FIRST FINANCIAL TRUST

YOUR FUTURE FIRST

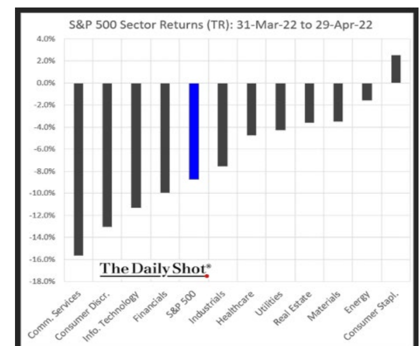
EQUITY MARKET UPDATE

As of 04/30/22 | Volume 11, Issue 4 | FFTAM.com

Stocks experienced heavy losses in April as volatility remained high. The four factors influencing the economy and the market—COVID-19, the war in Ukraine, inflation, and the Fed's response to inflation—all worsened. China's expanded lockdowns on major cities to combat the spread of new COVID-19 infections placed additional strain on fractured global supply chains. Russia continued its aggressive military campaign against Ukraine. They tested a new intercontinental ballistic missile and have threatened to use nuclear weapons if Ukraine receives additional aid from the US and Europe. Inflation data climbed further to levels not seen in 40 years, and the Federal Reserve signaled a rapid rise in interest rates is coming in the next three months.

US Stocks Plunge on Fears of Upcoming Economic Slowdown

The S&P 500 fell 8.80% in April, its biggest drop since March 2020. Over 45% of the decline was attributable to seven large tech stocks—Tesla, Apple, Microsoft, Amazon, NVIDIA, Alphabet, and Netflix. Collectively, those names shed over $1 trillion in market value during the month. Selling was broad-based as every sector declined except consumer staples. The worst results were seen in financials (-10.02%), info tech (-11.31%), consumer discretionary (-13.03%), and communications (-15.77%). In 2022, the S&P 500 is down 12.92% with only energy and consumer staples posting positive returns. That return is deceptive, however, given the median stock within the S&P 500 is down over 20%.



The Dow Jones Industrial Average dropped 4.91% for the month. A higher allocation to consumer staples and big pharma aided results versus the S&P 500. Boeing shares plunged 22.27% during the month. That prevented the Dow from experiencing even better outperformance. Year-to-date, the Dow is down 8.73%.

The NASDAQ sank 13.26% in April, its worst monthly showing since the depths of the financial crisis in October 2008. The index was crushed by large declines in Netflix, Amazon, Alphabet, and Tesla. Year-to-date, the NASDAQ is the worst performing major index with a total return of -21.00% as investors shy away from high valuation companies as interest rates rise. The index has also been hurt by disappointing earnings announcements from Meta Platforms, Netflix, PayPal, Alphabet, and Amazon.

Middle-to-small-sized companies fared better than most of the large cap indexes last month with the S&P 400 Mid Cap Index falling 7.18%, while the S&P 600 Small Cap Index lost 7.87%. A lower allocation to technology helped these indexes. So far in

Not FDIC Insured | May Lose Value | No Bank Guarantee

EQUITY MARKET UPDATE
As of 04/30/22 | Volume 11, Issue 4 | FFTAM.com

2022, this area has similar returns to its large cap peers with the S&P 400 Mid Cap Index falling 12.02%, while the S&P 600 Small Cap Index is down 13.34%.

