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Capital Markets Review and Outlook

By: Cyril M. Theccanat, Chief Investment Officer

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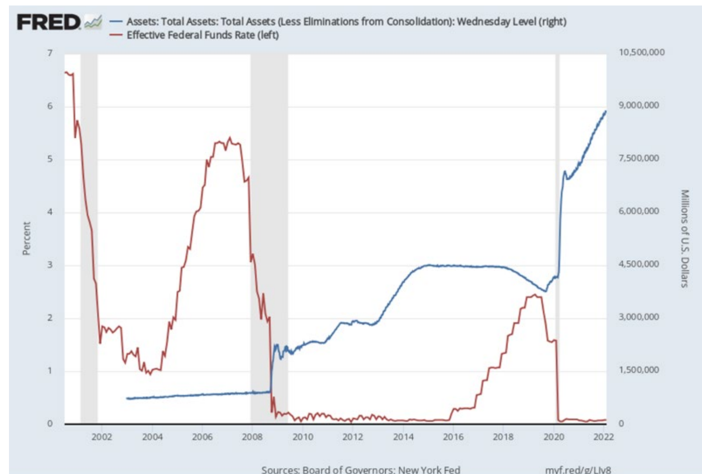
Economy and Outlook

Despite the rapid spread of the highly contagious Covid-19's Omicron variant, the effects from infections proved milder than those from prior variants such as Delta. Additionally, the daily number of new infections dropped rapidly as the month of January ended. However, the grim milestone of over 900,000 deaths in the United States and a worldwide death toll approaching 6 million from Covid-19 is a sobering reminder of the extremely deadly nature of the pandemic. While the world is now entering the third year of the worst global healthcare crisis in generations, there are increasing signs of optimism. Over 10 billion vaccine doses have been administered worldwide – a remarkable feat given that vaccinations started a mere 14 months ago. Much progress has also been achieved in making testing more widely available. New treatment regimens are also coming including oral medications to successfully combat the effects of the disease and prevent complications. Light at the end of the long Covid-19 tunnel does seem to be coming into focus. Despite the surge in Omicron infections in December and into January, economies remained resilient. In the United States, the monthly employment report for January showed nonfarm payrolls rose 467,000, significantly higher than the estimates of most forecasters. In addition, revisions to the November and December employment reports resulted in gains of another 709,000. Wages also rose steeply by 0.7% for the month and 5.7% for the 1 year ending 1/31/22. The surprising strength in the economy and the much higher inflation rate have put pressure on the Federal Reserve to more quickly unwind the enormous monetary stimulus injected into the economy since the pandemic began two years ago. The unprecedented magnitude of the Fed's stimulus measures is shown in the chart on the left. The Federal Reserve's balance sheet has increased almost 10-fold since 2008 while the central bank's key interest rate, the federal funds rate, has been maintained at near zero for almost 2 years. These measures by the Fed have forced investors of all stripes and even savers to take on risk. The result has been the lofty valuations of risk assets across the board. A renormalization of valuations



accompanied by increased market volatility is likely to result as the Fed unwinds its accommodative monetary policies.

Equity Markets

Sharply higher interest rates, stubbornly high inflation, geopolitical concerns and worries about less accommodation from central banks all weighed on equity markets in January. After making record highs just as the new year began, the broad domestic equity market represented by the Russell 3000 index dropped sharply ending the month with a loss of -5.9%. While this is a significant decline, it is important, especially for institutional investors, to keep the downturn in perspective. Despite the magnitude of the decline, the one-year annualized return for the Russell 3000 is +18.8%. More importantly, the annualized returns for the past 5- and 10-year time periods are +16.1% and +15% respectively. In fact, the 10-year annualized return of +15% is the highest 10-year return (on a rolling 10-year basis) in over 20 years. As is typically seen in market declines, Large Cap (-5.6%) outperformed both Mid Cap (-7.4%) and Small Cap (-9.6%) in January. Value also outperformed Growth by a significant margin (7 to 8 percentage points) across all capitalizations. This is historically the case when the Federal Reserve turns hawkish. As is also usually seen in market declines, sector performance favored Defensives over Cyclicals. Consumer Discretionary (-9.7%) was the worst performer while Consumer Staples (-1.4%) was one of the best performing sectors. Despite the sharp rise in Treasury yields and a continued flattening of the Treasury yield curve, Financials managed to close the month almost flat with a gain of +0.1%. Building on its massive performance (+54.6%) in 2021, Energy was again the best performer in January skyrocketing 19.1% on the heels of the continuing rally in energy prices with crude oil (WTI) approaching $90 a barrel. International equity markets also declined in January as apprehensions grew about the spillover effects from the U.S. Federal Reserve moving into its interest rate hiking cycle. Foreign currencies (especially in developed markets) also broadly declined against the U.S. dollar with the dollar index (DXY) rising +0.6% for the month. The MSCI Developed Markets ex-US equity index lost -4.8% in January. Australia (-8.8%) was the worst performer as its currency declined -2.5% against the U.S. dollar. Japan also experienced a sizeable decline of -5.1% as the country's borders remain closed to foreigners thus pushing out expectations for a full recovery of its domestic economy. Equity markets in the United Kingdom (+0.9%) and Canada (-0.9%) were the leaders in the developed markets helped by the rise in oil prices. The Emerging Markets index (-1.9%) held up much better than its Developed Markets counterpart as Brazil shot up +13% in January with its currency rising +4.6% against the U.S. dollar. Economic activity was better than anticipated, and there is some optimism ahead of Brazil's presidential elections later this year. The Emerging Markets index was also helped by the relatively smaller declines in both China (-2.9%) and India (-1.4%). The outperformance of Emerging Markets relative to Developed Markets in January is a reversal from its significant underperformance for 2021.

