HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

By William N. Hudson, Jr., David D. Burrows, William Hudson III, Evan Coppola, & Jeremy Hudson

Volume 91 April 2022

We are thinking of the quote by prominent hedge fund investor Leon Cooperman: "He who loses the least in a bear market, wins." The stock market is not in bear market territory yet. But the outlook is troublesome, and the defensive philosophy of Cooperman's quote is appropriate at this time.

We evaluated the "pros" and the "cons" for the market outlook. On the pro side, the pandemic still lingers but is receding and it is not likely to cause major disruption again. The U.S. economic recovery is strong and employment growth is buoyant. Corporate earnings are positive.

But the list on the con side is longer. The problem of supply side bottlenecks is looking more structural than temporary. Inflation is soaring and the Federal Reserve is embarked on aggressive monetary tightening. The war in Ukraine threatens to create sustained global shortages in energy and food supplies. In the view of some analysts, the combination of an aggressive inflation-fighting Fed and all the geopolitical turmoil makes it possible for the U.S. to slip into recession sometime in 2023.

At Hudson Advisors, we are concerned about all of the "cons" listed above and about the rich price of stocks from the market run-up in 2021. That said, we think U.S. equities remain among the best and safest long-term investments. We encourage our clients to be positive on equities even though our investment approach in the period ahead is careful and defensive.

MARKET TRENDS

The accompanying chart summarizes stock and bond market trends in the first quarter of 2022. Both markets took a strong negative hit from the prospect of higher interest rates and from all the economic uncertainties spun by the Ukraine war.

Equity Market: The stock market saw its worst quarter in two years: since the spring of 2020 when Covid first emerged. The market was highly troubled in January and February. Inflation exceeded 6%, the highest in 40 years, and the Federal Reserve announced its intention to raise interest rates by as high as 2% over the course of 2022. The war in Ukraine also loomed. The S&P 500 dipped over 13% from its highpoint and the Nasdaq Composite was temporarily in the bear market territory of a 20% decline.

Stocks did make a comeback in March as investors adjusted to the challenges ahead. Some were reassured actually by the Fed's determination to fight inflation. The S&P 500 ended the quarter with a decline of 4.6%. The Dow Jones Composite Average was off 1.69%. The Russell 2000 was down 7.5% The worst performer was the Nasdaq Composite which was down 8.95%.

Fixed Income Market: The U.S. bond market was more troubled and anxious than the stock market. It suffered its worst quarter in more than 40 years and deprived investors of its traditional safe haven. The yield on the benchmark 10-year U.S. Treasury Note (which moves inversely to prices) settled at 2.324% up from 1.496% at the end of December. The Bloomberg U.S Aggregate bond index – a mix of Government and highly rated corporate bonds – returned minus 6%, its biggest quarterly loss since 1980.

MAJOR MARKET INDEXES

	YTD Return
Dow Jones Composite Average TR	-1.69
S&P 500 Index TR	-4.6
Russell 2000 Index TR	-7.53
NASDAQ Composite TR	-8.95
EAFE Index NR	-5.91
Bloomberg Aggregate Bond Treasury TR	-5.58

Source: Morningstar® as of March 31, 2021

THE OUTLOOK

The Economy: The U.S. economy is on the "pro" side of our list. In December the Fed had predicted GDP growth of 4.0% in 2022. In March they did reduce that number to 2.8% in the face of the many uncertainties. But employment numbers remain strong. Jobs have grown an average of 600,000 in the past 6 months and the unemployment rate is now at 3.6%. Total employment is 90% of pre-pandemic levels and consumer spending is healthy. Corporate profits also look good with an expected increase of 9.0% for the year – down from the pandemic recovery in 2021 – but above the preceding 10-year average of 5.0%.

