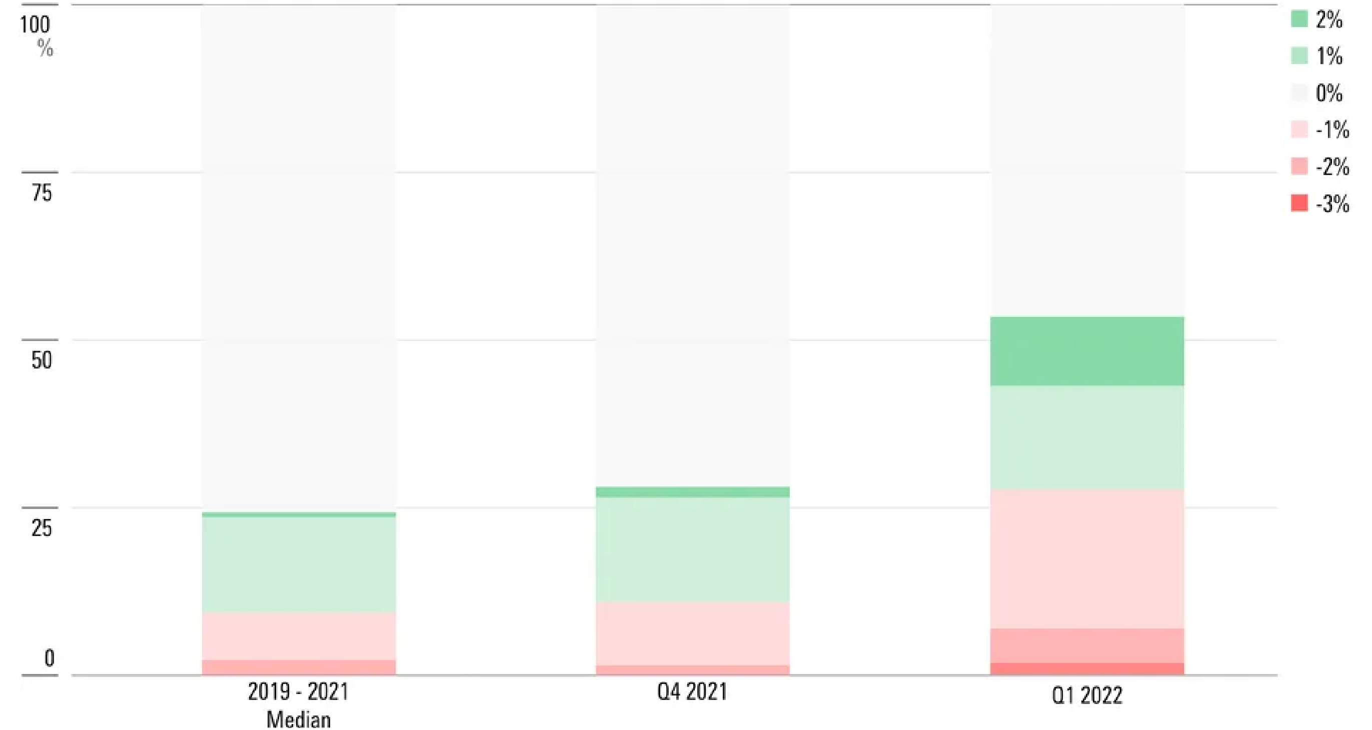
Source: Bloomberg, LP

1 https://www.businessinsider.com/tldr-meaning?op=1

Traders Shouldn't Go Off the Grid for a Day... Maybe Some Investors Should...

Between the Fed and Russia's invasion of Ukraine, we saw some major swings in equity markets during the first quarter of 2022. Nearly everything ended the quarter in the red,[2] with some statistically outsized daily moves both down and up. (*See chart to the right.*)

In general, there was almost double the volatility than we've seen over the last three years. The Morningstar US Market Index had down days of between 1% to 2% on 13 days, and down 2% to 3% on three days. On March 7, the index lost 3.1% in its biggest one-day drop since the worst of the pandemic-driven bear market in March 2020. Volatility is bidirectional and there were also a number of sessions where the market saw outsized gains. The Morningstar US Market Index gained 2% to 3% on six days. Those kinds of rallied have typically been seen just once per quarter in the past three years. (*See chart to the right.*)



Source: https://www.morningstar.com/articles/1087132/13-charts-on-the-markets-first-quarter-performance

2 https://www.msn.com/en-us/money/news/stocks-just-posted-worst-quarter-since-covid-market-crash-e2-80-94but-buffetts-new-favorite-sector-logged-meteoric-ascent/ar-AAVJtXp

S&P 500 Perspective

From a historical perspective, daily changes of 1% or more occur an average of roughly 60 times per year and in the first quarter of 2022, we saw 32 days of plus or minus 1% or more. Looking at days that are greater than 2% in either direction for the S&P open to close, we saw double the yearly average number of days in just one quarter, with five days up greater than 2% and 3 days down more than 2%. In comparison, the closest full year in (now) distant memory was 2008, which saw over half of the trading days with 1% moves and less than a third of 2% or more days. (*See chart below.*)

S&P Dow Jones Indices
S&P 500 daily changes of 1%

YEAR	DAYS	UP	DOWN	TOTAL	% up	% down	%
3/31/2022	62	15	17	32	24%	27%	52%
2021	252	34	21	55	13%	8%	22%
2020	253	64	45	109	25%	18%	43%
2019	252	22	15	37	9%	6%	15%
2018	251	32	32	64	13%	13%	25%
2017	251	4	4	8	2%	2%	3%
2016	252	26	22	48	10%	9%	19%
2015	252	41	31	72	16%	12%	29%
2014	252	19	19	38	8%	8%	15%
2013	252	21	17	38	8%	7%	15%
2012	250	29	21	50	12%	8%	20%
2011	252	48	48	96	19%	19%	38%
2010	252	39	37	76	15%	15%	30%
2009	252	62	55	117	25%	22%	46%
2008	253	59	75	134	23%	30%	53%
2007	251	31	34	65	12%	14%	26%
2006	251	16	13	29	6%	5%	12%
2005	252	13	17	30	5%	7%	12%
2004	252	21	20	41	8%	8%	16%
2003	252	45	37	82	18%	15%	33%
2002	252	53	72	125	21%	29%	50%
2001	248	51	54	105	21%	22%	42%
2000	252	48	54	102	19%	21%	40%
MAX	**302**	**97**	**107**	**199**	**34%**	**36%**	**66%**
MIN	**226**	**0**	**3**	**3**	**0%**	**1%**	**1%**
MEAN	**262**	**32**	**30**	**62**	**12%**	**11%**	**23%**
MEDIAN	**252**	**27**	**25**	**53**	**10%**	**9%**	**20%**

***Annual 1928-2021**

S&P Dow Jones Indices
S&P 500 daily changes of 2%

YEAR	DAYS	UP	DOWN	TOTAL	% up	% down	%
3/31/2022	62	5	3	8	8.1%	4.8%	12.9%
2021	252	2	5	7	0.8%	2.0%	2.8%
2020	253	19	26	45	7.5%	10.3%	17.8%
2019	252	2	5	7	0.8%	2.0%	2.8%
2018	251	5	15	20	2.0%	6.0%	8.0%
2017	251	0	0	0	0.0%	0.0%	0.0%
2016	252	4	5	9	1.6%	2.0%	3.6%
2015	252	4	6	10	1.6%	2.4%	4.0%
2014	252	2	4	6	0.8%	1.6%	2.4%
2013	252	2	2	4	0.8%	0.8%	1.6%
2012	250	3	3	6	1.2%	1.2%	2.4%
2011	252	14	21	35	5.6%	8.3%	13.9%
2010	252	12	10	22	4.8%	4.0%	8.7%
2009	252	27	29	56	10.7%	11.5%	22.2%
2008	253	31	41	72	12.3%	16.2%	28.5%
2007	251	6	11	17	2.4%	4.4%	6.8%
2006	251	2	0	2	0.8%	0.0%	0.8%
2005	252	0	0	0	0.0%	0.0%	0.0%
2004	252	0	0	0	0.0%	0.0%	0.0%
2003	252	10	5	15	4.0%	2.0%	6.0%
2002	252	23	29	52	9.1%	11.5%	20.6%
2001	248	12	13	25	4.8%	5.2%	10.1%
2000	252	18	19	37	7.1%	7.5%	14.7%
MAX	**302**	**68**	**72**	**140**	**23%**	**24%**	**47%**
MIN	**226**	**0**	**0**	**0**	**0%**	**0%**	**0%**
MEAN	**262**	**8**	**9**	**17**	**3%**	**3%**	**6%**
MEDIAN	**252**	**3**	**5**	**7**	**1%**	**2%**	**3%**

