Market Review and Outlook
March 31, 2022

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Market Environment

March 31st, 2022

- Economy
  - As the nightmare pandemic tries to fade to history, economic momentum still in place from excessive stimulus will drive the US economy through 1H 2022.
  - Flushing out remaining supply chains, rebuilding inventory and return to travel, the office, and eating out will provide broad based activity and continued employment gains.
  - The Russian invasion of Ukraine will have significant impact on commodity prices and exacerbate inflation, but little direct impact on the US economy.
  - The current economic headwinds of inflation, employment (shortage), and supply chain disruptions were well seeded prior to the Russian invasion of Ukraine, and will take time to normalize.
  - Inflation is reaching new highs and continues to accelerate in broad fashion. CPI = 7.9%, PCE = 6.4%, Unemployment = 3.6%.
  - Monetary policy is a disaster, as the Fed talks about tightening via rate hikes with little action, yet continues to stimulate via active Quantitative Easing. They will have to move aggressively and risk a recession.
  - Home sales remain robust with 19% Home Price appreciation (HPI) amid still low rates from Fed policy and high prices from still high demand and low inventories.
  - The dislocations in the housing market (supply/demand imbalance) continue to be evident in many other industries such as auto's, grocery stores, restaurants, hotels and other goods and services; where having the goods to sell and/or having the workers to deliver the services remains problematic.
  - Input costs including commodities and raw materials, manufacturing and operating, freight and transportation and employment costs have risen significantly, and companies are passing those costs along to increased final prices and fewer discounts**. Price pressures are persistent, not transitory.**
  - Payrolls should continue to increase as government benefits continue to expire and there continue to be more jobs available than people looking for work.
  - There is a significant risk of a negative GDP in the next few quarters as inflation measure may be higher than nominal GDP.

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Market Environment

March 31st, 2022

- Policy
  - Monetary policy is a disaster as the Fed talks about tightening while in reality continuing to ease amid accelerating inflation, despite owning up to error. Continuing to buy Treasury and Mortgage bonds keeps long rates low.
  - Despite discussion (and votes) for 50bp hike, the Fed tightened 25bp in March. There is no choice but to tighten 50bp at the next (May) meeting and perhaps a few more in 2022. Expectations are for the Fed Funds to end the year at around 2% with active work to wind down the balance sheet. Still too slow…
  - Fiscal policy is on hold amid high inflation and as massive funds already approved are yet to be used.
  - Energy policy has been harmful for both fossil fuels and alternative energy.
- Markets
  - Stocks have hit the 10% correction mark this year as accelerating inflation and a significant rise in interest rates, together with a war in Ukraine increased market volatility.
  - The S&P 500 ended the quarter down about -5%, and are stuck between rising inflation and interest rates, and economic momentum remaining from excess policy, rising employment, and flushing out supply chains.
  - Equity markets will have the economic tailwinds countered by inflation and interest rate headwinds. Company earnings will be challenged by their ability to continue to pass through cost increases, and the consumers willingness to pay.
  - Bond markets posted significant negative returns in Q1 with the Aggregate Bond Index declining -6% in total return as interest rates rose 160 basis points in 2-year notes and 83 basis points for 10-year notes. Meanwhile corporate and mortgage yield spreads widened, furthering the losses.
  - Treasury Inflation Protected Securities (TIPS) continued to perform very well but may still be under valued.
  - Earnings season had a significant majority of companies beating earnings expectations as many companies have successfully passed through higher input costs to consumers that readily paid up. Those that did have been rewarded with higher stock prices, while those who did not have suffered.
  - Looking forward, the market will be watching if companies are able to continue to push costs through to consumers, and/or have the goods and services and workers to satisfy demand, all while interest rates move higher.

