Market insights

Phoenix Chamber of Commerce

9/23/2022

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Key points

1. The economy is going to slow. This is not just a forecast, it is the goal of Fed monetary policy actions.

2. The Federal Reserve will continue its tightening cycle, via raising rates and reducing the size of its balance sheet. Longer term inflation expectations are a key metric for the Fed. Higher rates and QT certainly increase the risk of at least a shallow recession but this is a risk the Fed is willing to take

3. If, as we expect, inflation begins to subside and the outlook is for the Fed to cap short term rates in the 4-4.25% range, then the majority of the damage in the bond market is behind us.

4. Equities will remain volatile. We are watching earnings estimates for the balance of 2022 and into 2023 closely. Slower economic activity, higher input costs, and higher labor costs will pressure margins. To what degree remains a question.

5. Overall, downside risks to the economy and markets have increased; we have positioned portfolios more defensively as a result. However, we would not recommend changes to longer term investment plans.

Base case outlook

Economy

Economic growth is slowing as consumers face higher prices, uneven supply of goods, and a Fed raising rates.

Risks: Russia-Ukraine war persists and China maintains a zero-COVID policy.

Policy

The Federal Reserve continues to accelerate its response to decade-highs in inflation while fiscal policy is muted.

Risk: Monetary policy actions don't slow inflation.

Markets

Bond markets have built in a 4-4.25% terminal rate. Equities remain volatile though many stocks now reflect recession valuations.

Risk: Earnings are below expectations and/or the Fed has to be more aggressive.

Economic Drivers- Global

1. The Russia-Ukraine conflict
2. China’s zero-COVID policy
3. Commodities

Russian invasion exacerbates inflation

- The Russian invasion of Ukraine is the largest military conflict in Europe in 75 years.
- In a world already struggling with goods inflation, supply disruptions across commodities markets pose a significant risk to global price stability.
- Higher energy prices act as a tax on consumption, lowering global real GDP potential for 2022.

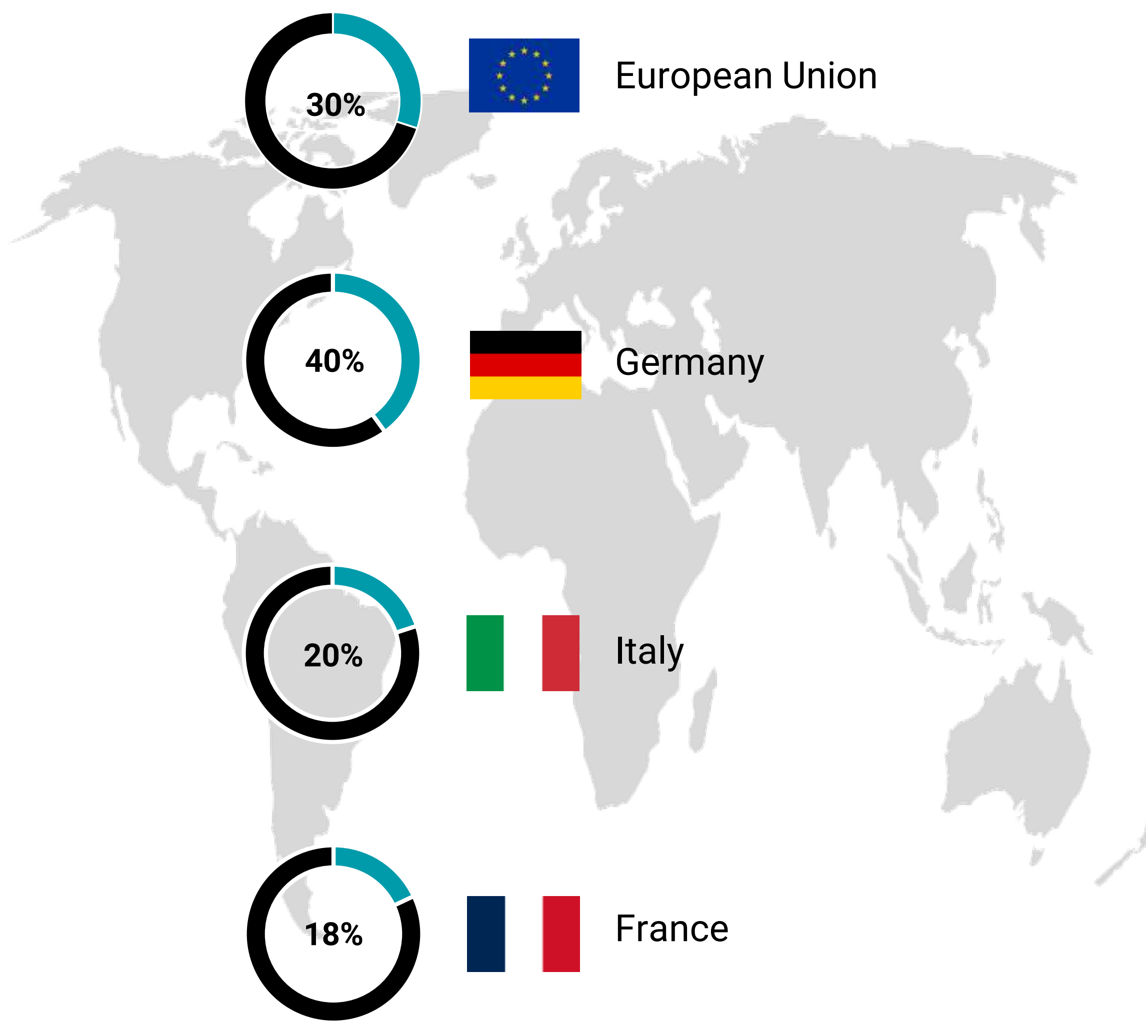
Russia's share in global commodity production in 2020 (in percent)	
Palladium	44%
Potash	20%
Natural Gas	17%
Platinum	14%
Oil	12%
Wheat	11%
Gold	10%
Aluminum	6%
Nickel	6%
Coal	5%
Silver	5%
Copper	4%

Source: J.P. Morgan Commodities Research

Russian influence on Europe

- As Europe transitions to clean energy sources, Europe has increased its reliance on Russian natural gas.
- Europe has been aggressively pursuing liquefied natural gas on the global market to displace Russian gas, exacerbating inflationary pressures across the continent.

European Dependence on Russian Gas

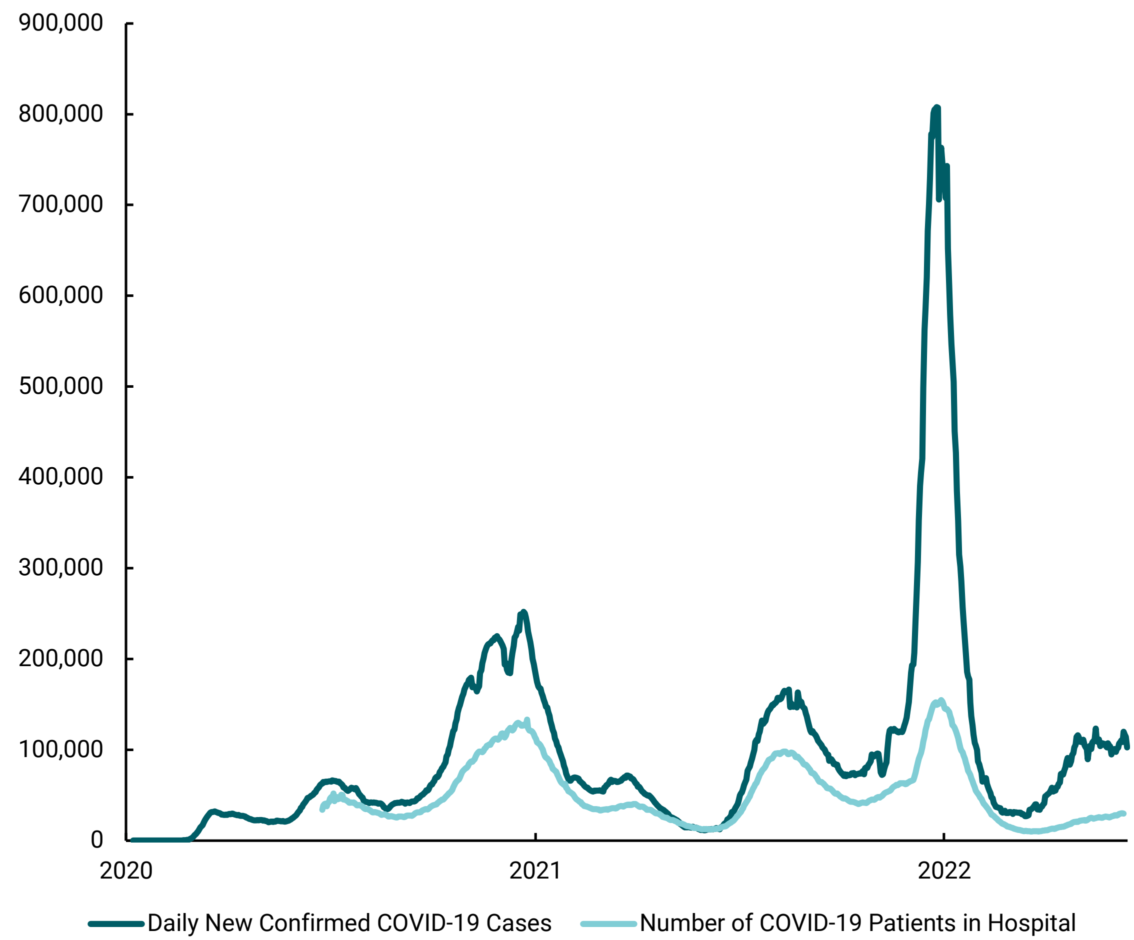


Source: Statista

COVID's impact is diminishing

- Even as the CDC reports of cases increasing in the United States, hospitalizations are not increasing significantly.
- Absent a new variant which shows increased danger of hospitalization or death, the U.S. is treating COVID as endemic.
- Despite declines in COVID restrictions in the West, China remains focused on a zero-COVID policy.
- Supply chain disruptions have led to inflation, but much of the West has returned to normal.

