

## Economic Summary – Q1 2022

The first quarter of 2022 showed (yet again) just how quickly the economy can turn. Fourth quarter GDP rose by an annualized +6.9%, making 2021 *the strongest full year of economic growth since 1984*. However, as the new year began, the Omicron variant was spreading rapidly, forcing schools and businesses to operate in limited capacity as millions of Americans fell ill to the virus. This wave, which was both more contagious and less deadly, peaked in mid-January with a 7-day moving average of more than 800,000 cases, more than triple the previous high point in January 2021. Fortunately, the descent was as steep as the climb, and a month later new cases had fallen by roughly -84%.

Any positive impact associated with the fading virus was lost just weeks later when Russia launched an invasion of neighboring Ukraine. In retrospect, the number of Russian troops and weaponry massing on the border should have been a dead giveaway, but it was easier to assume Putin was angling for a better negotiating position. The attack, when it finally happened, was a surprise. Similar to the gradual creep of COVID-19 before it suddenly exploded on the global radar, the war in Ukraine has quickly dominated headlines.

Global sanctions were swift and crippling to the Russian economy, which has likely entered a severe recession already. The United States banned the import of Russian oil, natural gas, and coal in early March, but so far other western nations have been reluctant to fully join the energy ban. Russian supplies 25% of Europe's crude oil, 50% of its diesel fuel and 45% its natural gas, which makes the decision extremely challenging.

Europe did announce it would reduce Russian gas imports by two-thirds in 2022 and will phase out oil and gas imports within five years. The United Kingdom plans to eliminate Russian oil imports by the end of this year, while Germany announced it would halt the 750-mile Nord Stream 2 natural gas pipeline between Russia and Germany.

On the flip side, oil and gas accounted for nearly half of Russia's exports in 2021. The world needs Russian energy, and Russia needs receptive markets. About 20% of Russian oil goes to China, although this is a longer and more expensive path to market. China has been reluctant to condemn Russian aggression, but individuals and companies around the globe have embarked on what CNN Money describes as a "de facto embargo," terminating business relationships and distancing themselves from any sign of support as the humanitarian crisis worsens.

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Adding to the crisis is a global food emergency, further compounded by an estimated 4 million Ukrainian refugees fleeing the war-torn country. Russia and Ukraine supply the world with close to 30% of its wheat supply, around 20% of its corn, and about 80% its sunflower oil, while Russia is the leading global exporter of fertilizer. The United Nations warned in early March that global food prices (which are already at record highs) could increase by an additional 22%.

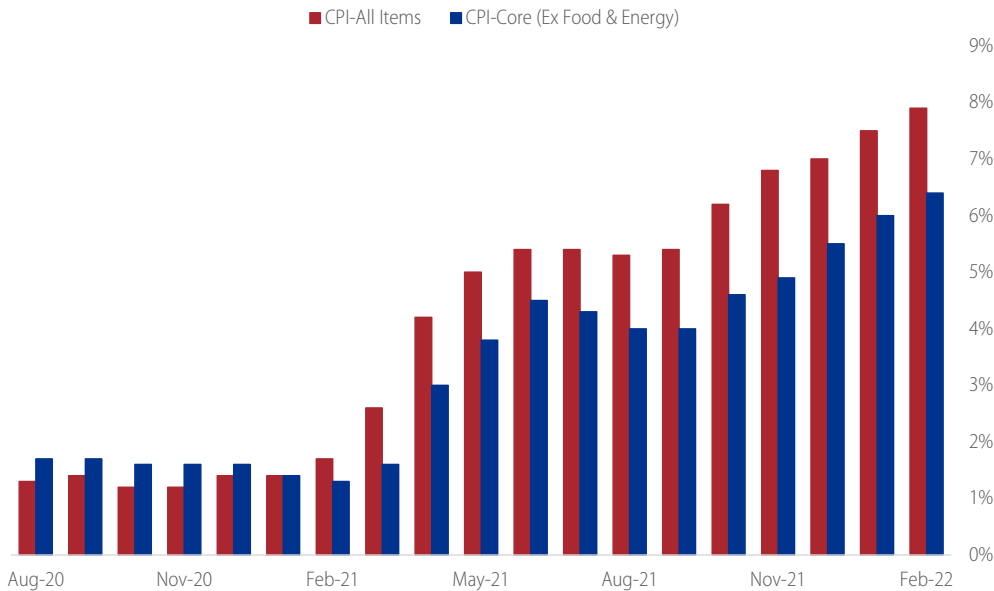
As if global shortages of food and energy and existing supply chain disruptions weren't bad enough, two Ukrainian companies, producing half of the world's semi-conductor grade neon, have now halted operations; and the supply of high-grade nickel (used in lithium batteries) is threatened as Russia is a leading global producer.

All of this will almost certainly push inflation higher in the coming months. The consumer price index (CPI) rose +7.9% on an annual basis in February to yet another four-decade high. With the price of WTI crude up 20% month-over-month, headline CPI should be even higher in March. Core CPI, which excludes food and energy prices and shows just how pervasive inflation can be, was up +6.4% year-over-year in February, also a 40-year high.