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Market Outlook

March 31st, 2022

- We are in the midst of perhaps one of the greatest policy mistakes, simultaneously on fiscal, monetary, and energy policy in history.
- The Fed has fallen behind the curve and recently acknowledged their policy mistake but are still not moving quickly enough to accelerate the unwinding of excess stimulus. We expect larger moves and significant action on the balance sheet before Q3.
- We feel inflation will continue to be a key focus of markets in the near term as it continues to rise above expectations and forces the Fed to pull plans forward to remove excess stimulus more quickly, pushing rates higher and upsetting equity markets.
- Financial and risk assets have been the beneficiary of excess stimulus in the system and will now be faced with its removal.
- Volatility will surely continue amid rising rates with the 10-year Treasury nearing 3% and a real risk of S&P 500 reaching 3840, a 20% correction from the highs set in 2021, down about 15% from end of Q1. Strong enough economic momentum could provide support.
- With government benefits expiring, children back in school, a high level of vaccination and new covid 19 treatment progress, employment growth should continue to accelerate, subject to inflationary pressures pushing back.
- Evidence has shown businesses are having to raise wages to attract workers, while also cutting back on service hours and production as the cost and unavailability of labor prevents business growth. The employment void has begun to close.
- Rising costs of labor, raw materials, transportation, and other input costs are being passed through, with CPI printing 7.9% in Q1. An open question will be the ability to pass through higher costs and maintain volume through all phases of production and delivery.
- The inability to source materials or to produce finished goods, together with higher input costs being passed through to final prices, may both decrease sales and margins, curbing corporate cash flow and profit growth.
- As previously discussed, manufacturing will likely exhibit continued growth amid onshoring of supply chains and growth in logistics, new technology, including alternative energy, electric vehicles, efficient operations and transportation of goods and services.
- If job growth expands with people going back to work and supply chains begin to flow, economic growth could accelerate; however, if the current record number of open jobs don't get filled and inflation remains high, a recession is possible.
- Continued monetary and fiscal stimulus has flooded markets with liquidity, supporting high asset prices. With monetary policy removing excess stimulus and expiration of fiscal programs, fundamentals will have to support markets going forward.
- We expect the tailwinds of economic momentum to meet the headwinds of inflation and policy change to meet around Q3, which could result in technical recession.
- There is a significant risk of a recession as defined by negative GDP growth, where inflation is higher than nominal GDP.

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Investment Strategy

March 31st, 2022

- We are at an inflection point in the markets and the economy, prompting some rebalancing in investment strategy.
- The excessive monetary and fiscal stimulus in response to the pandemic has pushed demand with businesses able to pass higher costs through to consumers, resulting in solid earnings and supporting markets.
- It will be an open question moving forward if companies will be able to continue to pass through still rising input costs.
- Investment strategy has been reducing overall equity allocation by harvesting gains/trimming core positions in strong growth-oriented performers at record highs and rebalancing to high quality dividend paying value stocks and short-term fixed income.
- **During Q1, investment strategy established an explicit 5% underweight equities relative to neutral strategic asset allocation. Given defensive posture in Fixed income, temporary allocation to Cash and short-term Treasuries was made.**
- Within equities, Utilities and Energy are primary areas of focus, with short term Treasuries purchased to earn income.
- Within fixed income risk has also been reduced by harvesting gains in High Yield credit and MBS (selling HYT and BKT at premiums), reducing credit risk and increasing quality into short term Treasuries and Treasury Inflation protected securities (TIPS).
- Supply chain disruptions are likely to last longer than expected. The ultimate flushing out of supply chains could benefit transportation sector such as trucking and rails. Increased materials could boost production of low inventory products like homes.
- Themes of onshoring of supply chains and new technology will continue to push growth allocations, while income producing value companies in banking, industrial, energy, and utility sectors will occupy core equity and corporate bond allocations.
- Fixed income allocations will continue to defend against interest rate sensitive longer-term bonds as interest rates rise, while looking to generate income in shorter term securities across the range of sectors. At higher levels, we will lock in higher rates.
- As we move into Q2 2022, higher interest rates, inflation, energy costs, and a growing debt burden, there is a risk of decelerating economic activity, and earnings. Rates will likely move toward 3%, and S&P 500 has a real risk of completing 20% correction.
- As we see progress unclogging the supply chains, jobs getting filled in critical sectors, and pricing pressures ease, we will feel more comfortable increasing risk exposures; however, significant progress is needed.
- Geopolitical risks have increased recently and may have consequences on the global economy.
- The yield curve is not “telling us” anything being flat/inverted as long as the Fed continues to sit on long rates.

