Trust & Financial Services
HILLTOPBANK
www.hilltop.bank

QUARTERLY MARKET INSIGHTS – FIRST QUARTER 2022

To the Clients and Friends of Hilltop Trust and Financial Services:

The first quarter of 2022 brought with it one topic, of which we are all aware, that requires a place of preeminence in this or any other discussion of economic conditions. Unfortunately, that topic is not a pleasant one to read or write about, and that is the decision by Vladimir Putin to invade another sovereign nation.

In this second-quarter newsletter I will add some context to this horrible development, explain what it could mean for us as investors, and finally, attempt to demystify the course-correction the Fed is currently undertaking.

Ukraine and Russia

First and foremost, any discussion of Ukraine needs to acknowledge the immense human suffering that is occurring as a result of the invasion. At the time of this writing, the UN estimates at least 3,455 noncombatant casualties and another four million external refugees. There are almost daily reports of indiscriminate bombings of civilians, accusations of Russians committing horrible atrocities, and a country's populace forced to take up arms to defend its very right to self-governance.

Being an expert in neither military affairs nor geopolitics, I'll keep this letter to what I do know about, which is that Russia's destruction of the Ukrainian economy, and the West's attempted destruction of Russia's in response, will have significant reverberations - not just on those two nations, but across the globe.

To set the stage, while Russia represented just 3% of global GDP prior to the invasion, and Ukraine less than 1/3rd of 1%, they were both major suppliers of raw materials to the global economy. Russia was the #1 exporter of natural gas, the #2 exporter of oil, the #3 exporter of coal, the #3 exporter of aluminum, the #1 exporter of palladium, the #3 producer of gold, and the #8 exporter of iron ore. Ukraine itself was the #5 exporter of iron ore, the #5 exporter of wheat, the #4 exporter of corn, and produced 90% of the neon used to manufacture microchips in the U.S.

While Ukraine has more important things to worry about now, its previously-burgeoning economy is estimated to contract as much as 35% this year. For Russia, the outlook is similarly grim. Economists expect Russia's loss as a result of western sanctions to be 10-15% of their GDP. For reference, the 2008 recession resulted in a total loss of just 4.3% of GDP in the U.S.

This economic disaster is entirely self-inflicted for Russia. Instead of the disjointed, uncoordinated response Putin expected from the West, sanctions have been unprecedented and near-universal. They include a ban on Russian flights in western airspace, removal of Russian banks from international financial systems, and asset freezes for over 1,000 Russian individuals and business. Of Russia's $630 billion in foreign reserves, roughly half has been cutoff and sequestered by its custodians. Their financial markets have been hamstrung, foreign direct investment has disappeared, and over 400 multinationals have announced they will cease operations in the country.

What it Means

In a general sense, up until the pandemic the modern economy was constructed around the basis of international trade flows and just-in-time inventories. These meant sellers could bring goods in from the cheapest, global source, and ship them out without long, inefficient waits in a warehouse. As anyone who has tried to purchase a car, household appliances, or even fill up their gas tank has come to appreciate, that structure seized up in 2020 and those supply chains have remained snarled ever since.

What the invasion of Ukraine adds to this predicament is a substantial reduction in the supply and availability of the raw materials needed even further down the chain of production. In short, the invasion of Ukraine will mean a substantial supply shock for the global economy, at a time when we are still recovering from the effects of the pandemic. All of those raw materials listed above, and all of the goods that incorporate them, will become harder to source and more expensive. In our globally-connected economy, that has an impact on everyone to varying degrees.

It will have an unimaginable impact on Ukrainian citizens, whose lives have been irreparably transformed. It will have significant impact on the average Russian, who is already finding store shelves empty of the products they hope to buy. It will have an impact on Europeans, where Russian oil represents 27% of the market and Russian gas 40%. It will have an impact on developing nations, where farmers are already finding it difficult to get the fertilizer they need to feed their own citizens.

For those of us lucky enough to have won the genetic lottery that let us be born in the United States, there will be less impact – we don't have to worry about bombs falling on our houses, or heating our homes next winter - but there won't be none, and it's not the only thing roiling markets.

For that, let's talk about something a little more familiar.

This Economy of Ours

One thing those of us who have chosen to live our lives on the high plains know a little something about is winter driving.

