JOHNSON
INVESTMENT COUNSEL

Quarterly Insight

MARKET UPDATE

2022 FIRST QUARTER

TOUGH START FOR FINANCIAL MARKETS IN 2022

Stock and bond markets were dragged down in the first quarter by a powerful combination of rising inflation, the Russia-Ukraine war, and tightening Fed policy. Any one of these could have been the sole catalyst for a market downturn, and together they led to broad weakness across asset classes. The economic environment was already skewed entering the year thanks to post-pandemic issues like supply chain disruptions and imbalanced supply and demand dynamics.

Unfortunately, a strange economy got even stranger when Russia invaded Ukraine. The military conflict and subsequent sanctions on Russia caused slowdowns or shutdowns of critical supplies in Europe and around the world, most significantly in the energy and agriculture industries. Prices of impacted commodities rose, and the S&P 500 energy sector trounced the S&P 500 index with a gain of 42%. Natural gas, crude oil, gasoline, and wheat prices rose even more, and the Bloomberg commodity index gained 30%.

In general, stocks declined, particularly in the tech and consumer discretionary sectors. Notably, bonds had a historically bad quarter, especially those with longer maturities. The Bloomberg Aggregate Bond Index fell 5.9%.

MARKETS AND GEOPOLITICS

The human suffering from war is tragic, and any costs borne by the economy and markets pale in comparison. In many cases military conflict leads to economic fallout that increases the suffering. Damage to critical infrastructure has a larger ripple effect than ever in our globalized economy. The question is always the extent of the damage, and thus the duration of the disruption to normal economic activity.

In this case, Russia and Ukraine are major European hubs for oil and gas as well as wheat production. Sadly, this means that energy and food shortages will be a problem for the European economy and beyond for the near future. The rest of the world continues to deal with inflation that was already rising before the invasion.

The sooner the conflict comes to a halt, the less fallout for the global economy. Wars typically cause market volatility in the short-term, and a cease-fire alone won't necessarily send stocks higher. The toll on the overall economy and corporate profits will determine the ultimate reaction of markets. Historically, the further out from the conflict, the more likely the market has returned to or even surpassed previous highs.

IT'S (MOSTLY) ABOUT THE FED

Despite its significance the Russia-Ukraine war has not been the main driver of markets so far this year. Instead, the stock and bond markets have been more sensitive to what the Fed has in store. After over a decade of historically low interest rate policy, the Fed is now responding to increasing inflation by hiking its benchmark interest rate. These hikes are anticipated by investors, and result in rising rates across the bond market. In addition, the Fed is in the process of reducing the size of its balance sheet. This also serves as a withdrawal of stimulus to reduce inflation.

FEATURING

- **MARKET UPDATE** pages 1 & 2
- **SPRING CLEANING THE PORTFOLIO** pages 2-3
- **JIC NEWS** page 4

TOTAL RETURNS

	1Q 2022
S&P 500	-4.6%
Dow Jones Industrial Average	-4.1%
NASDAQ	-8.9%
Russell 2000	-7.5%
MSCI EAFE (International)	-5.8%
Bloomberg U.S. Aggregate Bond Index	-5.9%

- WEALTH MANAGEMENT
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This process is a sensitive one, and the Fed does whatever it can to balance achieving its objective without choking off economic growth. The market handicaps both the upper limit of Fed hikes (known as the terminal rate) and the pace of the hikes. Lots of careful messaging is involved, but inevitably the market can't accurately predict the future, and neither can the Fed.

BOND MARKET OUTLOOK

Bonds have been much more volatile than normal since late 2021 as rates have risen. It's important to note this volatility is nowhere near that of stocks. The recent losses reflect the expectation of roughly twelve rate hikes in the coming year. It's likely that most of the losses are behind us. If it becomes clear that the Fed would hike further or faster than currently expected, there could be further price declines.

However, with rates at higher levels, bonds are positioned for positive returns in the years ahead. The stock market can stray far and wide from fair value based on swings in investor sentiment. Unlike the stock market, the bond market is driven by math. Therefore, the higher the starting interest rate, or yield, the higher the likelihood of a positive total return.

The bottom line for bond investors is that as rates rise, bond prices fall. This means negative returns in the short term, but better prospects for positive returns in the months and years ahead.

ECONOMIC STRENGTH, WITH CAVEATS

There are many measures by which to judge the overall strength of the economy. It's an extremely complex picture, so no single data point is ever enough. There are still many positive indicators displaying economic health, even though recession odds have been rising of late.

One of the classic indicators of oncoming recession is known as an inverted yield curve. In the lead up to many past recessions yields on shorter-term bonds rise and longer-term bonds fall. If this relationship inverts to a point where short-term yields are higher than long-term, recession becomes more likely.

