

## Market Outlook

With all that the financial markets have grappled with this year, it's hard to believe that we are only one quarter into 2022. Alas, Spring is here, and with it comes greater daylight, more sunshine, and generally cheerier moods. Surely the markets will follow suit, right? That remains to be seen. There are more reasons for pause today than this time last year, but that doesn't mean it's all doom and gloom. For the upcoming quarter, we outline the elements that we view as most likely to influence the economic direction of travel, preferred positioning amid rising rates and lingering inflation, and how Blue Chip would look to handle potential forward-looking scenarios.

### Continued Crossroads



### Navigation Amid Uncertain Seas



### Blue Chip Radar



## Your Bottom Line



Some information on the path forward has been revealed, but the waters have been muddied significantly. The knock-on effects from the conflict in Ukraine equate to further disruption in an already disrupted balance between supply and demand. The commodity-heavy nature of the Russian and Ukrainian economies could prolong the semiconductor shortage, which is leading domestic and international automobile manufacturers to cut production forecasts for 2022. Increasingly tough comparisons vs. 2021 indicate that inflation should not persist at the 7.9% seen in February, but the developments seen year-to-date have introduced additional variables.



Warning signs are flashing, but we have yet to see anything definitively troublesome as it pertains to economic growth and corporate profitability. In fixed income, investors will continue to struggle to obtain meaningful yield without increasing exposure to interest rate and default risk. In this environment, layering in high-quality floating rate securities can provide benefits amid rising rates. On the equity side, the economic backdrop calls for a focus on profitable firms that generate significant free cash flow today, not 20 years from now.



We don't have a crystal ball, but we do have a plan of attack. As new information becomes available, we will be watching closely to interpret what factors into the big picture and what is just noise. Regardless of the path forward, the Investment Committee at Blue Chip Partners holds a defined view with regards to how to position client portfolios.

# Blue Chip Partners: Quarterly Edge

## Q2 2022



## Continued Crossroads

While market participants have received pieces of additional clarity on the path ahead, domestic financial markets still very much find themselves at a crossroads. Thus, we thought it prudent to expand on some of the themes highlighted in the [Q1 2022 Quarterly Edge](#) and opine on the road ahead.

### Inflation

Coming into 2022, we had expected year-over-year price increases to show moderation in the back half of the year. We still believe this is possible, but the waters have been muddied significantly. As outlined in [our thoughts on the situation in Ukraine](#), removing Russia from the global economy has minimal direct impact on domestic GDP, but the knock-on effects from the conflict equate to further disruption in an already disrupted balance of supply and demand. The potential re-routing of trade routes, along with the commodity-heavy nature of the Russian and Ukrainian economies, may lead to increased costs, technical frictions, and further shortages of the commodities and goods that rely on them as vital components. All these support higher inflation. The semiconductor shortage, which we viewed as likely to resolve throughout 2022, could be exacerbated by a lack of vital inputs such as neon, aluminum, nickel, and copper – all of which are meaningfully sourced from Russia and Ukraine. Domestic and international automobile manufacturers have already taken down production forecasts for 2022, which can serve to place a higher floor on a contributor to CPI that has already evidenced significant pent-up demand. So, although increasingly tough comparisons vs. 2021 indicate that inflation should not persist at the 7.9% seen in February, a return to a more normal 2-3% CPI may have been kicked down the road.

### The Federal Reserve

In line with our expectation for some level of natural moderation in year-over-year price increases, we felt that the potential for an overly hawkish Fed (i.e., favoring significantly tighter monetary policy) throughout 2022 was unlikely. Fast forward a few months, the U.S. central bank has had its hand forced by the elements discussed above and has now targeted seven interest rate hikes for 2022. Further, the Fed has left the door open for more intense hikes, meaning 0.50% at a time instead of the traditional 0.25%. While we won't argue against the need for tighter monetary policy, the fact is that the Fed initially placed an undue emphasis on the employment side of their dual mandate, leading to an extreme stimulus when the U.S. economy should have had the training wheels removed. Playing catch-up is now required, but doing so, so intensely in a period in which there is already greater potential for slowing growth (see table below) as wage growth tempers and demand moderates, can foreshadow a recession. The yield curve has flattened significantly – take cues from the 10-year / 2-year spread in U.S. Treasury yields. In normal times, the longer an investor locks up their money in a fixed rate bond, the greater the yield expected. When the economic outlook is less certain, making investors nervous about the future, this can change. Investors will be willing to pay up for longer-term safety, which caps the yield on longer-dated maturities relative to the short-end. In extreme cases, the yield curve “inverts” (i.e., long-term yields lower than short-term yields), and market participants accept a lower level of income in a flight to safety. While this isn't exactly what is happening today as rates have been predominantly driven by the short end, this specific measure of relative movement in yields does have predictive power, historically speaking. (Continued on next page.)

