Summary

Economic data for the week included a robust employment situation report, as well as other labor metrics, and improved manufacturing and construction activity.

Global financial market sentiment continued to be driven by the Russia-Ukraine conflict, with U.S. and especially foreign stocks losing ground and staying in correction territory. Bonds were mixed, with higher-quality safe haven debt faring positively. Commodities experienced sharp gains, led by crude oil and grains—exports most affected by Russian and Ukrainian supplies.

Economic Notes

(+) The **ISM manufacturing index** for February rose by 1.0 point to 58.6, exceeding expectations calling for 58.0. While all but two of the 18 industries showed growth, the underlying broad components were mixed. Production and new orders rose—the latter above the strong 60 mark—but employment fell back over a point, but remained in expansion, as it remains difficult to find sufficient workers to fill all open positions. Supplier deliveries and inventories gained, while prices paid ticked down a half-point, but remained at a high level. Delivery metrics have fallen from peak levels a year ago, indicating that some of the inflation-perpetuating logistics issues seem to be easing (albeit very slowly).

(-/0) The **ISM services/non-manufacturing index** for February fell back by -3.4 points to 56.5, short of the median forecast calling for an increase to 61.1. Specifically, the underlying composition showed drops in business activity and new orders. Order backlogs rose sharply, deeper into expansionary territory in the mid-60's, while supplier deliveries also ticked higher, as did prices paid. Employment also fell by nearly -4 points back into contraction, due to a lack of available workers here as well.

There is a bit of irony in some of these recent economic releases. In most economic growth cycles, and reflected in the way the measures are constructed, data like order backlogs and longer supplier delivery times reflect high consumer and business demand—which is considered a positive from an economic standpoint. Recessions, on the other hand, are characteristic of demand falling off, featuring a lack of backlogs as new orders decline. In this case, strong demand growth is coupled with the inability to fulfill this demand, due to the ongoing supply constraints, which in and of themselves have restrained the economic recovery to at least some degree, if not by a lot. Recent sanctions on Russia may trickle into global growth, not because of the nation's large GDP influence, but as energy prices rise in Europe and elsewhere, it may steal away spending power on other goods. Much remains to be seen on that front.

(+) **Construction spending** in January gained 1.3%, far surpassing the median forecast of 0.1%, and included slight revisions higher for the prior two months. Private residential and non-residential spending rose in the 1.5-2.0% range, while public residential gained 3.6%, offset by public non-residential, only up 0.5%.

(+/0) **Initial jobless claims** for the Feb. 26 ending week fell back by -18k to 215k, below the 225k consensus estimate. **Continuing claims** for the Feb. 19 week, on the other hand, ticked up by 2k to 1.476 mil, above the 1.420 mil. level expected. Initial claims fell most notably in MI, NY, and TX, in keeping with continued reopening of manufacturing and service activity around the country.

(+) The **ADP private sector employment** report for February rose by 475k, beating expectations for 375k. Additionally, the January report saw a substantial and unusual revision upward from an initial decline of -301k to a positive 509k. (Revisions this large are rare; in this case, it seemed to be due to some internal sector recalibrations.) Service sector jobs rose 417k, with 40% of new employment being in leisure/hospitality. Jobs in goods-producing sectors rose by 57k. Interestingly, almost all job growth was in large firms (1000+employees), while smaller firms fell backward a bit. The ADP measure continues to show strong job growth across the

board, especially in areas most heavily influenced by pandemic shutdowns (the leisure group), with total payrolls now back above their Dec. 2019 pre-pandemic levels.

(+) The employment situation report for February was far better than expected, with a variety of metrics showing continued improvement in the labor picture. Concerns over the Covid omicron variant from January also appeared to reverse as the month went on.

Nonfarm payrolls rose by 678k, exceeding the 423k expected, and about 200k higher than January. In addition, Dec. and Jan. payrolls had been revised up by a total of 92k. Gains in Feb. were widespread, led by a 179k gain in leisure/hospitality (one of the most Covid-sensitive segments, with the majority of job gains being in restaurants/bars), professional/business services (95k), health care (64k), construction (60k), transportation/warehousing (48k), as well as gains in retail and manufacturing. However, per the BLS, overall employment remains down -2.1 mil. from pre-pandemic Feb. 2020 trough levels.

The **unemployment rate** ticked down by -0.2% to 3.8%, which was a tenth better than expected, and caused by a small upward improvement in the labor force participation rate. However, the U-6 underemployment rate ticked higher by a tenth to 7.2%, due to more 'part-time workers for economic reasons'. The household survey component showed a gain of 548k, strength consistent with the nonfarm payroll survey. Importantly, the number of workers on temporary layoff and permanent job losers have stabilized at lower levels, but are still above the Feb. 2020 low-water mark.

