Quarterly Economic Update

June 14, 2022

MACROECONOMIC COMMENTARY

Fiscal/Monetary Policy

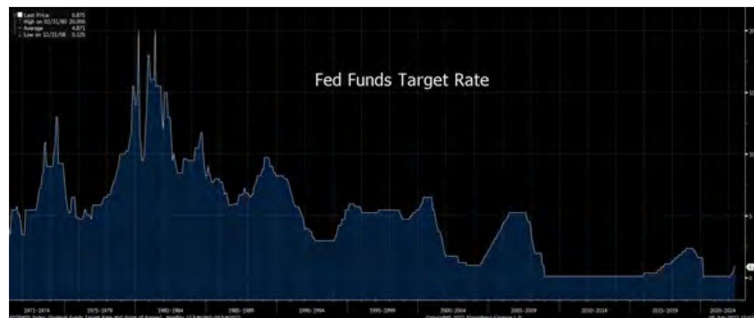
By Michael McNair

I stood at the gas pump, transfixed on the screen displaying the cost of filling my tank, when the gentleman at the pump next to me un-provokingly declared, “I don’t know what’s dumber, printing money or being surprised it caused inflation?” It seems that monetary policy, once confined to the pages of investment reports, has crossed the chasm to the mainstream small talk. You would have to be living under a rock to be unaware that the Fed is currently in a tightening cycle. At their May meeting, the Federal Reserve raised its benchmark interest rate by a half-a-percentage point, following a quarter-point increase in March. The moves mark a sharp U-turn from the easy-money policies the Fed had pursued through most of the pandemic.

Fed governors also signaled that they are likely to peruse half-point rate increases at their June and July meetings (The Fed’s June rate decision will occur just after publication).

Fed Chairman, Jay Powell, has vowed to keep tightening monetary policy until the central bank sees “clear and convincing” signs that inflation is slowing and moving back to its 2 per cent target. “We’re going to keep pushing until we see that,” he said earlier this month.

The Hiking Cycle in Context:

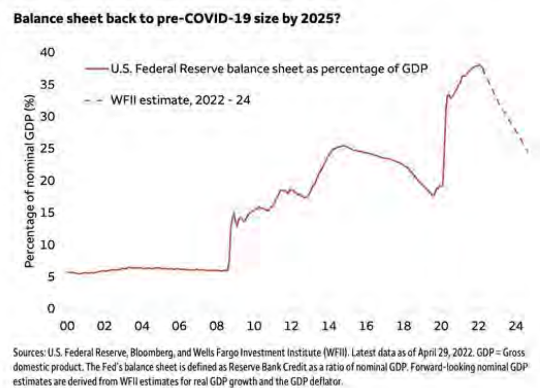


The Fed also agreed to begin reducing its $9 trillion-dollar balance sheet through a process called “quantitative tightening” (ie QT). Under quantitative easing (QE) the Fed buys Treasury securities (ie bonds) and increases deposits in the banking system. QT is

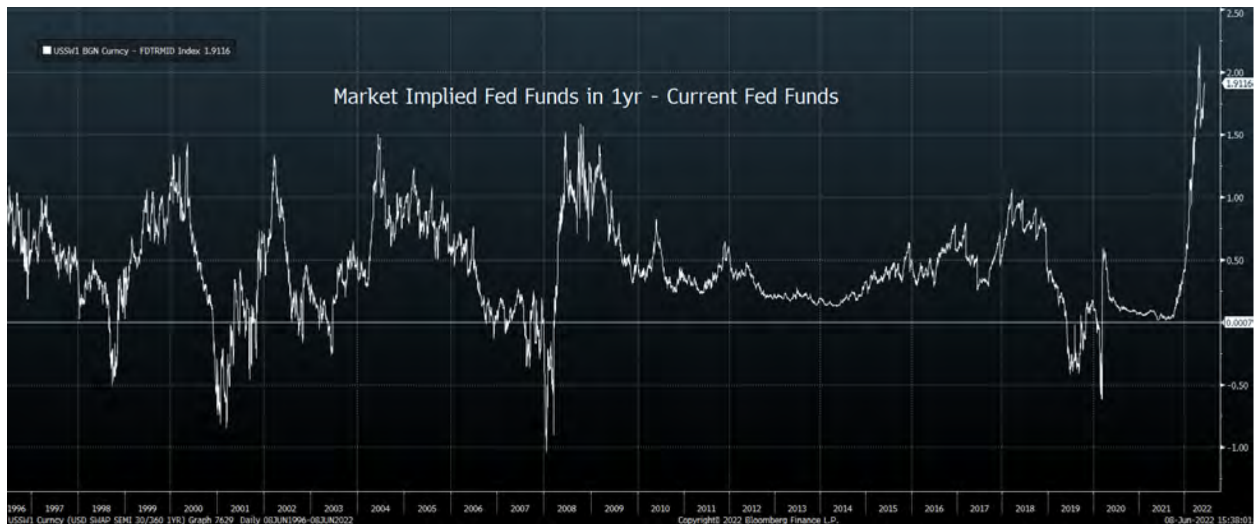
the reversal of QE, whereby the Fed will begin selling treasuries back to banks and removing deposits from the banking system.

The Fed initiated its QT program at the beginning of June. The Fed has committed to selling its holdings of Treasury securities, agency debt, and agency mortgage-backed securities by a combined $47.5 billion per month for the first three months. After this, the total amount to be reduced goes up to $95 billion a month, with policymakers prepared to adjust their approach as the economy and financial markets evolve.

The Fed will also allow maturing securities to roll off their balance sheet and will no longer reinvest the proceeds of its securities. Between QT and the roll-off of maturing securities, the Fed estimates that their balance sheet will shrink by $1.5 trillion by the end of 2023 (a 17% reduction). According to the Fed, "this $1.5 trillion reduction in the balance sheet could be equivalent to another 75 – 100 basis points of tightening".



The market believes the Fed's monetary tightening cycle has just started. The Fed has hiked less than 0.75% this cycle, while the market is currently pricing in rate hikes of nearly 2% over the next year. The market is pricing in one of the sharpest tightening cycles on record.



Is Monetary Policy an Appropriate Tool for Fighting Inflation?

The Fed's Plan to Tackle Inflation

The Fed has come under immense scrutiny due to inflation measures reaching their highest readings in 40 years. The prevailing perception is that the Fed was slow to react to signs of rising inflation; therefore the Fed is, at least, partially responsible for inflation continuing to accelerate. Pundits have filled the airways debating the amount of rate hikes needed to bring inflation under control. However, the appropriate question is not "how many basis points does the Fed need to lift rates to reduce inflation", but whether monetary policy is the appropriate tool to manage inflation in the first place?

At the Fed's May news conference, Fed Chairman Powell was asked:

“What is the mechanism by which a higher federal funds rate is supposed to bring down inflation, if not by raising unemployment?”

Chairman Powell’s responded candidly:

“There is a very, very tight labor market, tight to an unhealthy level. Our tools work as you describe … if you were moving down the number of job openings, you would have less upward pressure on wages, less of a labor shortage.”

Powell’s intentions are clear. Increase the cost and availability of credit so that businesses invest less, leading to a reduction in demand for labor, weakening labor’s bargaining power, and forcing labor to accept lower wages.

Employment decisions are made by the private sector. The Federal Reserve can only attempt to indirectly influence the labor market. The Fed’s tool to “cool” the labor market is to increase the overnight lending rate between banks and sell off some of its holdings of longer-maturity Treasuries and mortgage-backed securities that currently sit on their balance sheet.

The higher short-term lending rate should manifest in higher interest rates, which – theoretically – should tighten lending standards. Finally, rising rates and security sales are could reduce the value of financial assets and diminish the willingness of businesses to invest.

In summary, rising rates are expected to lead to tighter credit conditions and falling financial asset values, which should reduce borrowing, and in turn, reduce aggregate demand. Since inflation is a result of aggregate demand exceeding the production capacity of the economy, the Fed’s goal is to indirectly reduce demand.

The best-laid plans of mice and men often go awry

There is ample reason to be critical of using monetary policy to fight inflation. First, tighter monetary policy reduces aggregate demand by lowering real incomes and reducing demand for employment. If rate hikes have any effect on inflation, it is through a reduction in incomes. Whether or not you accept the textbook view that the path from demand to prices runs via unemployment wage growth, it is still the case that reduced output implies less demand for labor, meaning slower growth in employment and wages.

Prior to the pandemic, the economy was in a demand-constrained environment for decades. Therefore, the proper policy response was to stimulate demand. However, when the economy is running up against capacity constraints (as it currently is) increased government spending will push demand above the capacity of the economy to produce at stable prices – i.e. inflation.

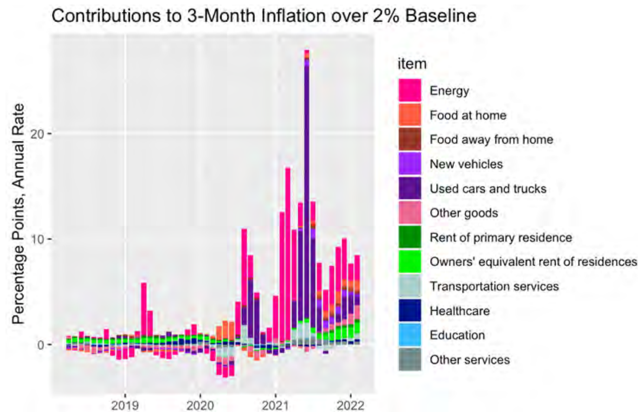
Therefore, Powell's goal is to use monetary policy to reduce aggregate demand through a reduction in income.

The biggest problem with the logic of using monetary policy as a tool for managing inflation is that it disproportionally impacts the wrong part of aggregate demand. Aggregate demand consists of investment and consumption. Powell, like Keynes, is focused on aggregate demand in general; however, John Hobson took this idea further and said that the proper policy depends upon "exact circumstances as to which component of aggregate demand should be increased or decreased respectively".

Rising rates will likely temper demand but the component of demand that falls the most is investment, not consumption. Inflation is about demand exceeding supply. In the short-term consumption and investment look the same because investment consumes goods while it is being "built". In the short term, it matters little which component of demand falls relative to supply in order to reduce inflation. The problem is that in the mid/longer-term (most) investment increases the economy's productive capacity; thus, relieving inflationary pressures. Therefore, the composition of demand very much matters.

Spending equals income in the economy. Therefore, if you choose to reduce demand, it will lower incomes and weaken the economy. However, if demand is stable but the relative composition of demand shifts from less consumption to more investment, then total spending - thus income – in the economy can be maintained all while loosening supply and demand because investment leads to higher future supply. Thus, when the economy is in a supply-constrained state and inflation is running hot, the fundamental impediment to economic growth is a lack of supply and not a lack of demand. In this scenario, you need supply-side policies that tax consumption and incentivize investment. The most fundamental problem with using monetary policy to rein in inflation is that it causes the opposite adjustment (it shifts aggregate demand from investment to consumption). While tighter monetary policy might be effective in reducing inflation in the short term, it increases inflation in the long term by reducing the investment needed to increase the future production capacity of the economy.

Second, rate hikes will have a disproportionate effect on certain parts of the economy that may not be the source of the supply constraints that have led to inflation. The decline in output, incomes, and employment will initially come in the most interest-sensitive parts of the economy. Non-housing services (which make up about 30 percent of the CPI basket) are still contributing almost nothing to the excess inflation. Yet, according to the Bureau of Industry and Security (BIS), it's these services where the effects of tightening will be felt most.



The third point is that monetary policy acts with a significant lag. It is true that some asset prices and market interest rates may move as soon as the Fed funds rate changes — or even in advance of the actual change, as with mortgage rates this year. But the translation from this to real activity is much slower. According to the Fed's own FRB/US model, the peak effect of a rate hike comes about two years later and significant effects continue up to four years later.

Therefore, the Fed's current rate hikes are setting policy for 2023, 2024, and 2025. If you have a tool that only works with a multi-year lag, then you need to know what the economic conditions will look like years in the future. Yet, by the Fed's admission, they can only successfully forecast economic conditions a few months in advance.

The significant time lag of monetary policy makes it unlikely that the Fed can deliver a "soft landing". Anyone who has taken a shower with a significant lag between adjusting the hot and cold water will understand the difficulty of achieving the appropriate temperature. The Fed's tightening will either be too little and too late to impact prices or their policies will be overly restrictive. The Fed may feel they've done enough once they see unemployment start to rise. But by that point, they'll have baked several more years of rising unemployment into the economy. By the time the full effects of the current round of tightening may be felt, the US economy may be entering a recession.

The economy is a complex adaptive system. Higher interest rates might eventually reduce spending, wages, and prices. However, countless feedback loops will dampen or amplify the effect of interest rate changes. The idea of a "neutral rate" that somehow corresponds to the true inter-temporal interest rate is a fantasy.

In short: Monetary policy is an anti-inflation tool that works, when it does, by lowering employment and wages; by reducing spending in a few interest-sensitive sectors of the economy, which may have little overlap with those where prices are rising; whose main effects take longer to be felt than we can reasonably predict demand conditions; and that is more likely to provoke a sharp downturn than a gradual deceleration.

Conventional monetary policy is a bad way of managing the economy and entails a bad way of thinking about the economy. We should not buy into a framework in which

problems of rising prices or slow growth or high unemployment get reduced to "what should the federal funds rate do?"

The Fed's Dual Mandate

Contrary to widely held belief, the Fed's governing statutes do not give it a legal responsibility for inflation or unemployment.

In a recent research paper, Professor Lev Menand, of Columbia Law School, points out that the legal mandate of the Fed has been widely misunderstood.

The Federal Reserve Act charges the Fed with:

Maintain[ing] the long run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.

Menand points out that the mandate is not to maintain price stability or full employment but to prevent developments in the financial system that interfere with them. Limiting the Fed's macroeconomic role to this narrower mission was the explicit intent of the lawmakers who wrote the Fed's governing statutes from the 1930s onward.

Price stability, maximum employment, and moderate interest rates (an often forgotten part of the Fed's mandate) are not presented as independent objectives, but as the expected consequences of keeping credit growth on a steady path.

According to Menand:

The Fed's job, as policymakers then recognized, was not to combat inflation—it was to ensure that banks create enough money and credit to keep the nation's productive resources fully utilized. This distinction is important because there are many reasons that, in the short-to-medium term, the economy might not achieve full potential—as manifested by maximum employment, price stability, and moderate long-term interest rates. And often these reasons have nothing to do with monetary expansion, the only variable Congress expected the Fed to control. For example, supply shortages of key goods and services can cause prices to rise for months or even years while producers adapt to satisfy changing market demand. The Fed's job is not to stop these price rises—even if policymakers might think stopping them is desirable—just as the Fed's job is not to … lend lots of money to companies so that they can hire more workers. The Fed's job is to ensure that a lack of money and credit created by the banking system—an inelastic money supply—does not prevent the economy from achieving these goals. That is its sole mandate.

