Colorado Capital
MANAGEMENT

QUARTERLY MARKET UPDATE / APRIL 2022

Economic Outlook

Overview

Russia's invasion of Ukraine is expected to result in a sharp slowdown in the global economy. Western countries have introduced a series of sanctions on Russia, including a U.S. ban on Russian oil and energy imports. The full degree to which the war will affect the broader U.S. economy remains to be seen, and it is difficult to foresee how the crisis on the ground will evolve in the coming weeks.

Separately, the U.S. economy has pushed through the Omicron surge reasonably well. Against a backdrop of soaring case counts, employment growth, retail sales, and industrial production each expanded at a robust pace during the first few months of the year. The expansion of economic activity at the beginning of the year is an encouraging sign that not only are households and businesses taking new waves of the pandemic in stride, but they are also standing tall in the face of supply chain disruptions, labor shortages, and the hottest inflation in over 40 years.

While COVID case rates have plummeted, the lengthy list of supply-side problems that have accompanied the public health crisis stubbornly persist. Tangled supply chains and multiple rounds of fiscal support from years past have resulted in a broadening of inflation pressures, which has spurred a hawkish pivot from the Federal Reserve which in March implemented the first of several planned interest rate hikes this year.

CCM Key Economic Indicators

Indicator	3.31.22	12.31.21	3.31.21
U.S. Economy			
Quarterly GDP Growth	Est. 1.0%	6.9%	6.3%
Unemployment Rate	3.6%	3.9%	6.0%
U.S. CPI (Core)	6.4%	5.5%	1.7%
Interest Rates			
Fed Funds Rate	0.2%	0.1%	0.1%
10-Year Treasury Rate	2.13%	1.47%	1.61%
Currency & Commodities			
Crude Oil (WTI)	$100.53	$ 75.33	$59.19
Gold Price	$1,924	$ 1,820	$1,685
Trade Weighted Dollar Index	116.4	115.8	113.4
Confidence			
Consumer Confidence Index	107.2	115.2	114.9
ISM Purchasing Managers Index	57.1	58.8	63.7
Stock Prices			
Dow Jones Industrial Average	34,678	36,338	32,982
S&P 500 Forward P/E ratio	19.5	21.2	21.9

Source: Capital Market Consultants

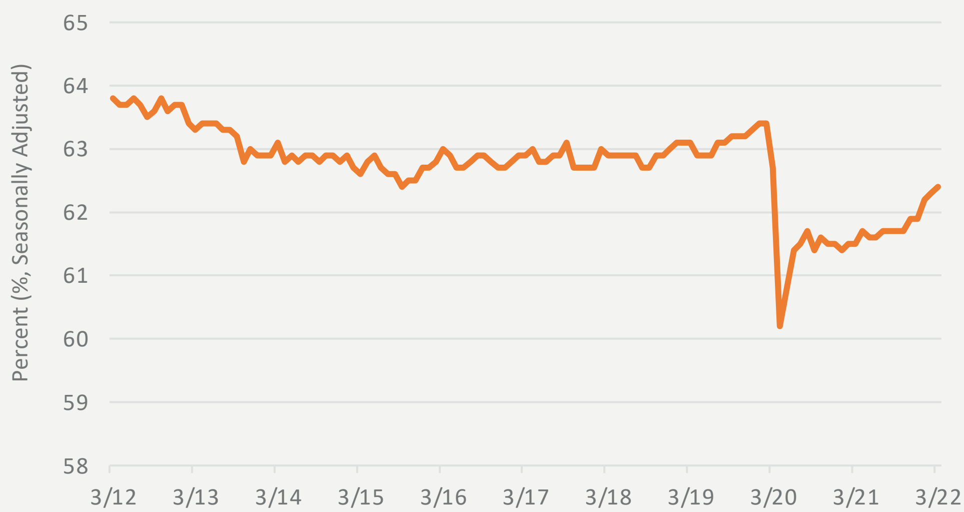
GDP

Despite slowing to an estimated 1% annual pace during the first quarter, real GDP is still expected to expand by roughly 3.0% in 2022. While this remains above the average rate of growth seen over the last few decades, it is far below the blazing 5.7% pace registered in 2021. Falling consumer confidence may lower consumer spending, the main driver of GDP growth.

Employment

The U.S. labor market continues to be quite hot as the economy added 678,000 jobs in February. Employers continued to boost wages in February as they competed over a depleted pool of workers. The jobless rate fell from 4.0% to 3.8% as more people entered the labor force. While the labor force participation rate rose sharply, it remains well below pre-pandemic levels. This has resulted in a high number of unfilled job openings and upward pressure on wages.

