SUMMIT
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Out of the Pandemic and into the War

Dear Clients and Friends: April 19, 2022

Much like the last couple of years, 2022 seemed to start on a positive note. The world was settling into a post-COVID economy where both growth and employment were historically high. Unfortunately, so was inflation. Nonetheless, we appeared to be on a road to normalcy. Then, in mid-February, Russia attacked Ukraine setting off the largest invasion in Europe since WWII. The world was taken aback, and expectations were reset for just about everything: economic growth, inflation, supply chains and geopolitical stability.

These events resulted in market volatility and the first quarter of negative equity returns since the beginning of the pandemic. Fixed income performed as poorly as equities, proving to be a challenging backdrop for investors who rely on bonds as a defense against negative equity returns. Bonds, as represented by the Bloomberg Aggregate Index, fell (-5.9%) as interest rates rose in response to inflation data. Although stocks staged a significant rally in the last weeks of March, coming back from a (-13%) decline, it was not enough. The S&P 500 ended the quarter down (-4.6%) while smaller company stocks (-7.6%), developed international (-6.5%) and emerging markets (-7.0%) all underperformed. The only areas of positive returns were in energy and commodities.

Inflation and Interest Rates

Inflation remains top of mind and continues to be elevated. The Labor Department reported that the Consumer Price Index surged 8.5% in March, a four-decade high. This was the sixth straight month of inflation above 6%, well above the Fed's target of 2%. The increase was driven mostly by energy costs, rising food prices, and strong consumer demand. Higher prices result from supply/demand imbalances. Demand remains exceptionally strong as the economy emerges from COVID with pent-up spending, stimulus checks, and years of low interest rates. Supply is still being hampered by ongoing COVID restrictions in manufacturing parts of the world, supply chain issues, and now the conflict between Russia and Ukraine.

The Fed has been tolerant of inflation, for the most part, believing it would prove transitory and the causes were temporary. However, the first quarter marked a turning point. The Fed now seems to have grown tired of being blamed for inflation and has become much more hawkish. It now appears the Fed will raise rates seven times this year and start trimming its balance sheet in May. This is a quickening of the anticipated pace.

Markets, both equity and fixed income, lurched when digesting this new attitude. The two-year Treasury Note rose from 0.73% to start the year to 2.28% to end the quarter. The ten-year Treasury rate has jumped a full percentage point. While not large in absolute terms, these moves from such low starting levels caused the sizable negative returns in the bond market. These higher rates also affected stocks, especially the faster growing, less profitable ones that have performed so well the last couple of years.

We believe the direction of inflation and the Fed's response remain key market drivers. Inflation dictates the magnitude and pace of future Fed rate hikes, which ultimately impacts borrowing costs for consumers and the valuations assigned to investment assets. Until recently, the Fed had been hoping that market forces, mainly on the supply front, would bring inflation back in line. It now appears they will attack the demand side in hopes to stem future price increases without harming the economy too much. The impact of the events in Ukraine only makes the Fed's job more difficult and increases the potential for a policy mistake.

Russia Invades Ukraine

On February 23rd, Russia invaded Ukraine, unleashing untold human suffering and war atrocities on its much smaller democratic neighbor. In retaliation, the developed world imposed extensive economic sanctions, its only real option. If not for its nuclear weapons, Russia would not be taken as seriously. The Russian economy is slightly larger than that of Texas and about half the size of California. However, they are a significant supplier of oil, gas, and certain important metals. The region is a major supplier of wheat. These are the issues that have brought the war to our doorsteps.

Commodity prices were increasing before the invasion; the attack and subsequent sanctions have caused another surge. We do not see any quick or easy solutions to this crisis. Russia looks as if it massively miscalculated how things would play out in Ukraine. They also appear be as incompetent as they are brutal. We therefore expect prices for energy, wheat, and other commodities to remain elevated until alternative supplies are established. This could take years. The global economy will likely endure sustained shortages and higher prices as the necessary sanctions are maintained on Putin.

Europe will bear the brunt of the economic cost. Economists estimate Europe imports about 30% of its energy needs from Russia. Additionally, the flood of refugees coming from Ukraine will need food, housing and other assistance. Ukrainians may also seek permanent residency. All these costs could force Europe into recession. The bottom line is that a very tight labor market in the U.S., shortages of energy and commodities around the globe, higher inflation and interest rates are likely to persist for the foreseeable future.

Drill Baby Drill

We live in a politicized country; therefore, every problem seems like a political one. When gas prices hit $4 a gallon, we needed someone to blame. Biden's green energy and climate agenda has his administration in the current crosshairs. As with most things in life, it's a bit more complicated. Economic forces, not political ones, are mostly at play here.

Oil accounts for more than half the cost of gasoline, so prices at the pump rise and fall in tandem with oil prices. Several issues have caused the recent move upward. The first is slowing supply. The sanctions on Russia have limited their output, but supply was already tightening for other reasons. Drillers globally have been adapting to a world weaning itself off fossil fuels. The movement to cleaner energy production and electric vehicles is real, clouding the view for future oil consumption and therefore investment.

Supply has also been withheld in an effort by oil companies to resist overproducing. In the past, overproduction has sunk profits for their investors and caused billions of dollars in losses. Several years of oversupply, culminating in 2020, led to plunging oil prices, widespread losses and an industrywide determination not to get burned again.

Americans familiar with "fracking", the new drilling technology that led to a surge in U.S. oil and gas production starting around 2010, may think ample energy sources now mean American firms can drill at will. What many forget is that U.S. energy production is a for-profit, private-sector industry, not a government agency that can control output. Additionally, federal drilling permits often are associated with an administration's efforts to increase/decrease oil production. Less than 25% of domestic drilling occurs on public lands; the rest is on private property where the government has no jurisdiction. Companies only drill when they want to drill and believe it is in their best, profitable interest to do so.

Lastly, all oil is not the same. In fact, it comes in a continuum of *sweet* or *sour* and *heavy* or *light* varieties based on its sulfur content and overall density. Different places around the world extract different types, and it takes different equipment to process the variations into the products we use. In the late 2000s, America's refinery industry, those who turn oil into gasoline, made a bet that the U.S. would use more heavy/sour oil because of its lower price. They invested billions of dollars into equipment to process this cheap oil that was mostly imported. Ironically, U.S. fracking came along shortly after and produced significant amounts of… light/sweet oil. Currently, we have a mismatch of our domestic production and our ability to process it into the commodity we need the most, forcing imports to continue for the time being.

Did we mention that this was complicated? The solutions thrown about like "drill, baby, drill" are often overly simplistic and just sound bites to play to political interests. These problems will be overcome, but it will take time. In the interim, higher oil and gas prices will continue to contribute to the inflationary pressures we are all feeling.

Outlook

In a recent quarterly commentary written by a long-time manager we follow, he remarked on the trying times investors had been through in the 30 years he had been running his mutual fund. He listed 35 "troubling events" ranging from the original Gulf War to Y2K and the tech bubble to Hurricane Katrina, the Financial Crisis, COVID and now Russia's war with Ukraine. Those events led to 12 stock market corrections and five bear markets. They also led to long-term investors making more than 15 times their original investment. When confronted with global uncertainty, it can be difficult to imagine what the next year or even the next month will bring and that can be scary. Historically, patience has been rewarded.

Remembering that investing is a journey, and often a very bumpy ride, can be helpful during the challenging times. You can always find something to be worried about. In almost all cases, it is important to stick to your investment plan and abide by your long-term objectives. Problems tend to lead to solutions, and markets tend to defy negative expectations and appreciate over time.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Please stay safe and well.

Summit Asset Management LLC