U.S. COVID-19 Cases & Hospital Patients

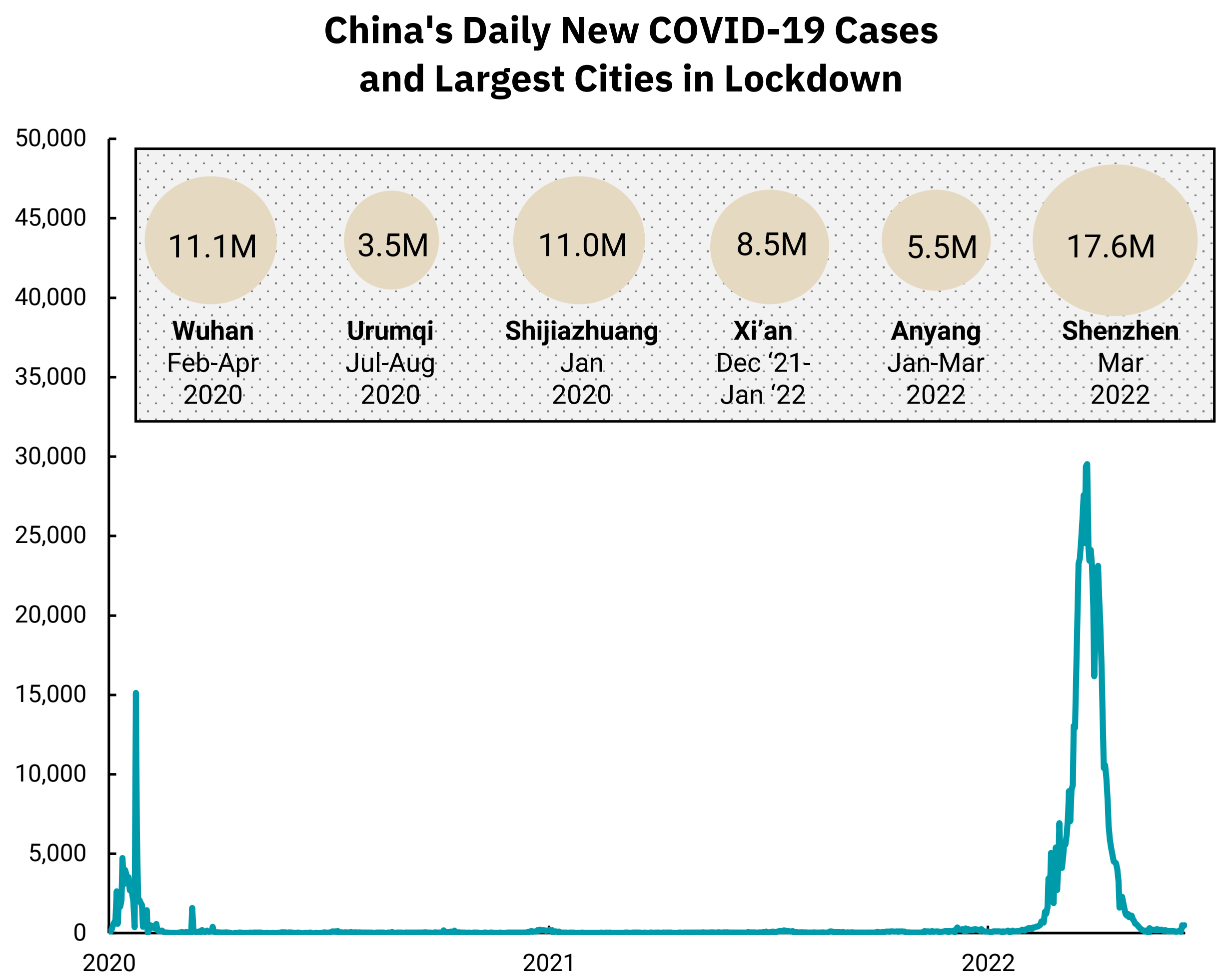


Source: *Our World in Data. Data shown as of July 4, 2022*

China lockdowns impacting supply chains

- China maintained its zero-COVID policy beyond the Olympics, even locking down Shanghai this spring.

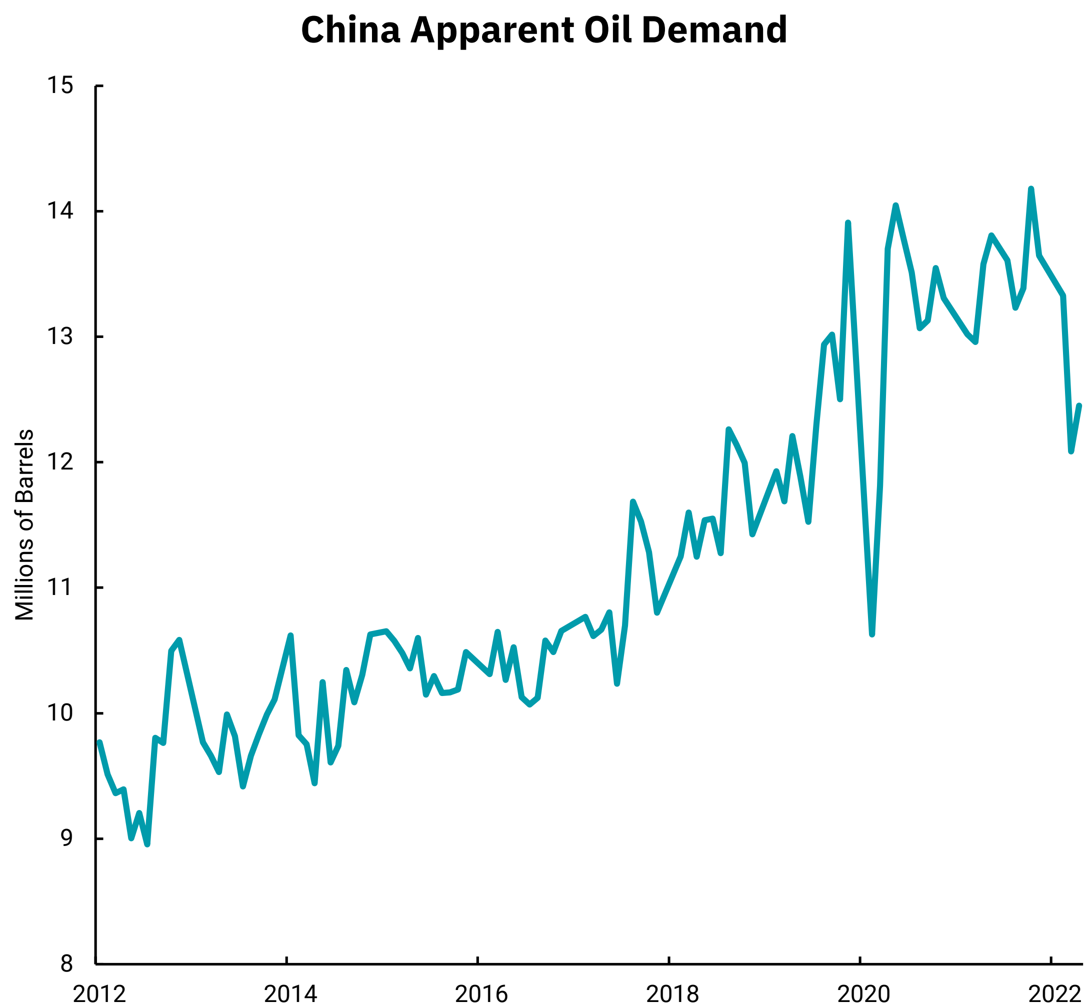
- China business activity remains volatile, and interruptions to production remain an issue for the global supply chain.



Source: *Our World in Data. Data shown as of July 4, 2022*

China may drive commodities higher

- The impact of China's COVID lockdowns can be seen in the decline in Chinese oil demand.
- Despite the decline in demand, oil prices have moved to well above $110 per barrel globally.
- Unfortunately, the next million barrel change in oil demand from China is likely higher – putting additional pressure on global oil markets.



