INVESTMENT MANAGEMENT

Economic & market outlook

Second quarter 2022

KEY POINTS

- A Russian military invasion into Ukraine and lingering COVID variants are creating substantial uncertainty in the global economy.
- Inflation has broadened and remains frustratingly persistent. Above trend inflation remains the greatest risk to the U.S. economy as excess demand coupled with supply-chain disruptions continue to drive prices higher. The war in Ukraine exacerbates this trend.
- The upper income U.S. consumer remains in a favorable financial position and the U.S. economy seems poised to continue growing. The extraordinarily strong labor market supports personal income growth even as real wage gains are not keeping pace with short-term inflation pressures.
- The tailwind from government spending is abating, and the Federal Reserve is being compelled to tighten financial conditions as inflation remains stubbornly high.
- Equity markets have been volatile, and the backdrop of rising interest rates limits potential future returns as multiple expansion from here is unlikely in the face of significant economic uncertainty.

1Q Results

S&P 500	-4.60
Russell 2000	-7.53
Bloomberg U.S. Aggregate Bond	-5.93
MSCI EAFE	-5.91
MSCI Emerging Markets	-6.97

J. BRIAN HENDERSON, CFA
Chief Investment Officer
BOK Financial

Portfolio seeking refuge

When the new year began, our base case outlook was for above trend economic growth at 2.5% to 3.0%, primarily driven by the high-end U.S. consumer, an improving job market, and a reopening bounce from Omicron that would be sufficient to overcome headwinds from fiscal and monetary policy. What a difference a quarter makes. Trends for growth and inflation have deteriorated considerably, and the Russian invasion of Ukraine in February exacerbated the negative near-term environment for risk assets.

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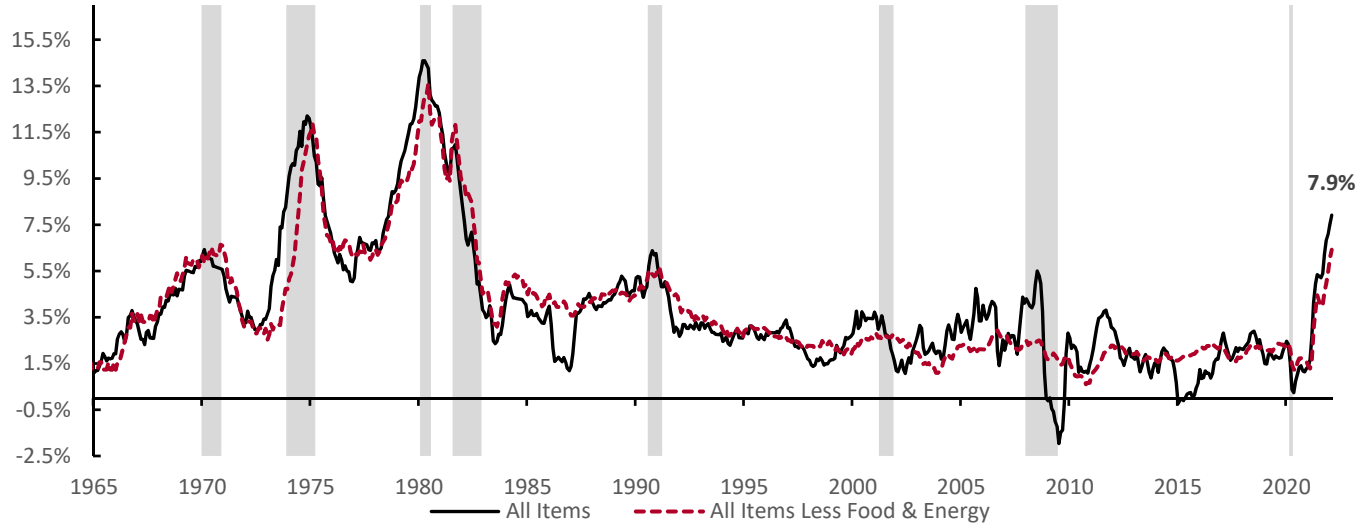
Inflation was heating up even before Ukraine

Even before the invasion, Q1 inflation trends fanned out beyond the rise in energy prices from the economic reopening in the service sector, and price spikes in a narrow subset of durable goods, particularly supply-constrained goods such as new and used cars. With consumer price inflation at 7.9% year-over-year, we are now seeing higher inflation across the board with increasing prices for energy, goods, services, rents, and food. In addition, the probability of a wage price spiral is increasing with the Employment Cost Index recently reported near a 20-year high of 4.0%, an unemployment rate at a very low 3.8%, and job openings remaining firm at over 11 million.

