Investor Insights & Outlook

April 2022 1st Quarter Concorde Investment Management

Domestic Economic Overview

A Message from Concorde Investment Management

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It's difficult to describe the current economic activity in the United States. Spending will indicate the economy is on fire as consumer spending (2/3rds of the US economy) is increasing but the Gross Domestic Product numbers that were printed the morning of April 28th showed negative real economic growth (-1.4%) after a 6.9% gain in Q4 2021. Recall one of drivers of the Q4 number were increases in inventories in addition to consumer spending. Well, those inventory numbers were not there in Q1 plus defense spending decreased. The trade deficit widened, showing a net export contribution to GDP of -3.2% (imports indicated strong internal consumer and business demand while export numbers were weak). Ironically, the new Omicron variant that reared its head in late December and January did not meaningfully impact consumer spending activity. It seems that the US population has learned to deal with Covid being endemic.

There are multiple conflicting indicators and depending on which one an individual focuses on can drive differing expectations of the economy. Anyone trying to buy a house anywhere right now will inform you that supply is tight and nobody wants to move. From Tampa to Seattle or LA to New York, housing inventory is not available, driving prices through the (theoretical) roof. The Federal Reserve is raising interest rates, rapidly, to combat inflation concerns.

continued next page

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Domestic Economic Overview (continued)

Energy costs were already on the rise prior to Putin and the Russians invading Ukraine (more on this in the international section) due to supply issues. While consumers are still in good shape, rising interest rates, energy costs, and food costs will impact growth numbers in the future. Some research we read indicates inflation may be peaking, however the new level will still be elevated from recent historical levels. The inflation numbers are impacting consumer confidence, with the consumer sentiment index at 59.4. It's only been below 60 a few times since 1970, with the low in May of 1980 just at 50. The US economy is on edge; however, we still think the Consumer looks strong enough that we might avoid two quarters of negative real growth (which would indicate a technical recession). In any event, as long as the Federal Reserve is hawkish (finally) on inflation, the economy will have a difficult time generating real growth.

International Economic Overview

Two main items are driving the international economy, the Ukraine War and the Chinese governments belief they can reach "Zero Covid".

The Ukraine War started in late February when Vladmir Putin decided to send his troops across the border into Ukraine in order to, in his words, free the Ukraine people from Nazi rule. Historically, this message would resonate inside Russia and give him domestic support for the war given how Russian soldiers were treated after World War II. Obviously, there are no Nazi issues inside Ukraine and rationale is ridiculous on its face. Outside of the horror and tragedy of the War on the Ukrainian population and the countries coping with war's refugees, the economic impact is going to be felt across the globe. Energy and food costs are going up everywhere. Secondarily, to the immediate and direct impacts, yields for crops are going to decline due to the lack of supply of fertilizer to countries across the globe. Anecdotally, one of our principals traveled to Peru in April and missed populist strikes by one day. The strikes were due to fuel and food cost increases while wages haven't moved. This is on the front end of the issue that is going to get worse the longer the Ukraine war lasts.

China has decided to battle their Omicron variant wave with full lockdowns that only a totalitarian regime could accomplish. Shanghai effectively has the population of Texas and the Chinese government fully closed the city and instituted mass testing. They don't have western vaccines and their homegrown vaccines are basically ineffective at reducing symptoms of Omicron. Rather than ask the US for assistance, they are attempting to reach Zero Covid via lockdowns. This will have impacts on the world economy during Q2 and Q3. Supply chain issues will be exacerbated due to a Chinese population not able to go to work. Delays in shipments will continue until the disease works through the population or until the Chinese government declares they have successfully beat Covid. Our expectation is that it will be short-lived given how Omicron impacted other countries, but the issues created by shutting down their country will persist.

Fixed Income

Fixed income markets continued to be a focus of investors for the second consecutive quarter as Federal Reserve policy changes and movement in market yields had a significant investment impact. The realization that the short-term Federal Funds rate is very likely to rise quickly over the next 4-6 quarters began to influence longer term bond yields and this change is having an outsized impact on higher growth equity valuations, where many stocks have been in correction for a year. The Fed made an initial 25 basis point increase and telegraphed the potential for 50 basis point moves in the near term. This guidance implies their acknowledgment that the recent inflation surge might go higher or persist longer than originally thought.

With regards to investment implications, clearly the rise in bond yields has created negative total returns in most credit investments. Shorter maturity investments have held up better as bond math suggests. For a benchmark, the 10-year Treasury note yield to maturity went from 1.52% at yearend to 2.34% at 3/31/22.

Yield spreads on corporate and other non-government credit sectors widened modestly around 0.50%, creating higher total return losses. This widening represents to us more of a return to normal market conditions rather than a warning sign of real economic weakness to come, although this relationship should be monitored closely. Even if the surge in inflation recedes later this year and into next, the rate is likely to be well above what the U.S. has experienced over much of the last ten years. Assuming that ultimate inflation is in the 3-4% range, the current 10-year Treasury yield is still negative. Derived inflation expectations from actual 10-year Treasury yields and 10 year TIPS bonds has recently risen to 3%. Under this scenario it seems likely that bond yields will trend higher unless significant economic weakness manifests soon. The investment implications for this scenario for fixed income are to remain in shorter maturity instruments with higher credit quality. There is value being created in some credit sectors but levels are not yet compelling enough for significant exposure.

U.S. Treasury Notes	9/31/21	12/31/21	3/31/22
2 year	0.26%	0.73%	2.28%
10 year	1.52%	1.51%	2.34%
BBB U.S. Corporates	2.38%	2.60%	3.89%

Source: Morgan Stanley; JP Morgan; Forbes/Fridson Income Securities

Equity Markets

Domestic and international stock markets were broadly down in the first quarter although there was a wide divergence in results from a geographic, sector and individual stock perspective. In the U.S., the benchmark S&P 500 and NASDAQ composite fell 4.6% and 8.9%. The weaker NASDAQ reflects the focus of growth stocks in that index. Value oriented stocks and sectors generally outperformed growth. Two traditional value sectors, energy and utilities, were the only segments with positive results, gaining 39% and 4.8%. The energy and utility stocks however only represent 6.6% of the S&P 500. The important financial sector, a traditional value component that typically performs well as rates rise, was down modestly as economic concerns outweighed the positive rate impact. This may be an area of investment opportunity.

Internationally, most of the developed European markets and Japan had negative performance similar to the U.S. Outliers in the international markets include China and Russia, both down significantly. Markets in Mexico and Brazil rose, with the positive 39% return in Brazil reflecting commodity supply restrictions and higher prices resulting from supply chain problems and implications on trade from the Russia/Ukraine conflict.

Looking at investment prospects going forward, many value-oriented stocks still have good return potential even with modest economic projections. In addition, there are some established, larger growth stocks which are becoming more attractive to fundamental investors as a result of their weak performance over the last four quarters. In the event that a recession or significant economic weakness returns over the next year, equity holdings should be focused on market leaders with strong cash flow and/or balance sheets that have an ability to capture market share when weaker competitors struggle. Our valuation analysis continues to utilize base discount rates higher than the current risk-free ten-year Treasury yields, providing some cushion if rates rise further. In addition to the financial sector mentioned above, other relatively attractive areas include consumer discretionary and health care.