Labor Force Participation Rate



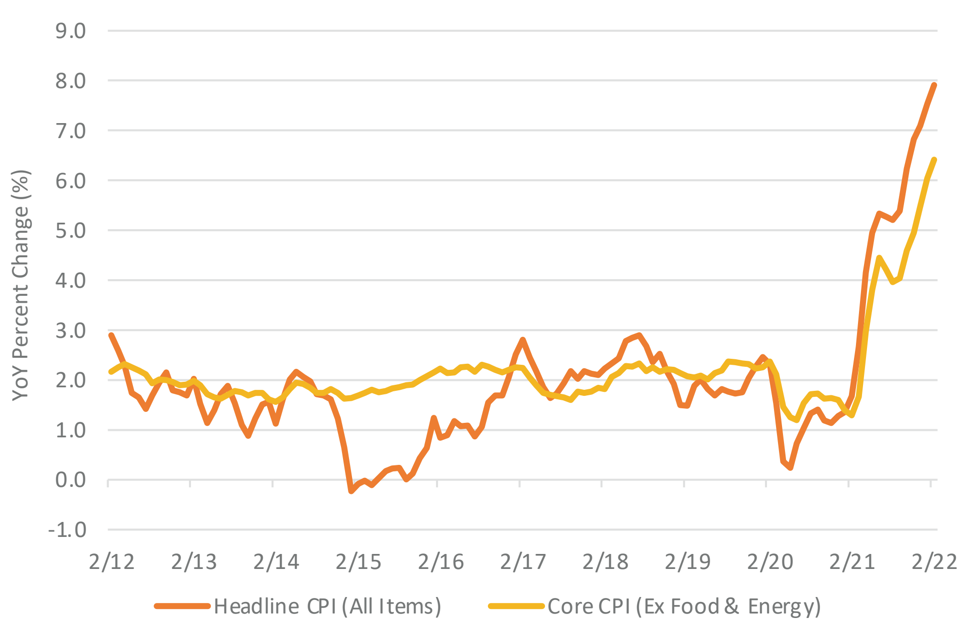
Source: U.S. Bureau of Labor Statistics

Inflation

Energy prices have surged since Russia invaded Ukraine. CPI inflation is now expected to peak at around 8.5% in April, although the timing and degree will depend heavily on the highly volatile and uncertain path of oil prices. Besides energy, food-related commodity prices have also shot up 9% since the start of February and will influence consumer prices for months to come.

With considerable price pressures remaining in place, core inflation is expected to remain above 4% throughout the year despite the Fed raising rates.

Inflation (Consumer Price Index)

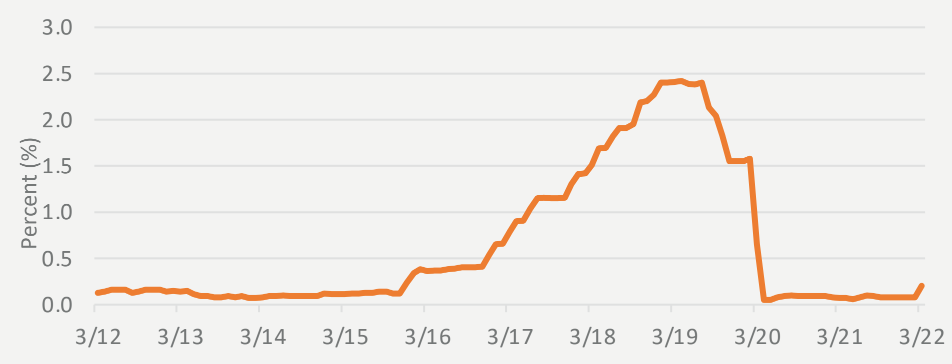


Source: U.S Bureau of Labor Statistics

Interest Rates

The Federal Reserve raised its benchmark federal-funds rate in March by a quarter percentage point to a range between 0.25% and 0.5%, the first interest rate increase since 2018. It plans to raise interest rates five more times this year. The market expects that the Fed interest rate will approach 2% by year-end and 3% by the end of next year.

