MILL CREEK CAPITAL ADVISORS

MC

OUR VALUES APPRECIATE YOURS

Q2 2022 Outlook

CONTENTS

04 Apr 2022

Simplify, Simplify, Simplify!

"Our life is frittered away by detail. Simplify, simplify, simplify! I say, let your affairs be as two or three, and not a hundred or a thousand; instead of a million, count half a dozen, and keep your accounts on your thumb-nail."

—Henry David Thoreau

Financial markets got off to a horrendous start in 2022. US equities fell more than 12% over the first 45 days of the year — their second worst start to a year since 1900 — and high-quality fixed income portfolios simultaneously declined 4–5%. We've also seen a lot of volatility within markets. Daily price moves of 2–4% have been common in equities, the yield on a 2-year US Treasury jumped 0.7% to 2.4%, and oil prices bounced from $77 per barrel to $123 and then back below $100.

While we believe equity investors should be prepared to weather peak-to-trough declines of 10–15% nearly every year, we must take seriously the risk that markets are signaling something worse is in store. We maintain our current view that the economic growth story in the US remains quite robust, but we're approaching a big macro call. Conditions outside of the US are deteriorating and repeated supply shocks are putting central banks in a tough position.

Buy the dips?

We find that it can be helpful during these periods to follow Thoreau's advice and simplify, simplify, simplify! Let's start with valuing financial assets. The value of a financial asset is the present value of future cash flows, discounted by an appropriate rate (generally a long-term Treasury bond yield). This fundamental worldview, which can't explain meme stock phenomena but does a pretty good job otherwise, implies that stock prices can fall for three reasons:
(1) expected cash flows have declined in magnitude;
(2) expected cash flows have been pushed into the future; or (3) the appropriate discount rate has risen.

If equity prices are declining due to a decrease in the magnitude of future cash flows, we should view it as a sign that economic conditions are deteriorating. On the other hand, if equity prices are declining due to a change in prevailing interest rates, investors haven't lost any future cash flows in dollar terms — they're just discounting the present value of those cash flows more than before. We view that second scenario as more positive than the first, but how do we disentangle the two?

One way is to compare the return on equities to the return on a long-term US Treasury bond. Treasury bond prices only fluctuate based on prevailing interest rates, making them a very good proxy for the interest rate impact on equity prices. As it turns out, long-term Treasuries have declined in line with US equity markets (Fig.1) earlier this year. This is a pretty good indication that interest rates, not earnings, drove the sell-off.

We can see the same thing reflected in equity fundamentals. Consensus estimates for earnings per share growth remain around 8–10% this year and the forward-looking price-to-earnings ratio on the S&P 500 has declined from 32 to 21. Higher earnings, lower price: to the extent that the earnings outlook remains solid, we see the current dip as a buying opportunity for investors with reasonable time horizons.

Stagflation?

We've seen some prognosticators call the current environment stagflation. While many of the 1970s inflationary forces are back in play, there's no stag (low economic growth) in the US economy. We certainly have high inflation, but real economic growth remains above trend (Fig. 2). It is striking that consumer sentiment has fallen to levels not seen since the financial crisis, but the fundamentals (*simplify, simplify, simplify!*) remain positive for the US economy. The unemployment rate has fallen to 3.8%, and over 11 million job openings remain unfilled. Workers are seeing median wage growth of nearly 6% year-over-year. Aggregate household wage growth (a proxy for spending capacity) continues to grow at 10% year-over-year.

It is striking that consumer sentiment has fallen to levels not seen since the financial crisis, but the fundamentals remain positive for the US economy.

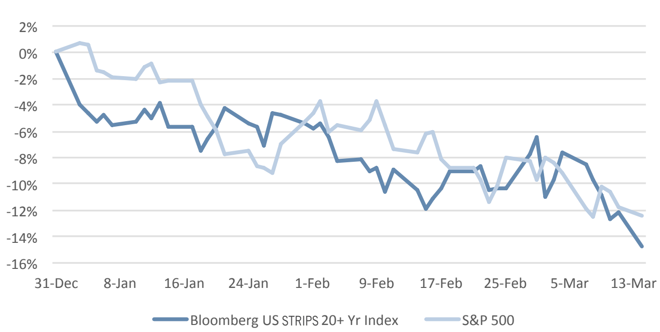
Household net worth reached new highs in the first quarter of 2022 and financial obligations as a percentage of net worth remain near all-time lows. These are all factors that will support consumers and the broader economy against higher commodity prices and tightening monetary policy.

