1st Quarter 2022

VAAM forecasts **economic growth** greater than the consensus viewpoint. This is primarily due to the strength of the consumer sector that comprises 70% of the U.S. $24 trillion economy. The U.S. consumer is as large as China's economy. A strong underpinning to consumer spending has been the strength of the labor market. The unemployment rate at 3.8% is significantly below the 2015-2022 average of 5.1% and the 2000-2022 average of 6.0%.

Fed Scorecard = A+

Maximum Employment

	Current	Average 2015-2022	Average 2000-2022
Unemployment Less Job Openings	-1.40%	0.26%	2.84%
Unemployment Less Quits	2.30%	2.26%	4.07%
Unemployment Rate	3.80%	5.10%	6.00%

Consumers are in excellent financial shape. Consumers have built up a significant cash cushion partly due to the generous social programs of the government to support the economy through the pandemic. Checkable deposits for households and nonprofit organizations rose to $4.06 trillion in December from $1.16 trillion at the end of 2019. The previous high before the pandemic was $1.41 trillion. Retail spending was stronger than expected in February after incorporating upward revisions to January's blockbuster gain. While oil and gasoline prices have risen, spending on gasoline and energy as a percent of disposable income has dropped by half since the late 1970s and early 1980s. The economy has become much more fuel efficient. Another important component to consumer spending is that household wealth has surged $40.3 trillion since the start of the pandemic to a record $150.3 trillion through the end of 2021. This is a 37% increase over the last seven quarters and almost equal to the previous seven years combined. Net worth exceeds disposable income by more than 8 times compared with 4.5 times during the last inflation shock. During the pandemic consumers reduced debt thereby strengthening their balance sheets. Household revolving credit lines currently are only 20% utilized providing plenty of borrowing power to fuel post pandemic spending. In addition to the strength of the consumer sector, the business sector is also well positioned. Corporate leverage continues to decline, the cash/debt ratio continues to rise and earnings are strong. Corporations have been able to maintain profit margins by raising prices. Fourth quarter earnings were strong with 76% of S&P 500 companies exceeding their estimates.

The Leading Economic Indicators have posted 12 consecutive months of increases. The U.S. economy has historically avoided a recession when the components of the LEI are all rising. The Purchasing Managers Index is another important metric that measures the strength of the economy. The U.S. is more of a service economy than a manufacturing economy and in February the PMI recorded a level of 58.6 (a level of 50 or more indicates the economy is expanding) and February was the 21st month in a row that the economy has demonstrated continued growth during the pandemic.

The Federal Reserve receives high marks for the strength of the economic recovery, but their other mandate of low and stable inflation is now a serious problem. VAAM believes the Federal Reserve is behind the **inflation** curve. The consumer price index has risen 7.9% the past 12 months (vs.an average 2.0% from 2015-2022 and 2.3% from 2000-2022) while the personal consumption expenditure index (the Fed's preferred inflation gauge) has risen 6.1% the past year (vs.an average 1.7% 2015-2022 and 1.9% 2000-2022).

Fed Scorecard = F

INFLATION

Rising Prices	Current	Average 2015-2022	Average 2000-2022
CPI	7.9%	2.0%	2.30%
PCE	6.1%	1.7%	1.90%

During the 1970s and early 1980s hyper inflation was the result of loose monetary policies that were ultimately reined in by Fed Chairmen Volcker and Greenspan. We are now in a period where all inflation gauges are growing well in excess of policy targets. The strong labor market, where unfilled job openings are 5.3% above their pandemic level, have resulted in wage cost pressures. This leads to cost-push increases as companies raise their prices to protect profit margins. In addition, the surge in spending coming out of the pandemic has led to demand-pull inflation and put further pressure on supply chains. Onetime events have also exacerbated inflation such as the drought in Brazil (a large commodity exporter) and the covid lockdown restrictions in China.

Looking forward we believe inflation will remain high and will only begin to moderate during the second half of 2023. The housing sector will have a persistent upward push on inflation due to the rising costs of shelter. Home prices and rents tend to be "sticky" and operate with a lag. One-third of the CPI is driven by shelter related components. Housing will continue to contribute to inflation until supply catches up with demand. Automation and productivity will serve to eventually lower inflationary pressures. During the fourth-quarter of 2021, productivity rose at a

6.6% annual rate from the previous quarter. This is the largest advance since the second quarter of 2020 and will help offset wage cost pressures.

