



SPINNAKER TRUST

From the Helm

APRIL 2022

In this Issue

- 01 MARKET REVIEW AND OUTLOOK
- 02 INFLATION, ENERGY, AND THE CONSUMER
- 03 THE FED
- 04 A PERSPECTIVE ON RUSSIA & UKRAINE
- 05 BACK TO THE OFFICE
- 06 WELCOME

01

FIRST QUARTER 2022: MARKET REVIEW AND OUTLOOK

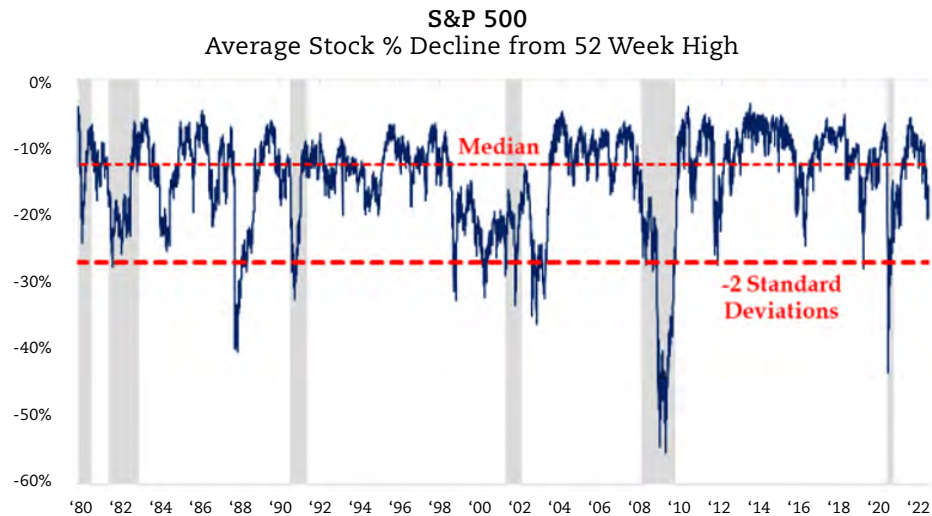
While it is our job to report on markets and economics and manage your investment portfolio, we would like to recognize that the trauma in Ukraine is on our minds and puts our work into perspective. Despite more than fifty years of relatively stable borders, imperialism has not been eliminated from the human experience. Markets will recover, but the lives lost in Ukraine are permanent. Our thoughts are with Ukrainian families around the world.

The first quarter of 2022 can only be described as tumultuous. It was filled with a historic bond rout, an epic rally in commodities, and a fierce bear market rally in equities from deeply pessimistic conditions. Overall, the shaky performance

of both the bond and equity markets during the first quarter of 2022 marks a contrast to the steady ebullience of 2021 and the second half of 2020, with the S&P 500 and Nasdaq down -4.6% and -8.9% for the quarter, respectively. While these performance figures seem relatively benign, they understate the volatility that we've already dealt with this year as market participants adjusted first to a much more aggressive Fed tightening agenda and then to a Russian invasion of Ukraine. At its worst point intra-day, the S&P 500 was down -12.2% while the Nasdaq had fallen by -20.0%. The best performing large-cap sectors were Energy (up 39%) and Utilities (up 4.7%). There are numerous pockets of the equity market which have experienced bear markets (small and mid-cap stocks for example) or recessionary conditions (small and mid-cap growth stocks).

In mid-March, and for only the fifth time, the S&P 500 gained 1% or more for four consecutive days. 93% of U.S. stocks are above their short-term moving averages. The S&P 500 was up 10% over the last eleven days in March. This rare occurrence is bullish, as a year later it has preceded equities rising more than 20% every time with an average gain of 28%. Bear market rallies are always the fastest, most pronounced, and least expected.