Ukraine

Equity markets opened sharply lower (-13.5% year-to-date loss at that point for the S&P 500) on February 24 following the Russian invasion of Ukraine. We published an adhoc note to clients titled "If you hear the missiles are flying..." that retold Art Cashin's Cuban Missile Crisis anecdote and suggested buying, not selling, was the appropriate response at the time. We continue to believe the war in Ukraine, in its current scope, will have negligible impact on US economic growth and earnings growth.

Fig. 1: Long-duration Treasuries and US equities have sold off together

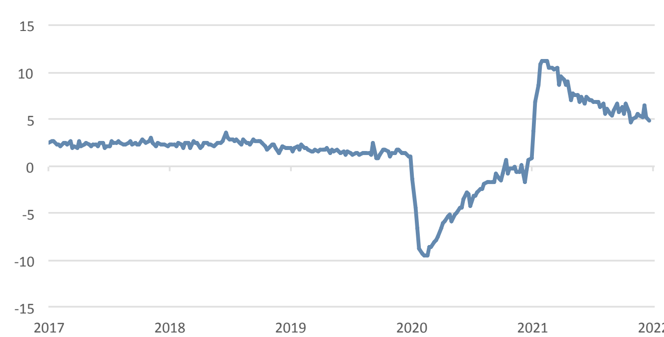
S&P 500 and 20+ Yr Treasury STRIPS and Bloomberg AGG



Source: Bloomberg, Mill Creek, The Bloomberg US STRIPS 20+ Yr Index has a duration of 26.

Fig. 2: US economic growth remains above trend

US Federal Reserve Bank of New York Weekly Economic Index



Source: Bloomberg, Mill Creek.

Higher energy prices associated with the Russian invasion of Ukraine will impact Europe more than the US. European economic and earnings growth estimates have been marked down to 3.5% and 2.4%, accordingly. The US is not insulated from higher energy prices, but recent dollar strength will help offset the cost of energy imports as long as these higher prices do not persist indefinitely. Oil prices are also not currently high in inflation-adjusted terms (Fig. 3).

It bears noting that the situation in Ukraine can change very quickly and impact our outlook across the board. War is a world of unknown unknowns. We can't specify the outcomes with clarity, nor can we place probabilities on their occurrence. We're happy that most of our portfolios' assets are US dollar denominated, but the optimal asset allocation in such a scenario is one that prefers diversification to concentration. *Simplify, simplify, simplify!*

Interest Rates

Our fears around bond market returns played out in the first quarter. Bond prices decline as interest rates rise, and we've seen steadily rising interest rates across nearly all parts of the bond market. As of late March, the often-quoted Bloomberg Aggregate Bond Index had underperformed global equities year-to-date and suffered its worst drawdown in over 40 years.

Our advice regarding bonds hasn't changed: We expect the headwinds to bonds to continue this year and that return potential remains asymmetrically skewed to the downside. Therefore, we believe investors should hold an appropriate amount of high-quality bonds, but not more than necessary based on risk tolerance or risk capacity considerations.

Crossroads

US bond markets currently project a troubling road ahead. Market participants expect the Fed to hike very aggressively, including multiple 50bps hikes, this year. The gap between two- and ten-year Treasury yields has also narrowed to nearly zero. Historically, an inverted Treasury yield curve (the two-year yield is higher than the ten-year yield) has been a decent, but not perfect, predictor of forthcoming recession.

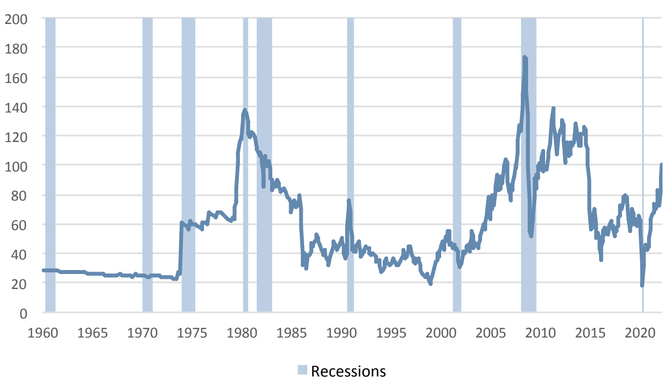
Bond markets also indicate that inflation will remain elevated for at least a few years. Sustained excess demand (the ongoing quantity of goods purchased by consumers remains 15% above the pre-COVID trend) and supply shocks (COVID and energy related) have driven inflation from an isolated phenomenon to something that is broad-based and well entrenched across goods and services (Fig. 4).