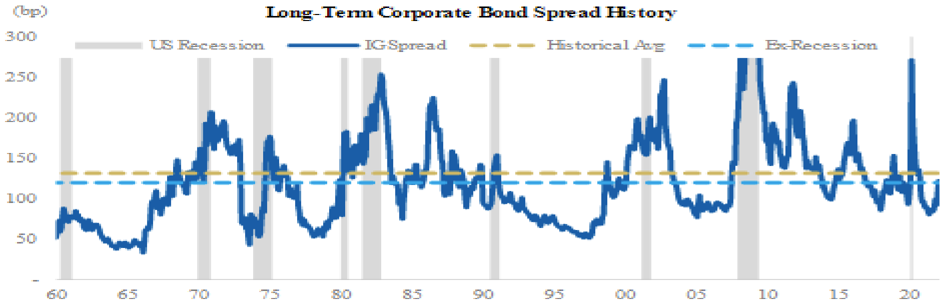
Russia's invasion of **Ukraine** raises uncertainty and further complicates the outlook. We do not know when or how the hostilities will end. There will be multi-year lasting impacts, the uncertainty is such that it is impossible to forecast all of the possible outcomes. The resultant humanitarian and refugee crisis will be at the top of the list to address. Diversifying energy sources away from Russia (particularly for Europe) and rising defense expenditures are two trends that should have multi-year implications. Another consequence from the invasion is that economic globalization has been set back. Inflation pressures have been further intensified as reflected in the broad-based rise of energy, grain and metal commodity prices. This inflation will serve as a headwind to growth and supply chains will be further stretched. This makes the Fed's job all the more difficult in trying to raise interest rates enough to bring down and control inflation but not enough to tip the economy into a recession. It is important to note that while Russia supplies 10% of global oil production its economy is small (approximately 7% of U.S. GDP) and is one dimensional consisting of energy and natural resources. The energy ramifications for Europe are much greater than for the U.S. Russia supplies 40% of Europe's natural gas and 24% of its oil. U.S. liquified natural gas exports to Europe will be an important benefit, significantly lessening their dependence on Russian energy. Food prices will also feel the effects of the invasion. Russia and Ukraine provide approximately one-third of the world's wheat exports and 19% of corn exports. Russia runs a risk of experiencing significant negative effects (from both an economic and non-economic perspective) from their actions for a number of years. We believe China will only go so far vis-à-vis their alliance with Russia. China's priority is on a stable and growing economy. The U.S., Europe and Japan accounted for 52% of China's total foreign trade in 2021 compared to 3.8% for Russia. Given the uncertainties, the Ukraine war will continue to result in heightened volatility for the investment markets-stocks, bonds, commodities and currencies.

Corporate Bonds
1st Quarter 2022

The first quarter of 2022 was marked by volatility in interest rates as the markets digested the highest inflation rate in decades as well as geo-political upheaval. The treasury curve ended 2021 with a relatively flat 10 year (1.51%) to 2 year (0.73%) spread differential, just shy of 80 basis points, and throughout the first quarter this difference continued to compress to under 20 basis points. However, the curve as measured by the difference between 3 month t-bills and 10 years treasuries actually increased from a differential of around 1.50% on 12/31/21 to about 2.00% at quarter end. While a flatter middle part of the curve may signal recessionary concerns, observing the curve in its entirety (from t-bills to 10 years) suggests that the economy is poised to continue growing. The shape of the yield curve is an important indicator when measuring the strength or weakness of the economy. A steepening yield curve implies that rates favor economic recovery/growth. Currently, the yield curve, as measured between the three-month US treasury bill and ten-year US treasury note, shows the curve steepening. Banks borrow near the 3 month range of the curve and lend at the long end. This determines profitability, which leads to strong

economic growth. Vanderbilt believes this measure of the yield curve to be more appropriate than the widely-followed measure between two and ten year US treasury notes.