***Annual 1928-2021**

Source: https://www.spglobal.com/spdji/en/documents/additional-material/sp-500-market-attributes-web-file.xlsx (See tab: "Additional 8")

S&P 500 Perspective

Some of the large moves can be attributed to a historically high concentration of the top holdings in the S&P 500 index, which is market-cap weighted, i.e. the larger the market cap of the company, the higher the weight. The top ten holdings of the S&P accounted for nearly 29.47% of the entire index of 502 stocks. (*See chart to the right.*)

S&P Dow Jones Indices		3/31/2022	
MKT VAL $MIL	**% OF INDEX**	**TICKER**	**COMPANY**
$2,707,061	7.07%	AAPL	Apple Inc.
$2,311,359	6.04%	MSFT	Microsoft Corp
$1,426,573	3.73%	AMZN	Amazon.com Inc
$902,104	2.36%	TSLA	Tesla, Inc
$836,505	2.18%	GOOGL	Alphabet Inc A
$775,787	2.03%	GOOG	Alphabet Inc C
$682,150	1.78%	NVDA	Nvidia Corp
$646,311	1.69%	BRK.B	Berkshire Hathaway B
$513,447	1.34%	FB	Meta Platforms, Inc. Class A
$480,316	1.25%	UNH	Unitedhealth Group Inc
$11,281,612	**29.47%**		**TOP 10**

Source: https://www.spglobal.com/spdji/en/documents/additional-material/sp-500-market-attributes-web-file.xlsx (See tab: "Top Market Value")

To further the illustration of the massive daily swings, March alone saw the average "up" stock increasing by 7.48% on average for the month. For the quarter, of 192 stocks in the S&P that were positive, the average price return was 13.20%. The downside, no pun intended, is that the number of down stocks for the quarter also averaged a price return of almost -12.88% and the number of declining issues outnumbered gainers by 1.64:1. S&P stocks down over 10% (average of -18.94%) outnumbered gainers of >10% by nearly 2.23:1. (*See chart to the right.*)

S&P 500

Issues with monthly price changes as described by type:

TYPE	MAR,'22	AVG % CHG	3-MONTH	AVG % CHG
Up	315	7.48	192	13.20
Down	190	-5.71	312	-12.88
Up >=10%	81	15.28	94	22.37
Down <= -10%	30	-13.58	181	-18.94
Up >= 25%	5	36.53	27	40.92
Down <= -25%	0	0.00	35	-30.44
Up >= 50%	1	56.37	6	64.75
Down <= -50%	0	0.00	1	-55.63

Source: S&P Dow Jones Indices

Source: https://www.spglobal.com/spdji/en/documents/additional-material/sp-500-market-attributes-web-file.xlsx (see tab: "Breadth 4,5,6,30")

EQUITIES

Valuations

With the last few points in mind, one might expect that an equal-weighting methodology would have smoothed out some of the outsized movement. However, the S&P Equal Weighted Index only slightly outperformed the market cap weighted index over the quarter and on a 3-year, 5-year, and 10-year lookback, has noticeable underperformance. (*See chart to the right.*)

As one might reasonably expect, higher valuation growth stocks saw a drastically larger downturn over the quarter than the index as whole with the S&P Pure Growth index off -13.01% vs. -4.95 for the S&P 500. Over longer time periods, growth has marginally outperformed the full S&P 500 and over the last five years, growth nearly doubled the return of value within the S&P 500. Further illustrative of a dispersed market, the highest beta stocks in the S&P 500 outperformed the broader index for the quarter by a noticeable margin and performed relatively close to the Low Volatility segment. Just to add further confusion on the surface, the highest volatility stocks in the S&P finished the quarter with a positive return. Finally—call it reversion to the mean that value fans have been waiting on for almost a decade…or whatever you like—value stocks had not only a positive quarter, but rebounded with a positive quarterly return of over 5%. (*See chart to the right.*)

S&P Dow Jones Indices
A Division of S&P Global

As of: Mar 31, 2022

	Returns (%) 1 MTH	3MTH	Annualized Returns (%) 1 Year	3 Year	5 Year	10 Year
Price Return S&P 500 EQUAL WEIGHTED	2.39	-3.15	11.23	14.72	11.70	11.75
Price Return S&P 500 Pure Value	3.28	5.73	15.48	10.58	7.68	10.15
Price Return S&P 500 Pure Growth	2.26	-13.01	11.78	16.69	15.44	14.11
Price Return S&P 500 Low Volatility Index	5.13	-2.30	15.30	8.41	9.07	9.61
Price Return S&P 500 High Beta Index	0.67	-3.79	9.47	22.86	15.60	13.48
Price Return S&P 500 Volatility - Highest Quintile Index	2.20	3.68	14.11	23.30	15.46	13.51
Price Return S&P 500	3.58	-4.95	14.03	16.92	13.91	12.39

Source: https://www.spglobal.com/spdji/en/

Source: S&P Global

EQUITIES

Investment Idea: Collect Cash

While perusing the S&P Dow Jones database, an interesting dataset lent some credibility to the theory of dividend payers in times of market uncertainty. For the quarter, the dividend payers in the S&P were only off 1.06% from a total return perspective (includes the dividend payments along with price change), while the non-dividend payers saw a quarterly decrease of -9.50%. Over the trailing twelve-month period, the dividend payers outperformed the non-payers by 14.71% from a total return perspective and slightly edged out the total return of the S&P 500 Index as a whole. (*See chart below.*)

S&P Dow Jones Indices
S&P 500 dividend payers vs. non-payers performance
2/28/2022

Total Return Performance:

	Average S&P 500 Payers	Average S&P 500 Non-payers	S&P 500 Weighted Change	S&P 500 Weighted Total Return
Month	3.02%	1.29%	3.58%	3.71%
YTD	-1.06%	-9.50%	-4.95%	-4.60%
12 Month	15.80%	1.09%	14.03%	15.65%
Issues	394	111	505	505

Source: https://www.spglobal.com/spdji/en/documents/additional-material/sp-500-market-attributes-web-file.xlsx (See tab: "Dividends-Payers-NonPayers")

Inversion, Inflation, Employment, and War

The first quarter of 2022 saw turbulence not only in the interest rate market, but in the world overall geopolitically. The main themes were undoubtedly:

- The Federal Reserve officially ending its "Taper" program[1] and officially raising interest rates[2]
- Inflation—as measured by the Consumer Price Index and Producer Price Index, as well as daily consumer experience—surging to 40+ year highs[3]
- The unemployment rate falling to near pre-pandemic levels[4]
- Russia invading Ukraine and triggering a variety of sanctions and potential implications[5]

Let's examine where we've been and where we could go from here.

