2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

2022 First Half Review and Second Half Outlook

Executive Summary

- The first half (1H) of 2022 brought its fair share of bad news. Russia invaded Ukraine accelerating already worrisome global inflation to levels not seen since 1981. China's regulatory crackdowns, COVID lockdowns and Cold War posturing snarled supply chains and further stoked inflation and geopolitical risk. Higher inflation pushed the Federal Reserve, Congress, and their global peers toward much more restrictive policies and led to uprisings in Sri Lanka and other countries.
- This volatile cocktail put significant pressure on asset prices. US stocks suffered their worst 1H since 1962. Bonds offered no safety with the 10 Year US Treasury bond suffering its worst loss since 1788. The dollar appreciated sharply pushing numerous foreign currencies to multi-decade lows. Crypto assets plunged. Commodities and particularly energy assets were the sole positive 1H outlier, but even these traditional inflation hedges stumbled in June on recession fears.
- The silver lining is that a lot of bad news has been priced in, and assets are now much cheaper. The bond market is pricing in one of the most aggressive Fed rate hiking cycles in history. Consumer, investor, and CEO confidence levels are near record lows. After years of near zero yields, cash and bonds now offer at least some yield before inflation. US equities are closer to historical valuations, and international equities are near their cheapest valuations in decades.
- We have been defensively positioned with excess cash and may buy into pockets of opportunity but expect to remain highly selective and relatively defensive. The Federal Reserve is embarking upon an unprecedented policy shift, geopolitical uncertainty is high and much hinges on two unpredictable individuals in Xi Jinping and Vladimir Putin.

Cash & Bonds

Cash, held in US dollars, was the only major asset class to register a positive, pre-inflation return for both Q2 and the first half of 2022. For investors, low-returning, safe cash went from being total "trash" in 2020 and 2021 to king here in 2022. This is largely due to the Federal Reserve's actions and their abrupt, but necessary reversal from emergency easing to emergency tightening. In 2020 and 2021, the Federal Reserve has been able to print trillions of dollars in new cash while simultaneously holding the interest rates on cash at close to zero. They were able to do this with little negative discernable impact on financial markets as inflation remained near or even below their desired levels. But following the COVID recovery with added fuel from continued supply chain disruptions and heightened geopolitical risk, inflation has accelerated and is now public enemy #1.

To fight inflation, the Fed has made a 180 degree pivot from emergency easing to emergency tightening, from flooding the market with trillions of zero-yielding dollars to soaking back up trillions of dollars with 2-3% yields. We do not portend to know how long the Fed will remain in emergency tightening mode. We do know that the Fed, the 800-pound gorilla in the room (global economy), has moved from being the wind at the back of all asset prices to the wind in the face, from everyone's friend to everyone's enemy. As a result, we think it continues to be prudent to hold excess cash in the near-term.

Against this backdrop, bonds have suffered some of their worst losses in decades. Bonds broadly began the year with low yields, abundant liquidity and hopes that inflation would prove transitory. With the Fed increasing yields rapidly, draining liquidity, and with inflation accelerating, broad bond indexes suffered historic losses. In the first half of 2022, the Barclays US Aggregate lost 10%, and the Barclays 5 Year Muni Index fell 5.5%. Riskier high yield debt fell 14%, and global high yield debt lost nearly 17% given the strong dollar. While we find today's yields much more attractive than the yields on offer at the outset of the year, we maintain an underweight and defensive position across the fixed income universe.

Equities

US equities were also affected by Fed tightening, inflation concerns and heightened geopolitical risk. The broad Russell 3000 Index fell 21% in the first half of the year, registering both the first correction (10% loss) and first bear market (20% loss) since the pandemic. Investor sentiment, following these losses, is at or even below the levels we witnessed in the depths of 2008-9 during the Great Financial Crisis (GFC). While we typically like to buy into weakness and fear as long-term investors, we have yet to buy this dip for several reasons. First, and foremost, with inflation now a binding constraint, neither the Federal Reserve nor Congress can come to the rescue as they did during the pandemic and GFC. Next, despite the 20% pullback and solid year-to-date earnings, US stocks are not exceptionally cheap on either a standalone or relative basis. Finally, while investor pessimism is high, analyst expectations for future earnings growth and margins are still potentially lofty. We still like US stocks for the long-term, but believe an underweight, more cautious stance is still warranted in the near-term.

