Economic & Market Perspectives

Spring 2022

"War is the realm of uncertainty" — Carl von Clausewitz

Uncertainty was a dominant theme for the economy and financial markets for the first quarter of 2022. And the war in Ukraine certainly added to the level of uncertainty.

At the start of the year, COVID-19 continued to drive the narrative around the economy as the Omicron variant contributed to the recent wave of new cases. Supply chain pressures and a tight labor market fueled historically elevated levels of inflation, which caused the Federal Reserve to pivot to a more hawkish stance on monetary policy. While the full implication of Russia's invasion of Ukraine is yet unknown, including the impact of the growing humanitarian crisis, the war in Ukraine is putting upward pressure on inflation and will weigh on economic growth.

The Economy

Since July 2020, the Fed has reiterated in its Federal Open Market Committee (FOMC) meeting press releases that "the path of the economy" depends significantly on "the course of the virus." But we are beginning to see a shift in focus.

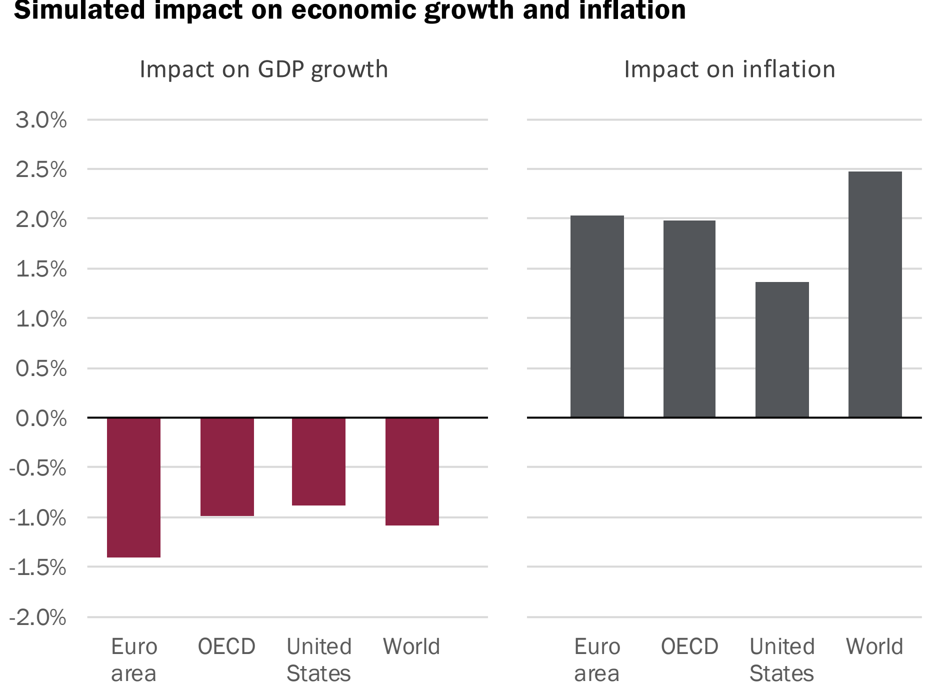
In early January of this year, the number of COVID-19 cases attributable to the highly transmissible, but less deadly Omicron variant of COVID-19 were still rising to levels three times what we experienced with the Delta variant wave, which peaked in the fall of 2020. According to the Centers for Disease Control and Prevention, the number of COVID-19 new cases, hospitalizations, and deaths have declined significantly. The seven-day moving average of new cases is down over 95% since peaking around January 15th of this year.

Despite concerns about the impact of Omicron, the U.S economy ended 2021 on a high note, growing at an annualized rate of 6.9% for the fourth quarter and 5.7% for the year – marking the fastest growth since 1984 – but growth is expected to moderate in 2022. Economists and Atlanta Fed's GDPNow model are forecasting 1-2% real GDP growth (annualized) for the first quarter of 2022.