Menand goes on to note that the idea that the Fed was directly responsible for macroeconomic outcomes was a new development in the 1980s, an aspect of the

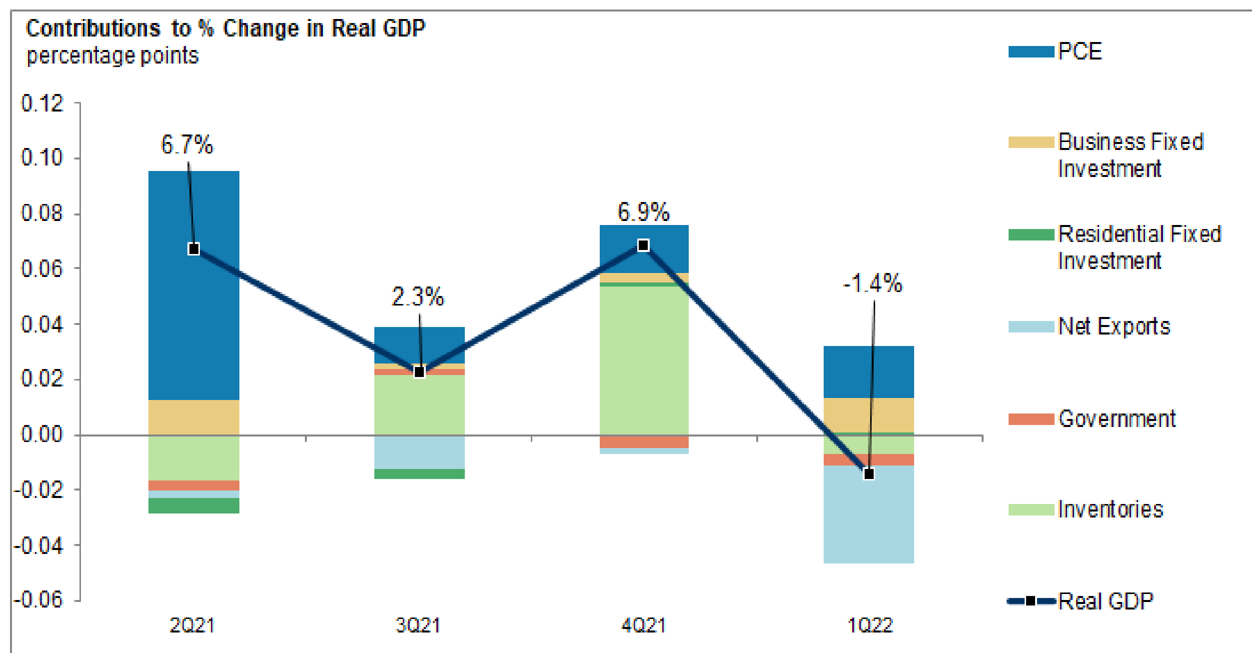
broader neoliberal turn that had no basis in law. Nor does it have any good basis in economics. If a financial crisis leads to a credit crunch, or credit-fueled speculation develops into an asset bubble, the central bank can and should take steps to stabilize credit growth and asset prices. In doing so, it will contribute to the stability of the real economy. But when inflation or unemployment come from other sources, conventional monetary policy is a clumsy, ineffectual, and often destructive way of responding to them.

Economic Outlook

By Bobby Long

As the US economy emerged from the self-induced COVID recession, it has experienced a uniquely sharp rebound supported by policy actions that fueled consumer spending. The strong consumer demand boosted corporate profits and stimulated manufacturing activity as businesses have sought to restock depleted inventories. A combination of low interest rates, increasing household formation trends, migration from large cities to suburban areas, increased desire for second homes and vacation properties, and a low housing stock have served to drive a robust level of housing and residential construction activity. Labor conditions have tightened considerably, with more jobs available than willing workers. All of these factors have contributed to the generally healthy state of current economic conditions, however with these tailwinds fading economic growth will likely slow over the next several quarters.

Real GDP growth trended above average coming off COVID restrictions. The recent quarter, while expected to be weaker, somewhat surprised us with a contraction of -1.5%. The chart below breaks down the contributing components to the most recent number and the prior three quarters for comparison. Personal consumption grew by 2.7%, representing a slightly stronger rate over the prior quarter. Business fixed investment was a positive contributor, supported by an uptick in equipment investment and continued strength in intellectual property product investment. Inventories and net exports weighted the number down enough to pull the overall percent change in real GDP negative for the quarter. Inventories saw strong increases in the second half of 2021, and while they increased again in 1Q22, they did so at a lower rate which made them a drag on the rate of change. Imports were strong, however they were offset by much weaker exports.



Source: Bureau of Economic Analysis, Morgan Stanley Research

The contraction in 1Q22 is likely more of an anomaly and does not necessarily represent a sharp deterioration of economic conditions. As noted, the weaker contribution from inventories can largely be attributed to calculation methods coming off an abnormal period of large drawdowns and restocking of inventories. The weakness in net exports probably reflects some weaker conditions outside the US and continued supply chain disruptions. Net exports are historically volatile from quarter to quarter, so it is something to watch but may not represent a significant deterioration at this point. Personal consumption and business fixed investments are much larger components to US economic activity, so we are reassured by the healthy contributions from these components. Consensus forecast for 2Q22 real GDP calls for 3% growth with the view that the first quarter weakness was an outlier. The Federal Reserve Bank of Atlanta's GDPNow estimate, which attempts to provide a running estimate of real GDP growth based on available economic data for the current quarter, has been running below this and has more recently trended lower to 0.9%. Contributing to the more recent declines in the GDPNow estimate are lower consumer spending and both residential and nonresidential fixed investment.

The Federal Reserve's most recent Beige Book report, which assesses economic activity across the twelve Federal Reserve Districts, noted that the majority of districts reported continued economic growth at a slight to modest rate with several indicating that the pace of growth had slowed since the prior report. The Beige Book report indicated some weakening in consumer spending and lower residential real estate activity. It also indicated that labor market difficulties and supply chain disruptions continued to plague businesses and weigh on economic activity. Eight districts reported that expectations of future growth among their contacts had diminished and three districts reported that contacts specifically expressed concerns about a recession.

Economic activity is slowing and real GDP growth will likely trend below the levels seen over the past two years. Part of this can be viewed as a natural reversion to the mean. Economic activity and consumer spending were brought to an unprecedented halt at the onset of COVID restrictions, only to rebound to the upside once restrictions were lifted. A normalization of activity and consumer spending should be expected following these swings. However, many tailwinds that supported the rebound in activity are now diminishing and some are likely to serve as headwinds to further economic growth.

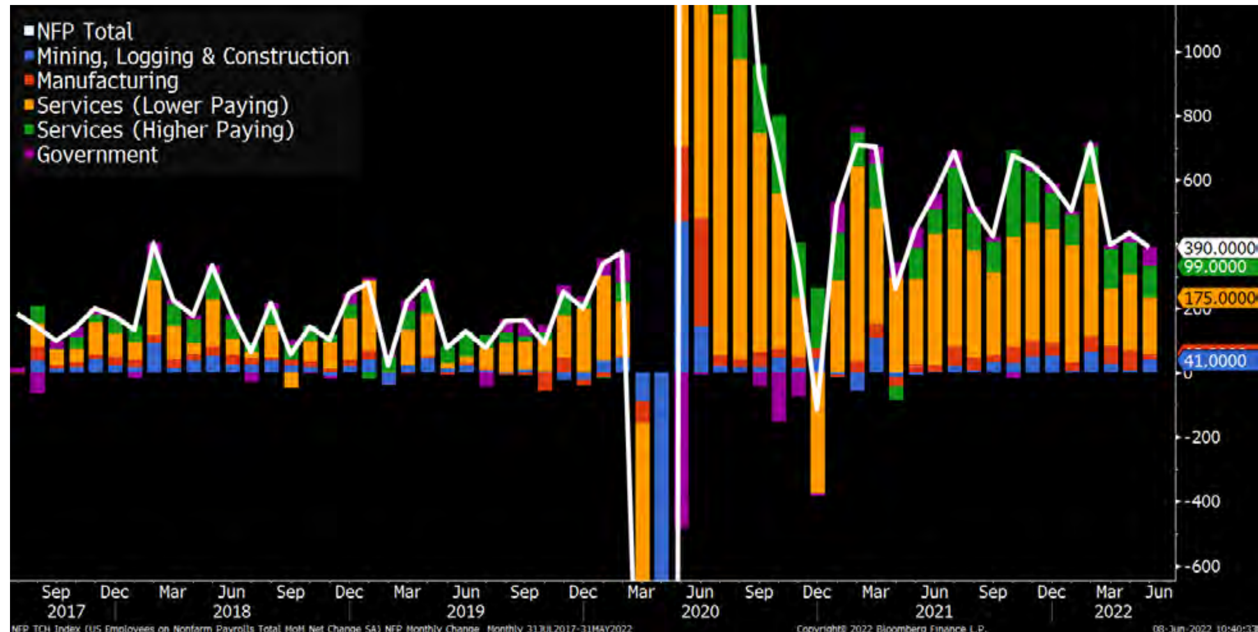
Consumers were relatively healthy going into the COVID recession. Higher savings rates, fiscal stimulus payments, and low interest rates on debt increased consumer spending power. Rebounding financial markets and higher housing prices also boosted consumer balance sheets. Fiscal stimulus payments have now ceased and excess savings have been drawn down. Savings rates and excess savings are still elevated, but more bifurcated across the income spectrum with lower income brackets now having more limited spending capacity. Higher interest on debt service is also cutting into disposable income and consumer credit liabilities have ticked up. Debt-service costs are still low and manageable, but they will be increasing as interest rates rise. Tight labor markets have provided nominal wage growth to workers, however real

wages over the past year have been broadly declining with inflation. The consumer remains healthy overall and spending levels have not registered a decline, but spending capacity is less and more likely to diminish over the next several quarters.

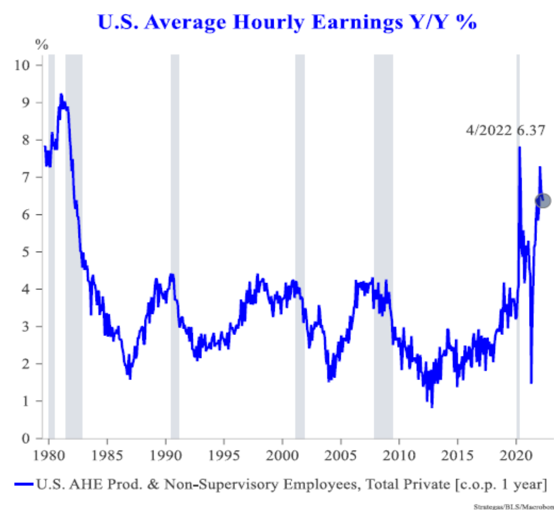
Consumer sentiment never fully recovered post the COVID recession, but it has weakened significantly further over the past twelve months. The University of Michigan Consumer Sentiment Survey largely reflects how individuals view their financial situation and purchasing power. Declining real wages and inflationary pressures on household expenses are likely driving this lower despite improving employment and economic conditions. Real wages had held up better for the lower income brackets where labor conditions have been tighter, but they have also slipped into negative territory more recently which may partly explain the further deterioration this year in sentiment. The May survey ticked down further to 58.4. As sentiment weakens, even those with the excess capacity to spend may pull back on discretionary spending. The chart below shows how this index has trended over a longer period of time and overlays the measure with recessionary periods highlighted by the gray bars. An improvement here would provide some comfort on the sustainability of consumer spending and continued economic expansion.

The employment situation has improved further. Total US payrolls are almost back to their February 2020 level. Healthcare, Leisure and Hospitality, and Education payrolls still lag, but total payrolls are now within -0.5% or roughly 822,000 jobs short of pre-COVID levels. The unemployment rate has held steady over the past three months at 3.6%. The labor force participation rate remains roughly flat at 62.3%, still below the February 2020 level of 63.4%. With a surplus of jobs available and rising nominal wages, this seems to indicate that many employees have permanently left the labor force and are unlikely to return; however there are still a large number of prime-age workers who can be drawn back into the labor market as tight labor conditions are enticing workers with higher wages. There has been an uptick in jobless claims recently, which should be watched for signs of a larger trend developing. Layoffs and reduced hiring plans have also surfaced in some industries. It would not be surprising to see more of these announcements as revenue growth slows and margins shrink.

Nonfarm payrolls have continued to come in strong over the past few months. The white line in the chart below is the total number of monthly payroll additions over the past five years, pre- and post-COVID, with the large swings truncated to highlight the running trend. Payroll gains have been trending at an above average rate over the past 18 months. There are limits to the pace of additional payroll gains as labor markets approach full employment, so it would be reasonable to see monthly payroll additions trend lower going forward which would not necessarily be a sign of weakening labor conditions by itself.

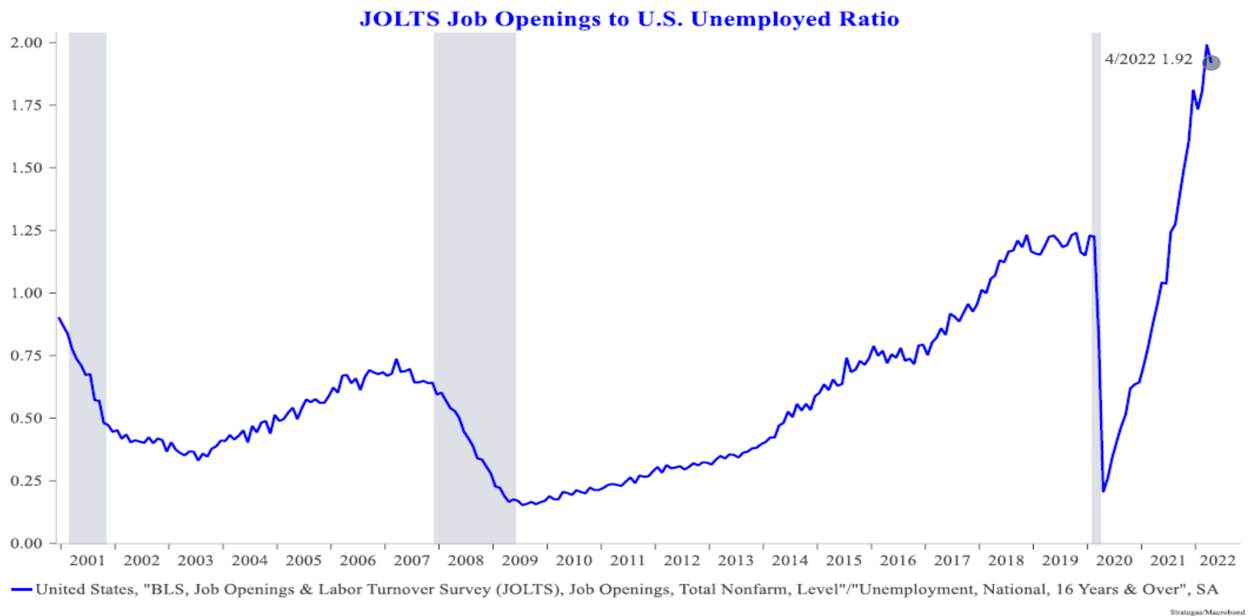


Strong economic activity and tight labor conditions have led to higher wages for workers. Supported by profits and the ability to pass higher costs on to consumers, employers have been able to digest this. Continued increases at this pace would be negative as it would feed into the larger inflationary problems and cut into profit margins. More recently, wage gains have shown some signs of slowing, which would be largely positive. The Fed's Beige Book also noted that some districts were seeing increases leveling off or edging down.



