

Investment Update — April 2022

This is a quarterly update of economic conditions and investment strategy.

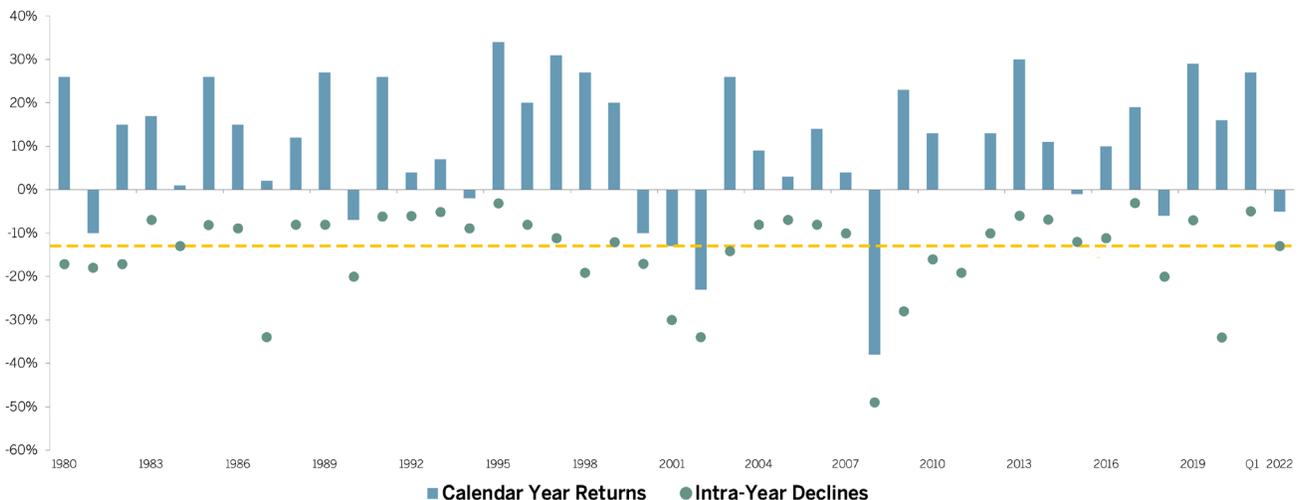
A Jarring Quarter after an Extended Calm

The first quarter saw a steep rise in volatility and the first significant sell-off in two years, as investors digested troubling world news and the Federal Reserve began to end a record period of easy money.

Weakness and high volatility characterized U.S. equity markets for the first eleven weeks of 2022. From the start of the year through March 14, 2022, the S&P 500 fell 12.4%, and the Nasdaq dropped an even greater 20.1%. But market momentum reversed in mid-March, and both Indexes began to recoup their losses. After seven consecutive up quarters, the S&P generated a 4.6% loss in the first quarter of 2022, and the Nasdaq, an 8.9% loss. Most other major stock markets also declined during the quarter. Only indexes dominated by commodity-related stocks, such as those in Canada, Brazil and Australia, delivered positive returns.

The first quarter felt jarring after the smooth, rapid ascent of U.S. equities over the last two years. However, the volatility experienced in Q1 2022 is not particularly unusual. Significant intra-year drawdowns are quite common and not necessarily a harbinger of major trouble ahead.

S&P 500 Calendar Year Returns and Largest Intra-Year Declines 1980–Q1 2022



Source: JP Morgan Asset Management

While the volatility in equity markets captured headlines, the performance of the bond market during the quarter was more noteworthy. U.S. bonds delivered their worst quarterly returns since 1980. High inflation and strong economic growth led the yield on the U.S. 10-year Treasury bond to rise from 1.51% at the start of the year to 2.33% at quarter end. The move in yields on shorter maturity bonds was even more dramatic. The Bloomberg U.S. Aggregate Bond Index fell over 5.9% in the first quarter of 2022. Global bond markets delivered similarly poor performance.



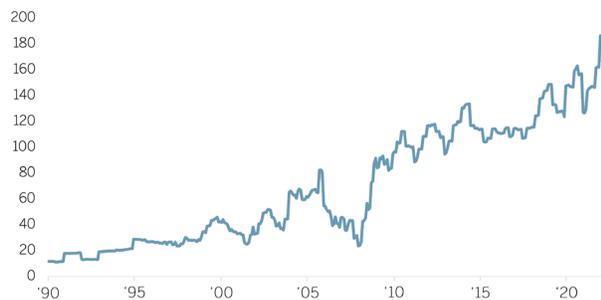
Compared to the frequent declines seen in equity markets, the bond market’s drop may not seem alarming. But bonds are generally lower-risk, lower-return investments that are supposed to provide ballast in investors’ overall portfolios. Therefore, it is understandable that some investors may be concerned when bond prices and equity markets decline simultaneously. As a reminder, at Chevy Chase Trust, clients hold the vast majority of bonds to maturity. Therefore, unrealized losses, (or gains for that matter), that occur due to intra-quarter changes in yields, do not necessarily impact realized returns.