International Markets Fall on Ukraine War and China COVID Shutdowns

The war in Ukraine continues to be a major focus for investors. The United States, along with its European allies, have applied numerous financial sanctions against the Russian government, its leaders, its state-owned companies, and its banking system. With few signs of peace, President Biden banned the purchase of Russian oil, while Europe is nearing an agreement for a phased-in ban. Vladimir Putin retaliated by halting natural gas deliveries to non-NATO members Poland and Bulgaria. The European Union gets 35% of its total energy needs from Russia, so prices have skyrocketed as the region scrambles to find new sources. The US government agreed to significantly increase the amount of LNG exported to Europe through 2030, and talks are underway to extend the timeframe to ensure ample supply of American LNG to the region for decades to come. The EU has also reached an agreement to procure LNG from UAE and Qatar. However, none of these solutions provide an immediate fix. There is not enough excess capacity of LNG currently available, so it will take several years for Europe to wean itself off Russian energy. In the meantime, the Eurozone continues to be plagued by record high levels of inflation. In Germany, the producer price index (PPI) surged 30.9% from the previous year, the highest reading in 73 years! Much of the jump was due to higher energy prices. Businesses are unable to pass along the full extent of inflation, so profits are being squeezed. As a result, the German government lowered their 2022 GDP growth forecast to 2.2% from 3.6%. For 2023, they expect growth to pick-up slightly to 2.6% due to upcoming supply chain disruptions from China. The entire Eurozone reported first quarter GDP growth of 0.2%.

For the second straight month, President Xi resorted to strict lockdowns of major Chinese cities to curb the spread of omicron. At month-end, over 40% of the Chinese population is unable to leave their homes, and the government continues to conduct mass testing. China's "zero-COVID" policy will cause further stress on the global supply chain in coming months as the locked down regions are home to major factories for many global companies. Politics is complicating matters. China has a very low vaccination rate with just 51% of citizens over the age of 80 receiving two doses. President Xi has also ordered that no American vaccines or therapeutics be used. To stabilize the economy, he allowed select factories to reopen with "closed loop" operations that require workers to sleep and live onsite while being tested daily. China's Service PMI dropped to 42 from 50.2 the previous month, the sharpest decline since the origins of COVID-19 appeared in February 2020. Manufacturing PMI fell further into contraction territory with a reading of 46. Finance Premier Li Keqiang reiterated GDP growth of 5.5% and CPI of 3% for 2022 even though most analysts believe those targets will be difficult to achieve. His comments could open the door to further stimulus measures from the Chinese government.

Lower valuations helped the international markets outperform the US in April with the MSCI EAFE Index losing 6.78%, while the MSCI Emerging Markets Index dropped 5.75%. Year-to-date, the two indexes are down 11.79% and 12.13%, respectively.

US Economy Grows, Inflation Worsens, Fed Prepares for Further Rate Hikes

The US remains on solid footing with the economy creating 431,000 jobs. We have seen 11 straight months of over 400,000 job gains, the longest stretch since 1939. Hiring was broad based with all major industries adding new employees. Unemployment

ABILENE
400 Pine Street
Suite 300
Abilene, TX 79601
325-627-7100

BEAUMONT
3515 Dowlen Road
Beaumont, TX 77706
409-600-6460

BRYAN/COLLEGE STATION
1716 Briarcrest Dr
Suite 400
Bryan, TX 77802
979-260-2134

ODESSA
3555 Billy Hext Rd
Odessa, TX 79765
432-367-8912

SAN ANGELO
222 S. Koenigheim St San Angelo, TX 76903 325-659-5987

SAN ANTONIO
9601 McAllister Fwy
Suite 1204
San Antonio, TX 78216
210-864-4774

FORT WORTH
1000 Forest Park Blvd
Suite 200
Fort Worth, TX 76110
682-703-6404

HOUSTON
24080 Hwy 59 N
Kingwood, TX 77339
281-318-4625

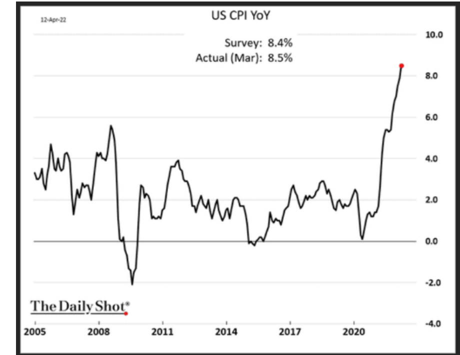
Not FDIC Insured | May Lose Value | No Bank Guarantee

