MACRO & MARKET

PERSPECTIVES

2ND QUARTER 2022
A FIRST LOOK

1ST QUARTER 2022
KEY TAKEAWAYS

STOCKS, BONDS & ASSET ALLOCATIONS
OUTLOOK & OVERVIEW

PRESENTED BY
The Investment Committee
of Oakworth Capital Bank
April 2022 | 1st Quarter

1Q

1ST QUARTER ECONOMIC OUTLOOK & OVERVIEW

October 2021

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A FIRST LOOK AT 2ND QUARTER 2022

JOHN NORRIS
Chief Economist

A letter from our

INVESTMENT COMMITTEE

After two consecutive bizarre years, would it have been too much to ask to have some sense of normalcy during the first quarter of 2022? Apparently it was. January started off poorly, and things only seemed to get worse through the end of February.

Stocks started the year in the red due to pretty standard seasonal factors. However, given the outsized returns of the past three years, some investors sold into the sell-off in sort of a reverse "fear of missing out" trade. This was undoubtedly due to nontransitory inflation, which had been plaguing, and continues to plague, the economy. At some point, the Fed was going to have to do something. But when and how?

With this on investors' minds, the last thing anyone needed was a war in Europe. Unfortunately, that was exactly what we got when Russia invaded Ukraine. This surprised and didn't surprise everyone at the same time. Not surprisingly, we had to worry whether the conflict would escalate and expand into other European, namely NATO, countries, forcing the U.S. to get involved.

Of course, all of this sent commodity prices through the roof, this at a time when the Consumer Price Index (CPI) was growing at its fastest pace in decades. Again, at some point, the Fed was going to have to do something. But when and how?

Finally, on March 16, the Federal Open Market Committee met and announced it was going to raise the overnight lending target by 25 basis points, or 0.25%. Further, it telegraphed an additional 150 basis points in rate hikes by the end of the year. Curiously enough, this seemed to calm investors. Essentially, they breathed a sigh of relief knowing the Fed was still in control, their fingers crossed.

Further, by this point it appeared the conflict wasn't going to spread and that the Russians might not be as formidable as originally feared. This, too, soothed frayed nerves. By the end of the quarter, worries started to ease.

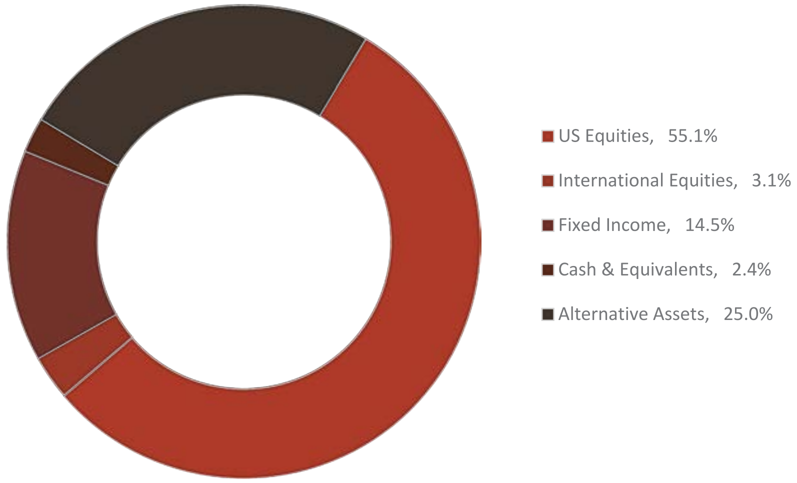
This takes us to the second quarter of 2022, with a strong economy, cheap money and lots of it, strong labor markets, healthy personal balance sheets and continued corporate profitability. That isn't a bad way to start. At least we don't think it is.

We hope you find our insights into the events of the first quarter and where we stand for the remainder of the year helpful. Obviously, no one can look into the future with crystal clarity. However, by anticipating potential changes, we can capitalize on them for our clients' benefit.

Sincerely,

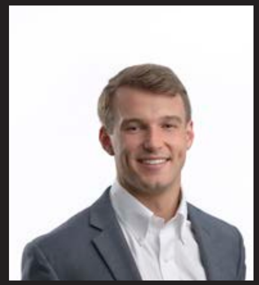
John Norris
Chief Economist

The Oakworth Capital Investment Committee distributes information on a regular basis to better inform our clients about pending investment decisions, the current state of the economy, and our forecasts for the economy and financial markets. At the end of the fourth quarter of 2021, Oakworth Capital advised on approximately $2 billion in client assets.

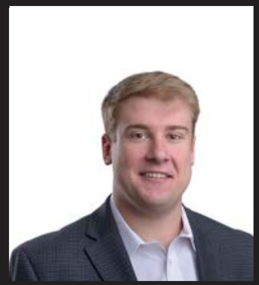


ADAM KIRKLIN
Managing Director

DAVID MCGRATH
Associate Managing Director



SAM CLEMENT
Portfolio Manager



SAM HARRIS
Analyst

1st Quarter 2022

KEY TAKEAWAYS

01. US ECONOMY

The U.S. economy entered 2022 with far more tailwinds than headwinds. However, that didn't keep the markets from having a very disappointing month in January, as normal seasonality almost turned into panic selling.

02. INFLATION

Although it had been creeping up in 2021, inflation really reared its ugly head during the first quarter 2022, reaching 40-year highs. There was no shortage of explanations, all of them with some merit: supply chain bottlenecks, a surge in consumer demand, a shortage of hourly workers, easy monetary policy, profligate government spending, a surge in commodity prices, etc. It was a perfect storm.

03. FEDERAL RESERVE

While the turmoil in Ukraine dominated the headlines, it seemed U.S. investors were more worried about the Federal Reserve. What was it going to do? Once the markets knew the potential path of U.S. monetary policy, the selling stopped and buying began. After all, the uncertainty was gone.

04. STOCKS

Stock prices ultimately come back to corporate profitability. When profits go up, so does the stock market. Thanks to strong earnings, cooler heads started to prevail by the end of the quarter, and all of the red ink during January and February had become only pink by the end of March.

05. INTEREST RATES

Sometimes stock prices seem to have neither rhyme nor reason. However, bond prices are little more than math. When interest rates go up, bonds go down. During the first quarter, rates went up, and fixed income investors felt the pinch.

06. BONDS

Historically, investors tend to buy bonds when stocks go down, for their perceived safety. So, what happens when bonds fall at a more rapid rate than stocks at the same time? Where do you hide then? That is what investors were asking by the end of March, after the worst quarter for the bond markets in years.

07. MARKET VOLATILITY

Due to the volatility in the markets and the turmoil across the globe, the first quarter was a perfect time to reassess risk tolerances and return expectations. Interestingly enough, just as our Investment Committee has long thought, bonds were riskier than U.S. stocks during the quarter.

08. INTERNATIONAL

With the Federal Reserve and Ukraine/Russia taking center stage, investors mostly took a breather from Washington's persistent dysfunction.

ECONOMIC OVERVIEW

John Norris

Years ago, a famed business economist told us he based his forecasts on two key variables: interest rates and the price of crude oil. The higher both are, the more slowly the economy will grow. The inverse is also true: when money and energy are both cheap, economic activity should be robust. The trick is predicting the future when one is high and the other is low, which shouldn't be all that often.

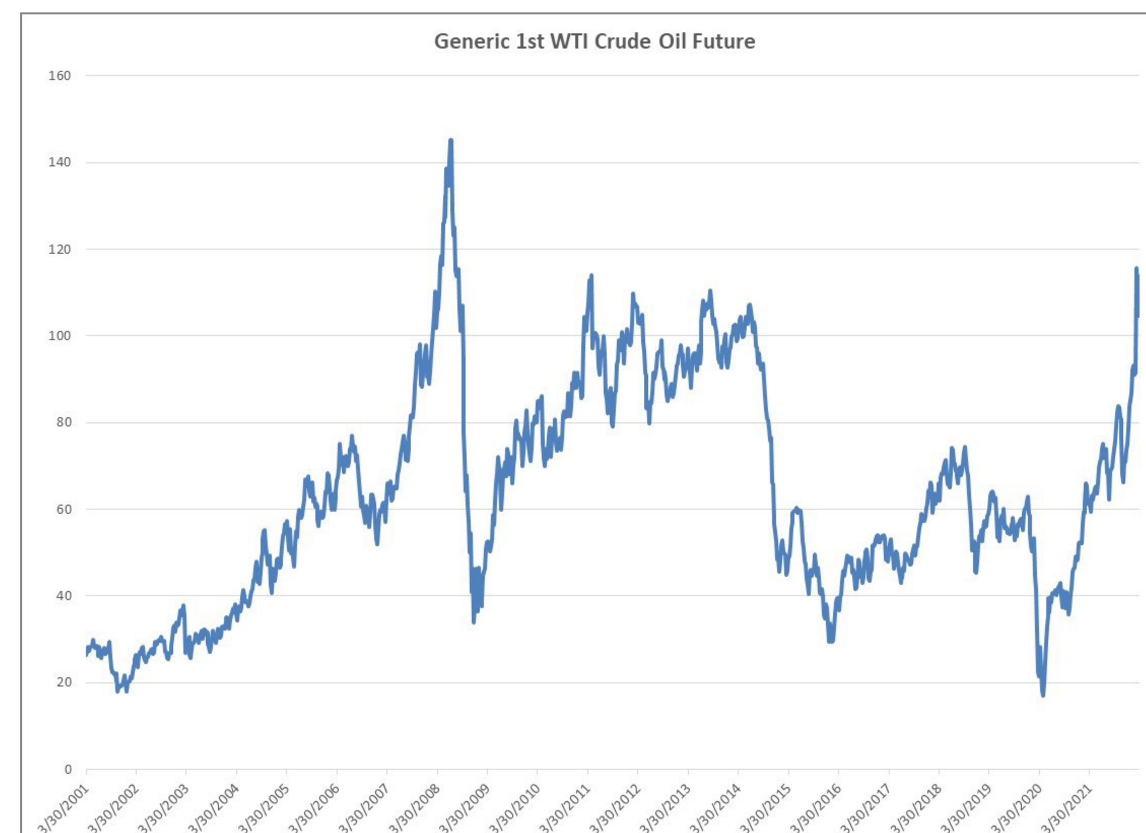
That is exactly what happened during the first quarter of 2022.