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Market Review

S&P 500 – March 31st, 2022

- Equity markets have been volatile in 2022 due to inflation, supply chain issues, the war in Ukraine, and uncertainty around future global monetary policy.
- This past earnings season was mixed, with firms that maintained margins, passed through price increases, and maintaining forward guidance performing well, while those that did not pass-through increased cost pressures struggled.
- Interest rates are poised to rise amid inflation, continued debt issuance, Fed rate hikes and the end of QE; however, are experiencing short bursts of flights to quality.

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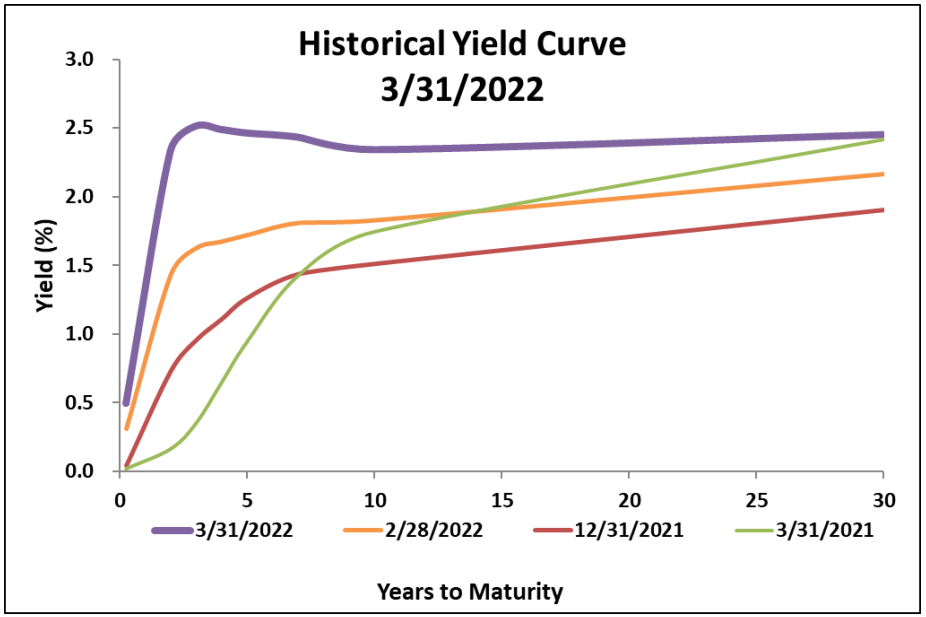
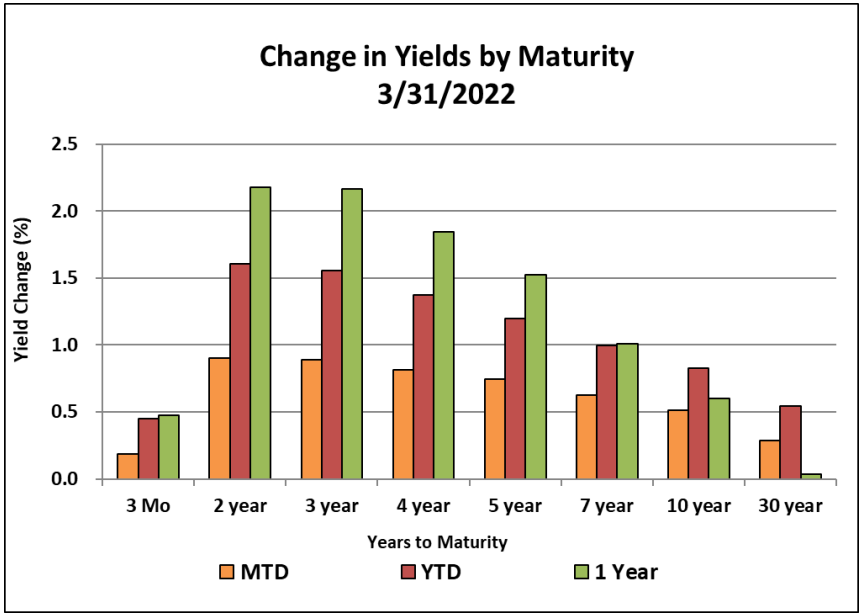
Market Review

