Sentinel Trust
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April 2022

First Quarter, Year-to-Date Investment Recap

Inflation is the driving force impacting policy makers, consumers, and markets thus far in 2022. Recent inflation is global and broad, hitting nearly all consumers and categories including food, shelter, and energy. Economists understand the forces driving inflation in the present, but future inflation has generally been nearly impossible to predict. In the current high inflation environment, it is easy to become pessimistic and focus on the bad news and the signs of rising prices everywhere. However, while we are concerned about inflation and do think investors should proceed with added caution, we also see many long-term disinflationary forces and opportunities. This note discusses how inflation is impacting various market participants, how we are positioning portfolios, and where we see opportunities and risks ahead.

Inflation and the Federal Reserve

Inflation's biggest impact, in our opinion, has been on policy makers, particularly the Federal Reserve. The Fed's goals are to maintain maximum employment, stable prices, and moderate long-term interest rates, which they achieve through setting interest rates and printing money. From the start of Covid-19's economic effect through a few months ago, the Fed engaged in unprecedented, emergency stimulus to maximize employment. They essentially created $4.5 trillion of cash and set the yield earned on cash at 0%. While their actions certainly helped the markets and the global economy weather the most severe times during the COVID pandemic, those actions also sowed the seeds for today's inflation.

The Fed and the markets are now reaping the consequences: the harsh reality that emergency easing may likely lead to emergency tightening. Whereas market participants expected just two rate hikes totaling a 0.5% increase on cash yields heading into 2022, they now expect the Fed to hike 8-9 times for a total 2.5% hike. Whereas the Fed was still injecting cash into the economy earlier this year, they are now making plans to unwind their $9 trillion balance sheet. This would be the fastest rate-hiking cycle in over twenty years, and the Fed might still be behind inflation when the dust settles. The Fed is simultaneously reducing the supply of US dollars and making them more valuable on a nominal basis. This is relatively bad news for other assets that are often priced in relative terms to dollars, but good news for savers who can at least earn some nominal yield on cash for the first time since the pandemic. We think continuing to hold an overweight to cash, now with some yield, in this emergency tightening phase is prudent.

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Bonds

Bonds, where we remain underweight, have struggled more than any other asset class to date in 2022 thus far; in fact, Q1 was the worst quarter for bonds in over forty years. We protected portfolios by being underweight the asset class and underweight interest rate risk, though still took some losses. While many investors wonder if bonds are worth it given steep losses in Q1 and yields still below current inflation. We continue to think US bonds make sense for most portfolios as protection against disinflation and recession. And though it may be hard to imagine lower inflation in the current environment, long-term forces, including technology, demographics, and debt, are still in play. In addition, various recession indicators are on the rise. For example, most workers are still worse off after adjusting for inflation despite solid nominal wage growth. Consumer sentiment is below pandemic levels, credit card balances are rising, and sub-prime auto delinquencies are ticking up. While we are not calling for an immediate recession, we still think owning bonds, now at higher yields, makes sense for most investors.

US Stocks

US stocks, where we are also slightly underweight, closed the quarter off roughly -5% and now stand down -10%, in correction territory, year to date. We remain underweight largely due to our view that the Federal Reserve, the 800-pound gorilla, is moving from emergency easing to emergency tightening. By making both cash and bond yields more attractive, the Fed has made relative equity yields less attractive, especially in light of the current geopolitical backdrop.

We are, however, unlikely to become much more defensive in the near-term for various reasons. First, investors are about as pessimistic as they have ever been and such pessimism is usually positive for future stock returns. Next, corporations are still delivering solid earnings while buying back stocks. Last, valuations on various metrics are back to and in some cases below their pre-pandemic and historical averages. Calling recessions and timing markets are difficult to impossible endeavors and the market has priced in a fair amount of damage already. We at Sentinel generally subscribe to the view that US equities are to be owned for the long-term, and in the long run, the US maintains, and perhaps is growing, numerous sustainable competitive advantages. These advantages include our rule of law, a large, relatively homogeneous society, two oceans to trade from, and an abundant supply of natural resources.

