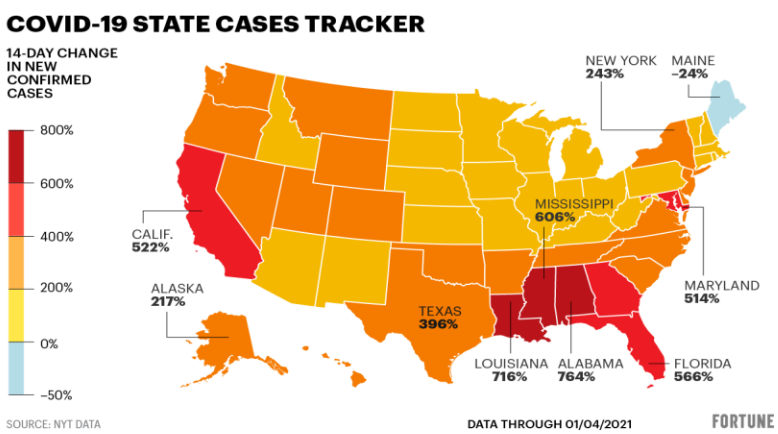
Courier Capital, LLC
Registered Investment Adviser
An affiliate of Five Star Bank

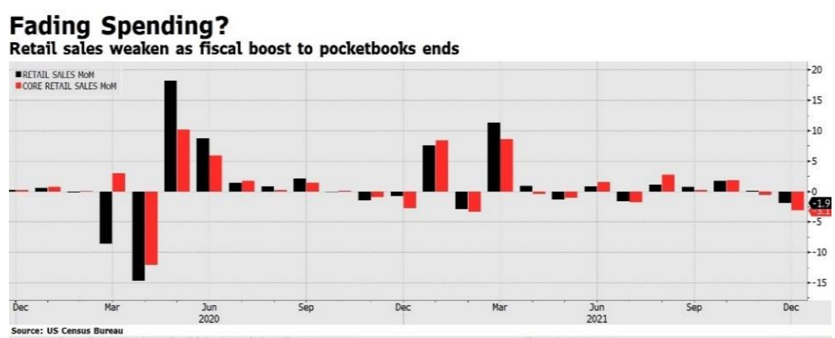
Economic and Market Update – A BALANCING ACT (01/31/2022)

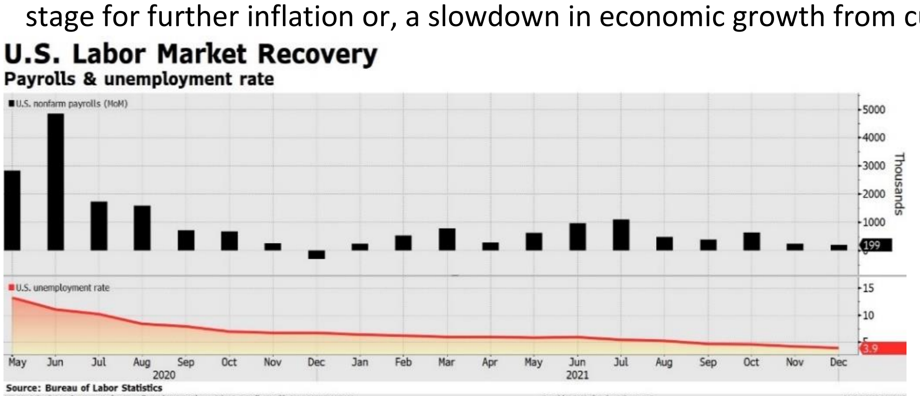
Latest Developments and Economics

We have seemed to enter 2022 with several issues that will require very delicate handling as we move forward. There are economic, political and public health topics that will require the skills of a circus tightrope walker in order not to tip things in a direction that would be too extreme. This first is the progress on the COVID virus. Omicron has been surging in some areas of the country while in others, it is believed to be past its peak. This requires very careful handling to control the virus spread while still continuing with in person schools, the transition of workers back to the office and normal prepandemic activity (think travel and leisure activities). State responses vary from a focus on virus prevention to those focused on economic reopening.



