
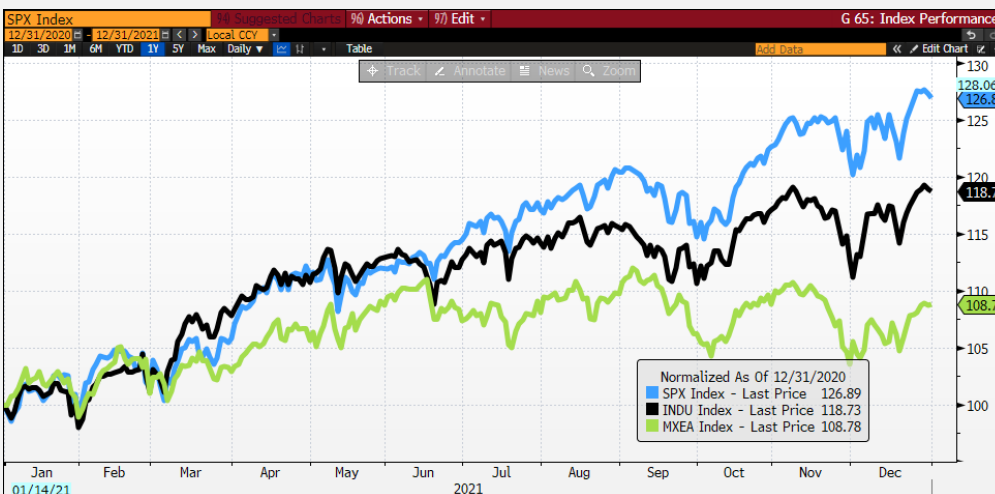


QUARTERLY NEWSLETTER

The Fed's Double Edged Sword - Tight or Loose Policy?

1Q • 2022

 **Chart 1.** Index Performance as of 12.31.2021



INDEX PERFORMANCE Returns as of 12.31.2021

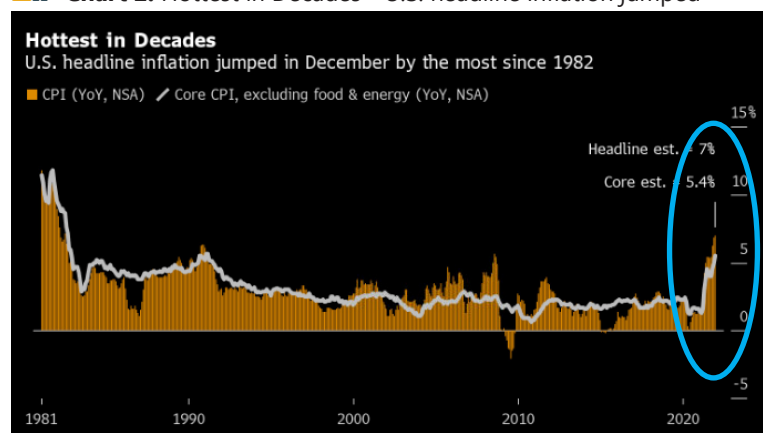
S&P 500 (SPX)	11.01%
Dow Jones Indus. Avg (INDU)	7.86%
Bloomberg 1K Growth	10.47%
Bloomberg 1K Value	8.01%
Bloomberg Developed Ex North America & Mid Cap	2.71%
Bloomberg World Index	6.43%
U.S. Corp High Yield	0.71%
Alerian MLP	0.49%

Chart & Performance Numbers Source: Bloomberg as of 12.31.2021

During the 4Q of 2021, CPI, the U.S.'s measure of inflation, rose 7% (Chart 2) making it the highest it has been since 1982. To make a comparable print, we need to travel back to when Ronald Reagan was President. During his presidency, Reagan and Speaker of the House Tip O'Neill passed the Tax Equity and Fiscal Responsibility (TEFRA) Act, one of the most sweeping reform acts in U.S. history. In other significant events, the historic breakup of AT&T occurred, the Commodore 64 computer made its debut, war in Falkland Islands broke out, compact discs were produced, China became the first nation to reach a population of one billion people, and the U.S. saw a short but deep recession.