Fixed Income Markets

Increasing signs that the Federal Reserve may need to move more aggressively in removing monetary policy accommodation pushed interest rates sharply higher in January. The yield on

the 2-year Treasury note rose decisively above 1% for the first time in almost 2 years, rising 45 bp to end the month at 1.18%. Five- and ten-year Treasury yields rose 36 and 27 bp respectively with the yield on the 10-year Treasury closing the month at 1.79%. The yield increase on the 30-year Treasury bond was 21 bp resulting in a yield of 2.11%. The differential in yield changes caused the Treasury yield curve to flatten further. The 2-year/30-year Treasury yield spread narrowed 24 bp to end the month at +93 bp. This is also the first close below +100 bp for this spread in almost 2 years; just 9 months ago, the spread was more than twice as steep at +225 bp. Reflecting the selloff in the equity markets, the credit markets also declined in January. The Bloomberg investment grade credit index option-adjusted spread (OAS) widened by 12 bp to +99 bp resulting in -105 bp of underperformance versus duration-matched Treasuries. As is typically seen during periods of underperformance, both the quality curve and the credit curve steepened in January. The Single-A rated sector outperformed the BBB rated sector by +27 bp in excess return, while long maturities underperformed short and intermediate maturities by an average of -120 bp. Like the equity markets, Cyclicals underperformed Defensives for the month. The worst performing major sector was Industrials (-133 bp), while Noncorporates (-41 bp) held up better. Higher Treasury yields and wider spreads led to a total return of -3.2% for the Investment Grade Credit sector in January. In the High Yield sector, its higher correlation with the equity markets led to a greater widening in spreads with the Bloomberg High Yield index OAS widening by 59 bp to end the month back above +300 bp at +342 bp. Contrary to the investment grade sector, the lower quality high yield sector outperformed higher quality: the Ba rated sector posted a total return of -2.1% while the lower rated Caa-rated sector declined -0.2%. On the credit curve, however, results were similar to the investment grade sector – the longer duration high yield sector underperformed the shorter duration sectors. Reflecting the sharp rise in energy prices, Refining (+0.9%) and Oil Field Services (+0.4%) were the best performers for the month, while the laggards include Food and Beverage (-4.2%) and Retailers (-3.5%). The higher coupons in the high yield sector together with positive performance in energy-related names helped cushion the negative effect from higher Treasury yields and wider spreads. For the month, the High Yield index had a total return of -2.7%. Government bond yields across developed markets also rose sharply in January due to persistently high inflation, and as expectations mounted that the Federal Reserve would raise interest rates. The German 10-year yield rose 18 bp to +0.01% marking its first positive yield since May 2019. Yields in the United Kingdom rose even more with the 10-year UK yield rising 34 bp to 1.3%. The combination of higher yields and a stronger U.S. dollar led to a -2.3% decline in the FTSE non-US Government Bond index in January compared to a decline of -1.9% for the U.S. government bond index.

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			Returns as of 1/31/22 (In %)		
		Month	1 Year	3 Years	5 Years
Russell 3000®	US AllCap Equity	-5.9	18.8	19.9	16.1
Russell 1000®	US Large Cap Equity	-5.6	20.3	20.5	16.6
Russell 1000® Growth	US Large Cap Growth	-8.6	17.5	26.4	22.3
Russell 1000® Value	US Large Cap Value	-2.3	23.4	13.8	10.5
Russell Midcap®	US Mid Cap Equity	-7.4	13.9	16.1	12.8
Russell Midcap® Growth	US Mid Cap Growth	-12.9	-1.5	17.4	15.8
Russell Midcap® Value	US Mid Cap Value	-4.3	23.1	14.1	9.9
Russell 2000®	US Small Cap Equity	-9.6	-1.2	12.0	9.7
Russell 2000® Growth	US Small Cap Growth	-13.4	-15.0	11.4	10.9
Russell 2000® Value	US Small Cap Value	-5.8	14.8	11.7	7.9
MSCI ACWI ex-US	Global Equity ex-US	-3.7	3.6	9.1	8.0
MSCI EAFE	Global Developed Mkts Equity	-4.8	7.0	9.3	7.8
MSCI EM	Emerging Mkts Equity	-1.9	-7.2	7.2	8.3
Bloomberg/Barclays US Agg	US Core Fixed Income	-2.2	-3.0	3.7	3.1
Bloomberg/Barclays US Interm. Agg	US Intermediate Fixed Income	-1.5	-2.6	2.8	2.5
Bloomberg/Barclays US Credit	US Corporate Bonds	-3.2	-3.1	5.3	4.3
Bloomberg/Barclays US MBS	US Mortgage Backed Securities	-1.5	-2.6	2.2	2.2
Bloomberg/Barclays US Corp HY	US High Yield	-2.7	2.1	6.3	5.4
FTSE Non-US WGBI	Global Fixed Income ex-US	-2.3	-10.5	0.3	1.9

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3333 Piedmont Road NE Suite 755 • Atlanta, GA 30305 • 404-883-2500 • consequentcm.com