The current challenge for the Fed, and all central banks, is to (1) tighten monetary conditions sufficiently to reduce excess demand growth while (2) looking through and accepting supply-shock inflation for as long as necessary. Doing too little risks allowing inflation expectations to become unanchored. Doing too much risks a recession. As a result, central banks are walking a tightrope.

We're not ready to forecast a recession, but also recognize preparation, not prediction, is more important for navigating uncertainty. The history of modern central banking is repeated episodes of hiking too much in the face of inflation and causing a recession. Central banks are already behind the curve, so the temptation will be there to do the same this cycle. On the contrary, it's possible dovish hands will prevail and accept higher inflation for as long as palatable. Incorporating assets that will do well in all these outcomes plays a significant role in our thought process around asset allocation at the current time.

Fig. 3: Oil prices remain manageable on an inflation-adjusted basis

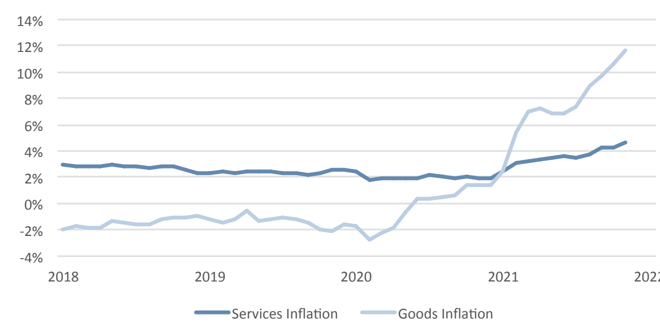
WTI spot crude price adjusted by CPI Index for All Urban Consumers, monthly frequency.



Source: Federal Reserve Bank of St. Louis, Mill Creek.

Fig. 4: Services inflation has started to accelerate

Personal Consumption Expenditures inflation indexes



Source: Bloomberg, Mill Creek.

House View Summary

Global economy

- Global real GDP growth peaked in 2021 at around 6% and will gradually decline to 3–5% for 2022–2024.
- Most major central banks have begun tightening cycles to combat inflation, but we expect inflation to remain elevated through at least 2023.
- Energy markets have taken the spotlight from COVID. Elevated energy prices will impact economic growth in Europe and emerging countries more than in the US.

US economy

- The US economy is growing above full capacity. We believe real GDP will average 5–6% in 2021 and 3–4% in 2022. Nominal GDP growth, a proxy for income growth and an important recession indicator, will likely remain above trend in 2022.
- Bond market pricing implies that inflation will normalize over the next five years due to demand destruction and a slowing economy. We are concerned that repeated supply shocks, including energy markets, could lead to unanchored inflation expectations.
- Aggregate weekly payrolls, an indication of consumer purchasing power, continue to increase at 10% year-over-year. Inflation will remain elevated until payroll growth slows to 3%.
- Labor markets are very tight. Job openings remain near all-time highs, and the unemployment rate has fallen to 3.8%.
- US consumers can absorb higher energy prices. On an inflation-adjusted basis, oil prices of $120 per barrel are in line with 2012–2015 prices.

Portfolio positioning

- We removed our lower-duration (reduced interest rate risk) position in our bond portfolios in February after markets quickly priced in seven rate hikes this year.
- We are overweight high yield municipal bonds in our tax-exempt FI portfolios.
- We are overweight US equities, small-cap equities, private debt, absolute return hedge funds, and private equity.
- We are underweight international developed and emerging market equities.

Risks we're watching

- Sustained oil prices above $150 per barrel
- An agricultural supply shock due to a lost planting season in Ukraine
- A Fed policy mistake (e.g., continued hiking once unemployment increases or pausing before aggregate income growth drops to 3%)
- An unanchoring of inflation expectations that would force the Fed to hike into a recession
- Exacerbated geopolitical tensions

Please click any link to access additional information and insights.