STEPHENVILLE
2201 W. South Loop
Stephenville, TX 76401
254-918-6262

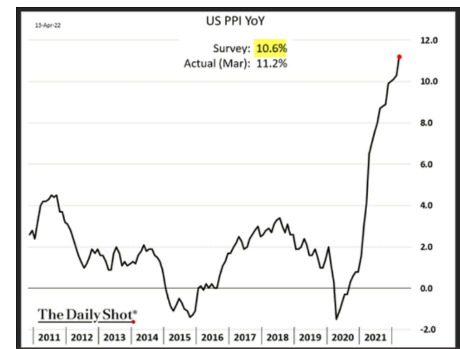
SWEETWATER
201 Elm Street
Sweetwater, TX 79556
325-235-6644

fell to 3.6%. Labor force participation barely budged. We have stated for months the effect retirements have had on the size of the labor pool. Wages grew 4.5% from one year ago. Plentiful employment and wage gains fueled consumer spending. Total

consumer spending grew 1.1%, while retail sales advanced 0.5%. The reports showed a further shift in consumer spending towards services, like dining and travel, away from physical goods. Personal income grew 0.5%, but inflation rose more quickly. Income after taxes, adjusted for inflation, has fallen for eight straight months. Consumers continue to tap savings to maintain their brisk pace of spending. The savings rate, which measures income left over after paying for expenses, has fallen to 6.2%, the lowest reading in nine years. The data paints a picture of an economy growing from strong employment and rising wages, but those benefits are being eroded by rising inflation.

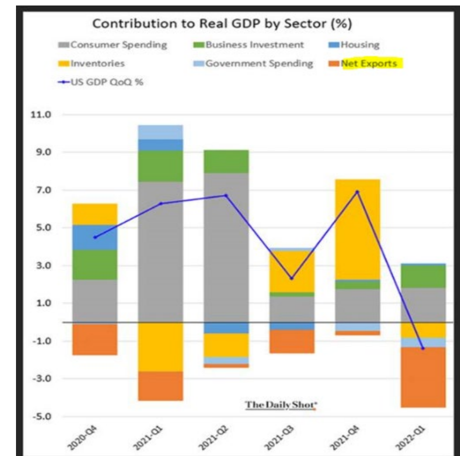


Inflationary pressures continue to plague the economy with consumer prices jumping 8.5% from one year ago. That was the hottest reading since December 1981 and the sixth straight month of inflation above 6%. The price hikes were widespread. Core CPI, which strips out the volatile components of food and energy, climbed 6.5%. Grocery prices rose 10%, the sharpest rise since 1980, and energy surged 32%. We continue to see sharp increases in rent, which accounts for one-third of the CPI calculation. Even though rent is up double digits in many US cities from last year, the rental vacancy rate dropped to the lowest level since the early 1980s. This means housing expenses could continue to rise at an above average pace given the limited inventory, although it will be difficult to replicate the gains of the past two years as the 30-year mortgage rate is now 5.25%. These reports serve as another reminder of the ills coming from supply chain constraints, tight labor markets, and strong consumer spending.



Businesses are trying to keep up with strong consumer demand; however, supply chain disruptions are wreaking havoc on the availability and price of components with the producer price index (PPI) jumping 11.2% on a 12-month basis. PMI readings remain strong, although new orders fell briskly.

First quarter GDP shrunk by 1.4%, which caught many off guard. However, the details confirmed what we have been seeing in various other reports. Net exports accounted for the entire decline by falling 3.2%. Private inventories also shrank 0.84%. These two items show how difficult it is for factories to get ample raw materials and products to meet demand. The consumer, meanwhile, remains bullish with private spending growing 3.7%, well above the Fed's forecast for 1.8%. The mismatch between supply and demand is fueling further price hikes.

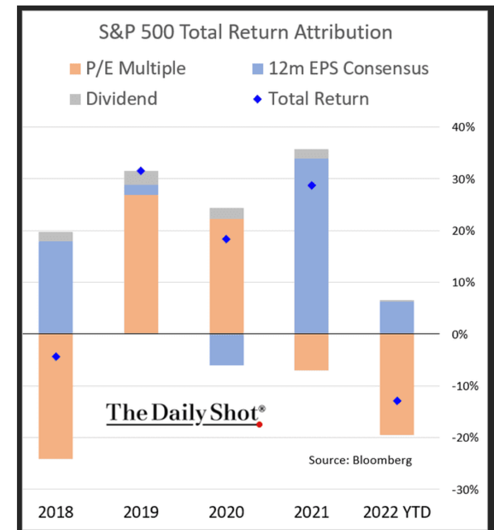


Elevated inflation is forcing the Federal Reserve to speed-up monetary tightening. They stopped monthly bond purchases in March and increased interest rates by 0.25%. Federal Reserve Chairman Jerome Powell laid the groundwork that rate increases are

