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SOL CAPITAL MANAGEMENT COMPANY

Client Investment Letter

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Global financial markets were impacted by several negative catalysts in the first quarter that weighed on the returns of risk assets and left few safe harbors for investors to hide. Sustained high inflation in many economies triggered fears that monetary policymakers, particularly at the U.S. Federal Reserve, were “behind the curve” and that interest rates would need to rise much faster than anticipated. A shift away from growth stocks that began last year intensified as a result, and duration took its toll on the prices of high-quality bonds as yields rose. All this was before Russia’s invasion of Ukraine sent a shock wave through commodity markets.

Since then, equity, fixed income, and commodities markets have all remained volatile, navigating through a myriad of concerns. First, they continue to react to war headlines and analyses of the conflict’s potential, longer-term consequences, particularly in Europe. Meanwhile, aggressive actions by regulators in China have spooked foreign investors. Recurring COVID outbreaks and draconian lockdowns of mega cities are also beginning to take a heavier toll on growth in the world’s second largest economy. And, global markets have kept a watchful eye on the Fed as it begins what is widely expected to be one of the steepest rate hike cycles since the 1990s.

The Fed’s main challenge will be to tighten financial conditions just enough to rebalance the labor market and slow price increases down to a pace consistent with its medium-term target, without triggering a recession at home or a financial crisis abroad. This result is commonly referred to as a “soft landing,” and to set expectations, it is a feat that has rarely been achieved in modern U.S. history. Later in this letter we endeavor to analyze the numerous and complex components of the stubbornly high inflation we are currently experiencing, as well as the potential ramifications of the choices that will ultimately be made by the Federal Reserve.

Financial Markets Performance

Equities

In the U.S., performance of S&P 500 sectors varied significantly; energy stocks advanced 39% thanks to rising oil and natural gas prices, while all other sectors (except utilities) lost ground. Sectors highly sensitive to rising inflation and interest rates (i.e., information technology, consumer discretionary, communication services) all declined nearly 10%, continuing their slide in April

Financial Markets Performance Cont.

"The performance differential between value and growth was significant across all capitalizations, with value outperforming growth by a relative eight percentage points in the S&P 500 index and ten percentage points in the small-cap Russell 2000 index."

(see Exhibit 1). While in broad terms large caps outperformed smaller stocks, performance variance was nominal. However, the performance differential between value and growth was significant across all capitalizations, with value outperforming growth by a relative eight percentage points in the S&P 500 index and ten percentage points in the small-cap Russell 2000 index.[1]

Prior to the outbreak of war, equities in non-U.S. developed markets were roughly flat on the year as post-pandemic inflationary pressures and the prospect of rising interest rates were less pronounced in Europe and Japan. However, the former's reliance on Russian gas and its proximity to the conflict sparked a sharp equity selloff in late February, causing the equity markets of some of the continent's largest energy importers to end the quarter with significant declines.[2] Japanese shares also lost ground as investors worried about the prospects of a decline in global trade, but losses were tempered by the Bank of Japan's unwavering commitment to accommodative monetary policy. Equity markets in countries less dependent on Russian energy (and/or large commodity producers in their own right), such as the United Kingdom, Australia, and Canada, ended the period in positive territory.

Broad indices of emerging market equities declined as well, but performance varied widely. Equities in China, South Korea,

Exhibit 1

Total Return* for Selected Equity Indices	First Quarter (12/31/21 to 03/31/22) %	Year-to-Date (12/31/21 to 04/30/22) %
S&P 500 Index	-4.60%	-12.92%
S&P 500 Growth Index	-8.59%	-20.00%
S&P 500 Value Index	-0.16%	-5.02%
Russell 3000 (Total U.S. Market) Index	-5.28%	-13.78%
Russell 2000 (Small-Cap) Index	-7.53%	-16.69%
Russell 2000 (Small-Cap) Growth Index	-12.63%	-23.35%
Russell 2000 (Small-Cap) Value Index	-2.40%	-9.97%
MSCI All Country World ex-U.S. Index (Net)	-5.44%	-11.38%
MSCI All Country World ex-U.S. Growth Index (Net)	-10.78%	-17.41%
MSCI All Country World ex-U.S. Value Index (Net)	0.13%	-5.06%
MSCI EAFE (International) Index (Net)	-5.91%	-12.00%
MSCI Emerging Markets Index (Net)	-6.97%	-12.15%
MSCI ACWI Commodity Producers (Net)	20.51%	15.27%

Source: FactSet. *Includes price appreciation plus dividends and/or interest.

[1] Value stocks generally tend to be less sensitive to rising interest rates.

[2] The MSCI Germany Index declined -12.8% in U.S. dollar terms in the first quarter, while the MSCI Netherlands Index declined -17.4% and the MSCI Sweden Index -15.1% over the same period.