Average hourly earnings were flat, well below the expected 0.5% increase, and a deceleration from the 0.6% rise in January. Year-over-year, earnings came in at 5.1%, well below the 5.8% expected. The **average workweek** length ticked up by 0.1 to 34.7, a positive, with overtime hours up.

Earlier in the week, **nonfarm productivity** for Q4 was unchanged from the initial estimate at an annualized rate of 6.6%. **Unit labor costs** were revised over a half-percent higher to an annualized rate of 0.9% for Q4, exceeding expectations calling for little change. This elevated the year-over-year rate by 0.4% to 3.5%, in keeping with general gains in wage inflation for the year.

Question of the Week

What is the primary global economic fallout from the war in Ukraine?

Aside from the substantial and devastating human suffering, there are several other ways the impact has been or could be further felt abroad.

- 'Indirect warfare'. This encompasses supply of arms, necessities, and intelligence to Ukraine from the West and other regions. While it's been made clear that U.S. forces will not be directly involved on the field, all bets are off if nearby NATO borders are threatened (including Poland, Romania, and the Baltic states). Other tactics involve cyberwarfare, which could be hampered on the Russian side if hardware/software technology embargoes are kept in place, or even internet access blocked altogether.
    - Chinese participation remains a wildcard. While there had been a loose but strengthening alliance with Russia (to offset Western economic power), it is unclear the Chinese will violate sanctions policies, which could threaten their own trade interests with the rest of the globe. China has also been philosophically opposed to violations of national sovereignty by meddling neighbors, which has led to surprisingly strong condemnations of Russian military actions.
    - There has been increasing concern that Russian actions toward Ukraine may have emboldened a potential similar action by China towards Taiwan. This has more significant economic implications, due to Taiwan's role in global semiconductor manufacturing. A variety of national security experts don't appear to view this as an immediate threat.

- Inflation effects. These are due directly to higher commodity prices. A significant majority of Russia's GDP is tied to natural resources extraction (perhaps two-thirds). Due to sanctions, the products taken offline immediately decrease supply and raise costs at a time when Covid is waning—and more 'normal' demand is rising. This is a 'perfect storm' to some extent.
  - Crude oil. As a member of OPEC+, Russia has long been a key energy producer. Per the U.S. Energy Information Administration, it's the second-largest, behind the U.S., and roughly tied with Saudi Arabia—at just under 10 mil. barrels/day—much of which is exported to Europe and Asia. Per the Capital Group, this represented 12% of global energy production in 2020 (however, less than 5% of U.S. oil imports). More directly, diverting purchases away from Russia benefits other producers in the Middle East. However, it creates a more difficult situation for net energy importers, such as Japan and India, where rising prices can put the brakes on growth. Interestingly, there has been evidence of increasing 'self-sanctioning' by major oil companies, which have been moving away or shutting down Russian operations and partnerships outright. In fact, at recent oil auctions, Russian barrels have been the outcast, with price discounts of up to $20/barrel vs. oil from other regions, as buyers are not buying. Pressure has been mounting on the U.S. political side to ban Russian oil completely, which is a significant step. This may not last indefinitely, but has shown the strong resistance of the international community toward sectors at the heart of Russian revenue generation, and hence, funding the Ukrainian war effort. It also raises pressure to agree to a renewed Iran nuclear deal, in order to get their oil production back online.
  - Natural gas. This is a tricky commodity and volatile in price—dependent on local inventory and near-term weather conditions. Unlike crude oil, it is difficult to store and transport, making pipelines the most effect method for getting it from point A to point B. (Condensing and liquefying natural gas into 'LNG' is increasingly possible, but less efficient or cost-effective to ship over long distances.) This dynamic has resulted in Russia providing Europe with almost half of its natural gas needs (an estimated 40%, per Reuters) and 17% of global supply (Capital Group, as of 2020). Several countries, such as Italy, are dependent to an even larger degree. This is the primary reason why energy has been exempted from export and SWIFT bank payment sanctions so far, although the threat of deeper cutoffs remain if situations worsen. There is both pressure from the West to move away from Russian gas, and pressure on Russia to keep the spigots open, due to this being a key source (among few) of ongoing revenue to keep the government afloat.
  - Agriculture. Ukraine and parts of Russia have been known as the 'breadbasket' of Europe, due to a climate well-suited to grains, particularly wheat and corn. The two provide 30% of global wheat exports (per the University of Illinois Agriculture, Consumer and Environmental Sciences Dept.), as well a substantial contribution in products such as sunflower oil. Along with an already-challenged growing season due to poor weather in some regions, the new war and reduced ability to harvest crops has already driven prices sharply higher. The U.S., Canada, and other European producers will be forced to take up the slack. On a broader note, as we saw with the Arab Spring a decade ago, higher food prices represent one of the most potentially dangerous situations a closed political system can encounter—as it has been the catalyst for many populist uprisings over the centuries.
  - Metals/other. Russia remains a key exporter of palladium and aluminum, in demand as the global economy continues to reopen from Covid. Ukraine is a key producer of neon, which is technically a gas, still used in signage to a smaller degree, but more critical in the manufacturing process of semiconductors (which is already challenged).
- Economic growth.
  - Higher inflation and war each have the historical tendency for depressing growth, depending on the magnitude and supply chains affected. (We've heard the Covid pandemic described as 'war-like', which wouldn't be a bad analogy from a historical standpoint.) Inflation at times has been a byproduct of faster growth, but in this case exacerbated by supply/logistics disruptions and an engorged monetary base from fiscal stimulus. The Ukraine war remains regional, without broader spread, and the smaller size of the two nations from a global GDP standpoint has kept further impact contained. But, as noted,

