INVESTMENT STRATEGY INSIGHTS

Repricing During the Storm

May 9th, 2022

The Market's Perfect Storm

- Market volatility is likely to persist as rate hikes continue, but bonds have repriced and may again offer protection

Adjusting to Tightening

- Recent market volatility reflects a transition to lower valuations given higher rates and rising recession risks

Inflation, Still

- Supply chains, energy prices and wages remain stubborn tailwinds for hotter-than-normal inflation

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The Market's Perfect Storm

- **Market Volatility.** Markets ended last week with the S&P 500 roughly where they started, down 0.2%, but the path was far from straight. Thursday saw a broad market decline with the S&P 500 down a discomforting 3.5%, but this followed a similar sized rise the prior day. The whiplash-inducing market performance appeared to center around the Fed's press conference, which some may have judged as more dovish than expected, but is equally as likely to have been technical in nature due to short-covering and levered positions.
- **Rare Stock/Bond Correlation.** Markets have faced a perfect storm of geopolitical events, high inflation and tightening monetary policy in 2022. The S&P 500 has declined almost 14% so far this year, and investment-grade bonds* are not far behind, down 10.5%. Perhaps most shocking is that bonds are now on track for their biggest decline since the early 1900's. Interestingly, the closest historical comparisons (1931, 1969 and 1994), during which stocks and bonds fell simultaneously, occurred during similar periods of aggressive tightening of monetary policy.
- **Shelter From (or After) the Storm.** With equities and bonds declining, investors have been left with few options for protection. The best performing assets during the decline fall into three groups: cash and short-duration assets that are not negatively impacted by rate shifts, real assets that are tied to inflationary causes and absolute return, which is less correlated to all of the above. However, with longer-term Treasury rates having risen above 3.0%, a level that now exceeds longer-term inflation expectations, bonds may finally be better positioned to protect portfolios during the late cycle.

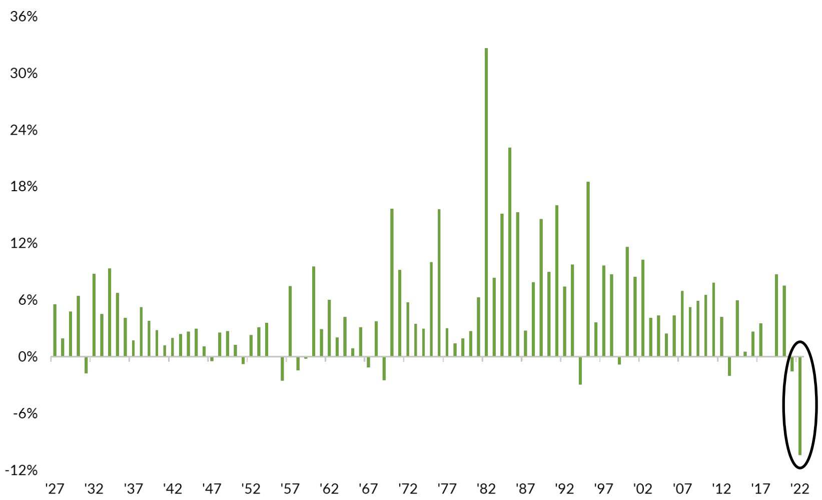
Market volatility is likely to persist as rate hikes continue, but bonds have repriced and may again offer protection

As represented by the Bloomberg Barclays U.S. Aggregate Index

Chart of the Week:

Negative annual returns for bonds are rare

Annual Bond Returns Since 1927



Source: Glenmede, FactSet — Data through 5/05/2022

Data shown are the annual returns for stocks (as represented by the S&P 500 Index) and bonds (as represented by the Bloomberg Barclays U.S. Aggregate Index). Data in the table lists the three full years when stocks and bonds both posted negative returns, and the return for those asset classes in the year directly following. Past performance may not be indicative of future results. One cannot invest directly in an index.

