Davenport Asset Management Quarterly Update | Q1 2022

March 31, 2022

The first quarter brought investors yet another curve ball with Russia's invasion of Ukraine. This sent shockwaves through global markets and added to already notable inflation pressures, while also casting a new light on international investing. Meanwhile, the Federal Reserve raised interest rates as policymakers began to reign in monetary stimulus. Markets ultimately proved more resilient than one might expect given these circumstances, with energy and commodity-related stocks leading the way. While the S&P 500® Index and Russell 2000® Index were down 12% and 14% at one point during the quarter, they finished down 4.6% and 7.5%, respectively. It's worth noting, however, that the major indices belie underlying weakness in the market. Many stocks, especially in riskier corners of the market, have experienced steep declines.

Market Returns	Q1 2022	2021
U.S. Large Caps	-4.6	28.7
U.S. Mid Caps	-5.7	22.6
U.S. Small Caps	-7.5	14.8
International Developed Markets	-5.9	11.3
Emerging Markets	-7.0	-2.5
Intermediate Term Bonds	-4.5	-1.4

Source: Morningstar Direct. Please see last page for index definitions.

War in Ukraine added a new layer of risk to equity markets. One major consequence of the situation has been a spike in oil prices and many other commodities (Russia is the world's second largest producer of oil). The S&P GSCI, an index of commodities, advanced 29% for its biggest gain in over 30 years. This is prompting a variety of pressures ranging from higher prices at the pump to higher input costs for companies. While good for commodity producers, higher prices could squeeze consumers' pocketbooks, crimp corporate margins and generally help promote an economic slowdown. Moreover, many corporations have shut down activities in Russia and we seem to be going through a process of de-globalization in the near term. This corporate warfare seems warranted, but could become a slippery slope. What if some companies decide to do less business with China (a huge source of demand for many companies) given ideological differences? Such a scenario seems far-fetched, but less so than it did just a few months ago.

Inflation is now even more of an issue. We were already dealing with significant inflation given pandemic bounceback demand and associated supply chain challenges. To wit, the consumer price index advanced 7.9% in February, a 40-year high. The geopolitical situation has added fuel to the fire. In turn, the Federal Reserve is committed to tighter monetary policy to ensure inflation doesn't spiral out of control. It just raised interest rates for the first time since 2018 and remains intent on 7 rate hikes this year. True, the emergency stimulus post pandemic is no longer needed and inflation does need to be constrained, but many fear excessive tightening could also prompt a slowdown or even a recession.

How likely is a recession? Many sources of inflation pressure could prove ephemeral and higher interest rates may only serve to quell economic activity. Or, we could see a period of stagflation, which is defined as elevated inflation alongside no/low economic growth. Economists continue to forecast decent growth domestic product (GDP) growth for this year and next, thereby implying that most do not anticipate Fed policy will trigger either scenario, but the risks have risen. On the positive side, the COVID recovery continues unabated. One only needs to look at the results of a casino, concert and/or theme park operator to see there is a thirst to spend, and rising inflation has had limited impact so far. To that end, consumer balance sheets are very healthy with debt relatively low by historical standards, and household disposable income very strong. Corporations are also flush with cash and have significant capacity to spend money.

Putting it all together, we think the risk/reward profile for stocks is relatively balanced. Valuations look more reasonable than they did at the start of the year, but we still find ourselves expecting more moderate returns than in recent years. While a sudden outbreak of peace in Ukraine could prompt a relief rally, rising interest rates and tighter monetary/fiscal policy will remain a headwind and higher input costs could weigh on corporate profitability. Despite a more subdued market outlook, we continue to find exciting individual ideas for our portfolios and have added a number of new positions. Please refer to our portfolio letters for a discussion of recent actions and we look forward to reporting to you next quarter.

The dominant first quarter drivers included elevated inflation, rising interest rates and Ukraine/Russia economic ramifications. China and North Korea must also be closely monitored. Investors saw the inversion of the U.S. Treasury curve, highlighting the interconnectedness of inflation and economic growth expectations on interest rates. The Fed faces three critical challenges in its quest for a “soft landing”, inflation, recession and stagflation risk

Inflation has proven more than a transitory pandemic response. Elevated **Energy** (gasoline, jet fuel, electricity & more) and **Shelter** (mortgage & rental payments), the largest constituent of headline and core consumer price index (CPI), will hurt consumer savings and spending trends. Wage growth has been robust but not on par with inflation. Fed liftoff began in March with a 25 basis point hike with many more expected to bring inflation closer to the 2% target. The market and economists forecast multiple rate hikes in 2022 as the Fed works towards a neutral rate (interest rate that neither supports nor restricts growth). For all the headwinds, there are positives including the base effect on year-over-year inflation measurements and slowly improving supply chains.