Yield Curve – March 31st, 2022

- Q1 2022 saw interest rates rise across the curve, with the belly leading the way in classic fashion, being the first step in rate movements due to a shift in Fed policy. The following steps in reducing the balance sheet should have the impact of pushing longer rates higher to help curb longer term inflationary pressures.
- March saw the most dramatic move, with 2-year rates up 90bps, with 10-year rates up over 50bps. This flattening shows the markets understanding that the Fed will be raising rates dramatically throughout 2022.
- The curve inverted slightly towards the end of the quarter, showing risks associated with long term growth, however it is likely that this is due to the Feds continued quantitative easing program, which is expected to wrap up and start to unwind at the next Fed Meeting in May 2022.





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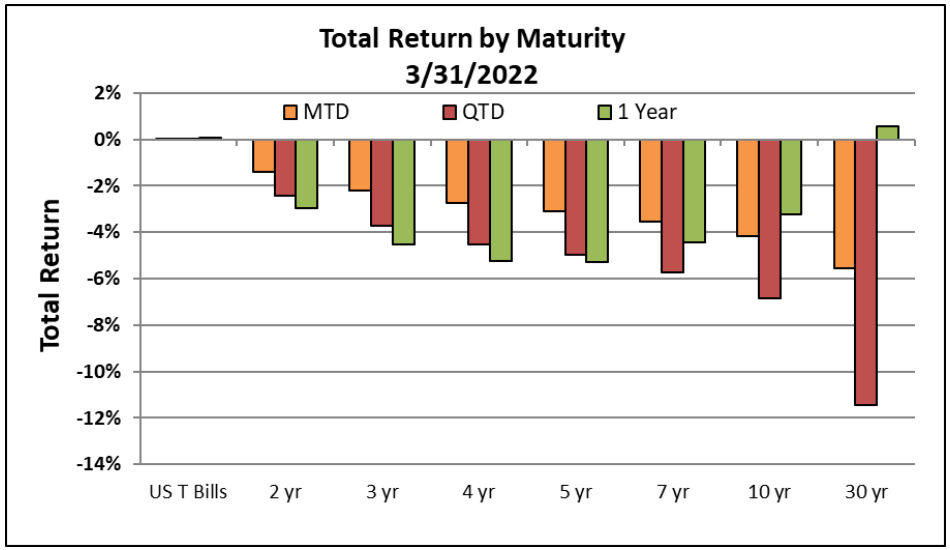
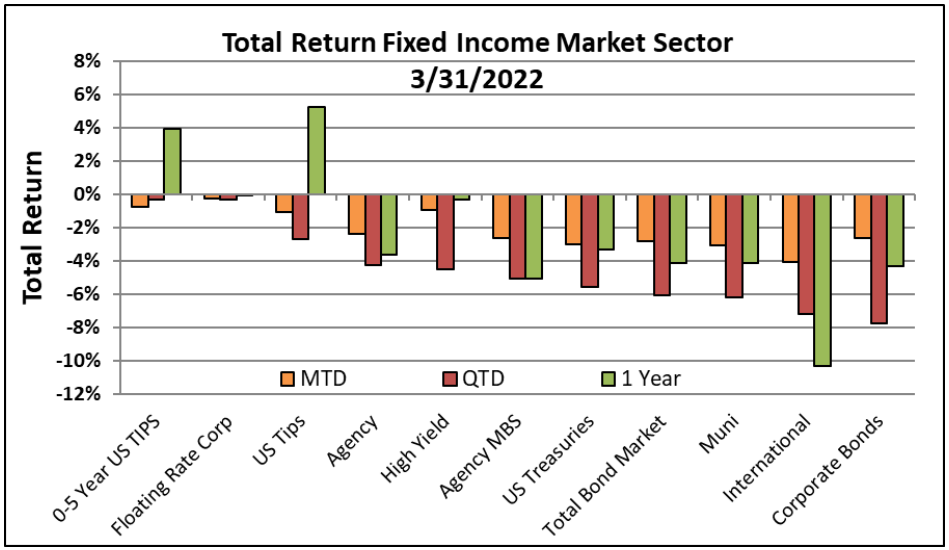
Market Review

