MARKET REVIEW & OUTLOOK

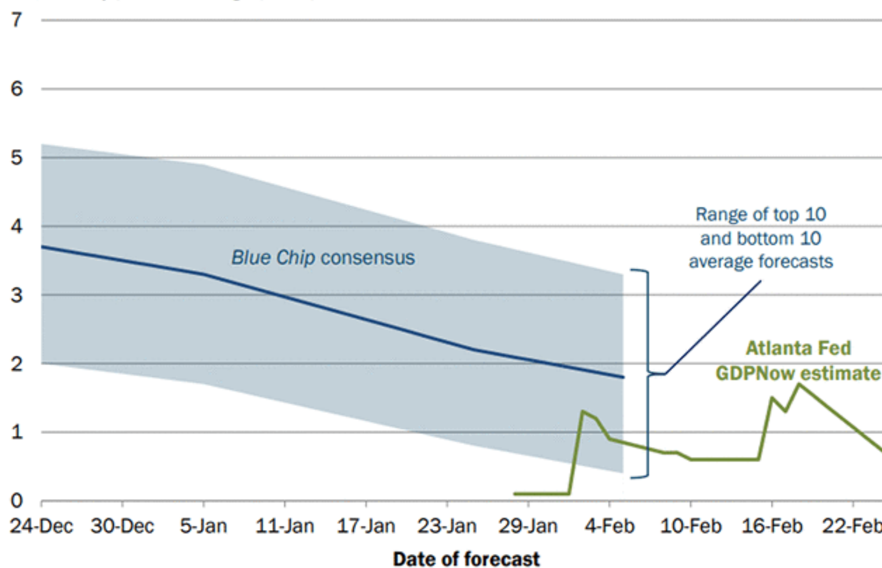
February 2022

KEY TAKEAWAYS

- Clearly the biggest news and market mover was the Russian invasion of Ukraine. The market saw wild gyrations that have rarely been seen. The strong 2-day rally late last week once again kept the declines in check.
- Interest rates continued marching higher as the "talking heads" continued 1 upping each other's interest rate forecasts for 2022, hitting 9 hikes. Then the war drums started sounding and the rush for safety drove yields back down on Treasuries. The Fed meeting is in mid-March.
- Of course, Russia is a big oil producer and part of OPEC+. So, the headlines of Russia advancing into the Ukraine kept the pressure on oil and gas prices. The situation is very fluid, but not many scenarios paint a reprieve anytime soon in the oil patch.

The U.S. Economy

The second release of 4th quarter GDP came in stronger than expected at 7.0%, beating the first print of 6.9%. As a reminder, the strength was led by the 2nd largest inventory restocking at 4.9% in history. The flip side of inventory builds is contractions and drags on future GDP if too much inventory is built. The 1st quarter GDP forecast bounced around since last month, but ended in about the same spot, forecasting 0.6% growth. The consensus has fallen and is now under 2%. Don't know if it is Omicron related or how the invasion of Ukraine may impact GDP. Please see the chart below.



Source: https://www.frbatlanta.org/cqer/research/gdpnow

Stocks and Bonds

Interest rates continued trading higher through mid-month working to price in the Fed hikes expected to start at the next meeting in mid-March, due to inflation. However, as Russia's talk turned to action, the market stopped caring about inflation and focused on safety, which saw the 10-year Treasury rally sharply in price. The prospect of a prolonged conflict in the Ukraine certainly doesn't bode well for humans, the economic impact will also be meaningful. Russia and the Ukraine both produce and export a lot of commodities, which will likely only increase the already high inflationary pressures in the system. So, while the Fed would probably like to take a pass during the geopolitical uncertainty, many feel the cat is out of the bag and the Fed is forced to raise rates. The flight to safety to close out the month reduced the ugliness, but bonds are still off to their 3rd worst start ever. Please see the chart below. The result for High-quality fixed income, as measured by the iShares US Aggregate Bond ETF, finished the month with another loss at -1.12%. The U.S. 10-year Treasury bond yield ended the month at the low end of the range, at 1.84%, but up modestly from January's close of 1.78%.

Source: https://www.zerohedge.com/markets/crypto-jumps-stocks-pumpndump-cracks-appear-global-financial-system-plumbing

The Dow Jones Industrial Average fell -3.53%, the S&P 500 declined -3.14%, and the small cap Russell 2000 eased -2.06%. The international markets traded in a similar fashion as the U.S. The MSCI EAFE iShares Core International Developed Markets ETF Index slid -2.89%, and the MSCI Emerging Markets iShares Core ETF Index dropped -4.71%.

In February + 2 days of January, we had a mixed bag, Energy and Communication Services had big moves.