The investment landscape in 1982 saw the Dow Jones Industrial Average begin the year at \$875.00, and closed at \$1,046.54 with a total return of 27%. Despite tax increases, war, recession, and inflation, the market did pretty well. If you had invested in the index at the beginning of 1982, your return would have matured 12.88% through the end of 2021 making a \$10,000 investment grow into \$3,354,409.

 **Chart 2.** Hottest in Decades - U.S. headline inflation jumped



Source: Bureau of Labor Statistics, Bloomberg as of 12.31.2021

We highlight these historical facts to address concerns about the current environment and to add context. We believe long-term investing works, even with shorter-term market volatility, because of time arbitrage. We realize the return scenario presented is an extremely long holding period, but the point is, patience usually pays off. Level Four Capital Management is macro aware because we believe that it is difficult, if not impossible, to predict GDP, employment, or inflation, especially in the short-term. It is also near impossible to predict the closing price of the S&P Index or a company's quarterly earnings. This has been studied and the evidence is overwhelming that making market predictions is a loser's game.

THE FED'S DOUBLE-EDGED SWORD

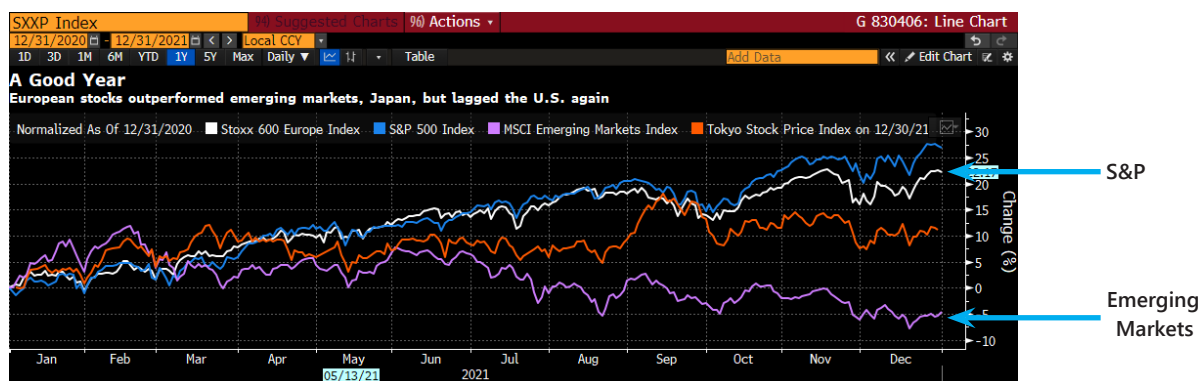
The current market concern is that the Federal Reserve (Fed) could make a policy error (i.e. raising rates too slowly, raising rates too fast) in an attempt to tame inflation given their history of getting it wrong. The Fed is certainly subject to the same bias as every other economist, strategist, or market participant. In addition, market reactions are more subject to surprises versus expectations rather than the printed number. At the end of November 2021, U.S. Fed Chairman Powell said the word "Transitory" is no longer applicable in describing the current inflation rate. If inflation persists for longer and is expected to remain for the foreseeable future, we need to be mindful that the Fed could become nervous about continued inflation by raising rates at a much faster rate in order to keep it under control. We are paying attention to what Powell and other voting members are saying in relation to just that point. We believe this could have the largest impact on short-term returns and potentially present even more opportunities in the portfolios.

INTERNATIONAL VIEW

SLOWING GROWTH IN EUROPE

Looking abroad, the Euro STOXX index gained 5.91% in the fourth quarter, led by utilities up 12.71%, and technology up 8.99%. Travel and leisure was the worst performing sector, down 11.43% amid revived virus restrictions. France outperformed its peers in the quarter, despite tightening mobility restrictions and subdued manufacturing activity. The CAC 40 index advanced 9.86% in the quarter as President Emmanuel Macron boosted his presidential campaign efforts to minimize threats from right wing and socialist candidates. The DAX index gained 4.09% during the same period, under the new German Chancellor, Olaf Scholz.