Consumer Price Index Heat Map (YoY% Change)

	Weight	Mar '21	Apr '21	May '21	Jun '21	Jul '21	Aug '21	Sep '21	Oct '21	Nov '21	Dec '21	Jan '22	Feb 22
Headline CPI	100%	2.6%	4.2%	5.0%	5.4%	5.4%	5.3%	5.4%	6.3%	6.8%	7.0%	7.5%	7.9%
Shelter	34%	1.7%	2.1%	2.2%	2.6%	2.8%	2.8%	3.2%	3.5%	3.8%	4.1%	4.4%	4.7%
Food	13%	3.5%	2.4%	2.2%	2.4%	3.4%	3.7%	4.6%	5.3%	6.1%	6.3%	7.0%	7.9%
Medical Services	7%	2.7%	2.2%	1.5%	1.0%	0.8%	1.0%	0.9%	1.7%	2.1%	2.5%	2.7%	2.4%
Vehicles & Parts	9%	4.5%	9.2%	13.3%	20.3%	19.8%	17.2%	14.9%	16.5%	19.2%	21.8%	23.4%	23.9%
Educ./Comm. Svcs	6%	2.0%	2.0%	2.2%	2.4%	1.2%	1.3%	1.7%	1.7%	1.7%	1.7%	1.7%	1.7%
Energy	7%	13.2%	25.1%	28.5%	24.5%	23.8%	25.0%	24.8%	30.0%	33.3%	29.3%	27.0%	25.6%
Transportation Svcs	6%	-1.6%	5.6%	11.2%	10.4%	6.4%	4.6%	4.4%	4.5%	3.9%	4.2%	5.6%	6.6%
Recreation Services	3%	1.2%	1.8%	0.6%	1.9%	3.7%	3.5%	3.5%	3.8%	2.8%	3.3%	5.0%	5.1%
HH Furnishings/Supplies	4%	2.8%	3.2%	3.7%	3.4%	3.0%	3.3%	4.8%	6.1%	6.0%	7.4%	9.3%	10.3%
Apparel	2%	-2.5%	1.9%	5.6%	4.9%	4.2%	4.2%	3.4%	4.3%	5.0%	5.8%	5.3%	6.6%
Recreation Goods	2%	0.8%	2.9%	3.5%	3.2%	3.2%	3.3%	3.5%	4.0%	3.9%	3.3%	4.1%	4.6%
Medical Goods	2%	-2.4%	-1.7%	-1.9%	-2.2%	-2.1%	-2.5%	-1.6%	-0.4%	0.2%	0.4%	1.4%	2.5%
Core (Ex Food & Energy)	79%	1.6%	3.0%	3.8%	4.5%	4.3%	4.0%	4.0%	4.6%	4.9%	5.5%	6.0%	6.4%
Core Services	57%	1.6%	2.5%	2.9%	3.1%	2.9%	2.7%	2.9%	3.2%	3.4%	3.7%	4.1%	4.4%
Core Goods	22%	1.7%	4.4%	6.5%	8.7%	8.5%	7.7%	7.3%	8.4%	9.4%	10.7%	11.7%	12.3%

Notes: Shows select YoY price change per CPI category, sorted by weight in the headline index. Category labels abbreviated from official titles. Not Seasonally Adjusted. Intra-category color scheme. Source: CreditSights, BLS