each country's impact is in the commodities sector, with the availability and price of petroleum, grains, and metals important inputs into the prices of goods manufactured elsewhere. Ongoing high prices either pressure costs on manufacturers, causing margins to shrink, or is passed through, to consumers, which lowers spending power. Rising political pressure over the weekend to sanction Russian oil pressures inflation even higher, with a scramble for other producing nations. Broader wars can divert spending away from consumer goods towards war armaments, which can have a mixed effect on growth for a period.

  - Foreign sanctions have been meant both as a deterrent, but more as a punishment, as they've been described by foreign policy experts. Energy has been largely exempted from sanctions thus far, due to Europe's reliance, but this is subject to change if public sentiment around the Ukraine war worsens (which it has). Consumers ultimately bear the brunt of higher energy prices, and this has been described as a potential Jimmy Carter-esque 'turn down the thermostat and put on a sweater' moment, at least in Europe. For Russia, ongoing sanctions that are not lifted run the risk of turning it into a 'pariah' state, along the lines of North Korea, Venezuela, and Iran.
  - Energy wildcard and recession risk. There have been some parallels between today and the situation in the early 1970's, which included the Yom Kippur war in the Middle East, and related oil embargo. Crude oil has the unique ability, if high prices are persistent, to be a catalyst for recession by itself. On the positive side, the global economy is less petroleum-dependent than it was in the 1970's, although green technology has not completely replaced it, either. (Political disagreement about U.S. oil and gas production during the transition period reflects this difficult challenge.) The price of oil has been historically volatile, and quick to react to changing supply and demand conditions. In the last 15 years, starting just prior to the financial crisis, saw West Texas crude in a range from 'below zero' in early 2020 (when they were giving away barrels due to storage issues) up to $150.
  - Cooperation, especially with and within Europe. One of the few positives in this situation has been the strong and decisive action between the U.S. and European nations. Following recent years where globalization may have peaked, stronger trade ties have generally been beneficial for growth.
- Monetary policy.
  - This represents one of the more difficult environments in years. The U.S. Fed to the largest degree, but also the ECB, face high inflation readings, which point to the need for higher interest rates. At the same time, strong economic growth is tempering, which could be hampered further by high inflation as spending activity decelerates. Rate hike expectations haven't been derailed, but earlier estimates of a potential 0.50% March hike and up to eight hikes in 2022 now seem overdone; a moderated pace of up to perhaps six quarter-point hikes seems much more likely at this point. However, conditions are subject to change as inflation pressures remain persistent and growth projections remain fluid.

Market Notes

Period ending 3/4/2022	1 Week (%)	YTD (%)
DJIA	-1.23	-7.15
S&P 500	-1.24	-8.94
NASDAQ	0.50	-13.36
Russell 2000	-1.92	-10.74
MSCI-EAFE	-6.51	-12.66
MSCI-EM	-2.29	-6.95
Bloomberg U.S. Aggregate	0.95	-3.09

U.S. Treasury Yields	3 Mo.	2 Yr.	5 Yr.	10 Yr.	30 Yr.
12/31/2021	0.06	0.73	1.26	1.52	1.90
2/25/2022	0.33	1.55	1.86	1.97	2.29
3/4/2022	0.34	1.50	1.65	1.74	2.16

U.S. stocks fell back again last week, with Russian advances into Ukraine dominating global news, and sanctions leveled from all sides, creating uncertainty about the near-term economic environment. Most notably, the role of Russia as a significant gas and oil producer has raised concerns over further near-term inflation as backup sources of energy are being rerouted globally. By the end of the week, a Russian bombing of a Ukrainian nuclear facility and subsequent fire raised concerns on several levels (one of which being that Chernobyl, site of the 1986 disaster, is also in Ukraine). By sector, high oil prices caused energy to spike by 9%, followed by positive returns in defensive utilities and health care. Real also ended positively as interest rates fell. Financials, technology, and communications all ended down around -3% or more for the week.

