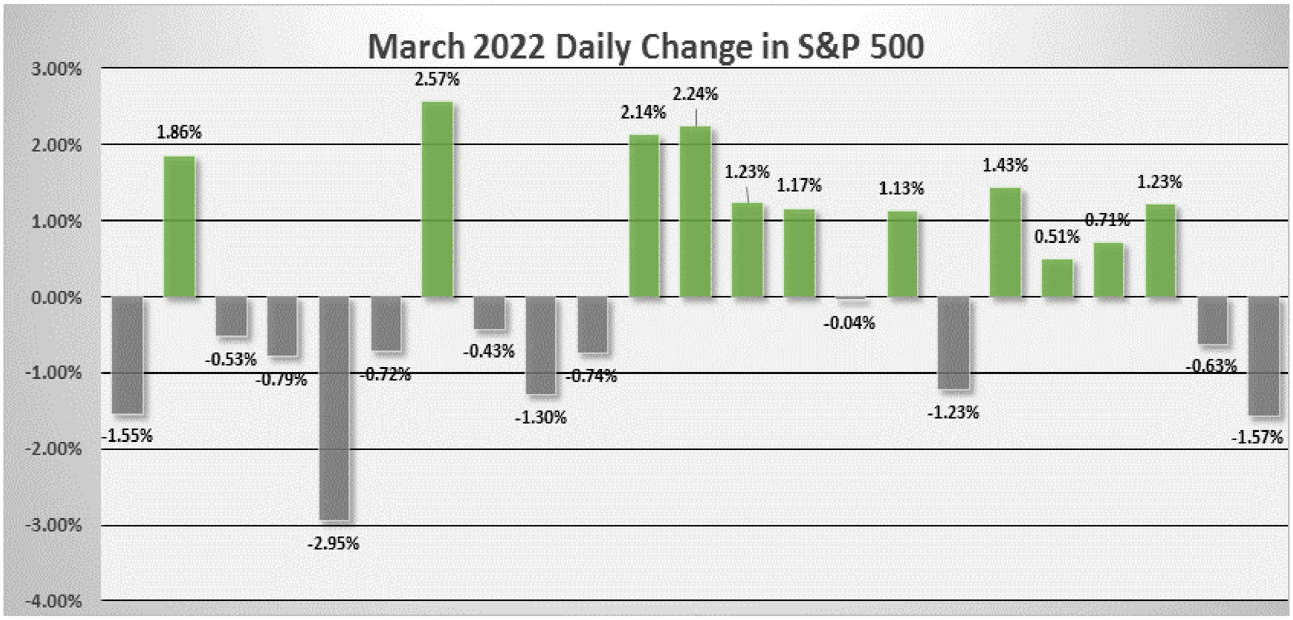
Courier Capital, LLC
Registered Investment Adviser
An affiliate of Five Star Bank

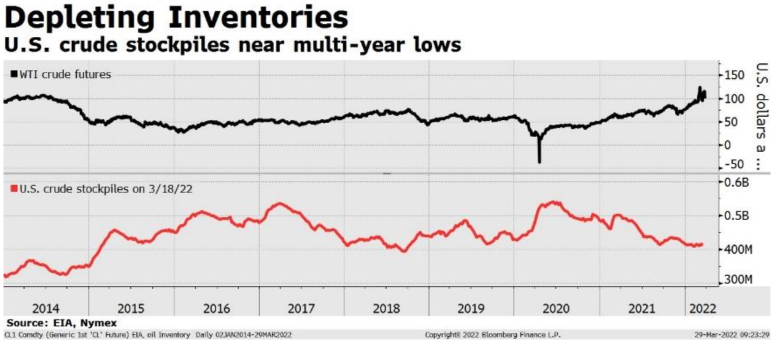
Economic and Market Update – HOW AGGRESSIVE? (03/31/2022)

Latest Developments and Economics

No, this month's title is not in reference to Will Smith's slap of Chris Rock at the Oscar's but to a couple of other topics relative to the near-term economic future. The first aggressive activity of course comes from the Russian action in the Ukraine. A significant amount of trading in March was based on headlines specific to the conflict. Increased military activity and rhetoric sent markets into a tailspin while hopes of negotiation and cease-fire have buoyed markets. This has made for a very volatile March. The chart below shows the daily movement of the S&P 500 in percentage terms for March. More than 60% of the trading days in the month had movements of more than 1%. This makes the greatest number of 1% or more moves since January 2021.