The most reliable of these relationships is the Fed Funds Rate / 10-year Treasury note relationship. This curve is still indicating economic growth ahead. Consensus economic forecasts are also calling for positive GDP growth, even after accounting for inflation. The labor market is strong, consumers have ample spending power, and are generally optimistic. Corporations are healthy and profitable overall, and bank lending has been accelerating.

Investors and the Fed will be keeping an eye on consumer confidence and spending, and of course, inflation. Persistent inflation could choke off growth and lead to a negative cycle of reduced consumer activity.

DIVERSIFICATION AS CRITICAL AS EVER

When both stocks and bonds have been under pressure it can be tempting to question time-tested investment principles. But in times of turmoil staying appropriately diversified and focusing on the long-term plan is as important as ever. Understanding the dynamics of both stock and bond markets allows us to filter out the noise and negativity that inevitably comes with bad news. It also prevents rash decision-making that can permanently damage portfolios. We remain confident that by building diversified portfolios tailored to the unique circumstances of each situation, focusing only on what we can control, we can help clients achieve their financial goals.

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SPRING CLEANING THE PORTFOLIO

Given all the tumultuous events in our world over the last couple years, it's a challenge not to sound like a broken record when attempting to provide perspective on the investment landscape. Unfortunately, headlines the last few years have often employed adjectives and phrases like "unprecedented" and "once in a lifetime" and "black swan event" when describing the environment for making decisions on portfolios and asset allocation. It seems as one event recedes (Covid-19 pandemic) another takes its place (Russia-Ukraine war), never providing investors any semblance of a break from the uncertainty.

All this uncertainty can lead to an acute sense of anxiety about the near term and longer-term outlook for stock and bond returns. This uncertainty has taken its toll on year-to-date returns in major asset classes as the broad-based stock and bond indexes have retreated from all-time highs thus far in 2022.

If market timing was already difficult if not impossible, this

SPRING CLEANING THE PORTFOLIO

is certainly not the time to try one's hand at predicting what's going to happen and how stocks, bonds and other asset classes might respond to so many conflicting factors. We have always held to the philosophy of taking the long view on allocating client capital, not trying to time when to "get in" and "get out" of stocks or bonds based on our interpretation of current events. The historical evidence is overwhelmingly clear these attempts usually cause more harm than good. Instead, we employ a sound diversification and consistent rebalancing strategy, time-tested principles foundational to success over the long term.

Since we can't control and can't predict what's happening in the world and how it will impact portfolios, what can we do? We can focus on wealth management strategies and tactics that make sense in any environment. One such tactic is to find opportunities to save money on taxes. One way to do this is to employ a tax-loss harvesting strategy in taxable investment accounts. This not only provides tax savings but also helps with other key aspects of portfolio management. Think of it as a good spring cleaning of the portfolio!

MAKING LEMONADE OUT OF LEMONS - LOSS HARVESTING IN TAXABLE ACCOUNTS

From a market perspective, the first several months of 2022 have started off poorly. The benefits of diversification have not been on display in the short term due to all the nuances of the current environment described above. Historically, stocks and bonds tend to have a negative correlation, meaning when stocks are up, bonds can be down (or up less) while falling stocks are usually counterbalanced by higher returns (or down much less) from bonds. While this dynamic still could play out for the year as a whole, the early stages of 2022 have not been so kind.

Simultaneous declines of both stocks and bonds are rare for a balanced portfolio as indicated in the historical annual returns table below. Using the Vanguard Total Stock Market ETF (Ticker: VTI) and the Vanguard Total Bond Market ETF (Ticker: BND) as a proxy for the 60% stocks / 40% bonds portfolio, this mix has provided relatively strong returns in the 10 years prior to 2022. But this mix is down about 5.6% year to date.

Annual Return of 60% Stocks (VTI) / 40% Bonds (BND)			
2012	11.13%	2018	-3.17%
2013	19.23%	2019	21.94%
2014	9.85%	2020	15.70%
2015	4.40%	2021	14.66%
2016	8.71%	2022	-5.58%
2017	14.15%		

Such downturns provide an opportunity to analyze holdings and make lemonade out of the lemons via tax loss harvesting.

TAX LOSS HARVESTING CONSIDERATIONS

Tax loss harvesting does have its complications and certainly requires a sharp eye and solid knowledge of current and future tax status. In addition, it's important to emphasize all these considerations apply to taxable accounts, not retirement accounts such as Traditional IRAs, 401(k)s, 403(b)s and Roth IRAs. Here are some key considerations:

