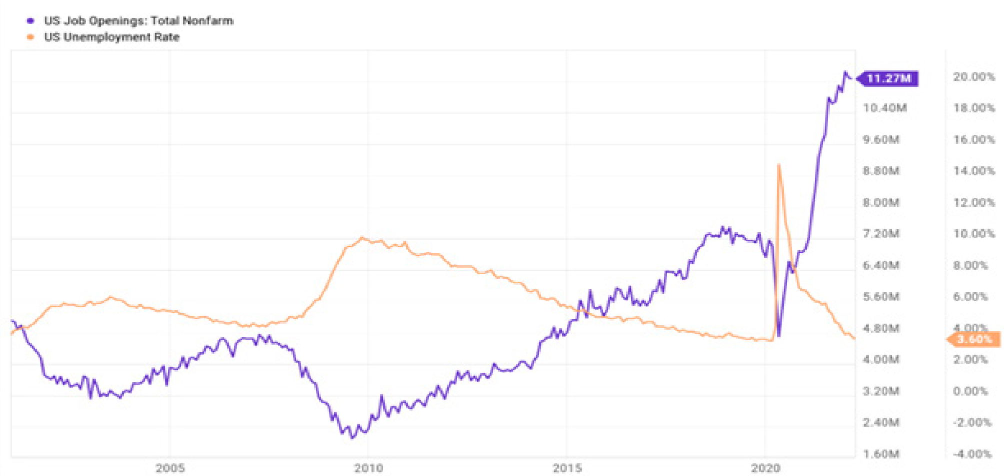
Market Commentary - Q1 2022

Economic Growth, Employment, and Inflation

Over the course of three months, 1.685 million jobs were filled, and the unemployment rate declined from 4% to 3.6%. Job gains were inclusive across race and education attainment groups. Furthermore, the labor market is about 1.6 million jobs away from pre-pandemic level in February 2020, and given that over the last 15-month, monthly job gains averaged approximately 600K, labor market can reach and even surpass pre-pandemic level by the end of Q2. On a more specific level, service-providing and manufacturing companies reported signs of improvement in hiring toward the end of Q1. However, both are still short of February 2020 level. Within manufacturing, the shortfall is solely on durable goods side, while non-nondurable goods companies have fully recuperated, with employment level slightly above February 2020 level. Another industry that is struggling to fill in openings is oil and gas extractions, which is about 8.5% below February 2020 level. On a positive side, truck transportation employment level is at an all-time high, surpassing the peak that was reached in mid-2019. Overall, the labor market is strong and current job openings of more than 11 million have reached a multi-decade high. This has led to an increase in employment costs and wage pressures are being pushed upwards; with workers demanding higher wages to offset inflationary standard of living costs. This wage-price spiral can be dangerous if not contained and has led to the Fed taking a tougher stance on inflation.

Overall, the labor market is strong. Current job openings of more than 11 million have reached a multi-decade high which has led to upward wage pressure, since workers demand higher wages to offset deteriorating standard of living, caused by high inflation. This dynamic can lead to wage-price spiral, something the economy has not seen since late 1970's. Implications of wage-price spiral would be extremely painful for the economy as the Fed would be forced to take austere measures to break the causation between the two. Thus far, wage-price spiral has been one sided, meaning wages go up because prices go up. However, this loop can close hastily if business margins continue to get squeezed by higher payroll bill.



Source: Ycharts, Liberty One Investment Management (04/2022)

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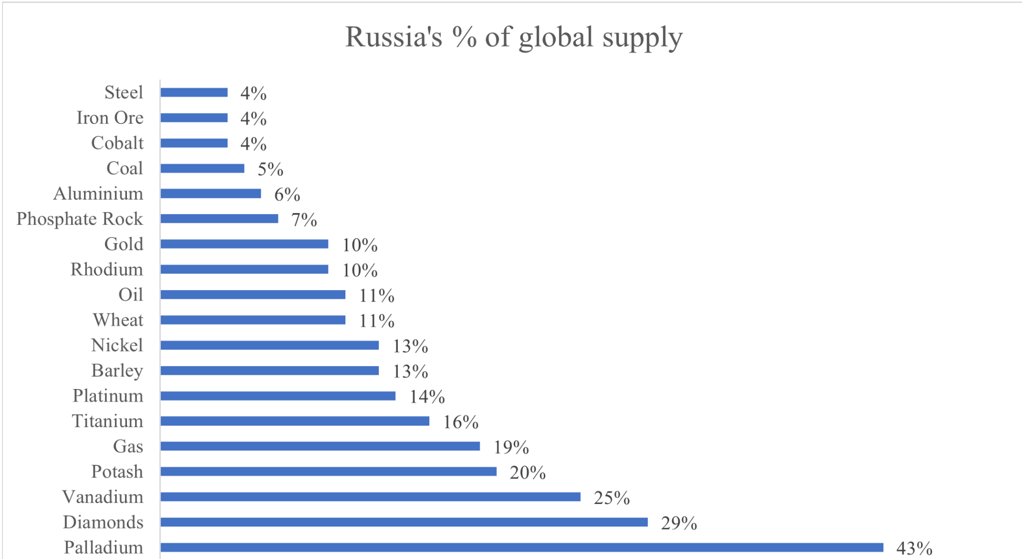
Inflation

