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MARKET REVIEW
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RCB BANK
Trust & Wealth Management

STAGFLATION CONCERNS LIKELY OVERBLOWN

Over the last few months, stagflation has become a buzzword among market commentators as the economy's momentum slowed and elevated inflation persisted longer than some economists and investors expected. Stagflation generally refers to the undesirable situation of high inflation, high unemployment, and stagnant economic growth. The stagflation phenomenon is sometimes caused by a supply-side shock that increases prices for inputs of production, which can lead to less demand and higher unemployment. The most notable episode of stagflation in the U.S. occurred in the 1970s when two oil price shocks amplified inflation that was already elevated. This, in turn, reduced demand and contributed to two recessions. Some investors have pointed toward similarities between the 1970s and today with supply shortages and higher energy prices fueling inflation and presenting a headwind for economic growth. However, there are a few differences between then and today discussed below that make 1970s-style stagflation unlikely to materialize any time soon.

HISTORICAL STAGFLATION

There are several notable instances in modern American history when stagnant growth and high inflation defined the domestic economic landscape. The most infamous and widely discussed of these occurred in various waves during the 1970s and early 1980s. From 1974 through 1982, the Consumer Price Index (CPI) rose at an average annualized rate of 8.7%. Over this period, the U.S. unemployment rate averaged 7.3% and real Gross Domestic Product (GDP) grew at an annualized rate of only 2.0%, which was weighed down by economic contractions in calendar years 1974, 1975, 1980 and 1982. As seen in Chart 1, year-over-year CPI peaked at a staggering 14.8% in March 1980. To provide some context from a more recent period, real GDP grew at an annualized rate of 2.2% over the nine years spanning 2011 to 2019. Yet, the U.S. unemployment rate averaged 5.8% (1.5% less than the 1974-1982 period) and CPI rose at an average annual rate of only 1.8% over this period (6.9% less than the 1974-1982 period).

Most economic historians agree that a group of unique variables were the key ingredients that produced this protracted era of stagflation. Those variables include: an extended period of elevated government spending and easy monetary policy in the 1960s, oil supply shocks in 1973 and 1979 and a climax in the collective bargaining power of labor unions. Years of elevated government spending to fund the Vietnam War and President Johnson's Great Society programs in the second half of the 1960s most likely contributed to so-called demand-pull inflation characterized by aggregate demand significantly exceeding aggregate supply. This development, in conjunction with the growing political and social power of labor unions to negotiate higher wages for workers, most likely laid the groundwork for persistently higher inflation expectations across the labor force heading into the 1970s.

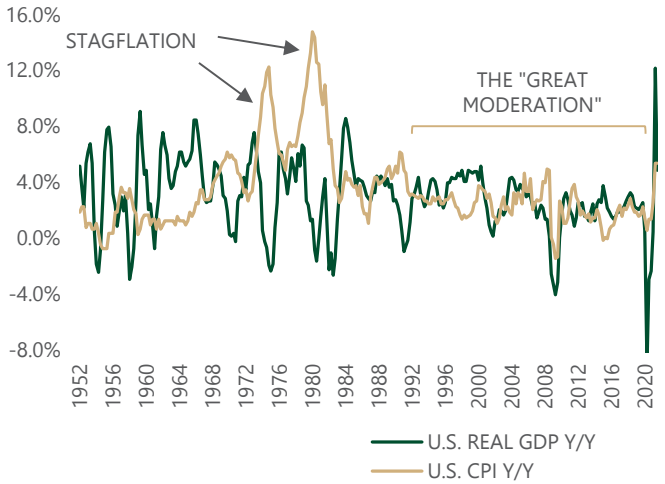
Later in this era, acute restrictions on oil supply in 1973 (OPEC embargo following Yom Kippur War) and in 1979 (Iranian hostage crisis) drove a simultaneous reduction in demand and increase in energy prices. This subsequently led to a period of painful, so-called cost-push inflation, in a U.S. economy with transportation and manufacturing sectors that were significantly more energy intensive than today. Some commentators have pointed to wage controls, price controls and import tariffs as culprits that compounded the twin problems of low growth and high inflation. Still others argue that the end of the gold standard (and subsequent era of pronounced U.S. dollar weakness) and muddled Federal Reserve policy between 1970 and 1972 prolonged inflationary pressures. With regard to the latter, the Federal Reserve's policy rate was raised briefly in 1971, but then quickly cut amid immense public and private pressure on Fed Chair Arthur Burns from the Nixon administration ahead of the 1972 presidential election.