Financial Market Performance Cont.

and Taiwan (jointly representing 57% of the MSCI Emerging Markets index) were weaker in large part due to new COVID outbreaks, fears around the delisting of Chinese companies in the U.S., and weakening global economic growth. In commodity-producing emerging markets, such as Brazil and South Africa, equities were sharply higher, though their smaller weight in the index did little to offset the weakness in East Asian stocks. [3]

Fixed Income

Accelerating inflation and an increase in the number of expected rate hikes by the Fed drove significant declines in the broad fixed income market during the first three months of the year (see Exhibit 2). Duration (interest rate sensitivity) played a major role in performance across most debt assets.

In the U.S. Treasury market, longer-duration securities were hit particularly hard due to their higher sensitivity to interest rate movements. So, although rates at the front end of the yield curve (i.e., shorter maturities) had a more pronounced move than rates at the long end of the curve, performance differentials were significant. Two-year Treasuries declined -2.5% over the quarter, while 30-year Treasuries fell an astonishing -11.4%. By the end of April, these declines (especially for 30-year bonds) had only gotten worse (see Appendix A). Developed market sovereign bonds fared poorly as well, though they still managed to outperform the emerging markets debt index, which was dragged down by the (albeit small) Russian and Ukrainian components that were priced for default and/or removed from the index.

Global investment-grade credit also posted negative returns. Higher-quality debt underperformed, as these securities tend to be more rate sensitive (i.e., higher durations) than lower-quality issues. The lower interest rate sensitivity of European investment-grade bonds generated outperformance as compared to comparable U.S. and U.K. debt.

Global high-yield debt posted negative returns mostly due to a reduction in the market's risk appetite and rising interest rates. Nevertheless, negative returns were somewhat muted thanks to the asset class's lower overall duration.

"Accelerating inflation and an increase in the number of expected rate hikes by the Fed drove significant declines in the broad fixed income market during the first three months of the year (see Exhibit 2)."

Exhibit 2

Total Return* for Major Fixed Income & Hedge Fund Indices	Fourth Quarter (09/30/21 to 12/31/21) %	Year-to-Date (12/31/201 to 1/31/22) %
Bloomberg Barclays U.S. Aggregate Bond Index	-5.93%	-9.50%
Bloomberg Barclays U.S. Government/Credit Index	-6.33%	-10.04%
ICE BofAML 1-3 year U.S. Broad Market Index	-2.55%	-3.07%
ICE BofAML U.S. High Yield BB-B Bond Index	-4.61%	-8.04%
JP Morgan Non-U.S. Global Bond Index (GBI) Hedged	-5.06%	-6.93%
JP Morgan EMBI Global Index in USD (Emerging Markets)	-9.26%	-14.23%

Source: FactSet. *Includes price appreciation plus dividends and/or interest.

[3] The MSCI Brazil Index advanced +36.0% in U.S. dollar terms over the first quarter, while the MSCI South Africa and the MSCI Indonesia indices advanced +20.5% and +9.9%, respectively.

Global Economic Update

Most major economies find themselves in the middle stages of the business cycle (with the notable exception of China). However, their trajectories are becoming more differentiated ever since Russia's invasion of Ukraine. Some commodity-producing economies (e.g., Australia, Brazil, Canada) are riding a tailwind from the price shock. On the other hand, major commodities and energy importers (e.g., China, India) are facing stronger headwinds, and there are hints of stagflation creeping into the economic outlook for Europe. Meanwhile, the United States is relatively self-sufficient and is facing less economic downside risk from the recent disruption.

"...despite the blip in [U.S. real GDP] growth in the first quarter, we believe the risk of recession in the near term remains low, and economic activity is still expected to return to pre-pandemic levels."

United States

Real GDP contracted by an annualized -1.4% in the first quarter due to the anticipated withdrawal of broad fiscal support, a deterioration in the trade deficit, and a decrease in inventory investment. Furthermore, the high infection rate of the Omicron variant this past winter (peaking at over 800,000 daily confirmed cases) caused temporary labor shortages and disruptions across wide swaths of the economy. However, despite the blip in growth in the first quarter, we believe the risk of recession in the near term remains low, and economic activity is still expected to return to pre-pandemic levels.