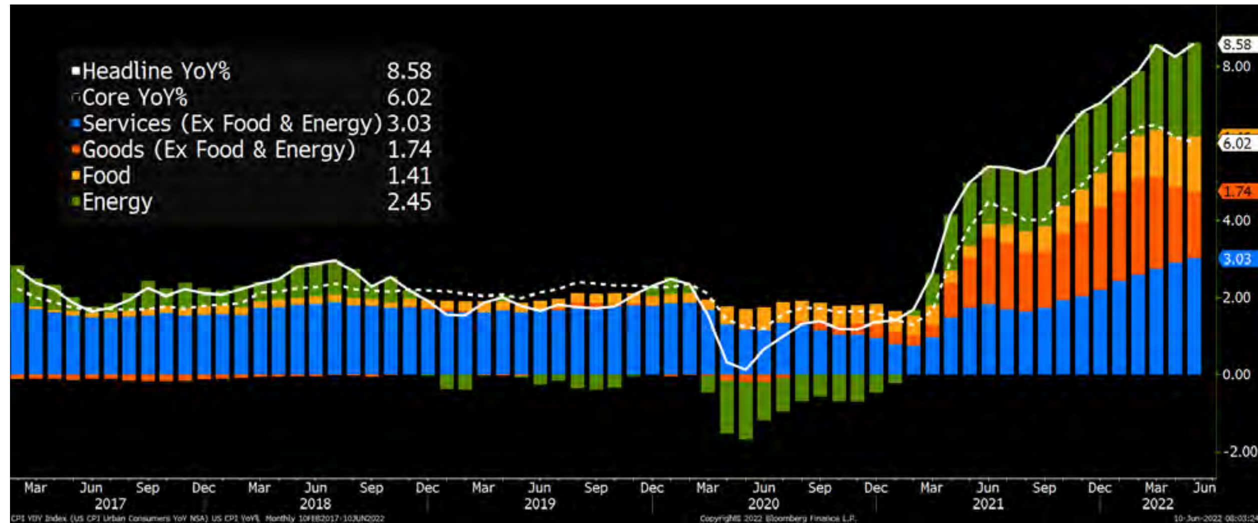
Inflation continues to be a problem that has proven to be more persistent and surprised to the upside. This is now broadly acknowledged with the Federal Reserve shifting focus to bring inflation back down. Inflation can be viewed as driven by two distinct

factors. One being supply chain disruptions that can work through over time and prove more temporary. COVID related bottlenecks have seen some improvement, but are still creating problems and pushing costs higher as businesses seek to secure inventory and manufacturing inputs. The demand surge for goods that occurred as supply chains issues developed should also continue to wane. The second factor creating inflationary pressures can be attributed to excess money supply from overly accommodative policy action that can be more persistent and harder to tame. With the Federal Reserve now raising the federal funds rate and reducing the size of securities holdings on their balance sheet, they are actively seeking to slow economic activity and reduce money supply in an effort to curb inflationary pressures. Quantitative tightening will shrink the Fed's balance sheet by 10% over the next year, which could cause money supply to contract. The Federal Reserve is attempting to slow economy activity without sending the economy into a recession. With their dual mandate to promote maximum employment and price stability, they would like to bring the job openings to unemployed ratio shown in the chart below down. This could serve to reduce wage inflation without triggering any real job losses.



A current debate is whether inflation has already peaked. Some recent measures have slightly eased and could be the beginning of a slower pace. The clearing of bottlenecks should help supply and lift inventories. At the same time, demand for goods may slow from the post-COVID surge and as consumers shift spending back towards services. Goods inflation can moderate with this combination as supply and demand imbalances are restored. There are some reports of excess inventories and price reductions that have surfaced more recently. Service inflation however can be more sticky and harder to constrain. Inflation may slow at some point, but if it remains persistently higher it can still be problematic. Many had looked for the May CPI numbers to back off a bit, however the release showed inflation running higher than expected. Headline YoY CPI came in at 8.6% and Core YOY CPI at 6.0%. The chart on the following page shows

how inflation has trended over the past five years and accelerated over the past 18 months.



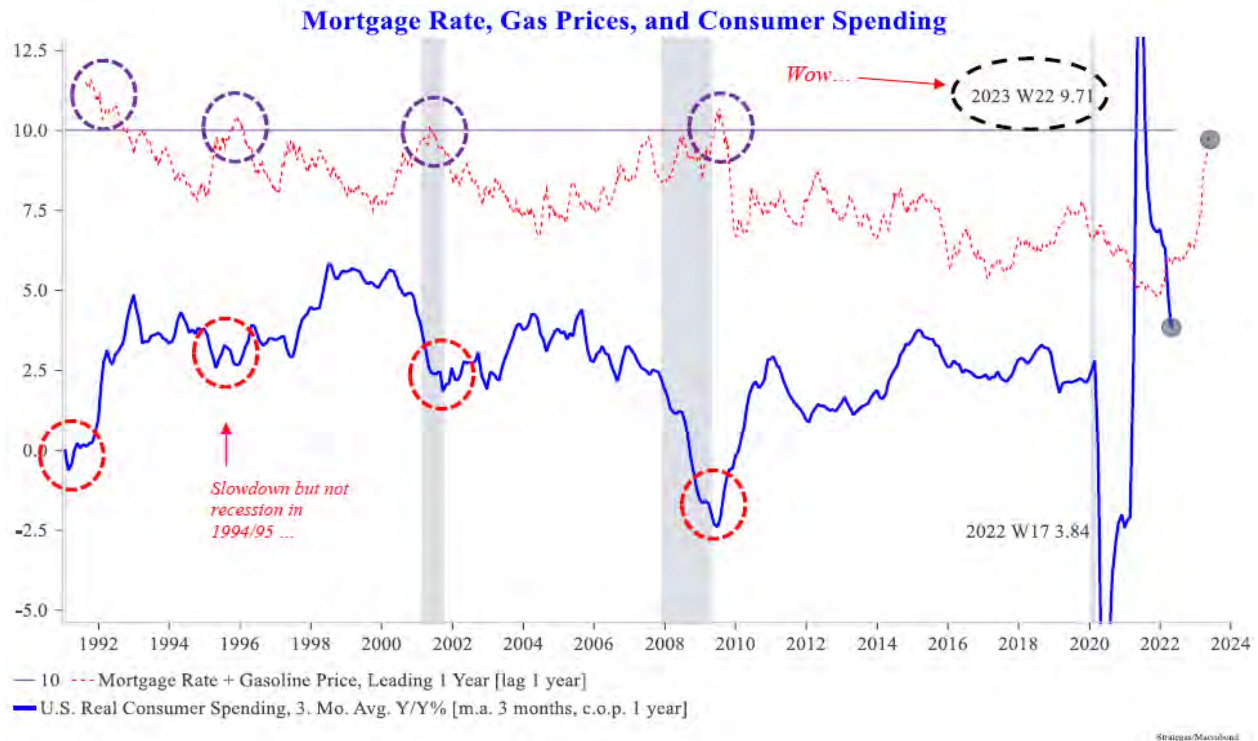
Manufacturing and capex investment have been positive and an important component in the strength of GDP growth. Manufacturing benefited from strong demand, but has also had to navigate supply chain issues. Manufacturing PMI's have weakened some recently, but remain on expansionary ground. Business profits have been strong and large companies have continued to reinvest in equipment. Order backlogs remain high and capex surveys show spending plans remain high.

Business confidence is mixed with the charts below highlighting divergent trends between small businesses and larger corporations. Small businesses are less able to deal with supply chain disruptions, labor shortages, and cost inflation. These problems can really cut into margins quickly. Larger businesses are more insulated from these disruptions and have more flexibility to manage these challenges, which has allowed them to enjoy stronger profits and supported capex plans. A deterioration in the CEO Confidence survey could signal weaker capex investment. The weaker small business optimism is somewhat concerning in that these businesses feel the impact of changing conditions quickly and have already had a difficult time navigation shutdowns and supply chain disruptions.

Rising energy prices have been troublesome for both consumers and businesses with gasoline prices pushing toward $5.00 a gallon. This represents a large risk to economic activity and inflation. Rising prices are a result of supply disruptions due to the Russia/Ukraine conflict and restrictive policy that has discouraged investment in resource and production capacity. Domestic resource is available, but requires additional investment to increase production and needs time to be brought online. Refining capacity is also limited. With limited spare capacity available to be quickly brought online and growing demand, prices continue to increase rapidly.

Housing and residential construction have been strong drivers of economic activity. With mortgage rates now on the rise, new and existing home sales have dropped sharply. Home prices have also increased sharply with stronger housing demand, low housing inventory, and rising construction costs. The combination has created affordability problems that are likely to persist and dampen home sales. Building material costs have been affected by supply chain issues, which may improve as these unwind, but NAHB surveys do not expect much relief. Labor shortages are also prevalent across the industry and rising labor cost are not coming down. If home sales remain weaker, this can weigh on housing related spending as well.

Rising energy prices and lower housing activity represent two of the larger risks to economic growth. The chart below shows that when the mortgage rate plus the price of gasoline climb above 10, consumer spending weakens and the risk of an economic slowdown or recession rises.



Policy actions have supported consumer spending and labor markets, however this support is now fading and economic growth is slowing. Rising interest rates and quantitative tightening are headwinds to further economic expansion. Consumer spending, especially from higher income brackets with plenty of excess cash and spending power, remains supportive and can carry economic growth further. Don Rissmiller of Strategas Securities, LLC recently noted that the top 20% of income earners do 40% of the spending and that the plan may be to "run the U.S. economy off rich people." Higher inflation needs to come down relatively quickly or more permanent damage will be done. We also need some relief on energy prices. Housing looks less likely to be the tailwind it has been for the economy over the past couple of years, or at least not as strong. Economic conditions are still okay and labor markets are strong, but there is less expansionary support. The Federal Reserve is shooting for a slower growth scenario as they combat inflationary pressures and looking to stick the "soft landing". The risk of a contraction in economic activity has risen, but conditions remain healthy overall underpinned by strength in labor markets, consumer spending, and business profits. A weakening by any of these three components would lead us to grow more concerned.

RSA PORTFOLIO STRATEGY

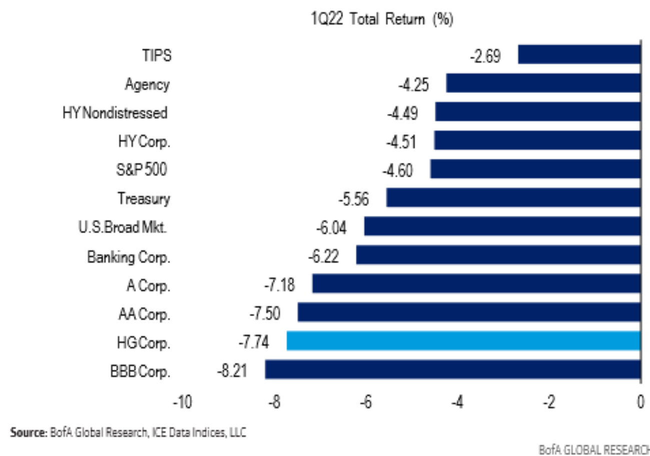
Interest Rates and Fixed Income Strategy

By Julie Barranco

When we last met in March, we spoke of the rising volatility in the markets due to numerous factors including geopolitical risks surrounding the Russia/Ukraine war, rising inflation and a more hawkish Fed. For the most part the risk-on sentiment persisted even as inflation data exceeded expectations and more rate hikes were being priced in for 2022. The Fed did raise rates in March by 25 basis points as expected, and also confirmed that their bond purchasing program would cease, and roll-off of securities from their balance sheet would begin soon. During the latter half of March the Treasury yield curve bear flattened as front-end yields rose. Equities were the only asset class to close the month with a positive return; all sectors of the bond market produced negative returns due to the rise in rates. On a relative basis high yield performed the best due to tighter spreads and a shorter duration profile, while high grade corporates and Treasuries performed the worst, declining nearly 3%. The chart below shows a summary of returns for the quarter ended March 30:

1Q-2022 returns

Figure 7: Broad Asset Class Total Return Performance, 1Q 2022
Quarterly total return for broad asset classes in 1Q-2022. TIPS outperformed (-2.69%), BBB Corporates underperformed (-8.21%).

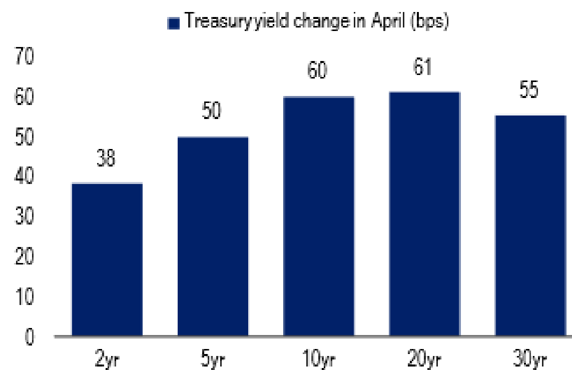


Source: BofA Global Research

For the March quarter all asset classes were negative. TIPS and shorter duration fixed income were the least negative, while high grade corporate issues performed the worst, mainly due to their longer duration profile.

All major asset classes sold off in April. Early in the month a strong March employment report bolstered expectations that the Fed would remain focused on taming inflation through tighter monetary policy. This pushed rate hike expectations higher for 2022 and moved the odds of a 50 basis point rate hike at the May, June and July meetings to

greater than 50%. Later in the month consumer and producer inflation readings were elevated once again which led to rates moving higher. Yields on the longer end of the curve increased more than shorter end, leading to a steeper curve. By mid-April the 10- year yield had reached 2.83%, the highest level since December 2018. High-grade and high-yield corporate spreads were widening, and new corporate supply was slowing as the cost of borrowing had risen notably in a short period of time.
Negative sentiment continued in the fixed income markets in the latter half of April as Chairman Powell opened the door to multiple 50 basis point hikes beginning with the May 3-4 meeting. Front end yields gapped higher while the longer end of the curve also sold off but at a less frenzied pace. The curve flattened and Fed Funds futures were now pricing in roughly nine hikes by December 2022. April ended with yields notably higher across the curve, as shown the chart below.



For the month of April, equities were the worst performing asset class, with a -8.72% return. Within fixed income, high-grade corporate performed the worst at roughly -5.0% due to higher rates and wider spreads. High-yield was slightly less negative at -3.64% due to its shorter duration profile. Government- related securities provided the least negative returns for the month.

May started off with the Fed meeting early in the month. The Committee voted to raise the Fed Funds rate 50 basis points as expected. In addition, the Fed also announced its quantitative tightening (QT) plan to aid in reducing its $9 trillion balance sheet. The central bank said that it intends to reduce its holdings of Treasury and mortgage-backed securities by $47.5 billion per month starting in June and plans to increase that amount to $95 billion per month three months later. One bit of positive news from the meeting was Chairman Powell's statement that the Fed would consider additional 50 basis point moves at the next couple of meetings, but they were not contemplating larger increases at this time. The Chairman also stated that Fed officials were "highly attentive to inflation risks" and that he thinks the Fed can cool the economy without pushing it into recession. These comments led to a strong rally in equity markets that afternoon.

The following week monthly inflation data was released. The April CPI rose 8.3% from the previous year, slightly higher than the 8.1% estimate. Excluding food and energy, core CPI still rose 6.2% from the previous year. The April PPI, measuring inflation at the wholesale level, rose 11% from the previous year. While these readings were down slightly from March levels, hopes that peak inflation had passed were dimmed. Treasury yields initially moved higher with the 10-year Treasury hitting a high of 3.20%, however this move was short-lived as broad based weakness in risk assets led to a flight to safety in Treasuries.