U.S. Treasury market

Maturity	Yield	Change (%) Week	Month-to-date	Year-to-date
2-year	2.52	0.06	0.18	1.78
5-year	2.76	0.20	0.29	1.49
10-year	2.71	0.32	0.36	1.19
30-year	2.72	0.29	0.27	0.82

Source: Bloomberg L.P., 08 Apr 2022. **Past performance is no guarantee of future results.**

Municipal market

Maturity	Yield to Worst	Change (%) Week	Month-to-date	Year-to-date
2-year	1.91	0.14	0.15	1.67
5-year	2.12	0.14	0.15	1.53
10-year	2.34	0.16	0.15	1.31
30-year	2.69	0.16	0.15	1.20

Source: Bloomberg L.P., 08 Apr 2022. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	86
30-year AAA Municipal vs Treasury	98
High Yield Municipal vs High Yield Corporate	70

Source: Bloomberg L.P., Thompson Reuters, 08 Apr 2022. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg High Yield Municipal Index divided by the yield-to-worst for the Bloomberg High Yield Corporate Index. **Past performance is no guarantee of future results.**

Characteristics and returns

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%) Week	Month-to-date	Year-to-date
Municipal	2.78	–	5.69	-0.83	-0.83	-7.01
High yield municipal	4.47	191[1]	8.33	-1.08	-1.06	-7.52
Short duration high yield municipal[2]	4.02	181	4.06	-0.56	-0.57	-3.79
Taxable municipal	3.83	101[3]	9.31	-2.77	-3.21	-11.23
U.S. aggregate bond	3.22	42[3]	6.59	-1.82	-2.08	-7.89
U.S. Treasury	2.70	–	6.64	-1.65	-1.93	-7.39
U.S. government related	3.18	49[3]	5.79	-1.40	-1.73	-7.03
U.S. corporate investment grade	3.91	116[3]	7.98	-2.36	-2.47	-9.96
U.S. mortgage-backed securities	3.33	31[3]	5.59	-1.72	-2.08	-6.95
U.S. commercial mortgage-backed securities	3.54	82[3]	4.91	-0.99	-1.42	-6.93
U.S. asset-backed securities	3.11	60[3]	2.30	-0.24	-0.48	-3.35
Preferred securities	5.09	200[3]	5.06	-1.34	-1.41	-7.65
High yield 2% issuer capped	6.42	339[3]	4.07	-1.34	-1.48	-6.23
Senior loans[4]	7.26	437	0.25	0.35	0.48	0.38
Global emerging markets	5.81	309[3]	6.78	-1.19	-1.36	-10.46
Global aggregate (unhedged)	2.35	44[3]	7.27	-1.77	-2.33	-8.35

1 Yield difference between the Bloomberg High Yield Municipal Index and the 20-year AAA MMD scale. **2** Data is a subset of the S&P Short Duration Municipal Yield Index that is below investment grade/nonrated. Spread is the yield difference between this subset and the subset rated AAA. **3** Option-adjusted spread to Treasuries. **4** Spread refers to the 3-year discount margin. Duration is estimated based on the frequency of the reset date.

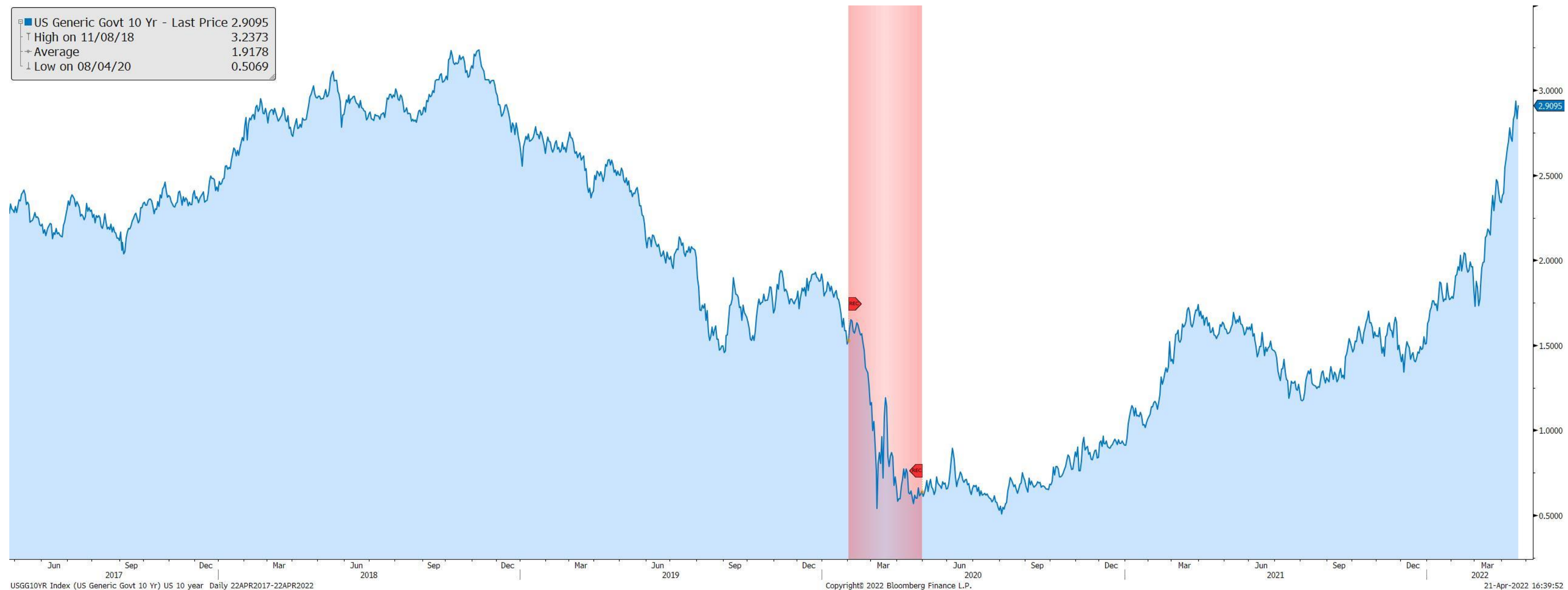
Source: Bloomberg L.P. and Credit Suisse, 08 Apr 2022. **Past performance is no guarantee of future results.** Unless otherwise noted, the index is Bloomberg. All index returns are shown in U.S. dollars. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting. **Effective duration** (expressed in years) measures the price sensitivity of a fixed-income investment to a change in interest rates, considering that expected cash flows will fluctuate as interest rates change. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account.

Source: https://www.nuveen.com/en-us/insights/investment-outlook/fixed-income-weekly-commentary

1 https://www.cfo.com/strategy/the-economy/2022/04/federal-reserve-fomc-taping-monetary-policy-inflation/
2 https://www.yahoo.com/now/federal-raises-interest-rates-first-225746509.html
3 https://news.yahoo.com/government-report-tuesday-confirms-inflation-043500293.html
4 https://www.cnbc.com/2022/04/01/jobs-report-march-2022-.html?&doc=107040388
5 https://www.investing.com/news/world-news/how-western-sanctions-target-russia-2785144

Inversion Drift

The bellwether 10-year Treasury Note began 2022 at 1.62% and ended at 2.33% (even rising as high as 2.47% at one point—see chart), but the story is much more complex than just the movement of that rate. The inversion that presented in the 20-year Treasury Bond and the 30-year Treasury Bond continued and at times even widened. Not to be outdone, much of the Notes portion of the curve (2-year, 3-year, 5-year, 7-year) began to flatten and invert to the 10-year. [6]