The war has dramatically impacted the Russian economy as well as the Ukrainian economy. The Ukraine economy is estimated to have contracted by 40-45% in one month. Close to 4 million people have fled the country and caring for the displaced people has put a strain on several Eastern European countries. The Russian economy has been subjected to the most severe and coordinated global sanctions in memory. While most of the developed economies have been united and coordinated in their response to Russia some have abstained in their condemnation and have indicated some level of support of Russia. This conflict puts China in a very difficult position. While they have common interests with Russia, they also must be mindful not to upset the U.S. and Europe as it could cause unpleasant economic consequences to China. This political alignment poses another significant threat to economic globalization which had been taking place over the last 20 years. The impact of the war will have repercussions in energy, grain, steel, nickel and palladium as each of those markets have been disrupted. The effect was immediate in the energy markets where Russia is a major oil exporter and Europe is dependent on Russian natural gas. In January 2022 Russia exported 8 million barrels per day and the loss of that production sent crude oil shooting to $140 due to supply shortages. Oil has since settled down back below $100/barrel, partly due to the President's announcement of a release of one million barrels per day from the strategic reserve for up to six months. The impact of the supply shock can already be seen in inventories of both crude oil and European levels of natural gas.

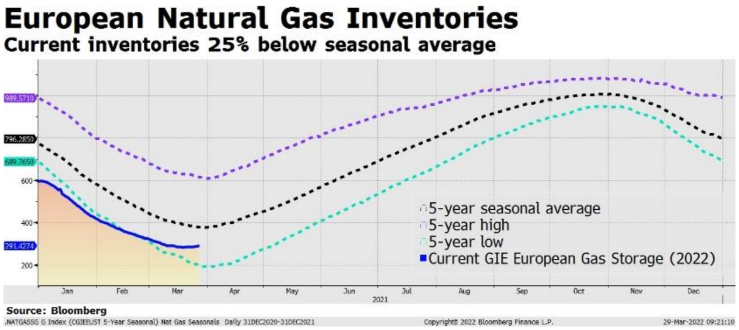


Depleting Inventories

U.S. crude stockpiles near multi-year lows

Source: EIA, Nymex

CL1 Comdty (Generic 1st 'CL' Future) EIA, oil Inventory Daily 02JAN2014-29MAR2022 Copyright© 2022 Bloomberg Finance L.P. 29-Mar-2022 09:23:29



European Natural Gas Inventories

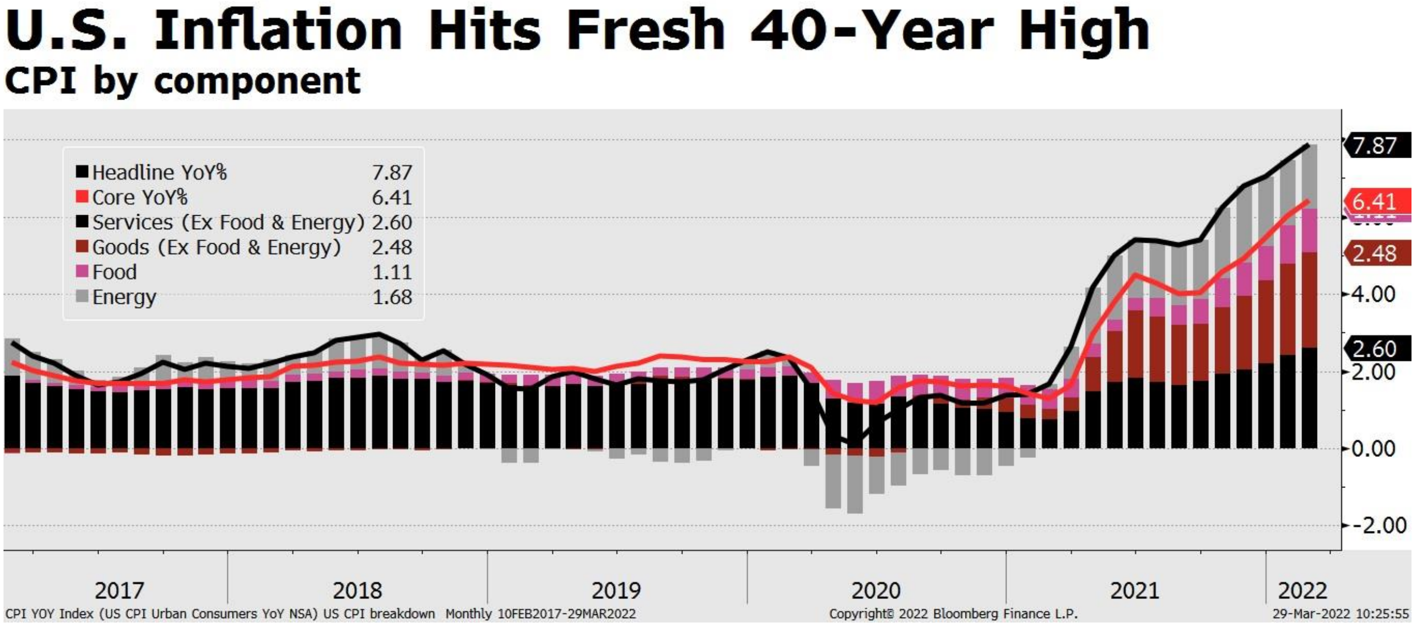
Current inventories 25% below seasonal average