 **Chart 3. A Good Year**



Economic data pointed to a softening of growth. Manufacturing PMI edged down from 58.60 at the beginning of the quarter, to 58.00 in December. Services PMI declined at a faster pace during the same period, from 56.40 to 53.10. This downtrend was corroborated by a sharp decline in consumer and business confidence in the wake of the Omicron variant proliferation. Indeed, a European Commission gauge of consumer confidence in the Eurozone reached the lowest level in December since March 2020. A similar gauge for business confidence dropped from 117.80 in September, to 115.30 in December.

Looking ahead, as in domestic markets, inflation remains a key data to watch after a new record high of 5% annual growth in December (Chart 4). Energy was the biggest contributor with 26% annual growth, boosted by higher oil prices. Christine Lagarde, European Central Bank (ECB) President indicated that raising rates was not the right answer to transitory rising prices, implying a sustained accommodative monetary policy to support the recovery. Another ECB member said the policy rate could start rising early 2023 if conditions are met. The European Central Bank staff projects 3.2% annual inflation in 2022.

Chart 4. New Record

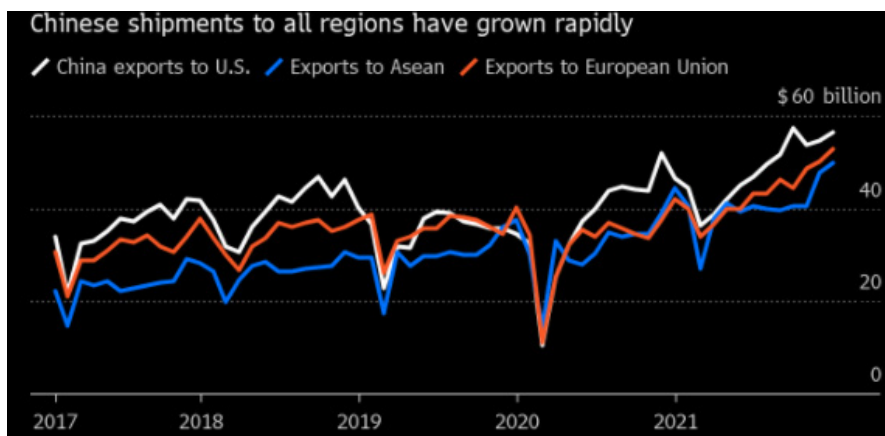


Source: Eurostat, Bloomberg as of 12.31.2021

SURGING TRADE IN APAC

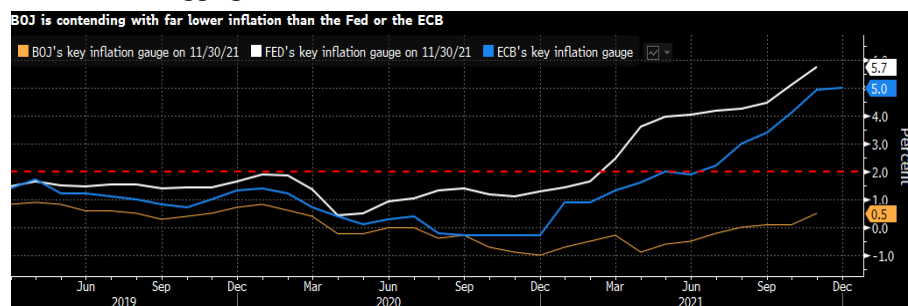
China has been a net beneficiary of strong global demand for goods such as electronic equipment, machinery, textile articles, and toys. Exports grew 20.9% year-over-year in December, as the trade surplus with the United States widened to \$39.2 billion. Manufacturing PMI gradually climbed back to pre-pandemic levels during the fourth quarter despite the zero-tolerance policy imposed by the government to fight COVID-19. The People's Bank of China started to ease monetary policy amid the debt crisis in the real estate market. The IMF projects China will grow 5.6% in 2022. Chinese equities advanced 2.01% in the quarter as depicted in Chart 5.