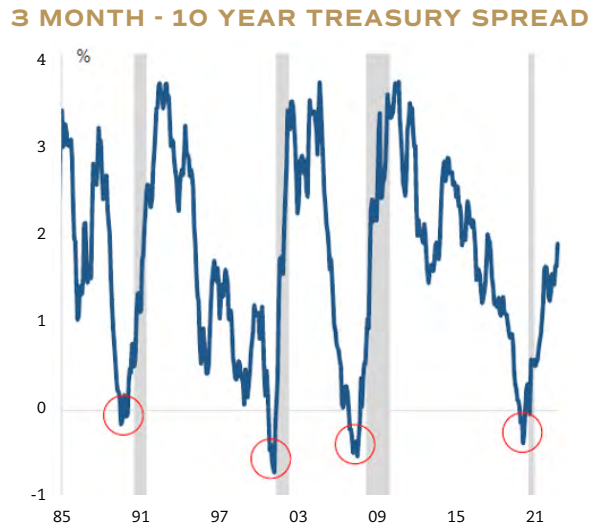
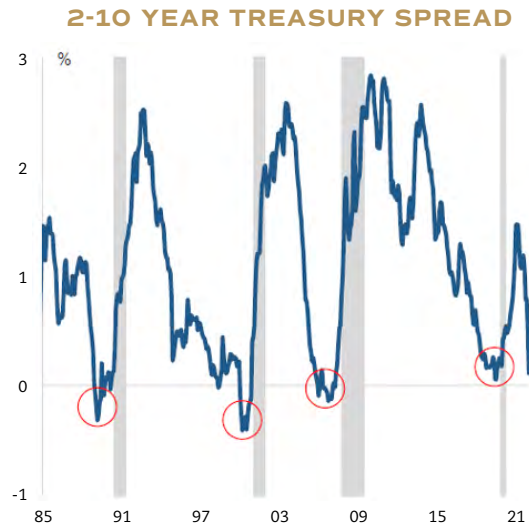
IV. THE AVERAGE STOCK HAS ALREADY EXPERIENCED A BEAR MARKET DECLINING -20%



Once again, international equity markets failed to provide diversification benefits, with developed and emerging markets equities down -6.5% and -7.6% year-to-date, respectively. While international equities started the year with some promise, another regulatory Chinese crackdown and the impact of the Russian invasion of Ukraine rapidly changed their prospects. On the bright side, international markets disproportionately exposed to the production of energy and materials, like Canada, Brazil, and the UK, have outperformed handily. Broad commodity prices rose by 25.5% during the quarter.

The bond market has borne the brunt of Fed policy and inflation expectations with the Barclays Aggregate Index down -5.8% year-to-date in the worst quarterly performance for the index in history. 10-year Treasury yields have risen by 55% in just one quarter, from 1.5% to 2.3%. The 2-year/10-year Treasury spread inverted briefly at the end of March, yet the 3 months/10-year spread remains wide, steep, and risk-on. An inverted yield curve has been accurate in predicting recessions, but the time lag between inversion and recession has been anywhere from 5 to 33 months. Further, equities and bond yields typically peak during the Fed hiking cycle, not preceding it.

The immediate direction of medium-to-long-term Treasury yields presents a conundrum and, of course, will determine the performance of the bond market. On one hand, our team believes that a global slowdown is upon us, and that the U.S. will be the last major economy to feel it. Inflation should peak in the coming months. At the same time, the U.S. ISM Purchasing Managers' Index (known as PMI), a proxy for economic activity, should also roll over from very high levels. When PMIs fall, corporate earnings generally slow or shrink. Of course, one should make such statements with humility as our previously predicted inflation peak was delayed by the third globalization shock in four years – the Trump trade tariffs on China, Covid-19 and now the Russian invasion of Ukraine.



The chance of recession in the next twelve months is 37% according to a New York Federal Reserve model. Of note, the probability of recession in any given year is 17%. The market is now pricing in interest rate cuts in late 2023.