First Quarter 2022 Market Review

- The Federal Reserve kicked off the post-COVID hiking cycle by raising the Fed Funds rate 25bps in March. They will likely hike by 50bps at each of the next two meetings and take short term rates above 2% by the end of the year.
- US Treasury yields jumped. The 2-year Treasury yield increased from 0.73% to 2.4% and the 10-year Treasury yield increased from 1.5% to 2.5% during the quarter.
- Taxable and municipal bonds continue to sell off. The Bloomberg Aggregate Bond Index declined 5.9% in the first quarter, and has fallen over 8% since August 2020.
- Equity markets corrected 10–15% during January and February, but have since recovered most of those losses.
- Value stocks outperformed during January and February. Growth stocks outperformed in March.
- US equities have outperformed international developed and emerging market equities this year.
- We've seen a significant dispersion in returns across equity markets following the Russian invasion of Ukraine. US equities are up about 10% post-invasion whereas international developed market equities are flat and emerging market equities are down 5%.
- Commodity prices continue to surge.
- The US dollar has appreciated 3% this year and remains strong.

Index Returns	January	February	March	YTD	1 year	3 years	5 years	10 years
Global Equities	-4.9%	-2.6%	2.2%	-5.4%	6.1%	13.3%	11.6%	10.0%
US Equities	-5.9%	-2.5%	3.2%	-5.3%	10.5%	17.8%	15.4%	14.3%
Large Cap US	-5.6%	-2.7%	3.4%	-5.1%	11.9%	18.3%	15.8%	14.5%
Mid Cap US	-7.4%	-0.7%	2.6%	-5.7%	5.4%	14.4%	12.6%	12.9%
Small Cap US	-9.7%	-0.1%	0.8%	-9.1%	-6.2%	14.1%	12.4%	12.5%
US Growth	-8.9%	-4.0%	3.7%	-9.3%	11.1%	22.2%	20.2%	16.6%
US Value	-2.6%	-1.0%	2.8%	-0.8%	10.0%	12.5%	10.2%	11.6%
International Equities	-4.8%	-1.8%	0.6%	-5.9%	0.6%	7.4%	6.7%	6.3%
Emerging Market Equities	-1.9%	-3.0%	-2.3%	-7.0%	-12.6%	4.5%	6.0%	3.4%
US Taxable Bond Market	-2.2%	-1.1%	-2.8%	-5.9%	-4.5%	1.8%	2.1%	2.2%
US Municipal Bond Market	-2.2%	-0.3%	-2.3%	-4.8%	-4.0%	1.1%	1.8%	2.0%
Hedge Fund Index	-1.5%	-0.4%	0.6%	-1.2%	1.0%	4.9%	2.9%	2.1%
Diversified Commodities	8.8%	6.2%	8.6%	25.5%	48.1%	15.7%	8.9%	-0.7%
Gold	-1.8%	6.2%	1.5%	5.9%	11.6%	14.4%	9.1%	1.5%

Key Rates (as of stated date)	1/31/22	2/28/22	3/31/22	12/31/21	4/1/21	4/1/19	4/1/17	4/1/12
US 10-Year Treasury	1.8%	1.8%	2.3%	1.5%	1.7%	2.5%	2.4%	2.2%
Barclays Aggregate Bond Index	2.1%	2.3%	2.9%	1.8%	1.6%	3.0%	2.6%	2.2%
BBarc Muni 1-10Yr Blend (1-12) Index	1.4%	1.5%	2.2%	0.7%	0.7%	1.9%	1.9%	1.6%

Source: Bloomberg, Mill Creek. Returns for periods greater than one year are annualized. Benchmark rates are yield to worst. Data as of March 31, 2022.

Indices used to represent periodic capital markets returns include: MSCI ACWI (Global equities), Russell 3000 (US equities), Russell 1000 (Large Cap US), Russell Mid Cap US (Mid Cap US), Russell 2000 (Small Cap US), Russell 3000 Growth (US Growth), Russell 3000 Value (US Value), MSCI EAFE (International Developed), MSCI Emerging Markets Index (Emerging Markets Equities), Barclays Aggregate Bond Index (US Taxable Bonds), Barclays 1–10 Year Municipal Bond Index (US Municipal Bonds), HFRI Fund of Funds Composite Index (Hedge Funds); Bloomberg Commodity Index TR (Diversified Commodities), Gold Spot Price (Gold). Hedge fund data generally trails by one month due to lags in reporting.