Source: Bloomberg. Data shown as of May 31, 2022

Policy response

1 Focus of the Federal Reserve

2 Fiscal policy no longer a tailwind

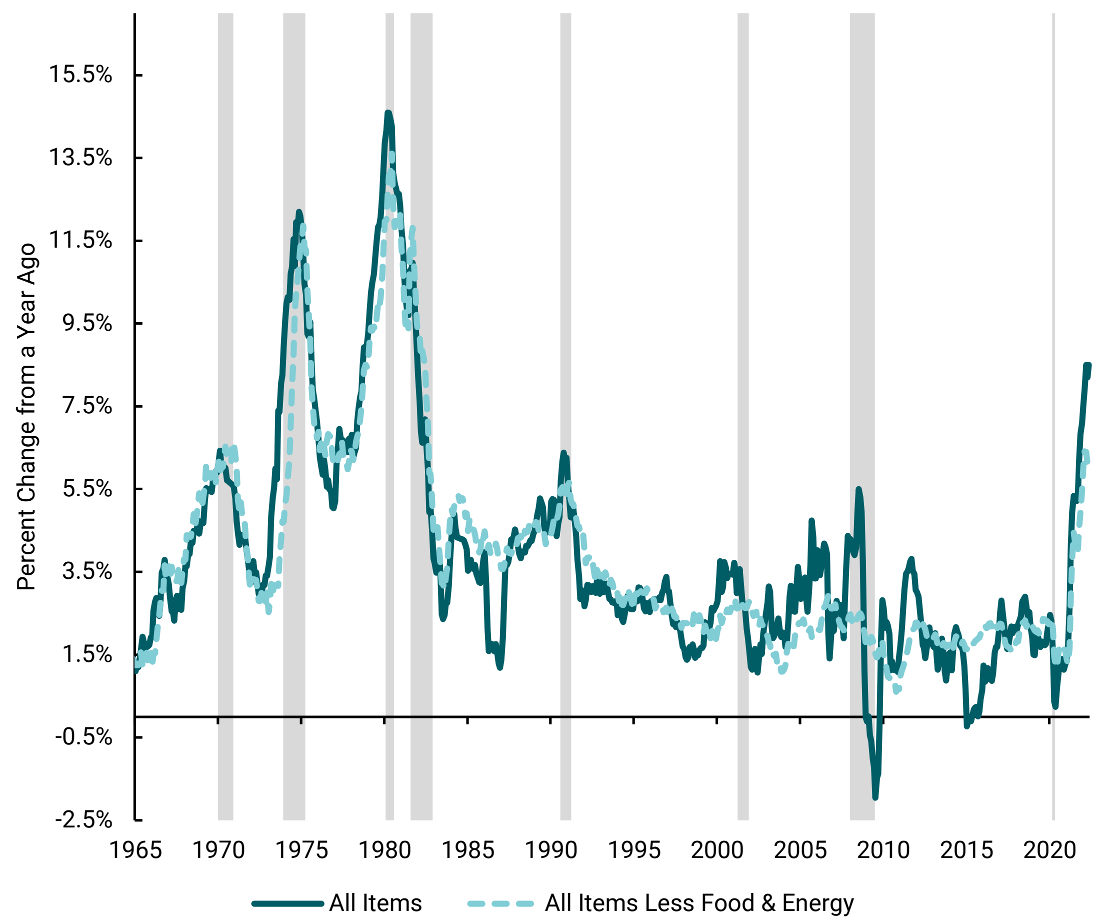
3 Inflation in goods rolling over

4 The political calendar matters

It's all about the 'flation....

- Inflation is at a 40-year high as supply constraints collide with stimulus-driven demand.
- A wage-price spiral remains a material threat to economic and price stability.
- The Federal Reserve has indicated they are willing to slow growth to recessionary levels to arrest continued intolerable inflation.
- There are multiple measures of inflation, but every measure is above the Fed's target of 2%.

U.S. CPI Y/Y %

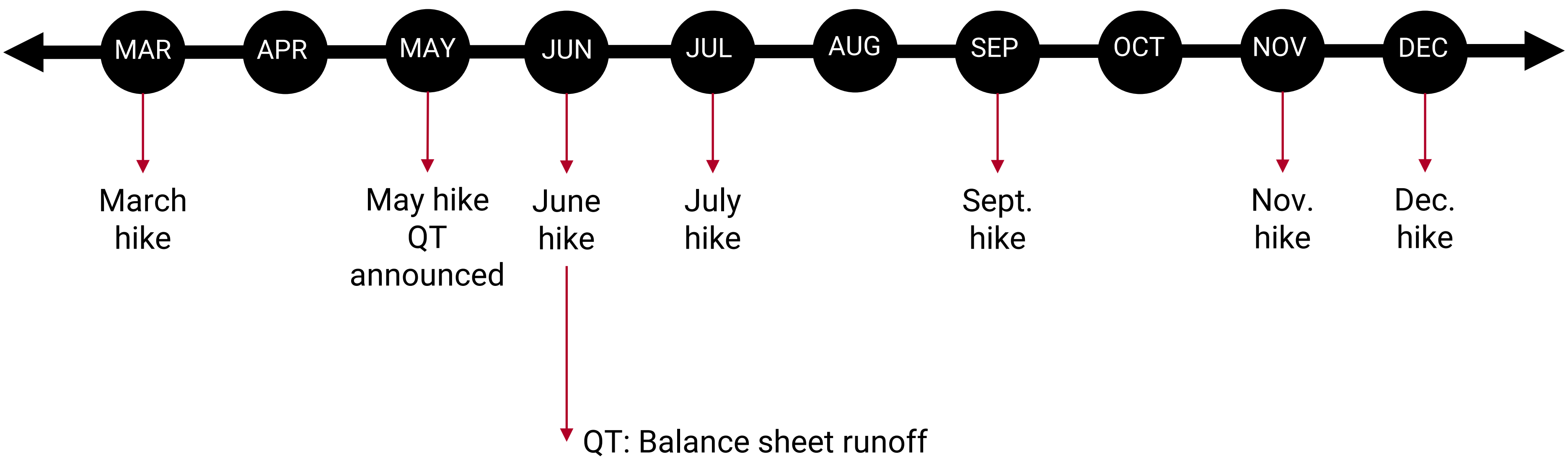


Source: Core Price Index, Federal Reserve Bank of St. Louis. Data as of May 31, 2022

The Fed Timeline for 2022

- The Fed hiked rates by 0.25% in March, another 0.50% in May, and 0.75% in June, 75 in July and 75 in September. Another 100 basis points in November and December are expected.
- Current year-end rate expectations are 4.0-4.5%.

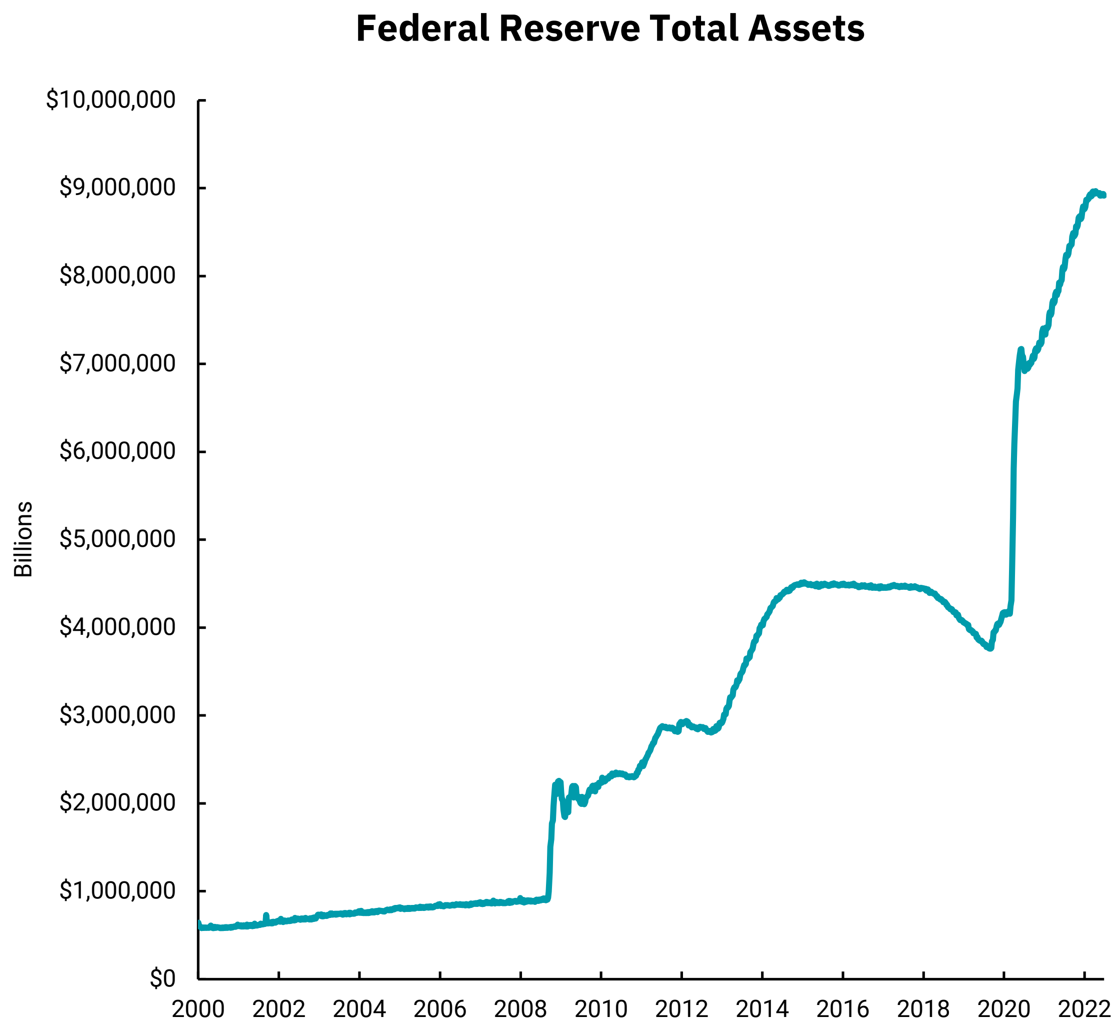
2022 FOMC Meeting Schedule



Source: Bloomberg.