Imagine you're out on the highway just a few months ago, in the depths of December. It could be I-25 or a country two-lane, but hopefully not I-80. The car has been in the shop for what seems like forever (say, since March 2020) and the mechanic is now hopeful everything is back to normal. As you go down the road, however, you start to hear a knocking. Maybe there's ice built up on an intake, or a blockage in the fuel line. Either way you have places to be, and you're an optimist, so you ignore it and hope it goes away as the car warms up. Instead, you realize it's getting louder as you get up to speed.

This is more or less the situation the Chairman of the Federal Reserve finds himself in today. The ignored engine trouble turned out to be the persistent problems with our supply chains, the knocking at high speeds is our now plainly non-transitory inflation, and the road ahead is a sheet of ice. Quite frankly, the economy is moving too fast for conditions, and his task is to slow it down without applying such excessive force that it locks up the brakes and sends us careening into the ditch.

In this metaphor, the Fed's brakes are the ability to raise interest rates. In the most basic sense, inflation is caused by a mismatch of supply and demand. Because aggregate demand is outpacing our supply chain's ability to keep up, prices have risen and the knocking intensified. The Fed can't fix the supply with the car in motion, so what they need to do is decrease aggregate demand until the economy slows and prices normalize. Higher interest rates accomplish this by making things that were worth taking on debt to purchase seem less appealing, and in that way reducing consumption. Raise rates too much, however, and the slowing effect will be too much for our economy to handle, and lead us into a recession. This balancing act is what you will hear referred to often in the next year-or-so as orchestrating a "soft landing".

In March, the Fed met and agreed to begin this slowing process with a 25-basis point hike to their benchmark interest rate. Throughout the rest of this year, they are predicted to follow this up with further rate hikes, and begin the transition I wrote about last quarter, from quantitative easing to quantitative tightening. Whether or not the Fed can apply just the right amount of pressure is the million-dollar question.

I can always be correct if I predict a recession at some point in our future. The cyclical nature of our economy dictates that there is always one somewhere off on the horizon. A more difficult question, is when that recession might come, and how bad it could be? Assuming the worst, that the Fed does misjudge, and we are

headed for one in the next few years, we are lucky to have a bit of a cushion in the form of strong economic fundamentals.

In the aggregate, the U.S. consumer is in excellent financial shape. They have saved $2.6 trillion more than they had just before the pandemic. Despite a hot housing market, 67% of new mortgage debt originated in the fourth quarter of 2021 was to borrowers with credit scores over 760, and just 2% was to subprime borrowers (a sharp contrast to the 12% average between 2003-2007). While Americans have borrowed $1.4 trillion more than they had outstanding at the end of 2019, the delinquency rates on that debt are down from 4.7% in Q4 2019, to 2.0% in Q3 2021, among the lowest on record. This is a much different economy than in 2007.

Finally, Investment Advice

From an investor's perspective, the confluence of the war in Ukraine, the need to raise rates quickly and dramatically to tame inflation, and the increased likelihood of recession mean a time of relatively less certainty among market participants. When uncertainty rises, it's generally bad for risk assets. Across asset classes this has led to a poor start to the new year. Taking a broader perspective, however, can grant some valuable perspective.

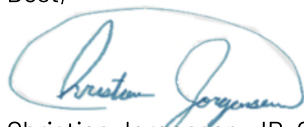
First, geopolitical sell-offs are typically short-lived. The average total return of the S&P 500 in the six months after such significant events as the Iraq war, the Arab spring, the annexation of Crimea, the Brexit vote, and all others going back to 1956 was +5%. The average total return one year from those significant events was +9%. The market has a short memory.

Second, since 1980, nine of the twenty best trading days in the S&P 500 occurred in years with negative total returns (and eleven of the twenty worst trading days occurred in years with positive total returns). One day's movement simply doesn't have predictive capacity over what will transpire the other 253 trading days of the year. Even for myself, whose job requires observing markets every day, I've found the exercise of checking my own portfolio on a much less frequent basis a healthy practice.

Third, in that same span since 1980, the nine bear markets have averaged total returns of -28%, but have lasted an average of just 236 days. The ten bull markets have averaged total returns of 99%, and lasted an average of 852 days. It may be that 2022 is not a banner year for our portfolios, but as the old adage goes, time in the market beats trying to time it.

For all of us here at Hilltop, we appreciate you allowing us to help you meet your financial goals. As always, if you'd like to discuss your investments in more detail your Trust Officer is just a phone call away.

Best,



Christian Jorgensen, JD, CFA
Vice President, Investment Strategist