TC Wealth Partners

Trust Company of Illinois

# MATTERS OF TRUST

QUARTERLY MARKET COMMENTARY
FIRST QUARTER 2022

FROM THE DESKS OF

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## Economic Growth

The U.S. economy grew 7% year over year during the fourth quarter of 2021, but estimates for the first quarter of 2022 have come way down due to Fed/inflation expectations and the impact from the Russia-Ukraine conflict. Economists now expect the U.S. economy to grow 0-1% in the first quarter, well below earlier estimates. The first quarter has been a traditionally weak period for growth due to some seasonality, but higher prices are clearly impacting sentiment and consumer spending. The latest first quarter of 2022 GDP estimate from the Atlanta Fed sits at 0.9%.

### OUR VIEW

While we monitor the trends, our conviction remains in above-average 2022 GDP that will surmount headwinds from Fed tightening and global macro, on the basis of sustained consumer demand, a robust labor market and a capex boom. We are closely monitoring consumer demand, which is supported in the macro data (retail sales and job openings) and by company narratives, sharing record backlogs and inelastic pricing..

## Employment

Payroll employment rose by 431,000 in March, after an upwardly revised 750,000 in February. Hiring in leisure and hospitality continued to drive overall gains, with an increase of 112,000. Separately, the unemployment rate dropped to 3.6%, close to the low of February 2020. Participation in the labor market edged up to 62.4% but remains almost one percent below the pre-crisis peak. About half of the drop in participation can be attributed to the pandemic-related surge in retirements. The over-65 crowd has begun to unretire and return to work; those on fixed incomes have little choice but to return amidst the increases in everyday expenses.

### OUR VIEW

The demand for workers continued to outstrip the supply in March; wages accelerated even as more people returned to the labor market. Those gains coupled with another sharp upward revision to last month's data underscore the strength of the labor market. We believe those shifts will reinforce the Federal Reserve's need to focus more on combating inflation, which in our view will get worse before it gets better.

## Inflation

The latest consumer price index (CPI) jumped 0.8% in February after rising 0.6% in January. The CPI leapt 7.9% from a year ago, the hottest annual increase since January 1982. Energy prices have surged in response to Russia's invasion of Ukraine. The price of regular gasoline jumped to a record high as the U.S. and UK decided to ban oil imports from Russia.

### OUR VIEW

Inflation, and its impact on the consumer, remains a concern. Several risks persist, including global COVID-related supply bottlenecks, supply impacts from the Russia/Ukraine war and the impact from rising wages and rents. While inflation continues to run hot, the inflation indicators continue to come in at or slightly below expectations, which we believe may signal that markets have started to price in higher inflation appropriately. We believe that inflation will likely climb even higher in the next one to two months, as the recent moves higher in oil and commodity prices have not yet been reflected in inflation measures.

## Federal Reserve

As was widely expected, the Federal Open Market Committee (FOMC) decided to raise rates by 0.25% at its meeting on March 16. But it was the materials that were released at the conclusion of the meeting that really grabbed the attention of market participants. Specifically, the FOMC released its quarterly Summary of Economic Projections (SEP), in which all 16 current committee members submit their individual forecasts, including their expectations of future monetary policy moves. Most committee members now believe that a more aggressive pace of monetary tightening will be appropriate this year than they did just a few months ago.

### OUR VIEW

In sum, the FOMC appears to have teed up a fair amount of further monetary tightening in coming months. The market now is priced for a Fed Funds rate of 3.25% to 3.50% by June of next year, which would be the biggest total increase the policy rate since 2007 should it happen. The sharply higher expectation for Fed policy rates has lifted all Treasury yields, but the effect has been greatest on short maturity obligations. This has led to an inversion in the Treasury yield curve. We believe that the outlook is unusually uncertain with higher energy prices and tighter financial market conditions exerting headwinds on the economy. Although rate hikes at the next few meetings seem more or less like "sure bets," the committee may become much more data dependent thereafter.

