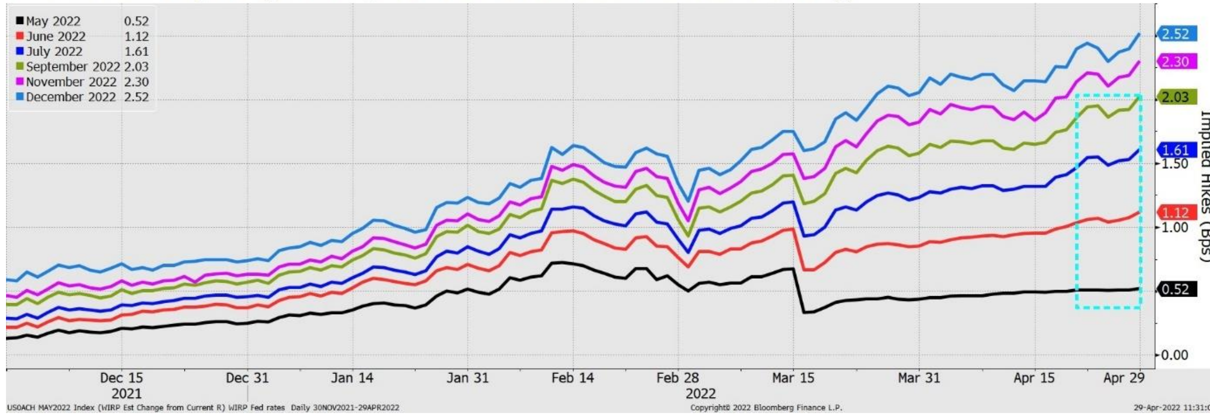
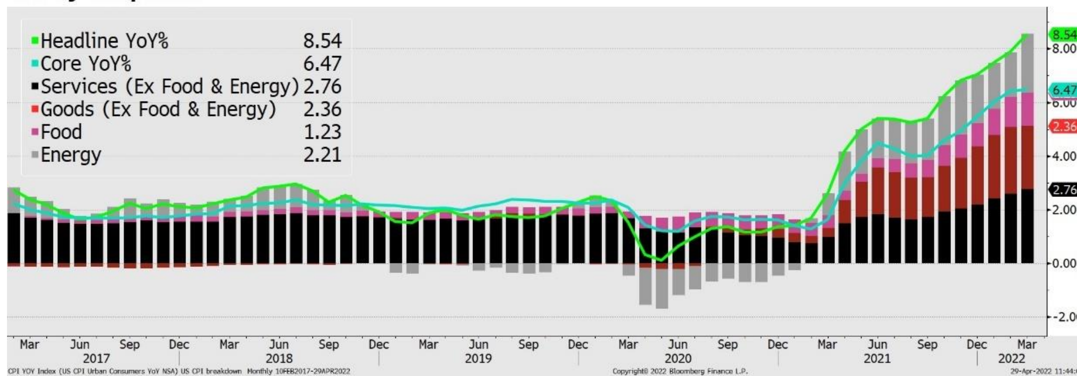
Courier Capital, LLC
Registered Investment Adviser
An affiliate of Five Star Bank

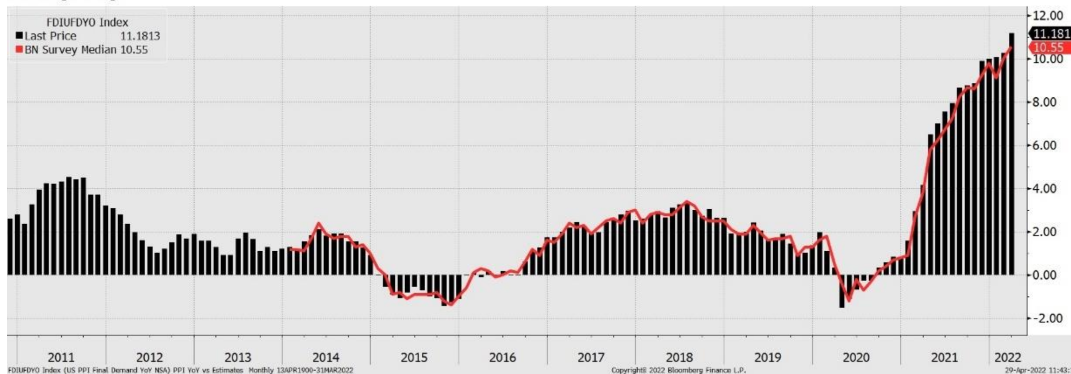
Economic and Market Update – MORE OF THE SAME (04/30/2022)