Source: Bloomberg

.NATGASSG G Index (CGIEEUST 5-Year Seasonal) Nat Gas Seasonals Daily 31DEC2020-31DEC2021 Copyright© 2022 Bloomberg Finance L.P. 29-Mar-2022 09:21:10

The humanitarian situation in Eastern Europe is putting significant strain on resources in Europe. Inflation in the Eurozone set a record high of 7.5% in March – driven by energy shortages and pricing. Natural gas is costing Europeans about four times what they paid in January 2021 and food prices will be impacted given the large production of wheat from Ukraine which is now offline. These two items are directly related to the war and create uncertainty not seen in Europe since WWII. Adding to this uncertainty, and contributing to inflation, is continued disruptions in the global supply chain. Speaking of aggressive, that is the exact approach that China is taking with "Zero-COVID" policy. China is shutting down whole cities, including industrial centers, in order to keep COVID at bay after experiencing the highest level of cases since the pandemic started. The city of Shenzhen, with a population of 17.5 million people was locked down for a week earlier this month and now Shanghai, with 26 million people will shut down in two phases of 4 days each. These three reasons are why many economists have increased the odds of a recession in Europe recently. The last issue will also have a slowing effect on the Chinese growth as well.

The main reason for the title of this month's update is due to the U.S. Federal Reserve. How aggressive will they be in raising rates to combat inflation going forward no one knows. We are certainly in a rising interest rate environment, but the Fed eased into it with an initial 0.25% increase in March. They did however, indicate that not only are they expecting to raise rates at each meeting this year (which would be seven times) but, also mentioned that they would be willing to move quicker (i.e.: more than 0.25%) each time if they feel they are making no headway on inflation. So far, inflation is not cooperating. The February print was a year-over-year 7.87% - higher than last month's 40 year high of 7.53%. Moreover, the monthly rate shows that inflation is not even slowing yet as the monthly rate was 0.80% (or about 9.6% annualized).



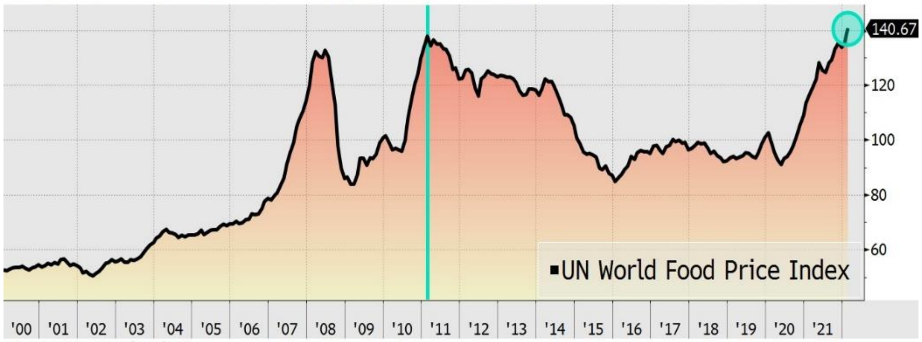
U.S. Inflation Hits Fresh 40-Year High

CPI by component

CPI YOY Index (US CPI Urban Consumers YoY NSA) US CPI breakdown Monthly 10FEB2017-29MAR2022 Copyright© 2022 Bloomberg Finance L.P. 29-Mar-2022 10:25:55