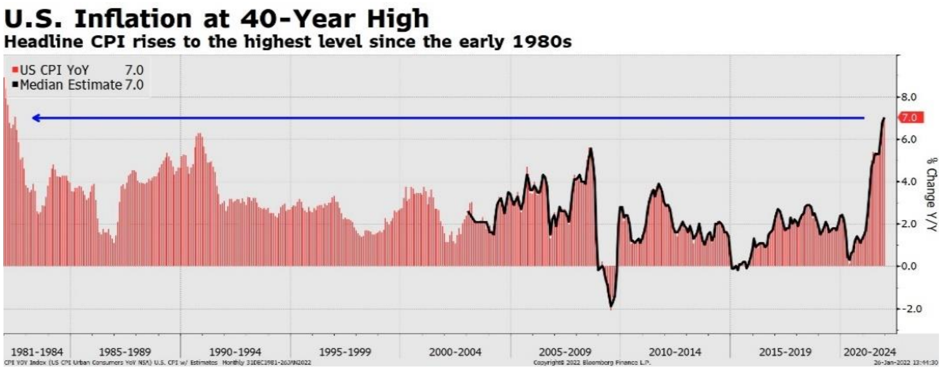
The first read on GDP for 2021 Q4 was 6.9% annualized rate (vs. 5.5% expected) with much of the pace set in the first part of final quarter as Omicron most likely slowed economic activity late in the year. While the first reading looked positive, the slowdown and the huge increase in inventories during the quarter will have a negative effect in the first quarter of 2022. This, together with a less accommodative Federal Reserve means that growth will most likely slow for the year. We have seen some evidence of slowing already as retail sales unexpectedly fell 1.9% (excluding autos) from last month in December and 3.1% year-over-year. This could be the result of consumers shopping early for the holidays or the impact of Omicron (or both). The International Monetary Fund (IMF) recently lowered 2022 growth estimates for the U.S. to 4.0% from the previous 5.2% noting "downside surprises" and believes the global economy enters the year in a weaker economic position. The balancing act here is between continuing GDP above trend, which helps set the stage for further inflation or, a slowdown in economic growth from current expectations.





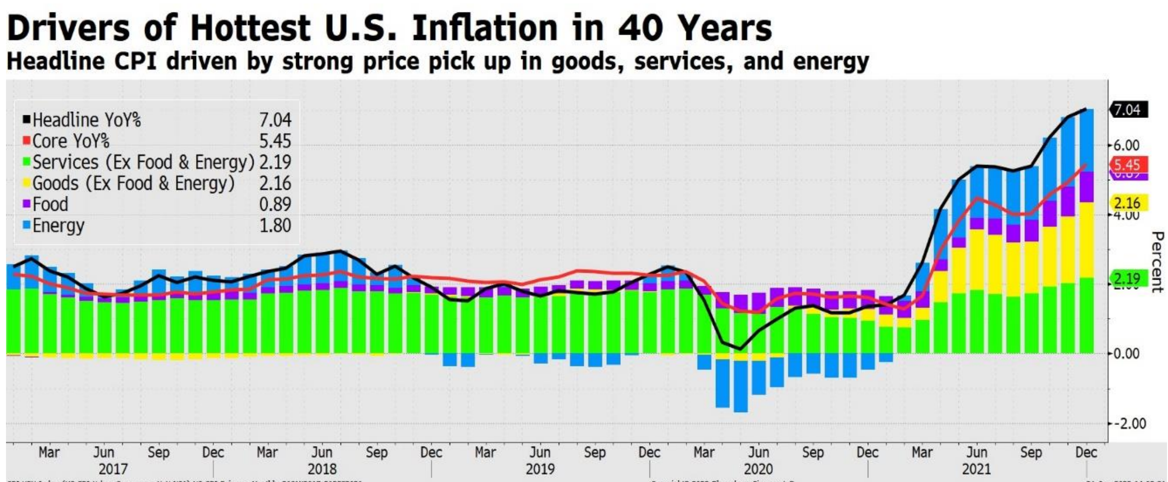
The labor news in January was rather disappointing. Only 199,000 nonfarm jobs were added in November, far short of the over 400,000 that were expected. This was surprising given that there are still over ten million jobs open for most of 2021. The unemployment rate stood at 3.9% - near prepandemic lows.

