MARCH MADNESS

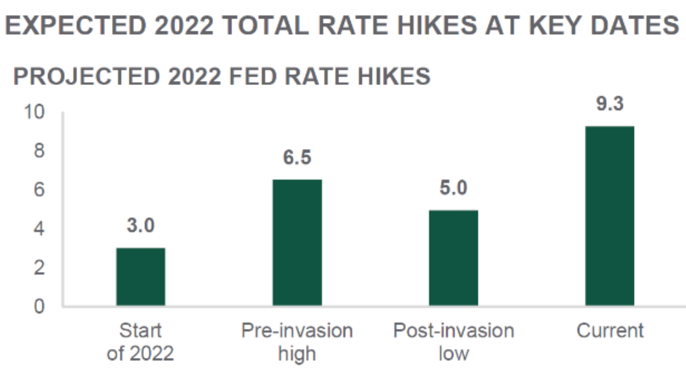
The NCAA March Madness basketball tournament is estimated to have cost employers over $13 billion due to unproductive employees watching games and checking brackets. The single elimination tournament exceeded expectations this year, with a few higher seeded teams making a deep run and the Final Four featuring four "Blue Blood" programs (technically three, however, if Villanova's more recent domination makes them a "New Blood"). There are many impressive facts about the tournament, like 30% more money is wagered on March Madness than the Super Bowl, or that there are nearly as many brackets submitted as there were ballots cast in the last Presidential election. An estimated $10 billion is wagered on the tournament, with only about $6 billion wagered legally, and the odds of filling out a perfect bracket are 1 in 9.2 quintillion.[i] This commentary would be more amusing if the title was directly referring to the basketball tournament, however, we are really referring to the turmoil surrounding the financial markets in this first quarter of 2022.

The "madness" was not contained to March alone, as the market's stressors have been evident over the last several months. Inflation and monetary policy have been the main drivers of the volatile equity and bond market action, with both factors exacerbated by wartime conditions.

- The war in Ukraine needs to be acknowledged first, as Russia's unprovoked invasion of a sovereign nation is a humanitarian tragedy. The coordinated response from the United States and Western allies has been stronger and quicker than anticipated. The increasing abandonment of the Russian market by the private sector, in addition to coordinated economic sanctions, will bring generational damage to its economy. The countries have a combined weight of just 1.9% of global GDP and account for a small percentage of direct trade with the U.S. Besides the humanitarian impacts, the financial impact from energy, metal and agricultural products is a main concern. Russia accounts for 12% of global oil production and 16% of global natural gas production, and notably supplies 44% of the European Union's total natural gas imports. Even after Russia's annexation of Crimea in 2014, the EU's dependence on Russian gas increased, most notably to 50% in Germany and Italy. Russia is also a major exporter of nickel, palladium, and uranium, which are critical for new technologies, auto production, and many industrial uses. Russia and Ukraine export 30% of the world's wheat supply, 20% of the world's corn supply, and several components of fertilizer production, creating a potential for a global food crisis. While the situation remains fluid, the U.S. economy is well insulated from the conflict, as opposed to countries with a closer geographic or economic link to Russia and Ukraine.[ii]

- Inflation, as measured by the Consumer Price Index ("CPI"), rose 8.5% in March year-over-year, with transportation commodities and energy increasing 21.8% and 32.0%, respectively, year-over-year. Contributing to these parts of CPI are used cars and trucks prices increasing 35% and gasoline prices increasing 48% over the same period.[iii] While the Omicron variant weighed on economic activity at the start of the year, consumer demand and ability to spend remained strong as the economy reopened (for the second time). The price of WTI crude was already climbing, but the war pushed prices to their highest level since 2014, surging as high as $130/bbl and ending the quarter around $100/bbl. It is important to note that inflation is not a level but a rate of change, thus these reopening effects are technically transitory in a sense that prices do eventually normalize. Assuming normalized levels of inflation for transportation commodities and gasoline prices, CPI would be around 4.5%. Despite this, the inflation risk from a disruption in energy, metal, and agricultural exports from Russia and Ukraine cannot be ignored, creating an even more challenging environment for the Fed's monetary policy.

- At the Federal Reserve's March meeting, the Fed funds rate was raised to 25 bps, as expected, for the first increase since December 2018. The meeting minutes showed that Fed officials also plan to reduce the central bank balance sheet by $95 billion per month, beginning in May. RMC shared a graph of the Fed's balance sheet growth in our last commentary, which has grown to $9 trillion, as the Fed continued to purchase bonds into 2022. This "hawkish" tilt from quantitative easing to tightening is in response to persistent inflation, and the Fed is expected to remain committed to higher rates and a runoff of its balance sheet to combat inflationary pressures. As shown in the picture below (left), the expected number of 25 bps rate hikes has varied throughout the first quarter, with consensus now projecting a Fed funds rate between 2.0% - 2.5% by year end (given six Fed meetings remain, this assumes 50 bps increases at some meetings). The picture below (right) provides a historical perspective that what is forecasted is not always what happens.[iv] As the Fed attempts to balance soaring inflation, rising interest rates, war conditions in Europe, and supply disruptions from China's Covid-19 lockdowns, the actual number of hikes is likely to not turn out as expected.



NUMBER OF FED RATE HIKES/CUTS BY CALENDAR YEAR

Year	Forecasted[1]	Actual[2]
2014	0	0
2015	+4	+1
2016	+3	+1
2017	+3	+3
2018	+3	+4
2019	+1	-3
2020	-1	-4
2021	0	0

The bond market's expectations of the Fed's hawkish tilt were reflected in a flattening yield curve, as measured by the 2 / 10-year treasury spread, which lessened to only 4 bps by the end of Q1. This was mostly driven by the 2-year treasury that rose 1.55% over the last three months to 2.28%, including 0.84% in March alone. With the yields on short to medium-term treasuries rising so quickly, the Bloomberg U.S. Aggregate lost 6.0%, recording the bond market's worst quarter since 1980. The equity market's response was shown with the S&P 500 closing in correction territory (defined as a downturn of greater than 10% but less than 20%) and the Nasdaq in a bear market (defined as a downturn greater than 20%), as the indices closed as much as 13.1% and 21.6% from their highs, respectively. Like the Fed, managing a portfolio in a new environment of elevated inflation and higher interest rates requires balance. Diversification remains key as the concurrent impacts of monetary policy, geopolitical events, and the enduring pandemic fallout are unknowable, and objective-based portfolio management tailored to one's financial situation should remain in focus.

[i] WalletHub
[ii] Northern Trust Asset Management
[iii] Bureau of Labor Statistics
[iv] Northern Trust Asset Management