A variety of factors caused commodity prices to soar during the last quarter. While the headlines seem to pinpoint the war in Ukraine as the source of the problem, the trend had actually existed since the worst of the pandemic lockdowns. In April 2020, the price of crude oil futures went negative, but it has gone in one direction since: up. Frankly, prices had nowhere else to go.

The reason for the increase is pretty straight forward: supply has not kept up with the surge in demand. Unfortunately, the situation seemed to reach a crescendo last quarter when the active WTI (West Texas Intermediate) future soared above $100/barrel. They reached a near and median-term high on March 8, at over $120/barrel.

Perhaps not so surprisingly, the Consumer Price Index (CPI) has also soared over the past 12 months or so, hitting a 40-year high of 7.9% "year over year" level in February 2022. However, interest rates have barely budged, for all intents and purposes, when compared to the spike in inflation. As a result, money has been extremely cheap, extraordinarily so, in relative terms.

EXPENSIVE ENERGY



Data points provided by Bloomberg

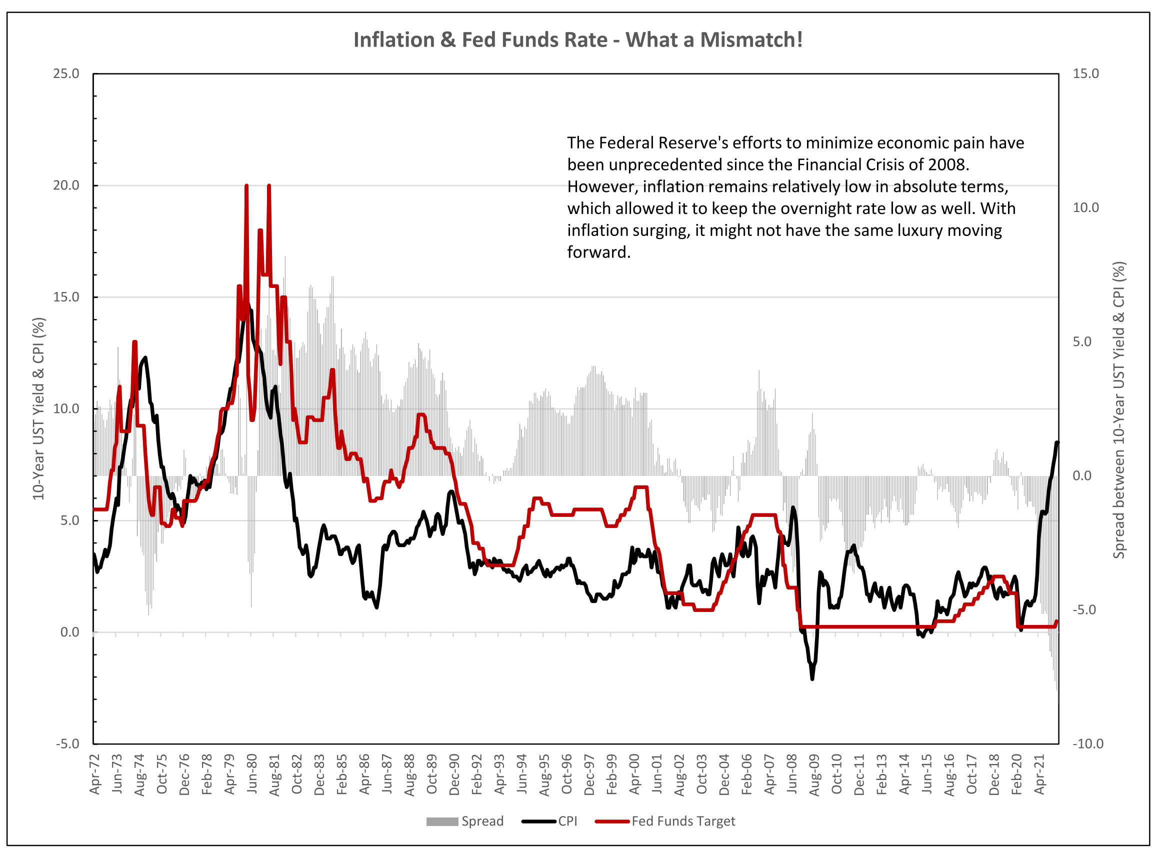
Consider the following chart, which will also be in the discussion on the bond market. It shows the spread between the target overnight lending rate (Fed Funds) relative to the 12-month CPI over an extended timeframe. As you see, the differential has been historic.

Obviously, something will have to give. Inflation will have to come down, interest rates will have to go up, or we will have to have some combination of the two. However, during the first quarter of 2022, the positive impact of cheap money had a bigger effect on economic activity than did the negative aspect of elevated energy prices. As we start the second quarter, interest rates remain more low than crude oil is high.

Basically, free money will help offset expensive gas in the short term, just as it has over the past 12 months. There is little other way to explain the next chart, which is simply "adjusted retail & food services sales total yearly % change SA".

Since consumer expenditures make up roughly 68% of the U.S.

….AND VERY CHEAP MONEY



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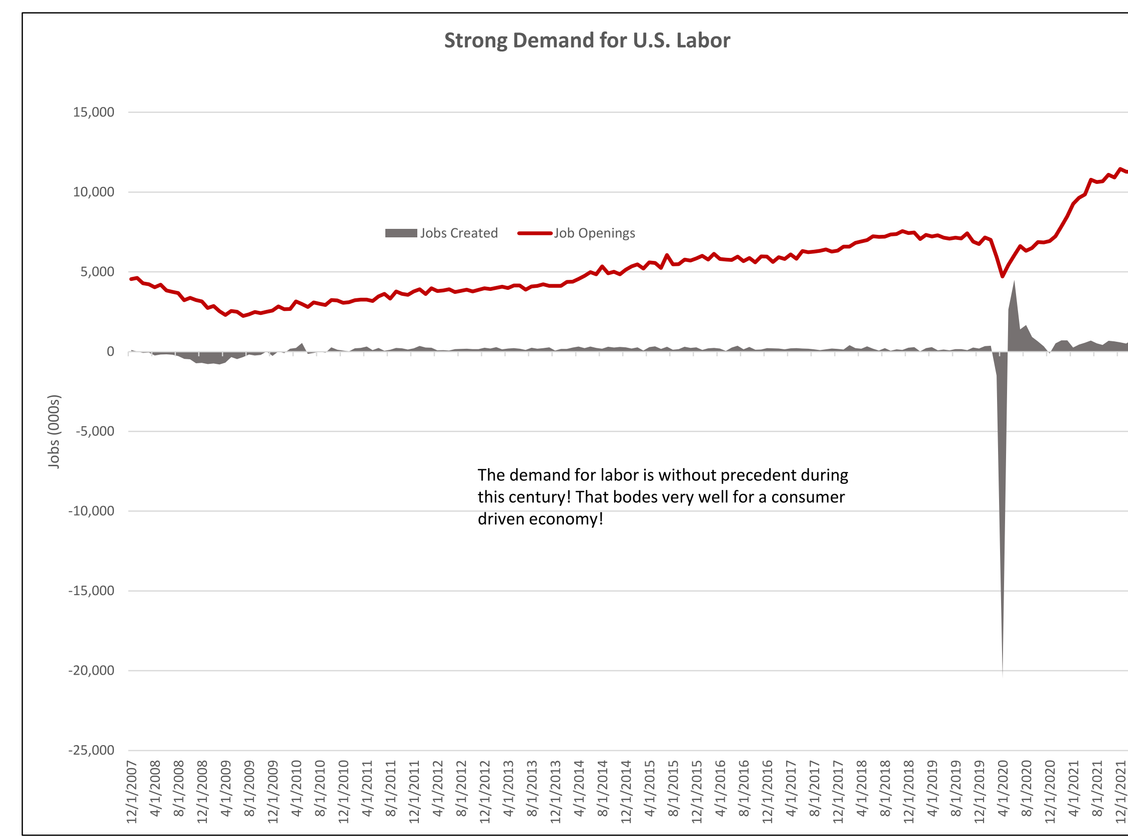
Gross Domestic Product (GDP) equation (C+I+G +/- Net Exports), it is fair to say how goes the U.S. consumer is how goes the U.S. economy. For all the talk about interest rates and energy prices, you can't have a meaningful discussion about the health of the economy without looking at the labor markets. After all, when the economy is creating jobs it is creating consumers.

So, just how healthy is the U.S. jobs market? In a word, very. So much so that employers have not only added millions of jobs over the past couple of years, but they also have near record levels of available job openings. There just aren't enough willing workers.

