FIRST NEBRASKA Trust COMPANY

First Quarter 2022

Quarterly Letter to Clients

By Chad G. Reeson, CFA

April 12, 2022

After a very calm 2021, volatility returned in the first quarter of 2022 – despite a waning COVID-19 pandemic. Inflation surged to 40-year highs, the Federal Reserve introduced tighter monetary policies, and Russia surprised the world with a full-scale military invasion of Ukraine, marking the first major military conflict in Europe in decades. In the capital markets, the quarter was characterized by wild swings in stock, bond, and commodity prices worldwide, pushing both stocks and bonds, which often move in opposite directions, into the red for the quarter.

In January, volatility increased as inflation readings hit multi-decade highs, prompting the Federal Reserve to signal interest rate hikes faster than markets anticipated. The prospect of sooner-than-expected interest rate hikes weighed heavily on stocks. The sectors with the highest valuations (i.e., growth-oriented technology stocks) were hit the hardest. Additionally, while the fourth-quarter earnings were generally positive, several large, widely held tech companies posted disappointing results and reduced forecasts, contributing to market volatility. Collectively, that led to the worst first-month stock performance since 2009.

February added even more volatility. Just as the markets seemed to be getting comfortable with the prospect of higher interest rates, western government warnings of a Russian invasion of Ukraine were fulfilled on February 24th. The conflict sent commodity prices such as oil, corn, natural gas, and wheat surging, as commodity producers and consumers feared production disruptions and supply shortages could slow the global economy. Those fears sent stocks into correction territory, falling by more than 10% from their all-time highs and ending negative for a second month.

Despite attempts at peace talks, the war in Ukraine intensified in March, prompting unprecedented economic sanctions against Russia. There is little doubt that the economic sanctions will have an extraordinary impact on the Russian economy; however, it isn't fully apparent to what degree the sanctions will hurt those imposing them. So far, the evidence would suggest that Europe stands to suffer the most because it relies heavily on Russian oil and natural gas exports. Yet, it seems reasonable that, at a minimum, the war in Ukraine will also hurt the global economy because of its impact on supply chains. Even if the war ended tomorrow, it would likely have shifted geopolitics for a long time, and in ways we may not yet foresee. On one end, the U.S. and Europe are more aligned than they have been in a while. On the other end, China and Russia may be inching closer together as well.

Despite all the challenges during the quarter, stocks mounted a strong rebound in late March thanks to incrementally positive geopolitical and monetary policy news. The Russian advance was stalled by Ukrainian resistance, lowering the conflict's probability of spilling beyond the Ukraine border. On March 16, 2022, the Federal Reserve raised rates by 25 basis points, as expected. That sparked a rally in stocks that helped claw back most of the losses by the end of the quarter.

Economic Overview

During the quarter, energy prices spiraled higher due to supply and demand imbalances caused by the strong global economic recovery. The surge higher was also exacerbated by fears that the Russian invasion of Ukraine would cause supply disruptions in the energy markets. As a result, the war pushed oil prices to a 14-year high of $125 per barrel before retreating 20% to close out the quarter, ending near $100 per barrel – a 33% increase for the quarter. Higher oil prices led to pain at the pump for consumers. The national average cost for regular gasoline was $4.23 per gallon at quarter-end, or $0.95 higher than the January 3rd price of $3.28 and $1.38 higher than a year ago. The higher prices are eating into disposable income, leaving consumers with less money to spend on other goods and services.

The Consumer Price Index (CPI), which measures what consumers pay for goods and services - accelerated in the first quarter. January, February, and March increased by 7.5%, 7.9%, and 8.5%, respectively. The March reading rose at the fastest annual pace since December 1981. That marked the sixth straight month of inflation above 6.0% - well above the Federal Reserve's target. There was strong inflation momentum across the board, both for goods and services, driven by skyrocketing energy and food costs, supply constraints, and strong consumer demand.

The Producer Price Index (PPI) for goods and services jumped 0.8% in February, following a 1.2% increase in January on a month-over-month basis. Producer prices increased 10.0% in February compared to the same month in 2021. Unlike the CPI, a lagging indicator, the PPI is a leading indicator, foreshadowing changes in the closely watched CPI.