Food Prices Surge to Record

UN gauge tops previous high, begs the question of social unrest



Source: UN FAO, Bloomberg

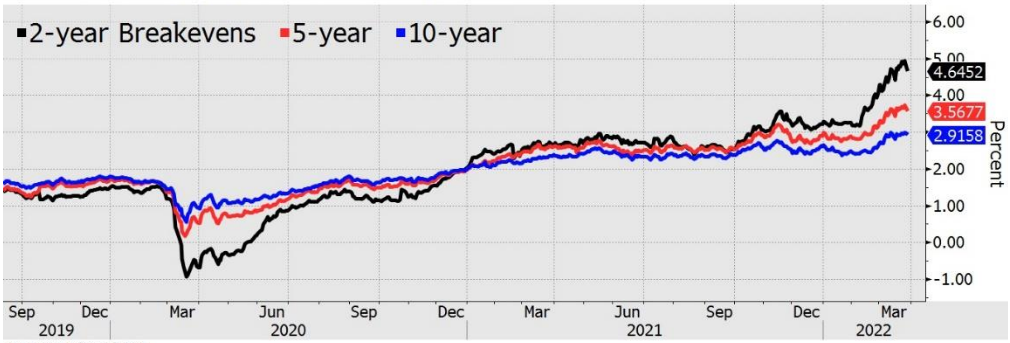
FAOFOODI Index (UN Food and Agriculture World Food Price Index) UN World Food Price Monthly 31JAN2000-28FEB2022 Copyright© 2022 Bloomberg Finance L.P. 29-Mar-2022 09:10:49

Food and Energy were significant contributors and the Russian incursion will serve to keep inflation higher for longer in those components globally. Even if we exclude food and energy, core CPI also increased at a rate of 6.41% year-over-year. This shows that inflation is much broader based than just energy and food. Even the Fed's preferred measure of inflation, core PCE (excludes food and energy), rose 5.4% from a year earlier.

The inflation data from around the world is increasing inflation expectations. As inflation expectations rise in the general population it can destroy consumer demand – people cut back their discretionary spending due to more spent on necessities (food/energy, etc.) and decide to delay spending on other goods and services. One read of inflation expectations is the comparison of yields on regular treasury securities and inflation protected securities of the same maturity (see chart). This shows that inflation expectations are 4.6% annually for two years and near 3.6% annually over 5 years.

U.S. Inflation Expectations

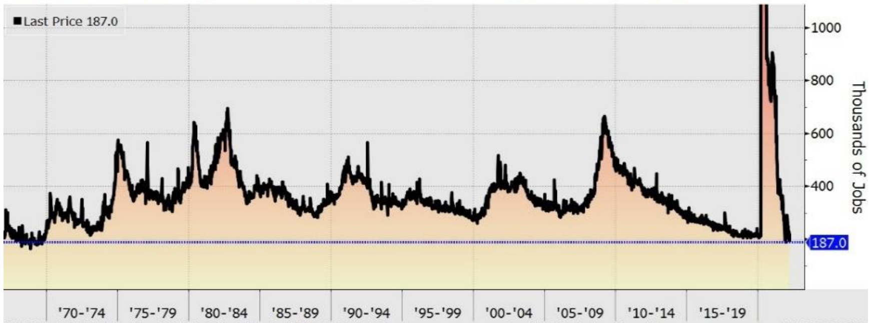
Breakevens close to record highs



Source: Bloomberg

USGGBE02 Index (US Breakeven 2 Year) US Breakevens 2,5,10,30 Daily 11SEP2019-29MAR2022 Copyright© 2022 Bloomberg Finance L.P. 29-Mar-2022 09:04:20

U.S. Jobless Claims Lowest in 50 Years



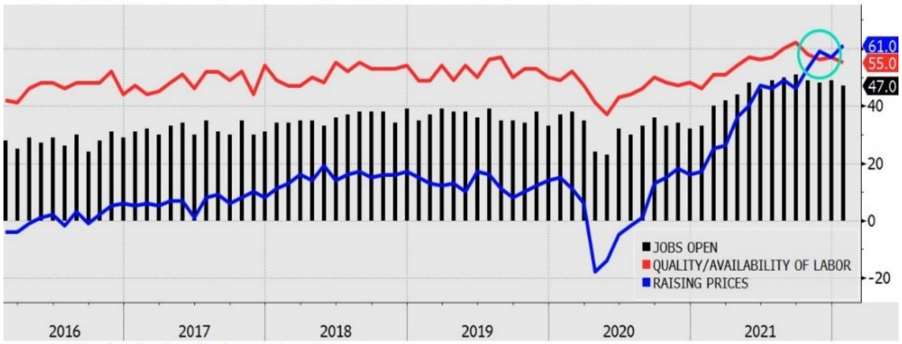
INJCJC Index (US Initial Jobless Claims SA) INJCJC - Jobless Claims Weekly 24MAR1900-18MAR2022 Copyright© 2022 Bloomberg Finance L.P. 29-Mar-2022 09:14:09

On a positive note there are still about 11.3 million jobs open in the U.S., 5.3 million more than workers who are searching. Jobless claims are also very low at 187,000 last month. So, the U.S. certainly looks to be in relatively better shape than much of world economically. The U.S. is also impacted by the war in Europe in a very limited way.