Yield Curve and Sector Returns – March 31st, 2022

- Total returns on Treasuries were negative in Q1 2022, with longer maturities performing the worst given their longer duration, or greater sensitivity to changes in interest rates.
- March saw the largest moves, as the move up in rates pushed prices down in a significant manor, driving negative returns; 2-year notes were down -1.38% and 10-year treasuries were down -4.16% in March alone.
- Corporate bonds, including High Yield, generated negative returns in March and for the Quarter as rising rates offset the additional income premium.
- Given the actual inflation, short term TIPS have been the best performing bonds this year.
- Longer term securities are still vulnerable with inflation accelerating while Fed policy is still months away from having any significant impact on curbing these rising prices.





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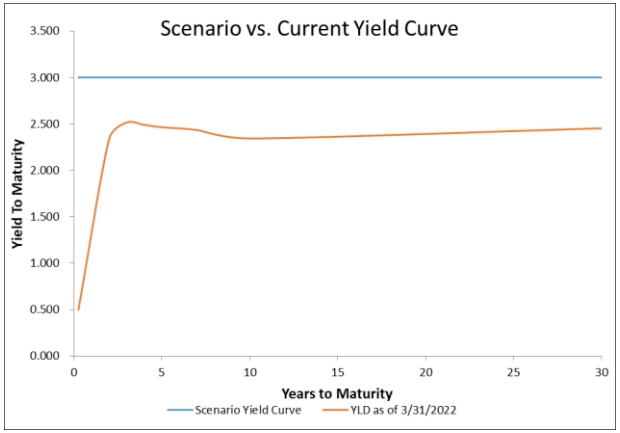
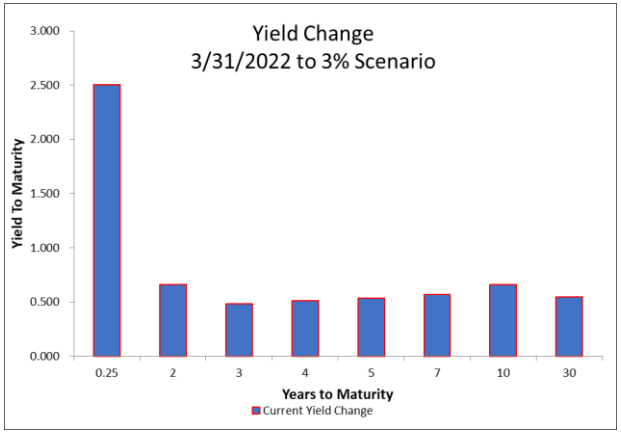
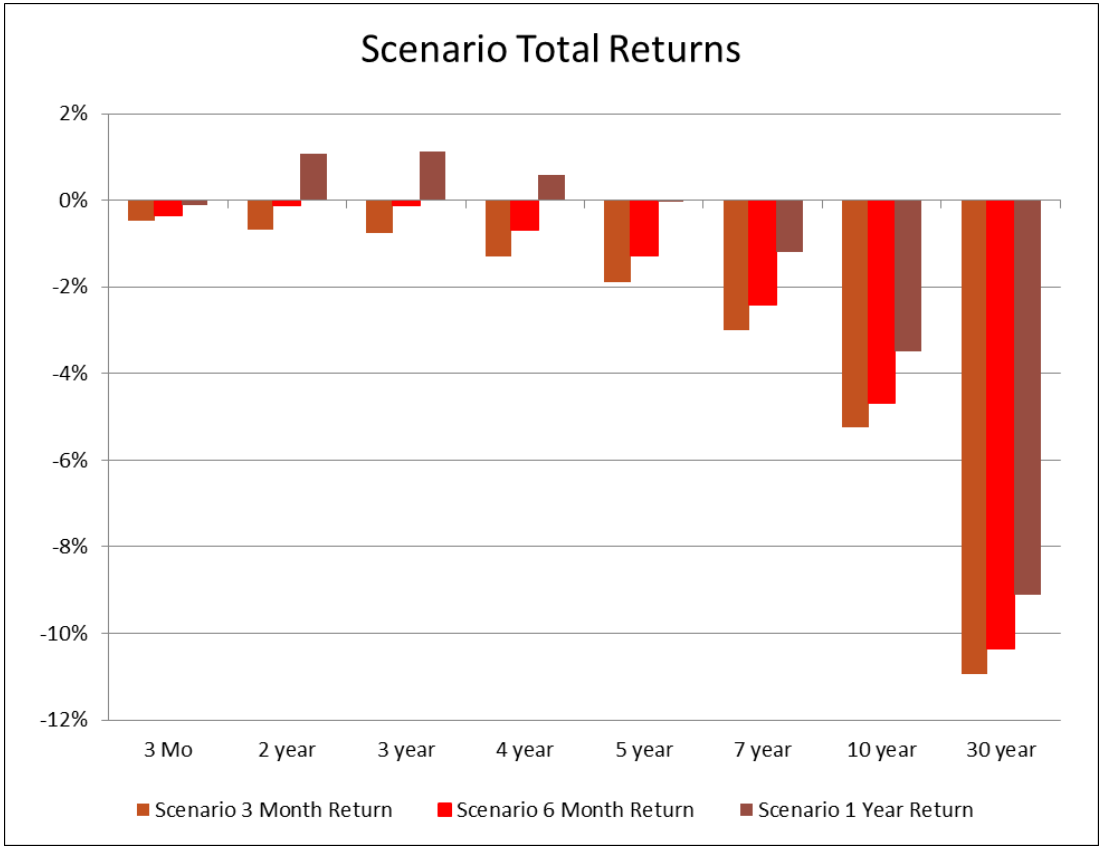
Market Review