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## Consumer Price Index (Year-over-Year Percent Change)



Source: Bureau of Labor Statistics

Fed officials, tasked with dual mandates of maximizing employment while achieving stable prices, acknowledged they'd met their employment mandate months ago. The labor market is still disjointed, but there's little question the jobs have returned. In fact, the most recent Job Openings and Labor Turnover Survey (JOLTS) counted more than 11 million job openings, while the March employment report showed less than six million unemployed workers, meaning there are now approximately 1.8 jobs available for every American who has looked for work over the past month. Compare this to 2010, when there was one job opening for every six job seekers.

## Job Opening and Labor Turnover Survey (JOLTS)



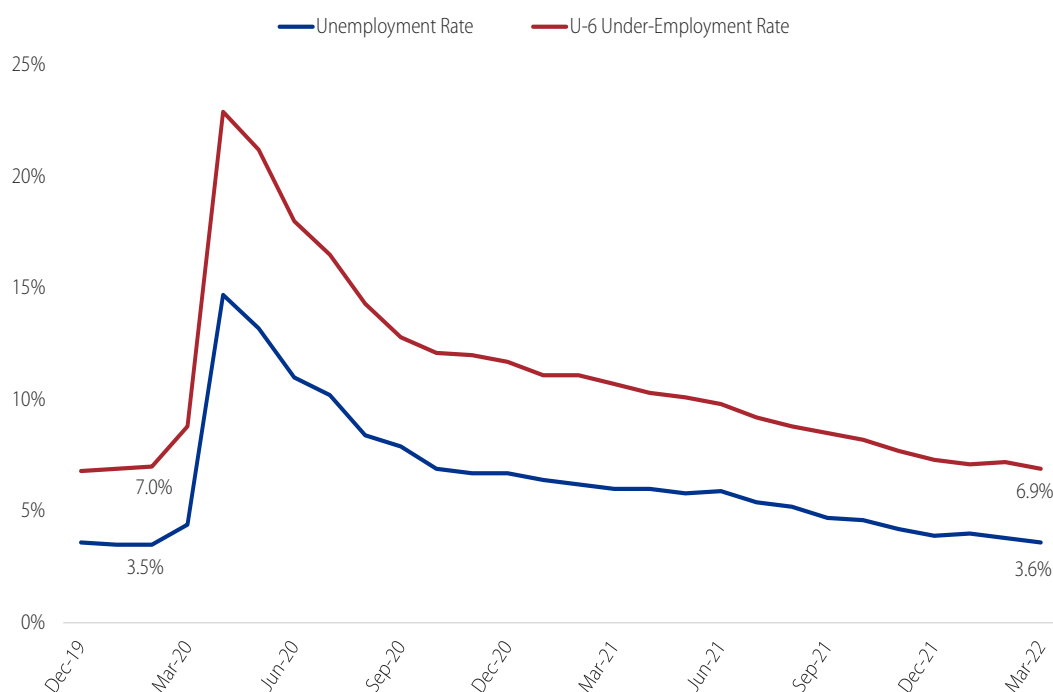
Source: Bureau of Labor Statistics

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The headline unemployment rate, which in all fairness *only* includes people actively looking for work, was 3.6% in March, now just a fraction above the 52-year low. The broader U6 measure, which includes people not actively looking for work but who would accept a suitable job if offered, was 6.9%, now a fraction below the pre-pandemic level. A low rate of unemployment puts pressure on wages which feeds into general inflation. So, with plenty of jobs available, the Fed has turned its full attention to combating price pressures. Since fixing supply chain issues related to the war in Ukraine are beyond the Fed's control, the policy-making FOMC will raise interest rates intending to *weaken domestic demand for goods and services*. In the process, they will likely destroy some of those job openings.

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## Unemployment Rate



Source: Bureau of Labor Statistics

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At the December Fed meeting, with inflation making headlines but widely expected to settle down by summer, the FOMC's "dot plot" had indicated four hikes were likely in 2022. As the March meeting approached and inflation expectations climbed, several Fed officials voiced support for more aggressive tightening. This idea took root amongst FOMC members as the quarter progressed, and treasury yields climbed progressively higher.

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At the March meeting, not only did the committee increase the overnight target for the first time since 2018, but it also adjusted its dot plot to show quarter point increases at each of the six remaining meetings in 2022. In the weeks that followed the meeting, committee members indicated a willingness to hike in larger increments. In anticipation, the bond market priced-in nine rate hikes over the next 11 months. When the first quarter ended, the Bloomberg U.S. Treasury Total Return Index had shed -5.6% of its value, marking the worst quarterly performance since record-keeping began in 1973.

Most of the damage during the quarter was done on the short end of the curve with the two-year Treasury note yield more than tripling from 0.73% to 2.33%, while the 10-year Treasury note yield increased from 1.51% to 2.34%. On April 1st, the 2-year yield climbed above the 10-year yield. Curve inversion has historically (although not always) preceded recession. Obviously, Fed officials hope their planned tightening doesn't wreck the economy, but in this case the inflation battle will take precedence.