Outside of the 1970s and early 1980s, there have been other, shorter-lived periods of low growth and high inflation that did not devolve into an extended period of economic malaise. As seen in Chart 1, year-over-year CPI outpaced real GDP growth for most of the three-year period spanning 1956 through 1958. This period coincided with the Recession of 1957-1958, which followed a period of very strong growth in the immediate post-WWII years. More than three decades later, a two-year span of moderate stagflation

CHART 1

HISTORICAL STAGFLATION

U.S. REAL GDP AND CPI Y/Y

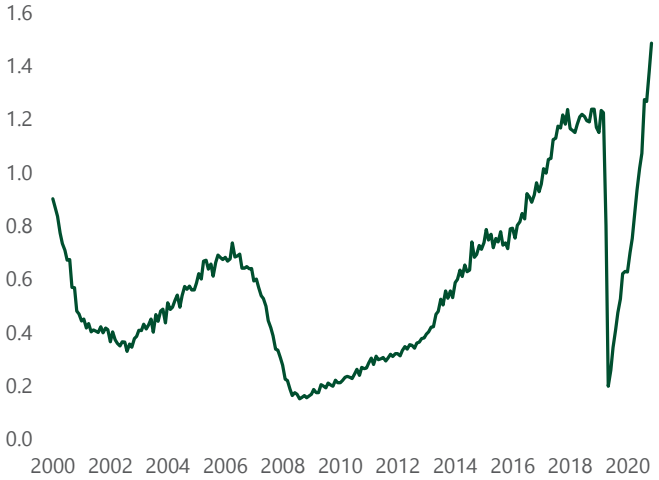


Source: Bloomberg.

CHART 2

RECORD NUMBER OF JOB OPENINGS

U.S. JOB OPENINGS PER UNEMPLOYED WORKER



Source: Federal Reserve Bank of St. Louis.

emerged in 1990 and 1991. This period was punctuated by a recession during those years widely thought to have been driven by the Federal Reserve's 1988-1989 rate hike campaign, Iraq's summer 1990 invasion of Kuwait and a subsequent oil price shock.

CPI AND GDP DIFFERING CALCULATIONS METHODS

In 2021, the stagflation debate ramped up in October after third quarter economic growth slowed to 2.1% from 6.7% in the second quarter. Meanwhile, CPI accelerated to 6.2% in October from 5.4% in September. The divergent trends in slowing economic growth and strengthening inflation provided fuel for the stagflation argument, but the divergence was actually influenced by differences in the two measures' calculation methods. GDP growth is calculated as a quarter-over-quarter rate and then that rate is annualized. CPI is viewed simply as a year-over-year rate. According to ClearBridge investment strategists, if CPI was calculated the same way as GDP it would have slowed substantially in the third quarter to 4.7% from 9.7%. Also, core CPI would have slowed even more dramatically to 2.7% from 10.6%. From this alternative perspective of standardizing the calculation method, inflation slowed down with economic growth in the third quarter, suggesting the COVID-19 Delta variant weighed on both measures. Comments from both corporate executives in third quarter earnings calls and the Federal Reserve's Beige Book provided additional evidence that the Delta variant slowed economic activity in the late summer.