# Blue Chip Partners: Quarterly Edge

## Q2 2022

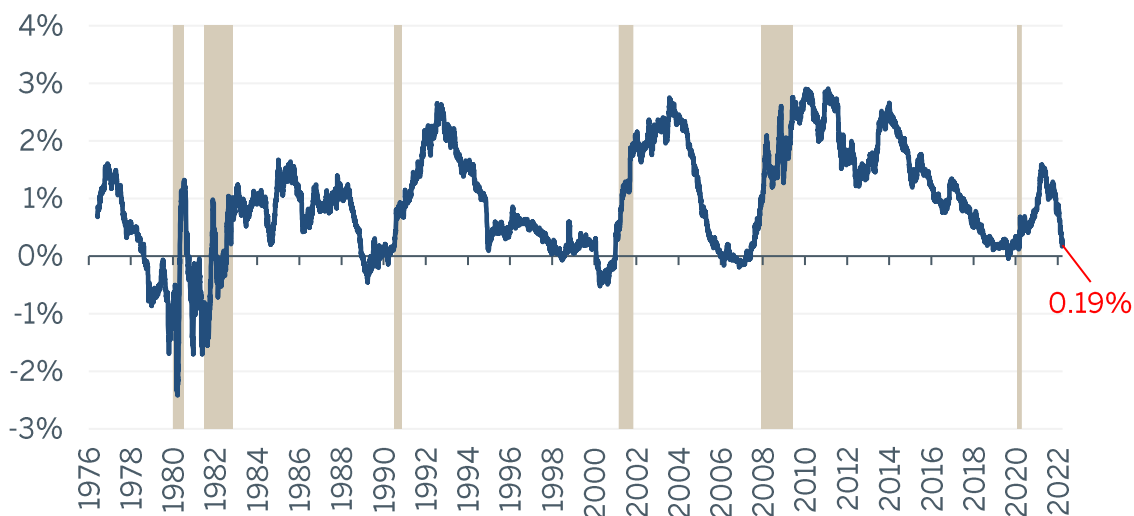


### Continued Crossroads

#### The Federal Reserve (Continued)

The Fed hiking short-term rates too far too fast into a slower growth environment increases the likelihood of an inversion and a recession.

#### 10-Year Minus 2-Year Treasury Yield Spread



Source: Federal Reserve Bank of St. Louis. Shaded areas indicate recessions per NBER. As of 23 March 2022.

2022 FOMC Median Forecasts	2022	2023	2024	Longer Run
<b>Real GDP (4Q/4Q)</b>	<b>2.8%</b>	<b>2.2%</b>	<b>2.0%</b>	<b>1.8%</b>
Dec 2021 forecast	4.0%	2.2%	2.0%	1.8%
Sep 2021 forecast	3.8%	2.2%	2.0%	1.8%
Jun 2021 forecast	3.3%	2.4%	--	1.8%
<b>Federal Funds Rate Target (4Q)</b>	<b>1.875%</b>	<b>2.750%</b>	<b>2.75%</b>	<b>2.375%</b>
Dec 2021 forecast	0.875%	1.625%	2.125%	2.50%
Sep 2021 forecast	0.250%	1.000%	1.750%	2.50%
Jun 2021 forecast	0.125%	0.625%	--	2.50%

Source: Federal Open Market Committee. As of 16 March 2022.