Latest Developments and Economics

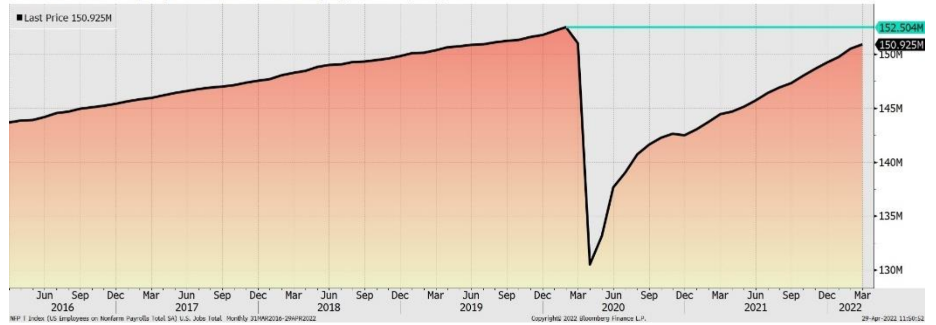
April did not resolve much in terms of U.S. economic direction, inflation or geopolitical events, and the uncertainty certainly weighed on equity markets. What wasn't the same as March was the direction and speed of forthcoming interest rates hikes as specified by Federal Reserve Chairman Powell. He indicated that inflation was much too high, and that taming inflation was "absolutely essential". He also confirmed that the Federal Reserve is prepared to move "expeditiously" on rate hikes in order to achieve their goal of price stability. Market participants have increased expectations of a 0.50% hike for the May meeting (vs. 0.25% increase in March) and further increases of 0.50% for the next three meetings beyond May. This, of course, is in response to continued highest readings of inflation in the last 40 years. At the consumer level the headline read was 8.54% and, even after excluding food and energy, still was at 6.47%. Interesting that food and energy were not even the highest components of the reading. The manufacturers are also dealing with high inflation as the producer price index, measuring prices paid by wholesalers, rose by 11.2% year-over-year, the highest reading recorded since the data series began in 2010. This is usually a signal of persistent inflation in the short term. The price level increases are not only in the goods and services but also in assets such as housing.

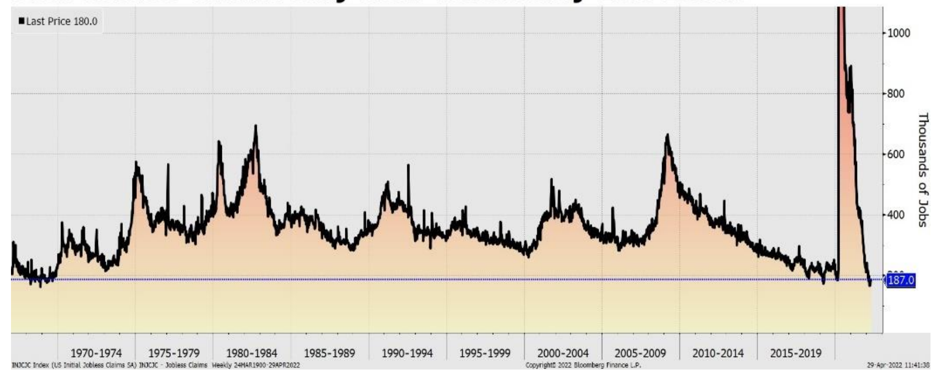






Historically, this pace of increases would have a significant impact on cooling the economy but there are some components that interest rate increases cannot impact. The first factor would be people willing to work. Despite the nearly 11 million jobs currently open in the U.S. there are still 2 million less people employed in non-farm jobs than there were before the pandemic. This also resulted in historically low jobless claims as companies are trying to find workers, not lay them off. This creates conditions for a very tight labor market and contributes to inflationary pressures in two ways. First, companies pay more for workers who are qualified and willing to work. Second, not having enough workers contributes to the supply chain issues we have experienced since the pandemic.