The Fed balance sheet has peaked

- After years of balance sheet expansion dating back to the fiscal crisis in 2008, the Fed is shrinking its balance sheet.
- Initially, the balance sheet will decline naturally as bonds mature and are not replaced.
- If inflation remains hot, the Fed may choose to accelerate its balance sheet reduction via bond sales.

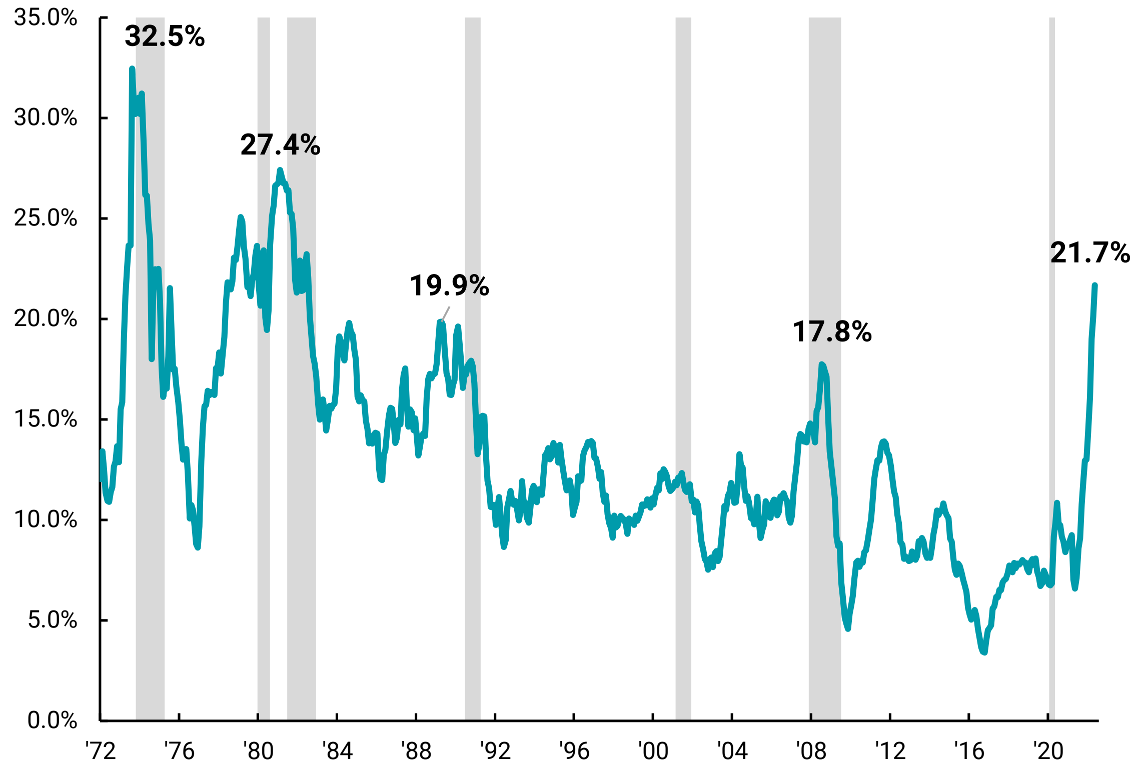


Source: Bloomberg. Data shown as of June 30, 2022.

Consumer stress is rising

- Lower income consumers spend a materially higher percentage of incomes on food and energy.
- Higher costs for food and energy remain a significant concern for the Fed.
- Higher food and energy costs globally may lead to political uncertainty and unrest this year.

Consumer Stress Indicator
(Food at Home + Mortgage Rates + Gasoline Prices)



Source: Strategas. Data shown as of May 31, 2022.

A wage-price spiral is a significant risk

- For decades, owners have had the upper hand compared with labor as labor's share of income has consistently declined.

- With COVID slamming on the economic brakes and then an above-trend economic recovery, labor has become a scarce resource.

- Labor demands for higher wages to meet increasing goods costs creates the potential wage-price spiral.

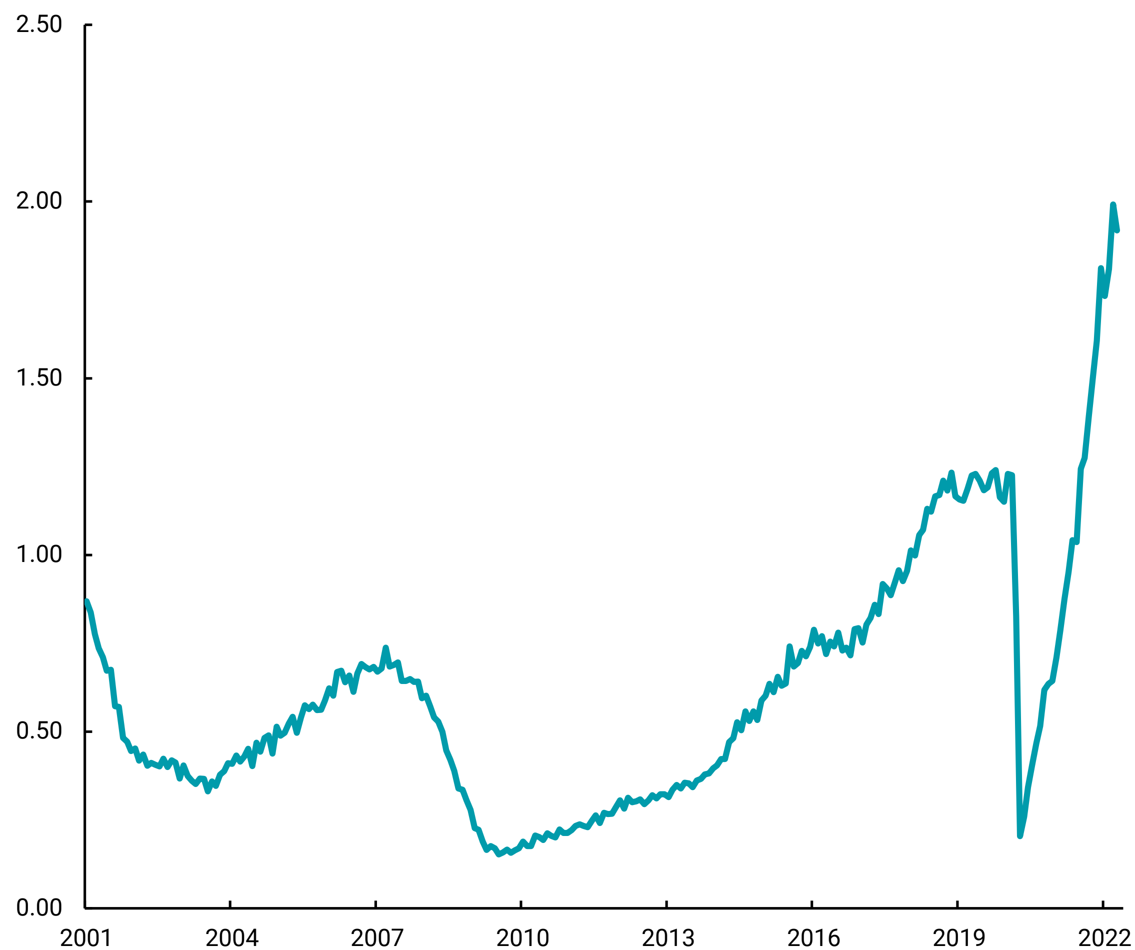
Employment Cost Index: Wages & Salaries
Private Industry Workers

Source: Federal Reserve Bank of St. Louis. Data shown as of March 31, 2022.

Tight labor market

- Jobless claims have hit all-time lows as COVID has moved to the back burner.
- For every unemployed person, there are nearly two job openings.
- Many businesses report their biggest challenge is finding qualified labor.
- This imbalance favors labor and higher wages, which could cause systemic inflation.
- The Federal Reserve is targeting a decline in job openings as an outcome from higher rates and QE.