So, what are the other contributors to inflation – the significant jobs mentioned above. The shortage of workers creates a tight labor market where companies must raise wages to attract workers. The economy added 431,000 jobs last month and the unemployment rate in February was 3.8% - generally considered full employment in the country overall. There are many people who have decided to leave the workforce (at least for now).

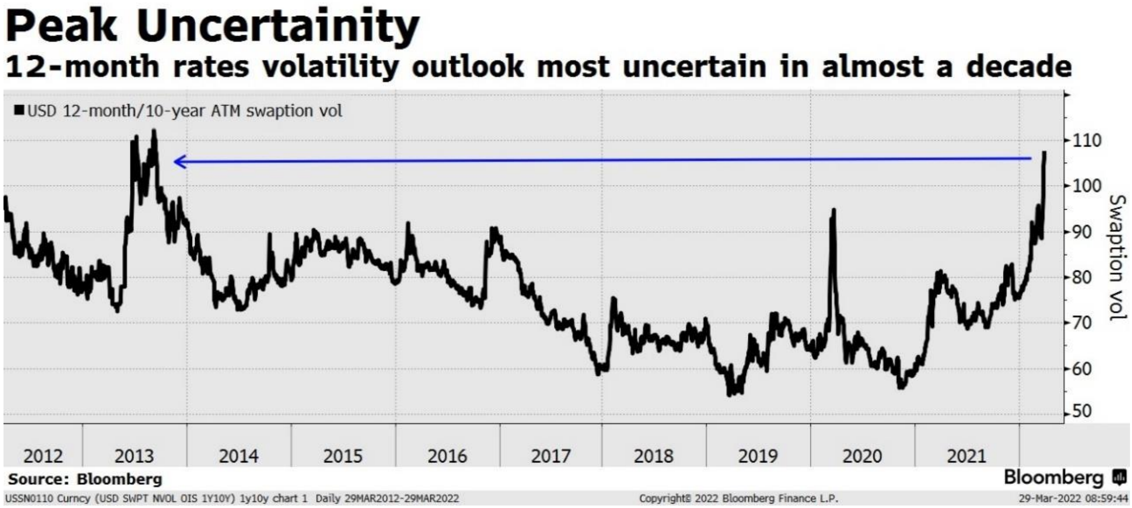
How Do You Find Workers?

Raise pay, raise prices say small business leaders



Source: National Federation of Independent Business

SBOIEMPL Index (NFIB Small Business Job Openings Hard to Fill) NFIB on Labor Monthly 08FEB2016-08FEB2022 Copyright© 2022 Bloomberg Finance L.P. 29-Mar-2022 10:39:20