# Blue Chip Partners: Quarterly Edge

## Q2 2022



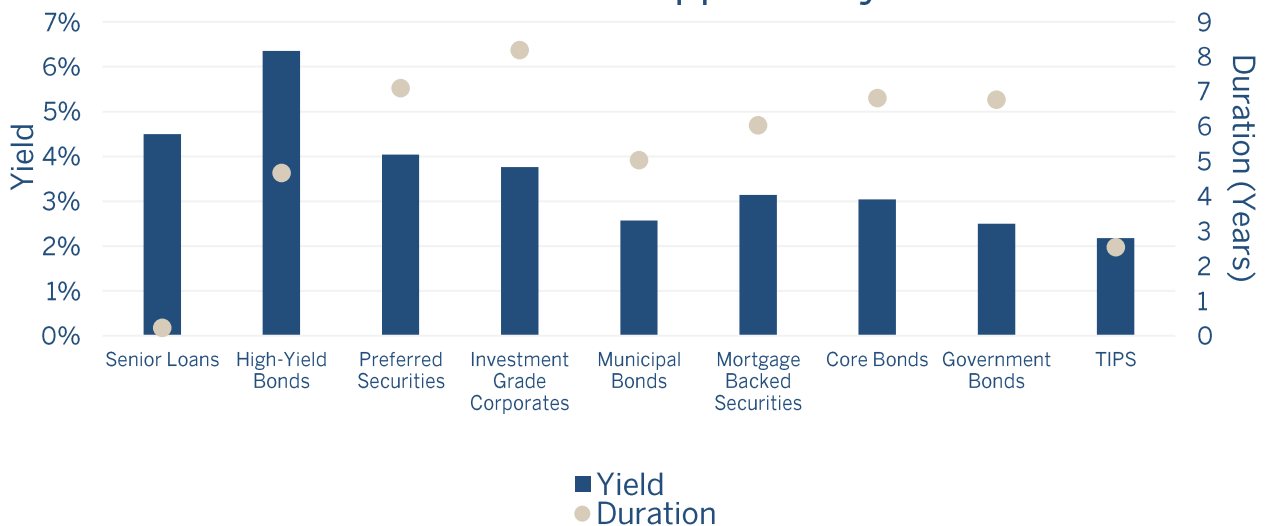
### Navigation Amid Uncertain Seas

Yes, the 10-year / 2-year spread is close to inversion, and the 10-year / 5-year and 10-year / 7-year have already inverted. Having said that, more compressed versions of these indicators (for example, the 18-month / 3-month spread, which the Fed is pointing to) look healthy. There is potential for slowing growth later this year and in 2023, but we have yet to see definitive cracks, as evidenced by strength in corporate results and management commentary. So how do we position with rising rates, lingering inflation, and our growth outlook in mind?

#### Fixed Income

Coming into this year, we took steps to reduce interest rate risk (duration) across our fixed income exposure. Bond prices and yields are inversely correlated, and thus as interest rates have elevated, securities with greater duration have underperformed. The Fed has come out noticeably hawkish, and we believe it is prudent to continue to lean into lower duration exposure in fixed income. Yields are still relatively low across the board, and reducing duration generally means lower coupon payments. Investors today have few options to generate a high level of income without assuming significant interest rate or default risk. In an environment that consists of low and rising rates without an immediate threat to growth, a category like Bank Loans can add value. These loans are floating rate, and thus have the potential to provide a growing income stream through the second quarter and beyond. While they are not guaranteed, Bank Loans (also called Senior Loans / Leveraged Loans) pose less default risk than high-yield bonds. Even though default rates are low and should continue to be so given healthy corporate fundamentals, we prefer exposure to higher-quality borrowers to further minimize default risk.

#### Fixed Income Opportunity Set



Sources: Blue Chip Partners with data from Bloomberg. As of 25 March 2022. See disclosure (1) for index information.

