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Quarterly Economic Update

First Quarter 2022



A Registered Investment Advisor

2021 closed as a banner year for many investors. Although history will record the Covid pandemic for causing one of the sharpest recessions ever felt by the global economy, the rebound investors continue to see nearly two years later has been just as remarkable. Post-pandemic equity markets in 2021 saw the S&P 500 create 70 record closes, the last one on Wednesday, December 29. The DJIA also realized 45 record closes in 2021. (Source: Barron's 12/31/21)

Stock valuations have soared in large part due to ultra-low interest rates and a healthy economic recovery. With a few exceptions like some bonds and gold, almost every asset class produced gains in 2021. (Source: Barron's 12/17/21)

Throughout the year equity markets showed perseverance and resilience against many potentially detrimental events and rewarded investors with notable gains, but investors still face continued variables that could affect the uptick of the economy and its recovery.

As we enter 2022, there are several areas that should play a key role in the economy and how it may affect investors. These include:

- The trajectory of the COVID-19 pandemic recovery – hopefully we will not experience any newer emerging COVID variants and we will see a reduction of new cases.
- The Federal Reserve's tapering and ultimate goal of ending the pandemic-induced monetary stimulus.
- The slowing down of global economic growth, particularly in China – the world's second largest economy.
- The current high valuations of stocks and real estate.



| MONEY RATES (as posted in Barron's 1/10/2022) | | |
|---|--------------------|---------------|
| | LATEST WEEK | YR AGO |
| Fed Funds Rate (Avg. weekly auction) ^c | 0.08% | 0.09% |
| Bank Money Market^z | 0.07% | 0.09% |
| 12-month CD^z | 0.14% | 0.21% |

c- Annualized yields, adjusted for constant maturity, reported by the Fed Reserve on a weekly average basis. z – Bankrate.com (Source: Barron's; bankrate.com)

- Rising interest rates.
- Inflation rates that could remain elevated.

These and a variety of economic factors could complicate equity market performance in 2022, so investors need to be prepared.

Inflation & Interest Rates

Interest rates and inflation concerns continue to be at the forefront of the economic news, especially after the Fed announced in December it will speed up its timeline for tapering down its stimulus.

In November, inflation statistics rose 6.8% versus the preceding twelve months. This was the fastest rise in inflation since 1982. Several factors have contributed to a swift elevation of inflation, including the imbalance of the supply and demand chain and the reopening of the economy. The Fed expects that supply chain bottlenecks and shortages will continue well into 2022.

Interest rates and tapering are currently closely connected. Even though 2022 is forecasted to bring slightly higher rates, at the conclusion of the Federal Reserve's meeting in December, the Federal Open Market Committee (FOMC) kept the federal funds rate at or near zero (0–0.25%). The median forecast of FOMC members is three quarter-point rate increases in 2022 and three more in 2023, which would raise rates to 2.1% at the end of 2024.

What does this mean? While these rate ranges are still low, the possibility of new volatility, less robust equity returns, and negative returns on bonds (when you factor in inflation) has investors wary and some have their selling finger on the trigger.

As your financial professional, we are committed to keeping a watchful eye on the economy and how interest rate hikes and the trajectory of inflation affects our clients. If you are concerned about how these key items could affect you, please connect with us to discuss.

Treasury Yields

2021 was a lackluster year for bond holders. While today's interest rates are still historically low, as we stated earlier, the Fed is expecting to raise interest rates several times in the next two years. When interest rates rise, the demand for bonds typically falls, reducing their prices and raising their yields.

KEY TAKEAWAYS

- Equity markets ended on a high note despite many potentially detrimental variables.
- Inflation and consumer price index had their highest rise in decades.
- The Fed started tapering and intends to increase interest rates in 2022.
- Covid variants still a key factor in economic recovery.
- Volatility is likely in 2022.
- Risk management techniques in portfolio management are essential.
- Call us for a comprehensive review of your personal financial situation.

Thus, 2022 may see a slightly better performance from bonds.

We are monitoring interest rate movements and their effect on bond yields. Investors should remember that bonds can be a critical component to a diversified portfolio. Bonds can be a good shield from volatility in equities and provide income. However, investors who put a high percentage of their portfolios in bonds with the hopes of producing stable returns could see minimal results.

Investor's Outlook

Investors are not out of the woods from COVID and its effects on the economy. Omicron introduced itself to the world in late November and equity markets reminded us that they are still vulnerable to the Coronavirus. The DJIA responded with its worst day since October 2020 and the S&P500 had its worst performance since February 2021. However, the markets quickly rebounded.

Monetary policy also could alter equity markets. The Build Back Better Act, which was not passed in 2021

is still proposing to bring some changes to tax laws that could also affect investors in 2022 and beyond.

Regardless of how equities are performing, investors should always focus on their personal objectives and long-term goals. Even when investing for the long-term, there is no guarantee that market volatility will decrease, stabilize, or increase over any timeframe.

As your financial professional, we are here to help you with your goals. We treat each client as an individual case with unique goals and circumstances. Prior to making any financial decisions, we highly recommend you contact us so we can help determine the best strategy. There are often other factors to consider, including tax ramifications, increased risk, and time horizon fluctuations when changing anything in your financial plan. As always, please feel free to connect with us with via telephone or email with any concerns or questions you may have.