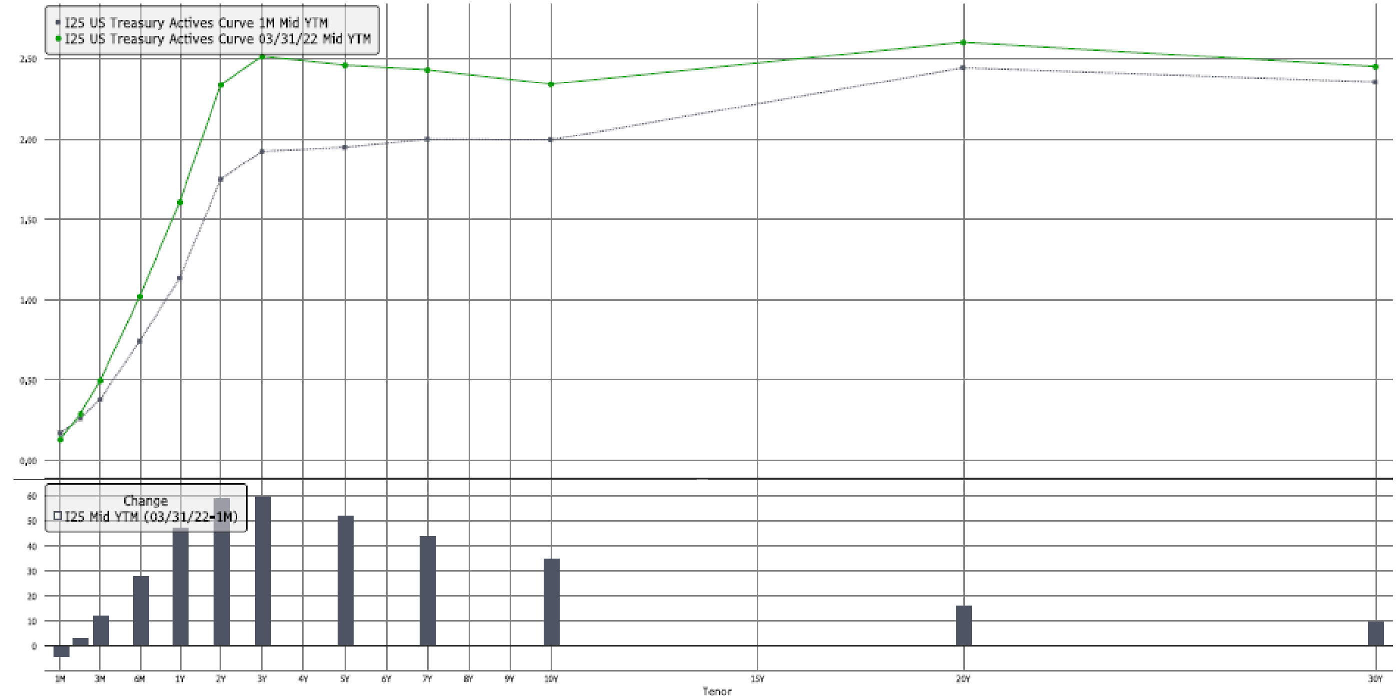


Source: Bloomberg LP

6 https://finance.yahoo.com/news/inverted-yield-curve-means-economy-123000655.html

Now, That Was Fast!

As a quick reminder, an inversion occurs when short-term debt yields more than longer-term debt. There are reams of data showing that yield curves tend to flatten when the Federal Reserve begins to raise rates. This is to be expected, as yields adjust to the Fed raising short-term rates and investors focus on shortening duration to take advantage of higher and higher rates. The difference vs. past inversions is that this flattening and subsequent inversion of the curve happened in just 16 days (see chart)! To our knowledge, this is almost unprecedented and represents one of the shortest time periods from first rate hike to inversion in modern history.

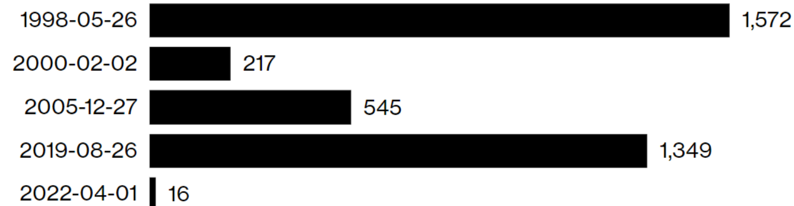


Source: Bloomberg LP

Upside Down

2022 marks quickest yield curve inversion since Fed hiking cycle starts

■ Days since first Fed hike until 2-year, 10-year curve inverts



Source: Bloomberg LP

Inflation, Stagflation, or Recession?

The bond market began to price in the risk of two possibilities: recession and "stagflation." As the Fed tries to engineer a soft landing for the economy by raising rates to tame Inflation while simultaneously not forcing the economy into a recession, the bond market began to price in the risk the Fed will make a mistake. That mistake is likely to be either 1) the Fed raising rates too aggressively and pushing the economy into recession, or 2) the Fed not raising rates enough to halt surging inflation and setting the economy up for a stagflation scenario. Neither is pleasant to consider. While the Fed has said they plan to raise rates at every meeting this year and even into the first three meetings of 2023—all while publishing GDP outlooks for the next four quarters[7]—it looks like the bond market may be thinking these projections are too optimistic.

Thesis A: A recession looks like a possible scenario. The Atlanta Federal Reserve Bank's GDPNow forecast of first quarter GDP is barely positive[8] and there is a very real possibility that we could get a negative or near-zero GDP print for the first quarter of 2022. This would have the effect of putting pressure on the FOMC to either stop raising rates or to raise less aggressively.

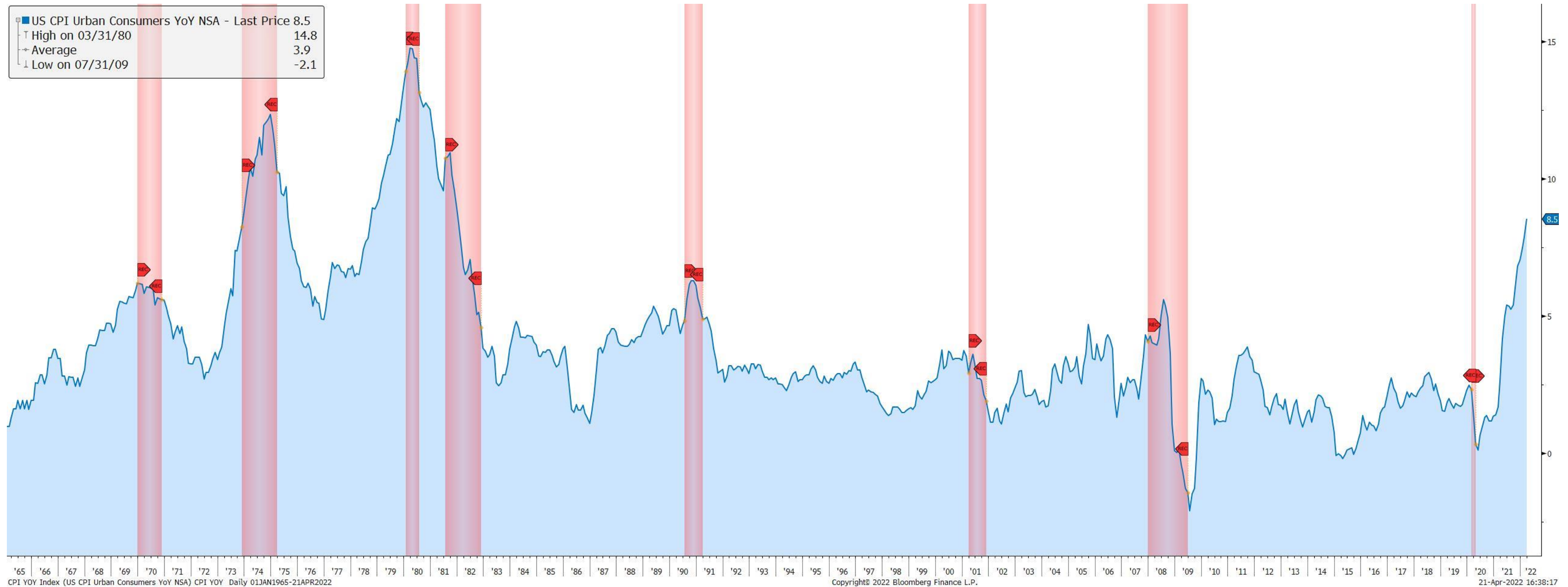
Thesis B: Stagflation is another possible scenario. As we discussed in previous Playbooks, this is when inflation stays persistently high, but the economy and productivity is either negative or barely positive. This would possibly be the worst-case scenario for the Fed. In a "stagflationary" environment, raising rates means GDP stays low or negative (the economy slows) and inflation *might* be curbed. However, if the fed lowers rates, they also run the risk of inflation surging higher. If GDP doesn't print higher as a result, stagflation persists. Hopefully. This scenario does not play out, as it would tie the hands of the Fed in a no-win situation. Currently, there is no good monetary policy solution for stagflation.