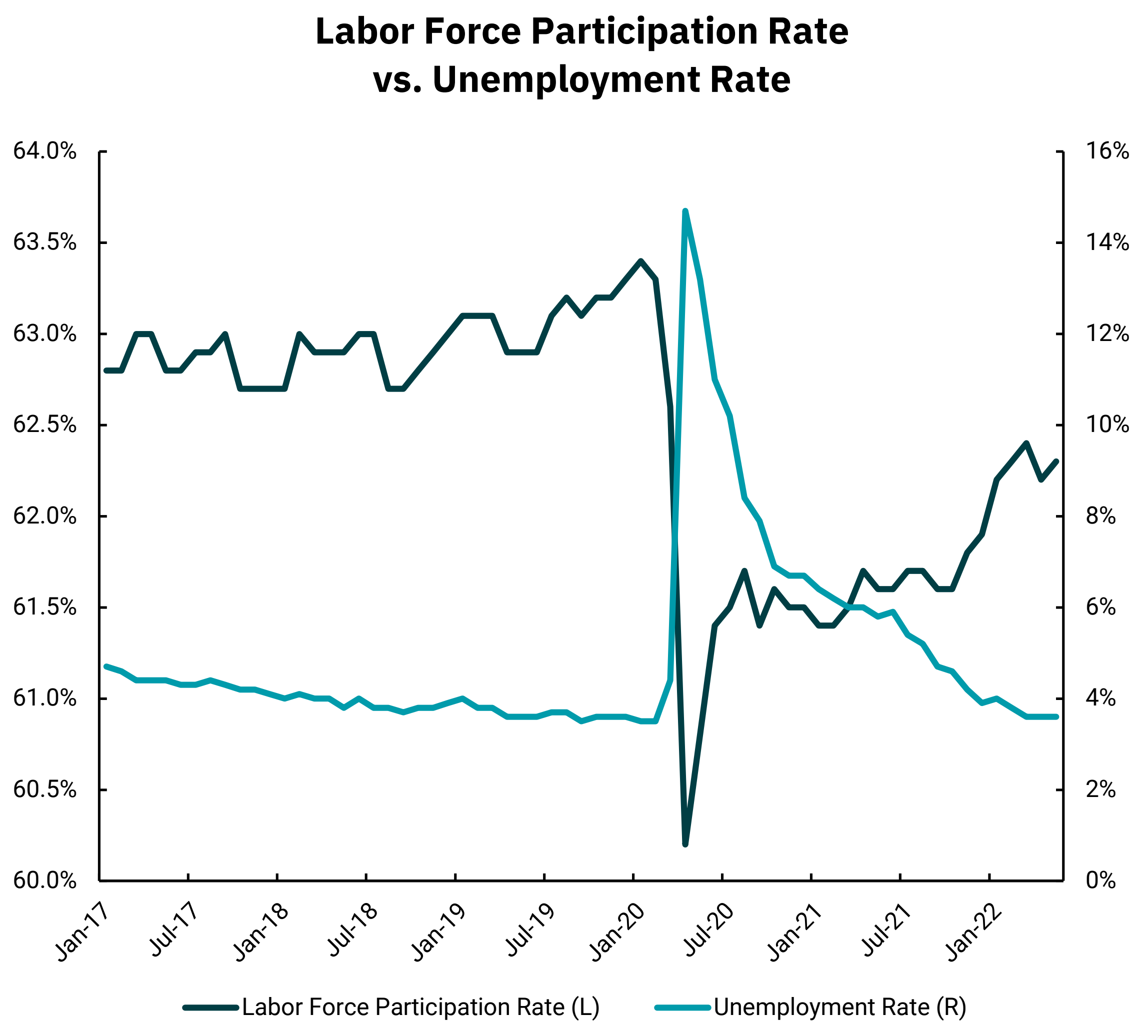
JOLTS Job Openings to U.S. Unemployed Ratio



Source: Federal Reserve Bank of St. Louis. Data shown as May 31, 2022. Job Openings: Total Nonfarm, Level in Thousands / Unemployment Level, Thousands

Labor force participation rate

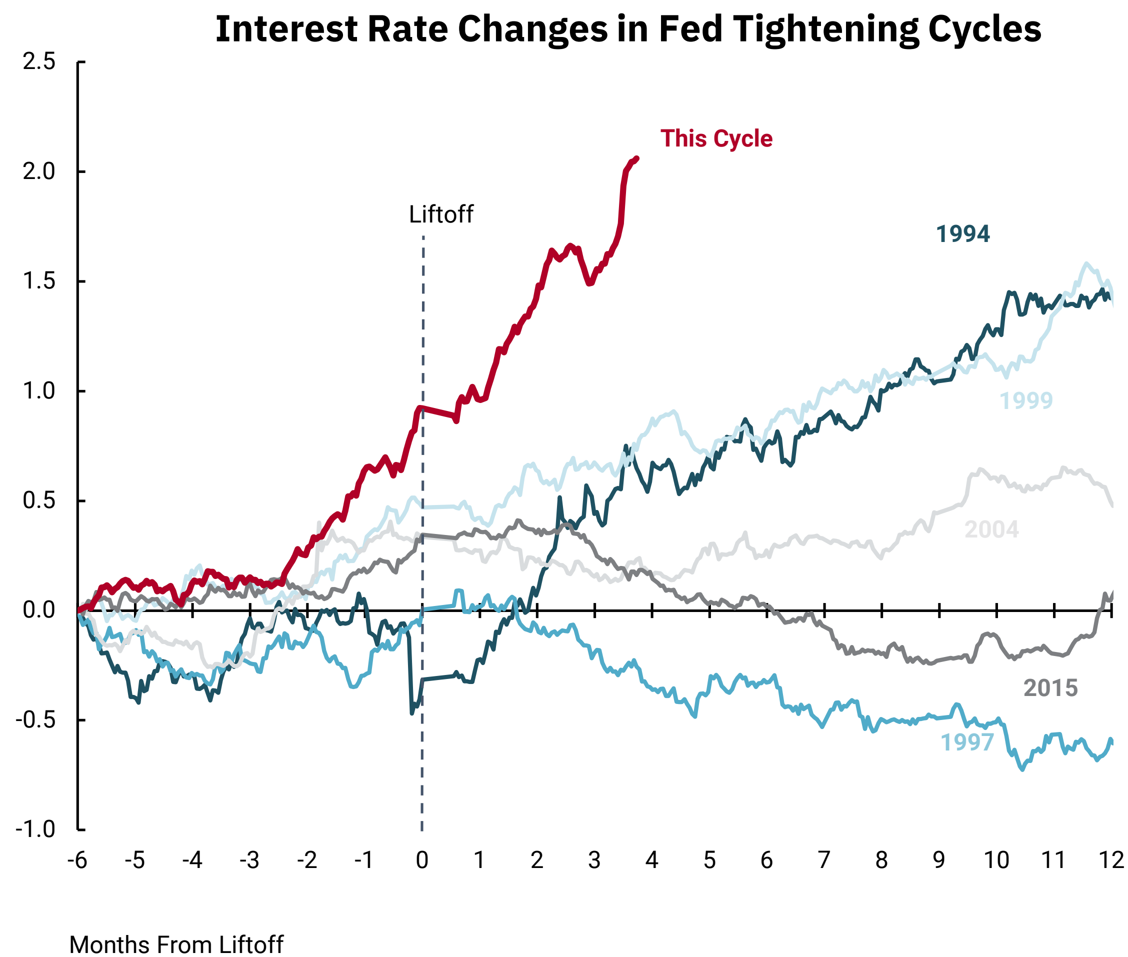
- Labor participation remains below pre-pandemic levels and represents nearly 2 million individuals leaving the labor force.
- Perhaps many of these individuals have not permanently left the labor force, resulting in a shadow pool of labor that will gradually return to the economy.
- Given the number of unfilled jobs, increasing the labor force participation rate would be a welcomed relief to employers.



Source: Barclays, Federal Reserve Bank of St. Louis. Data shown as of May 31, 2022