The International Monetary Fund (IMF) recently cut its forecast for global economic growth in 2022 due to weaker outlooks for the world's largest economies – the United States and China. Global growth is expected to moderate to 4.4% in 2022. The IMF is concerned that high inflation will lead to tighter-than-expected monetary policy in the U.S., which would tighten global financial conditions. In China, additional lockdowns, because of the 'Zero-COVID' strategy, could lead to more global supply chain disruptions. The IMF forecast does not include the impact of the Russia-Ukraine conflict.

The economic damage from Russia's war with Ukraine will be worldwide and risks becoming increasingly severe and long lasting, according to the Organization for Economic Cooperation and Development (OECD). Amid the uncertainty, the OECD estimates global economic growth could be more than 1 percentage point lower this year than was projected before the conflict, while inflation, already high at the start of the year, could be higher than it would have been if war had not broken out by at least a further 2.5 percentage points on aggregate across countries – see Chart 1.

(Chart 1)



Note: Simulated impact on GDP (% change) and inflation (% points) over the 1 year period beginning February 24, 2022. Source: OECD Economic Outlook Interim Report March 2022.

The Fed appears to have shifted its focus from COVID-19 to inflation. In its statement following the March FOMC meeting, the Fed dropped the "path of the economy" language, and replaced it with "the implications [Russia's invasion of Ukraine] for the U.S. economy are highly uncertain, but in the near term the invasion and related events are likely to create additional upward pressure on inflation and weigh on economic activity."

Inflation is soaring, reflecting supply and demand imbalances related to the pandemic. The U.S. rate of inflation jumped to a 40-year high of 8.5% (year-over-year) in March. And the Russia-Ukraine conflict will most likely prolong high inflation in the U.S. and abroad. Russia and Ukraine are major suppliers of commodities, especially oil, natural gas and wheat (for which Russia and Ukraine make up 30% of global exports). Disruption in the supply of these commodities will contribute to significant upward price pressure in the months ahead.

The Fed turned more hawkish at its March 15-16 meeting as inflation is coming in hotter and lasting longer than expected. The FOMC raised the target for the federal funds rate by a quarter percent to 0.25-0.50% — the first rate-hike since 2018. The Fed also indicated it planned six more hikes in 2022

and three more hikes next year. Fed Chair Powell said inflation is going to stay high in 2022 but vowed the central bank will do everything it takes to bring prices under control.

The Fed believes the economy and especially the labor market are strong enough to withstand a series of rate hikes. Job gains have been strong in recent months, and the unemployment rate has declined substantially. The U.S. economy added 431,000 jobs in March and the unemployment rate dropped to 3.6%, near a fifty-year low. Job openings are near record highs, resulting in 1.7 job openings for every unemployed person. And weekly jobless claims are also trending down to near 50-year lows – all of these indicators are signs of a strong labor market.

There is concern that the Fed has waited too long to begin raising interest rates and reducing its balance sheet, which has grown in size to $9 trillion as a result of quantitative easing measures put in place to keep long-term interest rates low and bolster the economic recovery from the pandemic. The concern is that the Fed will now have to raise rates more aggressively to combat inflation by reducing demand, which if they suppress too much, risks driving the economy into recession.

We are seeing this concern play out in the financial markets with stock market volatility and the changing shape of the yield curve, which recently inverted for the first time since 2019. That is, the yield on the two-year U.S. Treasury was higher than the yield on the ten-year, which has historically been a harbinger of recession.

However, there are several indications that a recession in the U.S. is not imminent. The New York Fed has a model that calculates the probability of a recession in the U.S. twelve months ahead, based on the spread between the three-month and ten-year Treasury rates, which is their preferred combination of Treasury rates. The probability of U.S. recession (twelve months ahead) predicted by the 3-month/10-year treasury spread was 5.49% in March, which is well below the estimated probability of 30% associated with prior recessions.

In addition, household wealth has surged as a result of increases in the value of stock holdings and real estate. And as a result of the strong labor market, wages are rising, albeit not enough to keep pace with inflation. The "wealth effect" and higher wages should help support continued consumer spending, the largest component of economic activity. Consumer spending expectations remain solid even though consumer sentiment is at a decade low.