Recession Fears Are Premature

High inflation and rising interest rates are often precursors to recession. Many pundits are now predicting that the U.S. economy will fall into recession later this year or in early 2023. Others are calling for an almost equally dire scenario of stagflation: very slow growth coupled with high inflation and high unemployment. Given the facts on the ground, we believe both these scenarios are unlikely:

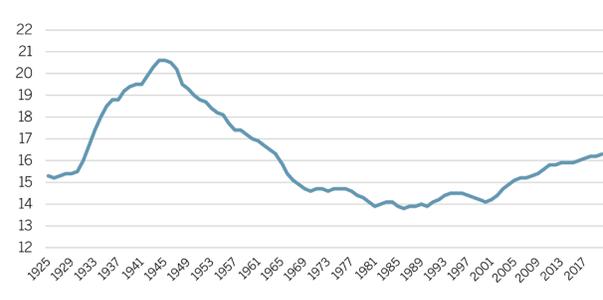
- U.S. households are sitting on \$2.3 trillion in excess savings, equal to 10% of GDP, as a result of decreased spending on services and generous government transfer payments during the Pandemic. In addition, household wealth has soared since the start of the Pandemic, due to house price and stock market gains.
- Household balance sheets are in good shape after an extended period of deleveraging, and banks are easing lending standards on consumer loans.
- Companies also fortified their balance sheets during the Pandemic and are generating record amounts of free cash flow, which they feel empowered to spend. For good reason: At an average age of 16.3 years, the U.S. nonresidential capital stock is older than it has been in nearly 60 years.

S&P 500 Free Cash Flow Per Share (In \$, Trailing 12 Months)



Source: Strategas

Age of Private Nonresidential Fixed Assets (In Years, Current-Cost Average at Year End)



Source: Bureau of Economic Analysis

- After crippling supply chain disruptions due to the Pandemic, many companies are planning to add redundancy to their operations and introduce new automation to offset rising labor costs. Both strategies should contribute to higher levels of capital spending.
- The U.S. labor market is exceptionally strong. Initial jobless claims for the week ending March 18, 2022, were at their lowest level since 1969, when the U.S. labor market was much smaller. On April 1, 2022, the unemployment rate was a very low 3.6%. There are currently 11 million job openings (1.7 for every unemployed person in the country), and the Atlanta Fed Wage Growth Tracker is at a 32-year high.



Of course, there are always concerns: war in Ukraine, economic sanctions on Russia, new COVID outbreaks in Europe and Asia, among them. Also, after a long period of very easy monetary policy, the Federal Reserve is raising interest rates to slow the economy and lower inflation. If the Federal Reserve sticks to its current projections and raises interest rates gradually throughout the remainder of 2022, we think the nominal growth rate in the U.S. economy will remain stronger than the trend level of the past decade.

Portfolio Positioning Amid a Broad Market Rotation

Both U.S. equity and fixed income markets have delivered exceptionally strong returns over the past few years. A period of consolidation would not be surprising. But we don't expect a steep decline in equities in the near term. Instead, we expect continued equity-market volatility, with periods of extended weakness followed by recoveries, as we saw in the first quarter.

For much of the past decade, Growth stocks handily outpaced Value stocks. Since we often invest in disruptive technologies, many of Chevy Chase Trust's themes over that time period had a Growth tilt. Our deep research led us to invest early in a broad range of companies that performed exceptionally well.

The current backdrop is much less favorable to Growth-oriented investing. The combination of faster GDP growth, moderate-to-high inflation and rising interest rates favors the Value style. Year-to-date, Value stocks have outperformed Growth stocks by 8.4%, and we expect this rotation from Growth to Value to continue for the foreseeable future. We believe we are well positioned to capitalize on this transition for two reasons.

- First, we are neither Growth investors, nor Value investors. We are Thematic investors, which gives us the flexibility to reposition portfolios when necessary, by adding, exiting or re-weighting our themes.
- Second, macroeconomic analysis is an explicit and important part of our four-step investment process. We adjust our portfolios not just based on our confidence in our thematic outlook, but also accounting for the tidal impact that fiscal and monetary actions can have on financial markets.

To reflect the changing environment, about 18 months ago we introduced a new inflation-related theme, and our portfolios started to generally become less "growth-y." Our *End of Disinflationary Tailwinds* theme is now the largest of our six portfolio themes. We also made a host of other adjustments to our thematic weightings, trimming or selling many of the Growth holdings that had soared in the past few years. With the sell-off of Growth equities in the first quarter, several of these core thematic investments are now, once again, approaching levels that we find attractive from a long-term perspective.

Conclusion

The past quarter has been a reminder to many that even in the absence of a pandemic, a great deal of uncertainty, change and risk exists in the world and in financial markets. Throughout the quarter and through the past many years, we have remained vigilant, seeking to protect clients from the market extremes that occasionally arise, while positioning portfolios for the broad secular opportunities that we see. We are confident that our approach, developed more than two decades ago and refined continuously since then, will continue to deliver great outcomes in the years to come.

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