## Q1 Interest Rates

		Fed Funds	3 mo. T-bill	12 mo. T-bill	2 yr. T-note	5 yr. T-note	10 yr. T-note
<b>Last</b>	12/31/21	0.00%-0.25%	0.03%	0.38%	0.73%	1.26%	1.51%
<b>High</b>			0.53%	1.66%	2.37%	2.56%	2.47%
<b>Low</b>			0.03%	0.36%	0.73%	1.26%	1.51%
<b>End</b>	3/31/22	0.25%-0.50%	0.48%	1.60%	2.33%	2.46%	2.34%

Source: U.S. Department of the Treasury

Rising market yields mean higher mortgage costs. Freddie Mac reported at quarter end that the average 30-year fixed mortgage rate had reached 4.67%, up more than 150 bps since December. With the S&P CoreLogic Case-Shiller national home price index reversing a downtrend in January with a +19.2% year-over-year increase, affordability is now at its lowest level since 2007. In theory, housing demand should cool, but available supply remains extremely tight. Zillow reported that total home listings fell for the fifth straight month in February. The 729,000 listings were 25% below a year ago, and down nearly 50% since February 2020.

With investors and all-cash purchases muscling out first-time buyers, it isn't clear the higher lending rates will have much effect on demand. Homes sold in February received an average of five offers, with nearly half above the asking price. The answer to this mad scramble is increased supply, which is easier said than done. In addition to a lack of skilled workers and an ongoing shortage of building materials, necessary finishes like windows, garage doors, plumbing fixtures and gutters are increasingly difficult to find. The number of homes authorized to break ground, but not yet started, is at a 48-year high, while the number of single-family homes under construction has risen for 21 consecutive months and now totals 799,000, the highest in 15 years.

The first three months of the year were brutal for stocks, with the DOW and NASDAQ both down -4.6% and the S&P 500 losing -4.0%. It was the first quarterly stock market decline since the pandemic began. But the equity story was more about volatility as the S&P 500 was up or down 1% or more in 47 of the 63 trading days during the quarter.

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## Economic and Interest Rate Outlook

The labor market outlook is one of few bright spots. There were nearly 1.7 million jobs added to company payrolls in the first quarter, and U.S. businesses are eager to add millions more. The personal savings rate for February was 6.3%, now *below* the pre-pandemic level. This suggests more Americans will be seeking work in the months ahead. The record number of current job openings should provide a cushion as growth slows.

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The inflation outlook, at least in the near term, is ugly. Global supply chain bottlenecks are worsening as many of China's largest industrial cities are back in lockdown mode as the Omicron variant reasserts itself. Amid this backdrop, it isn't hard to believe that headline CPI could move above 9% over the next couple of months. Energy prices, shelter costs and vehicle prices account for about 70% of the year-over-year increase. All of these spending categories remain under pressure.

A March Gallup poll showed Americans are more worried about inflation than they've been in 37 years, with 17% of respondents calling the recent inflation spike the "nation's most important problem," up from 8% in January. The University of Michigan Consumer Sentiment Index slipped to 59.4 in March, the lowest reading since 2011 and consistent with recession. Surveys mean very little to investors but are meaningful to politicians and Fed officials.

In late March, President Biden announced the release of 1 million barrels of oil per day for six months from the Strategic Petroleum Reserve. The Administration estimates this action will reduce pump prices by 10 to 35 cents per gallon. Crude oil prices have settled down since WTI closed at \$119.65 on March 8th, but the several Wall Street firms have floated the idea that oil prices could reach a record \$200 per barrel by summer. If this scenario played out, a 10 cent discount at the pump would be meaningless, and the chances of recession would escalate.

*The Fed dramatically revised its 2022 growth and inflation forecasts at the March meeting, slashing its GDP outlook from +4.0% to +2.8%, and boosting the expected inflation rate up from +2.7% to +4.1%. Both of these forecasts now appear overly-optimistic.*

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The futures market is pricing in a 2.50% overnight rate by yearend. The Fed hasn't tightened this much in a single year since 1994 but appears willing to sacrifice growth for price stability. Whether Chairman Powell can maintain a steady resolve if growth turns negative remains to be seen.

How the second quarter unfolds will depend largely on forces outside our control. The war in Ukraine has become the biggest economic wildcard in generations. At this point, it's safe to say no one has any idea how the conflict will play out. As long as bombs are falling and people are dying, U.S. economic data carries significantly less weight. Investors will be much more concerned with what lays ahead than what happened last month, and this promises to keep the volatility uncomfortably high.

## Market Indications as of 10:46 A.M. Central Time

DOW	Up 231 to 34,814 (HIGH: 36,800)
NASDAQ	Down -92 to 13,805 (HIGH: 16,057)
S&P 500	Up 10 to 4,511 (HIGH: 4,797)
1-Yr T-bill	current yield 1.73%; opening yield 1.69%
2-Yr T-note	current yield 2.50%; opening yield 2.46%
3-Yr T-note	current yield 2.71%; opening yield 2.66%
5-Yr T-note	current yield 2.74%; opening yield 2.70%
10-Yr T-note	current yield 2.69%; opening yield 2.64%
30-Yr T-bond	current yield 2.73%; opening yield 2.67%

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