Despite several weak earnings announcements, particularly within the retail sector, economic data for the month overall was mixed and financial conditions tightened. Lower break-even inflation and lower policy tightening expectations in 2023 after the release of the FOMC's May meeting minutes helped interest rate volatility to decline and helped markets to stabilize in the latter half of the month.

For the month of May returns across most asset classes were marginally positive as credit spreads narrowed a bit and the curve bull steepened. High-grade credit delivered the best results at .54%, followed by high-yield credit returning .25%. Government-related securities and equities were slightly positive for the month.

June has gotten off to a rocky start. Equity markets have in general have moved lower. Interest rates have been increasing and are back near their recent highs. Credit spreads have moved marginally wider so far into the month. The May employment report released early in the month was strong and reinforced the belief that job growth will need to slow to bring inflation back down toward the Fed's target. Recent consumer and producer inflation data have remained elevated and have proven again that it is too soon to talk about "peak inflation". When the Fed meets again on June 15th they are expected to raise the Fed Funds rate 50 basis points again, and likely indicate that they will remain on this path for the time being.

The charts below depict credit spread movement for 2021 and year to date 2022, as well as the 5-year average:

	Jun 3 2022	Change (bp) Week	MTD	YTD		Jun 3 2022	Change (bp) Week	MTD	YTD
High Grade	138	-6	-2	40	High Yield	421	-17	-1	111
Financials	135	-5	-1	49					
Industrials	137	-6	-3	36					
Utilities	151	-8	-4	34					

Source: CreditSights, BofA/ML Indices (C0A0) Source: CreditSights, BofA/ML Indices (H0A0)

Source: CreditSights

Uncertainties about growth and inflation continue to be very high right now but we hope to see this decline toward year end as we get more data. Financial conditions have already tightened notably due to the equity market sell off, the worsening growth outlook and the surge higher in interest rates, so much of the Fed's work has been done for them. Because of this, we have seen the market adjust pricing on Fed Funds down a bit from the 3.3% level for late 2023 we saw in early May but continued strong data could lead to rate hike projections rising again. All of that said, there are still risks out there. Sticky inflation and a hard landing in the US as well as risks to growth in Europe and China could change the current outlook. Many investors still believe that the chance of recession in 2022 is somewhat low due to strong household and corporate balance sheets which will keep the economy expanding, although at a slower pace. Into 2023 it is a different story, with a larger percentage of investors calling for a recession by the end of that year. The rapid increase in yields coupled with a decline in consumer sentiment are two of the main reasons cited.

With rates having moved higher since our last meeting, we have been somewhat active within the fixed income portfolio as we try to best position ourselves around the current volatility. Within the corporate sector we have added a handful of new positions; issues purchased include some short maturity General Motors as well as some Morgan Stanley callable subordinated notes. American Express, Nucor and Church & Dwight were among new issue deals we participated in. These purchases were offered at attractive spreads within their sectors and allowed us to add yield without a large amount of credit risk. The new issue calendar has been active here and there, with issuers taking advantage of risk-on windows in the market when the opportunity arises. Overall new corporate supply is expected to be slower for the remainder of the year as many issuers have already taken care of their financing needs. Corporate spreads have been widening for the past few months, but so far it has not caused any major concerns, and we are monitoring levels closely. If the economy moves into recession

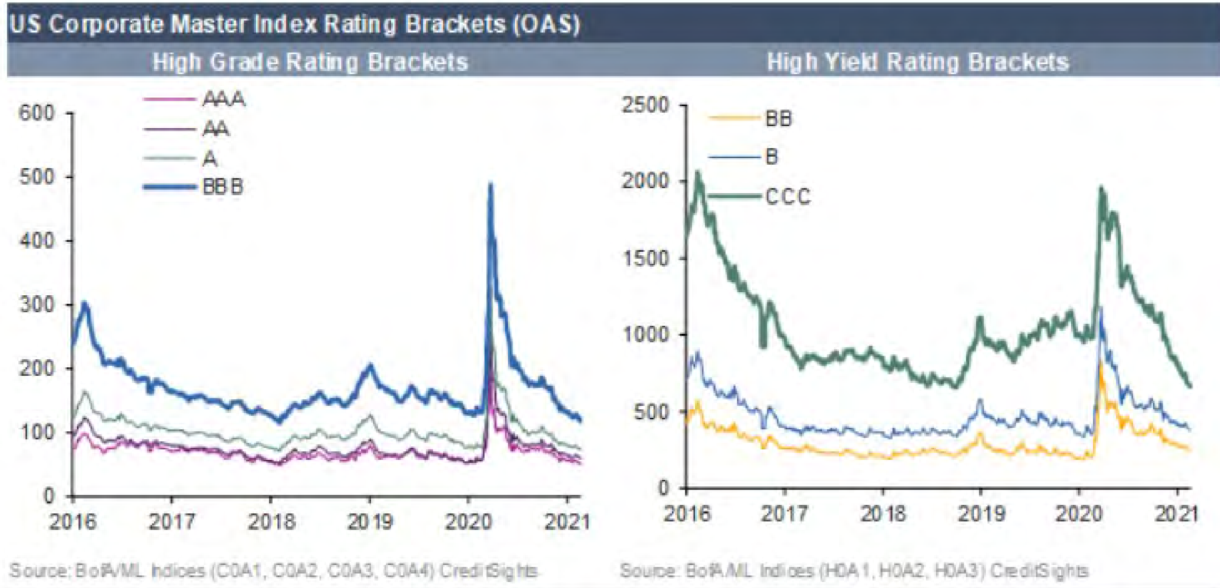
later this year or into next year as some believe, we would likely see corporate spreads continue to move wider, especially in riskier sectors. We continue to be overweight the credit sector, with a shorter duration position than that of the Index. We will continue to look for attractive names/maturities to selectively add to the credit sector, particularly if we get any further weakness in spreads that provides an opportunity.

In the agency debt sector we have seen spreads widen only marginally and overall levels are still fairly narrow. With yield levels higher and spreads a bit wider, demand has remained stable in this sector. We have added to the sector since our last meeting, purchasing a Federal Home Loan Bank 2023 issue, a Federal Farm Credit 2024 issue and a Federal Farm Credit 2031 issue. These issues were offered at attractive spreads within the agency sector and helped to better diversify the maturity stucture of the portfolio along the curve while keeping duration close to neutral. Because issuance within this sector remains fairly low, we expect spreads to remain stable. Given that spread levels are not as attractive as those offered from corporate bonds or mortage backed securities, we do not expect to add siginificant new money here, but we will continue to do maintenance type trades to replace a call or maturity, or perhaps a swap to adjust interest rate risk.

Spreads have widened within the mortage sector as well. With rates rising and the Fed no longer purchasing mortgage securities outright as it begins its balance sheet reduction, demand for mortgages has declined. Mortgage rates have risen faster than ten-year Treasury rates, raising the cost of home financing to the highest levels since 2010. Prepayments have slowed further and the average duration of the sector has extended. With all this said, activity within this sector has been light. We did purchase two 3% 30-year pools to take advantage of the higher yield levels and diversify the portfolio a bit more. More recently we purchased a 2.0% 30-year pool offered at a significant discount to par to lengthen duration and also to act as a hedge if rates decline from current levels. Despite adding money to the sector, we are still underweight versus the index, and therefore have room to add to the sector when opportunities arise. We will also continue to monitor interest rate movements and adjust duration as needed.

Lastly, within the Treasury portfolio we added three maturities over the past quarter. Issues purchased include a 2028 maturity, a 2032 maturity and and 2040 maturity. With yields having moved notably higher in a fairly short time period, we wanted to take advantage of these higher levels. Additionally these purchases allowed us to diversify positions a little better along the curve and also add a bit more duration within this sector to provide some insurance in case rates rally from these levels. We continue to be underweight the index, and our duration is a bit lower than the index, which we think is prudent at this time. We continue to watch yield levels closely and will adjust our Treasury positions and duration as

needed.



Source: CreditSights

Domestic Equity Strategy

By Hunter Bronson

In preparing to write this piece each year, I always find it helpful to take a step back to look at what were the themes, standouts, and worries on our minds twelve months ago and beyond. With the constant deluge of information, the worries of each day, and the seeming schizophrenia of global equity investors, I find it helps to ground myself by taking a step back and looking at today through the lens of the past. I started my career here at RSA almost exactly a decade ago. As I reflect on that time, and this may be a bit of recency bias, but it seems as though the first 8 years were relatively sleepy. Yes, there were the flash crashes, commodity deflation & energy credit scares, taper tantrums, and growth concerns. We suffered through some market corrections (10% off the highs), but we managed through them relatively quickly and without much fuss.

In many ways, the groundwork for today's volatile marketplace was laid with the rise of global populism in mid-2016. It was in June of that year that the UK held its first referendum on Brexit, and in November U.S. voters ushered in Donald Trump and with him a de-globalization push that the world hadn't seen since the early 1900s. All the while, the Russo-Ukrainian conflict had been seething just below the surface with near constant skirmishes, small-scale battles, and continuous bloodshed from aggressors on both sides since the annexation of Crimea in 2014.

If we consider the events of 2016 to be the catalyst to today's conflagration, health issues aside, the global spread of COVID-19 and its aftermath have proven to be the accelerant. Since 2019, a disturbing rise in the distrust of institutions, nation-states, and global partnership has seemingly turned the world on its ear. Just one year ago today, we marveled at the speed of the recovery in employment and economic activity thanks to the benevolence of fiscal policymakers and the rollout of vaccination and economic re-opening. We celebrated the mid-double-digit percentage returns in major equity market indices year-to-date led by early cycle issues. Yes, there were nascent signs that inflation might be becoming an issue to bother about, and a transition to mid-cycle leadership could be in the offing. Humbly, to our credit, we pointed those out. But ultimately all I can think of in reflecting over the last 12 months is "life comes at you fast."

Figure 1: The striking step-change in volatility since the beginning of the "COVID age"

To give some context to Figure 1, 1-month realized volatility recently reached a 95th percentile reading on a 90-year data set. Combine it with the picture below of equity returns since January and the breadth of the selloff – even the generals like Apple, Walmart, and Amazon have been battered – and the feeling is one of no place to hide.

S&P 500 Performance Fiscal YTD

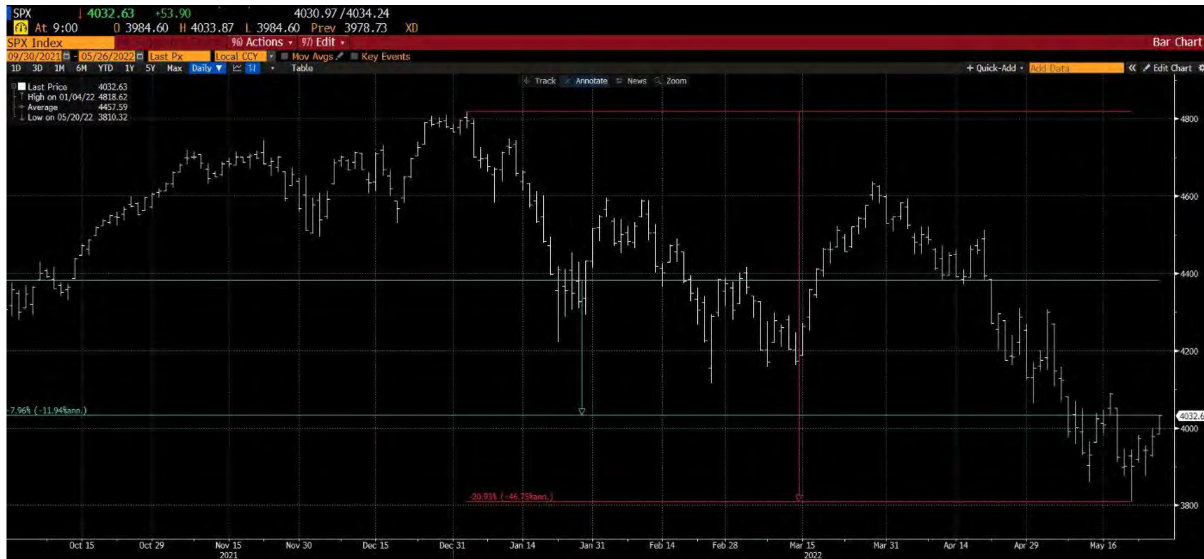
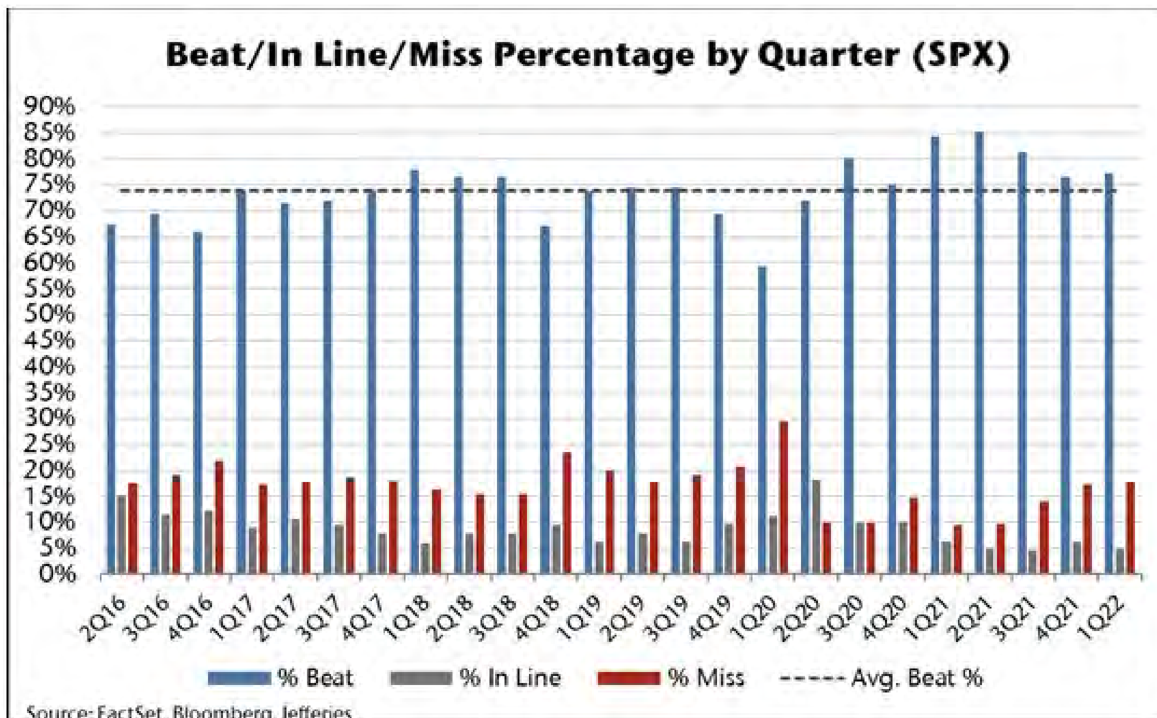


Figure 2: While the S&P 500 is down ~8% FYTD, it has experienced a "bear market," or a 20% drawdown from the January peak.