The Federal Reserve confirmed that it's serious about getting inflation under control, even if it comes at the expense of growth. In March, the Fed hiked the federal fund's target rate by 25 basis points, putting the new target range at 0.25% to 0.50%. The last time the Federal Reserve raised short-term rates was in December 2018. From here, Fed officials have indicated an aggressive path ahead, with rates rising at each of the remaining six meetings in 2022. The federal funds rate is expected to end 2022 at 2.00% - 2.25%. With the Fed seemingly feeling the need to catch up to regain control of inflation, the rapid-fire pace of aggressive interest rate increases heightens the chances of a policy error that could be enough to topple the economy into a recession.

Gross Domestic Product (GDP), the primary measure of economic growth, rose 7.0% in the fourth quarter of 2021 compared with a 2.3% advance in the third quarter. Most of the increase was due to inventory accumulation. As measured by the personal consumption expenditures index, consumer purchases grew modestly by 2.5%. Spending on goods rose by 1.1%, while spending on services climbed by 3.3%. However, consumers are facing headwinds in higher energy and food prices that could ultimately impact a broad range of sectors in the coming months. The Conference Board forecasts that U.S. real GDP will slip to 1.8% in the first quarter of 2022, vs. 7.0% growth in Q4 2021. According to the most recent estimate, full-year 2022, GDP is predicted to moderate and grow by 3.0%.

U.S. retail sales slowed to a 0.3% monthly clip in February, marking the slowest rate since December's 2.7% monthly decline. However, retail sales were still up by 17.6% compared to last year's same month. Meanwhile, real personal spending (which removes the effect of inflation) fell by 0.4% in February, suggesting that rising prices were taking a bite out of the amount of purchases consumers were making. This was especially apparent in goods, where real spending was down by 2.1%. Nevertheless, real services spending rose by the most since last July, increasing 0.6%.

The labor market added 431,000 jobs in March, which marked the 15th straight month it has expanded. During the quarter, job growth averaged 562,000 per month and matched the average monthly gain for 2021. The gains moved the unemployment rate to 3.6% from 4.0% in January, just above the pre-pandemic unemployment rate of 3.5%. Total claims (1,307,000) for unemployment insurance fell to the lowest level since 1969. A year ago, there were 3,753,000 total claims for unemployment benefits. Though some workers have come off the sidelines in recent months, the labor force remains depleted – leaving employers short-handed. As a result, average hourly wage growth continued to accelerate (5.6% YoY) above pre-pandemic levels, suggesting that inflationary pressures are continuing to build amid ongoing labor shortages. Unfortunately, inflation is undermining workers' purchasing power, as real wages have dropped on a year-over-year basis for 11 straight months.

After ten consecutive years of home price increases, the current U.S. median home sales price in February was $357,300, more than double the $155,600 median in February 2012, when home prices began their current streak. However, according to the latest survey from the National Association of Realtors®, housing affordability continues to be a major challenge, as buyers are getting a double whammy: rising mortgage rates and sustained price increases. According to Bankrate, the 30-year and the 15-year fixed national average mortgage rates for loans with a 20% down payment ended the quarter at 4.91% and 4.07%, respectively. The rate for a 30-year was just 3.36% one year ago.

Despite the headwinds (e.g., higher interest rates, inflation, etc.) facing the economy, the Conference Board Consumer Confidence Index rose slightly in March following a decline in February. Based on consumers' assessment of current business and labor market conditions, the Present Situation Index also improved in March. While sentiment data indicate how consumer spending may trend in the future, the measure has little impact on today's economy. Many people are spending even if they say they want or plan to spend less.

<u>Stocks</u>

All four major U.S. equity indices posted negative returns for the first quarter of 2022 (as noted in the table below). However, the Dow Jones Industrial Average (DJIA) and S&P 500 saw only mild losses compared to the Russell 2000 and Nasdaq. January turned out to be the worst first-month performance for stocks since 2009. By market capitalization, large-cap stocks (i.e., S&P 500) outperformed smaller capitalization (i.e., Russell 2000) stocks, largely driven by the rise in geopolitical uncertainty and rising interest rates. Small-cap stocks tend to be more reliant on debt than their larger peers, and therefore, rising interest rates can be a headwind for them.