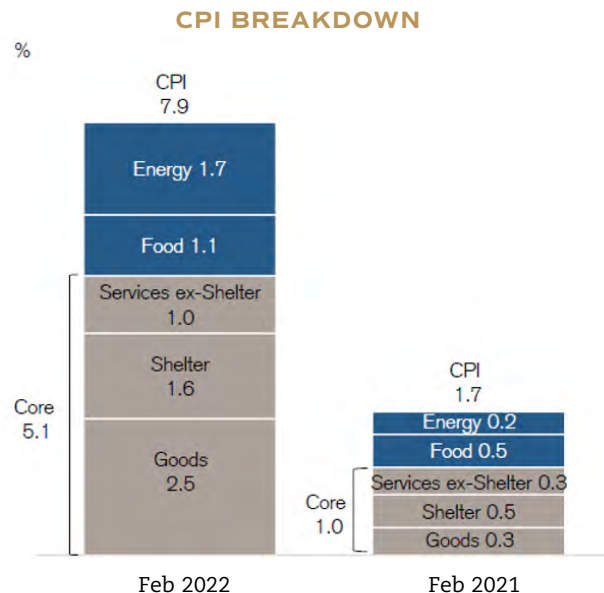
02

INFLATION, ENERGY, AND THE CONSUMER

We entered 2022 with severe supply chain issues and under-supplied energy, agriculture, and materials markets. The war in Ukraine was certainly not the cause but has made things worse. The CPI inflation reading was 7.9% YoY in February, the largest year over year rise since January 1982. Prices for gasoline, shelter, and food were the largest contributors.

The national average gasoline price has risen 48% year over year and 18% in March relative to February. At the end of March, we learned that the White House will be releasing a million barrels of oil per day from the Strategic Petroleum Reserve and is considering releasing up to 180mn total barrels. This would be the largest release in history from the SPR. If implemented in totality, this will take the SPR to its lowest level since the mid-1980s. U.S. oil inventories were already -14% below their 5-year average for this time of year, and down -17% from this same time in 2021. We are simply in an under-supplied energy market and increasing that supply is a long-term process.

Today, global energy comes 30% from coal (this is declining), 30% oil (flat), 25% natural gas (flat), while all renewables including nuclear, and wood contribute less than 15%. Coal is the easiest to convert to natural gas which produces 60% less in the way of emissions. The energy shortfall is set to widen, caused by increasing energy demands and years of underinvestment. We will be short up to 10% of global energy consumption by 2030 at the current rate of capital expenditure. The only way that energy scarcity can be addressed over the medium-term is higher prices for those who can afford it, and fuel aid and/or subsidies for those who cannot. Many emerging markets countries will struggle.



The new food and energy crises are intricately linked, particularly in Europe where fuel and utility bills are 3xs and 2xs per household what they are in the U.S., respectively. Russia believed that Europe would cave into Putin's demands because 1.) it always had in the past and 2.) he perceived their floundering energy security gave him an edge. Natural gas is the primary input for fertilizer, and farmers are disproportionately impacted by the rising costs of diesel and propane. Further, Russia and the Ukraine supply nearly 30% and 80% of the world's wheat and sunflower oil, respectively.

Slower consumption is nearly certain, with sharply slowing nominal income growth and still-elevated inflation crushing real (inflation-adjusted) consumer purchasing power. Depending upon which consumer sentiment survey you favor (University of Michigan or The Conference Board), consumer sentiment is either historically poor or moderately negative and worsening. Consumer spending fell sequentially in February versus January for the first time in a year. Materially higher utility, food and gas prices are hitting consumers, and net (after inflation) wage growth is simply not keeping up. U.S. new home sales fell -2% sequentially and -8.1% YoY in February. We saw another decline in disposable income in the final Q4 2021 GDP report, falling -5.6% versus the same point in the previous year. With critical, non-discretionary items rapidly rising in price and no additional stimulus checks in the mail, we expect consumer spending to slow in the coming quarters.

Last week, the 30-year, standard mortgage rate shot up to nearly 5% in the largest one-week increase since July of 2011 and takes the average U.S. mortgage payment back to 2018 levels. In February, the average payment on a

new mortgage rose by 25% over the same time last year. The lumber market appears to be front-running housing weakness as lumber prices fell by -30% in March.

CHART OF U.S. FIXED 30-YEAR MORTGAGE RATES



While the team believes that the year-over-year growth in inflation will peak in the coming months, we see inflation as structurally higher relative to our most recent experience. Inflation as measured by CPI was 1.2% per year from 2011-2020. We believe that one of the most durable components will be "Shelter" which makes up 33% of the CPI basket. Historically, shelter prices have lagged the Case-Shiller home price index by about 18 months. As rents typically re-set annually, inflation will creep into this category slowly and persistently.