Inflation is a key determinant that could influence the trajectory of interest rates and future growth. Year over year (YoY) headline Consumer Price Index* (CPI) rose 7.5% and 7.9% in January and February, respectively, and March number is expected to be above 8%. Excluding food and energy, inflation rose 6% and 6.4% in January and February, respectively. Within the numbers, new and used vehicle prices account for about 15% of headline CPI in February. Excluding that item, February YoY headline and core growth drops to 6.7% and 4.9%, respectively. However, because lower base from early 2021 still makes YoY numbers quite elevated, month over month (MoM) changes provide a better read into inflation developments. Until February, headline MoM CPI growth had been decelerating from .9% in October to .6% in January, driven primarily by declining energy prices.

However, the Russia and Ukraine crisis have reignited inflationary pressures. Historically, wars have been inflationary as military on top of civilian demand strains the economy's productive capacity. Secondly, sanctions and the war disrupt global supply chains. Global supply chains today have been severely interrupted by a health crisis (COVID-19) and military crisis (Russia-Ukraine) in a span of two years. Russia's involvement in the military crisis exacerbates supply chain challenges because Russia is commodity powerhouse- accounting for a large share of global energy, metals, and agricultural supply. Russia accounts for 19% of global gas supply, 20% of global potash supply, 25% of global vanadium supply, and 43% of palladium supply.



Source: Bloomberg, VanEck, Goldman Sachs Global Investment Research, Argus, WoodMac, USDA, USGS. (01/2022)

Recent developments in China's zero-Covid policy are also exerting tremendous pressure on global supply chains that may result in further shortages and price increases. Activity in Shanghai, the world's busiest container port, was restricted- causing difficulties for transporting goods in and out of the ports. Containership delays and displacement are likely to extend lead times which have a ripple effect through the entire supply chain.

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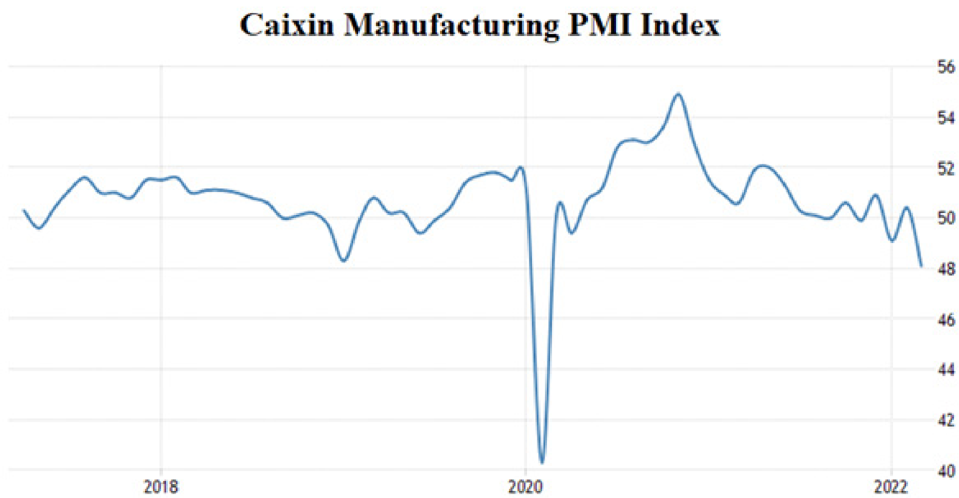
China's Caixin Manufacturing PMI Index contracted and was measured at its 25-month low prior to the lockdowns in China. Expectations are for China's PMI to contract even further in April, prompting China to signal that it will step up monetary and fiscal stimulus for its economy, a stark contrast to the rest of the world which have signaled a path for removal of such stimulus.