Financial Markets

The war in Ukraine, surging inflation, and a Federal Reserve that is raising rates for the first time in four years wreaked havoc on bond and stock market performance – only commodities (+26%) and cash (0%) posted positive returns in the first quarter.

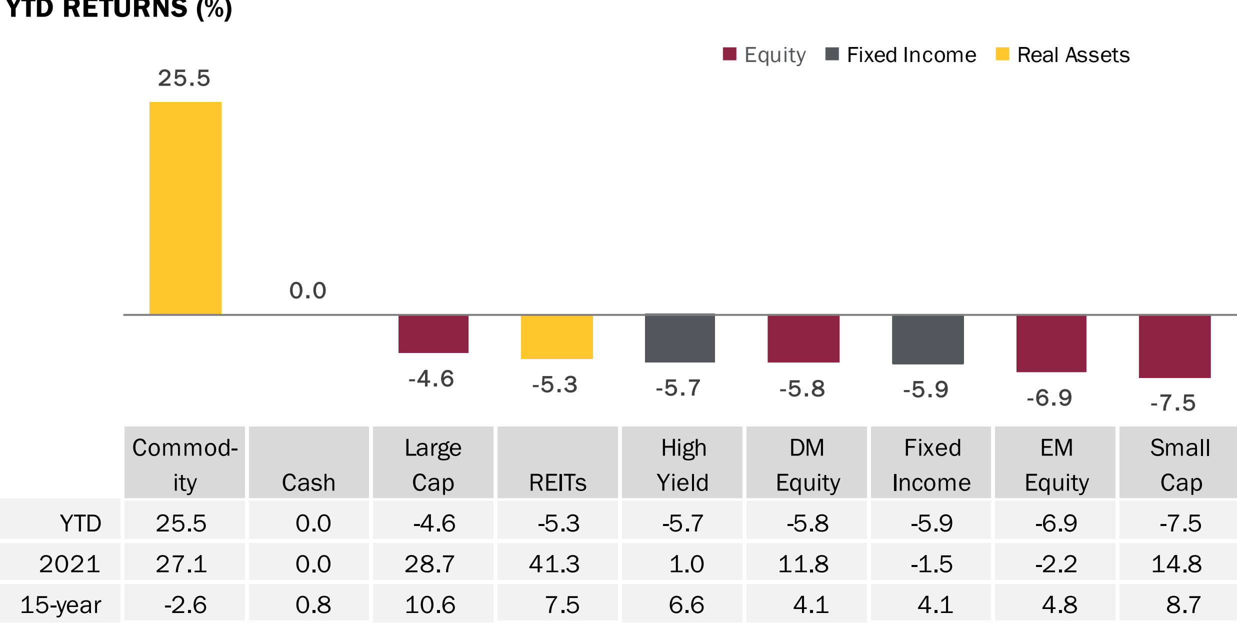
The U.S. bond market had its worst calendar year start (-6%) since 1980. Prices plunged and yields soared, especially for intermediate-term and long-dated bonds, which are more sensitive to changes in interest rates, as the yield on the benchmark 10-year U.S. Treasury note jumped from 1.50% at the beginning of the year to 2.32% at the close of the first quarter.

Stocks also took a hit, with major indexes experiencing their worst quarter in two years. Markets reacted negatively to persistently high inflation data and the prospect of the Fed having to raise interest rates higher and faster than expected. And Russia's invasion of Ukraine in late February also helped drive equity markets lower, although stocks have since rebounded from low points reached in early March.

Commodities posted their best quarter in more than 30 years driven by a sharp increase in the price of oil since the beginning of the year. Increased global demand for commodities and constrained supply chains contributed to strong price performance over the past year. And concern over further disruptions to the supply of oil, wheat, and metals as a result of the Russia-Ukraine conflict pushed commodity prices even higher in the quarter.

For more on selected asset class returns, see Chart 2.