03

THE FED

After months of discussion and speculation, the Fed finally delivered "lift off" in mid-March, hiking the Federal Funds rate by 25bps, and indicating 7-8 more hikes in 2022 as well as balance sheet run-off. Chair Powell's hawkish comments made it clear that they will not hesitate to raise by 50bps if inflation continues to accelerate. The most notable news out of the meeting was the new dot plot, which showed that the committee consensus is to exceed their estimated neutral rate of interest (approximately 2.4%) in both 2023 and 2024.

Surprisingly, it appeared that this hawkish message had already been absorbed by the markets, as equities rocketed higher in the late hours of trading. There is something to be said for clarification and certainty as well as a deeply negative and oversold market.

Regarding Fed Funds tightening, we believe that the Fed will hike at every meeting through mid-year, at which point it will likely stop to evaluate. We will likely get a 50bps hike in the coming months. We do not believe that we will get seven interest rate hikes in 2022 which is priced into the market today. This means that the 2-year yield may fade a bit which is good for the traditional yield curve, but we are more negative on the 3–7-year range. There has never been a Fed tightening cycle where the yield curve did not flatten.

Quantitative tightening (QT) should commence in May or June, with \$800bn in runoff this year and another \$1.1tr in 2023. That alone amounts to the equivalent of 75-100bps worth of interest rate hikes. There is even the possibility of outright asset sales. The Fed aspires to bring the size of its balance sheet down to the pre-COVID level of approximately \$7tr from \$9tr. A large supply of Treasury Bonds entering the market naturally leads to falling prices for bonds. Falling bond prices lead to higher interest rates. However, this is offset by the fact that the Fed will be hiking into a slowing economy which would normally lower rates.

For the Fed, wage growth is the critical variable to consider, perhaps even more than CPI. The hot labor market supports the Fed plan and extended interest rate tightening. U.S. initial jobless claims recently fell to levels last seen in the 1960s, i.e., employers are hanging onto their workers and are desperate for more. The unemployment rate in March was 3.6%. Wage growth was 5.6% year over year, the largest jump in the data series since 2007, and 0.4% relative to one month ago. There are two factors driving wage growth – job switching and low supply of workers.

In Conclusion: We believe that the U.S. economy is in the early stages of a broad slowdown. The million-dollar question is, will this be a standard, mid-cycle slowdown or a late-business-cycle slowdown that leads into a recession? We believe that the growth in inflation and GDP will peak in the second quarter. We believe that U.S. ISM PMI readings will begin to roll over aggressively as they have globally, and that corporate earnings growth will follow. We believe that consumer spending will begin to slow given negative net income growth, i.e., inflation is higher than wage growth. The Fed has not hiked into a slowing business cycle in decades.

We believe that the growth rate of inflation will peak and roll over, but that prices for energy and energy derivatives will remain uncomfortably high. There is no quick answer to a world-wide supply shortage, and our leaders have not settled the issue of traditional versus greener, ESG-friendly sources. Climate change is a long-term problem whereas the availability of reasonably priced gas, home heating oil, and food are more acute issues. Likewise, we believe that the “Shelter” CPI component will grind higher over the next year or two.

We believe that the Fed simply has no choice but to pursue its aggressive monetary strategy. The employment picture is robust, now it must focus on its second mandate. Economic data over the next several months will support its hawkish agenda, but the Fed may reconsider the speed of its plan in the second half of this year.

With Russia rapidly losing its gains around Kyiv and in the east of Ukraine, the Russian Ministry of Defense reported it would scale back operations in those areas, likely to head-off a retreat by Russian forces that have been depleted by fighting and logistics challenges. While the possibility of an end to the war in Ukraine is an obvious positive catalyst for all manner of investment risk assets, will Putin just give up? This seems too easy. It is likely prudent to ignore his words and rather gauge his actions.

While this is a rather downbeat conclusion, we’d like to emphasize that U.S. equity markets rose 29% in 2021, 18% in 2020, 32% in 2019, and 22% in 2017. Only in 2018 did the S&P 500 experience a mild decline of -4%. We expected that this business cycle would be fast and furious, unlike the last cycle which was drawn out over 11 years. In the short-term, we expect notable cross-asset volatility as the Fed plans to reduce liquidity after years of easy monetary policy. We are constructive on markets over the long-term and know that investing is about “time in the market, not timing the market.”