Source: Trading Economics, Liberty One (03/2022)

Consumer Demand

Overall, demand continues to be strong. This is being confirmed by the Fed and by management of public companies in the latest earnings season. In fact, most companies reported inelastic demand towards price increases, which is a fancy way of saying that consumers continue to buy products even though they cost more. However, assessing whether demand is growing or weakening in the current business environment is difficult. For example, when inflation growth is stable, one can look at the nominal retail sales and make a judgment. However, rising inflation makes nominal numbers poorly comparable between periods. To combat this impediment, one can adjust nominal values for inflation and solely look at whether quantities sold increased or decreased under constant price. However, shortage of goods due to supply chain issues make this measure unreliable because real growth can be zero or negative not because there is no demand but because there is just no product to sell. For that reason, one must look at alternative ways to evaluate demand. A more reliable way to evaluate demand in today's environment is to look at new orders activity for products and services. A manufacturing report from the Census Bureau* shows new orders for consumer goods increased MoM by 1.09% and 1.4% in January and February, respectively. All the growth were for non-durable consumer goods, which increased by 1.98% and 1.84%, while orders for durable goods decline by -2.95% and -0.68%. One of the reasons for this decline is temporary new orders freeze to allow backlogs to catch up. But overall, this measure indicates that consumer demand did not slow down during the first two months of the year.

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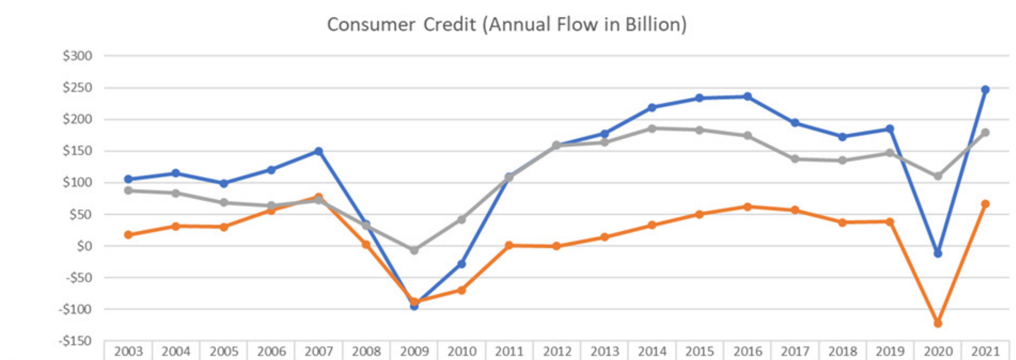
Consumer balance sheet also points to a strong and resilient consumer. In 2021, consumers borrowed a record amount of revolving and non-revolving funds. Within non-revolving funds, motor vehicle loans accounted for 50%, which is above the historic average of approximately 40%. The momentum continued into 2022, where both measures came in at an all-time high for January and February, combined. This indicates that consumers are confident about their financial situation. Additionally, revolving debt balance is still below pre-covid levels, leaving room for additional borrowing capacity. Moreover, whenever consumers were anxious or worried, revolving credit historically gets repaid first, which is not evident today.



	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total	105	115	99	120	150	34	(95)	(28)	109	159	178	219	233	236	194	173	185	(12)	247
Revolving	17	31	30	56	78	2	(88)	(70)	1	(0)	14	33	50	62	57	37	38	(122)	67
Non-Revolving	88	84	69	64	72	32	(7)	42	108	159	163	186	183	174	138	135	147	110	180

Total Revolving Non-Revolving

Source: Board of Governors of the Federal Reserve System, Liberty One Investment Management (2022)

Although consumer balance sheets are healthy today, cracks and vulnerabilities may appear in the future. In addition to stimulus checks and generous unemployment insurance, freezes on student loan payments, loan refinancing, job and wage growth, excess saving, and confidence from appreciation of asset values in the stock market and real estate have driven demand over the last two years. Most of this support is expected to be removed soon.

The average student loan payment is approximately $400 per month; there are about 45 million Americans with a student loan debt. This means that over the course of 2 years, on aggregate, consumers had spare capacity of $216 billion per year for discretionary spending, or about 1% of nominal GDP in 2021.This spare capacity is expected to be removed by September 2022 when moratorium on student loan payments ends. On the refinancing front, it is hard to estimate savings from refinancing of home and auto loans because data is not widely available, but it is reasonable to assume that some of that savings will be a permanent boost to discretionary income while being offset by higher property taxes because of appreciated home values. Consumer confidence is also driven by the labor market and is typically high when jobs are plentiful. However, there are no assurances that jobs will remain plentiful while workers continue to struggle locking in positive real wage growth. Real wage growth has declined and may result in consumer cutbacks and lower spending.