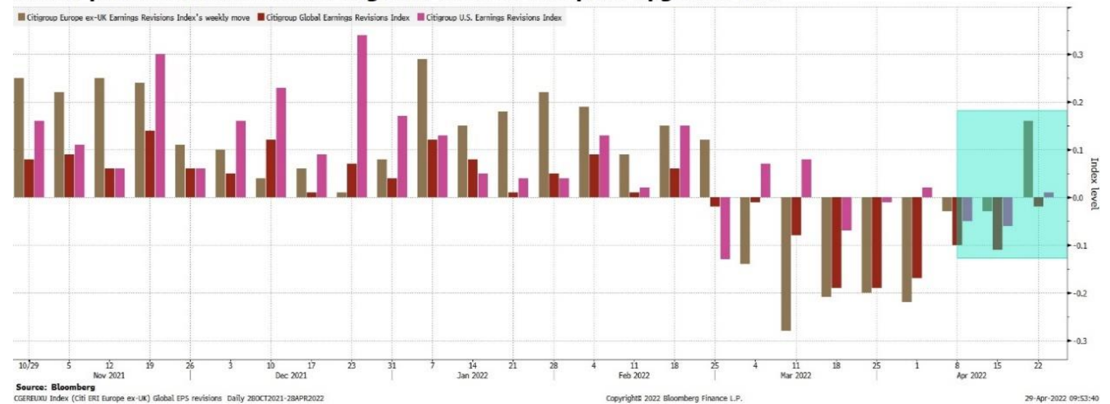


Another problem impacting the supply chain issues (and eventually inflation) is the strict zero tolerance policy in China. Leadership in China have doubled down on the policy recently. There are now some forms of lockdowns and/or mass testing in 27 cities in the country – including Shanghai and now Beijing. Shanghai, which has recorded more than 500,000 cases since March 1 went from partial lockdown to whole city lockdown. Beijing is now under partial lockdown. This has caused significant economic damage, not only in China but globally through the supply chain. Unemployment in China hit a 21-month high and the Chinese currency (Yuan) fell to its lowest level versus the dollar since 2020.

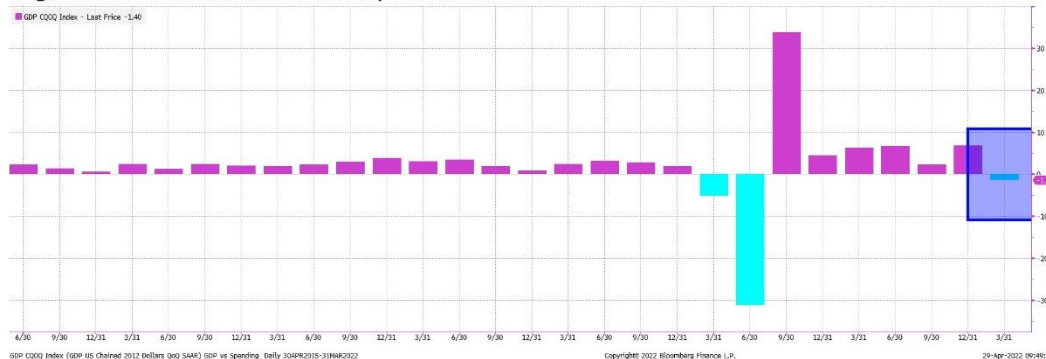
Also, internationally, we see no progress towards a cessation of hostilities in Ukraine. While the Russian army has regrouped and seems to be targeting the eastern and southern parts of the country a diplomatic resolution seems further than in March. This is taking a significant toll on economies in both Russia and Ukraine and having a negative impact on wider Europe. Russia began using natural gas as an economic weapon by cutting off supply to Poland and Bulgaria after they refused to pay in Rubles. Russia is also still expected to imminently default on their international debt and the insurance cost against default (CDS) has risen significantly since the invasion. Finally, in a bit of welcome news around 'more of the same' French president Macron defeated potentially disruptive Marine Le Pen giving him a second term. Populist Le Pen historically has been critical of the European Union and NATO.

All of these challenges domestically and internationally are cause for concern economically in the U.S. The announced acceleration in the pace of interest rate increases by the Federal Reserve means that the short-term direction of 'soft landing' or recession hangs in the balance. According to former Treasury Secretary Larry Summers, there has never been a moment when inflation was above 4.0% and unemployment below 5.0% when we did not have a recession within the next two years. What works in the Fed's favor is that the economy is currently on solid footing. Jobs are strong (as noted above), interest rates are still historically low and consumer balance sheets are healthy. There are, however, some recent data that point to a tougher time with a soft landing. The first is the consumer confidence. It has been declining as of late and most likely tied to the significant inflation at the consumer level.

