Capital Markets Commentary and Quarterly Report: 1st Quarter 2022

Capital Markets Highlights

In Q1, 2022, the U.S. stock market[1] experienced a meaningful correction. It was the first negative quarter since the start of the pandemic in the first quarter of 2020. At its low point on March 8, the S&P 500 was down more than -12%, before rallying to cut its losses to -4.6% by the quarter's end. The stock market sell-off was broad-based, with only the Energy and Utilities sectors showing gains in the quarter.

Though the S&P 500's recovery in March was impressive in the face of rising interest rates, persistently high inflation, and the tremendous upheaval created by Russia's invasion of Ukraine on February 24th, other market indexes did not fare as well as the S&P 500 Index. Small-Cap and Mid-Cap, and Growth stock indexes, as well as International markets (both developed and emerging), were down in the mid-to-high single digits/low double digits. During the quarter, Value and Dividend strategies were far more protective than Growth stocks.

It was a tough quarter as well for fixed income investments with interest rates rising across the yield curve. The Federal Reserve took the first steps towards "normalizing" monetary policy, ending its bond purchases on March 10 and raising the Federal Funds rate on March 16th for the first time since 2018, from zero to ¼%, with plans to raise short-term rates six more times this year to 1.9% by year's end. Even lower risk, shorter-term Treasuries showed a loss in the quarter while the Bloomberg U.S. Aggregate bond index – U.S. Treasuries, highly-rated corporate bonds, and mortgage-backed securities – was down -5.9% in the quarter, the biggest quarterly loss since 1980[2].

Oil prices spiked to over $100 from less than $80 at the beginning of the year, adding to inflationary pressures.

Stock market corrections are an unsettling but normal part of investing. The market's decline and bounce-back rally were fast and unpredictable, once again highlighting the importance of sticking with an investment plan and not overreacting to current events or short-term market moves.

[1] All references to the stock market and stocks are the S&P 500 unless otherwise noted.
[2] WSJ March 31, 2022

Our Thoughts Going into Q2

The U.S. economy started the year with good momentum that we expected would continue in 2022 as we learned to live with Covid and economies around the world reopened. In mid-March, a few weeks after Russia invaded Ukraine, Fed Chairman Powell said that "Indicators of economic activity have continued to strengthen. Job gains have been strong in recent months, and the unemployment rate has declined substantially"[3]. A week later, on March 24, the CEO of Union Pacific (the second-largest railroad in the United States) confirmed this assessment in a CNBC interview, saying "the U.S. economy feels very strong to us broadly"[4]. On April 1, the March unemployment rate was 3.6%.

The war between Russia and Ukraine has added significant uncertainty to the near-term outlook but we do not believe it will derail the medium to long-term positive outlook for the U.S. economy and stock market.

At the height of the Q1 2022 correction in mid-March, we sent out an email and audio clip from a Bloomberg Radio interview with Matrix CIO David Katz with our thoughts about the stock market correction and attached an updated white paper "Corrections, Recoveries and Long-Term Returns." We are happy to resend it if you missed it.

In that March email, we said, "The Russia/Ukraine war is heartbreaking in terms of the human devastation and is hugely worrisome from a geopolitical perspective, but we are confident the US economy and stock market will get through this crisis. While there are lots of big worries, there are also positives. The US economy is strong, businesses are doing well, the consumer is in very good shape, life is getting back toward normal as Covid becomes more manageable, and interest rates are still low. So taken all together, we think, in all likelihood, the majority of the stock market pullback has run its course. We also believe that the current decline will be followed by an equally robust rebound, and still believe that the most likely course is for a reasonable year of positive stock market returns."

We noted that "over the past 29 years, from the period 1993 to 2021, there were 35 stock market corrections of 5% or more, with 13 of those that were 10% or greater. During this time, even though there was a great deal of volatility, stocks returned about 10.6% per year. [5]

Generally, market corrections were swift; the average pullback occurs in just 2.8 months. What is equally surprising, and never feels like is possible or will happen, is that the average recoveries are also swift, with stocks fully recovered to their past highs in an average of 4.7 months. It is easy to be overwhelmed by the negative news and the market's reaction. But this is a normal part of investing, and recoveries often occur when they are least expected and will frequently play out faster than seems possible.

