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Q1 2022 Prometheus Capital Newsletter

This has been an extremely eventful quarter and although there is too much to cover in one newsletter, I'll discuss some of the highlights, and in particular, the current state of the U.S. and global economy, inflation, the state of the U.S. equities and debt markets, recent overall market volatility, the Ukraine conflict, and Federal Reserve action.

What is going on with the U.S. economy?

The U.S. experienced fairly strong jobs growth in March, with nonfarm payroll increasing by 431,000 and the U.S. unemployment rate declining 0.2% to 3.6%.[1] For context, that March 2022 unemployment rate of 3.6% is slightly above the pre-pandemic unemployment rate of 3.5% in February, 2020. We continue to see an extraordinarily tight labor market with U.S. wages and benefits rising to a two-decade high as inflation picks up. The U.S. employment-cost index (a quarterly measure of wages and benefits paid by employers) showed a 4% non-seasonally-adjusted gain in the fourth quarter of 2021 compared to a year ago.[2]

Despite the impact of the pandemic, U.S. corporate earnings have remained robust with corporate pre-tax profits surging 25% year-over-year in 2021 to $2.81 trillion; and **corporate profits increasing 37% year-over-year**, which represents the **largest year-over-year increase in U.S. corporate earnings since the Federal Reserve started tracking profits in 1948**.[3] Some analysts are predicting an overall slowdown in corporate earnings growth in 2022 driven by increased production costs, supply chain issues, and surging oil prices which could impact consumer discretionary income.

This strong jobs and wage growth should be viewed in the context of a broader surge in the U.S. inflation rate. As I am sure all of you have experienced first-hand, the prices of staple goods have increased dramatically in recent months. I have been acutely aware of my increasing grocery bill each week – I finally took a stand when strawberries hit $7 / box and refused to buy them.

The annual inflation rate accelerated to a **four-decade high of 7.5%** in January 2022![4] Although many factors can impact the inflation rate, two recent factors that may have contributed to this historically high inflation rate were government stimulus through the pandemic and global supply chain disruptions. Throughout the pandemic the U.S. government attempted to stimulate the economy through fiscal policy actions (such as congress approving tax reductions and stimulus checks) and monetary policy (such as the Federal Reserve

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[1] *U.S. Bureau of Labor Statistics, March Employment Report (https://www.bls.gov/news.release/empsit.nr0.htm)*
[2] *The Wall Street Journal "U.S. Wages, Benefits Rose at Two-Decade High as Inflation Picked Up" (https://www.wsj.com/articles/us-employers-labor-costs-inflation-11643331612)*
[3] *U.S. Bureau of Economic Analysis, Corporate Profits After Tax (https://fred.stlouisfed.org/series/CP)*
[4] *U.S. Bureau of Labor Statistics, Feb-2022 Consumer Price Index Press Release (https://www.bls.gov/news.release/pdf/cpi.pdf)*

reducing the Federal Funds rate by 1.5% in March of 2020, and initially embarking on a large-scale quantitative easing strategy of purchasing debt securities).[5] At least in the near term, it is safe to assume that a historically-elevated inflation rate is here to stay.

The Federal Reserve has a dual-mandate from the Congress: to maximize employment and maintain stable prices. The Federal Reserve announced it intends to embark on a series of rate hikes in order to help combat inflation. At its March 2022 meeting, the Federal Reserve's Open Markets Committee approved a 0.25% rate increase of the Federal Funds Rate (which represents the FOMC's first rate hike since December 2018), and announced it will likely increase rates an additional 6 times this year.[6] The market consensus is generally aligned with that outlook; in a recent equity research note, Goldman Sachs' Chief Economist Jon Hatzius noted that he is anticipating seven 0.25% rate hikes this year and four next year for a terminal rate of 2.75-3%.[7]

How do Federal Reserve rate hikes impact you?

One of the key risks for the U.S. economy is if the Federal Reserve increases interest rates too quickly and it leads to a recession. If the Federal Reserve increases interest rates faster than the market is pricing in, it could also negatively impact the price of bonds. Longer term and lower-yielding bond investments tend to have the greatest duration, and therefore could be most impacted by price declines in rising rate environments. Given the increased interest rate risk, we are very cautious in the near-term regarding bond investments and are considering factors on how to decrease price risk (through inflation-protected instruments and lower weighted average duration funds and portfolios). Increasing interest rates is also going to make borrowing more expensive for clients with variable-rate loans, or in the market for new auto or home mortgages.