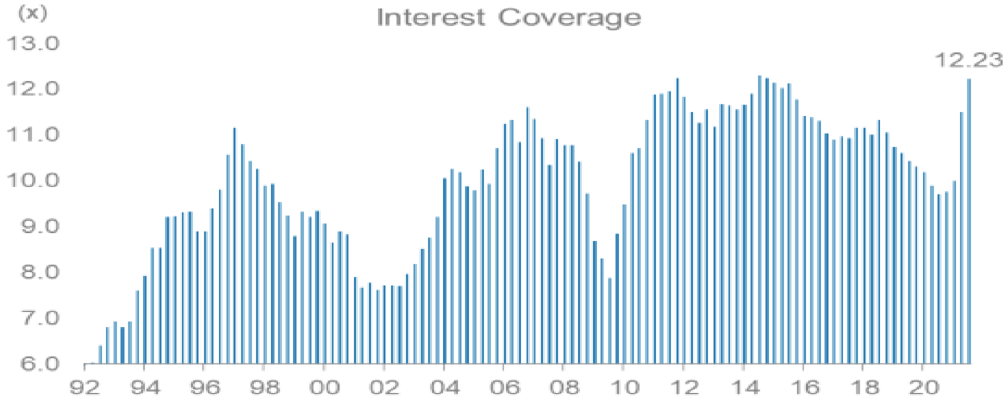
During the first quarter, inflationary and geo-political precautions overshadowed corporate bond fundamentals, causing spreads on investment grade corporate bonds to widen, and resulting in corporate bonds underperforming treasuries by on a duration-adjusted basis. But even as spreads widened in response to soaring global inflation and geo-political tensions, as shown in the chart below, they are only widening to historical average levels. This can be attributed to the strength of the underlying fundamentals.



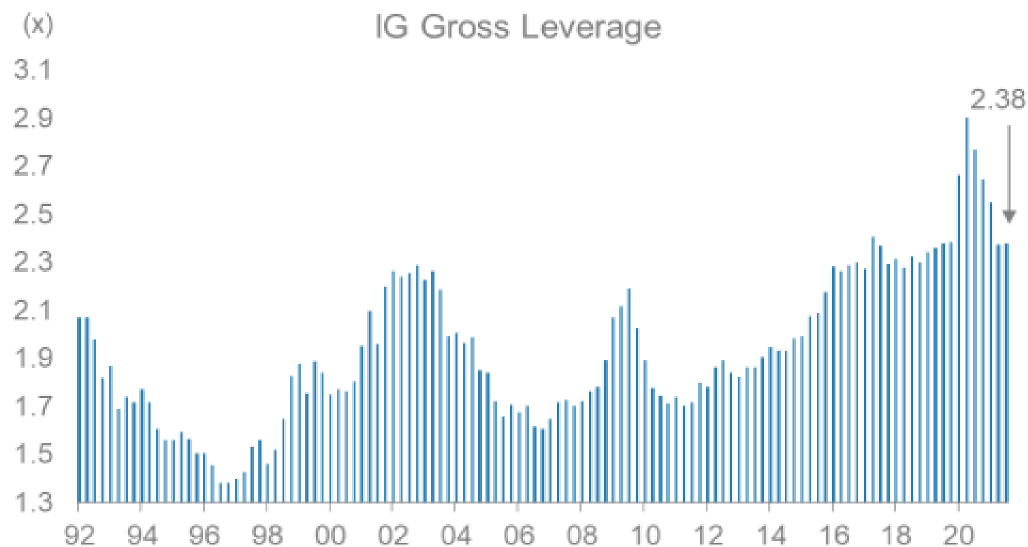
Source: Morgan Stanley Research, Moody's, Bloomberg

Investment grade earnings and fundamentals have remained strong. For example, interest coverage ratios, which measure how easily a company can pay interest on its outstanding debt, have been rapidly increasing throughout the pandemic, and is averaging a healthy 12.23 EBITDA to interest expense. At the same time, companies have been buying back their debt, taking gross leverage down to an average of 2.38. The charts below demonstrate the positive movement in these two critical measurements.

Source: Morgan Stanley, Bloomberg



Source: Morgan Stanley, Bloomberg



Although the corporate sector underperformed treasuries during the first quarter, we find investment grade corporates extremely attractive due to their strong underlying fundamentals. For example, within the banking sector, we like Citibank. Citibank plans to streamline its operations, focusing on core businesses and divesting from retail operations in Asia and freeing up resources to deploy in wealth management and in serving corporate customers. As the spread between the very short end of the treasury curve, where banks borrow, and the 10-year part of the curve, where banks lend, has increased, Citibank is poised to perform well. Within industrials, we like General Dynamics, which operates as an aerospace and defense company worldwide. Favorable cash flows have enabled General Dynamics to continue reducing debt, bringing its interest coverage ratio (EBITDA/interest expense) to 13.71, returning value to shareholders and investing in future growth.

As real interest rates have been overwhelmed by inflation, your portfolio has benefited by being invested in TIPS (Treasury Inflation-Protected Securities), which, over the first quarter, have outperformed treasuries by 4.0% on a duration-adjusted basis. TIPS's principal value rises as inflation rises, and their interest payment increase accordingly as well. As the first quarter witnessed the highest inflation in decades, TIPS sheltered your portfolio from inflation, and allowed it to reap rewards.