The unemployment rate fell to 3.6% in March (well below the 50-year average of 6.2%), while wage inflation reached 6.7% (well above the 50-year average of 4.0%). There continues to be immense excess demand for workers – job openings per person are at levels unseen in over 20 years. Furthermore, there continues to be a generational shift in the labor force as workers over age 55 have exited the labor force since the pandemic hit, while those aged 25-54 (predominantly men on a net basis) have replaced them (see Appendix B).[4]

Consumer prices rose an astonishing 8.5% in March (6.5% excluding food and energy), the highest year-on-year increase since 1981. Housing and food now account for a larger portion of broad inflationary pressures, with prices rising 6.4% and 8.8% year-over-year in March, respectively.[5]

Given the spike in oil prices and high wage inflation, many commentators have made comparisons to the oil shocks and wage-price inflation spiral of the 1970s; we do not think they are appropriate. Chiefly, the U.S. economy is significantly less energy dependent than it was fifty years ago, and the U.S. consumer (in aggregate) is better insulated from the price increases than in previous oil shocks (see Appendix C). Also, organized labor is not as powerful in the current economy, and workers are more efficient than they were before the pandemic. In fact, after adjusting for increased productivity and higher prices, real wages are actually below where they were a few years ago (see Appendix D).

[4] Source: Fidelity Investments.
[5] Source: FactSet, the U.S. Bureau of Labor Statistics.

Global Economic Update Cont.

China

There are indications that China's industrial cycle appears to be bottoming out, but COVID and political headwinds are impeding progress. There continues to be widespread weakness in the property market, regulatory uncertainty is pervasive, and restrictive lockdowns to combat outbreaks of the highly contagious Omicron variant among a population with an overall lack of herd immunity is casting a shadow over economic growth.

While the country's strict "Zero COVID" strategy will likely remain in place for the rest of this year, putting continued strain and uncertainty on global supply chains, some policymakers suggest fiscal and monetary stimulus may be in the pipeline. The central bank already released guidelines for relaxing lending to local governments, while the State Council has indicated support for fiscal measures to stimulate consumption.

Europe

Unsurprisingly, the war in Ukraine is weighing heavily on consumer and business sentiment in Europe. The continent was set to benefit from a gradual post-COVID reopening, but it is now the most exposed to headwinds coming from the war. With the massive rise in energy costs (significantly more than in the U.S.) bleeding into aggregate inflation, monetary policymakers may be forced to cut short their ultra-accommodative stance. Cost of living has become a potent political issue (as seen in the French presidential election, for example), and national governments may move to further subsidize consumers to cushion the blow from the energy market dislocation.

Emerging Markets

Economic fortunes are more mixed across emerging markets. Commodity producers such as Brazil and South Africa stand to benefit from the run-up in market prices for their exports. However, net importers of energy and commodities, such as India and Turkey may face more pressure. Beyond energy and raw materials, the production and export of agricultural goods has also been severely impacted by the war. Prices of wheat, other grains, and cooking oils have stoked food price inflation across numerous vulnerable economies in the Middle East, South Asia, and Africa. Governments may be forced to spend considerably in order to subsidize these costs for their populations, straining budgets.

"Unsurprisingly, the war in Ukraine is weighing heavily on consumer and business sentiment in Europe. The continent was set to benefit from a gradual post-COVID reopening, but it is now the most exposed to headwinds coming from the war."

Special Note: Inflation and the Federal Reserve

In the first quarter, earnings estimates for S&P 500 companies were revised downward from +5% sequential growth to -5%. Inflation was the main culprit, with nearly 75% of companies citing it during their fourth quarter 2021 earnings calls. The Russia-Ukraine conflict has only intensified already worrisome trends. Inflation is very relatable; we all notice it in our daily lives, discuss with family and

Special Note: Inflation and the Federal Reserve

friends, and the media whips up a hysteria in the headlines. However, inflation is not one monolithic thing, and it is helpful as investors to deconstruct some of the key components in order to consider the path forward.

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The Elements of Inflation

First, there is the fiscal component. Governments across the world implemented record stimulus programs since the Covid outbreak in 2020 to help ease human and economic hardships. Although fiscal stimulus contributed to strong demand, ongoing supply disruptions constrained the availability of goods and increased the cost of providing services, resulting in rising prices.

Next, there is the monetary component. Most large economies were still running historically accommodative monetary policy, a lingering aftereffect of the Global Financial Crisis (GFC). When the pandemic hit, they eased policy even further to lower borrowing costs, guarantee liquidity in financial markets, and expand the availability of credit. Cheap money and increased leverage supported purchases of homes, cars, and other investments, leading to richer valuations across most asset classes.

All the while, as many countries accelerated their transitions toward green energy and zero carbon, fossil fuel producers had sharply cut capital expenditures and production. This reduction in supply supported a strong rebound in energy prices with post-Covid reopening but left the world vulnerable to the sudden energy supply shock from the sanctions against Russia this year.

Finally, on the heels of the U.S.-China trade war, COVID-related supply chain disruptions further revealed vulnerabilities following decades of globalization. Besides interdependent networks crisscrossing borders, the economic well-being of net importers and exporters of critical resources was at the mercy of supply and market conditions outside of their control.