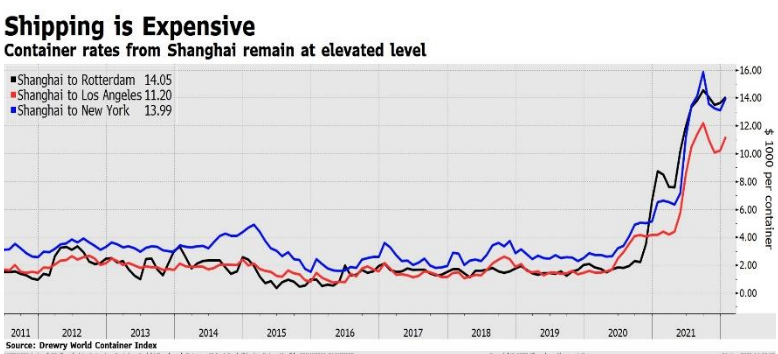
This statistic is a bit misleading though as it only measures people who are actually looking for jobs. There are currently still about 2.9 million less jobs than there were in February of 2020. The percentage of working age population with jobs is currently about 1.5% below where it was in early 2020. This worker shortage is another factor in the supply chain issues we have been experiencing and has contributed significantly to the increase in worker wages. Wages are up over 4.0% from the prior year and are a driver of the inflation we see so far. The challenge for firms is how to fill openings to meet customer demand without locking in excessive wage costs. Wage costs cannot be easily adjusted once given and "wage push" pressures can create a vicious cycle of inflation.



The inflation topic has been a headline for much of the last year but took on more significance as it increased in breadth, length and now depth. The latest headline CPI reading of 7.0% over the last year was the highest since 1982. Core CPI (excluding food and energy) rose 5.45% year-over-year.

Reviewing the drivers of headline inflation reveals that energy went from a source of deflation to a significant source of inflation. We also see a larger increase in the price of food as well. There are certain items that have impact across many products (such as transportation /shipping and wages) which are translating in higher prices for goods and services.