- **Opportunity to Realign the Portfolio:** Capital gains taxes on the sale of appreciated assets can be a constraint on portfolio management. In down markets this potential roadblock can be reduced or eliminated by selling securities at a loss (or smaller capital gain) to reduce or eliminate out-of-favor securities as well as realign the portfolio to asset allocation targets.
- **The Math is Important, but Be Mindful of Holding Period:** By selling at a loss, investors can either deduct a maximum $3,000 / year from their income (in aggregate) for joint filers or they can offset other realized capital gains in the portfolio during the year. If the aggregate realized capital losses exceed $3,000, the remaining loss above $3,000 can carry forward to offset gains in future tax years. The holding period is important. Securities held over one year are considered long-term gains or losses, while a holding period of less than a year is considered a short-term gain or loss. The interplay between these two is important as a specific calculation determines what gains offset what losses.
- **Wash Sale Rule:** When executing these transactions we are mindful of the wash sale rule. Essentially, a taxpayer cannot sell at a loss and then turn around and immediately buy a "substantially identical" security right away. If the wash sale rule is violated, the capital loss is disallowed, and the disallowed loss is added to the cost basis of the new asset. This essentially preserves the tax benefit but defers the realization of the benefit until the new asset is sold. What constitutes "substantially identical" is subject to interpretation and caution is necessary.

BOTTOM LINE

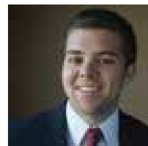
Foundational to our investment approach is the belief that successfully timing the market is virtually impossible over the long term. However, tax timing is much more predictable. Locking in tax-deductible losses or reducing taxable gains uses empirical facts (current prices and tax law) and can add real value to the portfolio. Capital loss harvesting can help take the sting out of the red ink on portfolio statements, making the market rebound more enjoyable knowing tax bills will be better as a result of the spring cleaning.

Disclaimer: Johnson Investment Counsel does not provide tax, legal or accounting advice. This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any transaction.

PROMOTIONS

Our mission to deliver peace of mind through trusted counsel, exemplary service, and a genuine heart to serve, is made possible through the hard work and dedication of our employees. We are pleased to announce that these individuals have been promoted to new positions:

- **Eric Bachus, CFA**
  Associate Portfolio Manager
- **Fred Brink, CFA, CFP®**
  President, Johnson Asset Management
- **David Christian, CFA, CFP®**
  Portfolio Manager
- **Kristen Curtiss**
  Research Analyst
- **Danielle DePew**
  Human Resources Coordinator
- **Rebecca Desch**
  Creative Marketing Manager
- **Emily Fox, CAIA**
  Senior Director of Institutional Business Development
- **Andrew Kucia, CFP®**
  Portfolio Manager
- **Bobbie Laker**
  Office Services Coordinator
- **Michael Leisring, CFA**
  Chief Investment Officer Fixed Income
- **Steve Linder, CCP®**
  Senior Managing Director of Human Resources
- **Kathleen Mahdasian**
  Senior Marketing Associate
- **Lori Marshall**
  Facilities/Office Manager
- **Lisa Oliverio, CPA**
  Director of Finance
- **Margaret Palmer**
  Senior Account Administrator
- **Charles Rinehart, CFA, CAIA**
  Chief Investment Officer
- **Joe White, CFA, CFP®**
  Associate Portfolio Manager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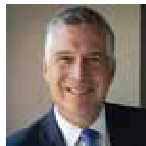
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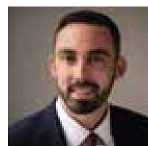
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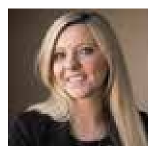
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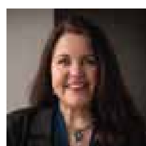
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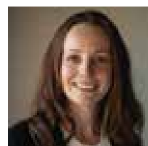
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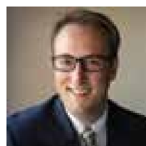
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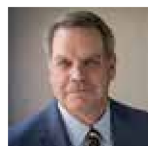
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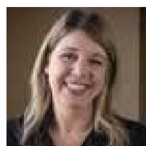
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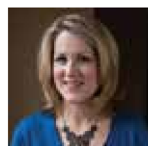
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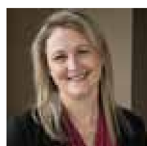
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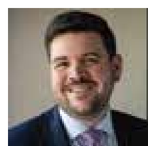
Rinehart

White

If you are a client of Johnson Investment Counsel, you should receive account statements on at least a quarterly basis directly from the qualified custodian that holds and maintains your assets. You are urged to carefully review all custodial statements for accuracy. If you are not receiving custodial statements, please contact our Chief Compliance Officer, Scott Bischoff at (513) 661-3100.

ABOUT US

Johnson Investment Counsel is one of the nation's largest independent wealth management firms, managing more than $18 billion in assets for clients in 49 states. Johnson Investment Counsel is an employee-owned firm, offering a full range of fee-based, integrated wealth management services, including: investment portfolios, education and retirement planning, cash management, estate planning, trust services, charitable giving, mutual funds, 401(k) plans, IRAs, and more. Johnson Investment Counsel has built strong, long-term relationships with individuals, families, charitable organizations, foundations, and corporations through four integrated divisions.

- WEALTH MANAGEMENT
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