But now we have the problem of inflation with increases close to 7% in recent months – the worst since the 1980s. The problem is complicated. With the pandemic receding, consumers are spending on both goods and services. Global supply chains are still disrupted by the pandemic and other new complications in international trade. The tight labor market is driving up wage costs. Rather than being "transitory", as many analysts had said, the inflationary spiral is spreading throughout the economy.

The Federal Reserve is determined to stomp on these inflationary trends with a series of hikes in the Fed funds rate. They began with 25 basis points in March and could do up to 2.0% in 2022 and to 3.0% in 2023. The goal is to achieve a so-called "soft landing" in which inflation is squashed while GDP continues to grow. But many economists are concerned about a "hard landing" which pushes the economy into recession in 2023. The uncertainty is compounded by the unpredictable economic fallout of the Ukraine war.

The Market: We are reminded now of that old bit of wisdom: "Stocks don't go up forever." We are acutely conscious that stocks are trading now at very high prices after the market rise of 2021. The current S&P 500 10-year Price/Earnings ratio is 35.7. This is 78% above the modern-era market ratio of 19.9. Admittedly, the number came down in the first quarter, but it still suggests the market is overvalued.

Some market analysts remain bullish despite all the macro headwinds. They believe the market has already priced in the interest rate hikes and can now move jaggedly upward for the rest of the year. Our view at Hudson Advisors is more restrained. Uncertainty in so many areas spells volatility. We think the market could easily slip for some period into that bear market territory of 20%. Assuming the Ukraine war does not widen, we think it most likely that stock prices will end the year, in the best case, at about their current levels.

OUR STRATEGIES

Asset Allocation: Most clients should stick to portfolio strategies previously identified. We advise against an increased allocation to equities at this time. For new clients, we will recommend a 50% allocation to equities to be phased in over a 12- to -18- month period. The other 50% of assets will be short to intermediate term bonds, cash, and alternative investments.

Preferred Equities: As always, despite market conditions, we look for long-term equity opportunities. Our focus is on companies that can weather both the short-term period and flourish in a longer time frame. We want fundamentally sound companies with reasonable valuations and that pay dividends. In that context, similar to last quarter, we are looking at these sectors:

HEALTH CARE: This sector has interesting opportunities in biotechnology and in the variety of new treatments and devices being developed for the aging population.

INDUSTRIALS/MATERIALS: The legislation to promote infrastructure investments, as it rolls out, should create opportunity for many companies in this sector.

TECHNOLOGY: We are interested in selective technology companies with emphasis on innovation. These companies can provide "juice" opportunity for a portion of client portfolios.

ENERGY: This sector has opportunities worth exploring in the electric companies that will be modernizing their power grids, and in some of the new alternative energies.

CONSUMER STAPLES: These companies can actually do well in an inflationary environment where consumers watch their spending and stick to basics.

Other Assets: Our aversion to long-term bonds remains and is reinforced by this interest rate outlook. We like bond maturities under two years and cash.

We also are looking at alternative investments through Broadly Syndicated Loan vehicles and Collateralized Loan Obligations which can provide investors with greater security through collateral, yields, and a hedge against inflation through floating rate structures.

Dow Jones U.S. Sectors Total Return
(Percent Change for YTD, Ending March 31, 2021)
Source: Morningstar®

Oil & Gas	**37.83**	**Consumer Services**	**-9.23**
Basic Materials	**3.01**	**Telecommunications**	**0.38**
Industrials	**-7.00**	**Utilities**	**4.38**
Consumer Goods	**-5.77**	**Financials**	**-2.64**
Health Care	**-3.83**	**Technology**	**-9.94**

William Hudson, Jr., William Hudson, III CFP ®, Jeremy Hudson, & Evan Coppola
4445 North Hwy A-1-A, Suite 233 • Vero Beach, Florida 32963 • (772) 231-8101
237 Main Street, Suite 600 • Buffalo, New York 14203 • (716) 803-6587
David Burrows
29 Hillside Drive • Greenwich, CT 06830 • (203) 302-3530
www.hudsonadvisors.com • **(877) 504-1964**