Chart 5. Strong Global Demand



Source: GAC, Bloomberg as of 12.31.2021

Chart 6. Lagging Behind



Source: Japan's ministry of internal affairs, Eurostat, U.S. Bureau of economic analysis, Bloomberg as of 12.31.2021

In Japan, exports grew 13.5% year-over-year, boosted by strong demand for vehicles, machinery, and electronic equipment. After three consecutive months of decline, Manufacturing PMI rebounded from 51.50 in September to 54.30 in December (Chart 6). Unemployment rates stabilized around 2.8% during the quarter, with real wages steadily declining during the same period. Inflation remains muted compared to other regions despite ongoing Quantitative Easing (QE) by the Bank of Japan. In fact, the Central Bank's balance sheet as a share of GDP reached a record high of 136% in November. Japanese stocks declined 2.24% in the fourth quarter, as markets negatively received the hawkish tone of the new Prime Minister, Fumio Kishida. The IMF projects 3.2% growth for 2022.

In South Korea, exports grew 18.3% in December amid robust demand for semiconductors, passenger cars, and general machinery. This reading contrasts with the weakening domestic economy as rising inflation hurts domestic consumption. The Korean Manufacturing PMI trended lower in the quarter, from 52.90 in September, to 51.90 in December. Unemployment rates rose 80bps to 3.8% during the same period as COVID-19 cases surged and haltered consumer and business sentiment. In December, the Korean finance minister announced a new \$3.6 billion stimulus package to help businesses affected by COVID-19 restrictions. The IMF projects South Korea will rank as the 10th largest economy in 2022 for the third straight year, with 3.3% GDP growth. The KOSPI index declined 2.97% last quarter, with chemicals down over 15%.

ASSET ALLOCATION VIEW: "HOW WELL WILL THE FED PIVOT?"

In light of the recent declines in the unemployment rate, and the continuation of higher-than-expected inflation, which is no longer considered "transitory" by the Federal Reserve, the Fed has announced a wind down of its Quantitative Easing program, along with discussions of future actions including increasing the target Federal Funds rate, and balance sheet reductions (Quantitative Tightening).

 **Chart 7. Fed vs. Market**

Fortunately, we have seen a similar situation before. In 2008, the Fed cut the Federal Funds rate to 0% and started a series of three Quantitative Easings (balance sheet expansions). Because of the financial crisis of 2008, the Fed's balance sheet grew from approximately \$1T to \$4.5T. Chart 7 depicts the movement in markets as the Fed attempted to unwind this action by raising rates and reducing their balance sheet simultaneously (2018 - early 2019).



Source: Bloomberg as of 12.31.2021

Note that during this time, the market had a peak in January of 2018, followed by a period of sideways volatility, but did not ultimately correct further until the end of 2018 after the Fed had raised rates four times during the year, and reduced its balance sheet by about \$500 billion. After the market pullback in late 2018, the Fed finished its rate hiking cycle and ultimately began increasing its balance sheet as markets moved up during 2019.

 **Chart 8. Fed vs. Market**



Source: Bloomberg as of 12.31.2021

If we look at the Fed's response going into the COVID-19 crisis as the pandemic progressed, in Chart 8 (July 2019 – Dec 2021), we can see that the Fed took a similar approach, again cutting interest rates to 0%, while more than doubling their balance sheet from around \$4.25T to \$8.75T. Notice that the S&P 500 Index also more than doubled from the bottom of the March 2020 trough value of 2,237, to the ending December value of 4,766, and increased over 40% from the pre-COVID peak of 3,379.

Current asset allocation positioning:

The fourth quarter of 2021 reflected uncertainty in financial markets with potential higher volatility. Passage of additional fiscal stimulus is highly uncertain. In the upcoming months, the Fed has indicated tightening via rate hikes and accelerated ending of Quantitative Easing. The Fed has also discussed implementing Quantitative Tightening through balance sheet reduction (selling bonds). We are closely watching what effects the Omicron variant may have on ongoing economic activity and government policy.

In accordance with this view, we currently see the following indications for asset allocation:

General Allocation – In the fourth quarter, markets, while volatile, were up 7.7% with our equity benchmark, while our fixed income benchmark was mostly unchanged at +0.01%. In the fixed income markets, interest rate spreads remain compressed. We recommend a quality core of equity focusing on companies with strong balance sheets and strong cash flows and a good balance between growth and value. For fixed income, we recommend a mix of core, multisector, and floating rate/inflation protected allocations, as we believe fixed income will remain challenged from both a return and risk reduction perspective. As the Fed withdraws support to combat persistent inflation, we believe volatility in the fixed income markets may increase, both in terms of overall interest rates and spreads. We also believe equities may see lower returns and higher volatility than has been seen in the recent past. Accordingly, we support an allocation to non-correlated alternative assets in mixed equity/fixed income models. We are closely monitoring the rate of changes in monetary policy the Fed will implement. We remain vigilant regarding our indicators and will modify overall allocations as these indicators and the market environment dictate.