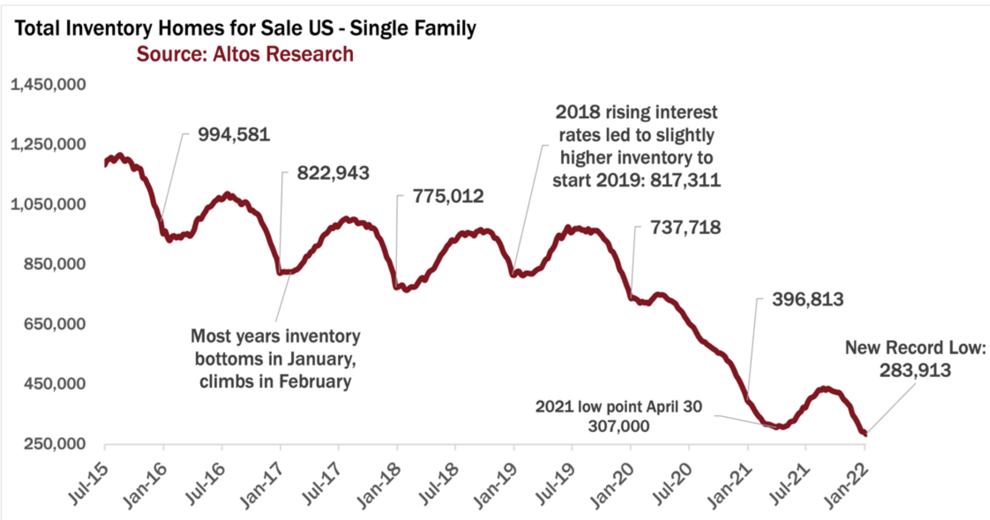




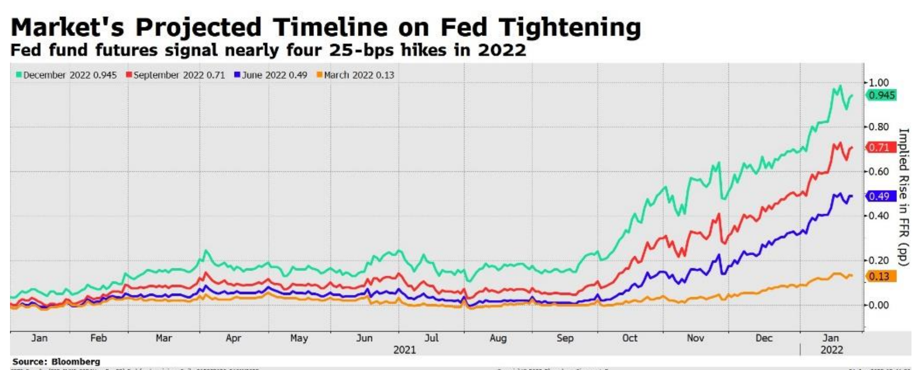
Shipping rates have come off their all-time highs but are still significantly above historical averages. Oil prices are near a seven-year high as well since starting to rise in November and are currently trading for about $87/barrel. Demand for oil has been increasing rapidly (China could see a rebound in demand of 7%) and is nearly at prepandemic levels globally. In addition, the OPEC+ countries have been having problems increasing their supply to agreed upon quotas. This leaves the markets very tight. So tight that a cold snap or other unforeseen issues could significantly impact the balance. There are also two geopolitical events impacting the oil markets which have some predicting that $100/bbl oil sometime this year. The first is the continued threats to the United Arab

Emirates by the Yemen group Houthi movement which is backed by Iran. Second would be an invasion into Ukraine by Russian forces. Russia is the second largest oil producer in OPEC+ and any tensions or sanctions would impact not only the U.S. but Europe especially as they supply oil and natural gas to several European countries.

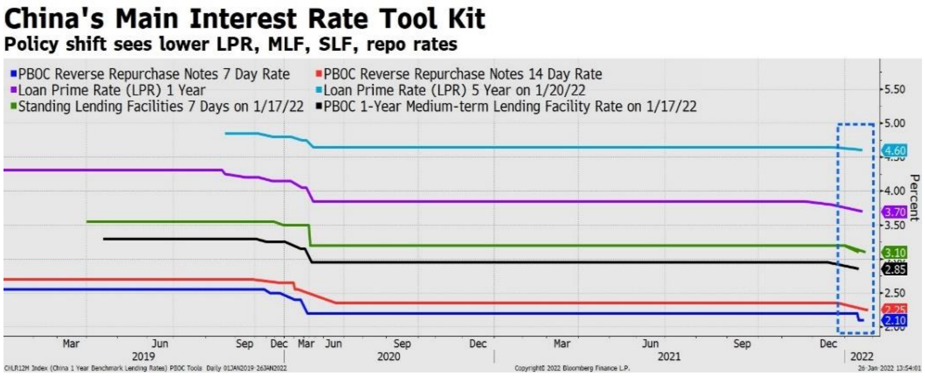
Another source of consumer inflation is housing – which has not been fully reflected in CPI inflation data. The combination of underbuilt housing supply and low inventory was a major factor contributing to housing's average price gain of 19% from November 2020 through November 2021. There is a record low number of houses for sale in the nation – about 1.8 months of supply where 6 months is considered a balanced market. Although the pace of price increases shows signs of slowing, the low inventory combined with rising mortgage rates have made homes less affordable. December saw housing sales disappoint versus expectations.