Inflation was perhaps the bigger issue in the first quarter of the year and is likely to be going forward, at least shorter term. The Consumer Price Index (CPI) just printed at 8.5% year-over-year,[9] the highest rate in over 40 years.[10] The Producer Price Index (PPI) printed at 11.2% year-over-year,[11] again another 40+ year high.[12] We certainly do not need an economist to tell us prices are higher. Every consumer feels it at the grocery store, car dealership, gas pump, and in housing prices. Surging oil prices have certainly fueled some of this run-up (pun intended) in inflation, but supply chains are still not back to pre-pandemic levels.[13] Even if they were, with so much money distributed during the pandemic—thanks to the Fed and Treasury combining on a "QE4" money print—and so much demand, we would still likely see decades-high inflation readings.

7 https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20220316.pdf
8 https://www.atlantafed.org/cqer/research/gdpnow
9 https://www.bls.gov/news.release/cpi.nr0.htm
10 https://www.msn.com/en-us/money/markets/inflation-rises-by-the-most-since-1981-as-cpi-jumps-85-25-in-march/ar-AAW8nsY
11 https://www.bls.gov/news.release/ppi.nr0.htm
12 https://www.msn.com/en-us/money/markets/monthly-annual-producer-price-index-jump-to-record-highs/ar-AAWbhyj
13 https://internationalbanker.com/finance/global-supply-chain-problems-are-likely-to-persist-this-year-and-beyond/

Inflation, Stagflation, or Recession?

It should be noted that this is not a U.S.-only phenomenon. The world is feeling the sting of inflation![14] We continue to see surging prices in housing, food and energy, transportation, appliances and just about anything else we consume regularly. (*See chart below.*)

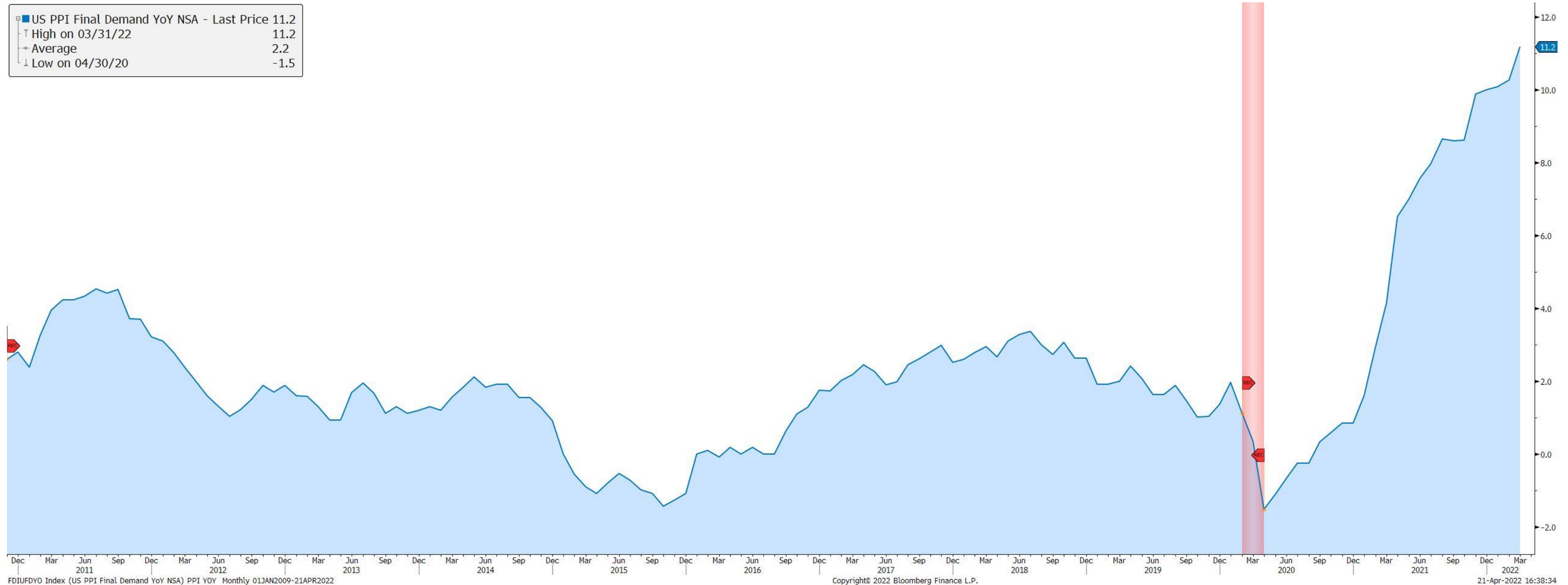


Source: Bloomberg LP

14 https://finance.yahoo.com/news/charting-global-economy-european-inflation-090000565.html; https://www.msn.com/en-za/news/other/soaring-prices-reach-asia-to-bring-global-inflation-in-sync/ar-AAWa6Lz

Inflation, Stagflation, or Recession?

As we mentioned previously, the cure for higher prices is higher prices and the American consumer is starting to consume less. Housing sales are negative month-over-month due to very low supply, higher prices (affordability), and higher mortgage rates.[15] Food is higher across the board at the supermarket—one estimate said that the average Super Bowl party this year cost 14% more to put on than last year[16]—and could potentially go much higher due to the Russian invasion of Ukraine.[17]



Source: Bloomberg LP

15 https://www.nbcnews.com/business/consumer/tough-housing-market-hurting-homebuyers-as-interest-rates-rise-rcna24219
16 https://www.producebluebook.com/2022/01/31/wells-fargo-report-shows-super-bowl-party-costs-up-14-over-last-year/#
17 https://au.investing.com/news/economy/americans-are-set-to-see-mounting-food-costs-after-producer-prices-surge-2553898

Inflation, Stagflation, or Recession?

The gas we use to fuel our cars (and the economy) is persists near all-time highs nationwide, and in many places regular unleaded is north of $4.50 or $5.00 per gallon. The national average for a gallon of unleaded was $4.10 as of this publication.[18] Used car and new car prices continue to remain pricey on low supply, though the rate of increase has finally started to decline a bit.[19]

Inflation is similar to a tax in terms of its impact on personal finances. However, unlike with a tiered tax system, it which impacts low-income earners significantly more than those earning higher incomes.[20] The consumer could react by consuming much less, which is worrisome, as Consumption makes up roughly 68% of GDP.[21] Some believe this process has already started. Others believe the consumer is and will remain strong.[22] We take a cautious view that falls somewhere in between. It would not be unusual for inflation (as measured by the CPI and PPI) to continue higher throughout the summer, before abating in the second half of 2022.