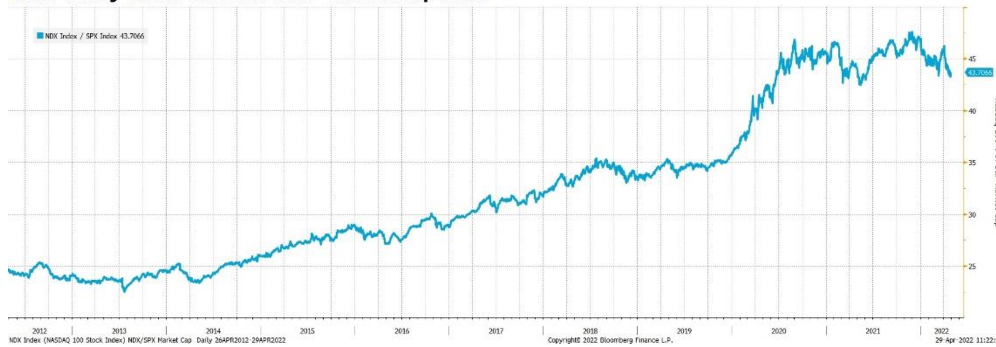
Globally, corporations are revising down their earnings growth expectations. In addition, the International Monetary Fund (IMF) reduced their estimate of global growth from 4.4% in 2022 to 3.6% (from 6.1% in 2021). Rather than citing COVID as a reason it is the impact from the war in Ukraine.



The biggest surprise came in the last week of April with the initial read on 2022 Q1 GDP. While recognizing the slower growth in the economy, the expectation was for +1.0% and it came in at -1.4% (vs. 6.9% in 2021 Q4). This will certainly fuel the recession talk but there were some specific items that indicate the report may not be as bad as feared. The decline mainly came from trade (we are importing more than we are exporting), slower inventory build (from a high-level last quarter) and decreased government spending. On the plus side consumer spending increased at a 2.7% annual rate and business spending increased. Both still point to continued underlying strength. However, as discussed above, risks skew to the downside and there is a lag effect to Fed rate increases which can take time to have their cumulative effect on the economy. The increased rates are already having a negative impact on home sales as the average 30-year mortgage is now over 5.00% (first time since 2011) from around 3.25% in January. That would mean a payment of $300 more per month on a $300,000 mortgage.

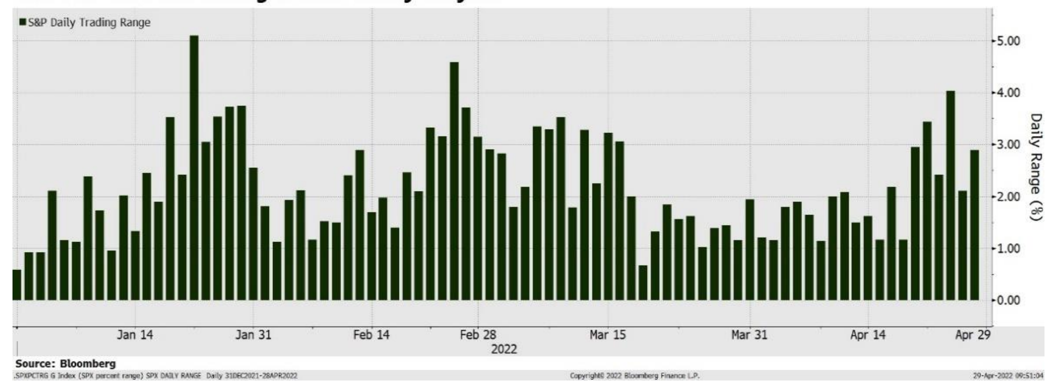


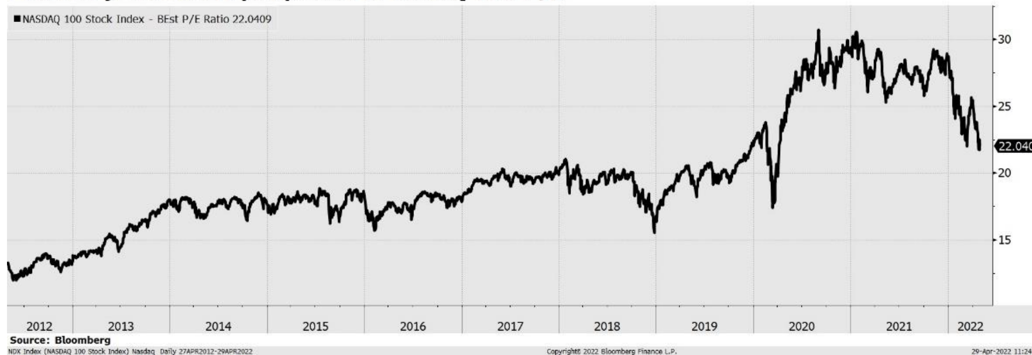
Financial Markets



All the items discussed above took their toll on U.S. equity markets in the month of April as they generally had their worst month since March 2020. The S&P 500 index total return was -8.7% for the month which brings the YTD total return to -12.9% and the rolling 1 year return almost to 0%. This was the worst April for the S&P 500 in 52 years.