Yield Curve Scenario Analysis – March 31st, 2022

- Given the recent shift in Fed Policy, the risks of rising rates across the curve have increased dramatically. To Better understand the effects of this, below is a scenario analysis of returns if the Yield curve moves to 3% from its current 3/31/2022 positioning.







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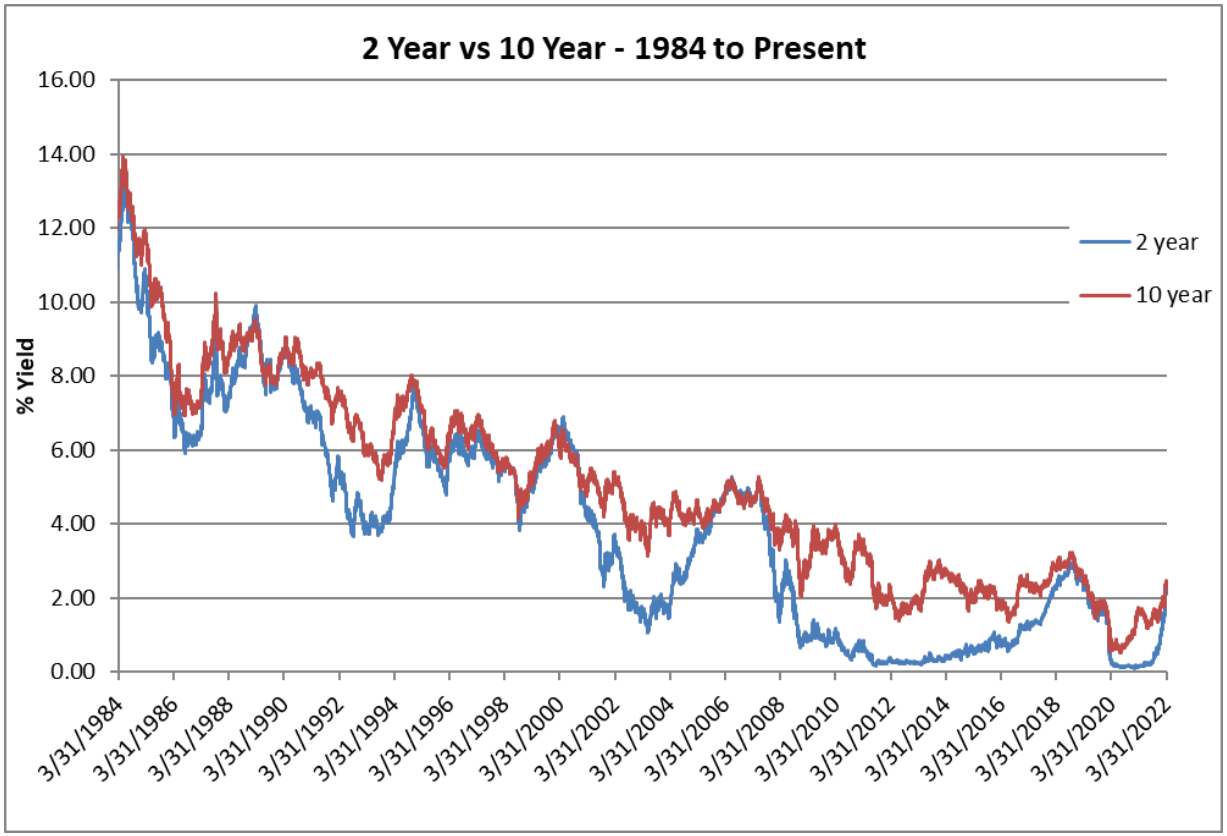
Market Review