I would be remiss not to dedicate a portion of this newsletter to discussing the conflict in Ukraine. Along with many of you, I am worried and praying for the Ukrainian people in this terrible time, and also the unfortunate Russians whose lives have been affected by Vladimir Putin's unsolicited invasion. I have found a few organizations that are helping Ukrainians in creative ways. Feel free to talk to me personally if you know of any ways to contribute to organizations making an impact.

How has the conflict in Ukraine impacted the markets?

One of the immediate impacts of this conflict has been a sharp rise in commodities prices, and in particular, oil & gas prices. Oil & gas prices had been creeping up steadily in 2021 and 2022 due to an imbalance in oil consumption and oil production since mid-2020; and this conflict drove prices up even further driven by a reduction in global oil supply due to sanctions and potential disruption to oil production and infrastructure. A number of major energy companies including ExxonMobil, Shell, BP and Equinor have announced that they are shutting down oil and gas operations in Russia and even more energy traders and shipping companies are refusing to purchase Russian oil & gas. On February 28th of this year, the **Brent crude oil price settled at over $100 per barrel for the first time since September 2014;** and my family has certainly experienced sticker shock at the price of filling up a tank of gas these days.[8]

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[5] *Brookings Institute, Federal Reserve Response to COVID-19 Crisis (https://www.brookings.edu/research/fed-response-to-covid19/)*
[6] *CNBC, Federal Reserve Approves First Interest Rate Hike in More than Three Years, Sees Six More Ahead (https://www.cnbc.com/2022/03/16/federal-reserve-meeting.html)*
[7] *March 16, 2022 Goldman Sachs Economics Research Note: US Daily: March FOMC Recap: A Hawkish Liftoff*
[8] *U.S. Energy Information Administration (https://www.eia.gov/outlooks/steo/marketreview/crude.php)*

As oil & gas supply and demand re-adjusts, prices may return to normal but the immediate term higher oil prices may be here to stay. Goldman Sachs downgraded its 2022 U.S. Real GDP growth forecast to 1.75% as a result of higher oil prices and other drags on growth as a result of the war in Ukraine; and estimated that near-term crude oil & agricultural commodities forecasts imply an effective **0.7% drag on real disposable income** that will weigh on consumer spending in 2022.[9] As householders are forced to spend a larger share of income on food and gas, consumer spending may slow.

What is happening with the Stock Market?

The U.S. equities market has been trending down after a large increase from around June 2020. As of March 31, 2022, the Dow Jones Industrial Average (DJIA) declined 4.1%, the S&P 500 index declined 4.6% and the NASDAQ composite index (which is more technology and growth focused) declined 9.6% year-to-date.[10] Some of this decline can be attributed to a reaction to the Federal reserve tapering off its bond buying program and increasing interest rates. Additionally, some investments have been overpriced in the short-term, especially growth-oriented and speculative investments. Institutional investors appear to be less willing to reward high revenue growth unprofitable technology companies with lofty valuations, and are instead shifting their focus to sustainable earnings growth.

While **past performance is no guarantee of future performance**, most of you have been richly rewarded for "staying the course" in 1987, 1998, 2000-2002, 2008-2009, 2010 and 2020 and **opportunistically taking advantage of buying opportunities at depressed valuation multiples, and dollar-cost-averaging** instead of immediately selling positions when the market declined slightly. Key areas of the market to monitor include the price of oil and a *potential* shift from investors rewarding unprofitable growth-at-all cost investments to prioritizing value-oriented investments and funds. I would also note that historically whenever there has been market volatility, especially with a global conflict as the backdrop, there has usually been a "flight-to-quality" as investors shift into investments and currencies they view as safer. That global push to move wealth into safer currencies has the potential to help make the dollar stronger versus international currencies, and those currency fluctuations are a portion of the reason international stocks and funds have experienced greater decreases than their U.S.-based peers.

My parting comment to you all would be to maintain the long-term investment outlook that served you well over the prior periods of market volatility and keep on the lookout for buying opportunities.

Please feel free to reach out to the Prometheus Capital team with any questions or if you'd like to discuss your current portfolio.

Sincerely Yours,

Steve Wetzel

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[9] *March 10, 2022 Goldman Sachs Economics Research Note: Downgrading Our GDP Forecast to Reflect Higher Oil Prices and Other Growth Drags from the War in Ukraine.*

[10] *Standard & Poor Global Data as of 31-Mar-2022*

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Sources: U.S. Bureau of Labor Statistics, The Wall Street Journal, Standard and Poor's Global, Brookings Institute, CNBC, U.S. Energy Information Administration, Goldman Sachs