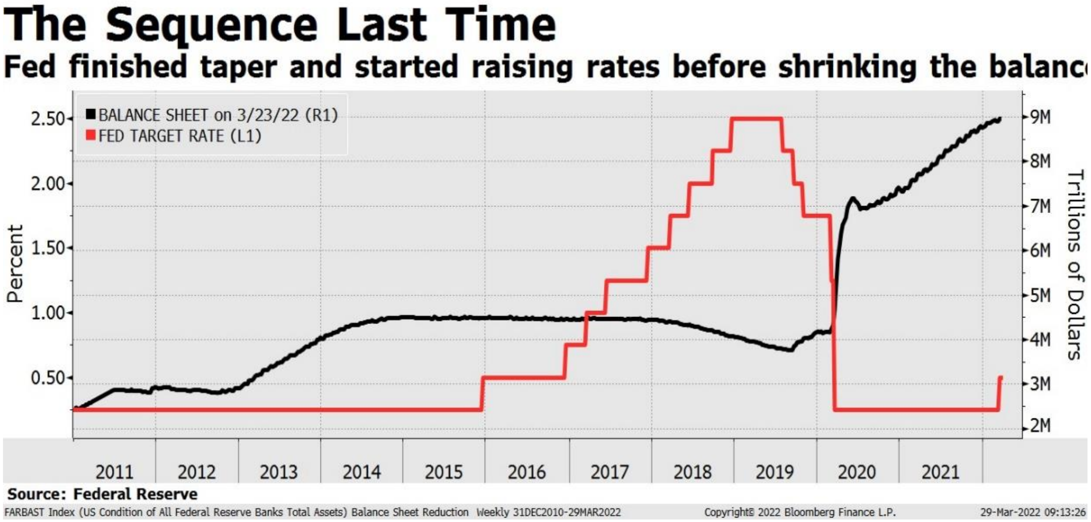
Peak Uncertainity

12-month rates volatility outlook most uncertain in almost a decade

Source: Bloomberg

Given the high level of inflation a slow progression of interest rate increases will not have a significant impact in reducing the rate of inflation. The Federal Reserve may need to raise rates quicker, which may catch markets off balance. There is much uncertainty regarding the path of rate increases (how many and how much).

Rate increases are not the only way the Fed can affect rates. The Federal Reserve still owns almost $9 trillion of mortgage bonds and treasury securities. Eventually those bonds will need to run off or be sold to wind down the balance sheet they built while keeping rates low. The Fed has been pretty mum on what they are thinking about for reducing the balance sheet.

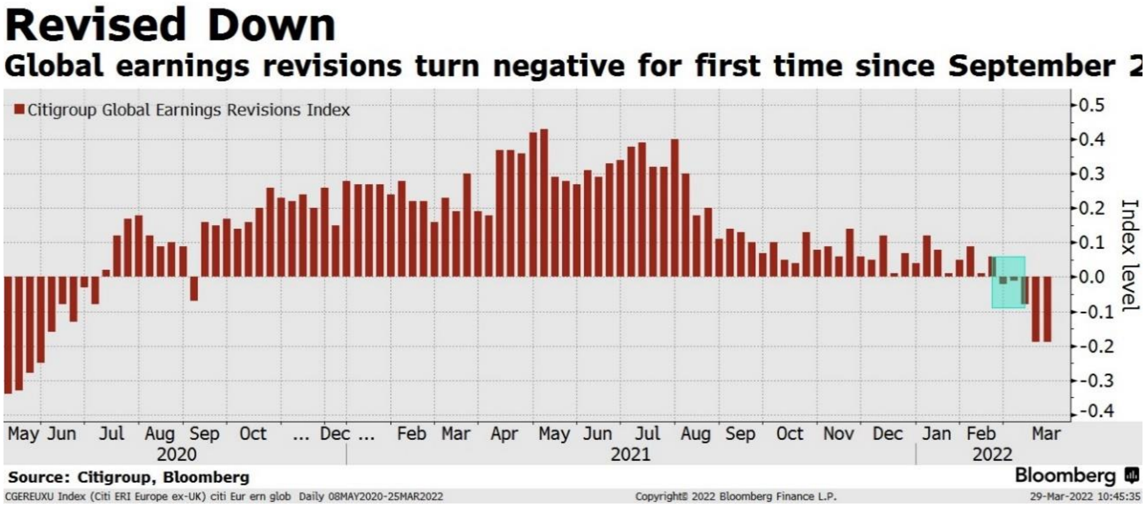


The Sequence Last Time

Fed finished taper and started raising rates before shrinking the balanc

Source: Federal Reserve

The inflation/interest rate uncertainty is already affecting behavior among consumers and businesses. The current 30-year mortgage is approaching 5.0%. Last week's average 4.95% mortgage rate means that it is much more expensive to finance homes that have increased in value themselves. The higher price and higher cost to finance means the median home costs about 20% more in monthly payment than it did one year ago.