The Response of Monetary Policymakers

The complex forces contributing to inflationary pressures make the task of combatting them all the more difficult. Ever since the stagflation of the 1970s, the U.S. Federal Reserve has been mandated by Congress, in addition to full employment, to seek price stability. Unlike the U.S. Treasury Department, the Fed does not have direct power to "print" money. However, the policy tools at its disposal have far-reaching impact across three tiers of the global economy.

First, it sets a policy target for the Federal Funds rate, which influences interest rates across U.S. government securities. These yield curves underpin spreads of credit-linked products (e.g., corporate bonds, mortgages, auto loans) as well as equity valuations. Second, the Fed has the power to create bank reserves, which influences capital within the U.S. and global banking system. Together with the "cost" of money (i.e., the interest rate

Special Note: Inflation and the Federal Reserve Cont.

level), this affects the demand and supply of credit and leverage in the economy. Third, with more than half of global trade and energy contracts priced in U.S. dollars, many countries – particularly net exporters of goods and net importers of oil – are highly "dollarized." Changes in Fed policy impact the economic situation for countries conducting trade in and holding U.S. dollars as well as U.S. government securities in foreign exchange reserves.

The Path Forward

Given the impact the Fed has over the U.S. and global economy, markets are anxious about the timing and pace the Fed will choose when implementing its two key policy tools: raising interest rates and reducing the size of its balance sheet. While their concern is warranted, we want to share some context regarding these actions.

Markets and the Fed are both considering seven to nine interest rate hikes, but it is important to remember that these increases are from an exceptionally low starting point. Over the past 40 years, interest rates in the United States have declined toward zero. In 1994, the yield on a two-year Treasury note was nearly 8%, but in the aftermaths of the GFC and COVID pandemic, the two-year Treasury yield was hovering near 0% for several years. After the Fed's recent hawkish rhetoric about rate hikes, the two-year Treasury yield has come up to near 3%, but this is still very low in historical terms (see Appendix E). If inflation peaks in the first half of 2022, as many forecasters predict, the Fed may not need to raise rates as aggressively as current expectations suggest.

In contrast to historically low interest rates, the size of the Fed's balance sheet is at historic highs, with nearly $9 trillion in assets. To keep markets functioning and avert harsher economic impacts from COVID, the Fed purchased a variety of securities, an action termed Quantitative Easing (QE) employed several times since the GFC. This had the additional benefit of boosting reserves within the U.S. and global banking system. Now that emergency conditions appear to be abating, the Fed believes it is appropriate to unwind its balance sheet, an action termed Quantitative Tightening (QT).

QT is a popular topic in financial media, but the narrative omits an important context: while the balance sheet needs to shrink, it does not need to be eliminated. Furthermore, while the Fed's assets are significantly larger than before QE was first initiated in 2008, the U.S. economy has grown considerably since then and therefore requires a larger operating balance sheet. Economists estimate that an appropriately sized Fed balance sheet should be around 25% of GDP (in other words, approximately $6 trillion); this implies only $3 trillion of QT is needed. Coincidentally, the balance sheet is set to shrink "organically" by just that amount; $3 trillion in assets are scheduled to mature within the next two years, perhaps negating the need for the aggressive QT the market and media fear.[6]

"…while the Fed's assets are significantly larger than before QE was first initiated in 2008, the U.S. economy has grown considerably since then and therefore requires a larger operating balance sheet. Economists estimate that an appropriately sized Fed balance sheet should be around 25% of GDP (in other words, approximately $6 trillion); this implies only $3 trillion of QT is needed."

[6] Source: Ben Bernanke. Interest Rates, Inflation and Implications: A Discussion with Dr. Ben Bernanke. PIMCO. 15 February 2022.

Investment Strategy

Equities

Within equity allocations, we maintain a diversified positioning across all sectors, styles, capitalizations, and geographies. We seek to hold a core of inexpensive, passive exposure to broad markets and combine it with a satellite of actively managed strategies that can more aggressively take advantage of market volatility. Even in portfolios where trades may not be visible on monthly statements, our underlying managers are buying and selling within their funds to take advantage of volatility. Where possible, we are also harvesting losses for tax purposes and redeploying the proceeds into other strategies that we believe have a similar opportunity to recover over the medium to long term.

"While many commentators in the U.S. are reading market volatility and other signals, such as inversions at various points along the yield curve, as omens of a recession on the horizon, we believe it is far too soon to make such predictions."

While many commentators in the U.S. are reading market volatility and other signals, such as inversions at various points along the yield curve, as omens of a recession on the horizon, we believe it is far too soon to make such predictions. The U.S. economy may be slowing from its red-hot, post-COVID recovery pace, but it is still expected to grow (the first quarter's results notwithstanding). We anticipate corporate earnings to remain robust, we are constructive on the consumer, and the recent market volatility has made the shares of many high-quality businesses much more attractive than they were just a few months ago.