The following chart shows the number of jobs created on a monthly basis and the number of jobs still available.

The big question remaining is will money remain cheap enough for long enough until inflation starts to ease? That depends largely on the Federal Reserve and how it implements monetary policy moving forward. It is going to be walking a tightrope. How to raise

THE U.S. CONSUMER IS ON FIRE



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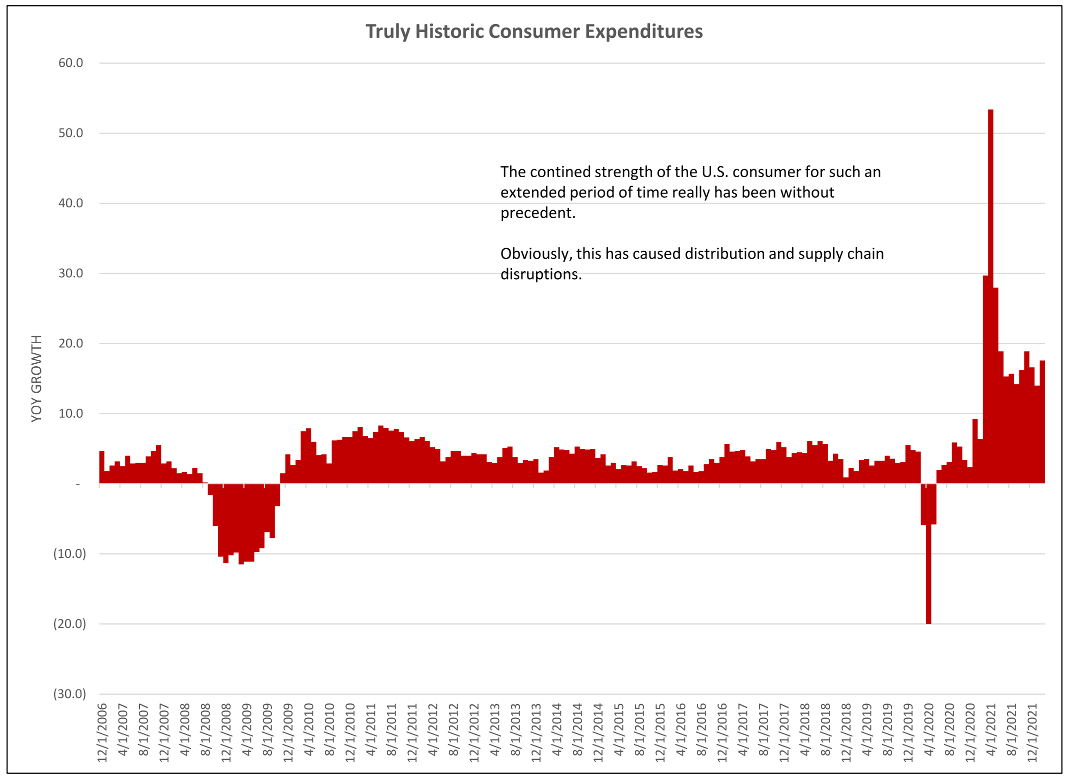
WORKERS WANTED IN THE WORST WAY



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interest rates enough to get inflation to ebb while keeping them low enough to stimulate borrowing and lending?

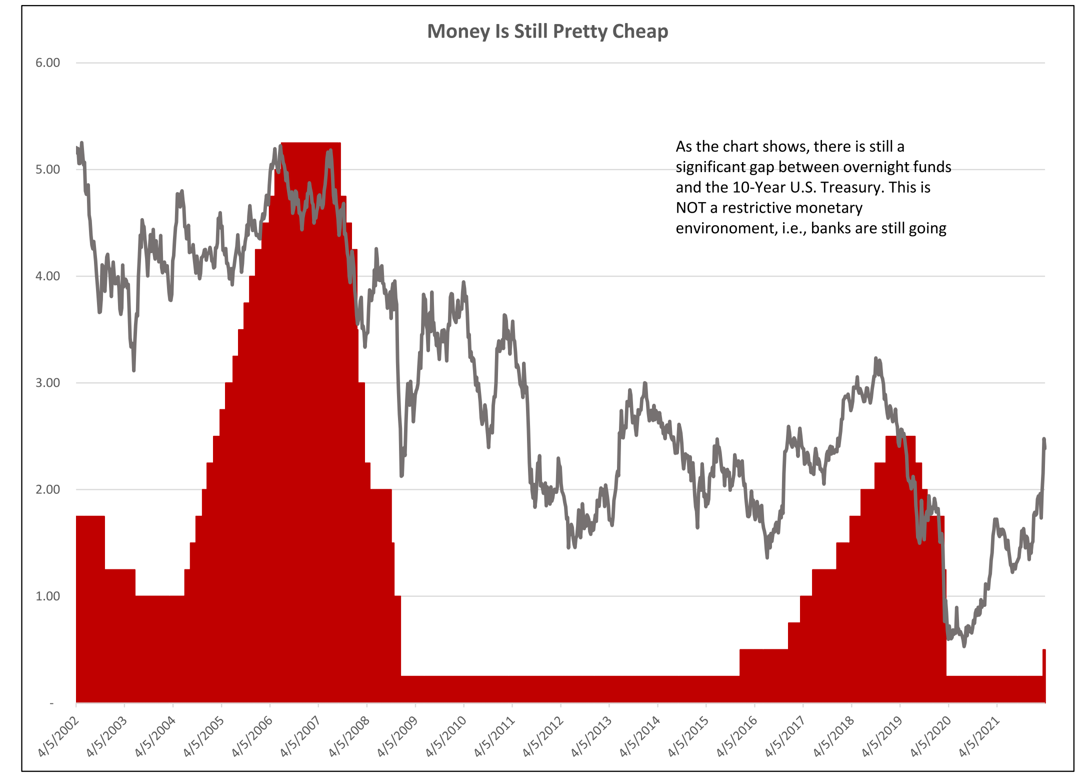
At the end of the quarter, the Fed had suggested the need for up to 150 basis points in additional rate hikes. This would take the overnight lending target to an upper range of 2%. Obviously, this is still substantially less than the CPI has been. As such, money would still be cheap, just less so. Will this be enough to get prices to start to drift downward?

At first blush, the Fed seems to think it will be. Much will depend on how longer term interest rates respond to the rate hikes. Will they go up or down? If down, by how much? This is important because banks borrow money short (deposits) and lend out money long (loans). If a bank's cost of funds, is higher than what it can make lending the money, it won't make loans. Obviously, this will slow the economy.

So, where are we in this cycle? In how much danger are we of the yield curve "inverting"? While there are many different ways to define a yield curve inversion, the simplest is target overnight lending rate compared to the 10-year U.S. Treasury. Essentially, this is a proxy for what banks can make on their cash relative to what they can make on a loan.

All of this is to say, the proverbial economic sky is NOT falling. Interest rates remain very low in both absolute and relative terms. The slight increase in the cost of money moving forward will likely

THE CURRENTLY LENDING ENVIRONMENT



Data points provided by Bloomberg

take some steam out of some overheated markets, like housing. However, it will not be so great as to create a financial system crisis or an implosion in real estate in general, just a slowdown.

This slowdown should or could be enough to help right the current supply/demand mismatch, which has helped stoke the CPI. If so, inflation will start to moderate from the recent lofty levels, even if it doesn't approach the Fed's desired 2% target any time soon. Frankly, the Fed's goal right now is to cool the economy off without crushing it like Paul Volcker did in the early 1980s.

Given the stock market's positive reaction to the Fed's projections after the March 16 meeting, early indications are investors believe Jerome Powell might just pull off a "soft economic landing" without inflation fully approaching the levels of the Carter administration.

So, in the end, money will be a little more expensive and crude oil should be a little less. This convergence should lead to a lower level of economic growth than 2021's feverish 5.5% pace. We have been telling clients to expect a more normal 2.75-3% rate, which should still be good enough to engender continued corporate profitability.

Oh yes, and remember that pesky little thing called COVID? It finally seems to be rolling over and shouldn't impact the economy significantly moving forward.

Let's keep our fingers crossed.