U.S. Inflation (Consumer Price Index, year-over-year % change)



U.S. CPI Inflation (Y/Y % and M/M %)

	Y/Y % (sorted)	M/M %	M/M %
Transport	21.07	1.92	
All Items	7.91	0.80	
Food & Beverage	7.62	1.00	
Apparel	6.59	0.72	
Housing	5.95	0.48	
Other Goods & Services	5.57	1.06	
Recreation	4.95	0.73	
Medical Care	2.43	0.17	
Education & Communication	1.60	0.01	

Russian invasion of Ukraine is putting pressure on commodities

Since the invasion, commodities across the board have spiked even higher. While economic and banking ties between western developed economies and Russia are relatively small, Russia is the second largest commodity exporter in the world behind the U.S. Legitimate fears about disruption in the supply of key industrial metals, energy products, and agriculture products have pushed these input prices in some cases to record highs. Global manufacturers were already dealing with supply chain shortages, and now the even higher input costs are crimping earnings and margins. The next phase of the cycle will likely be a hit to overall revenues from demand destruction due to the high prices and slower production.

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Meanwhile, the Fed has no choice but to move ahead with interest rate hikes

Despite a worsening trade-off for the economic growth versus inflation picture, the Federal Reserve has no choice but to go down an aggressive monetary policy tightening path. We saw this as a risk at the start of year for the economy and markets, but did not foresee how far behind the inflation curve the Fed would actually be at this point. Last month, the Fed initiated what likely will be a series of rate hikes by raising the federal funds rate by 0.25%. The market is expecting these 25 bps rate hikes to continue with almost 8 more hikes this year, with another 2- 3 hikes in 2023. In addition, the Fed is expected to announce detailed plans for reducing the size of its almost $9 trillion balance sheet through a monthly quantitative tightening program.

And, the market reacts…

How are the fixed income and equity markets reacting to these latest turn of events? Yields across the U.S. Treasury curve continue to ratchet higher with increased Fed rate hike expectations. Yields on the short end of the curve are moving higher with the 2-year Treasury yield at 2.28%, just below the 10-year Treasury yield at 2.32%. As forewarned last quarter, the flattening of the yield curve has raised the market's alarm bells for a potential recession, a rare event but not out of the realm of possibility considering that previous recessions have been preceded by a rise in oil prices similar to what we have seen in 2022. Credit markets and in particular high yield credit spreads have widened by over 120 basis points since the first of the year on weakening liquidity conditions in the bond market, and concerns about a more severe economic growth slowdown.

On the equity side, investor sentiment is awful, but can often be a contrarian indicator for future market performance when everyone is leaning the same way. The AAII U.S. investor sentiment bullish readings are below the March 2020 pandemic lows and approaching the lowest levels we have seen in over 30 years. To be sure, the year-to-date performance in the equity markets hasn't been good. The S&P 500 was down 4.6%% for the first three months of the year, and the only sector that was up for the quarter was energy at 39.0%. The tech heavy Nasdaq is now down over 20% from its highs last November when the interest rate picture started to turn higher.

Being in closer proximity to Ukraine and more reliant on Russian energy and commodities, the European economy and equities are bearing the brunt from the invasion. With the Euro Stoxx 50 index down 9.9% year-to-date, and trading at about a multiple of 12x earnings, the Eurozone markets are increasingly pricing in a recession. Within the emerging market equities, performance diverged between commodity exporters whose stock markets are up on the year versus the importers that are all down.

What's an investor to do?

Where should investors be steering their investment portfolio in this increasingly stagflationary macroeconomic environment within a highly volatile stock market with larger tail risks? In the very near term, the headlines out of Ukraine and poor investor sentiment have the potential to drive a lot of short term volatility in all markets. Given these conditions, I wouldn't make large tactical portfolio changes yet. The equity markets are trading off technical levels, and we are heading towards significant support potentially to justify a more significant overweight to equities. Valuations have come down in the S&P 500 Index, but aren't yet at levels that fully price-in a more persistent inflationary environment and weaker earnings growth expectations yet. We favor a slight overweight to cash for the very short term to allow investors to take advantage of any potential larger buying opportunity. We favor increased liquidity positions in equity as well as fixed income strategies. To tamp down inflation, the Fed has to tighten monetary policy. Given their history, however, it's possible we might see them repeat their track record of hiking rates too much and then having to back off.

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Disclosure

Chart data source: Bloomberg

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