While we expect the energy shock to affect European businesses harder than U.S. firms, we still believe their valuations remain attractive on a relative basis. International companies have yet to fully realize the economic catch up in terms of reopening and normalization of economic activity from COVID shutdowns.

Given concerns around virus lockdowns, heavy-handed changes to regulation, and an economic slowdown, share prices of many Chinese firms have contracted significantly to account for this added risk. As a result, valuations are beginning to appear attractive. While the risks are real, we believe they are most problematic in the near term and anticipate policymakers to support economic growth over the medium term rather than risk a recession for the sake of ideology.

Emerging market equities, broadly speaking, are currently trading at 12 times earnings, which is cheap relative not just to developed market equities (17 times earnings) but also their own history. They underperformed their U.S. counterparts by 23 percentage points in 2021, but in the risk-off environment of the first quarter, they only underperformed by two percentage points, suggesting valuations may be approaching a floor.[7]

Fixed Income

Broadly speaking, bonds in the first quarter did not provide the protection against equity risk investors typically seek. However, much of the carnage in fixed income returns can be found in areas that for years had been the most overvalued (i.e., longer duration, high-quality bonds such as U.S. Treasuries). Our decision to take a lower duration stance overall, while

[7]As measured by the total returns of the iShares MSCI World ETF and iShares Core MSCI Emerging Markets ETF.

Investment Strategy Cont.

it may have sacrificed some upside over the past couple years, made up for it by protecting on the downside this year.

The future of longer-term inflation and interest rates remains uncertain, especially as the Fed rapidly raises overnight rates and removes liquidity from the market. Without a clear outlook, we would opt to maintain our lower-duration positioning, particularly in a flat yield curve environment when you can earn the same yield without exposing your investment to more duration risk. We continue to complement the ultra-short bonds we use for ballast with nimble, flexible managers that can move quickly to take advantage of opportunities in corporate credit, securitized assets, high-yield bonds, and emerging market debt.

In Conclusion

Global financial markets have whipsawed over the past few months. Crowded investment strategies that to many over the past few years appeared to be intuitive (i.e., overweighting unprofitable growth stocks while relying on core bonds for downside protection) have rapidly unwound. While no one could have predicted two years ago that the developed world would be facing over 8% inflation, let alone a full-scale war in Europe, it is a reminder of the virtues of diversification in the face of uncertainty.

While navigating market volatility is never comfortable, these are precisely the moments that offer opportunity to long-term investors. They provide us (and the active managers we employ) the chance to harvest losses, rebalance, and deploy fresh capital at more attractive entry points.

Patience, discipline, and diversification have always served us and our clients well through past episodes of market stress and volatility. We fully believe they will do so this time as well.

If there are any changes in your risk tolerance, liquidity needs, and/or investment goals, please contact us so we may have a constructive conversation about any changes that may (or may not) need to be made to your investment portfolio. Additionally, if you have any questions or concerns about financial markets, please never hesitate to call us at +1 (301) 881-3727 or email us at client.services@sol-capital.com.