The best performers were…

- Energy: +7.54%
- Financials: +1.64%

The lagging performers were…

- Communication Services: -5.34%
- Technology: -2.49%
- Real Estate: -2.13%

Source: https://www.sectorspdr.com/sectorspdr/tools/sector-tracker

Oil Report

The oil market continued its steady march higher as supply constraints became more pressing, as the concerns over omicron faded. The rhetoric that Russia was going to invade Ukraine became reality. Whether that was provocation or simply predicted Russian actions is debatable. Of course, if predicated, maybe "they" should have had some constructive conversation to try and prevent the action. Either way, that is water under the bridge and the current reality is Russia is attacking Ukraine. The gyrations have been immense, but overall higher, with the potential to threaten 2008's highs of $145. Oil and gas are just one of the many commodities that are produced in Russia and the Ukraine. A prolonged war or substantial disruption/destruction of supplies will have more than oil and gas going through the roof. The current NYMEX WTI Crude Oil futures settled at $95.72 and posted a gain of over 8% from the prior month close of $88.15 a barrel, the highest levels since 2014. The strength in price for RBOB gasoline continued stronger than crude oil, with another double-digit gain of almost 15% vs January's close. The pain at the gas pump is already rivaling all-time highs and this is "low" season traditionally for prices.

The Rest of the Data

The January ISM Manufacturing Index declined 1.2 points to 57.6 from December's reading of 58.7. Additionally, the ISM Services Index fell to 59.9 in January from December's print of 62.0. The prices paid component reversed last months plunged for the Manufacturing survey and softened slightly in the Services survey. Any reading above 50 generally indicates improving conditions. Consumer confidence decreased to 110.5 in February, which compares to a downwardly revised figure of 111.1 in January. The unemployment rate rose slightly, coming in at 4.0% as more people than expected rejoined the labor pool. Additionally, the economy added 467,000 jobs in January vs. consensus's meager expectations of only 125,000 jobs. The Consumer Price Index for All Urban Consumers (CPI-U) was up +0.6% in January, holding steady from last month, on a seasonally adjusted basis. Over the last 12 months, the All-Items Index increased to +7.5% on a non-seasonally adjusted basis, still the highest since February 1982. The CPI ex Food and Energy, increased to 6.0% from last month's 5.5%. The beat was in line with the expectations we outlined last month with the jump in oil prices. The concerning item is that even without the invasion of the Ukraine, inflation was running strong across a very wide range of items. How much more pressure may come out of a prolonged conflict and the resulting response is definitely a wild card. Overall, these numbers show an economy on good footing with clear levels of high inflation that are not showing signs of abating. Thus, the corner the Fed painted itself into has gotten even smaller, where markets and the economy are likely going to be pushed further onto the back burner until we see meaningful or quick drops in broader terms around inflation. Otherwise, the Fed risks runaway inflation which has only one resolution, as the early 1980's showed, and that was a hard recession. The end of Fed tapering bond purchases is on track for March, along with an interest rate hike, the question is 0.25% or 0.50%. We will continue to closely monitor economic and geopolitical activity to see how long and hard the Fed needs to raise rates.

Summary

So, 1st quarter GDP growth looks on pace to be weak or flat, while current headline inflation is firmly holding steady with underpinnings for continued moves higher. Sure, glad we held out hope for so long that inflation was merrily transitory. Now with the war in the Ukraine looking to add to inflation pressures and potentially weaken economic growth, the Fed has really stepped in it. We have been discussing concerns on several levels about valuations, economic activity, and inflation pressures. Unfortunately, it looks like the Fed may be on its 9th live. No sugar coating it, at this point it seems hard to see how we avoid a rough patch of current unknown duration. Unless world peace is announced very soon, it seems some price is going to be paid for kicking the can down the road for the last 13 years as the Fed has done. To make matters worse, the price gets to be paid while a major oil and gas producer invades another important player in the commodity world. Hollywood has sure laid out a horrific path for the Fed and we are the ones that suffer.

However, as bad as that all sounds, we retain our focus on what we can control, which is the amount of equity risk that is taken in a clients' portfolio in concert with the clients' risk tolerance and long-term goals. The markets will always face different "worries", today it is inflation/war vs. growth expectations, tomorrow it will be something else. We have built our asset allocation models with dynamic features and quarterly rebalancing, both in fixed income and equities. If the markets continue to march higher,

we will capture some of those gains and reallocate to less volatile high-quality bonds. If the equity markets enter a period of negative performance, we have dynamic investment vehicles that utilize rules-based defense mechanisms to reduce the risk of the portfolio.   Further, if the market gets too extended on the upside, some of the vehicles will capture partial gains and wait for the extension to correct.

Some of these dynamic tools are kicking in. During the month a portion of U.S. midcap shifted to Treasury Bills. At the close Friday, a portion of the U.S. Large Cap also shifted to Treasury Bills. Additionally, the high yield allocation is currently shifting to intermediate Treasuries.

If you have specific questions about your portfolio or financial situation, we are here to help. Long-term financial planning is designed to deal with uncertainty like those we discussed above. Our portfolio management process is to design a prudent allocation across many asset classes. Equities are for long-term growth and several vehicles that we utilize offer defensive mechanisms to mitigate equity market declines.

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