International Stocks

International stocks largely fell in tandem with their US peers, off roughly -5% in Q1 and -10% to date as of this writing. While we entered the year a bit more optimistic on international stocks, we've moved underweight and continue to lighten up exposure for several reasons. First, the war in Ukraine and Europe's dependence on Russian energy supplies leaves much of Europe at risk of recession. Second, China continues to be plagued by COVID lockdowns and policy missteps. Outside of China, many emerging and frontier markets, Sri Lanka for instance, are struggling with rising food and energy costs. Finally, Japan has come under significant pressure recently due to their choice to remain in emergency easing mode despite global inflation. Again, markets have priced in a fair amount of bad news, but for the time being we'd prefer to own more US stocks than international equities.

Hedge Funds

Hedge funds held up relatively well in Q1 and largely have lived to fight another day. We were generally pleased with our roster of managers and how they navigated a challenging first quarter. We think amidst inflation, unprecedented changes to the bond market, and heightened geopolitical risk, that active managers with well-defined skill sets should deliver alpha. We continue to believe that most hedge funds, given the fee structure and illiquidity, do not make sense as investment opportunities for our clients, but we are gaining more conviction in our roster and added to various managers in some beaten down, opportunity-rich areas like biotechnology. We have a slight overweight to hedge funds.

Real Assets

Real assets, especially those focused on energy and materials, were the sole positive outlier for the quarter, but as we've noted before, not all real assets benefit from inflation. Listed public real estate, for example, fell in line with equities in Q1. Public real estate is often driven by large passive equity flows and often correlates with broader markets. Public real estate indexes also carry significant exposure to office REITs, which we think will struggle mightily to pass on inflation. On the other hand, we believe other liquid real estate classes, such as industrial warehouses, multi-family housing, cell towers, and data centers, will pass on higher prices and can act as good inflation hedges. We think the combination of passive flows impacting REITs broadly and the idiosyncratic nature of the property types creates a rich opportunity set for active managers. We remain skeptical of private real estate given the strong public market opportunity set, with the exception being American farmland. We continue to see this as one of the most stable inflation hedges, especially as the future supply of Russian and Ukrainian agricultural commodities remain in doubt.

Many of these same themes carry over to the energy complex, and we continue to add to the space. Both public and private energy related assets have largely been shunned or denigrated by investors and policy makers. Poor returns, boom/bust cycles, poor CapEx management, and environmental concerns have left only a few legitimate active managers standing. Given concerns around Russia and a global recognition that a transition to clean energy is no easy task, energy commodities and stocks rose strongly in Q1. Returns were a bit undiscerning, though, and we think backing a few of the experienced investors left in the space, ones that can hedge against the cycles while finding attractive cash flow, is a rich opportunity set.

Finally, we turn to currencies, cryptocurrencies, and gold. Of the group, we still favor the US dollar and gold, but Q1 highlighted the usefulness of cryptocurrencies. While we cannot argue with strong US sanctions against Russia, such actions will certainly lead other foreign bankers to question the value of the US dollar and its obligations. However, for the time being, we see no fiat or crypto alternative to the US dollar that possesses the same level of stability and liquidity. We do see the demand for gold rising, as foreign bankers diversify their reserves, and continue to build our allocation across portfolios.

While we do not own any cryptocurrencies directly, we think Q1 was a good test case for the space. Although cryptocurrencies fell broadly along with most other asset classes and did not act as the inflation hedge many view them as, they served a vital role in Ukraine. Refugees could flee with wealth stored electronically through cryptocurrencies. Individuals seeking to provide aid to those same refugees often raised and transmitted funds through cryptocurrencies. We generally believe that bitcoin and other cryptocurrencies can serve as a form of liquid gold and have made private investments around the space.

Summary

In sum, inflation was the driving force impacting markets and investors in Q1. Aside from cash and commodities, most assets struggled against inflation. We think the Federal Reserve, which has long been in emergency easing mode, will continue to move more toward an emergency tightening mode. We think this will drive down the supply of dollars and drive up the value of the dollar, making other assets less attractive on a relative basis. Against this backdrop, we thinking overweighting cash in US dollars and underweighting most other assets is the best course of action.

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