Equity Allocation – We continue to monitor financial conditions and market returns to determine our optimal equity asset allocation. Relative to benchmarks, we are currently equal weight equities relative to our benchmark. We are neutral U.S. equities versus international, though we note that international equities are currently priced more favorably than U.S. equities.

We are constructive regarding select small/mid-cap equities, and are particularly watching small cap value closely. We continue to emphasize high quality and high cash flow equities as those type of companies should emerge from the current crisis in the most favorable condition to take advantage of the recovering economy. We see opportunity in emerging markets, but are cautious regarding China due to increased involvement of their government in respect to capital markets.

Fixed Income Allocation – We believe fixed income going forward will continue to be challenging. In response to current inflations, the Federal Reserve has indicated potential upcoming hikes in the federal funds rate and an end to its Quantitative Easing program. The effects of these actions may pressure interest rates higher for interest rates across the yield curve. Due to current yield levels, higher duration fixed income may have limited upside and provide lower returns. There are tail risks of much higher rates in the event of a Fed miscalculation or lower interest rates in the case of significant equity volatility or an economic slowdown. Longer-term rates may simply rise with the improving economy, the existing debt level, and increased future debt needed to fund Social Security and Medicare as more Boomers retire. All of this indicates a more tactical approach of fixed income management as we expect limited opportunities and significant risks in this area. We continue to monitor company health and interest rate movements closely and will adjust positioning in accordance with the evolving economic and interest rate environment.

Liquid Alternatives – Liquid alternatives were helpful in reducing portfolio volatility and improving risk-adjusted returns during the recent market volatility. We recommend considering alternatives as an option to reduce portfolio volatility. Given the limited return potential of fixed income, we also recommend a consideration of liquid alternatives as an alternative to a portion of a traditional fixed income allocation.

As always, we are working hard on "best ideas" to take full advantage of any over index moves. We believe that our focus in all of our portfolios is on quality and value, and they are positioned even better in an inflationary environment. Inflation and uncertainty usually leads to more dispersion in returns and more focus on picking high quality and well-run companies at great prices, versus long-term intrinsic value.

Thank You,
Level Four Capital Management Team

IMPORTANT INFORMATION

The opinions articulated in this document are for general information only. This information is not intended to provide specific advice or recommendations for any individual. The economic forecasts set forth above may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All performance referenced is historical and is no guarantee of future results. No strategy including asset allocation assures success or protects against loss. All indices are unmanaged and may not be invested into directly.

Stock investing involves risk including loss of principal. Value investments can perform differently from the markets as a whole. They can remain undervalued by the market for long periods of time.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The Standard & Poor's 500 index is a market capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. Price-weighted means stocks with higher share prices are given a greater weight in the index. The DJIA is a stock market index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The value of the Dow is not a weighted arithmetic mean and does not represent its component companies' market capitalization, but rather the sum of the price of one share of stock for each component company.

The Bloomberg US 1000 Value and Growth Indices (B1000V & B1000G) are screened from the Bloomberg US 1000 Index (B1000) and are constructed based on a linear combination of risk factors. The four factors are: 1) Earnings Yield, 2) Valuation, 3) Dividend Yield and 4) Growth. The factors are equally weighted when forming a composite signal where Growth is considered to be a negative indicator and thus flipped to be a negative. The Indices are market-capitalization-weighted. The current price is used to calculate the price-based ratios. For detailed information, review the index methodology document.

Bloomberg Developed Markets ex N. America Large & Mid Cap Price Return Index is a float market-cap-weighted equity benchmark that covers 85% market cap of the measured market.

Bloomberg World Large & Mid Cap Price Return Index is a float market-cap-weighted equity benchmark that covers 85% market cap of the measured market.

The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

The Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

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