Effective Fed Funds Rate



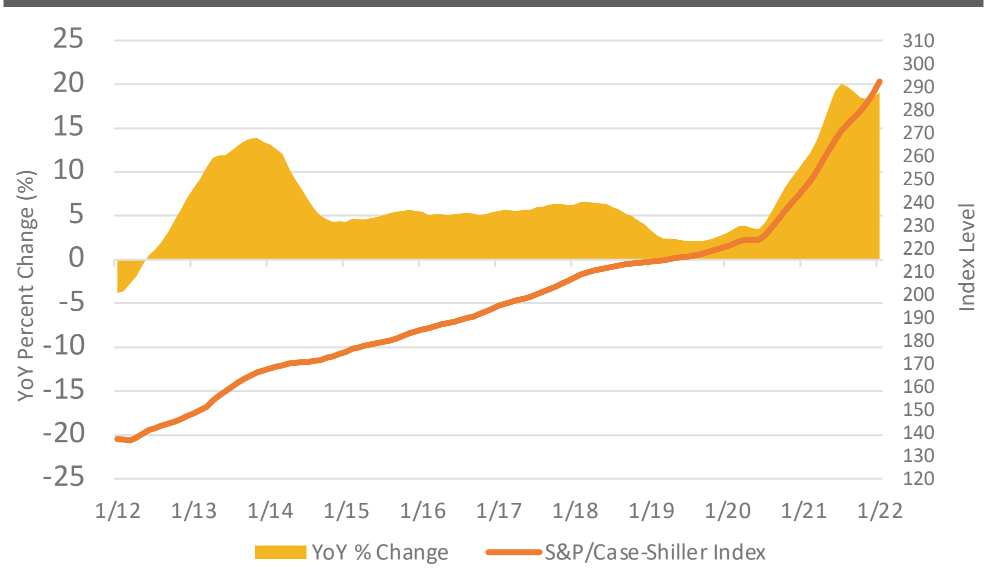
Source: Board of Governors of the Federal Reserve System

With a strong job market and inflation at multi-decade highs, there is considerable pressure on the Fed to get rates up to a level that can break the current inflation trend. The Fed is also expected to complete its taper of asset purchases and begin to gradually shrink its balance sheet later this Summer. The result of such actions will likely be modestly higher interest rates across the board.

Housing

The U.S. housing market has been a surprising source of strength throughout the pandemic. Strong demand has eaten into already-thin housing inventories, lowering them to record lows. This imbalance has resulted in strong price gains. Over the next year, the growth in housing prices is expected to slow as new construction adds to supply and higher interest rates dampen demand.

S&P Case-Shiller 20-City Home Price Index



Source: S&P / Case-Shiller

U.S. Dollar

Investor anxiety swelled as Russia advanced across Ukraine, upending markets across the globe and sending traders scrambling for assets perceived as safer, such as gold, U.S. government bonds, and the dollar. The recent move by the dollar builds on earlier strength that began last year amid expectations of higher interest rates in the U.S. Due to the war in Eastern Europe, both the euro and the British pound have lost against the dollar.

Eurozone

The Ukraine war could significantly dampen the eurozone’s economic growth by dragging on trade and sentiment, while also pushing inflation considerably higher in the near term. It is likely to curb exports, strain already-stressed supply chains, and drive-up energy and commodity prices for households and the region’s large manufacturing sector. The war is likely to be a stagflationary shock for Europe, which borders and has deep trade relations with Russia, including a heavy reliance on Russian energy. The European Central Bank is expected to raise interest rates and pare back its bond buying in an effort to contain inflation.

Global Outlook

The global economic landscape has changed considerably since the Russian invasion of Ukraine. Soaring commodity prices, sweeping financial sanctions, and the potential for a ban on energy imports from Russia are threatening to hobble a global economy still weakened by the Covid-19 pandemic. Oil prices will likely remain elevated for some time, contributing to stubbornly high inflation.

U.S. real GDP is expected to expand by roughly 3.0% in 2022. While stimulus from monetary and fiscal policy is set to fade, a massive stockpile of consumer savings and increased household wealth should drive growth in the years ahead. Corporate balance sheets are also exceptionally strong. Although economic growth is moderating, it is still expected to maintain a strong pace. However, the combination of high oil prices, inflation, interest rates and geopolitical uncertainty could significantly lower this outlook.

Europe, with its geographical proximity to the conflict and heavy dependence on Russian energy, is potentially facing its third recession in two years. In Russia, we expect an economic contraction of as much as 10%, which the nation hasn’t experienced since the messy post-Soviet economic overhauls of the 1990s. The initial shock is likely to be followed by a prolonged period of low growth or stagnation as Russia is pushed into economic isolation.

In China, growth is slowing, and high energy costs are a mounting concern. The country is still implementing a zero-Covid-19 policy, and household consumption has been weak, while policymakers are cracking down on excesses in the housing market. Further easing of monetary policy and fiscal support is expected to offset reduced purchasing power. For now, China's economy is expected to grow a little over 5% this year, well below the average pace of recent years.

Capital Market Commentary

With the COVID pandemic receding from the headlines, news of war, surging and sticky inflation, rising interest rates, and continued supply chain issues have filled the headline gap. Adding to that is the uncertainty of an as-yet unformed changed world economic order brought on by sanctions on Russia. Investors are groping for what it may all mean to business relationships, cash flows, and profits. This uncertainty has led to increased market volatility.