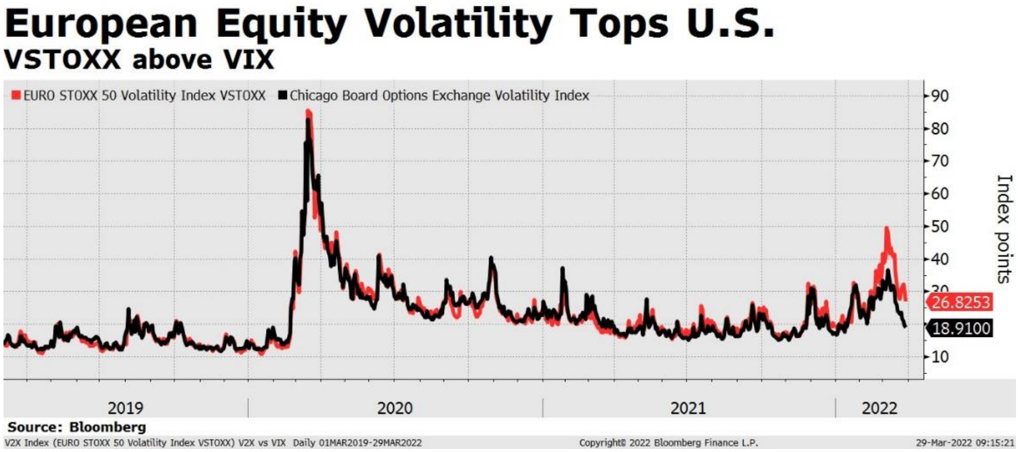
Revised Down

Global earnings revisions turn negative for first time since September 2

Source: Citigroup, Bloomberg

Companies are also lowering their earnings estimates for 2022. The reasons cited are higher costs associated with commodities and other material input costs as well as higher labor.

Financial Markets


European Equity Volatility Tops U.S.

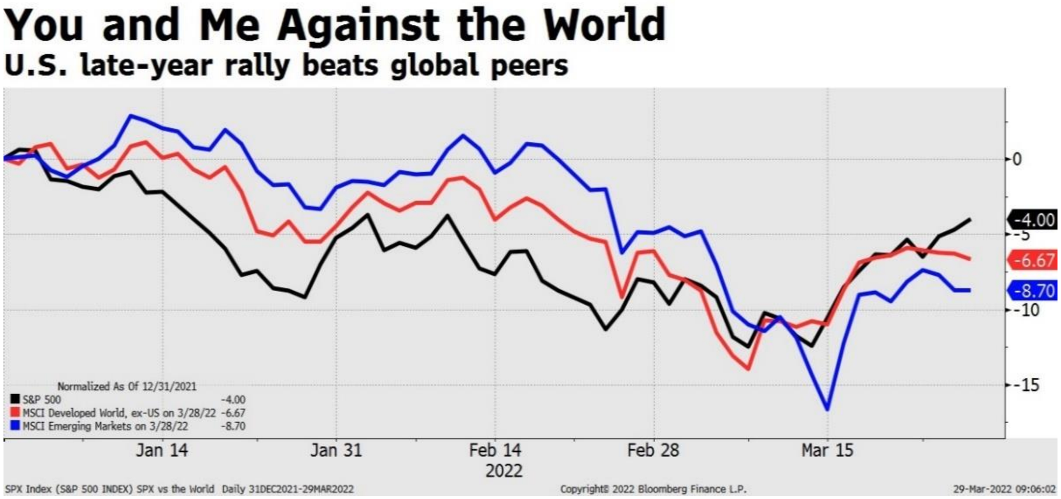
VSTOXX above VIX

Source: Bloomberg

V2X Index (EURO STOXX 50 Volatility Index VSTOXX) V2X vs VIX Daily 01MAR2019-29MAR2022 Copyright© 2022 Bloomberg Finance L.P. 29-Mar-2022 09:15:21

March saw a decline in what is generally considered the “fear gage”, which is the Volatility Index (or VIX). After rising due to the Russian invasion, the implied volatility has settled down for the month – under 20 for the U.S. but still somewhat elevated in Europe. Despite a volatile month the S&P 500 had recorded a gain for March of 3.6%.

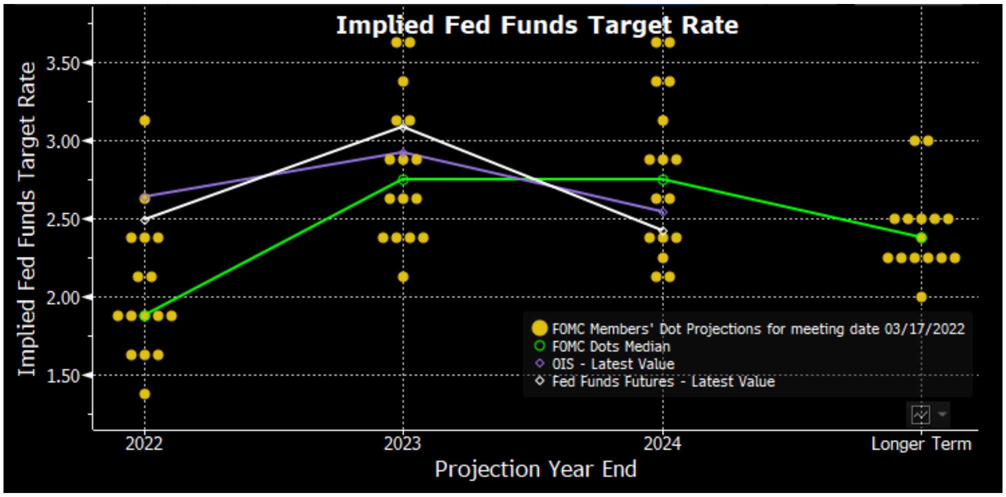
This wasn’t enough to overcome the losses for the year as the S&P 500 down about 4.6% for 2022. This is much better than the European equities which had to contend with the Ukraine conflict (which has greater economic impact to them) just as COVID was abating. Developed international equities are down 6.6% so far for 2022.