The fundamental contest of the second half of the twentieth century was between Marxist/Leninist collectivism on the one hand and free market capitalism on the other. Marx and Lenin believed that capitalism was inherently unstable, that the greed of companies and countries would lead to war and that citizens would eventually respond by electing socialist leaders. In the reality, communism failed to bring any measure of prosperity to either the republics of the Soviet Union or China, and autocratic leaders remained in power and were succeeded by further autocrats, notably Khrushchev and Brezhnev in the USSR and Mao Zedong in China. However, in 1976, Mao was succeeded by Deng Xiaoping, who retained the autocratic power of the Chinese Communist Party but allowed capitalism to emerge as the primary economic system in China. The results have been nothing short of a miracle, as Chinese economic growth soared, and China now stands ready to succeed the United States as the largest economy in the world. In the USSR however, Khrushchev and Brezhnev maintained the commitment to Marxist/Leninist ideals, and, when Yeltsin oversaw a move toward capitalism, it became closer to a kleptocracy, with selected oligarchs allowed to make great riches provided they were really serving the state. The concept of true private ownership was never fully established in Russia.

As we struggle to understand what Vladimir Putin is doing in Ukraine today, it is worth noting that the shocking disregard for human life and the barbaric cruelty to massive numbers of soldiers and civilians is not new. It was in fact standard operating practice for Russian leaders for most of the twentieth century. It was Brezhnev who established the Brezhnev Doctrine – which called for unlimited force in response to any threat that a Marxist/Leninist state might be moving toward capitalism. This was the Iron Curtain. But in the late 1980s, as the massive difference in economic success of Western European economies versus Eastern European

economies became more and more obvious (with the East German/West German contrast being the most glaring), the USSR no longer had the resources to enforce the Brezhnev Doctrine across all the Warsaw Pact. The extraordinary development is not so much that a Vladimir Putin has emerged on the Russian stage as a traditional, murdering dictator – that is consistent with much of the prior history of Russia. It is that in Mikhail Gorbachev, the USSR temporarily had a leader who was not prepared to murder millions to try to enforce an ideology. He simply allowed a degree of self-determination, and Eastern European countries ran for the exits.

Most observers in the United States assumed that the fall of the Soviet Union was the end of the Cold War, and that was true to a certain degree. However, it did not remotely end the belief on the part of Russian leaders in the inevitability of Marxism and Leninism as fundamental truths that would eventually be validated on a global scale. And, regardless of any realization that capitalism might be to some degree necessary for economic growth, there was never any willingness to subject leaders to the will of free people. Putin is a dictator, and he is acting precisely how his predecessors, other than Gorbachev and Yeltsin, would have likely acted. However, he is now doing it in a world that (i) has developed technologies that make the size of military forces less decisive, (ii) has previously unimaginable access to images and information about his actions, and (iii) has enjoyed 50 years of relative peace and is unwilling to stand idly as self-determination is extinguished in a large and vibrant country. It seems apparent that Putin did not understand any of these changes, and that his gameplan in Ukraine was essentially lifted out of the Czechoslovak, Afghan, Chechnyan or Serbian invasions.

So, what happens now? The Russian playbook has always been to escalate to de-escalate, and that raises terrifying prospects that Putin might resort

to chemical, biological or even nuclear arms to reset the situation. The Biden administration is certainly aware of that, and Republicans are criticizing the administration for being too careful in not providing Putin overt provocations that might provide a thinly veiled justification for extreme action. But as the Russian military continues to struggle, we are reaching a critical point where Putin must either move forward in some fashion or retreat. Even if a ceasefire can be found, an isolated, nuclear-armed, petro-state, zombie-economy Russia is not a stable situation, particularly with the Chinese looking to capitalize on the conflict for their long-term benefit in their ambition to succeed the United States as the greatest global power. The range of outcomes is extraordinarily wide, and we should recognize that this may be the most sensitive and important point in foreign relations since Yalta.