Quarterly Market Performance % Barometer	
US Equity Indexes	**Q1 2022**
S&P 500	-4.6%
DJ Industrial Average	-4.1%
Nasdaq	-8.9%
Russell 2000	-7.5%
MSCI ACWI Ex USA (Foreign Dev & EM)	-5.3%
Source: Morningstar Direct. Morningstar Indexes. Data as of March 31, 2022	
Performance Shown in Total Return USD	

In a knock-on effect of rising yields, some of the stock market's strongest performers in recent years saw share prices fall sharply, causing investors to rotate out of growth-oriented, high valuation technology stocks and into sectors that are more exposed to the traditional economy, which has traded at cheaper valuations relative to the tech sector for years. As a result, Morningstar's U.S. Value Index rose 2.4% for the quarter, while the Morningstar U.S. Growth Index lost 12.0%.

Quarterly Market Performance % Barometer	
Equities	**Q1 2022**
U.S. Market	-5.3%
Value	2.4%
Growth	-12.0%
Developed Markets - ex-US	-5.2%
Emerging Markets	-5.9%
Source: Morningstar Direct. Morningstar Indexes. Data as of March 31, 2022	
Performance Shown in Total Return USD	

Only two of eleven sectors finished the quarter with a positive return. The energy sector was the clear standout, benefitting from a surge in oil and natural gas prices due to the ongoing supply/demand imbalance and the Russia-Ukraine war. A traditionally defensive sector, Utilities, also logged positive returns, as investors looked for safety in response to market volatility and uncertainty.

Bonds

The bond market responded unequivocally to the Fed's decision to embark on a more aggressive rate increases path than expected, causing it to suffer its worst quarterly performance in 20 years. Most major bond indices declined as investors exited fixed-income holdings in the face of higher-than-expected inflation and as the Federal Reserve signaled that interest rates would rise faster than expected.

With inflation hotter than anticipated, the safest sector for bond investors has been the Treasury Inflation-Protected Securities market (TIPS). Still, even TIPS couldn't fully offset the impact of a more aggressive Fed. The Morningstar U.S. TIPS Index declined by 2.4% for the quarter, but that was still ahead of all other Morningstar fixed-income indexes.

The Morningstar US 5-10 Year Treasury Bond (Core) Index fell 5.9% during the first quarter. Since its peak in August 2020, the Core bond index has lost nearly 10.0%.

Morningstar Bond Index Performance %	
Broad Market	**Q1 2022**
Core Plus Bond (US 5-10 Year Teasury)	-5.9%
Sector	
U.S. Treasuries	-5.5%
Corporate	-7.9%
High Yield	-4.5%
Mortgage	-5.0%
Maturity	
Short-Term Core	-3.6%
Intermediate Core	-6.0%
Long-Term Core	-11.3%
Inflation-Protected	
TIPS	-2.4%
Source: Morningstar Direct. Morningstar Indexes. Data as of March 31, 2022	
Performance Shown in Total Return USD	

The hardest-hit bonds were those with longer maturities, which are more sensitive to interest-rate changes. The long-term core bond index declined by 11.3%, compared to a 3.6% loss in the short-term bond index. High yield bonds (-4.5%) outperformed U.S. Treasuries (-5.5%) as investors continue to pour money into risky bonds in search of yield.

Yields on both short- and long-term bonds jumped to their highest levels in years. The U.S. Treasury two-year note rose to 2.28% from 0.73% at the end of 2021, while the 10-year rose to 2.32% from 1.50%. The more pronounced move on the short end of the yield curve resulted in a flatter yield curve that appeared to be headed towards an inversion. Historically, inverted yield curves have preceded recessions.

As we move into the second quarter of the year, the outlook for capital markets and the economy remains highly uncertain, as headwinds from inflation, less-accommodative monetary policy, and geopolitics stay in focus. However, it’s also important to note that the U.S. economy is still strong, and unemployment remains near historic lows. Even if we experience temporary bouts of volatility as we did in the first quarter, we will continue to focus our attention on constructing portfolios to meet your long-term goals while minimizing the risks of permanent capital loss.

We thank you for your ongoing confidence and trust. If you have questions or comments, please don’t hesitate to contact us.