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Adjusting to Tightening

- **Fed Tightening Accelerates.** As expected, the FOMC followed through with a half percent rate hike last week, and will likely follow with a few more 0.50% hikes driving rates toward neutral over the next few months. The subsequent press release also outlined the contours of the Fed's quantitative tightening plans. The Fed plans to ramp up its balance sheet reduction to a maximum of $95 billion per month, which would return the balance sheet to its pre-pandemic size as a share of GDP by year-end 2025. Of course, the Fed may accelerate or decelerate this pace as needed to manage inflation and liquidity.
- **Roundtrip Rally.** The market initially rallied on confirmation that future hikes were unlikely to be more aggressive, after Fed Chair Powell reassured that the Fed was not "actively considering" a 75-basis point hike. The rally however was short-lived as the markets reassessed the Fed's comments. The S&P 500 slid more than 3% Thursday after scoring its biggest one-day gain since 2020 the prior day. Taking possible 0.75% rate increases off the table did not change the fact that the Fed is considering the most aggressive tightening path since 2000.
- **Assessing Neutral.** Markets have experienced significantly more downside volatility recently than other historical periods of easy-and-tightening monetary policy. Much of the downside reflects the magnitude of the shift in expectations for future interest rates and the associated impact on asset valuations rather than near-term disruption of the economy. However, investors may also be beginning to envision a tight-and-tightening environment, during which recession risk begins to rise. Based on expectations priced into fed funds futures, the Fed may reach the neutral rate of ~3% around the end of the year.

Recent market volatility reflects a transition to lower valuations given higher rates and rising recession risks

Inflation, Still

- **Supply Chain Pressures.** China's COVID-19 lockdowns, Russia's invasion of Ukraine and other factors continue to strain global supply chains. China accounts for ~12% of global trade and, while authorities have sought to keep factories and ports operating, its zero-tolerance approach to COVID infections has interrupted shipments and lengthened delivery times for exports. If portions of China's economy continue to face COVID infection risk, pressure on supply chains could continue to linger into the summer season.
- **E.U. Oil Embargo.** Last week the E.U.'s foreign policy chief proposed a ban on E.U. imports of Russian crude oil within six months and on refined oil products by the end of the year. The Czech Republic is seeking an exemption period to the proposal until capacity is increased in oil pipelines. Hungary and Slovakia will likely also continue to buy Russian crude until the end of 2023 under existing contracts, as they remain heavily dependent on imports of pipelined oil. Though some countries have spent recent years diversifying their energy supply, it will likely take time before a complete realignment of supply chains is feasible to meet Europe's energy needs.
- **Wage Gains Decelerate.** The April employment report confirmed that the labor market remains tight. Labor market gains were in-line with expectations, with 428k nonfarm payroll gains for the month of April. Wage growth came in at a slower and below expectations month-over-month growth rate of 0.3%, but one month does not yet make a trend consistent enough for the Fed to slow its monetary tightening intentions. Labor force participation fell marginally to 62.2%, which is still 1.2% below its pre-pandemic level.

Supply chains, energy prices and wages remain stubborn tailwinds for hotter-than-normal inflation

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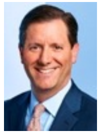
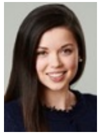


JASON D. PRIDE, CFA
Chief Investment Officer - Private Wealth
Responsible for formulating investment policy and strategy
Serves as a leading member of the Investment Policy Committee
B.S. from Massachusetts Institute of Technology

MICHAEL T. REYNOLDS, CFA
Vice President, Investment Strategy
Responsible for supporting the development of investment strategies, policy and portfolio construction methodologies
Is an active member of the CFA® Society of Philadelphia
B.S. from the Wharton School of the University of Pennsylvania



ILONA V. VOVK, CFP®
Investment Strategy Officer
Responsible for supporting the development of investment strategies, policies and portfolio construction methodologies applied to Private Wealth client portfolios
B.A. and B.S. from Drexel University

GLENMEDE CORPORATE FACTS

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