The topic of inflation was one of the reasons that the FOMC meeting last week was so highly anticipated. The Fed has already pivoted significantly from the message they were sending earlier in the year when rate hikes were not anticipated until 2023. Not only did they accelerate the tapering of bond purchases that kept rates low but signaled rate increases would be quickly on deck in 2022. While the Fed wasn't as hawkish as they could have been, they did indicate that there could be several rate hikes in store for 2022. Market expectations vary from two to six hikes in 2022. They were clear that bond buying will end in February and that they are thinking about how to reduce their $9 trillion worth of assets on their balance sheet (they could become bond sellers instead of bond buyers). The exact number and timing of rate increases will depend on several factors, but it is certain that we have ended the easy money accommodation in rates and have entered a new period of rate increases. In fact, the Fed has more justification now to raise rates than they did when they last started in December 2015. Then inflation was still benign, and the economy was growing slowly. With GDP growth markedly above trend, a 3.9% unemployment rate signaling full employment, and inflation well above their target of an average 2.0% the Fed has no choice but to be aggressive given that they are most likely behind the inflation curve a bit. What could impact their path? First would be inflation. If there are elements of inflation that are temporary and start to recede – either through supply chain improvements or even just the base effects of measuring against 2021 – they could slow the pace of increases. Also, given the levels of debt and asset prices (think stocks, housing, etc.) the economy may be more economically sensitive to interest rates than in the past, so would cool off much quicker (look at the housing described above). A significant geopolitical event may also give the fed reason to pause (i.e.: Russia). The Fed has the greatest balancing act of all. Chairman Powell is trying to navigate a "soft landing"; increasing rates



enough to cool the economy yet not tip it into recession. Not an easy feat to accomplish since rate increases are a blunt instrument and the effect is delayed by months. History is also not with him as, according to Bloomberg, inflation was above 5.0% eleven times since 1914 and the Fed policy caused a subsequent recession eight of those times.

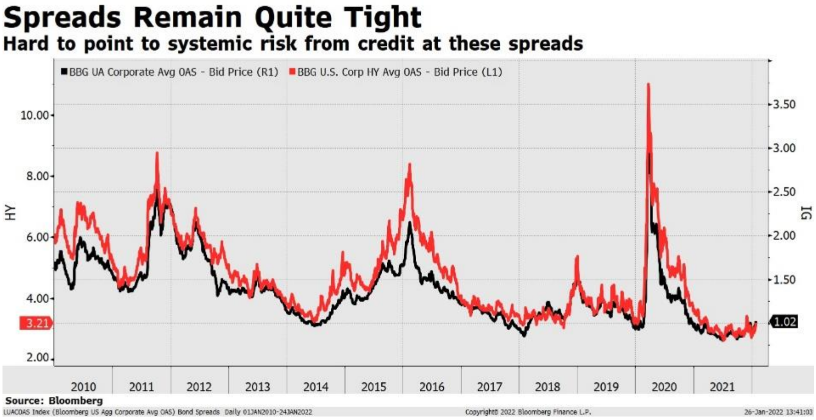


As a side note the situation in China is pursuing a different path than most developed markets. While most are bringing their low interest rate periods to an end China's central bank is going the other direction. Real estate sector woes and concern over growth has caused their central bank to lower lending rates.

