The beginning of 2022 marked a major shift in the global economy, led by developments in the United States. Inflationary concerns in the U.S. quickly shifted from “transitory” to “structural.” In other words, the Federal Reserve acknowledged it was wrong about inflationary concerns being temporary and embarked on a strategy to raise short-term interest rates and reduce its balance sheet. The result led to a strong uptick in treasury yields, with dramatic volatility. As bond prices have an inverse relationship with interest rates, bonds fell significantly during the first quarter. The index most institutions use to measure intermediate-term bond performance was down 5.9% for the first quarter.

To make matters worse, the Russian invasion of Ukraine and ongoing global concerns over COVID-19 not only increased geopolitical tensions, but significantly added to inflationary concerns. Commodity prices skyrocketed on the news of the Russian invasion, as did fear in the global stock market. China’s zero-COVID policy led to the complete shutdown of the city of Shanghai, a major supply chain hub for many of the goods consumed by the world. If some element of inflation was a result of short-term supply chain disruptions, it quickly became evident that those short-term issues could persist for some time.

Rising interest rates in the U.S. not only resulted in a significant decline in bond prices, but also led to a large rotation in the stock market. Many of the growth companies that were favored by the market over the last decade came crashing down, as the market began to question company valuations. Market “darlings” like Meta (formerly Facebook) and Netflix experienced massive corrections. The only sector in the S&P 500 that worked well during the quarter was energy, up over 30%, largely due to the massive rally in the price of oil and natural gas.

The large correction in the bond market led to an interesting phenomenon. Typically, during periods of stress for the global stock market, investors flock to safe haven assets like bonds (particularly U.S. Treasuries). Unfortunately, the large decline in bond prices led to the intermediate-term bond market producing a negative rate of return of 5.9%, which was worse than the decline in the S&P 500 of -4.6%. The result was that portfolios typically designed to be less risky (i.e., a heavier weight to bonds than stocks) performed worse than a riskier portfolio (more stocks, less bonds). This phenomenon has not occurred for a long period of time. The good news is that stock market valuations have rationalized, while the bond market is now offering a higher yield that can offset any additional price instability.

Market pundits have been voicing worries of a looming recession as a result of the market volatility. Unfortunately, there is not a person out there that can accurately predict a coming recession consistently. While we certainly do not know if a recession is coming, it is fair to say that the probability of a recession is as high as it has been since the initial COVID lockdowns. The big difference between now and then is the Federal Reserve. In early 2020, the Fed quickly took interest rates to zero, initiated massive quantitative easing, and the federal government stepped in with further fiscal stimulus. Today, the Fed must fight inflation, and have made it clear that short-term interest rates will continue to rise. The question that most are asking is, “Can the Fed successfully raise interest rates enough to combat inflation while not damaging the strong economic growth the U.S. has established over the last many years?”.
Endowment
The Endowment portfolio was down 1.5% for the first quarter, outpacing its Policy Index by 0.3%. Over the last quarter, one-year, and three-year periods, the Endowment portfolio ranked in the top decile amongst its peer set of similarly sized Endowments and Foundations. While stocks and bonds were a drag on overall performance for the quarter, the diversification offered by the portfolio helped to significantly protect capital during the period. Real assets produced a strong 10.9% rate of return due to exposure to energy and commodities, the best performing areas of the market. Hedge funds also produced a positive rate of return for the quarter of 2.2%, an area that had not done much for several years but clearly provides strong diversification benefits during periods of volatility. Private markets exposure across real estate, private equity and private credit all also produced positive rates of return for the quarter.

Non-Endowment
The Long-Term portfolio was down 2.7% for the quarter, outpacing its Policy Index by 1.1%. Like the Endowment, diversifying assets helped to protect the portfolio during a period of market stress. Both the real assets allocation and the hedge fund allocation produced positive rates of return for the quarter. Furthermore, an overweight to hedge funds was also additive to results.

The Medium-Term portfolio was hit by the phenomenon described above. As this portfolio is roughly 30% stocks and 70% bonds, it underperformed both the Endowment and the Long-Term portfolio. While a portion of the bond portfolio was in short-term bonds and cash, it was not enough to offset the losses with bonds. This portfolio, positioned to be more conservative, faced an extremely difficult environment given the significant decline in bond prices.

The Intermediate-Term portfolio, consisting of 100% bonds, also experienced higher losses than expected given the dramatic decline in bond prices. The portfolio was down 4.3% for the quarter, outperforming the traditional bond index. A key factor in this result is the portfolio’s 40% allocation to short-term bonds which experienced a lower loss.

The Short-Term portfolio was flat for the quarter. As the Federal Reserve has embarked on a tightening policy, there will be a future point in which the portfolio begins to deliver positive results. However, it will likely take several interest rate hikes before this becomes a reality.

The Sustainable portfolios were opened on January 1, 2020. These portfolios, invested in the same investment managers with the same asset allocation, performed extremely well out of the gate. In fact, each portfolio’s performance ranked in the top decile of similar organizations over their first two years of existence. In Q1, the portfolios lagged significantly for a couple of reasons. First, the portfolios are divested from fossil fuels, and the energy sector was up over 30% for the first quarter. Not owning energy companies meant the equity portion of these portfolios significantly underperformed the broader markets. Second, many sustainable equity strategies tend to be more growth-oriented because energy, materials, tobacco, defense, etc., is naturally excluded from the definition of Environmental, Social, and Governance (ESG). Growth stocks significantly underperformed value companies during the first quarter. The portfolios were down over 10.6% for the first quarter, but since inception, the portfolios are still up over 10.6% on an annualized basis, outperforming the policy index significantly.