But, while there is no doubt that we are in the midst of a textbook bear market, it is not yet the fault of earnings or economic growth. The trajectory of S&P 500 Q1 earnings was within a normal range as 77% of companies beat estimates - above long-term average of 74%. Operating margins look like they are peaking, but we see no reason

why they should plummet, and our base case, barring recession, is that earnings should return to long-term trend as the stimulatory effect of $5T in fiscal and monetary stimulus rolls off.

However, it seems that investors have much less patience for earnings misses now that the Fed put is gone. As you can see in the bottom of Figure 3, misses have been punished much more harshly. “Buy the dip,” it seems is dead, and the market’s attitude has clearly changed. Execution and earnings quality matter again. As you will see on the next page, most of the selloff to this point has been from the compression of valuation multiples driven by tighter financial conditions.



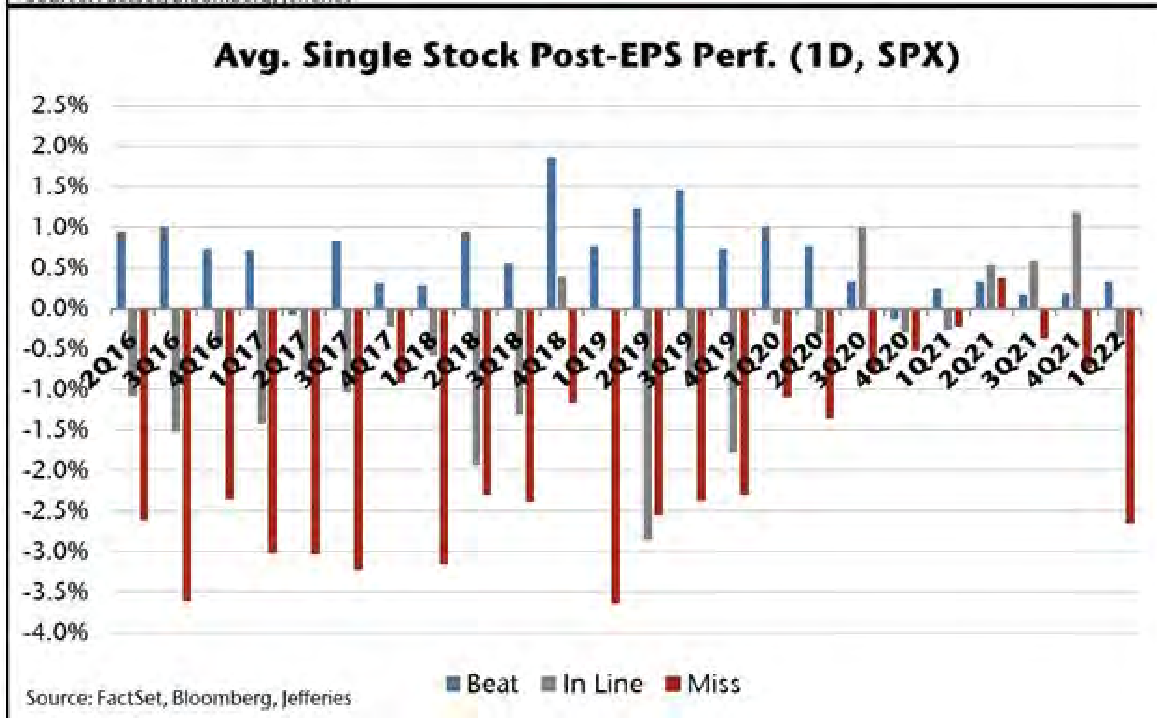
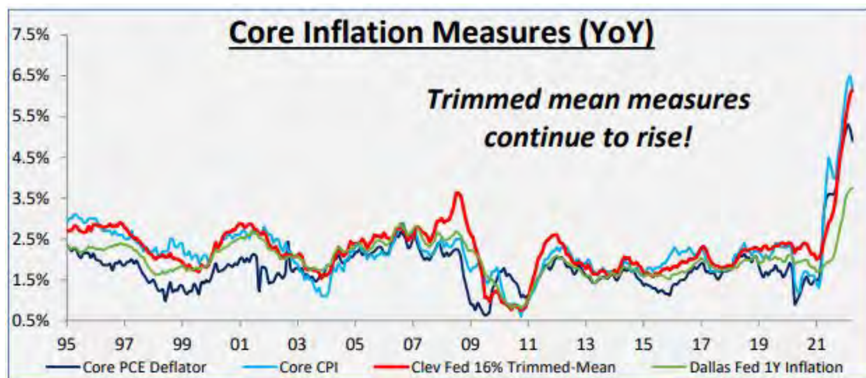


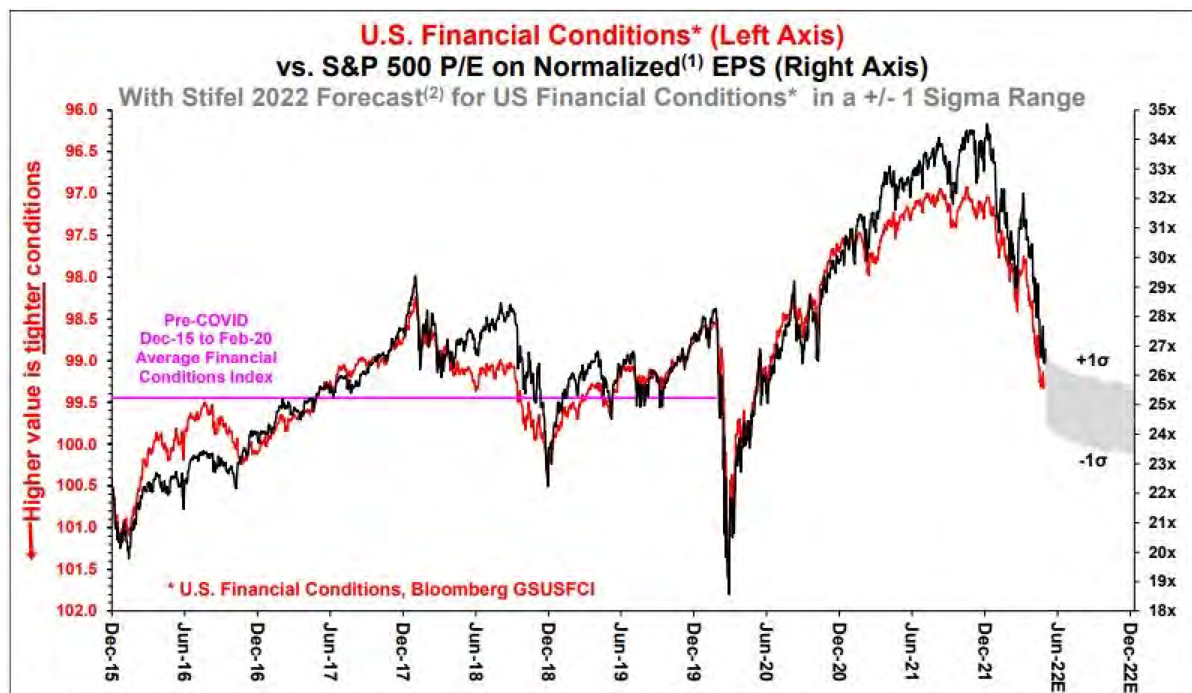
Figure 3: The number of earnings beats is still number, but misses are being punished much more harshly

Inflation & Policy Response

The bear market in stocks kicked off in early January of this year when it became obvious to market participants that the global inflation problem was stickier than almost anyone believed and that the Fed was going to have to do something about it. Unfortunately, there can be two sides to the ultra-aggressive monetary & fiscal stimulus coin, and if policymakers get too aggressive, you will see both. As we demonstrated in a chart this time one year ago, too many dollars are chasing too few goods within the framework of a global supply chain that simply can't keep up with demand. Unfortunately, the supply problems proved to be more persistent than many of us had hoped due to major geopolitical tensions, re-lockdowns in China, commodity spikes, shipping snarls, and on and on. The result has been rapidly rising and stubbornly persistent inflation – 8.1% on the headline CPI. Of major concern is inflation in the stickier components like wages and rents.



To its credit, the Fed knew that it had to act, and it has. Financial conditions have tightened tremendously on the back of Fed rate hikes, both enacted and anticipated.



Source: Bloomberg data, Stifel estimates.

Figure 4: Goldman Sachs US Financial Conditions Index and Cyclically-Adjusted, Normalized P/E Ratios; Source; Stifel

On top of that, we began to lap COVID fiscal stimulus approximately 14 months ago. In that time, the US budget deficit has fallen $2.8T. This amount of fiscal tightening is only equaled by the drawdown from World War II.

The effects of this dual monetary/fiscal-driven froth in hindsight are obvious, but in the moment, they were flabbergasting – not just crypto, but NFTs were all the rage. Meme stocks exploded higher with nearly insolvent video game retailers and EV-switching rental car companies trading at market caps of $20-30B, and a seemingly endless supply of celebrity-headed SPACs were brought to market. A nice way to think of these low-quality assets is as a sort of release valve for excess liquidity. As more liquidity is pushed into the system pressure builds until the release valve is triggered. Hard assets and financial assets like stocks and bonds are associated with tangible value and predictable cash flows. Sure, their values can fluctuate around their actual values, but the underlying tangible value provides a sanity check. In our (loose) analogy, they are part of the stable system. Not so with virtual art, thousands of alt coins, jpegs of rocks, and pictures of tweets – they can be worth whatever the highest bidder can dream! They are the perfect release valve, and pressure from too much liquidity quite literally forced dollars into them.

While the bubble was breathtaking, unfortunately, so too was the bust as the punch bowl was taken away. Predictably, as rates moved higher throughout the beginning of the year and fiscal spending rolled off, the lower the quality of the asset or the longer duration the cash flow, the more aggressively it was sold.

Figure 5: A broad index of NFTs is down some 85% from the top.

Business

'Jack Dorsey's First Tweet' NFT Went on Sale for $48M. It Ended With a Top Bid of Just $280

Crypto entrepreneur Sina Estavi bought Twitter founder Jack Dorsey's first-ever tweet as an NFT for $2.9 million last year. He listed the NFT for sale again at $48 million last week.

By Sandali Handagama · Apr 13, 2022 at 1:48 p.m. CDT · Updated Apr 13, 2022 at 7:01 p.m. CDT

Figure 6: This guy was left holding the bag.

Figure 7: S&P 500 Value (white) & Growth (gold); Value(low duration) has outperformed Growth(high duration) by nearly 20%, as we would expect in a rising rate, inflationary environment.

Looking Forward

With that little bit of history out of the way, where do we go from here? The essential question, at least for the direction of equity markets is do we have a near-term recession or not? In order to know the answer to that question, we think we need to know the ultimate outcome of a few different paths forward:

1. Does inflation continue to run despite aggressive Fed tightening?
2. If inflation and growth cool, does the Fed make a policy error and continue to tighten into a slowing economy?
3. Can the Fed execute a “soft landing” between the two?

Scenario 1: Inflation Continues to Run Relentlessly

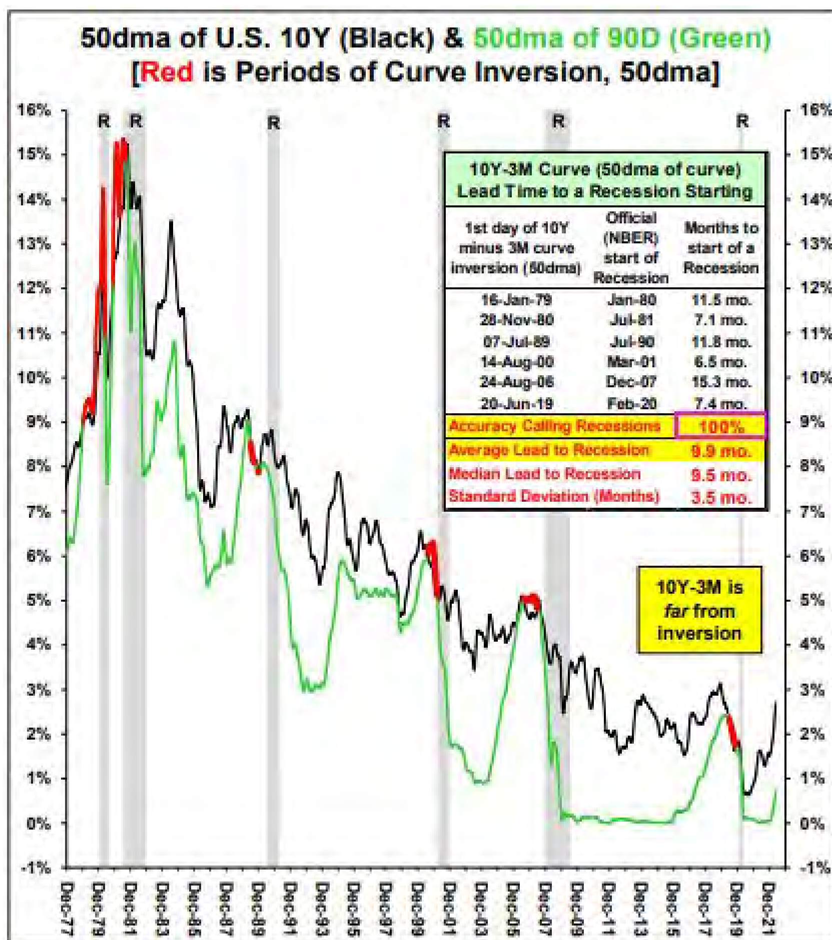
To be clear, this is not our base case, but we can think of one glaring potentiality that could bring this about - an increase in tensions in the Russo-Ukrainian conflict. This would have a cooling effect on global growth and would continue to exacerbate the

global dearth of supply – particularly in food and energy commodities. Unfortunately, the longer conflict simmers and the more blood and treasure are spilled, the more attitudes on both sides harden. Making peace feels more like admitting defeat. Sadly, we admit that trying to predict the path of war is nearly impossible without some very wide error bars, so we can only hope that a reasonable solution is reached soon.

If for this or any other reason, inflation continues to run above 3-4%, we believe that all bets are off, and a recession is probably imminent. In the modern age, inflation above that level is unsustainable, and there is zero political will to allow for it. The Fed will be forced to continue raising rates until it hits neutral or above, and its hard to imagine a scenario were that happens and recession doesn't soon follow.

<u>Scenario 2: Inflation/Growth Cool, But Fed Policy Error</u>

We think this is the least likely scenario going forward, but it is within the realm of possibility that even despite cooling inflation and growth, the Fed could choose to continue to tighten and send the economy into recession. We don't believe that we know any better than anyone else what the Fed will do, so why do we think a policy error is unlikely? In short, to this point, the market is not yet sniffing out a recession.



10Y-3M Curve (50dma of curve) Lead Time to a Recession Starting		
1st day of 10Y minus 3M curve inversion (50dma)	Official (NBER) start of Recession	Months to start of a Recession
16-Jan-79	Jan-80	11.5 mo.
28-Nov-80	Jul-81	7.1 mo.
07-Jul-89	Jul-90	11.8 mo.
14-Aug-00	Mar-01	6.5 mo.
24-Aug-06	Dec-07	15.3 mo.
20-Jun-19	Feb-20	7.4 mo.
Accuracy Calling Recessions		100%
Average Lead to Recession		9.9 mo.
Median Lead to Recession		9.5 mo.
Standard Deviation (Months)		3.5 mo.