(Chart 2)



	Commod-ity	Cash	Large Cap	REITs	High Yield	DM Equity	Fixed Income	EM Equity	Small Cap
YTD	25.5	0.0	-4.6	-5.3	-5.7	-5.8	-5.9	-6.9	-7.5
2021	27.1	0.0	28.7	41.3	1.0	11.8	-1.5	-2.2	14.8
15-year	-2.6	0.8	10.6	7.5	6.6	4.1	4.1	4.8	8.7

Source: J.P Morgan Asset Management *Guide to the Markets -U.S.* Data are as of March 31, 2022.
Cash: Bloomberg 1-3m Treasury, Commodity: Bloomberg Commodity Index, DM Equity: MSCI EAFE, EM Equity: MSCI EME, Fixed Income: Bloomberg US Aggregate, High Yield: Bloomberg Global HY Index, Large cap: S&P 500, REITs: NAREIT Equity REIT Index, Small cap: Russell 2000. 15-year annualized return represents period from 12/31/2006 to 12/31/2021.

Outlook

Our long-term outlook for risk assets remains positive despite near-term challenges posed by slowing economic growth, higher inflation, and the Russia-Ukraine conflict.

Projected economic growth, albeit slowing, is above-trend and corporate and household balance sheets are healthy. Corporate earnings are estimated to grow in the high single-digits in 2022 and profit margins are estimated to remain near historical highs as businesses are able to pass on higher costs.

However, given a high degree of uncertainty around how and when these challenges are resolved, we are neutral-weight equity and underweight fixed income relative to our strategic targets.

Within equity, we are overweight U.S. stocks and have a value tilt within U.S. large cap, mid cap, and international large cap. Although non-U.S. markets have more attractive valuations and greater

exposure to cyclical sectors than U.S markets, we are concerned about their geographic proximity to the Russia-Ukraine conflict and the potential for a more direct economic impact from sanctions on Russia, especially given the reliance of non-U.S. markets on Russian gas and oil.

Within fixed income, we have shortened duration and have a tactical overweight to higher-yielding sectors such as floating rate notes and high yield bonds, which should help mitigate interest rate risk.

As a hedge against higher inflation, we have a tactical allocation to commodities.

We are keeping a close watch on the shape of the yield curve as well as the labor market. Historically, stocks have performed well in the 12 months following an initial inversion of the yield curve. We will also keep our eye on weekly jobless claims, which is a timely indicator for the health of the labor market. An uptick in claims can be an early sign of weakening demand and a slowing economy.

Of course, the war in Ukraine, which could escalate and drag on, is a wild card. We will maintain a neutral-weight allocation to equity until there is less uncertainty around the conflict's impact and resolution.

For more on our positioning, see Chart 3.

The Investment Strategy Team

(Chart 3)

PBWM's STRATEGIC AND TACTICAL ASSET ALLOCATION

	Asset Class	Strategic (%)	Over/Underweight (%)	Tactical (%)
Equity	U.S. Stocks	30	7	37
	International Developed Stocks	22	-3	19
	Emerging Market Stocks	8	-4	4
Fixed Income	Core Bonds	38	-9	29
	Non-Core Bonds	0	4	4
	Cash Equivalents	2	0	2
Real Assets	Real Estate-related securities	0	0	0
	Commodity-related securities	0	5	5

PeoplesBank Wealth Management's (PBWM's) strategic and tactical asset allocation for its moderate growth total return strategy as of April 2022.

Notes

PeoplesBank Wealth Management's (PBWM's) asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. Strategic recommendations are based on how the Wealth Management Investment Strategy Committee (ISC) believes investment portfolios should be positioned in a generally neutral market environment over the next ten years. Tactical recommendations are based on where the ISC sees either increased opportunity or risk over the next one to two years.

The ISC is responsible for developing both the strategic (long-term) and tactical (short-term) asset allocations for Wealth Management's investment management and trust relationships. The ISC is comprised of the senior members of the Wealth Management team. The ISC is also responsible for monitoring and updating strategies, managers, and funds within client portfolios. The ISC meets monthly. If you have any questions or would like additional information regarding PBWM's investment process, please call or send an email to your relationship or investment officer.

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Sources: Barron's, Centers for Disease Control and Prevention, Federal Reserve, International Monetary Fund, J.P. Morgan Asset Management, MarketWatch, Organization for Economic Cooperation and Development, and The Wall Street Journal.