STAGFLATION IS AN UNLIKELY OUTCOME

Besides supply shortages and higher energy prices, today's economic situation bears little resemblance to the stagflation environment in the 1970s. Strong third quarter corporate earnings and upbeat comments from executives indicate demand is robust, and some companies are even cutting back on advertising to avoid driving more demand that they cannot fulfill amid constrained supply chains. All other things being equal, strong demand will likely lead to a continuation of solid economic growth rather than stagnation. Unlike most of the 1960s and early 1970s, the economy is operating below its productive capacity, as defined by GDP being below the Congressional Budget Office's potential GDP estimate. This suggests the U.S. economy still has more room to run before slowing toward mid-cycle growth. A Bloomberg survey of 60 economists shows the median projection calls for economic growth to return to above average levels in the coming quarters after the temporary slowdown in the third quarter attributed to the Delta variant.

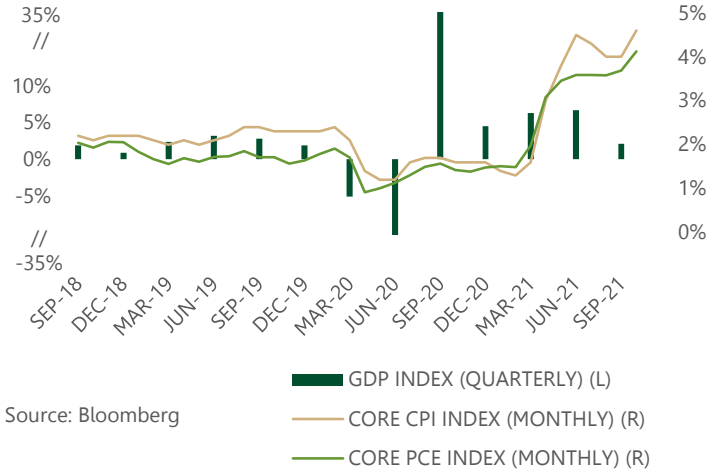
The healthy labor market is another factor standing in the way of the economy stagnating. The unemployment rate has steadily declined to 4.2% in November, and economists forecast further decline to 3.8% by the end of next year as the labor market recovery continues. As seen in Chart 2, a record number of job openings per unemployed worker (1.49) illustrates the high demand for workers that was lacking in the 1970s.

While a stagflation outcome appears to be unlikely, it cannot be completely ruled out because persistent inflation could prompt the Federal Reserve to raise interest rates more aggressively than currently expected. A more hawkish rate hike path could slow economic growth and the labor market recovery. Economists expect elevated inflation will peak this quarter and gradually fade throughout next year as labor and supply shortages ease. However, inflation could surprise to the upside if supply chain issues persist well into next year, wage growth accelerates or upward price pressures continue to broaden beyond reopening-sensitive items.

ECONOMY

GDP AND CONSUMER PRICES

SEPTEMBER 2018 THROUGH OCTOBER 2021



Source: Bloomberg

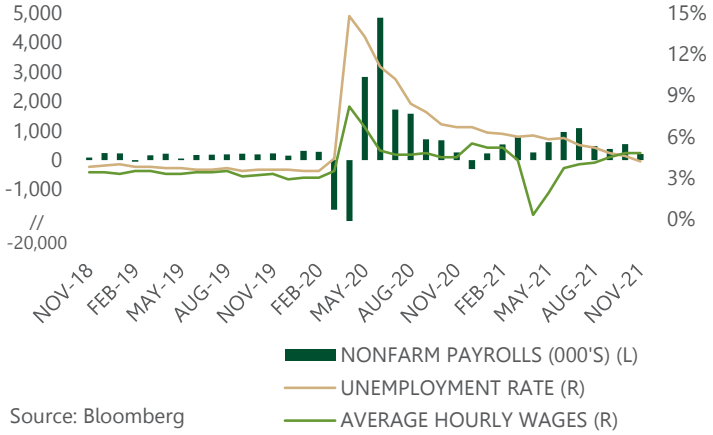
The second estimate of third quarter GDP growth was revised up to 2.1% from 2.0%, but was slightly under the earlier estimate of 2.2%. A jump in private investment was the leading driver, along with slightly revised higher consumer spending.