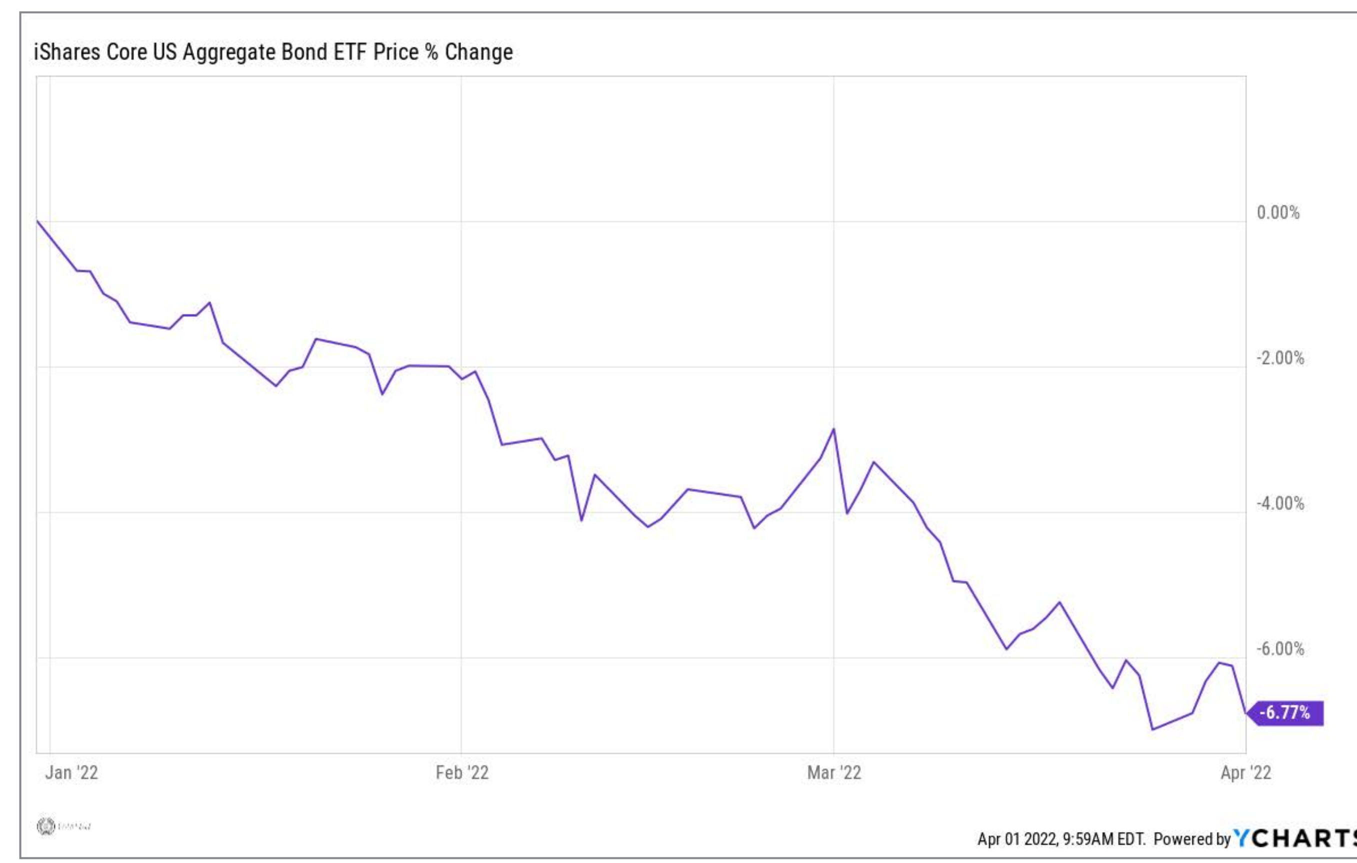
ASSET ALLOCATION

Sam Clement

The easy bet is usually the easy bet for a reason, and this time was no different. In the third quarter of last year, we wrote about rising rates. It was essentially all the pundits on CNBC could talk about. Easy bets are uncommon in the investment industry, and as we have come to learn, pundits like to be right. And they usually take the easiest path to get there. With rates previously at such low levels, inflation heating up for about a year now, and an extremely tight labor market, it was a no-brainer that rates would rise. We positioned ourselves accordingly. Different firms can look at rising rates and come up with different conclusions about how to allocate appropriately. However, some points are essentially fact: Bonds will not do well, and quality matters.

Bonds are essentially just math, and you can easily calculate returns for any fixed income instrument based on the path of interest rates. Without even needing to calculate it, everyone knows when rates rise, bond prices go down, and boy did they in the first quarter. The bond market represented by the ETF, AGG had a historically bad quarter. Looking at the chart below, one would think this is the stock market after the Russian invasion.

Again, bonds are just math. Since we were expecting interest rates to rise, we wanted to have as little of an asset that was mathematically going to perform poorly as our risk tolerances allowed. However, risk tolerance is there for a reason and bonds make up a portion of most people's risk tolerance. The goal is to have a risk tolerance we

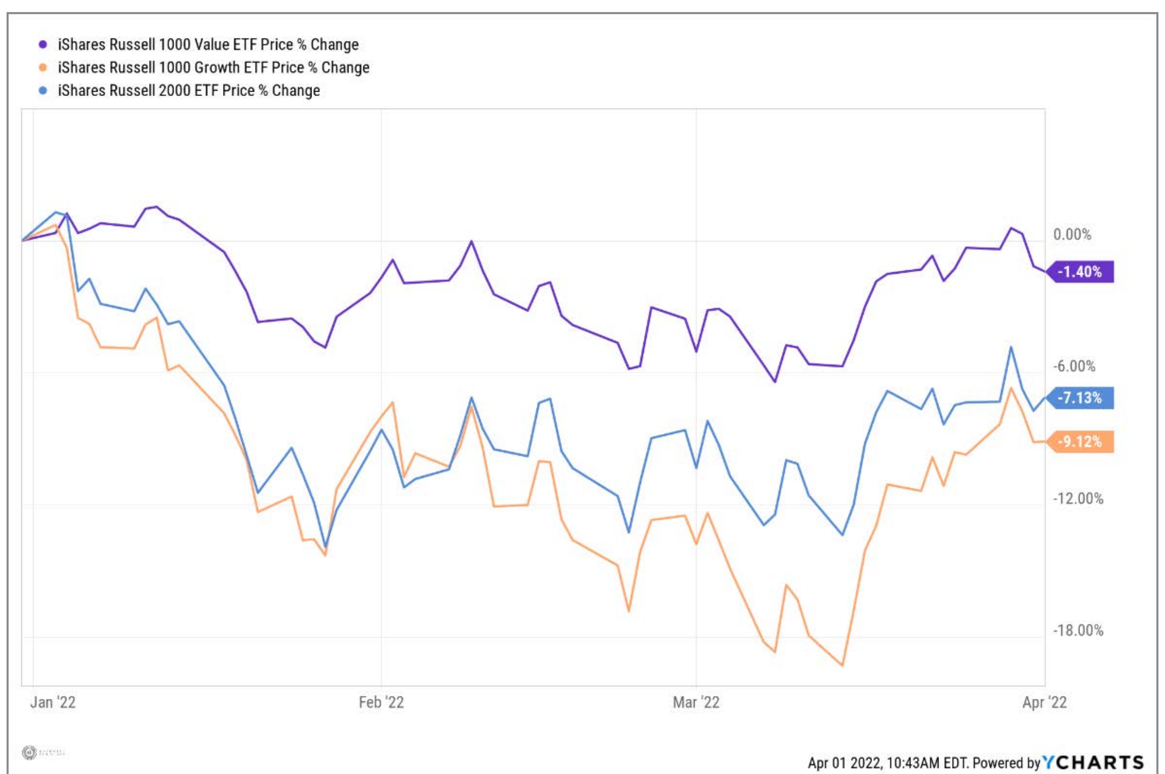


can stick with throughout our investing timeline. That said, our goal with fixed income investing then becomes making lemonade out of lemons. The asset class is going to do pretty poorly, but where can we outperform a little in the space? The key is understanding what is going on when we say rates are rising.

Longer term interest rates have been rising for the better part of a year, due in part to the reasons mentioned earlier. Inflation has been roaring and the economy remains robust. In addition, rates were at extremely low absolute levels. Inflation is most important, as in comes the Federal Reserve with its dual mandate. Maximum employment and stable prices. And clearly prices haven't been stable. Because of this the Federal Reserve is forced into hiking interest rates to help cool inflation. When we say the Fed is going to hike rates, we're talking about the short end of the curve. The Fed Funds rate is officially what they hike, but it has implications across the short end of the curve, and the only way to benefit from these short end rates moving higher is a debt product that benefits from higher interest rates. Floating rate debt. Pair this with intermediate term treasuries, and you have a bond portfolio that is not taking a ton of risk but can possibly turn those lemons into lemonade.

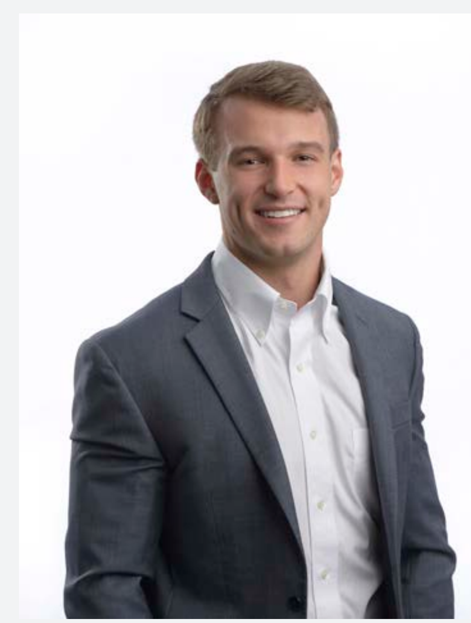
Quality still matters. Especially in a rising rate environment. For us, quality means a tilt toward large-cap and value. Historically, larger companies withstand a rising rate environment better than their smaller counterparts, and so far this has been true this go-round. Large companies typically have a stronger balance sheet, are able to withstand higher rates and are not as dependent on the yield curve for their sustainability.

Value stocks tend to do better for several reasons, some requiring more nerdiness to explain than others. First, higher interest rates typically slow the economy down, at least a little, and value stocks are typically those names with inelastic demand that consumers continue to demand independent of the strength of the economy. The nerdier reason is that higher rates mean higher stock discount rates, and higher discount rates mean a greater emphasis on those companies generating a profit now and not sometime in the future. Again, these are typically the companies that have well-established markets and strong inelastic demand, or value stocks. All these factors have culminated in the performance of these sectors so far this year, with large-cap value outperforming both growth and small-cap.