Rates rising may stifle demand

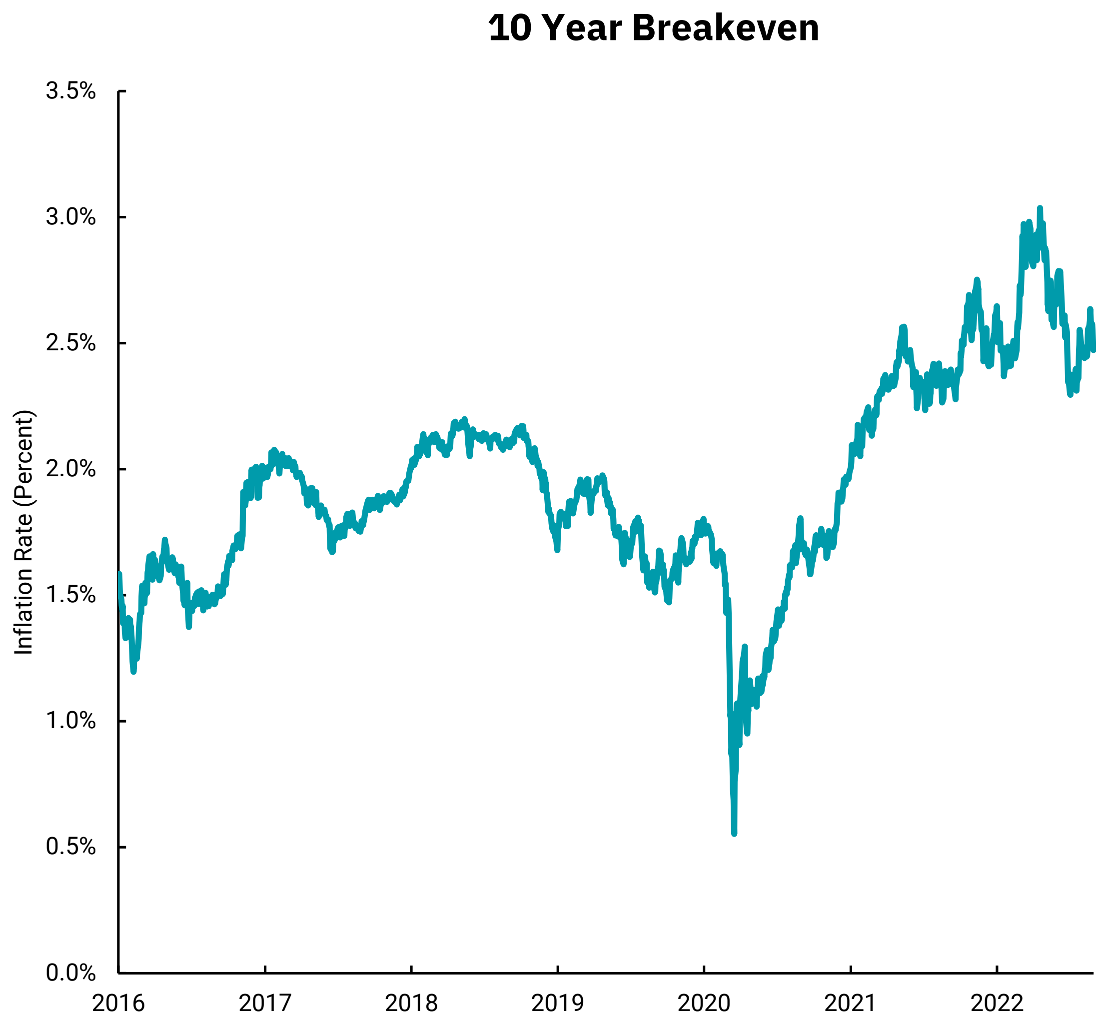
- Financial conditions are tightening faster than they have in 40 years.
- The Fed has now raised rates 1.50% through June, yet market interest rates have risen more as the Fed has communicated its focus on inflation.
- Higher credit spreads are also playing a part in tightening financial conditions.



Source: Piper Sandler.

Inflation expectations are declining

- As the Fed begins its tightening cycle, inflation expectations have stalled and turned lower.
- We are monitoring data such as this to determine how effective the Fed policy is in lowering expectations.



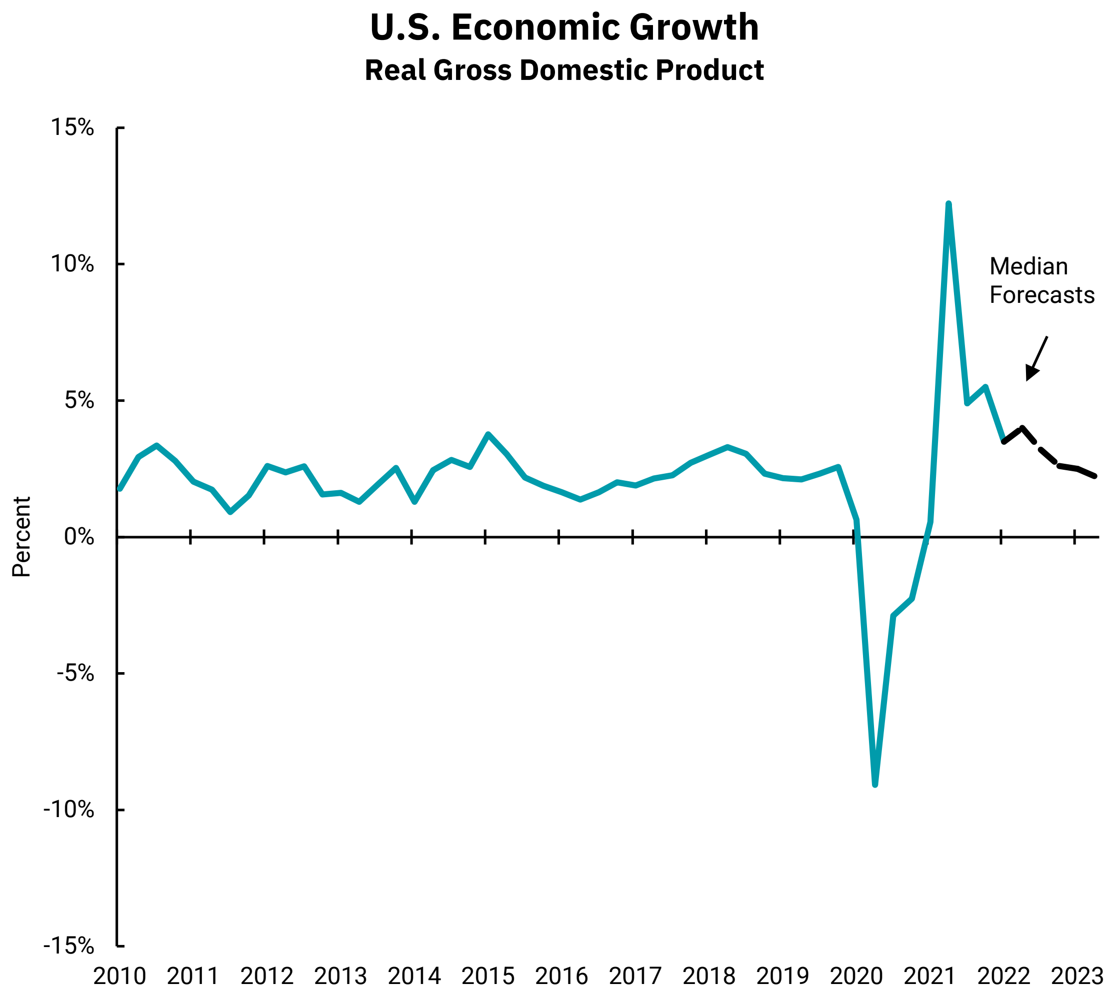
Source: Bloomberg. Data shown as of August 31, 2022.

Cool the economic boom to stop inflation

- Real GDP growth in 2021 was reported up 5.7%. Growth in 2022 is expected to slow below potential.

- U.S. 2022 GDP growth drivers:
    - Labor market is strong.
    - Broadly, household balance sheets are in great shape.
    - Pent up demand for services.

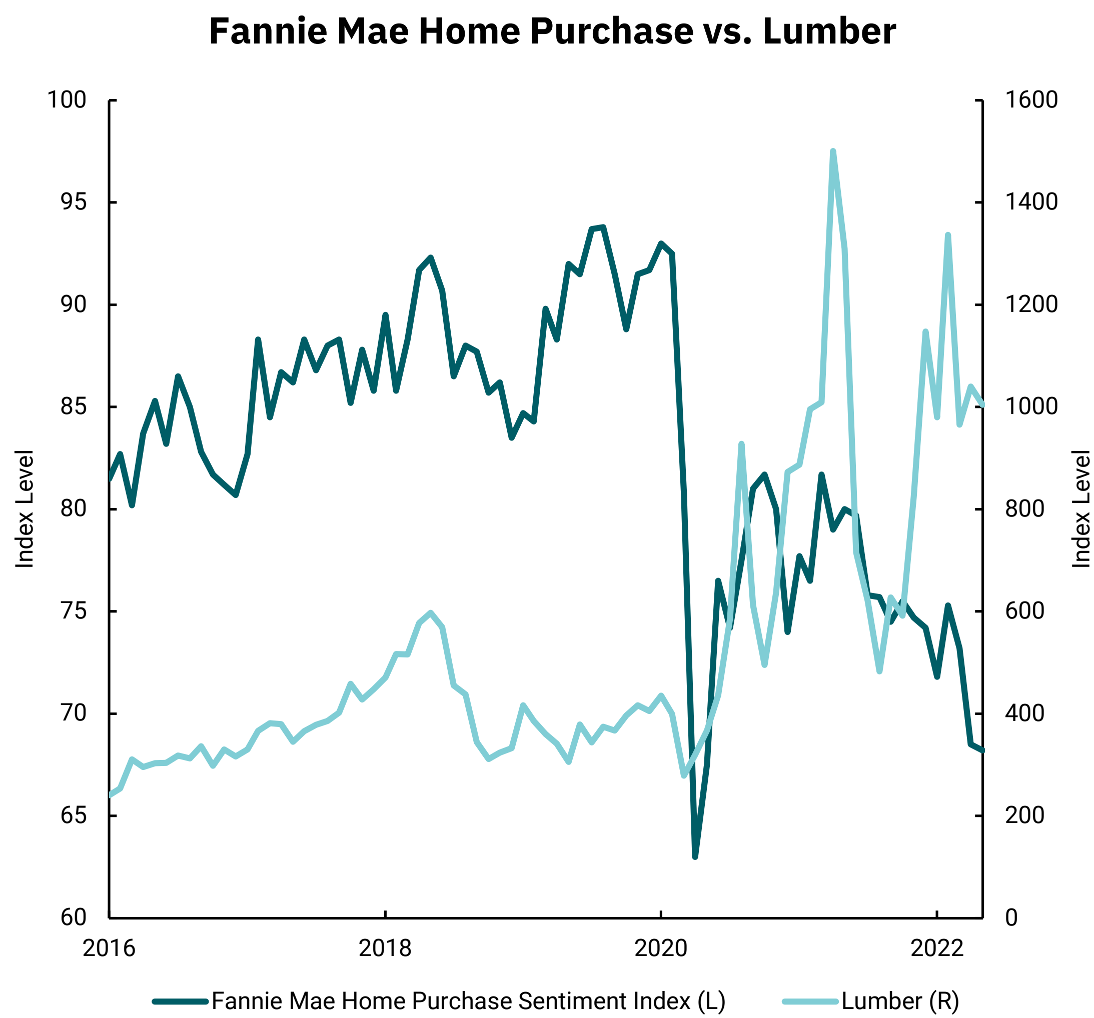
- A service recovery in 2022 is likely a blessing and a curse, as demand recovers but supply remains labor-constrained.