[3] Federal Reserve Press Release March 16, 2022.
[4] CNBC Squawk Box March 24, 2022
[5] Matrix White Paper - 2022.01 Market Returns and Subsequent Investment Performance

In its March 7th edition, Barron's looked at the current sell-off in the context of other market declines caused by war and other crises. They came to a similar conclusion: stocks (as measured by the Dow Jones Industrial Average) fell by "an average of 7% in the immediate aftermath of a crisis… after 18 weeks it was up an average of 9.6%."

We expect more volatility in the market this year and plan to take advantage of market swings, buying high-quality businesses at attractive prices during market selloffs and trimming or selling positions during rallies when they reach our price targets. We were active in Q1 and maintain a watch list of companies we are interested in at the right price.

In summary, we expect another year of U.S. economic growth, rising corporate earnings, and dividends. We believe that the most likely course is for a reasonable year of positive returns for the stock market and Matrix's portfolios, but with some scares and pullbacks along the way.

We think the biggest risks to the economy and stock market are on the front pages, higher interest rates pushing the economy into recession and the war in Ukraine expanding into a greater global conflict. In our opinion, a recession is unlikely in the U.S. this year given the underlying strength of the U.S. economy, and we are hopeful that the people of Ukraine, with the Free World's help, will persevere and ultimately be able to negotiate a long-term solution that works for its citizens.

We have modest expectations for fixed-income investments. With that said, after the sharp sell-off in bonds during Q1 2022, the market is already pricing in a significant further rise in interest rates. We believe a lot of the damage in high-quality short-term bonds has been done. We continue to be wary of intermediate to long-term bonds but believe shorter-term bonds will start to fare better over the next 9 - 12 months. We believe bonds (short-term bonds in this environment) have an important place in balanced accounts, providing income and stability during periods of stock market weakness. Our focus on high quality, shorter-term fixed income instruments mitigate interest rate risk and gives us the flexibility to eventually extend maturities at higher rates down the road.

Below we provide more detail on portfolio actions during Q1, 2022, and our thoughts on where we are finding the best values in the stock market today.

Large Cap Value Portfolio (LCV)

After our very strong 2021, the portfolio held up well in an environment that was most punitive to recent winners (of which we had many). Our Large Cap Value portfolio performed in line with the S&P 500 in Q1, 2022, but trailed the Russell 1000 Value Index (gross of fees). Over the period it held up better in the declining market but has had a slower bounce back than the S&P 500 to date.

Positive portfolio market sectors in the first quarter were Consumer Staples, Energy, and Health Care. The Technology sector was the biggest laggard this quarter, following strong gains over the past few years.

During the quarter, we added to positions in Comcast, Meta Platforms (the new name for Facebook), Paramount Global (formerly ViacomCBS), U.S. Bancorp, and Zimmer Biomet.

We started a new position in PayPal (PYPL), an industry-leading digital and mobile payments company. PayPal was a major beneficiary of the at-home Covid spending boom, with revenues and earnings rising by 50% and 80% respectively. During this time, the stock rose to a peak of $310 in mid-2021. Since then, the stock had been drifting lower and then took another big step down after giving disappointing guidance during its year-end 2021 conference call. We believe the company can grow its earnings at more than 20% in future years and that the stock was significantly de-risked when it approached $100, where we initiated positions.

We sold our positions in Chevron and PepsiCo when they reached our price targets and the small position in Zimvie we received as a spin-off from Zimmer Biomet. We also trimmed positions in AbbVie, CVS Health, and Coca-Cola on price strength.

At the end of the first quarter, our largest portfolio sector weighting is Technology, where we own a diverse group of industry-leading names. After years of outperformance, the group pulled back in Q1, but we expect their strong secular growth prospects should attract renewed interest again soon.

Other large sector weightings include Financials, Health Care, and Communication Services. Financials declined in the quarter on concerns about slowing economic growth. We believe this will prove to be short-lived as the economy continues to benefit from improving employment growth and a shift in consumer spending to services (approximately 70% of the economy), as restrictions put in place during Covid are phased out.

The Health Care sector was a bright spot in Q1. The companies we own remain attractively priced with good prospects in 2022. Communications Services is one of the most undervalued areas of the market. Our investments in this sector provide essential services that consumers depend on for communication and entertainment and should enjoy a nice tailwind as the global economy continues to reopen.