A major contributor was Russia's invasion of Ukraine on February 24th. The markets, which had already dropped substantially before this date due to concerns about high inflation, rising interest rates and the potential for war, continued their decline. However, they quickly rebounded. During March, the S&P 500 actually gained 3.7%, while international markets, including Europe, were generally flat. However, for the quarter, the S&P 500 was down 4.6%, the EAFE international index was down 5.9% and the MSCI Europe index fell 7.4%. Bonds fared no better, with the Barclays U.S. Aggregate bond index down 5.9% for the quarter. Munis fell 6.2%, while high yield dropped 4.8%. Unlike stocks, bond losses grew in March as the Fed raised interest rates. On the international stage, there was a big first quarter rally in Latin America (+27.3%), while the MSCI China index fell 8% for the quarter and 32% for the year. Russian stock trading was discontinued.

In the U.S., strong growth in corporate earnings together with lower stock prices have helped bring the valuation level of the S&P 500 closer to historical norms. Yet at 19.5x earnings, the market still appears to be relatively expensive.

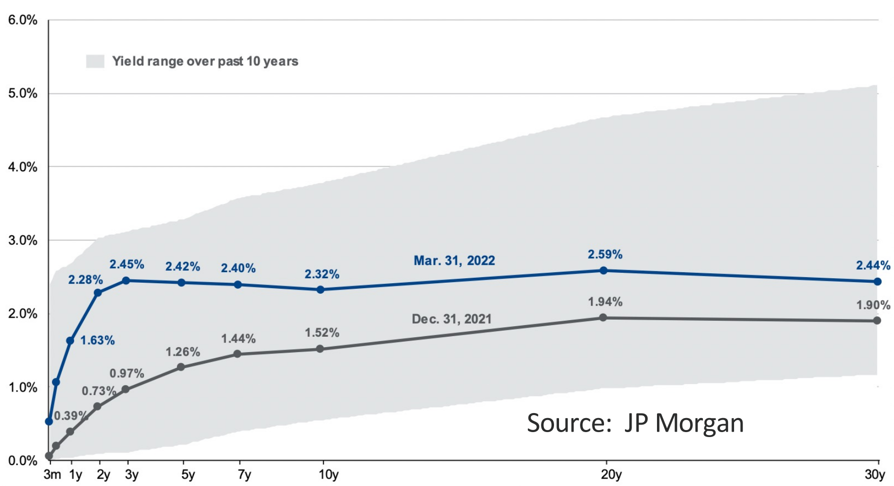
S&P 500 Index: Forward P/E Ratio

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	19.46x	16.83x	0.78
CAPE	Shiller's P/E	37.45x	27.98x	1.47
Div. Yield	Dividend yield	1.46%	2.00%	1.63
P/B	Price to book	4.07x	3.09x	1.22
P/CF	Price to cash flow	14.80x	11.12x	1.69
EY Spread	EY minus Baa yield	0.86%	0.19%	-0.34

Turning to the bond market, the bulk of the yield curve (see below) is now quite flat, with two-year, ten-year, and 30-year Treasury rates all closely bunched around the 2.3% to 2.4% range. These rates appear quite low given the nearly 8% current rate of inflation. Bond investors apparently expect inflation rates to fall significantly, but this will take some time. Although the yield on short and intermediate-term bonds has already improved, we believe rates will continue to head higher. Facing the prospect or rising interest rates and negative real (inflation adjusted) returns, we expect this year to be a difficult one for bond investors. While bonds still represent an important source of stability during stock-market downturns, we are increasingly looking to non-traded private market investments to help serve this purpose. These investments typically also offer the potential of substantially higher projected yields and/or total returns.

There are a number of variables that may significantly affect financial markets that cannot be reasonably forecasted at this time. First the course is the war in Europe. Does it wind down? Does it spiral out of control pulling NATO and the US into a broader conflict? What is the global impact of the sanctions?

U.S. Treasury Yield Curve



Second, what will be the effect of rising interest rates? Will this effectively slow inflation without crippling the economy? This rise in rates should help value stocks (e.g., financial companies) lead the market after years of lagging growth stocks. Rising rates should also benefit companies that do not need to tap the capital markets to fund business operations and hurt those whose borrowing costs are going up. This should favor high quality companies with strong balance sheets. At the same time, increased borrowing costs can also be expected to put downward pressure on real estate prices.

Third, as rates rise, economic growth will begin to slow with the Fed hopefully able to engineer a "soft landing" in the quarters ahead rather than tipping the economy into recession. As the economy slows, stocks that pay reliable and growing dividends should attract investor attention. A growing percentage of stock market return will likely be coming from dividends rather than capital appreciation.

And lest we forget, the future path of the pandemic is also unknowable. Given all these unknowns, strategic asset allocation and portfolio diversification remain key. At times like this, spreading risk out across asset classes would appear to be especially prudent.

Sources: Capital Market Consultants, JP Morgan, Department of Labor, Department of Commerce, Morningstar, Bloomberg, Standard & Poor's/Case-Shiller, European Commission, European Central Bank

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