Yield Curve Scenario Analysis – March 31st, 2022

- While it may feel like rates have risen significantly over the past year, by about 200 basis points in short rates but only 50 basis points in long rates, past tightening cycles have seen 400 basis point increases in rates.
- The rise in inflation currently dwarfs anything seen since 1984, so much larger rate moves are likely.



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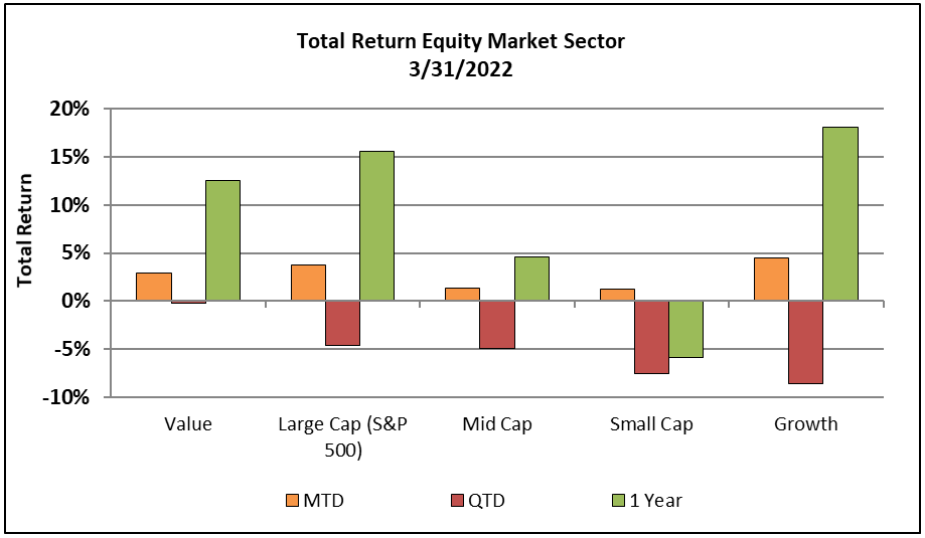
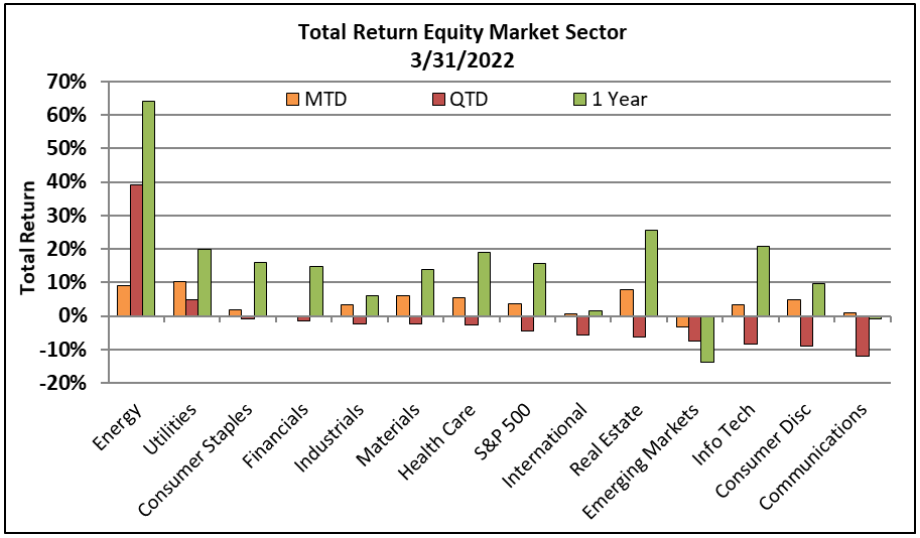
Market Review