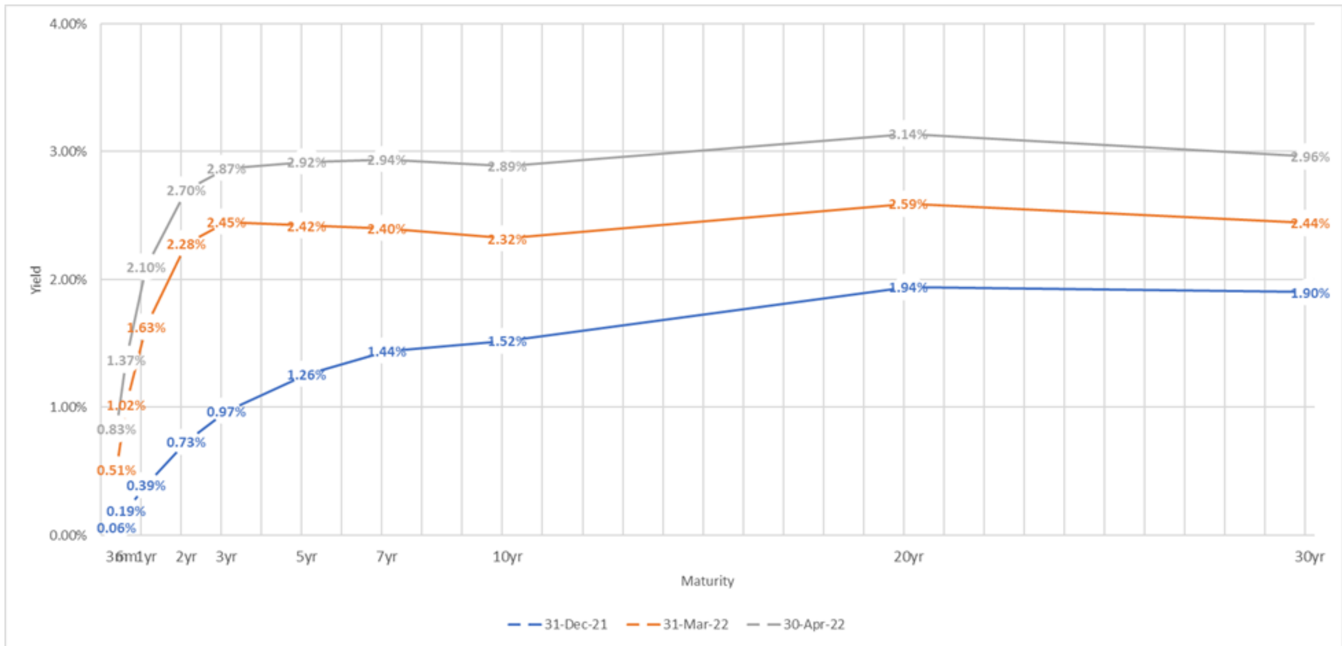
With our best regards,

SOL Capital Management Company

"While navigating market volatility is never comfortable, these are precisely the moments that offer opportunity to long-term investors. They provide us (and the active managers we employ) the chance to harvest losses, rebalance, and deploy fresh capital at more attractive entry points."

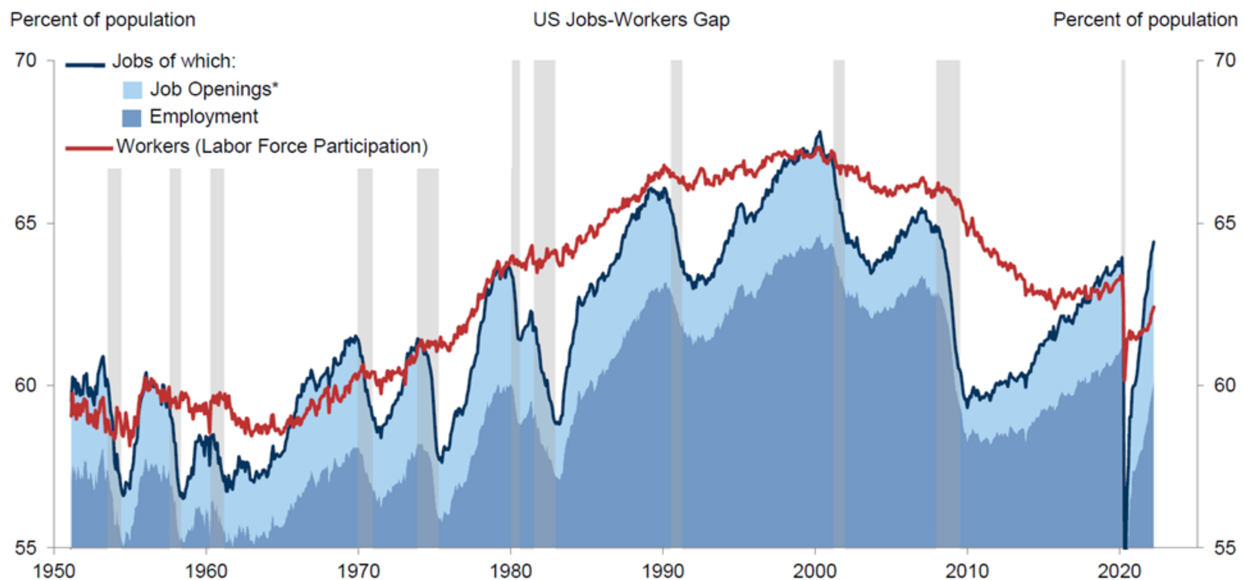
Appendices

Appendix A: Shifts in the Treasury Yield Curve



Sources: FactSet, the Federal Reserve Bank of St. Louis, JPMorgan Asset Management.

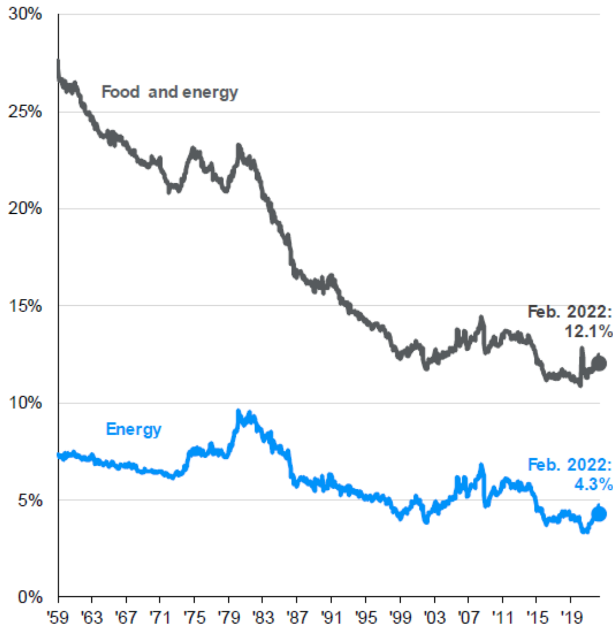
Appendix B: The Tightest Labor Market in Postwar U.S. History