Source: Bloomberg, Credit Suisse. Data shown as of March 31, 2022.

Housing likely to slow

- Fewer potential homebuyers see now as a good time to purchase a home.
- Housing activity is sensitive to interest rates, and we are seeing the market slow.
- Lumber prices are also falling, potentially indicating a slowing in demand for housing.

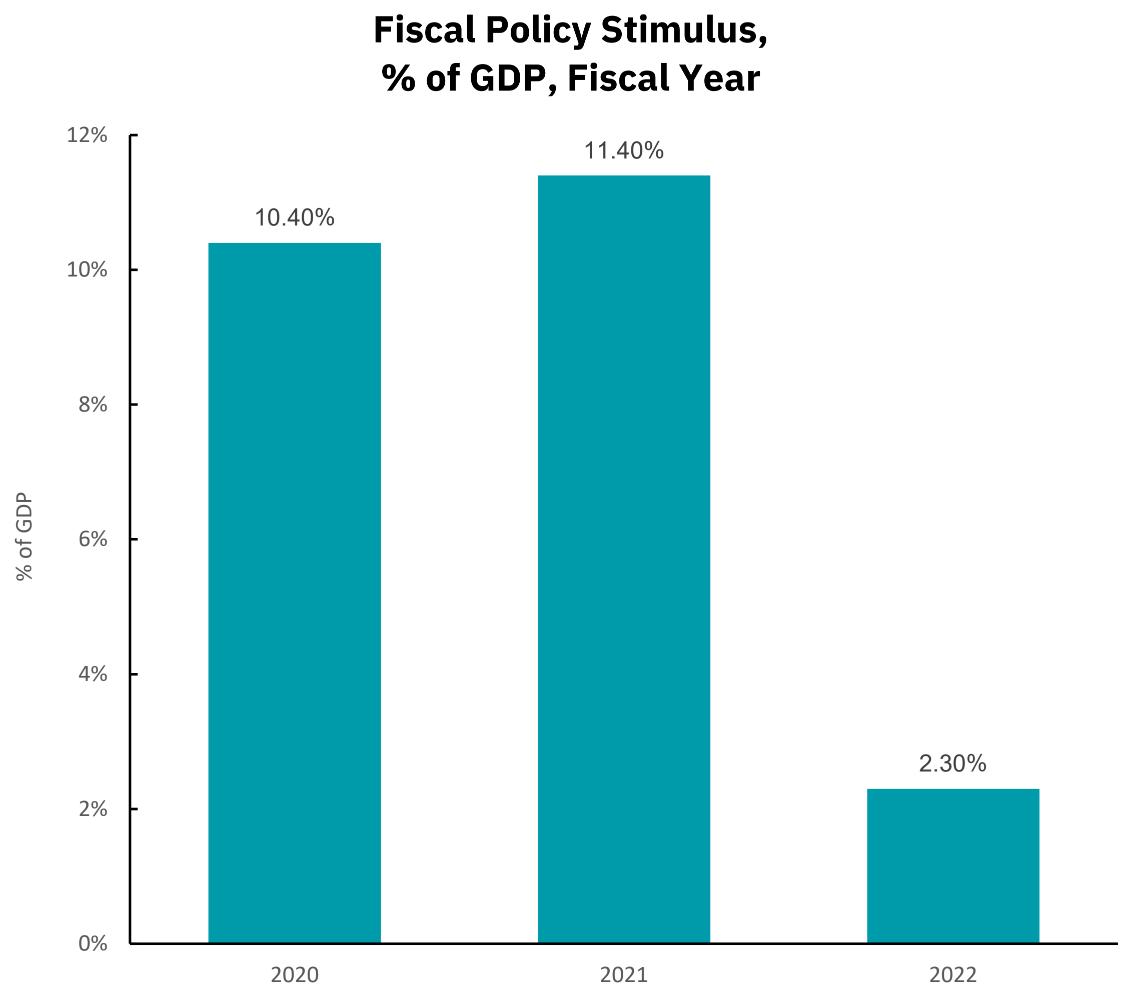


Source: Bloomberg. Data shown as of May 31, 2022

Fiscal support also disappears in 2022

- The fiscal support of the U.S. economy was extraordinary during the pandemic, with incremental spending approaching $6 trillion:
  - 2020
    - $2.4T CARES Act
    - $480B PPP & Healthcare
    - $900B COVID Relief
    - $198B Stimulus bill
  - 2021
    - $1.9T American Rescue

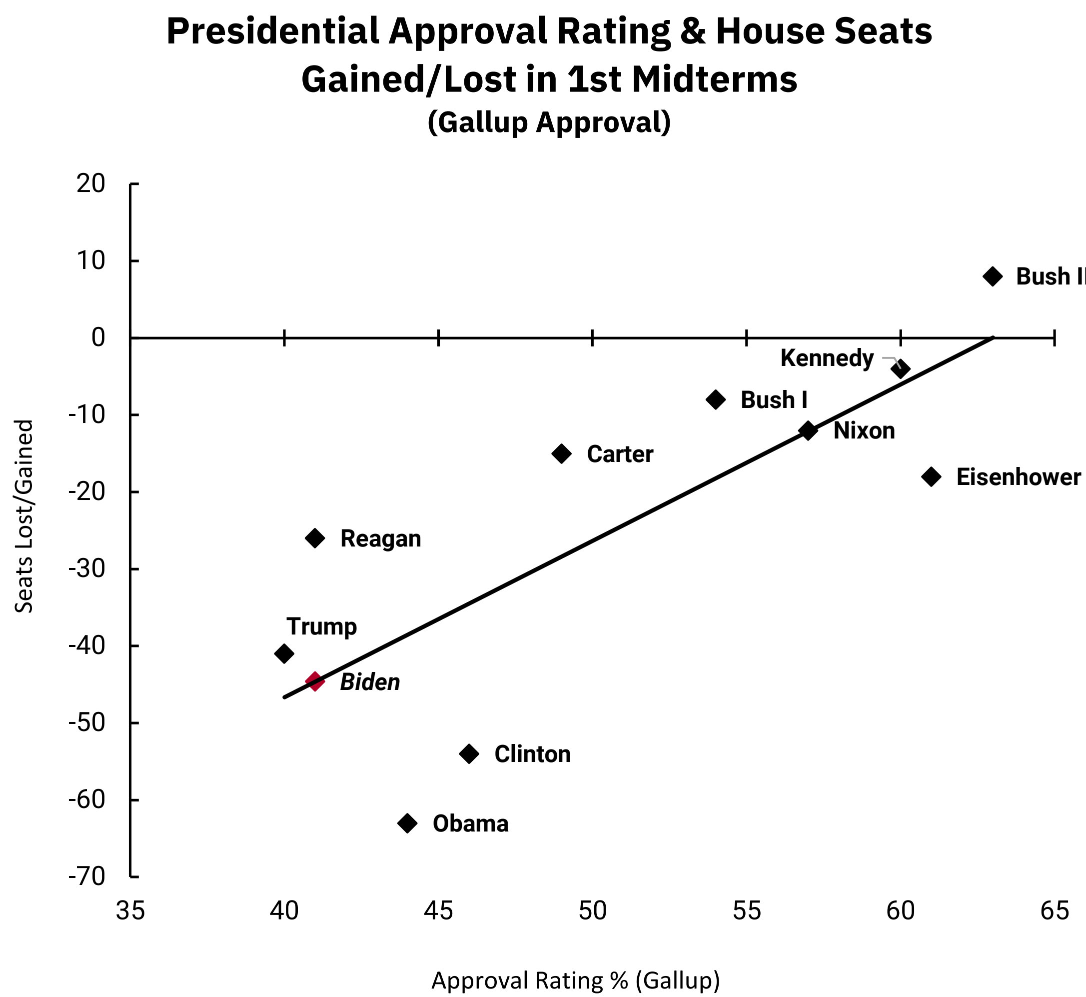
- In 2022, there will be a significant fiscal drag on GDP growth as the appetite and need for further government intervention in the economy is close to nil.



Source: Strategas.

2022 midterm elections add to uncertainty

- Historically, mid-term elections during a president's first term do not favor the party in power.
- Inflation, the war in Ukraine, and a stalled policy agenda have driven Biden's approval rating to around 40%.
- The president's approval rating correlates with House seat changes. Biden's current approval rating projects to more than 40 seats lost.
- There's a lot that can happen between now and November, but the political environment also adds to uncertainty.