## Yield Curve Inversion

The Federal Reserve (Fed) is behind the curve, and rates must go higher. As the Fed shifts from quantitative easing (QE) to a tightening cycle, rates have rallied in response. A key part of the U.S. Treasury yield curve, the difference between 10-year and two-year yields, has now inverted – on two occasions – for the first time since 2019 (See Exhibit 1). While a negative spread is considered a leading indicator of economic slowdown and recession, historically the indicator is more reliable when the inversion lasts for at least a month, and when other parts of the curve are also inverted. Thus far, this signal is not confirmed by another yield curve, the 10-year and three-month yields, which is often a preferred indicator and remains positive.

### YIELD CURVE INVERSION


Source: TC Wealth Partners, Bloomberg

### OUR VIEW

If the inversion persists and is confirmed by other parts of the curve, we believe that this would be a more meaningful indication, but even still, historically there has been a lead time until an economic downturn. It typically takes 15 months on average for a recession to arrive after the 10-year

versus two-year curve inverts, and markets have rallied about 7.0% on average during this period (See Exhibit 2). In addition, the U.S. economy today is starting from a position of relative strength.

| Date of Inversion | Time to Recession | Return to Recession Start |
|---|---|---|
| 8/18/1978 | 17.5 | 9.6% |
| 9/12/1980 | 10.7 | 3.8% |
| 12/13/1988 | 19.6 | 28.6% |
| 2/2/2000 | 14 | -18.7% |
| 1/31/2006 | 23 | 14.3% |
| 8/22/2019 | 6.3 | 5.7% |
| **AVERAGE** | 15.2 Months | 7.2% |

Source: TC Wealth Partners, Bloomberg

## Domestic Equities

The S&P 500 decreased by -4.6% in the first quarter, the first quarterly decline since the first quarter of 2020. The quarterly decline masks the overall volatility this year as the market dropped by -5.3% in January and -3.1% in February before rebounding by +3.7% in March. The S&P 500 also saw its first correction since the pandemic when the market dropped by -12.8% from January 3 to March 8. On a more positive note, the market was able to stage an +8.7% rally in the last three weeks of March.

### OUR VIEW

We favor domestic equities over international equities because the economic backdrop in the U.S. is still more favorable with above trend GDP growth expected in 2022. We continue to believe that the biggest risk to equities is a more hawkish Fed that is forced to reduce stimulus and raise rates more aggressively. We continue to stress the need to have elements of growth and value, and large caps and small caps in a diversified portfolio.

## International Equities

Internationally, foreign markets declined in the first quarter. Geopolitical uncertainty hit foreign markets early in the quarter, erasing what was moderately positive performance until that point. Emerging markets slightly lagged foreign developed markets due to a stronger U.S. dollar and rising geopolitical risks, but the underperformance was modest.

### OUR VIEW

The macro backdrop continues to be challenging in markets outside the US. The Eurozone is likely to bear the brunt of the fallout from the Russia/Ukraine conflict, including increased recession risk, given its proximity to the war and its significant trade and energy supply linkages to Russia. The sharp rise in oil and other commodity prices and the potential interruption of the flow of oil and gas to the Eurozone underscore the risks to growth. We continue to believe in the long-term investment thesis of higher earnings/economic growth for emerging markets, however this has not played out over the past few years and 2022 should be similar. We believe that active management is very important in emerging markets.

## Fixed Income

Fixed income securities registered some of the worst performance in years during the first quarter with most major bond indices declining as investors exited fixed income holdings in the face of high inflation and as the Federal Reserve consistently signaled that it was going to raise interest rates faster than investors had previously expected. Global bond markets have suffered steep losses since peaking last year. The Bloomberg Global Aggregate Index has fallen 11% from a high in January 2021. That's the biggest drawdown since 1990, surpassing a 10.8% drawdown during the Global Financial Crisis.

### OUR VIEW

We believe that yields will face upward pressure from continuing inflation pressure and central bank hawkishness. One positive we see is that markets have fully priced hawkish outlooks for most central banks, which should limit the extent of any further selloff in government bonds. We continue to stress our thesis that fixed income is principal protection first and yield/income second.

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