Relative Value

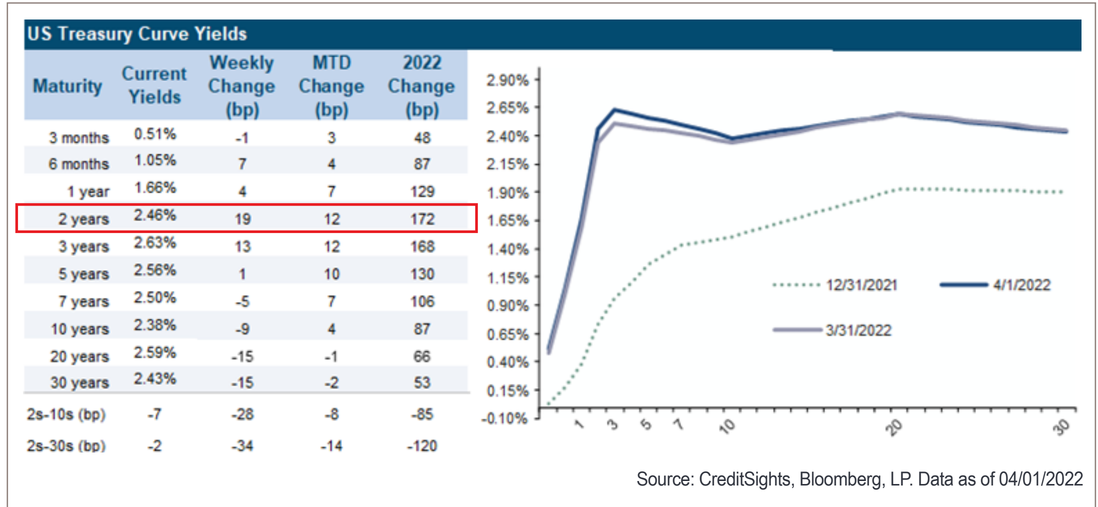
Relative value analysis highlights the breadth of the first quarter challenges with no true safe haven within fixed income. The Treasury market saw broad interest rate volatility with the yield curve pricing in much less accommodative monetary policy to tame inflation. The inversion highlighted growth concerns as short rates exceeded long term rates, historically a recessionary indicator. Investment grade bonds came under pressure with escalating Ukraine tensions. On a positive note, credit risk improved in the latter half of the quarter. Money market funds hold in excess of $4 trillion, which is ample dry powder to seize upon a more attractive entry point into investment grade debt.

Comparative Total Returns

Apr 1, 2022	Short-Term Cumulative Returns						Annualized Returns			
	YTD	WTD	1Mo	3Mo	6Mo	1yr	2yr	3yr	5yr	10yr
US										
Treasury	-5.78%	0.79%	-3.99%	-5.78%	-5.82%	-3.99%	-4.49%	1.54%	1.78%	1.75%
High Grade Corp.	-7.81%	1.34%	-3.36%	-7.81%	-8.02%	-5.03%	2.14%	3.07%	3.28%	3.66%
High Yield Corp.	-4.79%	0.73%	-1.32%	-4.79%	-4.15%	-0.77%	11.44%	4.23%	4.50%	5.67%
Leveraged Loans	0.03%	0.64%	0.16%	0.02%	0.79%	3.51%	12.57%	4.44%	4.22%	4.55%
Municipals	-6.18%	0.08%	-3.28%	-6.18%	-5.38%	-4.19%	1.67%	1.75%	2.62%	3.00%
Convertibles	-5.05%	1.01%	1.97%	-5.05%	-7.69%	-5.61%	34.48%	19.30%	15.84%	13.41%
Preferreds	-6.82%	1.69%	-1.12%	-6.82%	-6.78%	-4.10%	6.80%	3.21%	3.81%	5.15%
Mortgage Markets										
Mortgage Master	-5.39%	0.69%	-3.53%	-5.39%	-5.94%	-5.46%	-2.71%	0.54%	1.31%	1.66%
US Equity Market										
S&P 500	-4.28%	0.08%	5.70%	-4.28%	5.06%	14.66%	37.75%	18.57%	16.05%	14.66%

Source: CreditSights, BofA/ML, S&P/LSTA, Bloomberg.
Treasury=G0Q0, HG=C0A0, HY=H0A0, LL=SPBDPL, Muni=U0A0, Convert=V0S0, Pref=P0P1, Mortgages=M0A0, S&P 500=SPX