Finally, quality als can mean geographical quality. We view the United States stock market as the greatest quality stocks in the world. Often people talk about the discount that foreign stocks trade at relative to U.S. stocks, but all it takes is Russian aggression and sanctions or delisting of Chinese stocks to remind folks why they are "discounted." We remain very overweight to the U.S. stock market and underweight to foreign stocks, with one important caveat. We have essentially zero China exposure. This is us "going against the grain," as China is the largest emerging market economy. However, to us, the authoritarian anti-business regime in the Middle Kingdom is too much to overlook.

With the easy bets coming to fruition so far, the road ahead will likely be more difficult. We have long said that we are going to have to work harder for our return this year than last. Between continued rate hikes and geopolitical concerns, plenty of factors will impact the market. Our goal remains to be nimble, to take in new information freely and to be willing to change our thoughts as the outlook changes. We are in for an interesting year, but there is plenty to look forward to.



MEET

Sam Clement

Mr. Clement serves as a Portfolio Manager in Wealth Management for Oakworth Capital Bank. He joined Oakworth in March of 2018 and has previously served as an Investment Analyst. Mr. Clement co-hosts Oakworth's Trading Perspectives podcast. He graduated from Auburn University with an honors degree in Economics and is in the process of obtaining his CFA designation, currently a CFA level 2 candidate. He is active in the community through his involvement with Church of the Highlands.

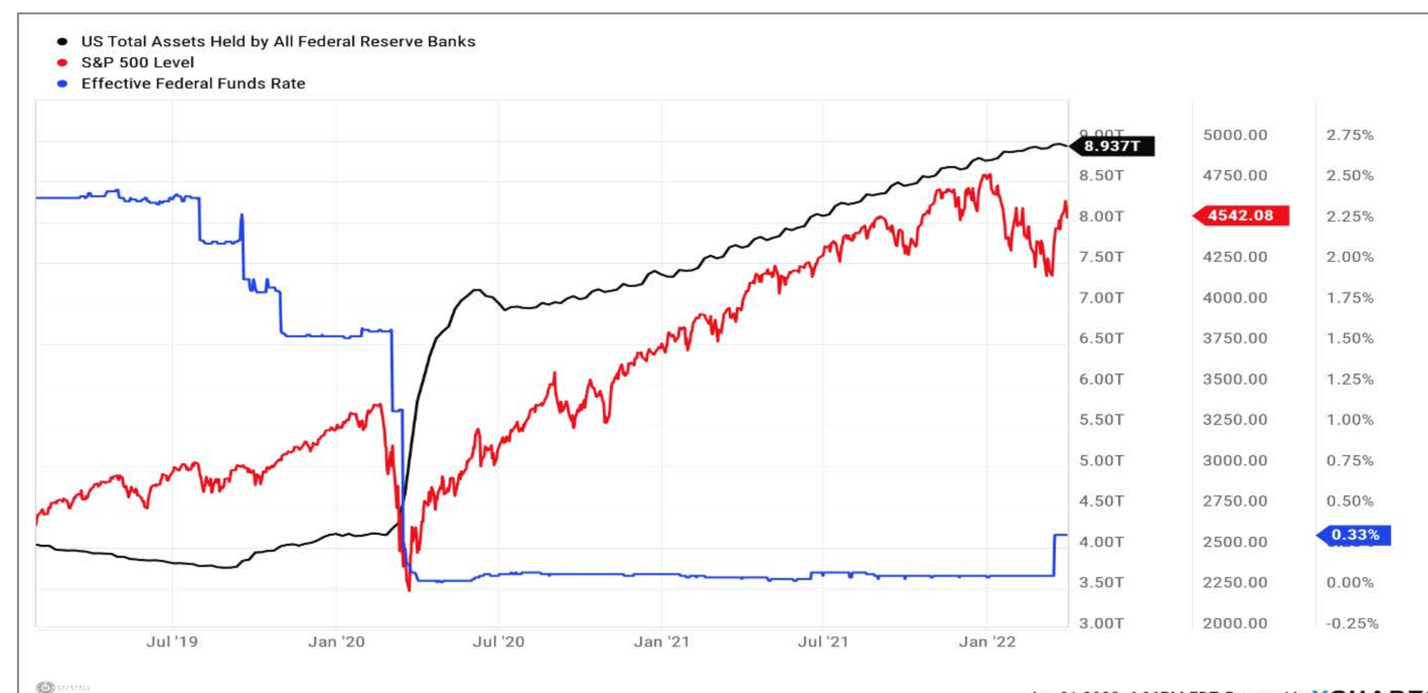
EQUITY

David McGrath

March 11, 2020, was the day COVID truly hit America. On that day, the World Health Organization declared the COVID outbreak a global pandemic, President Trump halted travel to Europe, the NBA suspended their season, and Tom Hanks announced he had COVID. The old saying is that the stock market hates uncertainty, and only two other days in the past 40 years could rival the amount of uncertainty we had at that moment. The terrorist attack on September 11, 2001, and the Lehman Brothers financial collapse on September 15, 2008 (the height of the Great Recession), were the other two. The S&P 500 had already declined 14.5% in the three weeks leading up to March 11, 2020, and then dropped another 22% the next eight trading days.

When the market bottomed on March 23, we still had very few answers on how the pandemic would play out. The amount of uncertainty was still enormous! We had no idea how long it would take for an effective vaccine to be developed, the best course of treatment for those who caught COVID, or even how to get the needed personal protective equipment to healthcare workers. But at that point the stock market did have something that was certain: a Federal Reserve that was going to take action. The Federal Funds Rate was dropped to near zero, and the forward guidance was that the Fed Funds rate would stay right there until the economy was through the worst of this pandemic. The Fed would also purchase bonds to keep interest rates low and support the economic recovery.

On November 30 of last year that certainty started to change. The 616 days from March 23, 2020, to November 30, 2021, saw the S&P 500 price increase 108%. Quite a bit of uncertainty remained over those 616 days, but the market knew it had the Federal Reserve on its side. The chart below shows the decisive action taken by the Fed, between the almost $5 trillion in bond purchases (black line) and the drop in the Federal Funds Rate (blue line) supported the price of the stock market. All of this to show how important the policies of the Federal Reserve played in the incredible equity returns of the past 20 months. This is the clarity that has been removed from equity markets this past quarter.



So, what happened on November 30 of last year? Just one week removed from being renominated for another term as chairman of the Federal Reserve by President Biden, Jerome Powell changed his outlook on inflation. At every opportunity in advance of his testimony before the Senate Banking Committee that day, Powell shrugged off the impact of inflation and continued to promote easy monetary policy, saying that inflation would be "transitory." Then we had the now famous J. Powell pivot. On November 30, 2021, he retired his use of the word transitory and said that the Federal Reserve would need to attack inflation. This translates to no more bond purchases by the Fed, and interest rates are headed higher.

That brief history set the backdrop for what happened during the first quarter of 2022 in equity markets. (Four paragraphs in, and we haven't mentioned Russia yet. Don't fret, it's on the way.) As we started the year, the markets tried to figure out how aggressive the Fed would be in raising interest rates. Much of the focus this past quarter has been on rising inflation. The longer we have elevated inflation, the more it drains cash from the consumer, and the more the Fed will have to raise interest rates to dampen demand.

The COVID surge from the latest Omicron variant also meant more roadblocks for the struggling global supply chain, which caused most of the inflationary problems to begin with. The first couple of inflation readings of 2022 were high, and thus the expectation for rate hikes also began to rise. For a few weeks it almost felt like an auction, with the larger investment firms raising the number of rate hikes expected this year. "I have eight rate hikes; do I hear nine?" Before you know it, the market went from expecting two to three rate hikes in 2022 to eight to nine hikes. That has a dramatic effect of equity prices, as we saw with the declining equity prices for most of the first quarter.

Then Russia invaded Ukraine (we told you it was coming). When Russia invaded Ukraine on February 20 (coupled with the economic sanctions against Russia that soon followed), commodity prices, especially oil prices, soared. It was this second leg of inflation that was not expected. How will the actions in Ukraine affect how the Fed attempts to tackle inflation? All of this uncertainty was too much, and by mid-March the S&P 500 was down 12.4% for the year.

Then came the Federal Open Market Committee (FOMC) meeting on March 12 and 13, and the stock market received some clarity on how the Fed would act. That, coupled with some optimistic news out of Ukraine that the war may not last much longer, allowed equity prices to move up the last two week of the first quarter. We quickly moved from a miserable quarter for equity returns to just a bad one. The S&P 500 finished the first quarter only down 4.6%.

Large-cap domestic stocks outperformed again in the first quarter, but it certainly looked at the beginning of the quarter that international stocks were poised to finally have a day in the sun. The Russian invasion of Ukraine swept the rug out from under the EAFE Index chance to outperform the S&P 500 for the first time in several years.

	1ST QUARTER RETURNS
S&P 500	-4.60%
Dow Jones Industrial Aver-age	-4.10%
NASDAQ Composite	-8.94%
EAFE International Index	-5.77%
S&P Mid Cap 400	-4.89%
S&P Small Cap 600	-5.64%

Only two of the 11 economic sectors showed a positive return for the quarter, and one was a true outlier. Driven by surging oil prices, the energy sector gave an astonishing 39% return for the quarter. Too bad the energy sector only accounts for 3.9% of the S&P 500. Utilities, arguably the most defensive sector, returned 4.8% for the quarter. Too bad both of these sectors account for around 6.5% of the S&P 500, so their strong performance had little effect on the return of the overall index.