Private Equity Market Update

After a record-breaking 2021, private equity markets cooled off during Q1 2022, lagging the sell-off in public equity markets. With nearly two-thirds of the 2021 IPO class trading below their offering price, investors have renewed scrutiny to valuations, extended investment timelines, and increased discounts offered in the secondary market. However, deal volumes in venture capital and middle-market buyouts keep bankers and sponsors busy planning their reopening strategies. As a result, most sponsors have continued to invest in fast-growing sectors like health care and technology.

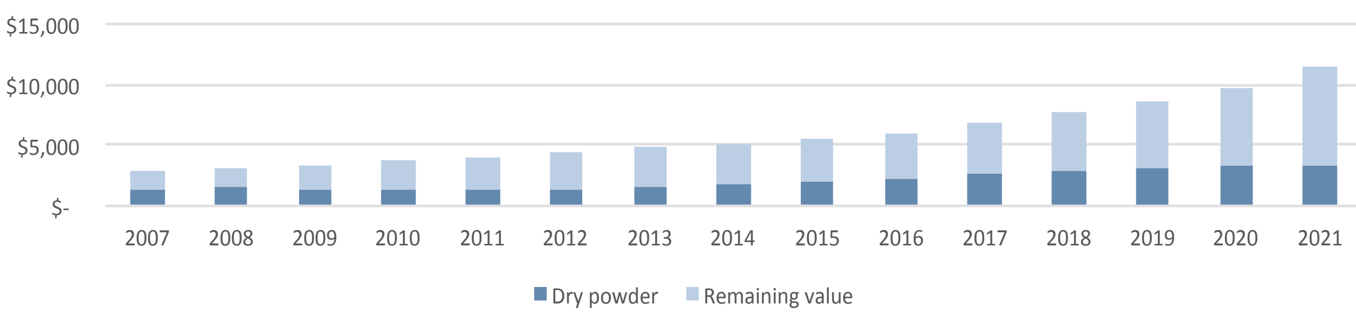
Industry headlines home in on the growth of the asset class, which is currently estimated at $10 trillion in assets under management. This record capital formation is attributed to the value added through active ownership by skilled sponsors in conjunction with increasing accessibility to investment opportunities by smaller investors.

An open question is whether the premiums paid for high-growth technology platforms will ultimately result in profitable returns to investors. The sheer volume of investments in the space is as staggering as the disruption caused by legacy industries and business processes. There appears to be no end in sight to the industry and business impact of artificial intelligence, personalized health care, and decentralized networks.

While we remain concerned about valuation levels, we are confident that the macro trends behind most of these shifts will endure whatever the next downturn may bring. We will continue to seek innovative managers with specialized skills to pioneer less efficient market segments where private capital can catalyze growth. With over 200 institutional-quality private equity funds raised per annum in the US alone, there are many opportunities to consider.

Fig. 1: Private capital markets continue to grow by size

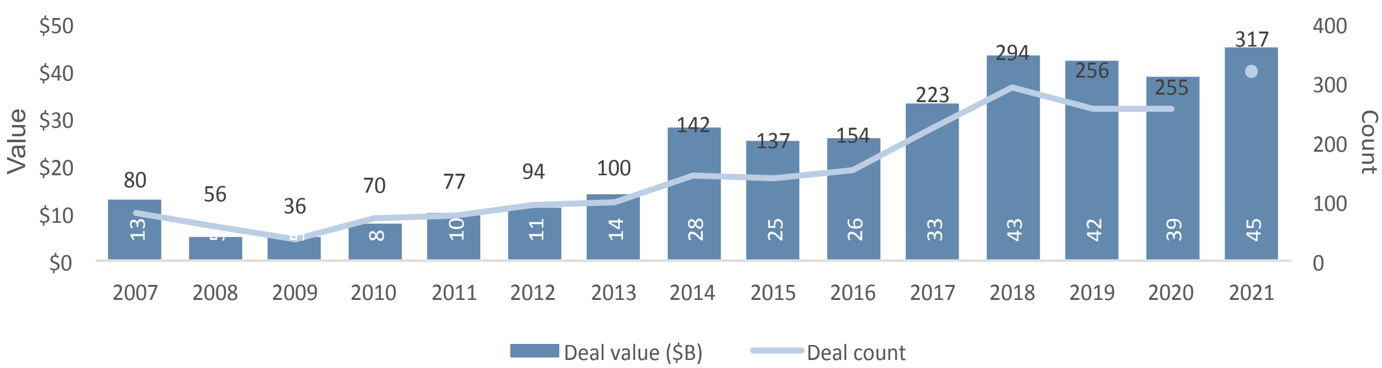
Private capital markets assets under management (AUM) over the last 15 years ($billions)



Source: Pitchbook, 2022 US Private Equity Outlook, Mill Creek.