Treasury Markets



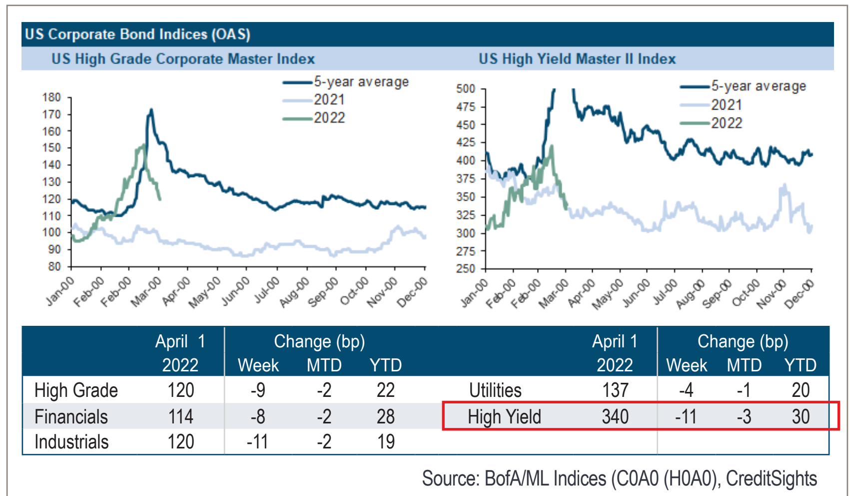
US Treasury Curve Yields

Maturity	Current Yields	Weekly Change (bp)	MTD Change (bp)	2022 Change (bp)
3 months	0.51%	-1	3	48
6 months	1.05%	7	4	87
1 year	1.66%	4	7	129
2 years	2.46%	19	12	172
3 years	2.63%	13	12	168
5 years	2.56%	1	10	130
7 years	2.50%	-5	7	106
10 years	2.38%	-9	4	87
20 years	2.59%	-15	-1	66
30 years	2.43%	-15	-2	53
2s-10s (bp)	-7	-28	-8	-85
2s-30s (bp)	-2	-34	-14	-120

Source: CreditSights, Bloomberg, LP. Data as of 04/01/2022

The move in Treasury interest rates has been nothing short of violent. Essentially all economic data from the strength of the labor market to the breadth of inflation have repriced front end rates while the long end remained more subdued. Front end rates offer compelling yields that make stepping out the curve an unattractive risk/reward tradeoff. Fed Funds Futures reflect almost 9 rate increases in 2022 and >50% for four consecutive 50 basis point hikes. Our portfolios remain underweight duration which has worked in our favor. The Fed is in the difficult spot of not raising rates enough to curb inflation or raising them too high, denting economic growth. Determining the optimal terminal rate is challenging and the accuracy can only be truly evaluated looking backwards with time. Additionally, QT (quantitative tightening) is in the initial phase of the Fed balance sheet reduction via allowing maturating debt to roll off with less reinvestment, removing the biggest price agnostic buyer from the market.

Corporate debt had a challenging quarter. Credit spreads moved in tandem with macro risk sentiment. Interestingly, high yield spreads have only widened ~30 basis points year-to-date. The most vulnerable investment grade pockets included the lower rated credits and sectors that lacked pricing power or hedging to offset rising input and labor costs. March delivered record new issue deals of $230 billion, supply should moderate in coming months to provide a technical tailwind.



US Corporate Bond Indices (OAS)

	April 1 2022	Change (bp) Week	MTD	YTD
High Grade	120	-9	-2	22
Financials	114	-8	-2	28
Industrials	120	-11	-2	19
Utilities	137	-4	-1	20
High Yield	340	-11	-3	30

Source: BofA/ML Indices (C0A0 (H0A0), CreditSights

Yields are much more attractive than the lows seen in 2020. Where we go from here depends on a few trends. If tighter monetary succeeds in managing inflation, it is possible rates won’t continue spiking higher. Broadly speaking, the additional spread component on corporate bonds seems fairly priced but remains vulnerable. We expected greater sector/industry dispersion by this point in the cycle but haven’t seen it.

US IG & HY Corporate Yield to Worst (%) by Rating, Tenor

	IG	AAA	AA	A1	A2	A3	BBB1	BBB2	BBB3	BB1	BB2	BB3	B1	B2	B3
Index	3.63	3.01	3.14	3.24	3.30	3.45	3.72	3.81	4.20	4.49	5.03	5.28	5.73	6.53	6.87
3Y	2.99	2.43	2.55	2.72	2.77	2.92	3.13	3.17	3.55	3.97	4.30	4.70	5.33	6.81	6.78
5Y	3.47	2.70	2.97	3.12	3.23	3.36	3.51	3.57	4.12	4.42	4.97	5.39	5.86	6.44	7.19
7Y	3.63	3.13	3.09	3.27	3.39	3.48	3.58	3.77	4.29	4.64	5.18	5.48	5.90	6.53	6.59
10Y	3.73	2.99	3.14	3.32	3.46	3.55	3.75	3.88	4.29	4.65	5.13	5.42	5.84	6.15	7.22
30Y	4.08	3.33	3.63	3.82	3.79	3.91	4.17	4.35	4.90	5.10	6.52	6.17	6.49	7.24	N/A

Source: CreditSights, ICE Data Indices, LLC. Data as of 03/31/2022

Pulling it all together, quality bonds from both a fundamental and relative value perspective are often trading at a discount. We always perform deep credit analysis on names we hold. Those with extra cash have an advantageous entry point. Existing positions trading at a discount can be held to maturity, removing the current mark-to-market impact. We remain committed to our energy sector overweight, favoring services over goods exposure and increased floating rate note allocation. With ratings, we expect BBBs to maintain financial prudence while A and higher rated borrowers present the possibility for unfriendly debt actions (M&A, buybacks programs and increased dividends) to counter margin and earnings pressures.

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