From an investment perspective, humility is a good place to start. We do not have great insight into the functioning of the Russian government or how the populace will react to a depression. Russia per se is not that important to the global economy, but the overall impact of current events is massive. For the last fifty years, we have been gradually optimizing supply lines around cost. The pandemic caused companies to reconsider the fragility of their sourcing, but the prospect of global conflict raises the issue to another level. Countries and companies must confront the potential of cutting ties completely

with Russia – while still recognizing that absent nuclear annihilation, there will be a future period where presumably the massive advantages of global trade will once again emerge.

What is clear is that on any given day, events could transpire that will shape our world for years or decades to come. Just as an example, consider the market reaction to a withdrawal by Putin compared to a nuclear attack on Poland. Now would not seem to be a time to be trading in and out of the market. We recommend remaining committed to asset allocation strategies that are in place. There are a great many economic crosscurrents in play right now – interest rates, inflation, remaining pandemic restrictions and supply line impacts. All of these are material and important but to some degree pale in comparison to the question of whether self-determination is going to be reinforced or sacrificed. In China and Russia, the world has two large autocratic actors, one of which has resorted to old fashioned imperialism to re-establish its place among the great powers. The world is now watching Ukraine. Can Western democracies defeat Putin's imperialist grab without plunging the world into war? Or will they stand by while Russia degrades and ultimately carves up Ukraine into Korea style parts. The contest of democracies versus autocracies is now being waged. It is hard to overstate its importance from a global perspective.

05

WELCOME BACK TO THE OFFICE: AMANDA RAND

It is hard to believe that it has been two years since the Spinnaker team packed up its computers and headed to work at home for what we thought would be a few weeks. Very quickly, we had to make sure that every team member had the tools to be productive at home. We had to rethink many processes, such as mail delivery and check disbursements/receipts, and we had to master the use of new video conferencing tools like Zoom and Teams.

While we were adjusting to our new home offices, the markets were extremely volatile, and our investment and portfolio management teams were positioning our clients to ride out the storm. Spinnaker client advisors were working diligently to reach out to clients and reassure them that we were fully operational. The account administration and operations teams were figuring out new ways to do things, so client needs were met. Our tax team was

weathering one of the most difficult tax seasons in recent memory with significant changes to tax code happening seemingly daily. The ESOP group was fielding countless calls from clients who were suddenly facing very difficult circumstances in their businesses, and our real estate group had to closely monitor the stability of our real estate holdings.

Looking back, I am incredibly proud of our team. Each member of the Spinnaker crew rose to the occasion, pitched in, and helped each other. We put each other's needs and those of our clients at the forefront of every decision. We were also very lucky to add to our team during the pandemic. We have had nine new team members join us since March 2020, with many of those joining while we were all still working remotely. These exceptional professionals have already been hugely additive to the firm and our clients. We were thrilled to be voted one of the Best Places To Work In Maine in both 2020 and 2021, placing in the top 10 in our size category in each of those challenging years.

After two years of separation, the Spinnaker team was finally all together in the office again on March 15th, and it was amazing to see everyone. Many folks were meeting in person for the first time. Our current plan is to be in the office three days per week, where we can collaborate, welcome clients and partners in our offices, mentor team members and continue to foster the culture that sets Spinnaker apart. The other two days, our team can work remotely and continue to take advantage of the flexibility we enjoyed during this pandemic.

I have never been more confident in the team at Spinnaker. I am grateful for our professionalism, collegiality and dedication to one another and our clients, and I know I speak for the entire team in expressing our gratitude for our clients and partners who have also been incredibly understanding and flexible during this strange time.



SPINNAKER
TRUST

06

WELCOME!

We are pleased to welcome Michael Sawyer and Hailee Borino to the Spinnaker team!

Mike Sawyer has joined the Spinnaker Trust crew as an Account Operations Administrator. With over 20 years of diverse accounting experience, Mike will be helping to support our operations team in all aspects. Hailee comes to Spinnaker by way of Hay Runner, a Portland-based real estate brokerage/design/construction company, where she was the Finance and Field Coordinator. Prior to Hay Runner, Hailee lived in Massachusetts and worked as the business office manager for a local design and construction company.