As interest rates climbed, the sectors dominated by growth stocks struggled, including technology (-8.4%), communication services (-11.9%) and consumer discretion (-9.0%), in the first quarter.

ECONOMIC SECTOR	1Q RETURNS
Energy	39.0%
Utilities	4.8%
Consumer Staples	-1.0%
Financials	-1.5%
Industrials	-2.4%
Materials	-2.4%
Healthcare	-2.6%
Real Estate	-6.3%
Technology	-8.4%
Consumer Discretion	-9.0%
Communication Services	-11.9%

As we move into the second quarter, we will be looking for a bit more clarity on a few issues. First, we will move into earnings season staring in mid-April, and we'll see if 1) the high inflationary environment slowed consumer spending, and 2) how much of the higher prices corporations found during the first quarter were passed on to the consumer. This will be evident in the earnings and profit margins reported through earnings season.

We also hope for reasons more than financial, that there is a resolution between Russia and Ukraine. The quicker we have a resolution, the quicker the "extra layer" of inflation can be removed.

We will have two FOMC meetings in the second quarter, one the first week of May and another the middle of June. Will changes in monthly inflation reading, or developments with Russia and Ukraine, alter the course laid out by the Fed during its March meeting?

Finally, how will the new BA.2 COVID variant change the trajectory of the economy, if at all? And, nearly as important, will this outbreak continue to slow the improvements needed for the global supply chain to thrive. A healthy global supply chain helps bring down very elevated inflation numbers. As we mentioned in the beginning, the stock market hates uncertainty. The more clarity we get from earnings season, geopolitical events, inflation and COVID, the higher the potential returns are for equity markets. The other side of that coin is that less clarity from those issues will equal more volatility, and a lower ceiling, for equity markets.

BONDS

John Norris

At the end of last year, we had this to say about fixed income: "The best thing to say about the fixed income markets in 2021 is, it could have and should have been worse than it was, much worse." That came during the first quarter of 2022, which was one of the worst quarters for the bond markets in recent memory. There wasn't any place to hide from the carnage.

The reason is pretty simple: when interest rates didn't keep up with surging inflation, something would eventually have to give. Either rates would have to go up, inflation would have to come down, or they would have to meet in the middle. The former made the first move, and bonds got crushed. Even so, the spread between long-term U.S. Treasury yields and inflation remains very wide, suggesting we probably haven't seen the end of this mess yet.

Consider the following chart from last quarter's piece. It shows the disparity between the yield on the U.S. 10-year Treasury note and the official Consumer Price Index over time. While there has been an ever-so-slight improvement since year-end, the spread between the two remains near all-time highs.

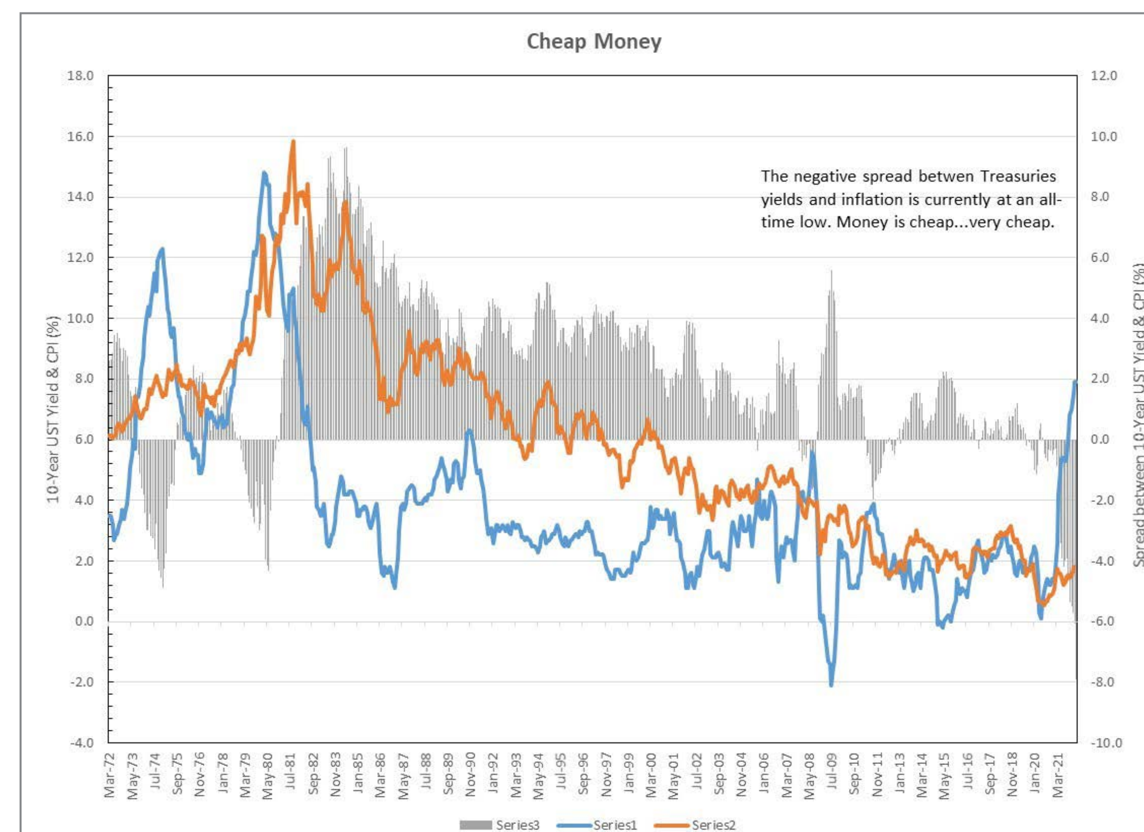
As a result, you could sensibly argue the correlation between long-term rates and inflation continues to appear somewhat broken. Further, you can tell what eventually happened to interest rates in the past when inflation was persistently elevated: they went up in a meaningful way. This was especially true following the last years of the Carter administration, when Fed Chairman Paul Volcker eventually decided "enough is enough" and crushed inflation with higher interest rates.

Since then, the U.S. has generally been in a declining interest rate environment. This has fostered debt accumulation on a massive scale, and arguably led to the globalization of the economy.

So, the big question in "bond land" is, "Will the previously dovish Jay Powell Federal Reserve reverse course and become hawkish?" Put another way, will the inflation that the Fed has helped make eventually get so bad it will have to kill it with Draconian methods? That is what inquiring minds wanted to know during the quarter. It wasn't whether or not the Fed was finally, finally, going to raise the overnight rate. No. It was by how much and how quickly.

On March 16, the Fed gave the markets the answer. It was going to get on with the process of raising interest rates, but it was NOT going to be the sledgehammer many had feared it would be, a la Volcker. The following table is something called the FOMC Dot Plot Chart, which shows the number of FOMC members who believe the target Fed Funds rate will be a certain level at the end of the stated year.

As crazy as it may seem, this actually brought a collective sigh of relief from the stock market. Whew. Okay, money is going to be a little more expensive, but not THAT much more. Shoot, rates were still going to be significantly less than inflation, making it essentially free in relative terms. However, bond investors took one look at the data and came to a simple conclusion: rates were going up, and that meant bond prices were going to go down.



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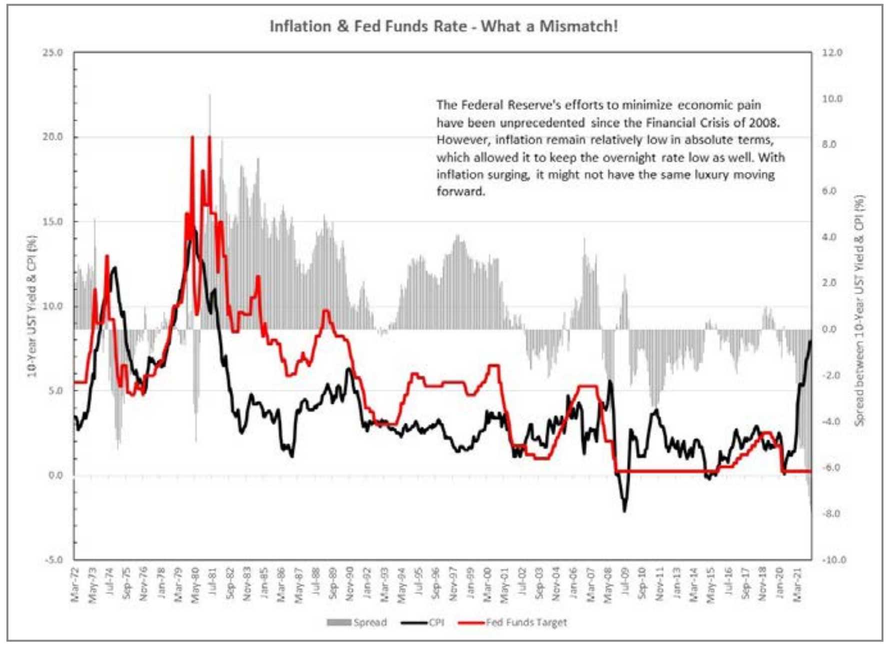