Source: Strategas. Data shown as of June 30, 2022

Market pulse

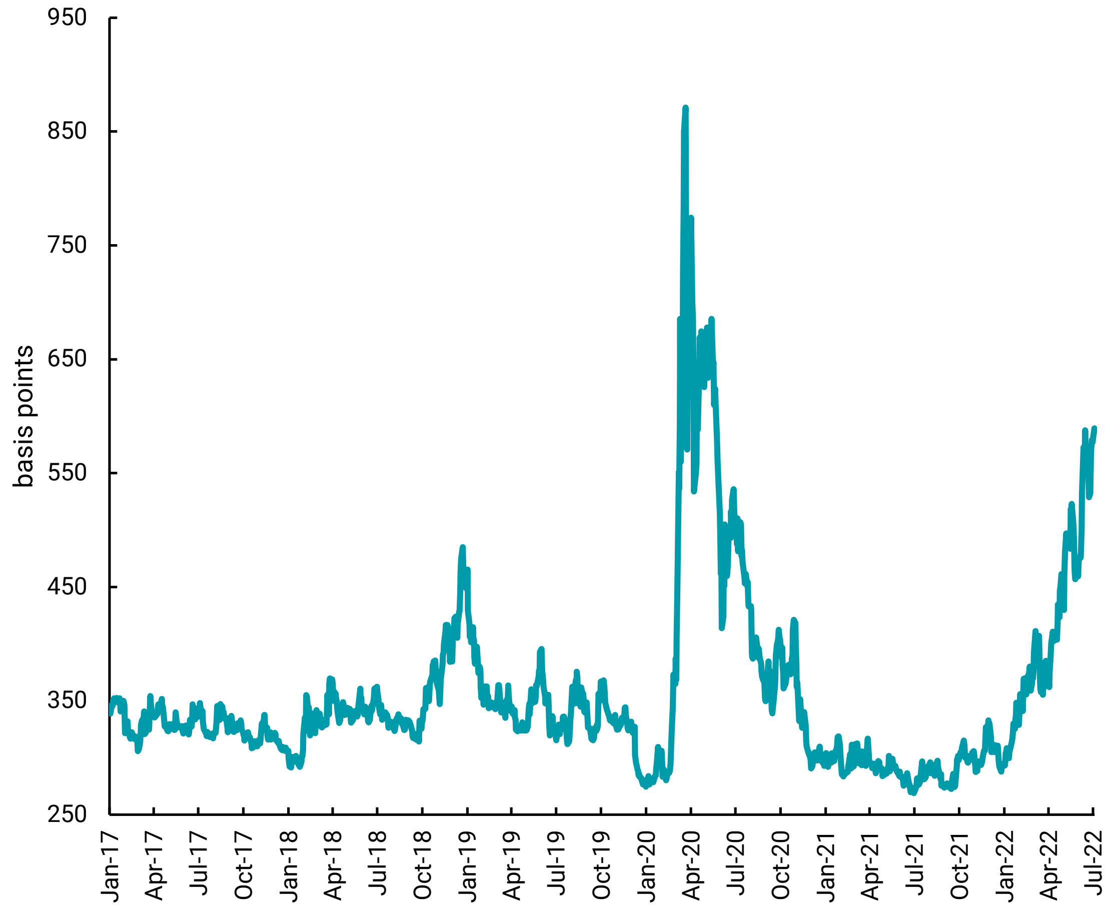
1 Fixed income spreads are widening

2 U.S. selloff and valuation

Credit spreads have widened

- Rising credit spreads have been a good historical indicator of concerns about future growth prospects.
- High yield credit spreads have moved to levels of historical concern.
- Higher spreads may result in fewer new borrowings, thus slowing economic growth.
- If a recession is avoided, there may be opportunities developing in pockets of the bond market.

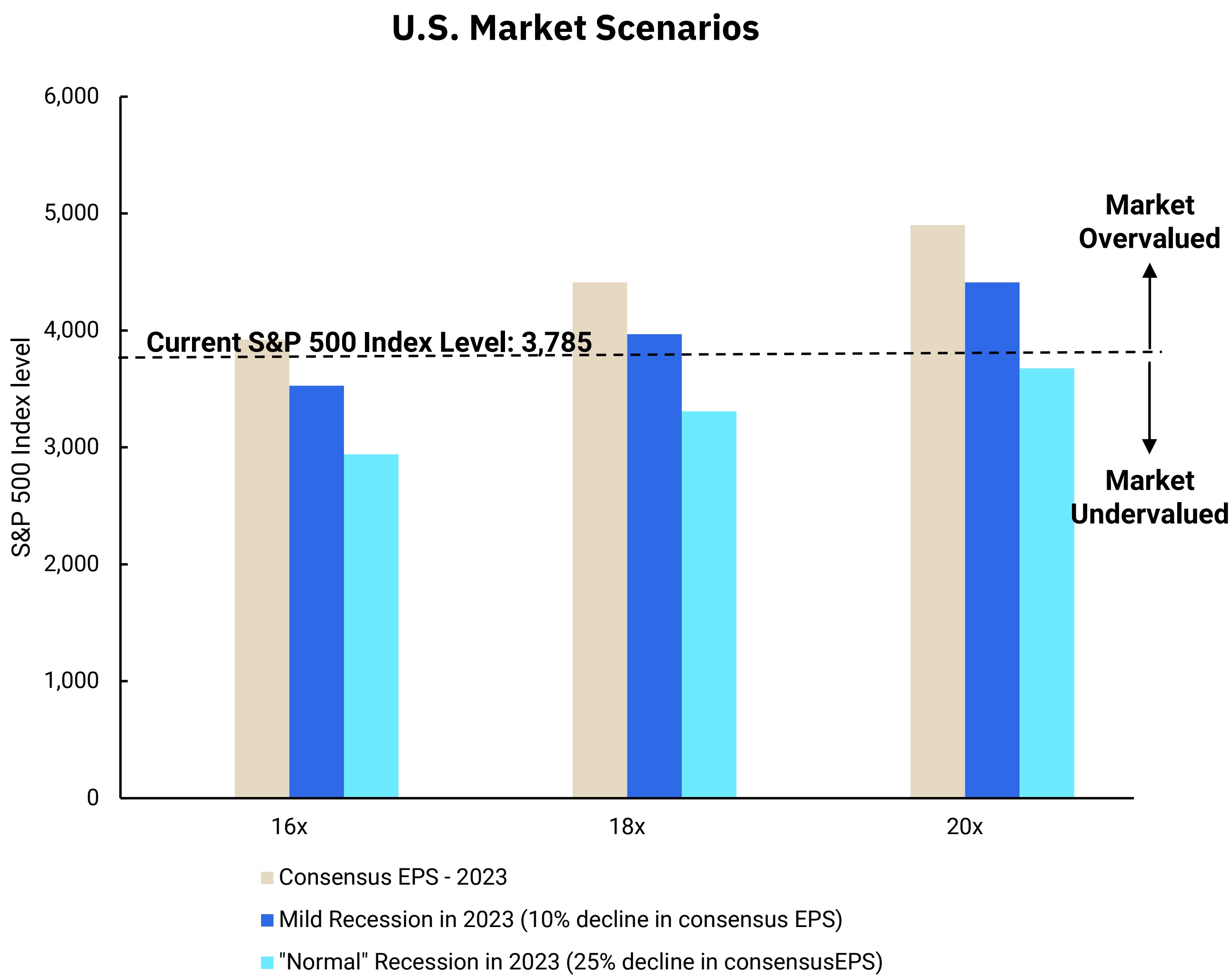
High Yield Spreads
5 Yr. CDX



Source: Bloomberg. Data shown as of June 30, 2022

U.S. market scenarios

- It appears the market is pricing in flat earnings in 2023 vs. 2022. However, we think earnings estimates will trend lower.
- A mild recession in 2023 is possible, and valuations are starting to reflect that possibility.
- A normal recession, where earnings drop 25%, would result in further losses in equity markets.
- A recession is not our base case.
- Upside is possible if inflation comes down more quickly than the market expects.



Source: Cavanal Hill. Data shown as of June 30, 2022.
Values assume consensus earnings per share (EPS) of $245 for 2023, $221 assuming mild recession in 2023, and $184 assuming "normal" recession in 2023.

Market pulse summary

1. Inflation remains stickier than previously thought with rents and wages still in uptrends

2. The Federal Reserve keeps interest rates higher for longer and will require significant data showing inflation is back to or near their 2% target

3. The economy weakens from here. A recession is not a foregone conclusion, but the ability of the Fed to reduce pressures in the labor market using interest rates and quantitative tightening without at least a shallow recession seem slim

4. Absent a need for the Fed to raise rates more than expected, the worst of the sell off in the bond market may be over

5. Equity prices may remain volatile as we now look for corporate earnings to decline into the end of 2022 and into 2023. The materiality of the decline will impact the downside risk to stocks

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11 years average tenure at BOKF

20 Chartered Financial Analysts®

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*The Investment Management team is part of the BOK Financial wealth management division, which had $105 billion in assets under management and custody as of 12/31/2021.

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