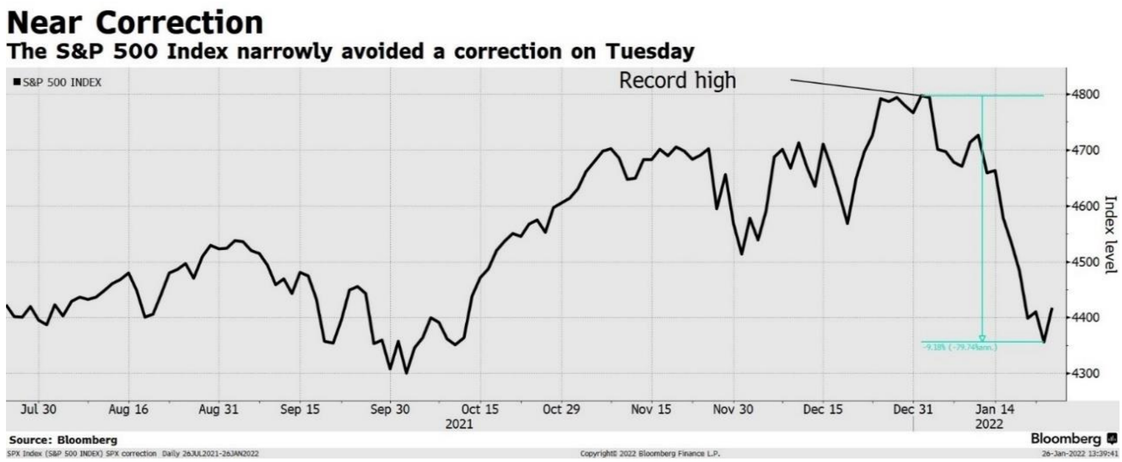
The other big geopolitical issue is the tense circumstances between Russia and Ukraine. The situation has escalated since last month and the potential for an invasion has increased, threatening 44 million people in Ukraine. The military buildup by Russia is one of the largest seen in Europe since WW II and it is the largest security crisis in Europe since the 1980's. Ukraine borders several NATO countries and as Russia has amplified its military buildup so has the rhetoric coming from Western countries. Germany has not been fully on board to criticize Russia and it is to Putin's advantage to fracture NATO. A search for a diplomatic solution continues but no substantial progress has been made. The Russian impact on oil was stated above and Ukraine is one of the top four exporters of grain in the world. Experts are of the opinion that an incursion is not likely before the end of the Olympics but could be soon. This is another key balancing act that will have significant global repercussions. Adversaries of the U.S. and the world in general will be watching U.S. and NATO resolve as the result could impact how the U.S. is viewed for some time. If Russia pursues invasion without commensurate response it could be seen as weak and if the U.S. comes on too strong (i.e.: military buildup in the region) it could ignite a larger conflict.

Financial Markets

The pivot by the Federal Reserve as well as the recent data coming from the U.S. economy has created volatility in financial markets which started in December but picked up in January. The 10-Year U.S. Treasury yield moved up from 1.50% in December to about 1.80% in January before settling down to 1.78% - highest yield since before the pandemic. This has already generated a loss of more than 2.1% in the bond markets (as defined by the Bloomberg Aggregate Bond Market Index) for 2022. The "Agg" is the most well-known index for U.S. investment grade government and corporate bonds. With such low yields there is no cushion in bonds to offset price declines driven by rate changes.



In addition, corporate spreads for taking on risk are very tight – meaning bonds are expensive. However, the tight spreads point to something else as well. These spreads usually will widen (red line and black line will separate) when bondholders perceive a significant amount of economic risk forthcoming (i.e. people will want to be compensated more for holding riskier assets). We have not seen this widening as of yet.