Data points provided by Bloomberg

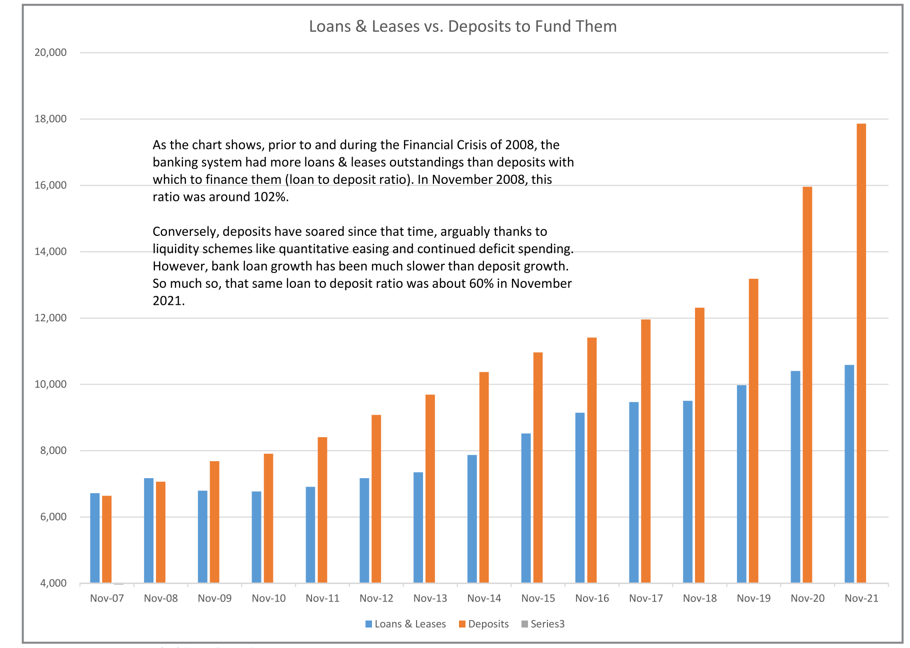
So, between inflation readings, which no longer seem "transitory," and a Federal Reserve signaling up to an additional 150 basis point increase in the overnight rate by December 31, 2022, an already bad quarter for the bond market got even worse. As the table at the end of this section shows, there was no room to hide in the fixed income markets. It was ugly.

In a lot of ways, you could say the fixed income markets got the negative year they should have had last year. But what will happen moving forward? That is the $64,000 question.

At first blush, high inflation numbers and a more aggressive Fed could, would, or should spell trouble with a capital T for bonds. However, since the correlation between inflation and interest rates seems to currently be broken, there is no guarantee long-term rates will behave logically. In fact, you might even argue since the demand for money has been so much less than inflation for so long, why would it suddenly pick up now that the Fed is attempting to make it more expensive? Further, with so much cash sloshing around on their balance sheets, why would banks be willing to pay much more for deposits they already don't need? The quick answer is they won't.

Target	2022	2023	2024	Longer Term
1.250				
1.375	1.00			
1.500				
1.625	3.00			
1.750				
1.875	5.00			
2.000				1.00
2.125	2.00	1.00	2.00	
2.250			1.00	6.00
2.375	3.00	4.00	3.00	1.00
2.500				5.00
2.625	1.00	3.00	2.00	
2.750				
2.875		3.00	3.00	
3.000				2.00
3.125	1.00	2.00	1.00	
3.250				
3.375		1.00	2.00	
3.500				
3.625		2.00	2.00	
3.750				
Median Estimate	**1.875**	**2.750**	**2.750**	**2.375**

This leaves the fixed income markets in an extremely weird place where the Fed is trying to tackle inflation by making money more expensive even though banks can't lend out what they have at the cheaper levels. So, how do longer term interest rates respond? After all, if there is excess cash sloshing around on bank balance sheets, how does making it more expensive for borrowers get it out into the economy? Certainly, that won't increase loan demand, which would mean even more cash in the system.



Data points provided by Bloomberg

At some point, the Fed will HAVE to absorb all of this excess cash by reducing its balance sheet. This will require it to sell trillions of dollars in debt securities bank into the secondary markets. Obviously, this could have the potential to swamp the market's demand for the instruments, which means prices would have to go down. That means, that's right, interest rates would have to go up.

If it seems the Fed might have boxed itself into a corner this go-round, it has. This makes it extremely easy to be bear on bonds, which is the position our Investment Committee has had for the past several years. Obviously, this has helped relative performance, even in the first quarter of 2022, when the stock market was giving everyone fits.

The table below shows how some primary fixed income sectors performed during the previous, using appropriate Exchange Traded Funds as proxies:

Given everything that happened last year, 2021 could have been a lot worse for bonds than it was. However, after looking at that table, more than a few fixed income investors would love a repeat of last year in 2022.

Unfortunately, after the first quarter's horrible results and the current state of the markets, that doesn't seem likely.

TICKER	SECTOR	3Q PRICE RETURN	3Q TOTAL RETURN
AGG	Broad US Market	(6.12)	(5.85)
GOVT	US Treasury Debt	(6.63)	(6.47)
LQD	Corporate Debt	(8.74)	(8.38)
VTEB	Municipal Debt	(6.12)	(5.85)
MBB	Mortgage Debt	(5.18)	(4.90)
HYG	High Yield	(5.42)	(4.73)

THE BEST TRADES OF 1ST QUARTER

Sam Harris

Oakworth Capital traded a lot over the course of the past 24 months. A global pandemic and subsequent lockdown(s) will certainly throw a wrench into things. Tack on red-hot inflation, a sovereign nation invading another sovereign nation and a hawkish central bank insistent on raising interest rates, and you're left with no shortfall of cocktail conversations – only if you're into those kinds of things.

Our Investment Committee's ability to remain nimble in times of uncertainty has undoubtedly proved both imperative and successful. Ultimately, we feel as though this has allowed our clients to reap the benefit of outsized returns by historical standards over the course of the past three years. And then 2022 started.

The S&P 500 fell 5.25% in January as investors shifted their portfolios to more closely align with a Federal Reserve intent on raising interest rates in an attempt to eat away at pesky inflationary pressures. While not necessarily rare, rate hikes generally lead to market shifts and particular asset class out/under performance. While history never dictates future results, it typically is a pretty good directional indicator. So, investors in January took a step back, reevaluated, reassessed and, most importantly, rebalanced. So we did too.

Both mid- and small-cap stocks boomed in the first half of 2021 – money was too easy. For companies such as those within the SMID complex that rely so heavily on financing in order to meet cash flow needs, this was a huge tailwind. As inflation persisted into 2022, however, these smaller capitalization equities slowly began to see their gains lessen as the Federal Reserve telegraphed tighter monetary conditions. Due to their reliance on financing in the midst of a rising rate environment, we deemed it appropriate to reduce our small-cap exposure. This was accomplished through a 50% reduction in our iShares Russell 2000 Exchange Traded Fund, IWM.

We invested the proceeds into the iShares Russell 1000 Value Exchange-Traded Fund, IWD. The rising rate environment remains essentially a nonevent for many companies with "fixed-costs" – most of which fall into the value sector. For the most part, company balance sheets remain the healthiest they have ever been, and this is the driving theory behind the allocation shift. We felt as though adding an "overweight" to the Russell 1000 Value relative to the Russell 1000 Growth was (and is) a fantastic long-term call over the course of the next several quarters, potentially even years. The portfolio still remains in overweight growth, in its entirety, but recent additions to value allow for an anchor in times of greater market volatility.

As the quarter progressed, and as the Federal Reserve continued to telegraph a clearer stance around inflation, we continued to see signs of more persistent inflation, especially after January's CPI reading released in mid-February. Our thoughts remain mostly the same: The current run-up in inflation is driven by a host of factors currently omnipresent in

the market, and supply chain woes remain the most obvious culprit. The Federal Reserve must do something to get back in line with the target rate for inflation of 2%. In short, smaller companies should feel the brunt of these more hawkish pivots from the central bank at a greater magnitude relative to larger cap firms due to their reliance on financing. So we exited Small Cap (IWM) entirely.

The proceeds of this we put to a new position – Vanguard FTSE Developed Markets Exchange-Traded Fund, VEA. This gave the portfolio exposure to the Developed FTSE Index, ultimately encompassing those key European nations – such as France, Italy, Germany and the United Kingdom. While the U.S. has outperformed international on an aggregate basis for many years, with no indication for immediate change, the prospect for global growth remains robust, and that excites our Investment Committee. We first exited Developed International in March 2020, prior to the market's lows. Since then we have added the iShares Emerging Markets ex-China Exchange-Traded Fund, EMXC, and now the Vanguard FTSE Developed Markets Exchange-Traded Fund. Currently, the less-than-10% total allocation to international

remains a far cry from both the comparative Market Index Benchmark and Oakworth's respective Peer Group, though these positions are viewed as long-term allocation shifts that will almost certainly be added to in the coming months.

Consistent with past trades – as the more things change, the more things stay the same – we remain extremely nimble and fluid in identifying opportunities within the market should conditions allow. As such, the slide in large-cap, blue-chip names during the first quarter allowed for inappropriate market knee-jerk reactions and unwarranted price punishments. After watching Meta Platforms (Facebook) take it on the chin after reporting nothing of great concern in their earnings report, we saw one of these such opportunities and pounced. The company was beaten to a point of trading at a cheaper valuation than that of Philip Morris – a company unlikely to be in existence a half century from now. Meta Platform's ability to simply churn cash, operating as one of Silicon Valley's cash cows, caught the eyes of the Investment Committee – particularly at the price point entered, $235.22.