The core Consumer Price Index (CPI) jumped 4.6% in October from a year ago, and hit its highest reading in over 30 years. The Federal Reserve recently acknowledged the persistent inflationary pressures and will remove the word "transitory" in future communications surrounding inflation.

Core Personal Consumption Expenditure (PCE) prices were up 4.1% in October compared to the same period a year ago. The rapid rise in inflation as well as consumers' willingness to continue spending may encourage the Fed to expedite its asset purchase taper.

LABOR MARKET

NOVEMBER 2018 THROUGH NOVEMBER 2021



Source: Bloomberg

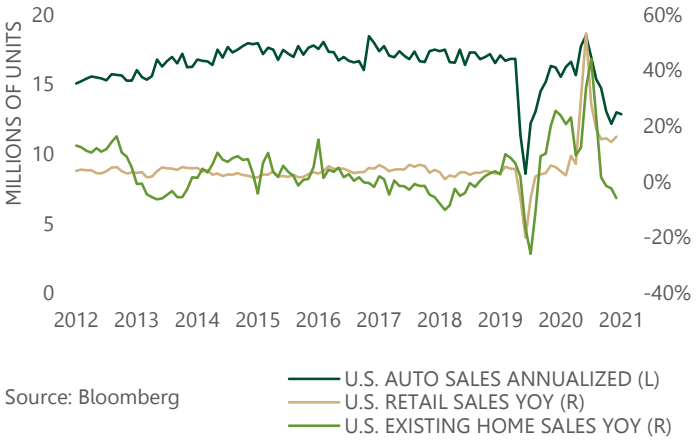
The effects of the tight labor market were evident in November as the U.S. added only 210,000 jobs, substantially missing economists' expectations of 550,000 and marking the smallest gain since December 2020.

Professional and business services industries led in jobs gains, followed by transportation and warehousing, construction, and manufacturing; retail trade declined over the month.

The unemployment rate dropped to 4.2% from 4.6%, while the participation rate climbed to 61.8%, the highest since March 2020. This report highlights more workers returning to the labor market, although COVID-affected sectors have slowed in job creation recently.

HOUSING, AUTO AND RETAIL SALES

NOVEMBER 2012 THROUGH NOVEMBER 2021



Source: Bloomberg

U.S. vehicle sales fell slightly in November to 12.9 million units annualized as dealerships continue to face supply constraints due to the semiconductor shortage. The reading was well short of the 13.5 million units forecasted.

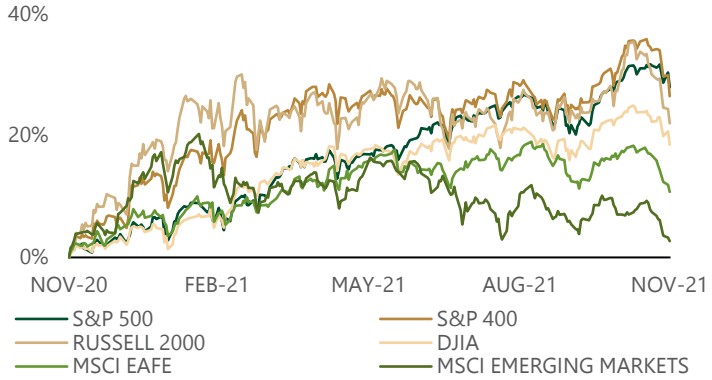
October U.S. retail sales increased 16.3% on a year-over-year basis due to a large push in online shopping. Supply bottlenecks will likely be a main determinant for future growth around the holidays.

Existing home sales declined 5.8% on a year-over-year basis in October; however, on a month-over-month basis and a seasonally adjusted rate, existing home sales are at a nine-month high. Additionally, sales of previously owned homes are well above pre-pandemic levels, with sales on track to be the strongest since 2006.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, NOVEMBER 2020 THROUGH NOVEMBER 2021



Source: Bloomberg. Past performance is no guarantee of future results.

