



MAY 31, 2022

Capital Markets Commentary

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CAPITAL MARKETS UPDATE

This month the S&P 500 Index reached a drawdown of more than -19% from its all-time high reached back in December, as fears over the Fed's ability to contain inflation remain widespread. At the end of May, the total return of the S&P 500 Index had fallen more than -12.7% year-to-date. Bond investors, which are usually sheltered from this type of volatility, also experienced negative returns as rising interest rates caused bond prices to fall. The widely held Barclays U.S. Aggregate Bond Index was down -8.9% year-to-date.

This instability is leading Americans to wonder if this could be the beginning stages of an economic recession. Last quarter's GDP unexpectedly declined by -1.5%. It is not surprising that with weak economic outlooks coming from Wall Street's largest retailers like Walmart and Target, some investors are bracing for the worst. At the very least, it is likely the economy is entering a period of stagflation, where interest rates are rising and there is little economic growth. This type of economy is something the U.S. has not seen since the 1970s but has occurred due to the combination of unusual circumstances that included the impact of COVID-19, low-interest rates, and the Russian war in Ukraine.

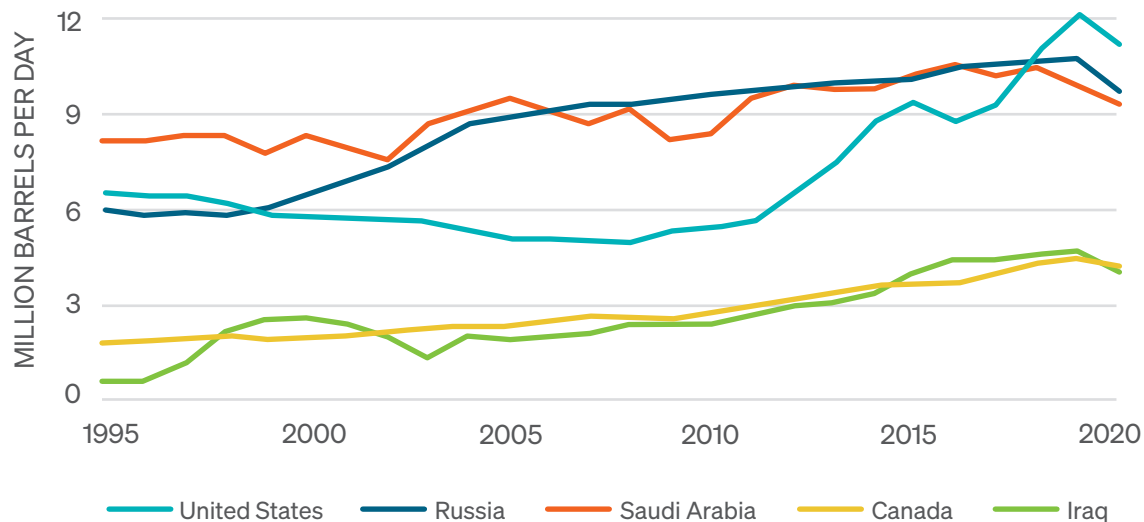
The Federal Reserve is the independent government agency, responsible for maintaining full economic employment and price stability. The May nonfarm payrolls report showed the U.S. created 390,000 jobs, exceeding consensus estimates of 325,000. Current unemployment remained at just 3.6%, so the Fed is remaining laser-focused on fighting inflation in the U.S. The latest May CPI annual report showed an increase of 8.6% year-over-year, making it the highest reading for this index since 1981. The headline CPI results were driven by nearly a 35% increase in energy prices and 10% in food costs. The positive news is that core inflation, which removes these two categories, decelerated to a 6% increase in May year-over-year, signaling that some components of inflation could be trending down.

The Fed is tasked with providing the U.S. economy with a “soft landing,” attempting to reduce inflation while not stifling economic growth. Fed Chair Jerome Powell referred to 1965, 1984, and 1994 as years where the committee previously accomplished this. The Fed is increasing interest rates over what is expected to be the foreseeable future. This is causing demand for big-ticket purchases like single-family homes to slow, as the cost to borrow money becomes more expensive. Mortgage demand has reached a 22-year low after this year’s rate hikes.

Smaller ticket items are also being impacted through shrinkflation. This is becoming more widespread and is another way manufacturers are cutting costs. This subtle tactic is used by manufacturers where they reduce the quantity of a product but keep the same selling price. For example, a popular sports drink reduced the number of ounces in its typical bottle from 32 to 28 oz. for the same price. This is a discreet way for manufacturers to pass along increases in input costs to the consumer without explicitly raising the price tag on their product.

One significant contributor to inflation is occurring at the gas pump and is reducing the discretionary income of most Americans. Oil, as represented by WTI crude, climbed higher during May as the commodity reached \$115/bbl. by the end of the month. The latest data, provided by the U.S. Energy Information Administration, shows that Russia remains one of the top 5 oil-producing countries, which combined are responsible for over 51% of global daily production. This illustrates the significance of the oil supply that the Russian ban is removing from the marketplace.

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SOURCE: U.S. ENERGY INFORMATION ADMINISTRATION

According to BBC News, the European Union imports 25% of its oil from Russia, equating to approximately 2.2 billion barrels per day. Despite their past reliance on Russia’s energy, the European Union agreed to phase-out purchases of Russian oil over the next six months. The ban will apply to the oil that it receives via cargo ship, but not yet from its pipeline. This still accounts for nearly 2/3 of the total imported from Russia to the European Union.

As developed nations continue the implementation of banning the purchase of Russian oil, global demand continues to exceed the available supply. This is continuing the streak of record-high gasoline prices. According to AAA, the U.S. national average for the cost of regular unleaded gasoline at the pump was \$4.62/gallon at the end of May. Expectations are that the national average for the price of regular gas unleaded may exceed \$6/gallon by the end of summer.



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