Fed Chair Powell's testimony before the House Financial Services Committee noted the Fed will 'proceed carefully' in raising rates (implying a March move of 0.25% as opposed to the more extreme 0.50%), which gave the market a short-lived rally. The run-off of the Fed's balance sheet was also discussed, which provided some reassurance that a plan was being considered. This tempered language was a reflection of higher inflation, driven by energy prices, but also uncertain effects from the Russia-Ukraine situation (and sanctions) on global economic activity. An important risk, in addition to inflation, is the fact that an intensifying war, perhaps greater participation by neighboring European countries, and sanctions/sanction reactions could depress growth enough to dip the globe into a recession. This doesn't seem to be the base case, but is now at a higher probability than a few weeks ago.

On the brighter side, measures of investor risk appetite and sentiment have fallen to lows, in keeping with worries about inflation and geopolitical concerns; however, such low points have tended to be bullish for risk assets from a forward-looking standpoint over the next six to twelve months. Any sign of an improvement in conditions or negotiated peace treaty could be especially bullish.

Foreign stocks were led downward by sharp declines in Europe, with the geographic proximity of the Ukraine war as well as an expected negative impact from higher natural gas and crude oil prices outweighing most other factors. Japan fared slightly better, but still lagged the U.S. by a few percentage points. In emerging markets, sentiment was negative but skewed toward Eastern Europe. China and India also saw losses as commodity importers, while net exporter Brazil fared positively. Russian equities fell over -30% Monday morning alone (nearly -70% for the week) as the brunt of sanctions and a possible recession caused investor sentiment to sour immediately. Index providers MSCI and FTSE Russell, among others, decided to remove Russia from equity and fixed income indexes, due to the lack of investability. Interestingly, and contrary to what might be expected, emerging market equities have outperformed U.S. and developed foreign stocks on a year-to-date basis.

U.S. bonds experienced a positive week, as general risk-off sentiment pushed flows toward fixed income, lowering interest rates. Treasures outperformed investment-grade and high yield corporates, as credit spreads widened. In foreign bond markets, developed markets were little changed, while emerging markets lost significant ground due to geopolitical concerns, a stronger dollar, and index composition.

Russia raised interest rates from 9.5% to 20.0% in an effort to stabilize their ruble, which had been hammered the prior weekend (-30%) after sanctions were announced. The fact that over $600 billon of Russian central bank assets held in the West have been frozen make foreign currency transactions to defend the ruble less possible. Unfortunately, higher interest rates in emerging markets can tighten conditions sharply as well, which

brings enhanced recession risk. It appears the Russian economy is already in a freefall, perhaps along the lines of 2008; unfortunately, citizens are bearing the brunt.

Is a Russian default a risk (as they did in 1998)? The environment remains hazy, but many institutional investors appears far less leveraged to Russia than they did in the 1990s, when emerging markets were the new and exciting growth story. Much of the current complication is operational and legal. By Thursday, it appeared Russia made the ruble equivalent of $100 mil. in local coupon payments; however, a central bank ban on funds leaving the country left foreign investors in the cold for the time being.

Commodity indexes were up dramatically last week (based on composition, 15-20%) led by a rapid spike in the price of crude oil (26%, from $92 to just under $116/barrel) and wheat (34%), as well as to a lesser extent, agriculture, natural gas, and industrial metals. Dislocations between U.S. and European-priced natural gas have reached extremes (as in $5 vs. $30 per mil/btu, etc.), as transportation problems for gas or liquid gas limit potential closing of prices through arbitrage. Broadening sanctions against Russia have already affected the prices of certain heavily-exported materials including oil and gas, but also aluminum and copper (among other metals), and wheat. After falling in a trading range for some time, gold has also seen stronger sentiment in keeping with the war-driven safe haven trade. Mid-week, the U.S. and several allies agreed to release 60 mil. barrels of oil from strategic reserves, in order to buffer lost Russian export production. (Crude touched $130 over the past weekend with discussion of a full U.S. ban of Russian energy.) With sanctions in place, as well as bad weather in Ukraine already, wheat supply is expected to be sharply down this year, which has caused the price of that and several related grain commodities to spike.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Standard & Poor's, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

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Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.