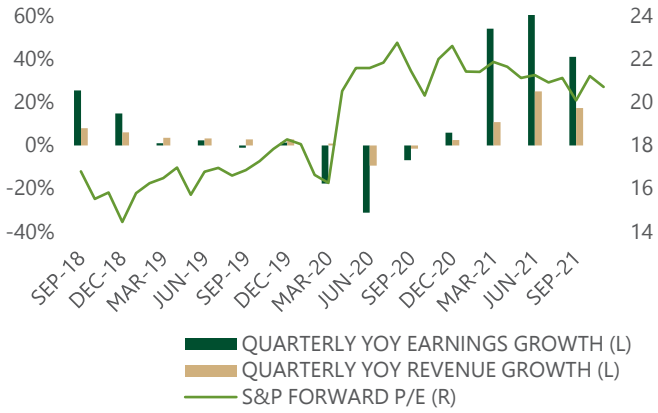
Major U.S. stock indexes rose to record highs in early November as strong third quarter earnings outweighed inflation concerns. However, stocks' gains were erased late in the month after news of the Omicron COVID-19 variant triggered a sharp sell-off. Hawkish comments from Federal Reserve officials suggesting the Fed could expedite their asset purchase taper also weighed on stocks.

The S&P 500 ended November with a 0.69% loss. Smaller capitalization stocks were hit especially hard due to their greater economic sensitivity. The Russell 2000 index fell 4.17% in the month.

Foreign stocks trailed the U.S. as some European countries tightened restrictions in response to the rising number of new COVID-19 cases.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, SEPTEMBER 2018 THROUGH NOVEMBER 2021



Source: Bloomberg

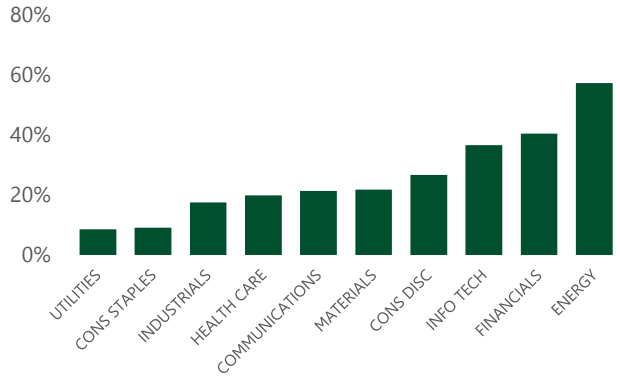
Second quarter earnings season is almost complete with 496 S&P 500 companies reporting results. Analysts continue to underestimate the strength of the earnings recovery. S&P 500 earnings are on pace for 41.07% growth compared to analysts' initial projection for 28.35% growth.

Around 83% of S&P 500 companies have exceeded analysts' earnings estimates, which is above the five-year average beat rate of 76% and long-term average of 64%.

Analysts project one more quarter of elevated earnings growth of 18.96% in the fourth quarter, followed by a sharp deceleration to single-digit growth in the first quarter of next year due to tougher year-over-year comparisons.

S&P 500 SECTORS 12-MONTH PRICE RETURNS

NOVEMBER 2020 THROUGH NOVEMBER 2021



Source: Bloomberg

Technology and consumer discretionary were the only two sectors with positive returns in the month. Semiconductor stocks in the technology sector performed especially well amid strong third quarter earnings results and Meta's (parent company of Facebook) announcement to increase its data center capital spending for the metaverse.

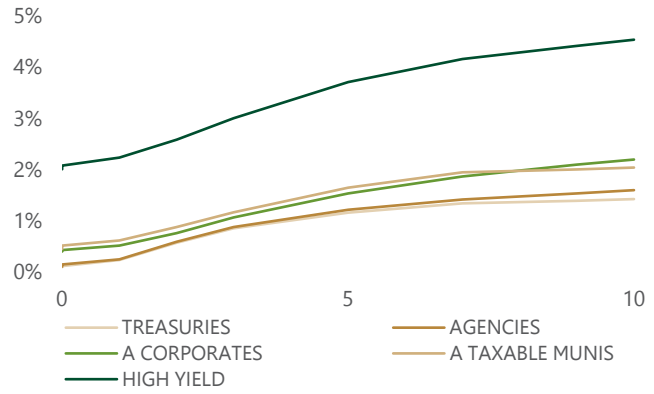
Financials and energy were among the worst performing sectors in the month with each falling over 5%. Uncertainty regarding the Omicron variant and its potential economic impact weighed on bond yields and oil prices.