Getting Positioned for 2022

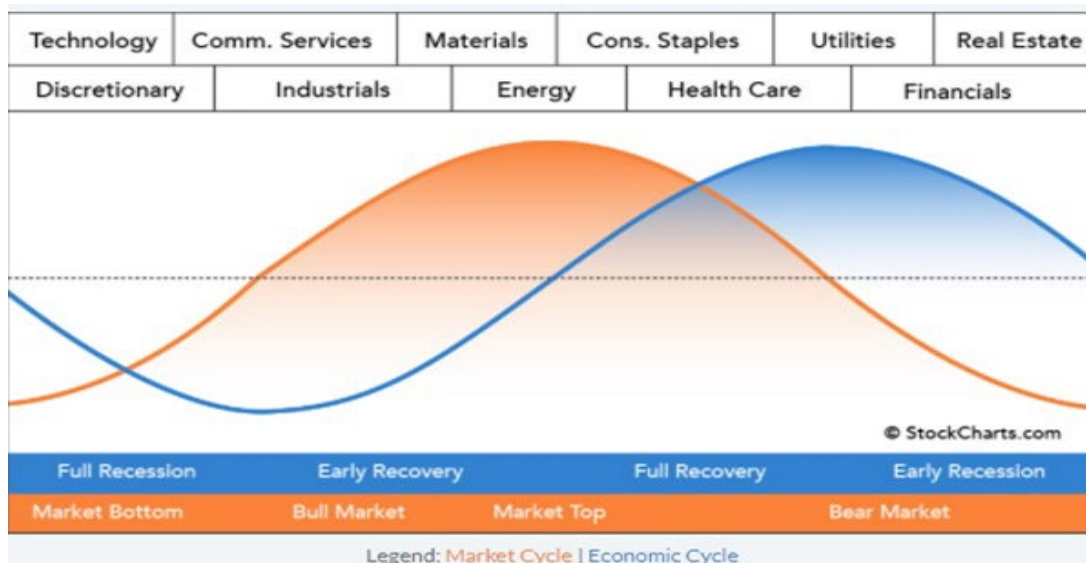
Quite often the most persistent and lasting trend changes in the markets happen when no one expects them to occur. What trend changes are we talking about? At a very high level, the market is now adjusting to the fact that the Federal Reserve is beginning their long overdue process of removing liquidity from the markets. Why? Because they now

understand clearly that inflation is not transitory beyond a moderate loosening of supply chain restrictions in 2022. As a result, we're seeing the economic cycle clock turn quickly toward full recovery/early recession environment.

In this part of the economic cycle the stock market usually engages in a long, broad, topping out process. From a sector perspective, we will be looking at the usual late-growth leaders of **energy, materials, consumer staples, utilities, healthcare and financials** (see chart). The worst performers late-cycle usually are technology, consumer discretionary, and communication services sectors. We are also seeing signs of a developing opportunity in the Value side of the market (selling at historically cheap valuations). This may be the start of a secular move where Value dramatically outperforms Growth as we quickly and not so quietly, graduate from a world dominated by just a few mega cap growth names. This is a time when investors must be very selective about what they own and keep risk management protocols firmly in place.

Risk management in the investing world attempts to control portfolio volatility and absolute downside losses when the financial markets experience deep corrections or bear markets. The practice is both art and science. But there are limits to what any form of risk management can accomplish. To be clear, risk

Sector Rotation through the Market and Economic Cycles:



management does not eliminate risk, nor does it try to sidestep every down week or negative giggle in the markets. It is about **reducing volatility and reducing downside losses to a tolerable level such that recovery periods are shorter in both time and magnitude.**

Investing – Not Gambling

One of the greatest risks we see in today's market is the very high concentration of wealth among a few mega cap technology names: Apple, Amazon, Google, Facebook (Meta), Microsoft. These same names collectively represent a weighting of over 30% of the entire stock market. So, what could go wrong? Investors should all acknowledge that if these companies run into trouble for whatever reason, they will take the market with them by the sheer fact of their market capitalization weighting in the stock market index.

We've seen this movie before. It happens when not so smart and inexperienced investors chase anything that moves fast. It doesn't really matter what "it" is, just that it's going to the moon! The last time we had a concentration of financial wealth in just a few names was the year 2000 when our markets were dominated by GE, Cisco, Exxon Mobil, Intel and Microsoft. Of those five, only Microsoft has generated a reasonable return on an average annual basis over the last 21 years – the only "horse" in the race that finished.

When gambling at the horse races, betting on a horse means putting money on a hopeful winner

before the announcer shouts "go" and either picking up a gain or losing it all several minutes later. Investing shouldn't be like that, though. In our view, no manager should pick a horse in the race. Unfortunately, that is usually how we see it work. Our approach is to make money without actually wagering on a horse in the race. We do not view the option of "loosing it all" if the horse doesn't win as a smart investment strategy. Instead, we identify the asset classes and securities trending positively when we make a decision to buy. We can and will consider investing in any security in a rising trend. However, when that uptrend switches to a falling trend, we seek to eliminate the impact on the portfolio by selling off some of the risk. Essentially, we place our wager on the horse with the best odds of winning but adjust our bet throughout.

Our strategy is always agnostic to the loudest (or "smartest") point of view. We won't pick a horse in the race, making money instead by owning asset classes in an uptrend, and selling and holding cash or conservative investments when the trends are all down. The most unique advantage this brings is the ability to manage risk to levels that are not so debilitating during Bear Market declines that you have to drop out of the race.

At Zephyr, we help you **Navigate the Investing environment – making the ride more comfortable – and help you get to your final destination (all while enjoying the journey).** You only get one life – it's our upmost desire for you to enjoy it!

Complimentary Financial Check Up

If you are currently not a client of Zephyr Investment Management, we would like to offer you a *complimentary, one-hour, private consultation* at absolutely no cost or obligation to you. **To schedule your financial check-up, please call Cher at (805) 496-6810.**

"We Cannot Direct the Wind, But We Can Adjust the Sails."

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