Fig. 2: Software deal activity in middle markets

Transaction value and deal count growth over the last 15 years ($billions)



Source: Pitchbook, 2022 US Private Equity Outlook, Mill Creek.

The Anatomy of a Bear Market

Key message

Equity bear markets, typically defined as a 20% or greater decline from all-time highs in large-capitalization US equities, loom large in the minds of many investors. Fortunately, bear markets are uncommon. Since World War II, we have had eight bear markets — a pace of about one per decade. Bull markets last considerably longer on average than bear market drawdowns — 120 months versus 12 months, respectively — but bear markets can be painful. Post-war bear markets have erased 12–141 months of prior gains and the recovery period following a bear market has averaged just short of two years. We do not believe that we, or anyone, can predict equity bear markets effectively. Public equities offer superior long-term returns in exchange for withstanding price volatility. Prudent asset allocation, not market timing, can reduce the magnitude and duration of portfolio drawdowns and prevent the pain of a bear market from becoming true financial damage.

Our view

1. Equity bear markets are infrequent but painful

- Equity bear markets occur, on average, every 9–10 years.
- Drawdowns and recoveries averaged 12 and 23 months, respectively.
- The median round trip (drawdown plus recovery) has been 34.5 months.
- Bear market declines have averaged -34% peak to trough.

2. Equity declines of 5–20% occur all the time

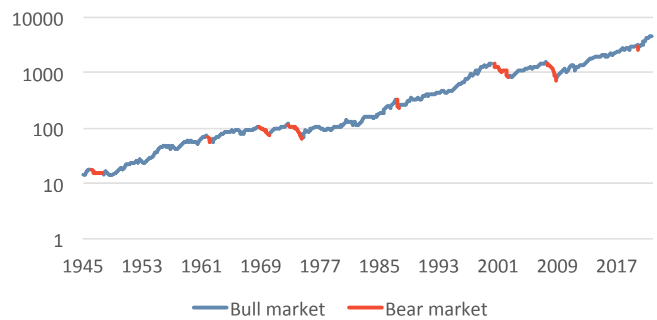
- Pullbacks of 5–15% occur nearly every year and should be considered part of normal equity volatility.
- Large-cap US equities have spent 35% of their time at 5–20% below all-time highs since 1945.
- Period positive and negative “swing days,” defined as daily price returns greater than 1% or less than -1%, tend to cluster together. Investors are just as likely to miss the best days as they are to avoid the worst if they attempt market timing.

3. Asset allocation prevents pain from becoming damage

- Asset allocation, not market timing, is the most effective tool for mitigating equity market declines.
- High-quality fixed income and other diversifying assets can mitigate the magnitude and duration of portfolio drawdowns during bear markets.
- We believe investors should hold enough safe assets to cover spending while equities and other risk assets recover.
- In the current environment, we believe it is important to diversify with private debt, absolute return hedge funds, and private equity.

Fig. 1: Bear markets are infrequent

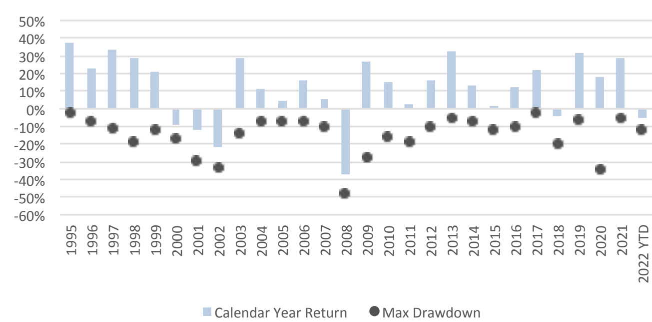
S&P 500, 1945–2022



Source: Bloomberg, Mill Creek. As of 3/7/2022.

Fig. 2: But equity markets are very volatile

Peak-to-trough drawdowns, S&P 500, 1945–2022



Source: Bloomberg, Mill Creek. As of 3/7/2022.

Women's History Month – Interview

As part of our series "Women in the Workplace," we interviewed **Tiana Juarez**, Executive Assistant to CEO Joshua Gross. Once a professional ballerina and also author of *The Pointe Shoe Manual*, Tiana talks about her career and finding balance.

Tiana and her son

Read the interview here.

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