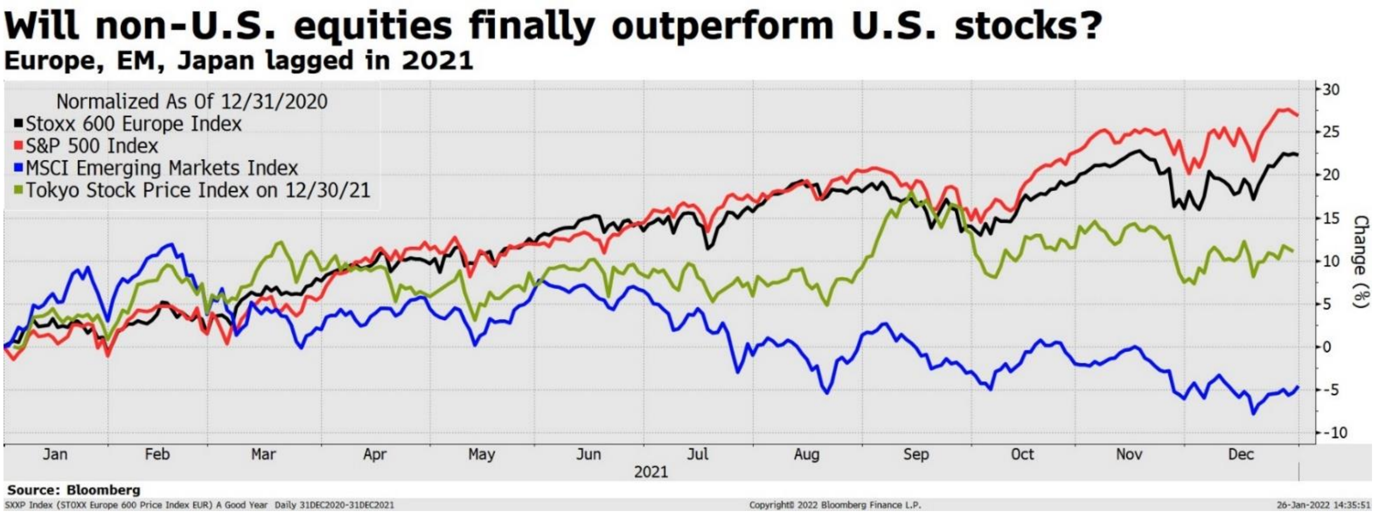


The S&P 500 has experienced the most volatility on a daily and weekly basis since March 2020. The same holds true for global equity markets. The change in the direction of interest rates discussed above is one of the primary reasons for the volatility and market declines. The S&P 500 did touch correction territory (down 10% from high) before recovering slightly. The index is still down about 7.00% in January - the worst monthly decline since the pandemic but, due to the 2021 performance, puts us back only to mid-October levels. The growth stocks have been hit hard with a loss of almost 11.00% while the value stocks have fared somewhat better – down less than 3.00%. The tech heavy NASDAQ has fared the worst down about 13.00% so far in 2022. After the long dominance of growth over value we are seeing another rotation of investment from growth to value which has resulted in value's better relative performance. In addition, 2021 Q4 earnings reports have started and there has been a mixed of good and bad news. Banks have reported good earnings but not quite hitting expectations and growth stocks such as Netflix and Peloton missed badly, and their stocks were down over 20% each. The growth-orientated stocks of small cap and NASDAQ are clearly in correction territory. Energy (a value component) has been the only positive sector in the S&P 500 so far in 2022 – due in part to the oil situation described above and concerns about oil supply disruption. The moderate 60% equity/40% fixed income portfolio as measured by Bloomberg was down 5.4% in January – its worst month since March 2020.

Although uncomfortable, 10% declines in large cap stocks are rather routine by historical standards. Since 1946 there has been 84 declines of 5%-10% which is almost one per year. Declines of more than 10% are less frequent and generally take longer to recover.

The following information about average recovery in S&P 500 declines comes from CNBC:

DECLINE (%)	# OF DECLINES	AVG MONTHS TO RECOVER
5%-10%	84	1
10%-20%	29	4
20%-40%	9	14
>40%	3	58



The past several years has seen the continued outperformance of U.S. stocks to both International developed and emerging markets. A large part of the U.S. dominance has been due to the heavy representation of Information Technology in U.S. equity markets. As there seems to be a shift to lower economic growth projections and higher interest rates having an outsized impact on technology what does this mean for the dominance of U.S. stocks going forward? Might this be an opportunity for international to outperform the U.S. in the near term? This helps to justify appropriate representation of international equities in a diversified portfolio going forward.

Should you have any questions please contact us.

Image sources: Bloomberg and CNBC unless otherwise noted

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