Travel and leisure stocks in the airline, hotel, and cruise industries fell around 8% or more in the month as the Omicron variant created uncertainty for those industries' outlook.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF NOVEMBER 2021



Source: Bloomberg

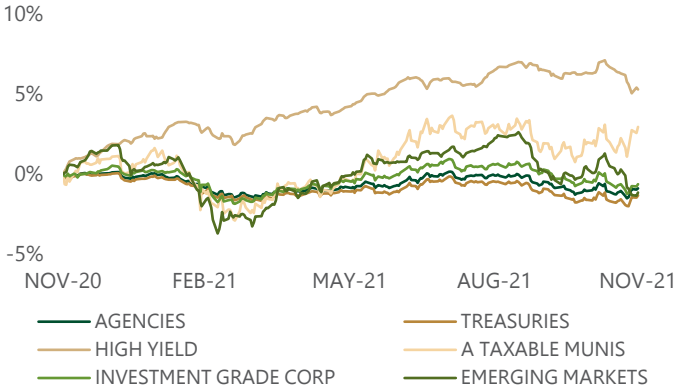
The U.S. Treasury curve flattened in November as the 10-year Treasury yield declined 11 basis points (bps) to end the month at 1.45%, while the two-year Treasury yield rose 7 bps in response to a more aggressive Fed policy outlook.

Shorter dated U.S. Treasury yields out to three-year maturities have finally moved off historically low levels in anticipation of reductions in Fed asset purchases and an increasing number of Fed officials projecting at least one rate hike by the end of 2022. Two-year Treasury yields closed November at a 20-month high of 0.57%.

Single A-rated Taxable Municipal yields are noticeably higher than single A corporate bond yields out to seven-year maturities despite similar credit rating profiles.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

NOVEMBER 2020 THROUGH NOVEMBER 2021



Source: Bloomberg. Past performance is no guarantee of future results.

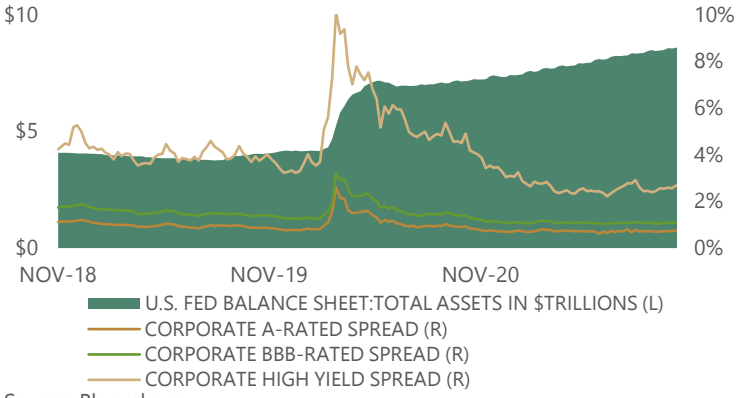
Above-trend economic growth and an accommodative policy backdrop have enabled lower quality bond segments to outperform their higher quality peers over the last twelve months.

Single A-rated Taxable Municipal yields reported a healthy 12-month return of 3.0% meanwhile investment grade corporates posted a negative return of 0.6% despite the two segments having similar credit rating profiles. The $1.2 trillion Infrastructure Investment and Jobs Act signed into law by President Biden in November has created a supportive backdrop for the municipal market.

Relative dollar strength in 2021 contributed to U.S. high yield bonds outperforming emerging market bonds despite each having similar credit quality.