To fund this purchase, we elected to take a winner off of the table and cut the Qualcomm allocation in half. Qualcomm still has a place in the portfolio, as the company has identified itself as a legitimate chipmaker giant, though we felt as though most of the company's tailwinds had already been priced in, and that there may be opportunity for a greater return elsewhere. Qualcomm was initially purchased at $143.94, and we sold half of the position at $179.91.

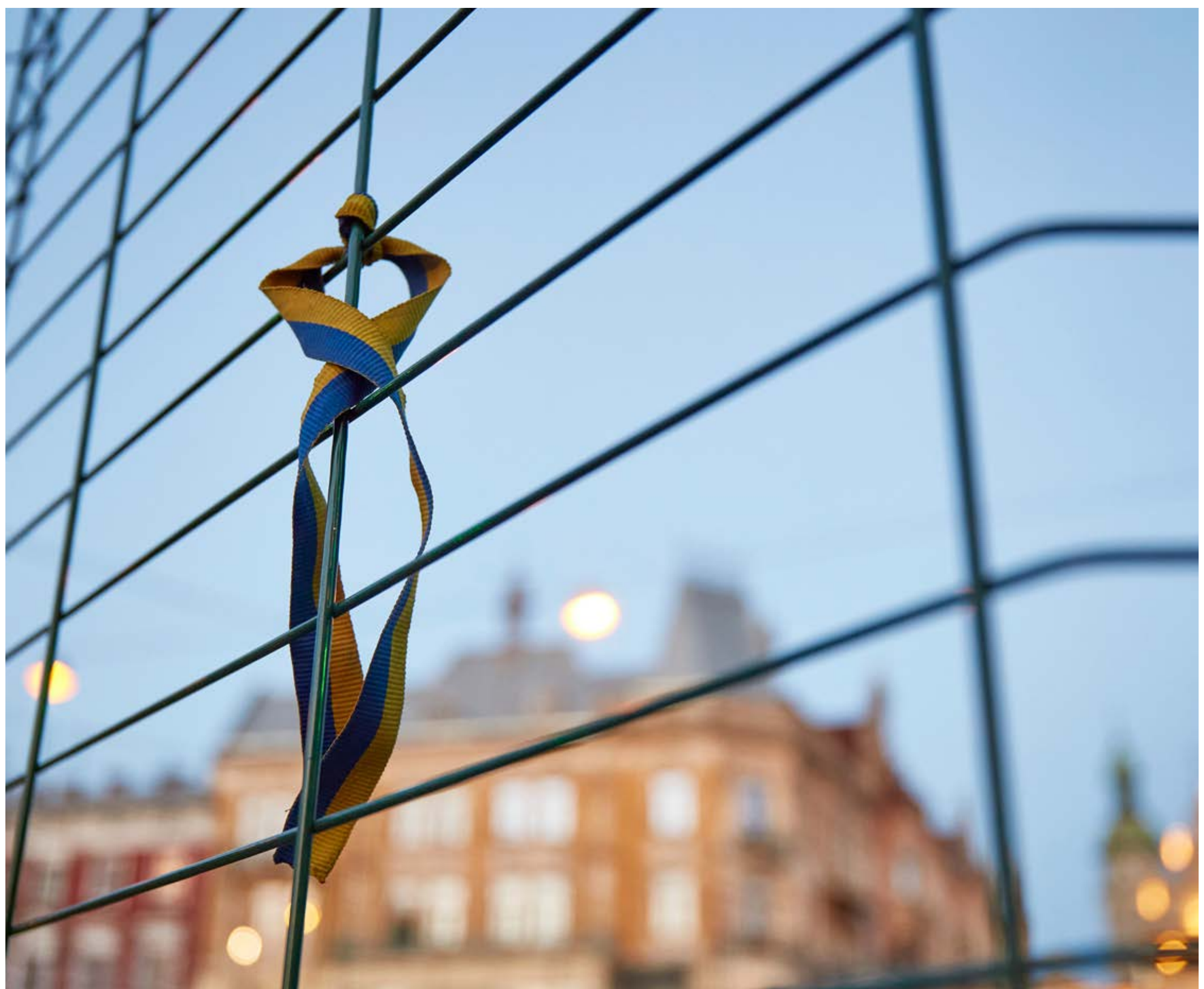
We remain in favor of equities and still view them as the most reasonably valued of all overvalued current asset classes. With that said, though, the current rising rate backdrop allows for some unique mitigation methods as far as conservation of principal in the fixed income space. As bond yields rise, bond prices decline – this is nothing more than a math equation. In March, ahead of the Federal Reserve's first rate decision for the year, our Investment Committee collectively decided in unanimity to "barbell" our fixed income allocation inside of the portfolio. The Fed's decision to raise rates sent the shorter end of the curve on a tangent, as evident by the 2-year's incredible spike in just the back half of the month. Ahead of this movement, we reduced our short-term corporate allocation in half – splitting the proceeds between an Ultrashort Floating Rate Mutual Fund, FULIX, and shifting more to the middle (or intermediate) segment of the curve, opening a position in IEF, iShares Intermediate Term Treasury Exchange-Traded Fund. The new position in the Ultrashort Floating Rate Fund, FULIX, allows the portfolio to capture shorter-end yield curve steepening while minimizing the effects of principal erosion.

If the first quarter should serve as any indication, 2022 is poised to be another wild ride. We, the Investment Committee, view current market conditions as still favorable – despite all of the "bad" news out there. Cash is still cheap by historical standards, and it remains ubiquitous throughout company financial statements. The consumer is free – and unrestrained – to purchase some of that 2019 normalcy. Employment is tight, with labor conditions at levels not seen since the late 1960s. The trades and portfolio shifts completed in first quarter 2022 should only align our clients for the best opportunity to capture competitive market returns while not assuming an unnecessary level of risk. The easy money has been made – let's look forward to the final three quarters.

2nd Quarter 2022

A FIRST LOOK

The turmoil in Ukraine will eventually dwindle, as both sides get tired of the fighting. Russia won't get all of its aims; however, the West will have learned Bismarck's secret to politics: "make a good treaty with Russia."



- The Federal Reserve will raise the overnight lending target rate at both the May 4 and June 15 FOMC meetings.
- What banks pay their depositors will barely budge due to the enormous amount of cash on their balance sheets. This will create an increasingly weird interest rate environment where banks' cost of funds is potentially a fraction of the official overnight rate.
- International investments will continue to lag domestic ones, as the U.S. dollar remains the most attractive foreign currency alternative.
- Despite all the turmoil in the world and the prospect for more expensive money, corporate America will still be able to increase profits this year.
- Slightly higher mortgage rates will take a little steam out of the housing market, but it won't be enough to crash it across the country. As a result, home prices will start to cool and construction materials will come down in price.
- U.S. stocks will continue to be the most reasonably valued of all overvalued asset classes. However, less cyclical economic sectors will become increasingly more attractive by the end of the year.
- As a result of potentially more expensive money this year, investors will turn their attention to less volatile dividend paying stocks.
- Inflation will start to top out at some point during the summer, as consumer spending cools slightly and more hourly workers get back on the job. However, it proves to be well above the Fed's desired 2% or thereabouts.
- The turmoil in Ukraine will eventually dwindle, as both sides get tired of the fighting. Russia won't get all of its aims; however, the West will have learned Bismarck's secret to politics: "make a good treaty with Russia."
- Although the first quarter of 2022 made a persuasive argument about the need for U.S. energy independence, Washington won't be able to cobble together a coherent and realistic energy policy.
- Moving forward, COVID-19 should become less of a global economic issue. As a result, business and international travel will get back to some sense of normalcy.
- While more of a longer term trend, the structure of Commonwealth realms will come under increased attack as more countries decide to become republics and remove the monarch of the United Kingdom as their head of state.

JOHN B. NORRIS, V

Managing Director & Chief Economist

Investments & Thought Leadership

Contact:

Office: (205) 263-4716

Mobile: (205) 910-1219

Email: john.norris@oakworth.com

Mr. Norris oversees Investments and Thought Leadership for Oakworth Capital Bank. Prior to helping to start Oakworth, Mr. Norris was also Chief Economist, Chairman of the Investment Strategy Committee, and a Senior Fund Manager for Regions Financial Corporation's Morgan Asset Management (MAM) subsidiary. Before joining Regions, he served as the Chief Investment Officer for The Trust Company of Sterne, Agee & Leach, Inc. and started his professional career with Mercantile-Safe Deposit & Trust Company in Baltimore, Maryland, as an Institutional Fixed Income Portfolio Manager.

As part of his role at Oakworth, Mr. Norris hosts a podcast, writes a weekly blog, and speaks publicly on the economy and the markets to a wide variety of audiences. Outside of Oakworth, he currently serves on the Board of Directors for the IPC Foundation, serving as the finance chair, and was recently appointed to Board of Directors of the Alabama Trust Fund by Governor Ivey. Mr. Norris also serves on the advisory board for Gabriella White LLC (Summer Classics), as well as the advisory board for the economics/finance department at Samford's Brock School of Business. Finally, he is a member of the Birmingham Rotary Club. He received his Bachelor of Arts from Wake Forest University and his Master of Business Administration from the University of Baltimore.

Central Alabama Office

850 Shades Creek Parkway
Birmingham, Alabama 35209
Phone: (205) 263-4700

South Alabama Office

1 St. Louis Street, Suite 3200
Mobile, Alabama 36602
Phone: (251) 375-7800

Middle Tennessee Office

5511 Virginia Way, Suite 110
Brentwood, TN 37027
Phone: (615) 760-1000

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