You and Me Against the World

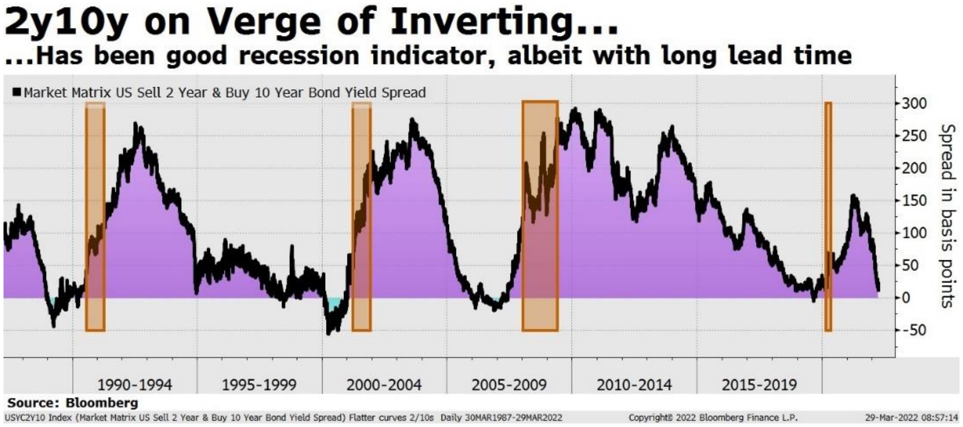
U.S. late-year rally beats global peers

SPX Index (S&P 500 INDEX) SPX vs the World Daily 31DEC2021-29MAR2022 Copyright© 2022 Bloomberg Finance L.P. 29-Mar-2022 09:06:02

The aggressive stance from the Federal Reserve makes it the only central bank planning increase interest rates in 2022 as many other developed market central banks are taking more of a ‘wait and see’ approach before raising rates. The chart at left plots where each Federal Reserve Open Market Committee (FOMC) member sees policy interest rates heading in the near future. The key takeaway is how quickly interest rates are projected to rise in 2023 and 2024 before settling back a bit in the longer term.



This has had a significant impact on bond returns in 2022 – this has been the worst quarterly return in bonds in the last 40 years. The general bond index (Bloomberg Agg) was down 5.7% for the year at the end of March (worse than U.S. equities) and down 2.8% for the month. The longer the maturity of the bond the worse the result – the 10-year treasury bond is down 6.6% for the year (4.2% in March) and the 30-year Treasury is down 11.0% for 2022, including 5.8% in March alone.


2y10y on Verge of Inverting...

...Has been good recession indicator, albeit with long lead time

Source: Bloomberg

USYC2Y10 Index (Market Matrix US Sell 2 Year & Buy 10 Year Bond Yield Spread) Flatter curves 2/10s Daily 30MAR1987-29MAR2022 Copyright© 2022 Bloomberg Finance L.P. 29-Mar-2022 08:57:14

Finally, there has been much discussion about the U.S. entering a phase of 'stagflation' – a combination of slow growth and significant inflation. While the U.S. economy may be slowing the rate of growth, jobs data currently is not indicating anything that resembles stagnant growth. Others have been concerned about a possible recession given that a reliable indicator is sending a warning signal. The indicator is the yield curve which is currently inverted in spots. Inverted yield curve means that shorter maturity interest rates are higher than longer maturity interest rates. One often-watched comparison is the difference between the 2-year treasury note and the 10-year treasury bond. Currently the difference between the two interest rates is negligible and a recession has followed each time the 2-year rate exceed the 10-year rate (see chart). While this has been a good indicator of a future recession it has been a bad predictor of timing. Recessions may follow up to 15 months beyond when the rate inverts for an extended period. While a recession is expected to happen someday, trying to time it has been a useless endeavor. While we are watching this indicator, it is the combination of macroeconomic data pointing in the same direction that will be a more reliable indicator of a looming recession.

Should you have any questions please contact us.

Image sources: Bloomberg and CNBC unless otherwise noted

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