In summary, we believe the Large Cap Value portfolio is well-positioned for upcoming periods as the businesses are operating at a very high level with strong earnings and cash flows, yet it sells at a very attractive valuation. As of March 31, the LCV portfolio's 2022 estimated P/E multiple was 16.6 times earnings compared to the S&P 500's estimated P/E multiple of 20.1 times earnings[6].

Matrix Dividend Income (MDI)

During a period of extreme market turbulence and downside volatility, the Dividend Income portfolio navigated the market as it was designed to do and ended the quarter with modest declines. At the height of the sell-off, the portfolio was generally down under -5%, whereas many areas of the market were down north of -10 to -20%.

[6] Source: Bloomberg

For the quarter, the Dividend Income portfolio was modestly lower. It outperformed the S&P 500 during the period and trailed the Russell 1000 Value Index (gross of fees). As mentioned above, the portfolio defended well during the market selloff but trailed both benchmarks during the March market rally.

Positive portfolio market sectors in the first quarter were Energy, Health Care, Industrials, and Utilities. The Technology and Financial sectors were the biggest laggards this quarter.

During the quarter we added to positions in American Electric Power, Bank of New York Mellon, Comcast, Gilead, Medtronic, Qualcomm, and Verizon.

Where cash was available, we started a new position in Texas Instruments (TXN), a leading global semiconductor manufacturer. After topping out at over $200 during the summer of 2021, Texas Instruments' share price declined to the $170 level on concerns about supply shortages and higher capital spending. We believe that these concerns provided a good opportunity to invest in this high-quality company. TXN is a shareholder-driven company, making necessary investments to enhance the product line-up and increase financial returns while returning excess cash after investment needs to shareholders, buying back its stock, and raising its dividend. TXN has grown its dividend by 20% annually over the past 10 years, most recently to $4.60 a share, providing a yield of about 2.75% at our purchase price.

We also repurchased Unilever after selling it earlier in the quarter when management indicated an interest in making a major acquisition of a consumer health business. We believed the proposed acquisition was a major strategic and financial mistake. Soon after we sold the shares, following tremendous shareholder criticism of the proposed acquisition, and news that an activist investor group had bought a large position in its shares, Unilever management reversed course, swearing off the deal, and vowing to refocus on improving the returns on its existing businesses. After a significant pull-back in its share price, measurably below our sale price, we reestablished a position in Unilever (UL). The shares have a dividend yield of over 4%.

We sold the positions in Chevron, General Mills, Consolidated Edison, and PepsiCo when they reached our target prices. We trimmed positions in AbbVie and CVS on price strength.

In Q1, 2022, seven portfolio holdings raised their dividends by an average of 5.2%. Looking forward, we expect further dividend increases in the portfolio as the year progresses.

On March 31, 2022, the portfolio had a 2.87% dividend yield, which compares very favorably with the 1.37% yield on the S&P 500[7], the 1.99% yield on the Russell 1000 Value, and the 2.34% yield on the 10-year Treasury.

[7] S&P 500 Index dividend yield is represented by the SPDR S&P 500 ETF.

At the end of Q1, 2022, the MDI portfolio's largest sector concentrations were in Health Care, Financials, Technology, and Consumer Staples. These large sector weightings provide a nice balance of economic sensitivity and stable earnings growth.

On March 31st, the MDI portfolio's 2022 estimated P/E multiple was 15.6 times estimated earnings compared to the S&P 500's estimated P/E multiple of 20.1 times earnings.[8]

We believe the MDI strategy is ideal for conservative, income-oriented equity investors. The portfolio has provided more downside protection than the S&P 500 Index, defending well during periods of market turbulence, while still allowing for meaningful appreciation over time.[9] We also think the highly diversified, all-weather MDI portfolio is well-positioned to have favorable performance in the stronger economy and rising interest rate environment that we anticipate over the next few years.

Bonds

In Q1, interest rates rose, and fixed income returns were negative in nearly all maturities, with larger losses in longer-dated securities. U.S. Treasury interest rates moved higher across the yield curve. The 2-year Treasury yield on March 31 was 2.34% compared to 0.73% at the end of 2021, the 5-year rate rose to 2.46% from 1.26%, the 10-year rose to 2.34% vs. 1.51%, and the 30-year rose to 2.45% from 1.90%.