# Blue Chip Partners: Quarterly Edge

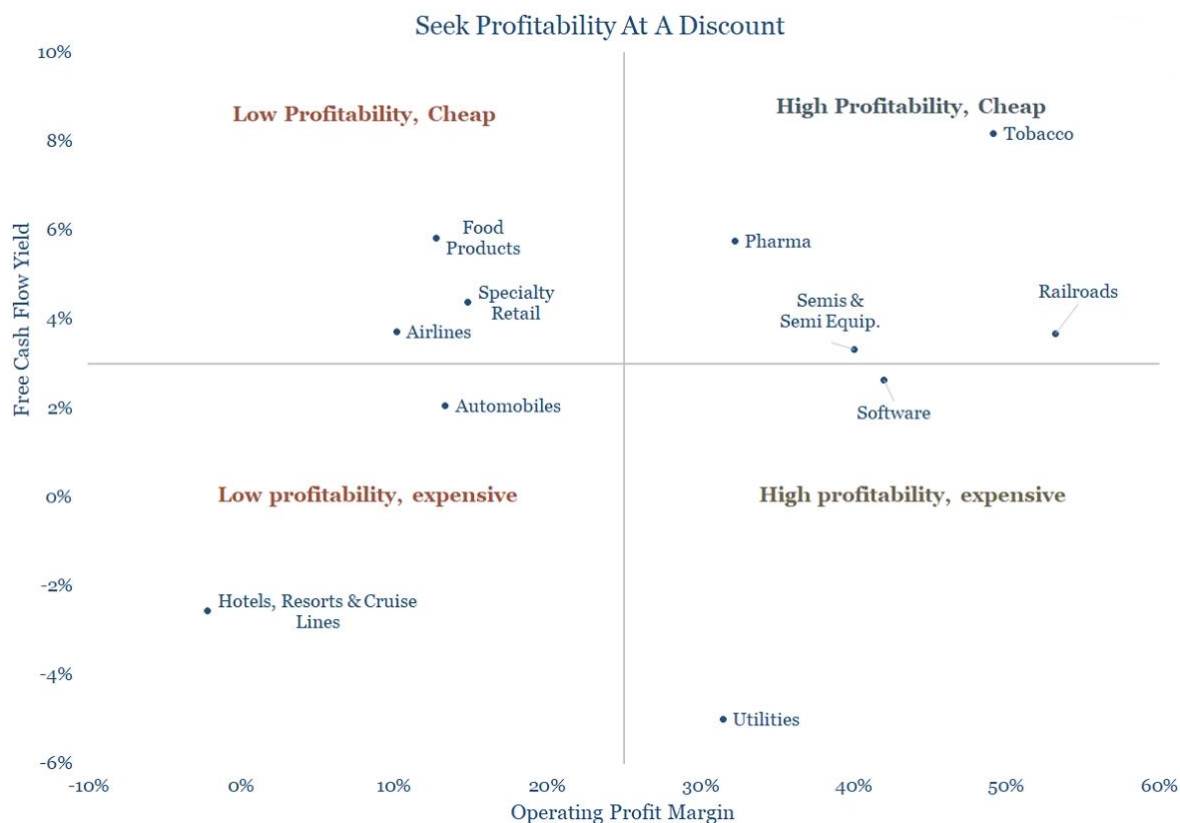
## Q2 2022



## Navigation Amid Uncertain Seas (Continued)

### Equities

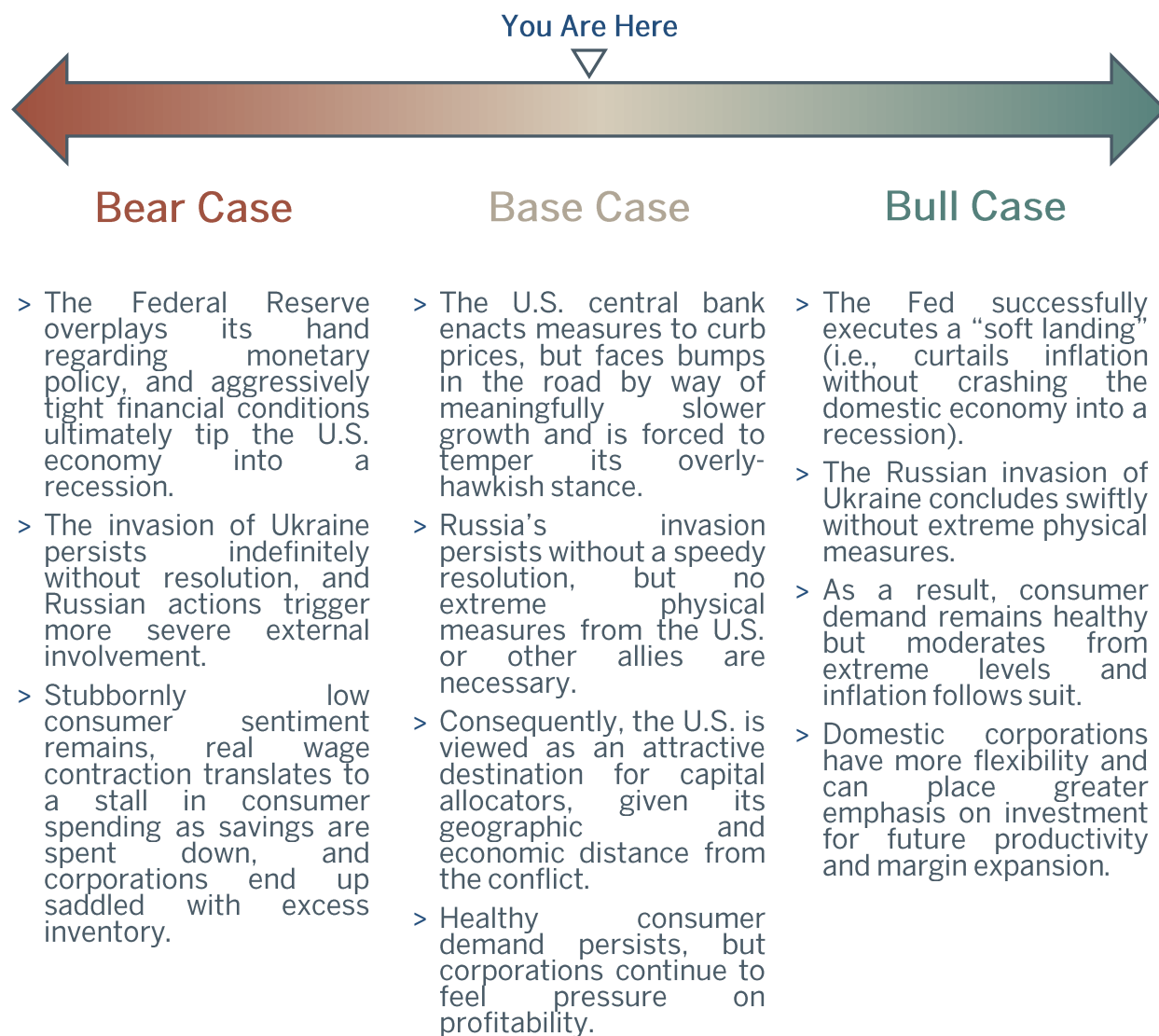
On the equity side, the changes we have made YTD and the direction of travel for our models align with our take on the current environment. In Q1, we returned select high valuation growth names that had run to target weights. We continue to believe this could be a difficult environment for stocks that have the bulk of their value derived from cash flows in the significantly distant future. Putting money to work in highly cash generative firms has historically proven a winning proposition in periods of elevated inflation and rising rates; we have no reason to believe that the remainder of 2022 will buck that trend. We think leaning into higher profitability names is intuitive, as tighter financial conditions and relatively slower growth could prompt market participants to hide out in companies that are better insulated from external pressure.



Sources: Blue Chip Partners with data from Bloomberg. As of 25 March 2022. See disclosure (2) for index information.