Source: Bloomberg data, Stifel estimates.

Figure 8: Smoothed 10Y & 3M yields

The yield curve has not meaningfully inverted – in fact, it's not close. This is our favorite "recession watch" monitor, and we will be watching it closely. Beyond that, most market signs still point to "no recession." We are in the midst of the strongest labor market in some 50 years. Consumer balance sheets are still in decent shape. Consumer spending has weakened a bit, but not to any significant degree. Housing starts are still in strong territory, and corporate credit spreads are still under control. In short, outside of exogenous shock or runaway inflation, we don't yet see any convincing signs that recession is imminent.

Scenario 3:
Can the Fed execute a soft landing? This is the trillion-dollar question for equities, at least through the end of 2022. Though we certainly don't have anything convincing yet, we are seeing early signs that inflation is heading in the right direction.

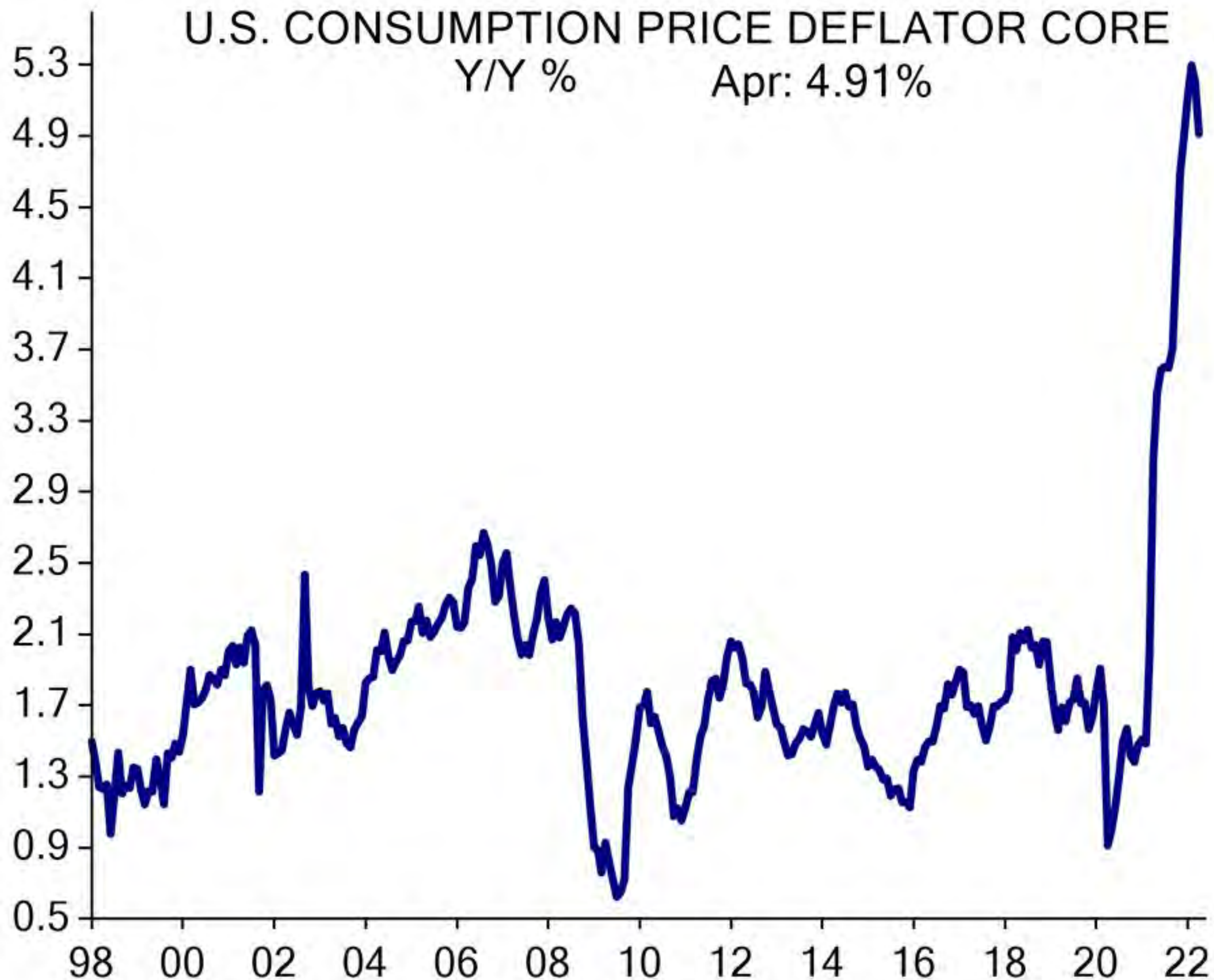


Figure 9: Core PCE; Source, Evercore ISI

The last monthly ticks of the Core Personal Consumption Expenditure price deflator have been more in line with 4% annual inflation which is getting closer to a range the Fed can be comfortable with. Fertilizer prices have come down, freight rates are down, corn and uranium are starting to tick down, and lumber is down tremendously. Again, it is early, but there are positive signs.

IF inflation continues to come down and approaches the 3% level, we believe the Fed will get its opportunity to take its foot off the brakes, and a soft landing is possible. Again, if core inflation is coming down and the Fed gets some help from commodity markets, we would argue that its heavy lifting is largely done. As you can see in Figure

10, because of convexity, the move of real rates from -1% to 0% is much more impactful on financial conditions than any 1% move
thereafter.

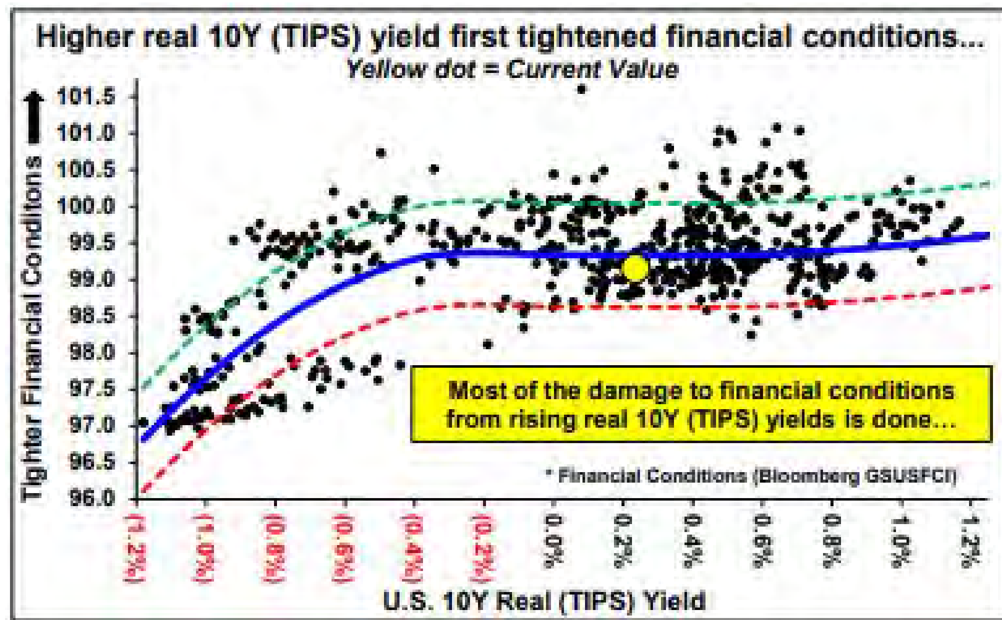


Figure 10: Real Rates' Convexity Effect on Financial Conditions

We believe that the Fed recognizes this just as well as we do and will choose to pause if inflation gives them the opportunity to do so.
Adding the final piece of the puzzle – if inflation gives the Fed the path to a pause, and if the Fed chooses to take that path, history tells us that we should expect at worst a choppy market through the end of 2022, and at best, a relief rally.

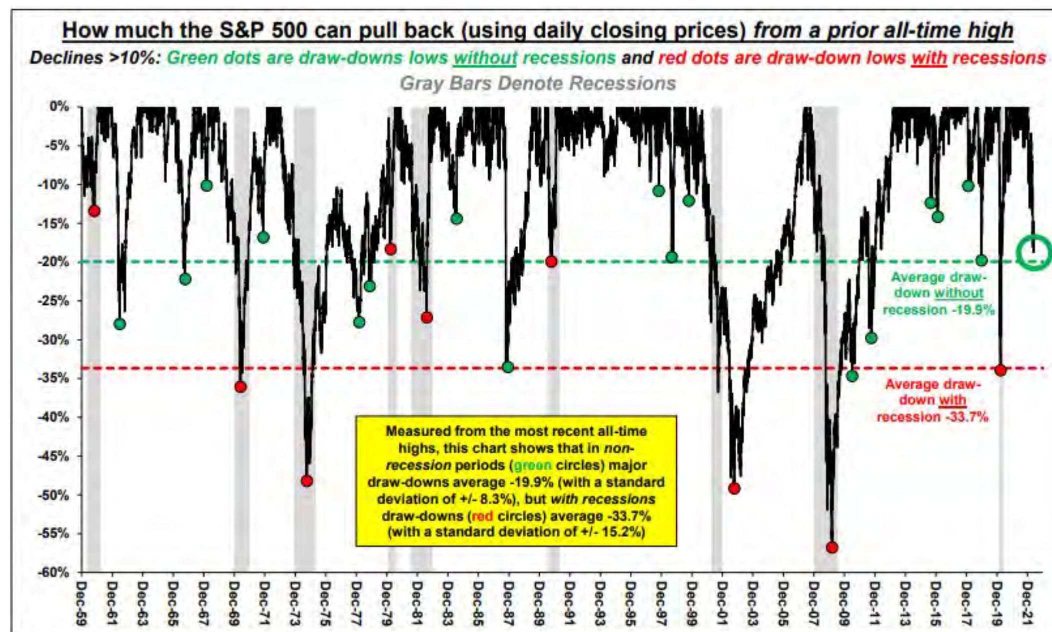


Figure 11: The S&P 500 has already surpassed the average non-recessionary bear market drawdown.

Looking Further Out

Is it possible that we are entering a secular bear market? We think it is a little to early to tell, but it is certainly possible.

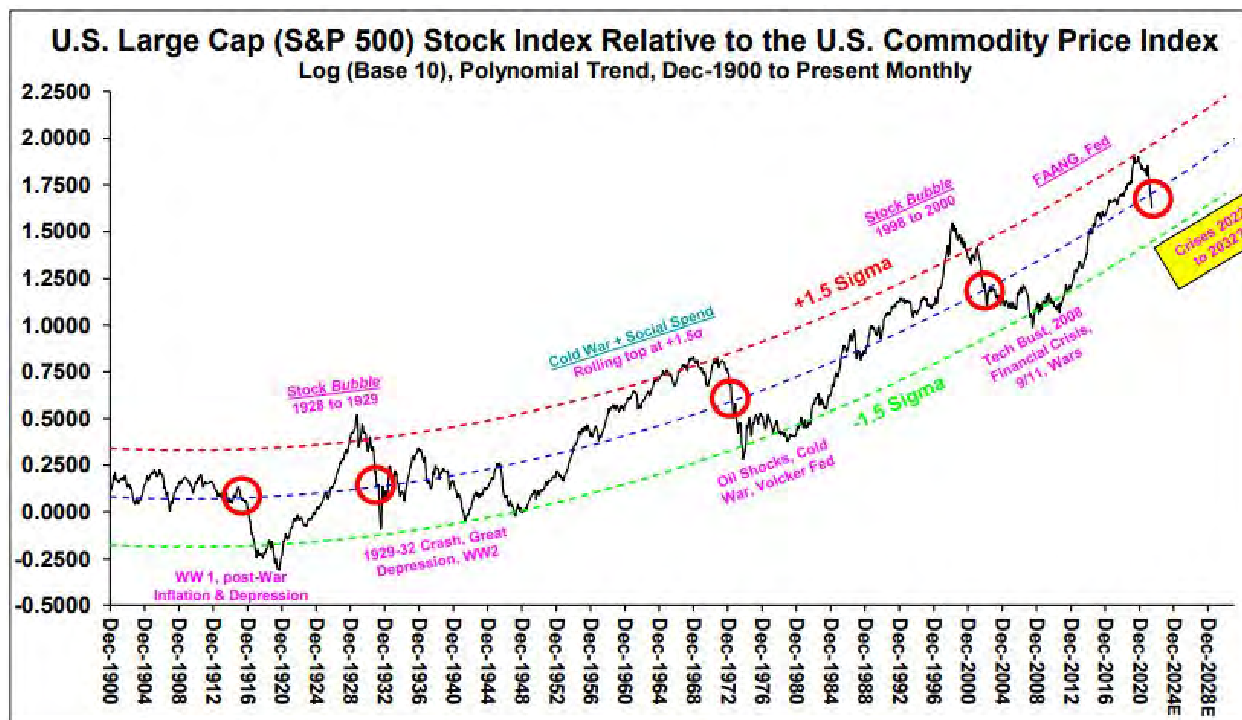


Figure 12: Large Cap Stocks (dividends excluded) divided by an amalgamation of commodity price indices

Looking at Figure 12, the history is hard to ignore. To be sure, there have been a few false breakdowns, so the signal is not crystal clear, but typically when the ratio of stocks/commodities breaks trend, a secular bear follows. We've spoken about several other long-term indicators that seem to point in the same direction: various CAPE (cyclically adjusted price-to-earnings) ratios, household stock ownership as a percentage of financial assets, Tobin's Q, and trailing 10 year returns. All the indicators point toward a secular bear market and have been for nearly 5 years now. Have they been wrong or just early? We don't pretend to know the answer.

To be clear, this is not advocacy for bugging out - far from it. However, it is important to ask ourselves "What works during secular bear markets?" in order to prepare for the possibility and position ourselves to take advantage. Typically, anything with short duration and of high-quality works during secular bears – dividend payers, high cash flow yielders, financials, health care, energy, real estate, materials, utilities, active over passive management, etc. Luckily, your staff is full of a bunch of CFA Charter holders.

We were trained – maybe even indoctrinated – to be more comfortable utilizing fundamental analysis and investing in these sorts of environments. It is still early to tell, but the relative results in our active funds so far this year are bearing that theory out.

Summary

In summary, as is typical of bear markets, stocks have been incredibly volatile over the course of 2022. We expect that volatility will continue over the course of the year until we get a clear signal one way or another on inflation. If inflation moderates – probably driven by decreases in wages & rents, we believe the Fed is likely to take its foot off the brakes in the 4th quarter and we could see a "Santa rally," probably in growthier names. If inflation continues to run or the Fed makes a policy mistake, we think the chances of recession either late this year or early 2023 are quite high. In either case, over the long-haul, relative to our alternatives, we think it is prudent to continue to own equities in size – especially with a preference for high-quality, shorter-duration, and value factor exposures.