While our bond portfolios were lower for the quarter, they benefitted relatively from their focus on high-quality corporates, U.S. Treasuries, agencies, and municipals (where appropriate) with nearer-term maturities.

With this conservative shorter-term positioning, our taxable bond and municipal portfolios performed in line to modestly better than their benchmarks for bonds with similar duration, and our declines were much more modest than the overall bond market.

Looking ahead, we expect that interest rates will continue to rise during the balance of 2022 and into 2023, in line with what the Federal Reserve announced after their March 2022 meeting. This is subject to revision by the Federal Reserve of course, as changing economic conditions warrant.

However, after the significant decline in bond prices in Q1 2022, we believe that current short-term high-quality bond prices largely reflect the anticipated Fed increases for the balance of the year. We believe Matrix's bond portfolios are well-positioned for the projected rises in the Fed Funds rate. Historically, short-term bonds have consistently generated positive returns even during periods of a rising Fed-Funds rate[10]. So, while we think rates will continue to move higher, we believe the much-improved yield on short term bonds and the more modest increases in short term bond yields from here

[8] Source: Bloomberg.
[9] Since the inception of the MDI composite on January 1, 2011
[10] Lord Abbett Short Duration Fund Update February 2022 for the period 1978-2021.

that we expect, should result in positive returns from this area of the bond market in the upcoming 9 - 12 months.

We believe that it is highly probable that we are near the peak in inflation numbers, which we think should begin to moderate by late summer, as supply chain issues improve, and the price of energy stabilizes or declines with new supply or reduced demand. We expect that after a period of rising rates, we will begin to modestly extend maturities to take advantage of better yields as our shorter-term bonds come due.

Balanced Accounts

Q1 2022 was a highly unusual period when both stocks and bonds declined. More typically, bonds provide a cushion during periods when the stock market declines. As both areas had modest declines for the period our overweighting to stocks had little impact (either positive or negative) on total returns for the period.

With our expectation that economic growth will continue in 2022, and that interest rates will move higher this year, we continue to believe that stocks are more attractive than bonds at current levels. However, bonds play an important role in balanced accounts and as rates have moved higher, we are less negative in our short-term bond outlook. It is also worth noting that the fixed income component is starting to have an increased income contribution to the portfolio.

Realized Capital Gains Outlook and Tax Mitigation for Taxable Accounts

With 2021 taxes on capital gains currently top of mind, we wanted to give some color on last year and some insights into our 2022 outlook. As we discussed several times in last years' correspondence, realized capital gains were much higher than usual in 2021. The portfolio had a strong 2021 with many stocks up over 125% from the Covid lows and several stocks reached levels where it made sense to take profits. In addition, we had very few losses to offset these gains. These were all good problems to have. But please know we are very thoughtful about capital gains and that we try to grow your assets in as tax-efficient a manner as possible.

As we look at our likely 2022 tax landscape, we expect capital gains to be higher than the last 5-to-10-year average, but well below our 2021 levels. Further, we expect our end-of-year gains to track our historic averages, with almost all our gains being long-term in nature and limited short-term capital gains.

We were more active than usual in Q1 2022, as market volatility provided opportunities to sell or scale back fully valued positions during rallies and to buy high-quality businesses at very attractive prices during market selloffs. We also had held back on certain sales in 2021, to control last year's gains as much as possible. So taken together, our 2022 gains are running higher than usual, but we expect the pace to slow looking forward and expect to be able to offset gains with losses as the year progresses.

So, by year-end, we expect a more manageable capital gains situation than 2021 and look for it to be much more in line with our historic trends. We always pay attention to managing our capital gains and expect to start executing some tax mitigation actions in the upcoming quarter.

Finally, we plan on starting a mid-August tax mailing with a general rundown on capital gains for the first half of the year and outlook for the second half of the year.

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Thank you for your continued confidence in the Matrix team.

After a lengthy period of communicating with you remotely, we are starting to get back on the road again. We look forward to catching up with you in person. In the meantime, if you have any questions with any parts of this commentary, our outlook, or your portfolio, please do not hesitate to call.

Stay well. Best regards.