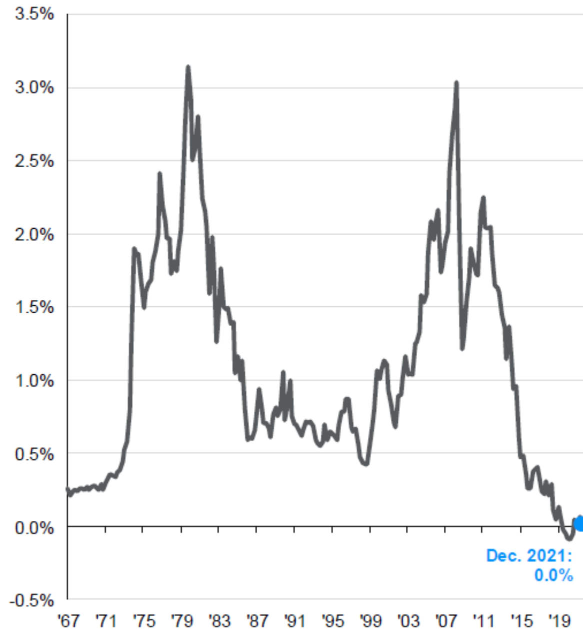


Source: Goldman Sachs Global Investment Research.

Appendices Cont.

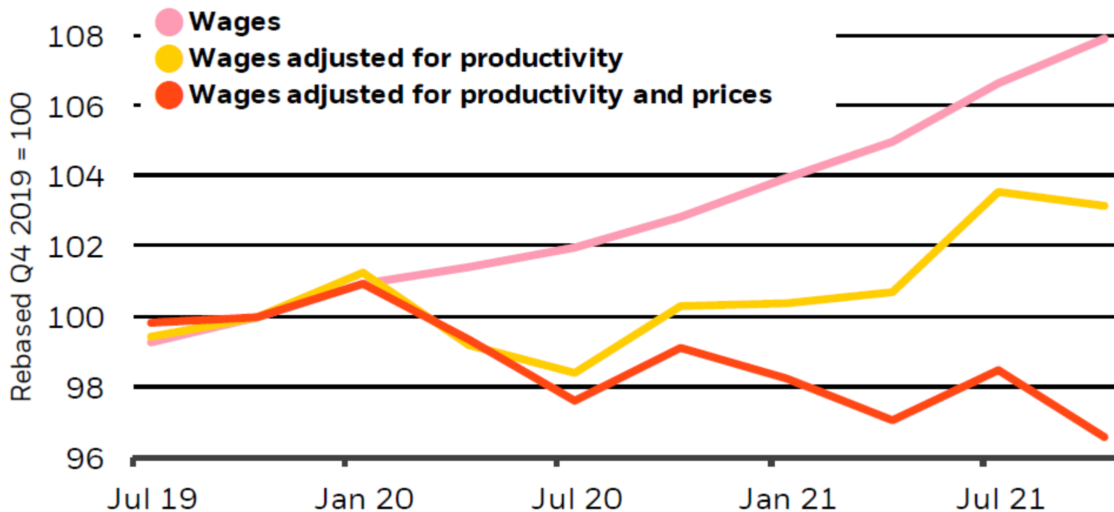
Appendix C: 2022 ≠ 1979





Source: JPMorgan Asset Management, U.S. Bureau of Economic Analysis. Data as of 30 April 2022.