International Equity Strategy

By Steve Lambdin

The global equity markets reversed course in the first quarter of 2022 and fell sharply due to Russia invading Ukraine, worsening supply chain issues, China's zero-Covid policy, historic inflation, and interest rate hikes by many of the global central banks. This led to extremely volatile equity markets as investors rushed to sell risky assets. The Russian invasion has led to the worst humanitarian crisis since the second World War as nearly 5 million people have left Ukraine seeking safety outside of its borders. This led to unprecedented economic sanctions on the Russian economy from NATO countries to curtail this military campaign. While many of these sanctions are almost instantaneous, many others will take months and even longer to be felt by the Russian economy. Nonetheless, the damage to this economy will take years to mend. We saw inflation rise to levels not seen in 40 years as food and energy prices soared around the globe in the period. Russia was the world's third largest producer of oil and second largest producer of natural gas. In addition, Russia and Ukraine are major producers of fertilizers, wheat, corn, and metals. This made an already delicate supply chain problem even worse. Many products cannot be finished as key components and inputs are in short supply or not currently available. China's zero-Covid policies shut down large parts of the industrial base in the period, resulting in a huge deceleration of economic growth in the region. This is on top of a weak property sector that suffers from little volume and poor developers' credit. Developed markets slightly outperformed the emerging markets in the period as the total collapse of the Russian equity market was the driving force of weak returns in the emerging markets. Many of the central banks around the globe raised interest rates in the quarter and are signaling for much more on this front in the coming months to stem inflation. This made for a tough climate for equities to perform well in. We expect investors to be very nervous and equity markets to remain under pressure in the second quarter as the issues mentioned above continue to play out.

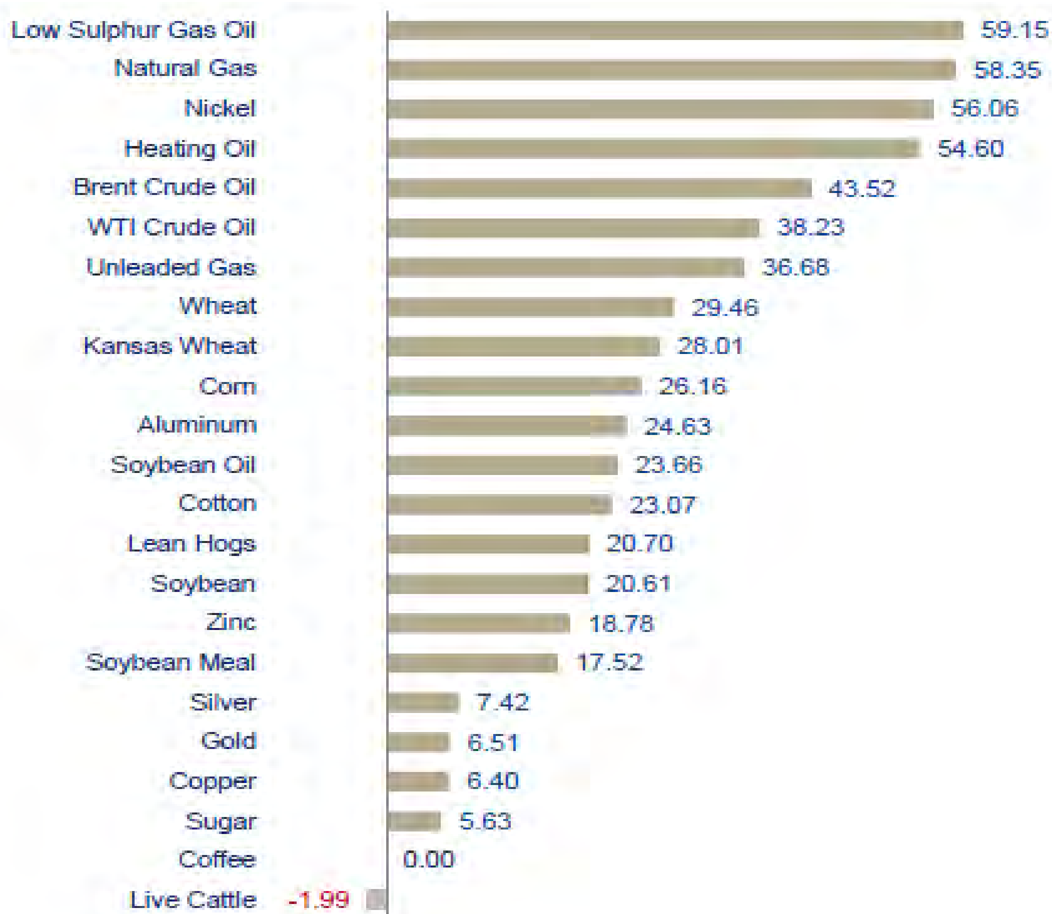
	March 2022		1Q 2022		YTD 2021	
Equity index returns (%)	U.S. dollar	Local currency	U.S. dollar	Local currency	U.S. dollar	Local currency
S&P 500	3.7	3.7	–4.6	–4.6	28.7	28.7
MSCI ACWI	2.2	2.5	–5.4	–4.7	18.5	20.9
MSCI ACWI ex USA	0.2	1.0	–5.4	–3.9	7.8	13.0
MSCI World	2.7	3.1	–5.2	–4.6	21.8	24.2
MSCI Emerging Markets	–2.3	–2.1	–7.0	–6.1	–2.5	–0.2
MSCI EAFE	0.6	2.1	–5.9	–3.7	11.3	18.7
MSCI Europe	–0.1	0.8	–7.4	–5.4	16.3	22.6
MSCI Pacific	2.1	4.8	–3.1	–0.5	2.6	12.0

Source: RIMES

Source: RIMES; Capital Group

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned -5.91% and -6.97% respectively during the first quarter of 2022 vs. -4.60% for the S&P

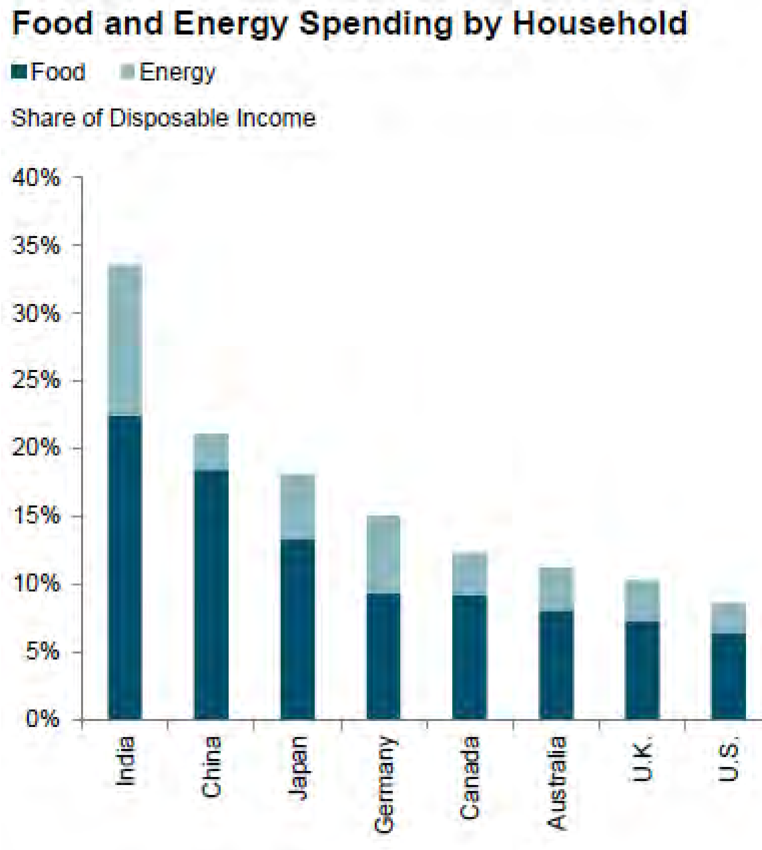
500 Index. This is not much of a surprise as investors view U.S. stocks as a bit safer vs global stocks when geo-political events dominate the headlines. The U.S. dollar continued to rise in the first quarter and depressed returns by -2.2% for unhedged U.S. investors in the MSCI EAFE Index and to a lesser extent in the emerging markets. The Pacific region significantly outperformed the European region as the Russian/Ukraine war threatens the European region much more than the Pacific region. Nine out of the eleven sectors of the MSCI EAFE Index posted negative returns, led by technology, consumer discretionary, and industrials. Commodities rose significantly in the quarter as the Bloomberg Commodity Index rose +25.55%, led by natural gas +58% and crude oil +38%.



Sources: Resource Consulting Group, Bloomberg

Quarter-to-date thru the end of May, most global equity markets remain under pressure as inflation remains stubbornly high, supply chains remain in a mess, central banks are still messaging for significant interest rate hikes, and the Russian/Ukraine war continues

to tread on with no progress toward a cease-fire. These issues are pushing reductions in global economic growth and investors are broadly selling risky assets such as equities. This will make for an extremely volatile market environment. The MSCI EAFE Index, the MSCI Emerging Markets Index, and the S&P 500 Index are down -5.6%, -5.1%, and -8.5% respectively. Currently, equities look oversold and maybe a small rally can develop in June from this condition.



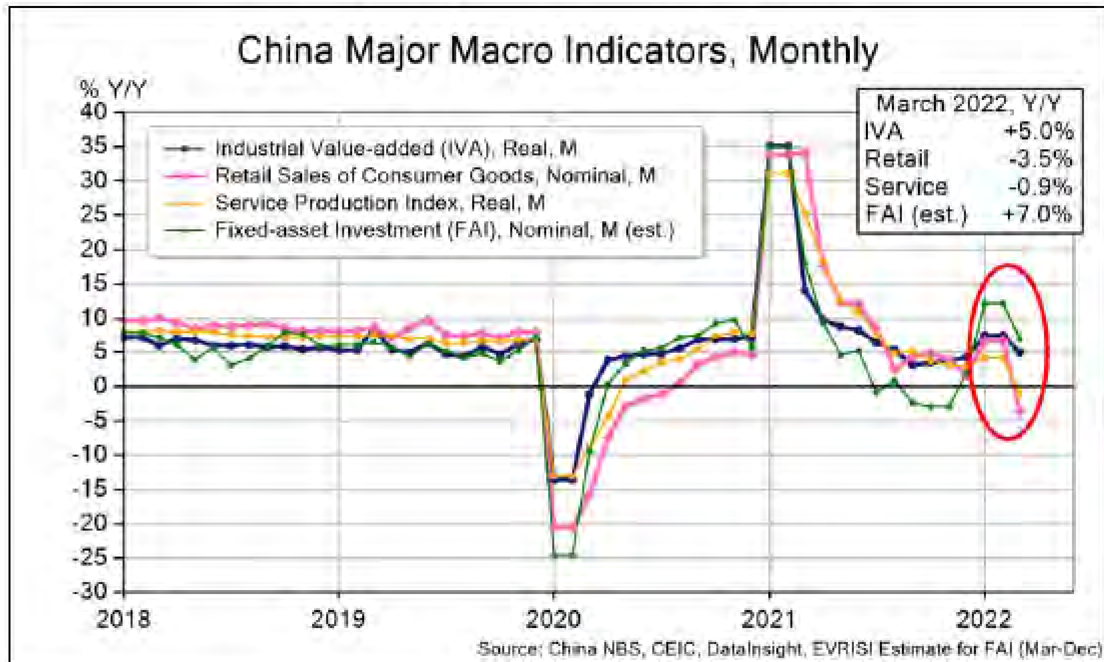
Source: Fidelity Investments AART

Asia Update

The Asia-Pacific region continued with its recent struggles as the Japanese equity market fell another -6.6% in the first quarter as Covid-19 restrictions were not lifted until March, energy prices surged, and the yen was very weak. In fact, the yen finished down -5% against the U.S. dollar after hitting a multi-year low. Japan is a major importer of energy and food and this will hurt the consumer in this region in the coming months. The Australian equity market posted a healthy +7% gain in the quarter as the post-lockdown recovery was very strong and the region benefitted from higher

commodity prices. Overall, the MSCI Pacific region fell -3.1% in the first quarter, which was not as bad as some of the other major regions around the globe.

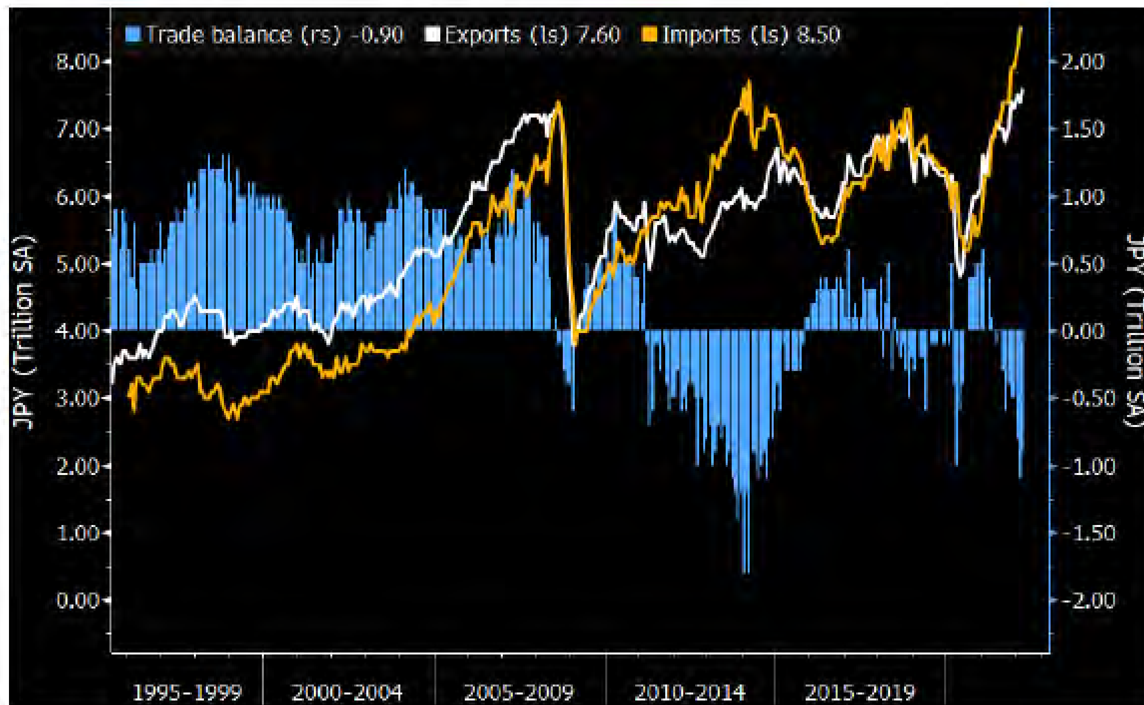
The Chinese economy continued to limp around for most of the quarter until March economic data points took a turn southward. First quarter GDP rose +1.3% from the previous period, or +4.8% on a year over year basis. This was a deceleration from the fourth quarter of 2021. Industrial production growth slipped to +5.0% from the previous year in March after posting +7.5% in the January-February period. The damage from the recent Covid-19 lockdowns in Shanghai and other major cities took a toll on production. We expect to see more damage to become apparent over the next few months. A variety of stimulus actions aimed at providing economic support to the region should be expected over the next several months. This would include a cut to the required reserve ratio (RRR) by another 50 – 75 basis points and lowering the interest rate on its medium-term lending facility to jumpstart the growth engine. Fixed asset growth came in a bit better than expected at +9.3% in the first quarter from a year earlier, but trends did slow as we moved through the quarter. Stress in the supply chains are being felt as projects are having a tougher time getting started. Trade slowed down recently as first quarter exports rose only +13.3% from a year earlier, a marked slowdown from the previous period. Logistical bottlenecks and port congestion continued to be a major issue. Retail sales continued to struggle lately as April sales fell -11.1% from a year earlier and was the weakest reading since the onset of covid-19. The recent lockdowns had a lot to do with this, but we expect this to improve going forward in a post lockdown environment. April CPI rose +2.1% from the previous year, which was an acceleration from the last few months. Food and energy prices led the increase in CPI. However, inflation remains less of an issue in this region vs. most other regions around the globe as non-food prices registered much lower gains. Going forward, we expect to see more easing measures by the PBOC and fiscal spending on infrastructure to help offset the growth pressures in this economy. Exports should pick up as the region exits the Covid-19 lockdowns and supply chains get slightly better on the margin. As this plays out, this could be a decent backdrop for better equity market performance than what investors have seen over the last six months.