The improved employment situation is one of the factors cited by the Jerome Powell and the FOMC as to why they can raise rates and possibly do so aggressively. Unemployment sits at 3.6% through the end of March, nearly back to pre-pandemic levels.[23] Wages for workers are up 5.6% year-over year,[24] as employers in need of labor are having to pay more and more to attract and retain employees. Job seekers are able to demand higher wages and more incentives (more vacation, work from home, higher signing and retention bonuses). Workers are quitting in record numbers monthly, and some are not returning to the workforce at all. Currently there are 0.6 job openings for every unemployed worker,[25] which means workers can afford to be selective. Fed Chairman Powell has stated that with unemployment hovering around 4%, the Fed can afford to raise rates.[26]

18 https://www.washingtonexaminer.com/restoring-america/community-family/inflation-means-bigger-bills-for-groceries-gas-and-rent-heres-the-breakdown
19 https://publish.manheim.com/en/services/consulting/used-vehicle-value-index.html; https://www.msn.com/en-us/money/companies/demand-for-used-cars-drops-from-a-year-ago-but-high-prices-arent-budging/ar-AAVXp1j
20 https://www.seattletimes.com/business/caviar-and-canned-tuna-fed-official-says-stats-miss-inflations-impact-on-lower-income-americans/
21 https://fred.stlouisfed.org/series/DPCERE1Q156NBEA
22 https://www.cnbc.com/2022/03/29/where-the-market-sees-signs-of-consumer-inflation-breaking-point.html
23 https://www.cnbc.com/2022/04/01/jobs-report-march-2022-.html?&doc=107040388
24 https://tradingeconomics.com/united-states/average-hourly-earnings-yoy#:~:text=Average%20Hourly%20Earnings%20YoY%20in,percent%20in%20April%20of%202021
25 https://www.washingtonexaminer.com/policy/economy/record-low-number-of-unemployed-workers-per-job-opening
26 https://abcnews.go.com/Business/wireStory/powell-tells-congress-fed-raise-rates-month-83202588

Geopolitical Instability

No summary of the first quarter of 2022 would be complete without a discussion of the Russian war with Ukraine. When Russian forces invaded Ukraine on February 24, 2022, Treasury yields initially declined, as investors went "risk-off," meaning they sold risky assets like equities to buy Treasuries for safety. This is generally referred to as a "flight to quality" for investments. Since then, rates have stabilized and have come up, as investors focus more on economic fundamentals and less on headline risk—although the Treasury market is not immune to ongoing short-term moves based on major news. What has followed are a series of sanctions against Russia and Russian citizens.[25] These range from exclusion from the SWIFT banking system, to bans on Russian imports and exports, as well as freezing the assets of Russian oligarchs. The Western World is fighting an economic war with Russia, as Russia fights a military war with Ukraine, a war which could be protracted for some time.

The sanctions against Russia will no doubt have significant impacts for the world. The Russians are the world's largest exporters of nitrogen fertilizer.[27] This will impact food harvests in 2022 and possibly beyond, and undoubtedly push food prices higher. Some countries, including Ukraine,[28] have already started halting grain and food exports, fearing they will not have enough food to feed their own populations. The Russians are also major oil and mineral exporters. Banning those exports will drive prices for oil, natural gas, and earth metals higher. The Chinese stand to benefit, and they continue to increase trade with the Russians.[29] If anything, these sanctions have driven Russia and China—two historical geopolitical rivals—to become more closely allied. Scarcity breeds demand and higher demand breeds higher prices. It is unlikely inflation can be brought under control, especially food inflation, unless the Russian war with Ukraine is resolved sooner than later.

27 https://www.fb.org/market-intel/ukraine-russia-volatile-ag-markets
28 https://www.msn.com/en-us/news/world/ukraine-e2-80-99s-wheat-harvest-which-feeds-the-world-can-e2-80-99t-leave-the-country/ar-AAVZ8zK
29 https://www.theguardian.com/world/2022/apr/13/chinas-trade-with-russia-up-by-12-in-march-from-a-year-earlier?ref=biztoc.com&curator=biztoc.com

Investing In an Inverted or Flat Yield Curve Environment

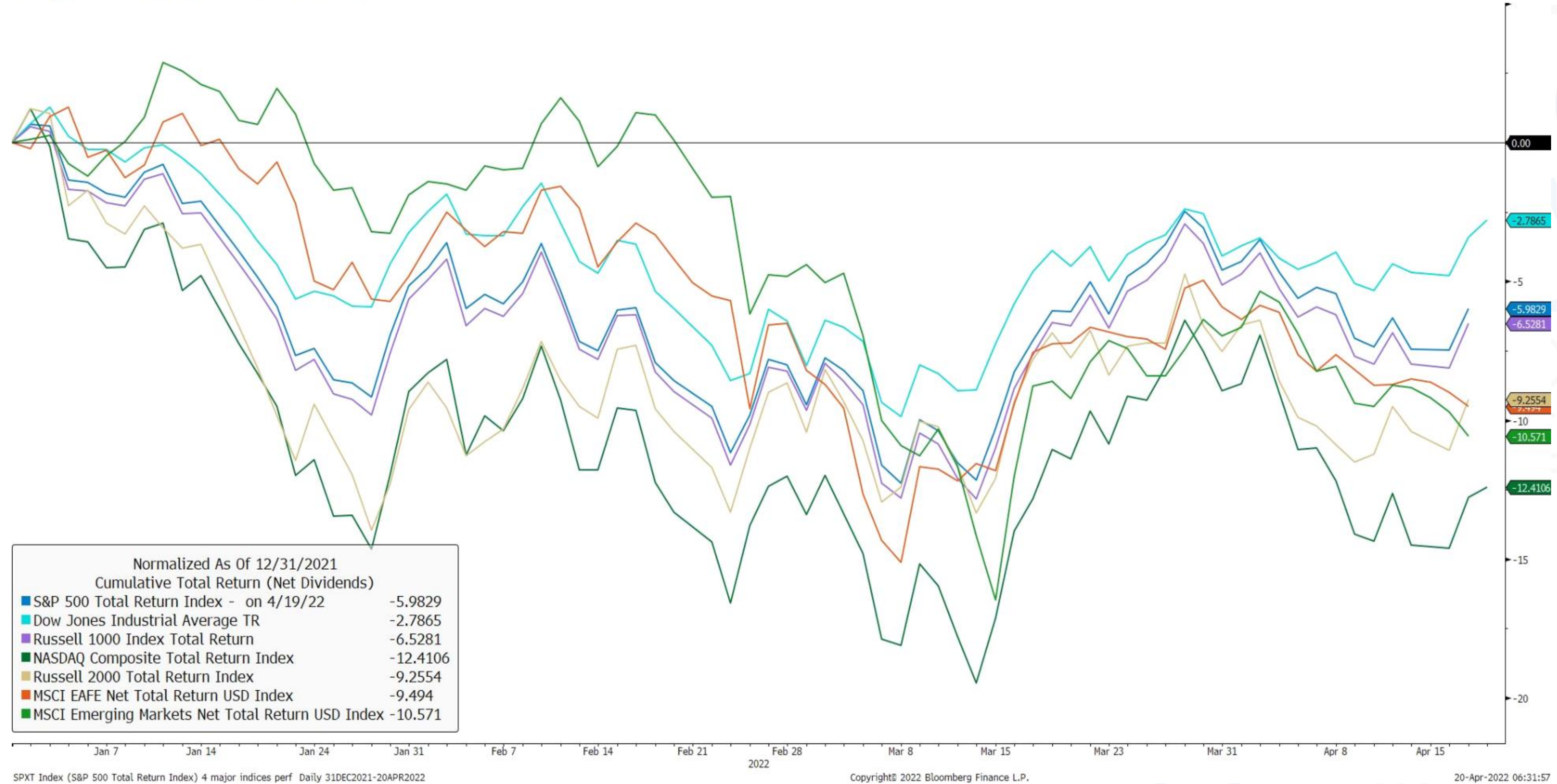
When yield curves invert, there is no compensation for investing long-term. Goldman Sachs recently published a research report saying this inversion could last up to three years. As a result, we recommend shortening the duration of fixed income portfolios and laddering to take advantage of rates rising. The duration recommendation in the area of 2-3X. For comparison, the AGG is approximately 6X.