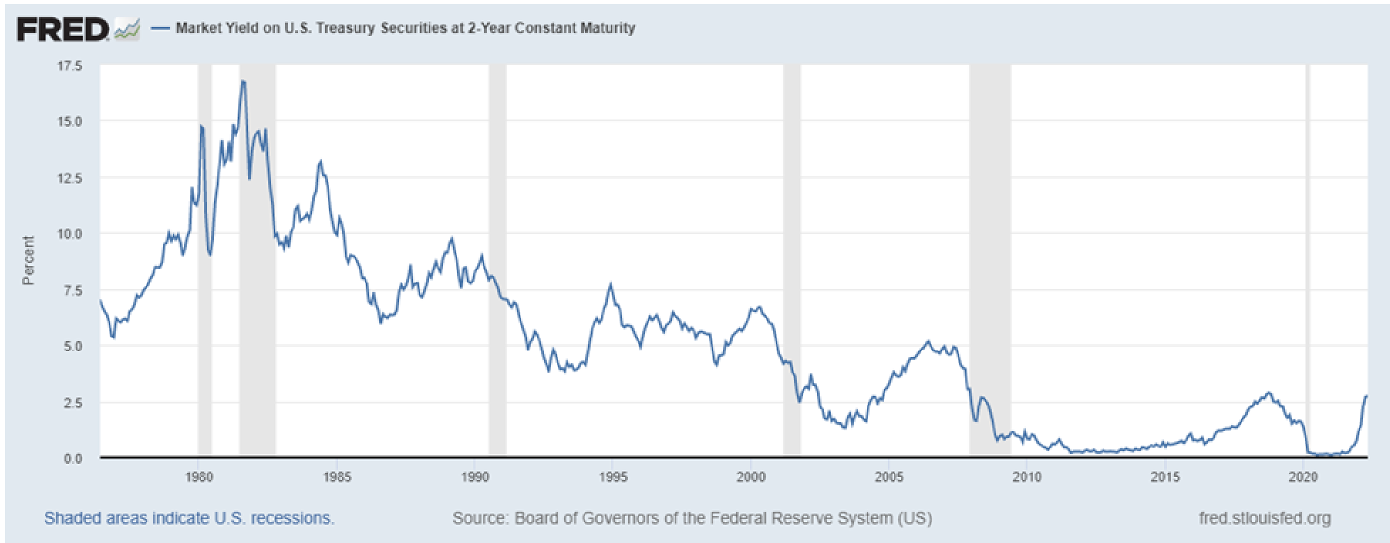
Appendix D: Real Wages Have Room to Rise



Source: BlackRock Investment Institute, with data from Haver Analytics. Notes: The chart shows the level of U.S. private wages and salaries (in pink) from the U.S. employment cost index measure of hourly labor costs. The yellow line shows this measure of wages adjusted for productivity, by dividing by the level of output per hour. The red line shows this productivity—adjusted series adjusted for inflation by dividing by the U.S. personal consumption expenditure headline price index.

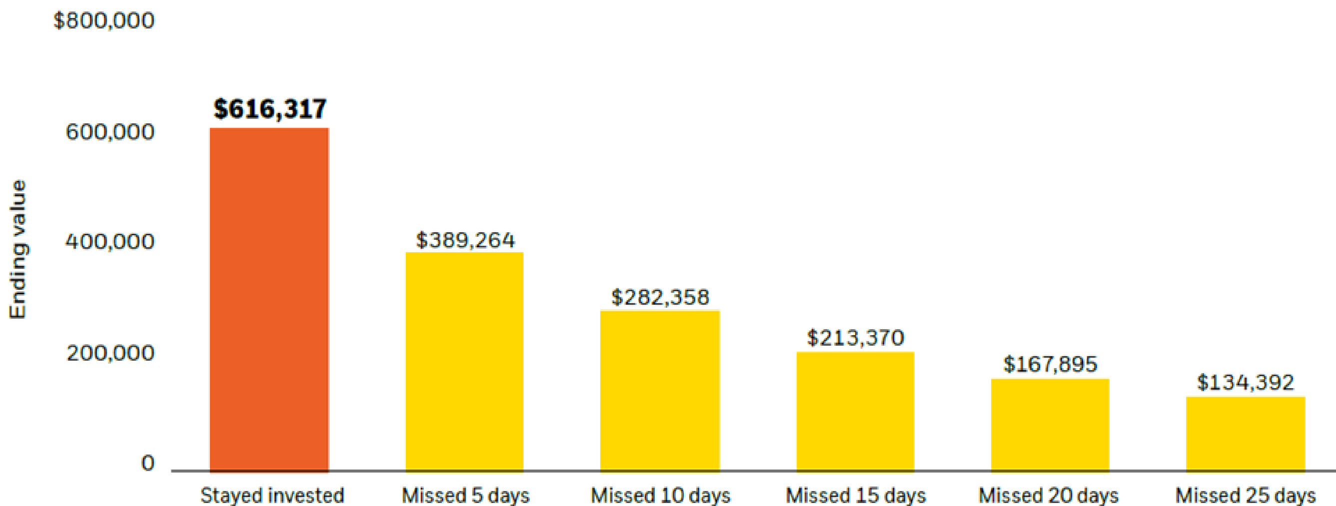
Appendices Cont.

Appendix E: Historical Context of Higher Treasury Yields



Source: : The Federal Reserve Bank of St. Louis. Data as of 30 April 2022.

Appendix F: The Virtues of Staying Invested



The above chart shows the hypothetical investment of $100,000 in the S&P 500 Index over the last 20 years (2002-2021).

Sources: BlackRock; Bloomberg. Stocks are represented by the S&P 500 Index, an unmanaged index that is generally considered representative of the U.S. stock market. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Disclosures

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