Source: Evercore ISI

The Japanese economy basically treaded water as first quarter GDP fell -.1% from the previous quarter, or -.5% from the previous year. The slight contracted was less than many had feared as virus restrictions did not curtail spending as much as anticipated. Trade did suffer as import prices rose substantially as the fallout from the war in Ukraine and a fall in the yen to 20-year lows. While exports grew +14.7% in March, the trade deficit has ballooned to the worst since 2013 as commodity strength lifted imports well above exports. We expect this to remain a problem throughout the second quarter as commodity prices seem likely to stay elevated over this timeframe. Industrial production registered a gain for the second month in a row as March rose +.3% from February. Production would have better had auto production not been curtailed by supply chain issues as well as an earthquake that hit in the quarter. We expect a better reading with this key data point in the upcoming quarter as some slight progress is made on these issues. Japan's leading economic index slipped throughout most of the period and finished at 100.8 in March. This came as little surprise to most investors as expectations were low in the region. We should see this improve in the second quarter. Consumer confidence also was weak in the quarter as March's reading fell to 32.8, the lowest level since January 2021. We also believe this key economic barometer will be better as we move through the summer months. The labor market still looked encouraging in the quarter, as the March unemployment level fell to the lowest level in two years at 2.6%, while the jobs-to-applicant ratio rose to 1.22. The falling covid-19 case numbers and less restrictive policies provided a nice push to the labor markets. However, wage gains are still likely to remain under the level to generate a strong economic cycle. Even though our view of economic conditions has been pushed to the

right just a bit, we still expect better economic readings over the next few months as the Bank of Japan (BOJ) remains one of the few central banks continuing to provide stimulus to support its economy.

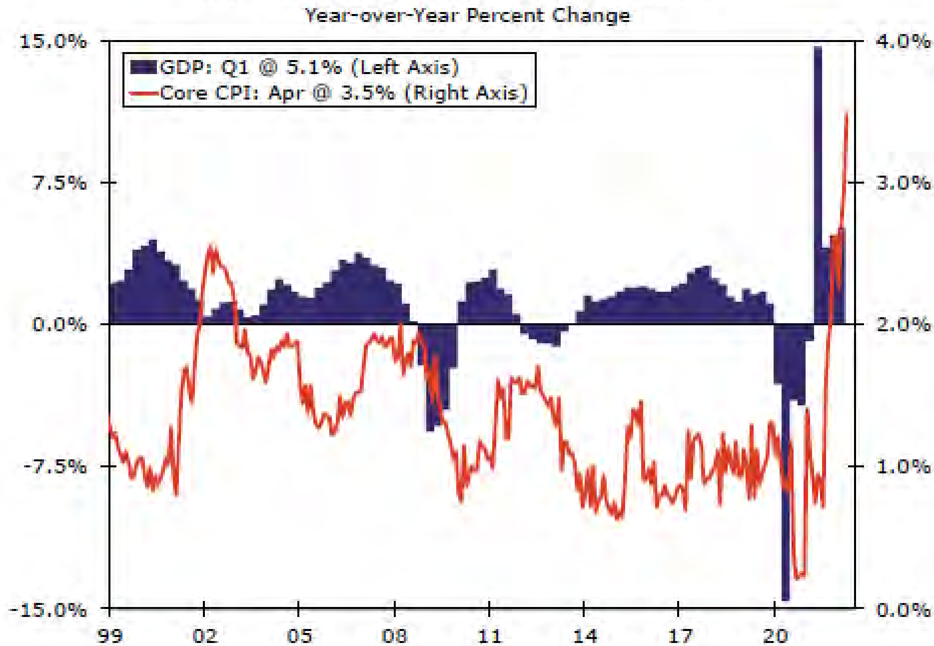


Sources: Ministry of Finance; Bloomberg

Europe Update

The eurozone equity markets fell sharply on the heels of the Russian invasion of Ukraine and much higher inflation readings. The invasion led to a surge in energy prices as the region has a heavy reliance on Russian oil and gas and allied nations are calling for a rejection of using these Russian commodities. This also led to a multitude of other economic sanctions aimed at punishing Russia for its military actions against Ukraine. The key German equity market fell -13% as fears that high energy prices will limit economic activity. The European Central Bank (ECB) also outlined its plans to raise interest rates later this year, which also spooked investors. This helped push the yield on Germany's benchmark 10 year note up 73 basis points to end the quarter at .55%. The MSCI European Index (ex. U.K.) fell -10% and was the worst performing major region in the MSCI EAFE Index. The equity markets in Norway and Belgium were relatively stronger in the period while the markets in Ireland, Austria, and the Netherlands where the poorest performing markets.

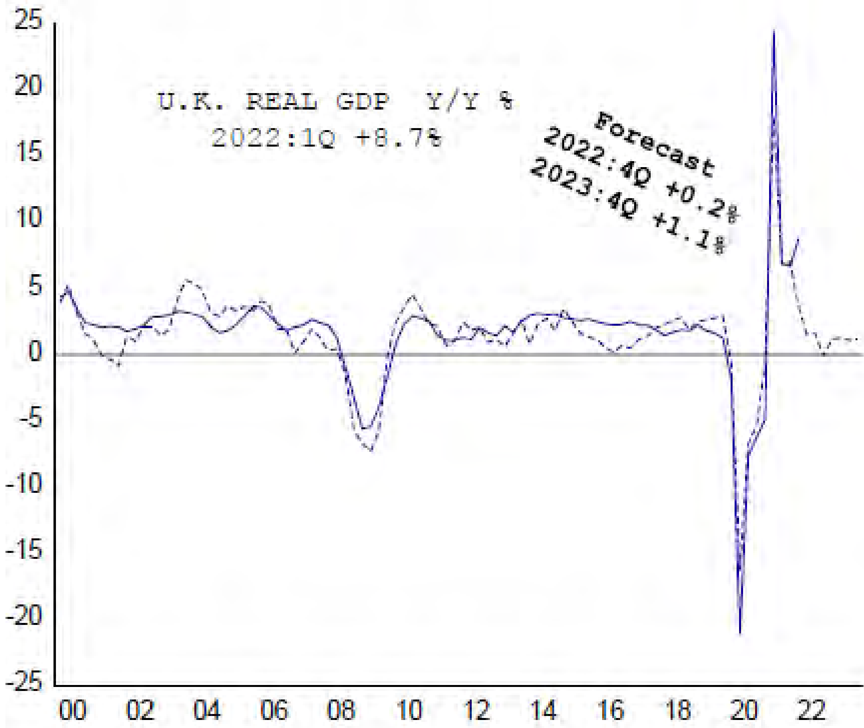
The European economy moved past another round of Covid-19 infections late in 2021 and early 2022 as first quarter GDP rose +.6% from the previous quarter or +5.4% from a year earlier. This was a nice acceleration from the previous period as trade and tourism were strong as consumers had a good level of pent-up demand and the war in Ukraine was in its early days. The key German economy did manage to turn around from the previous period as first quarter GDP rose +.2%, or +3.8% on a year over year basis. Even though this economy is a bit weaker than we expected, it's moving in the right direction and any easing in supply chain issues that have plagued the region would be upside going forward. The economies in Ireland, Belgium, and Spain were strong and posted decent growth, while Sweden, France, and Norway contracted in the period. Eurozone industrial production slid the most since early 2021 as March production fell -1.8% from the previous month. Most of this move can be attributed to the uncertainty brought about from the war in Ukraine and the epic rise in energy costs across the region. Following in similar fashion as other key economic data points, the economic confidence index continued to trend downward recently as April fell to 104.9, which was the lowest level in over a year. Perhaps this can move ahead in the coming months if businesses get a pickup in demand trends. Retail sales continued recent weak trends as March sales fell -.4% from February. Skyrocketing energy costs seemed to have dampened consumers' willingness to spend on other items. Inflation continued to move higher in the period as core CPI rose +3.5% in April from prior year levels and headline inflation, which includes food and energy, was reported at +7.4% in the month. This is the highest levels we have seen in the Eurozone economy since its formation. This continues to be the most significant negative piece of the economic puzzle in the region. However, we believe we are now at or very near peak inflation and this could be coming down in the coming months, but not at a steep pace. Persistently high inflation may be here for a while. The March unemployment rate fell to 6.8%, which is another new low since the beginning of the Eurozone. This should support wage gains in the coming months and provide more fuel for the ECB to move interest rates higher in the back half of 2022. At this point, we see the biggest risks to the economic outlook to this region are the war in Ukraine as well as inflationary pressures from rising energy costs. These issues create significant uncertainty with the region's outlook. Clarity and improvement on these two fronts could provide a better pathway to growth in this region as well as better equity market performance. We will see what happens.



Source: Datastream; Wells Fargo Economics

The U.K. equity market was one of the few major markets around the globe to post gains the first quarter. Many of the companies within the FTSE 100 Index have exposure to key sectors that worked well in the period, such as material and healthcare shares. In addition, the FTSE 100 Index has relative light exposure to the technology sector, which benefitted performance as this sector was hit hard globally in the period. The equity markets here are one of the cheapest of the major markets and offers a very healthy dividend yield. The MSCI U.K. Index rose +1.8% in the quarter, which was opposite to the broader MSCI European Index. GDP growth rose +.8% in the first quarter from the previous quarter, or +8.7% from a year earlier. This came in a slightly below expectations due mostly to a weak March. We believe real incomes are beginning to be squeezed as higher inflation cycles through the economy, especially as energy prices soar. Industrial production struggled for most the first quarter as February and March fell -.6% and -.2% respectively. Mining and Oil & Gas production were strong in the quarter as manufacturing struggled from the current supply chain issues. Retail sales struggled in the quarter as February and March fell -.9% and -1.1% respectively, as consumers cut back spending in the face of high fuel prices and increasing food prices. It would not surprise us to see spending come under further pressure in the coming months as we see little in the way of relief in the near term on these fronts. Core CPI continued to push higher as March rose +5.7% from the year earlier period. Inflation looks to be broad based as both goods and services costs are rising sharply. Rising wages are pressuring labor-intensive industries the most and businesses are forced to pass along these higher costs. Unfortunately, we expect Core CPI to continue to rise over the next few months and perhaps peak around the +8.5% to +9.0% level. This would put U.K inflation at the highest level of the major regions

around the world. At its early May meeting, the Monetary Policy Committee (MPC) voted to raise its main benchmark by +.25% to 1.00% and will start to unwind its government bonds held in the Asset Purchase Facility. This is the third interest rate hike over the last six months aimed at pushing inflation southward. We expect to see further rate hikes in the coming months as inflation remains well above the BOE's targeted level. The first quarter unemployment rate continued to move downward and fell to 3.7%, which was the lowest level in decades. The labor market remains very tight and regular wage growth was +4.2%, rising to +7% when considering bonus payments to workers. Employers continue to use bonus payments to retain staff. We expect the labor markets to remain tight through the summer months. Over the next few months, we expect economic growth to fall slightly from current levels as inflation will be a problem over the next few months as it peaks. With this backdrop in mind, it could be a difficult environment to see good equity market performance over the near term, barring some type of positive surprise on the geo-political front.



Source: Evercore ISI

Emerging Markets

The emerging markets were weak again in the first quarter as geopolitical issues took center stage following the Russian invasion of Ukraine. This compounded the fears of an already slowing global economy as commodity prices moved significantly higher

pushing inflation much higher in many of these markets. The Western world responded with a multitude of economic sanctions aimed at crippling the Russian economy. The Russian equity market virtually collapsed near -100% as Russia was removed from the MSCI Emerging Markets Index on March 9th. Equity markets in China were weak and lagged the overall index as lockdowns were imposed in several key cities as daily new cases of Covid-19 spiked in the period and China imposed its zero-Covid policy. In addition, regulatory concerns continued over the heavily indebted property sector putting additional pressure on the equity market in the period. As China's economic shutdown continued, concerns spread to Korea and Taiwan, pushing these markets downward as well. Conversely, other emerging market countries that are net commodity exporters performed quite well in the quarter. Brazil posted their largest gain since late 2020 as oil and mining companies surged. In addition, the South African equity market rode the same trend as basic material companies were bid up nicely by investors. Overall, the MSCI Emerging Markets Index fell -6.97% in the first quarter of 2022, making it the worst performing equity asset class for the third quarter in a row. Going forward, geo-political concerns, China's re-opening of the economy, and inflation readings will dominate most investors thoughts with this asset class. Any progress on these fronts could push a rally in these markets.

Quarter-to-date total returns (%)

Equity indexes (USD)	
MSCI Emerging Markets	–7.0
MSCI Brazil	35.9
MSCI China	–14.2
MSCI India	–1.9
MSCI Mexico	8.6
MSCI Russia	–100.0
MSCI South Africa	20.3
MSCI Korea	–9.6
MSCI Taiwan	–6.6

Sources: RIMES; Capital Group

International Equity Activity/Strategy

As we look out into the summer of 2022, the issues investors are faced with are quite numerous. The ongoing Russian/Ukraine war is a major wildcard. A sudden turn of events or expansion of military operations by Russia directed deeper into Ukraine or toward other countries in Europe could be met with significant downward pressure on the global equity markets as well as global economic growth. While this is not the course most expect, it still is not out of the realm of possibilities. Central bank actions

also remain on the fore front of investors thoughts. We see the central banks continuing to raise interest rates to combat a serious inflation problem in most parts of the world. Investors need to see tangible progress toward lower inflation readings to get more comfortable with the equity markets. Are we at or very near peak inflation is a key question being debated? Perhaps we will get an answer on this over the next few months. When will supply chains begin the long movement toward some type of normalization? We are seeing supply chain issues in the global automotive industry, semiconductors, appliances, various electronics, large industrial industries, and even in baby formula (wow). Another key issue is when does China get past the majority of its covid protocols? This is important in order to bring global production back on-line in many of the key industries around the world. At this point, many estimates for global economic growth have been trimmed for the balance of the year and even into 2023. Investors need to see cuts to growth fade away and avoid a recession scenario to provide a better backdrop for riskier assets moving forward.

We continue to be very active with our put/call writing strategy on the Emerging Markets as we position ourselves to add to this asset class on any significant weakness over the near term. Premiums remain attractive in the current equity market and interest rate climate. Emerging market equities remain an asset class that looks attractive to us going forward over the long-term. Our current allocation to Emerging Market equities is approximately 3.10% of total assets and approximately 11.30% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios. *(Credit is given to the following entities for charts provided: RIMES, Capital Group, Evercore ISI, Datastream, Wells Fargo Economics, Ministry of Finance, Bloomberg, Fidelity Investments AART, Resource Consulting Group,)*