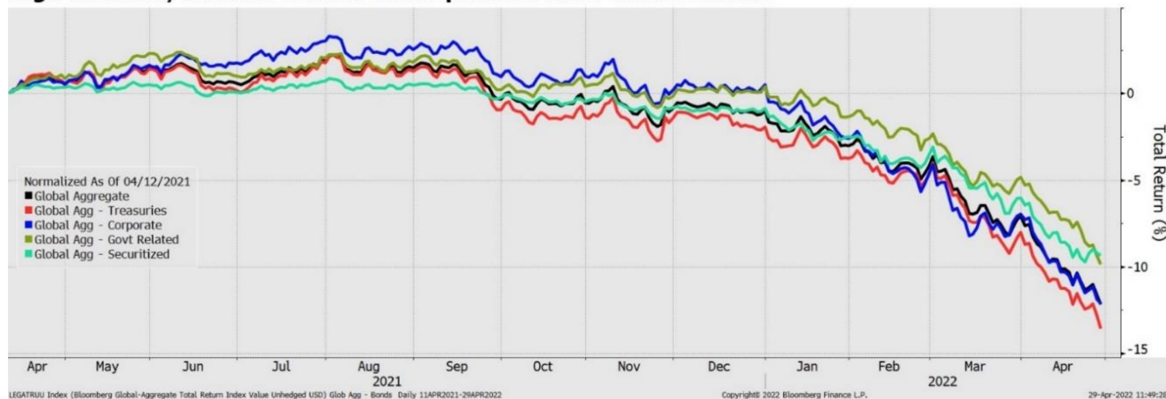
April also experienced continuation of elevated volatility levels in equity markets. Many current issues such as inflation, path of interest rate increases, and geopolitical events do not have much clarity in terms of their direction or resolution. This uncertainly is driving volatility in the markets as investors try to digest all new information.



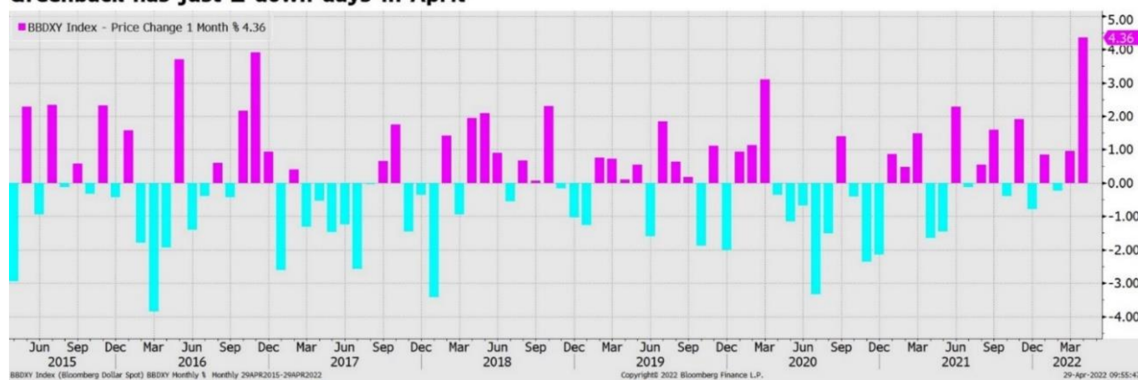


Much of the index decline can be pinned on the significant drop in tech stocks. All the FAAMNG names, which have been powering the market in recent years, are down 15% or more for the year. Amazon alone dropped 14% on Friday after poor earnings and is down 25% for 2022. Given the heavy weighting of the tech stocks in the S&P 500 they are having an outsized effect on the index return. The tech heavy NASDAQ 100 index is in bear market territory – down 24% for 2022 so far. Even with that decline the NASDAQ 100 is still rather expensive against historical as measured by the P/E ratio.

International returns have been similarly challenged. Developed and Emerging market equities are similarly down about 12.0% for the year. While Europe, especially, is going through the same inflation issues as the U.S., they are also dealing with the disruption of high energy costs due to the reduction in supply of Russian oil and gas on which they are dependent. They also have the war in their backyard which affects consumer confidence. The increase in probability of recession in the next 24 months are higher in Europe than the U.S.