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The Fed and Monetary Policy

We will attempt to avoid discussing future rate paths or expectations of the movement of interest rates because we believe that interest rates will continue to remain dynamic and subject to change, conditional upon new economic data releases which remain uncertain. However, we admit that the Fed is faced with a challenging task of taming inflation without tipping the economy into a recession and pull off a soft landing successfully. Monetary Policy can be effective in constraining demand to inhibit inflation, but the Fed does not have the ability to alleviate supply constraints which is a major contributor to the inflation challenges today. As a result, there is a risk that the Fed may have to compress demand more than normal which increases the probability of tipping the economy into a recession. Nonetheless, monetary policy is expected to be tightened, given that financial conditions today are still very loose and risk premiums are still very narrow.

Source: Federal Reserve Bank of Chicago, YCharts, Liberty One Investment Management (2022)

Unemployment rates have historically increased after a period of Fed tightening, and monetary policy subsequently becomes loose again to fight off the effects of slowing growth and potential recessions. As there were limits to how low interest rates could go to stimulate the economy, we portend that there is also a higher chance of a ceiling on how far interest rates can go before it becomes too restrictive. As federal deficits and debt have ballooned since the Covid pandemic, higher rates would act as a deterrent to future growth as a bigger share of the federal budget goes to financing costs, which leaves less money for the other more productive expenditures of the federal budget.

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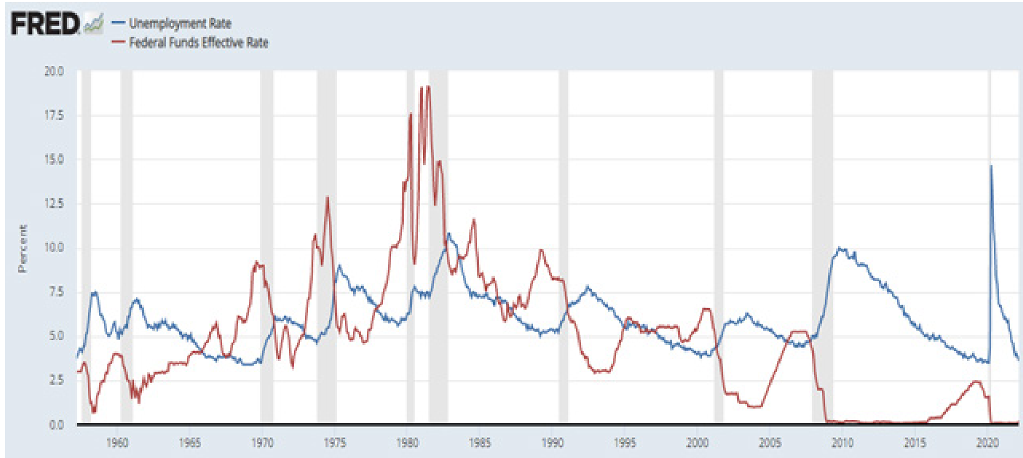

Source: Board of Governors of the Federal Reserve System (2021)

Conclusion

A strong labor market coupled with a military war, and frayed global supply chains have pushed inflationary pressures upward this year. Higher than expected inflation has added strains on consumer budgets and on corporate profit margins, although levels continue to remain somewhat healthy. The outlook for consumer demand is mixed and could be bifurcated depending on income groups as consumers are affected by different cost thresholds. The propensity to spend would likely remain fluid this year as global societies adjust to different price levels.

Tighter monetary policy is expected to compress demand and slow inflation, but the effectiveness of such tool remains uncertain. In our opinion, stagflation risks have increased since the start of the year and investors should monitor that risk closely. What would be more likely to happen this year is that financial conditions are going to tighten which could affect volatility in credit spreads, risk premiums, and liquidity in the financial system.

Today's investing environment is in stark contrast to what investors have been used to over the last decade's bull market. Low growth, low rates, and low inflation have been replaced with stronger growth, higher rates, and much higher inflation. We view this investing environment as a ripe environment for investors to be selective and invest in cash generating, strong balance sheet businesses that can dynamically adapt to a changing environment. Investing in inflation and recession resistant companies may also help if the economy is indeed in stagflation. Investors can also use the bucket system to manage risks and adjust portfolio allocations while opportunistically picking up positions in strong long-term businesses during volatile periods.

As the world adapts and adjusts, it is important to keep things in perspective. Markets and behaviors are cyclical which means there will be good periods followed by bad periods and vice versa. Allowing the fluctuations to affect your emotions can not only be detrimental to your psychology, but also to your investment portfolio. Managing your thoughts and temperament appropriately continue to be a commonly shared trait among the world's most successful investors.

Commentaries mentioned are opinions of Liberty One Investment Management, LLC and should not be taken as investment advice.

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