about to happen in larger and faster increments. He told reporters to expect half percentage point hikes at the next three meetings. The dot plots indicate the Fed wants interest rates to be at 2% by year-end and 2.75% by the end of 2023. If this comes to fruition, it would be the most aggressive rate hiking campaign in 15 years. Mr. Powell said the Fed will reveal the details of shrinking the balance sheet at the May 4th meeting with implementation happening shortly thereafter.

Sell-Off Shrinks Market Valuation but Earnings Picture is Mixed

We are in the thick of earnings season. So far, 55% of companies have released first quarter results. Earnings are up 7.1%, which is better than analysts' forecast of 4.7%. However, this is a sharp deceleration from the previous quarter when profits grew 31.4%. We have seen many high-profile earnings misses this quarter, including Alphabet, Amazon, and Netflix. This indicates that year-over-year comparisons are getting tougher, while profit growth is becoming more elusive in the face of high inflation and geopolitical uncertainty. For the full year, analysts are forecasting earnings growth of 10.3% with revenues increasing by 9.8%. These estimates are better today compared to the start of the year, and it shows that analysts expect economic conditions to improve in the 2nd half of the year, especially regarding inflation. Investors are wary that double digit profit forecasts for the upcoming three quarters are too aggressive, which contributed to the large sell-off last month.



The mixture of future earnings growth and the recent market sell-off has the S&P 500 trading at 18.1x 2022 earnings estimates. This is better than the trailing earnings multiple of 21.1x. Stocks now trade at levels below what we saw pre-COVID (19.4x) on a price-to-earnings (PE) basis. They are in-line with the 5-year average PE of 18.6x and slightly above the 10-year average of 16.8x.

The market has finally gotten serious about the Fed and inflation by removing the premium valuation on stocks. Even though current valuation appears attractive, it is based on aggressive profit growth estimates coming to fruition. This makes stocks ripe for increased volatility, especially among the higher valuation growth names.

Our Outlook & Strategy

The biggest challenge for stocks in 2022 is central banks navigating how to remove emergency stimulus policies needed during the depths of the pandemic without significantly slowing growth. Russia's invasion of Ukraine complicates matters by pushing energy and food inflation even higher. The prospect of higher interest rates reduces the PE multiples investors are willing to assign to stocks. This places outsized stress on stocks trading at lofty valuations, especially those that cannot clear the earnings growth hurdles investors have forecasted.

The best summary I have seen on how to navigate the upcoming environment is from Joe Zidle, Chief Investment Strategist at Blackstone. He said: "The path forward for investors will be more challenging as slower growth, higher inflation, and rising interest rates call for higher quality, greater selectivity, and a sharp focus on duration management for both equity and fixed income investors." This is historically a good environment for First Financial relative to the benchmark given our ownership of higher quality companies—those with consistent cash flows and less leverage.

Last month's sell-off was deep and widespread. As indicated above, it corrected the premium valuation placed on stocks. We

believe the recent decline presents many opportunities. Several of the companies we follow now trade at valuations only seen in the depths of recession. This is most clear when looking at the difference in valuation between defensive and economically sensitive stocks. The current disparity indicates investors believe a Fed mistake and a soon coming recession is a certainty. We believe the Fed is right to raise interest rates quickly to address inflation; however, it appears the market may be overestimating the number of rate hikes needed. Any indication that the Fed will not need to raise rates as high as current market forecasts will be viewed as a dovish signal and result in a rally for stocks, especially among cyclicals. Therefore, we are using this sell-off to invest excess cash, and we have begun trimming our defensive holdings in consumer staples to boost select positions in consumer discretionary and industrials.