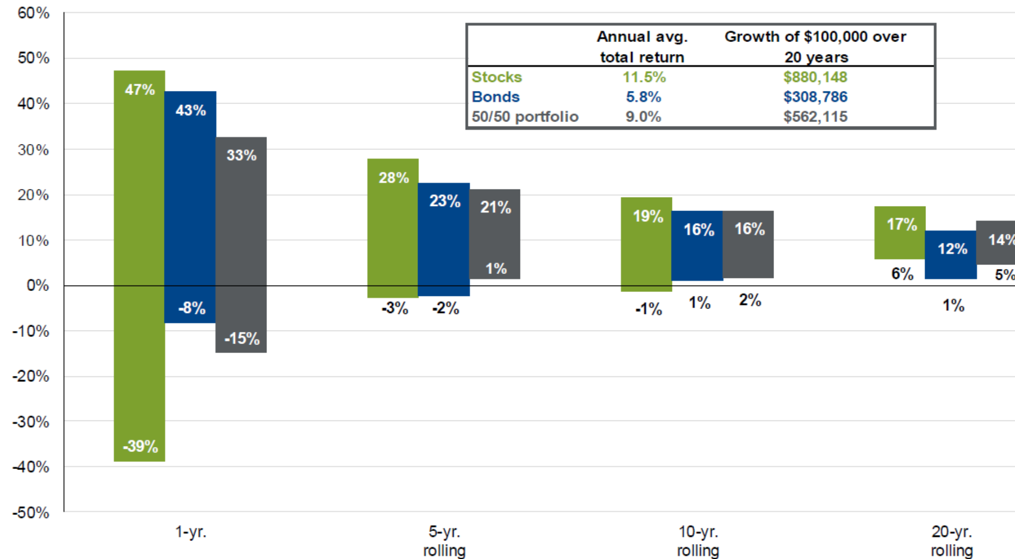
As poor as the equity returns have been in the U.S. fixed income is worse. The rate increases indicated by the Federal Reserve has been reflected in bond prices somewhat and returns have suffered. All sectors of fixed income are down this year so far with long-dated treasuries faring worst. One of the most often-referenced index for U.S. investment grade fixed income is the S&P U.S. Aggregate Bond Index. It is comprised of U.S. government and corporate bonds with a duration of about 6 years – considered intermediate in length. The 2022 YTD return of this index is -8.8% - while bad for people currently holding bonds it does increase the yield for those looking to purchase new bonds. The current yield on a 2-year treasury is about 2.5% and the for the first time in a long time the 3-year treasury is about the same yield as the S&P 500 dividend yield.



Since the U.S. is one of the few central banks around the world raising interest rates – and the most aggressive – the consequence is an impact on the currency exchange rates. Higher interest rates usually translate into a higher value of a country's currency and that is what we see happening to the dollar. The dollar is at its highest level in about 20 years and has increased about 7% in 2022 relative to a trade-weighted basket of other currencies.

Isolating the Japanese Yen on the chart to the left one can see the appreciation of the dollar relative to a 20-year time frame. It currently costs 130 Yen to buy a US dollar – most expensive since 2002. This is mainly due to the interest rate differential. While the U.S. is aggressively embarking on rate increases the Central Bank of Japan is not raising interest rates at all and still buying bonds in order to keep rates low. This change in exchange has the effect of making Japanese goods cheaper in the U.S. and U.S. goods more expensive in Japan and contributes to the net import deficit cited above in the GDP results.

Looking forward there are several topics that bear watching. The first would be a peak and subsequent decline in inflation – which has its roots in COVID cases (especially in China) and more people returning to work in the U.S. This would then have an impact on the pace of Federal Reserve monetary policy and future interest rates. Finally, some progress towards a resolution in the Ukraine conflict. Clarity and a positive outcome for each would go a long way in settling jittery markets and the challenges facing global growth.



Despite several challenges and current market performance history teaches us that timing the market is difficult. Time in the market rather than timing the market is more successful. The J.P. Morgan chart shows that the longer we are invested the better our outcome. Over a 20-year rolling period risk assets have not had a negative outcome.

Should you have any questions please contact us.

Image sources: Bloomberg and CNBC unless otherwise noted

Buffalo Office

1114 Delaware Ave.

Buffalo, New York 14209

PHONE: 716-883-9595

Jamestown Office

214 West Fifth Street

Jamestown, New York 14701

PHONE: 716-484-2402

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