Despite heightened geopolitical risk and major currency headwinds, international stocks fared slightly better than their US peers in 1H 2022 but still fell 19%. Factors including the ongoing war in Ukraine, continued crackdowns, lockdowns and Cold War tensions from China, and inflation causing significant unrest in countries like Sri Lanka all contributed to first half losses. Unlike their US peers, international stocks and currencies now trade at some of the cheapest valuations we've seen since the 2008-9 GFC and the 2011 European debt crisis.

Given the heightened geopolitical risk, we remain underweight international equities. Over the near-term, international markets will be driven significantly by the actions of a few individuals. Russia just shut down its major Nord Stream 1 gas pipeline to Germany for repairs. If Putin decides to keep the pipeline down, Germany and the rest of Europe likely face a significant recession. If, however, Putin and Zelensky are able to broker some peace in Ukraine, we could see a significant rally in European assets. Similarly, Xi Jinping in China wields outsized influence over international markets. As he heads for an unprecedented third term as president, any easing of restrictive regulatory, humanitarian and COVID policies along with a pivot to the West would likely lead to a major rebound for Chinese stocks. Conversely, a continued tilt toward crackdowns, Cold War actions and Russia, would lead to further weakness. While we don't like betting on geopolitical events, especially those driven by a handful of unpredictable individuals, we do like the international companies we own and like the diversification benefits that stem from various potential geopolitical outcomes.

Alternatives

Hedge funds as a group fared better than the overall equity markets, but failed to truly capitalize on the amount of dispersion and volatility in the markets. We are generally pleased with our directional, long/short equity managers that held up relatively well in 1H and even more pleased with our uncorrelated managers who delivered a small, but positive return in a very difficult environment. We continue to be highly selective and believe that most hedge funds are not worth their fees and illiquidity.

Even more illiquid private equity and venture capital assets have yet to meaningfully update valuations for Q2 and were generally flat in Q1. We've seen several high profile unicorns (private companies with $1B+ valuations) fall back to earth dramatically. For now, Klarna, a private fintech firm is the poster child with its $45B valuation from last summer slashed by 85% to $7B recently. While Klarna has a few idiosyncratic factors, we should expect some delayed weakness in private equity prices moving forward. On the positive side, we are hearing that investing new capital into private companies has become much less competitive recently, and we are finding some very attractive pockets of opportunities. The boom and bust nature of private capital, and especially venture capital, merits the vintage year diversification approach we adhere to diligently. We dig holes across time and sectors on a highly selective basis.

Sentinel Trust
Together, families prosper℠

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

Real assets, which are often broadly seen as inflation hedges, delivered mixed results for 1H highlighting our view that not all real assets behave the same. Listed real estate, which is known to correlate and trade with equities broadly, fell 21% on the quarter. We do think there are some very good inflation hedges and opportunities within this group and continue to like our active managers in the space. We remain highly selective in private real estate with American farmland being our largest purchase over the past year.

Commodities broadly jumped close to 20%, driven mainly by oil and natural gas but even these traditional inflation hedges experienced their own steep correction in June on recession fears. We remain optimistic about energy equities long term given their relatively cheap valuations and lack of continued investment into the space.

Finally, cryptocurrencies suffered the most damage in 1H with Bitcoin off nearly 60% and certain “stable” coins collapsing completely. To date, cryptocurrencies failed to be the inflation hedge many had hoped for. We think their appreciation prior to 2022 was driven mainly by excessive money printing and a lack of faith in the Federal Reserve. As the Fed regains credibility and embarks on its emergency tightening campaign, shrinking the dollar supply while making dollars more valuable, crypto assets have lost their shine. We do maintain a small position in gold which ended 1H down just 1.5%.

In conclusion, the first half of 2022 had more than its fair share of difficult surprises. Asset prices broadly buckled under the pressures of rising inflation, tightening monetary and fiscal policy, and accelerating geopolitical risk. We were defensively positioned with excess cash heading into 2022 and now are seeing pockets of opportunity. Absent a worsening geopolitical picture in Russia and China, we think a lot of bad news is priced in, but expect to be patient putting cash back to work. The Federal Reserve, the 800-pound gorilla impacting the global economy, has gone from emergency easing to emergency tightening with inflation being their biggest immediate concern. Added caution remains prudent, but opportunities are emerging.