FED BALANCE SHEET EXPANSION AND CREDIT SPREADS

NOVEMBER 2018 THROUGH NOVEMBER 2021



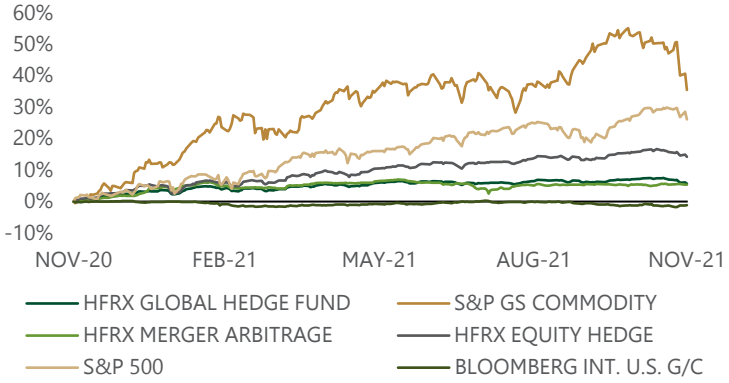
Source: Bloomberg

The Federal Reserve's balance sheet has expanded by roughly 107% during the pandemic to $8.7 trillion in October from $4.2 trillion in February 2020. The Fed communicated in its November 2-3 meeting that it will begin to reduce its bond purchases by $15 billion per month, but will remain flexible with the pace of tapering subject to economic conditions.

In mid-August, U.S. corporate high yield credit spreads touched their widest levels since early February amid a surge in COVID-19 cases driven by the Delta variant. High yield spreads have stabilized lower over the ensuing sixteen weeks as case counts have peaked and the economic outlook has improved.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS
NOVEMBER 2020 THROUGH NOVEMBER 2021



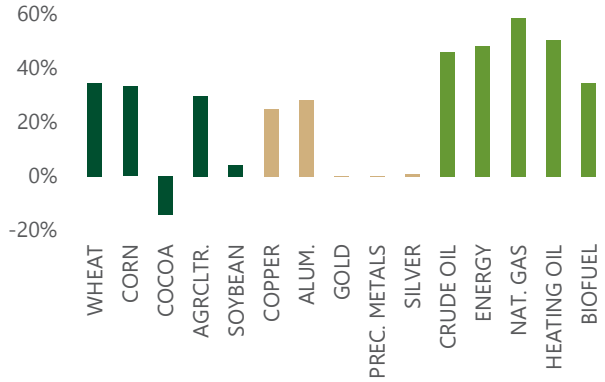
Source: Bloomberg. Past performance is no guarantee of future results.

The S&P GSCI, a broad commodities index, fell 10.8% in November following the discovery of the COVID-19 Omicron variant and strategic oil reserve releases by a group of major economies including the U.S.

The HFRX Global Hedge Fund Index declined 1.29% in November, which trailed both the S&P 500 (-0.69%) and the Bloomberg Intermediate Government/Credit Index (+0.12%).

The HFRX Merger Arbitrage Index was flat in November amid normal levels of merger and acquisition deal activity. Systematic trend-following hedge fund strategies had a particularly difficult month amid sharp declines in crude oil, natural gas, zinc and platinum.

COMMODITIES, 12-MONTH SPOT RETURNS
NOVEMBER 2020 THROUGH NOVEMBER 2021



Source: Bloomberg. Past performance is no guarantee of future results.

The U.S., Japan and other large oil-consuming nations released strategic oil reserves in November after the Biden administration failed to convince OPEC and its allies, led by Saudi Arabia and Russia, to increase crude oil production.

Wheat prices advanced 4.4% in November after climbing 7.4% in October. A Russian export duty and elevated demand from large Middle Eastern and Asian countries have created an imbalance in global wheat markets in recent months.

Gold prices were relatively flat in November after a modest 1.5% gain in October. Throughout 2021, the headwind of U.S. dollar strength has offset gold's traditional usage as a safe haven asset and inflation hedge.