We also recommend laddering—having fixed income investments come due at regular intervals—to take advantage of rising rates and not being afraid to keep a tactical allocation in cash. Fixed Income investors are seeing short term rates for durations two years and under which have not been seen since 2019. We recommend taking advantage of that.

Many conservative fixed income investors are building ladders using Treasuries and bonds maturing at regular three-month intervals and rolling those maturities in the 2-year to 3-year range upon maturity if they do not need the funds. This eliminates the need time Fed rate raises and/or market action and organically raises income and yield in the Fixed Income side of the portfolio. For the first time since at least 2019, Treasuries are yielding more than Certificates of Deposit (CDs) and investors looking for income are taking advantage.

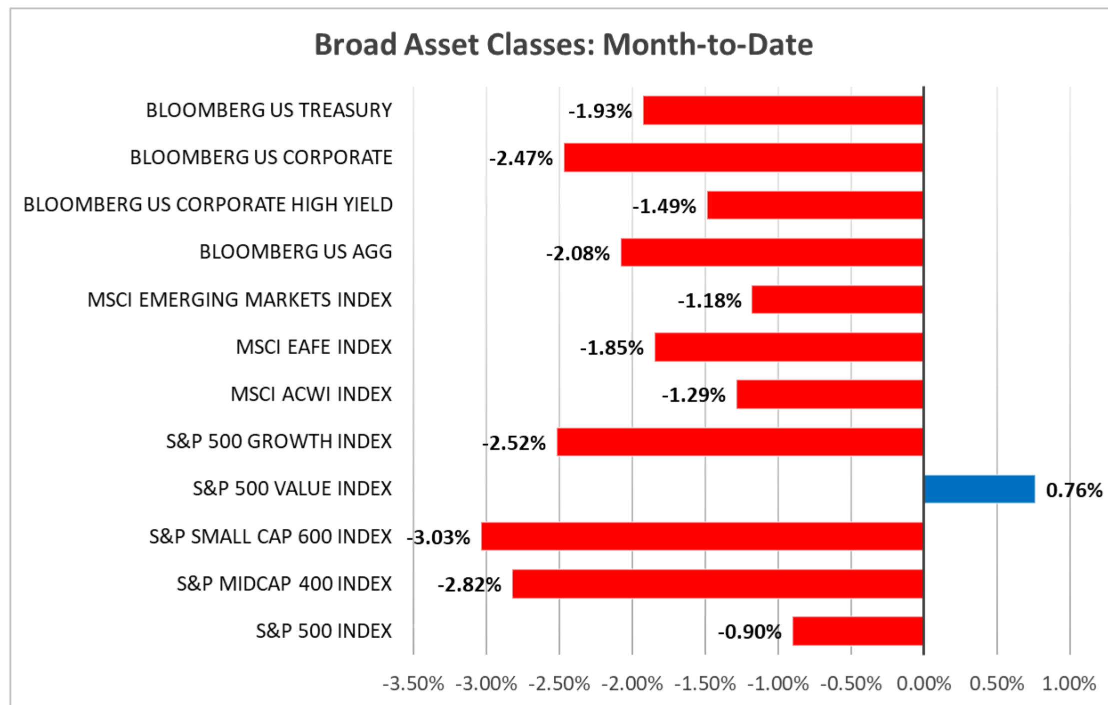
Will this beat inflation? No. But the strategy possesses significant advantages over passive fixed income ownership in a market heavily distorted by central bank intervention. The Ashton Thomas Asset Allocation can facilitate building a tailored Fixed Income solution for a specific need. We are here to help your advisor and help you.

Performance Charts:

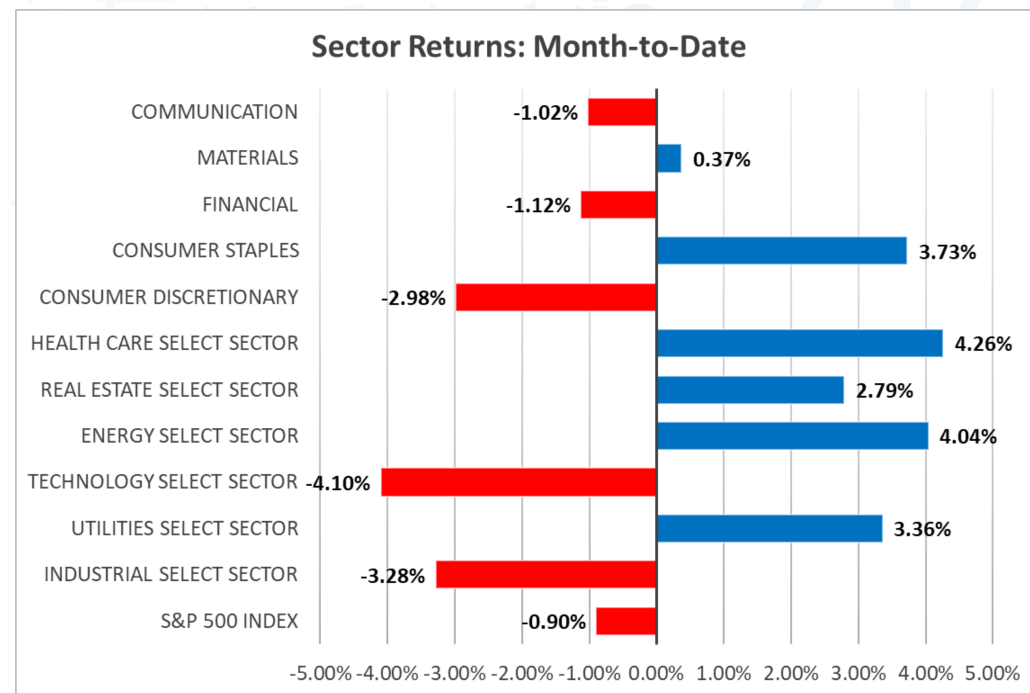


Source: Bloomberg, LP

Performance Charts: April 2022 MTD



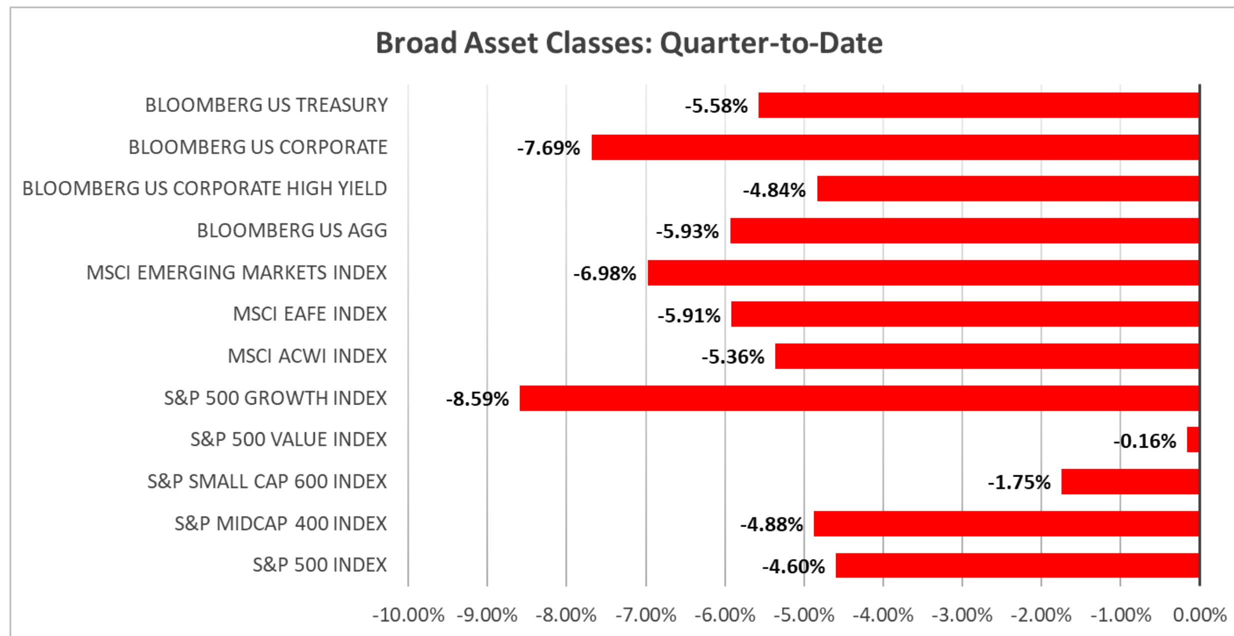
Source: Bloomberg, LP



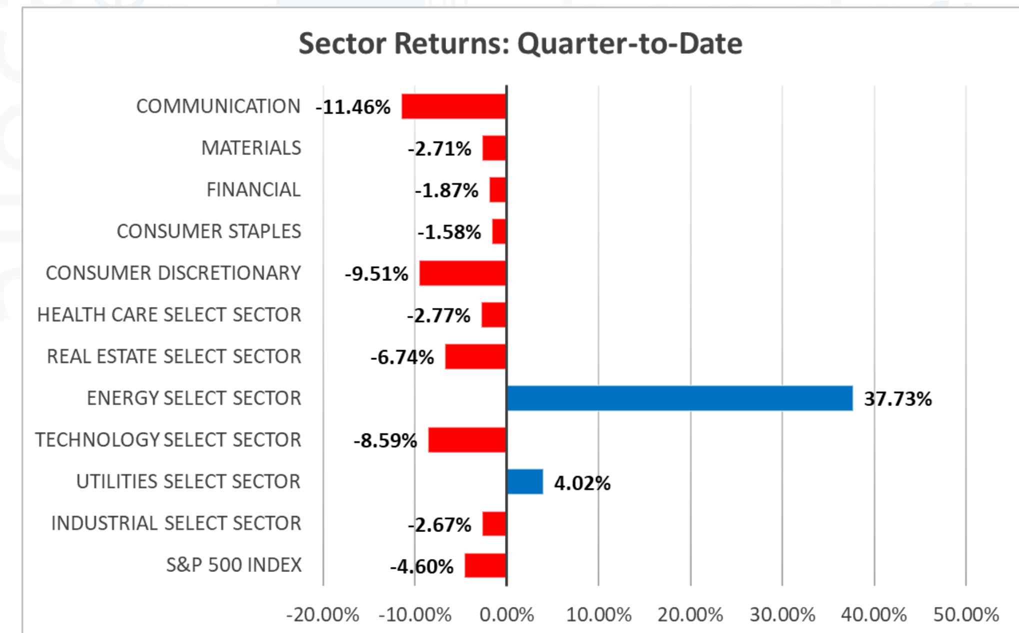
Source: Bloomberg, LP

ASSET ALLOCATION

Performance Charts: 1Q 2022

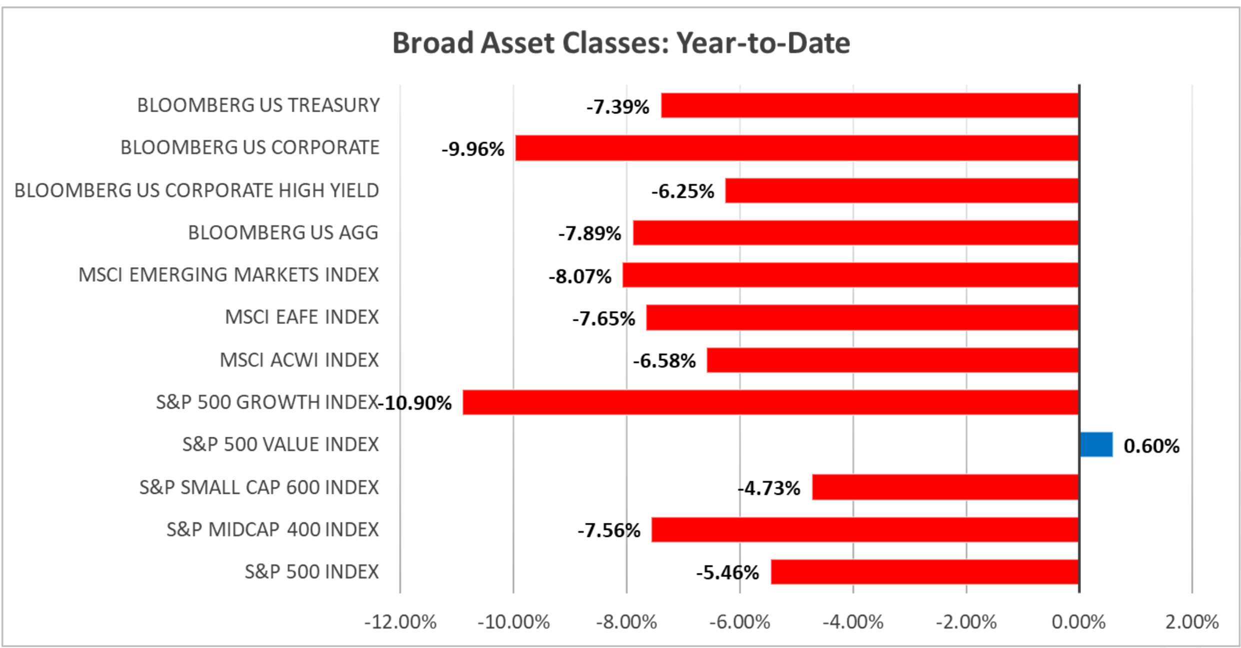


Source: Bloomberg, LP

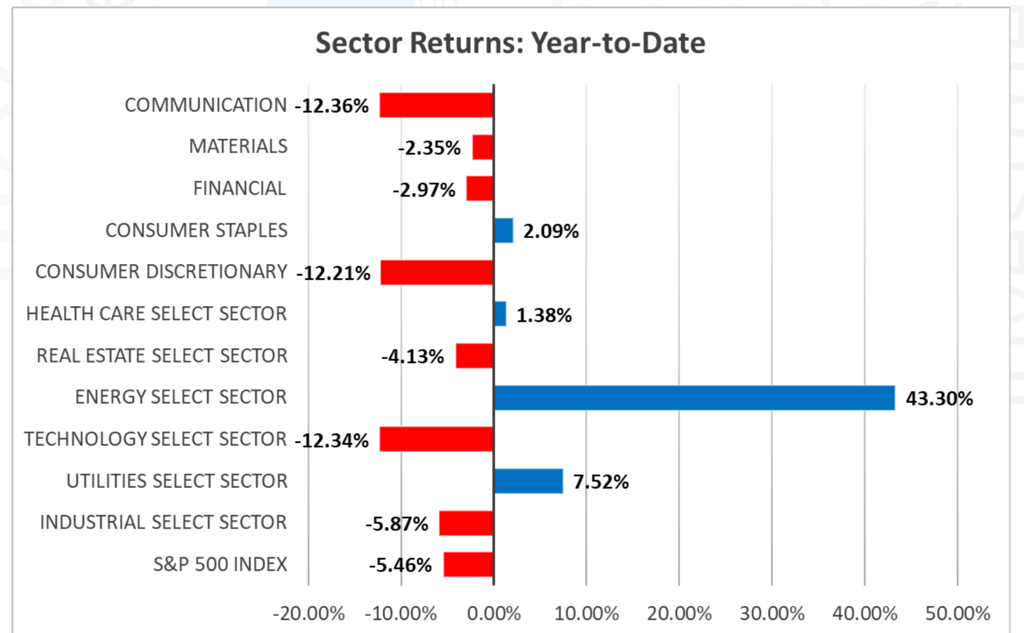


Source: Bloomberg, LP

Performance Charts: 2022 YTD (incl. April MTD)



Source: Bloomberg, LP



Source: Bloomberg, LP

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