

ECONOMIC OUTLOOK

Summary

Recently, market participants have been fixated on every syllable uttered by Federal Reserve officials, looking for any clues that might hint at how aggressive the Fed may be with rate hikes this year and into the future. However, Russia's invasion of Ukraine understandably resigned the Federal Reserve to second fiddle on the financial news cycle for the first time in months. There are severe human impacts of war and there are resulting economic ramifications for the global economy.

For example, war is traditionally inflationary, and we are starting from a point of already high inflation due to the pandemic. Consider that Russia and Ukraine's exports account for roughly 25% of wheat, 20% of palladium, 15% of corn, 13% of platinum, 10% of petroleum and 8% of aluminum for the global economy. The sanctions being put into place against Russia, as well as the inability for Ukraine to produce while defending itself, will almost certainly cause an increase in prices for these items as the supply decreases.

Fortunately, the United States is fairly insulated from direct trade with Russia. In 2021, we imported roughly \$30 billion of goods and services (primarily petroleum) and exported roughly \$10bn billion, making Russia our 20th largest trading partner. However, when considering the \$2.3 trillion in total trade with our top 5 trade partners alone, it hardly seems consequential. Additionally, imports of Russian crude and petroleum products account for only 3% of aggregate U.S. oil demand.

However, 40% of Europe's liquid natural gas comes directly from Russia, as well as 25% of its oil. Additionally, higher energy prices, which act like a tax on individuals, materially increase the odds of a European recession. Germany, for example, already had negative growth in the fourth quarter of 2021, and these new developments increase the odds of back-to-back quarters of declining growth.

The overall impact on the U.S. should be less considerable but we also just recorded the lowest savings rate since 2013, decreasing by 1.8% in January. This suggests people are already struggling to keep up with inflation and they are spending money from savings as they no longer have stimulus on which to rely. The situation in Eastern Europe is obviously fluid; we can only hope it is resolved with minimal loss of life and minimal inflationary impact.

Positives

Retail sales rebounded in January up 3.8%
(vs 2.0% expectations)

Retail inventories continue to rebuild growing 1.9% for the month

Continuing unemployment claims hit a post-pandemic low (1.476m)

Negatives

CPI came in higher than expectations for the 5th straight month (0.6% vs 0.4%)

Univ. of Michigan and Conference Board consumer confidence surveys continues to decline

Home sales slumped (pending sales -5.7% vs 0.2% – New homes -4.5% vs -1.0%)

EQUITY OUTLOOK

Summary

Entering February, the equity markets were already concerned about Covid, inflation and the Federal Reserve response to inflation and Russia's intentions in Ukraine. Russia's full scale invasion has sent a clear signal that drove global markets lower. The S&P 500 finished the month down 3.0% with growth stocks once again trailing their value counterparts.

Seemingly overnight, Covid has largely left the scene as far as its impact on financial markets. Inflation fears have risen further given the increase in the crude oil price, partly triggered by the crisis in Ukraine and corresponding sanctions imposed on Russia. Those pressures are almost certain to be limited as gasoline prices are unlikely to continue to appreciate at the rate seen in the previous 18 months.

The stock market's focus has squarely shifted to the crisis in Ukraine. The humanitarian toll is tragic and it is important for investors to weigh the potential impact on capital markets. If the conflict remains contained to Ukraine, the current market correction may be fully reflecting that outcome. Neither Russia nor Ukraine are major contributors to international trade, aside from Russia's obvious impact on the fossil fuels industry. So long as Western powers don't get drawn into a more significant role in this conflict, global markets should eventually stabilize and present a buying opportunity for equity investors. If matters escalate to the contrary, it becomes quite difficult to assign probabilities around those potential scenarios and the resulting

market reaction. So the near-term stock market outlook is unfortunately in the hands of an increasingly isolated and unpredictable autocrat.

Positives

Equity fundamentals

Oversold conditions in many individual stocks

Covid appears to be transitioning to an endemic

Negatives

Ukraine invasion

Inflation remains elevated

Supply chain and labor shortages

Unkowns

Federal Reserve's strategy evolving

FIXED INCOME OUTLOOK

Summary

Just when we thought there was a clear path for a full economic reopening and recovery from the pandemic, Russia's invasion of Ukraine has created a heightened level of anxiety and vast uncertainty in the outlook for the economy, inflation and Fed policy. While troops and supplies had been amassing for months, prior to the actions on February 24, the markets mostly ignored the threats with their focus on inflation, rate hikes and Fed balance sheet reductions.

As they did in January, interest rates rose across the curve during the first part of February. The 2-year Treasury note increased from 1.18% at the end of January to 1.60% as the market responded to various Fed officials call for a 50 basis point (bps) hike in March followed by another 50 bps before mid-year. At one point the futures market for Fed Funds was priced to reflect more than an 80% probability this would happen and the overnight rate would be 1.75% by the year's end. Less subject to the overnight rate, the 10-year Treasury note increased from 1.78% to 2.05% by mid-month. Yields eased back after the invasion as did the expectations for Fed rate increases. The 2-year ended the month at 1.43% while the 10-year dropped back to 1.83%. The yield spread between the two Treasury notes dropped to 40 bps from 60 bps at the end of January and nearly 80 bps at the beginning of the year. A flatter curve is usually cause for concern as it often signals that slower economic growth is on the horizon.

Going forward it is difficult to assess the outlook for the economy, inflation and the demand for fixed income securities as the range of the conflict's outcome vary widely. Acknowledging this uncertainty, we are confident it will cause inflation to increase and the economy to slow which will place the Fed in even more of a quandary. As for now, they remain committed to beginning the process of rate normalization by increasing the overnight rate at this month's meeting of the Federal Open Market Committee (FOMC). The chance for a

50 bps hike seems off the table this time as Chairman Powell emphasized they should proceed cautiously, but he then mentioned it could still be appropriate at some point later in the rate hiking cycle. They also appear to be on track to begin run-off of their \$9 trillion balance sheet.

We are not as optimistic as the market that they will be able to increase the Fed Funds rate by six times this year. We also believe the capital markets may be underestimating the fallout of Russia's invasion. There will be economic consequences not only for those countries directly impacted militarily, but also for those who chose not to condemn those actions. This could create a sharp divide among large global trading partners. Treasury note yields were correct to remove some Fed policy action and are reasonably priced in the short end of the yield curve. We are no longer confident the 10-year Treasury yield can move up to 2.25% in the near term even with persistent inflationary pressures.

Positives

Demand for safety as military actions escalate

Short maturity yields already reflect Fed rate policy

Negatives

Inflationary pressures no longer as likely to ease quickly

Unknowns

Resolution of Russia's invasion

Foreign demand for U.S. debt