### Blue Chip Radar

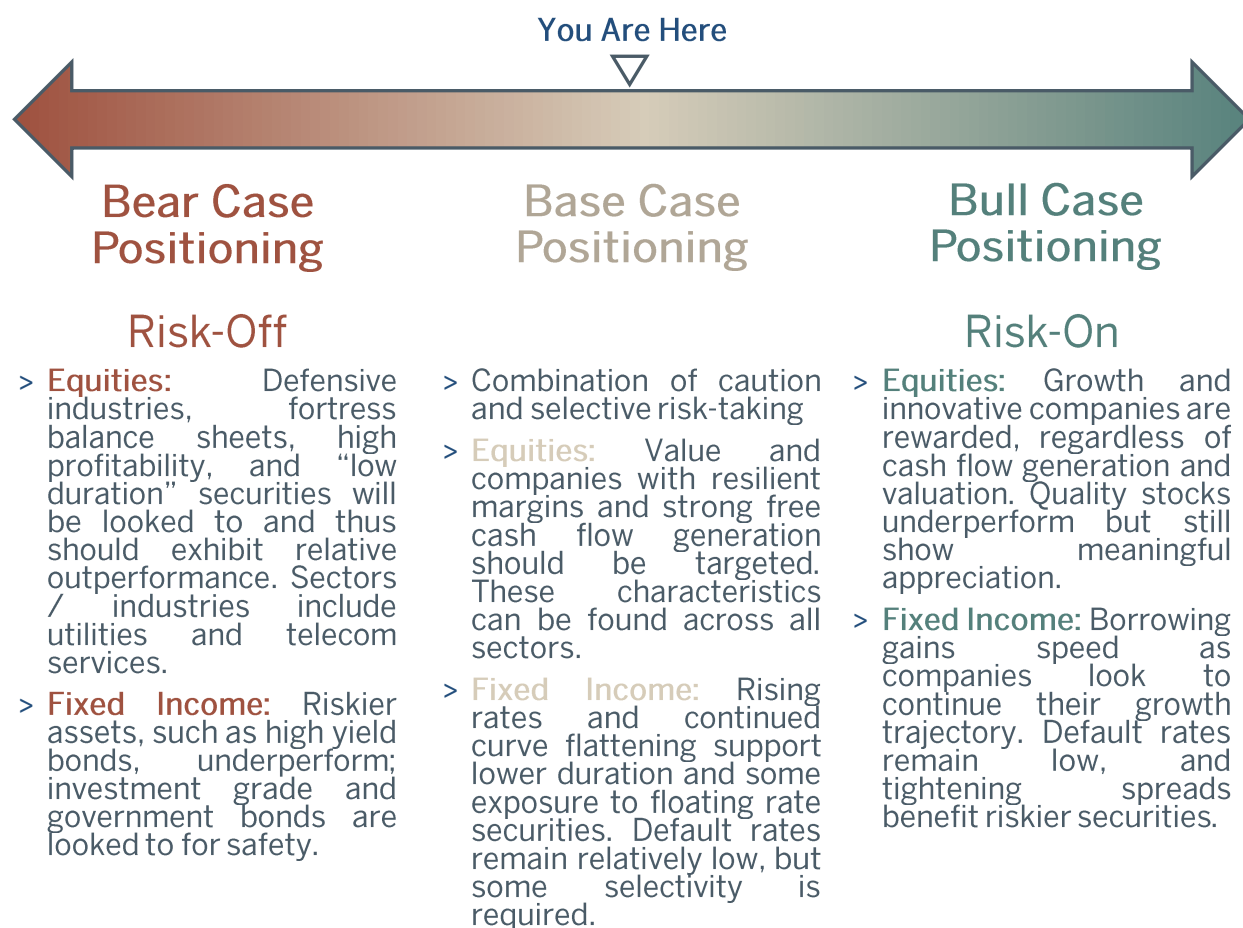
Given the multitude of potential paths forward that market participants are grappling with as we look towards the second quarter, we feel it prudent to outline a few scenarios. Our outlook cannot discuss all factors that will affect investor decision-making in the coming months, but the Quarterly Edge seeks to call out those that will likely prove top of mind as market participants allocate capital.





### Blue Chip Radar

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# Disclosures

## Q2 2022



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<sup>(1)</sup> Indexes are shown for illustrative purposes only. It is not possible to invest directly in an index. Senior Loans are represented by the S&P/LSTA Leveraged Loan Index. High-Yield Bonds are represented by the Bloomberg U.S. Corporate High Yield Bond Index. Preferred Securities are represented by the ICE BofA Core Plus Fixed Rate Preferred Securities Index. Investment Grade Corporates are represented by the Bloomberg U.S. Corporate Bond Index. Municipal Bonds are represented by the Bloomberg Municipal Bond Index. Mortgage Backed Securities are represented by the Bloomberg U.S. Mortgage Backed Securities Index. Core Bonds are represented by the Bloomberg U.S. Aggregate Bond Index. Government Bonds are represented by the Bloomberg U.S. Treasury Index. TIPS are represented by the Bloomberg U.S. Treasury TIPS 0-5 Year Index.

<sup>(2)</sup> Indexes are shown for illustrative purposes only. It is not possible to invest directly in an index. Railroads are represented by the S&P 500 Railroads Sub Industry GICS Level 4 Index. Tobacco is represented by the S&P 500 Tobacco Industry GICS Level 3 Index. Software is represented by the S&P 500 Software Industry GICS Level 3 Index. Semiconductors & Semiconductor Equipment are represented by the S&P 500 Semiconductors & Semiconductor Equipment Industry GICS Level 3 Index. Pharmaceuticals are represented by the S&P 500 Pharmaceuticals Industry GICS Level 3 Index. Automobiles are represented by the S&P 500 Automobiles Industry GICS Level 3 Index. Utilities are represented by the S&P 500 Utilities Sector GICS Level 1 Index. Specialty Retail is represented by the S&P 500 Specialty Retail Industry GICS Level 3 Index. Food Products are represented by the S&P 500 Food Products Industry GICS Level 3 Index. Airlines are represented by the S&P 500 Airlines Industry GICS Level 3 Index. Hotels, Resorts & Cruise Lines are represented by the S&P 500 Hotels, Resorts & Cruise Lines Sub Industry GICS Level 4 Index.