Equity Market Returns – March 31st, 2022

- For the Quarter, Value stocks and sectors such as Energy & Utilities were the only positive sectors as a market selloff pushed valuations lower. Utilities held their position as the "stable" sector while increased energy prices boosted profits for the Energy sector.
- Growth stocks were among the worst performers with sectors such as Information Technology and Communications being the most negative amid rising interest rates.
- In March, the market rebounded off the February lows, led by Utilities, Energy, Healthcare & Real Estate, while Banks and communications lagged.
- Over the past year, energy has dominated returns as the oil pushed above $100 a barrel.





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Market Scoreboard

March 31st, 2022

Market Summary - March 31st, 2022				
Bond Market	**MTD**	**YTD**	**1 Year**	**Yield**
Total Bond Market	-2.8%	-6.1%	-4.1%	2.9%
US Treasuries	-3.0%	-5.6%	-3.4%	2.4%
US TIPS (Inflation Prot.)	-1.1%	-2.7%	5.3%	3.3%
Corporate Bonds	-2.6%	-7.7%	-4.3%	3.6%
Floating Rate Corp	-0.3%	-0.3%	-0.1%	0.5%
US MBS Index	-2.6%	-5.0%	-5.1%	3.0%
High Yield Corporates	-0.9%	-4.5%	-0.3%	5.8%
Merrill Muni Index	-3.0%	-6.2%	-4.1%	2.1%
International Bonds	-4.1%	-7.2%	-10.4%	0.8%
Commodities/Other	**MTD**	**YTD**	**1 Year**	**End Value**
Oil (WTI)	7.3%	35.6%	82.3%	100
Gold	1.5%	5.9%	13.5%	1,937
Dollar Index	1.7%	2.8%	5.4%	98

Market Summary - March 31st, 2022				
Stock Market Indices	**MTD**	**YTD**	**1 Year**	**End Value**
NASDAQ Composite	3.5%	-8.9%	8.1%	14,221
DOW Jones Avg.	2.5%	-4.1%	7.1%	34,678
Large Cap Core (S&P 500)	3.7%	-4.6%	15.6%	4,530
Large Cap Growth	4.5%	-8.6%	18.2%	3,081
Large Cap Value	3.0%	-0.2%	12.5%	1,538
Mid Cap Core	1.4%	-4.9%	4.6%	2,694
Mid Cap Growth	0.5%	-9.1%	-0.4%	1,257
Mid Cap Value	2.2%	-0.6%	9.6%	880
Small Cap Core	1.2%	-7.5%	-5.8%	2,070
Small Cap Growth	0.5%	-12.6%	-14.3%	9,366
Small Cap Value	2.0%	-2.4%	3.3%	16,187
Europe	-1.3%	-11.3%	-2.7%	435
England	-0.5%	-0.1%	10.5%	7,516
Japan	0.1%	-7.7%	-11.7%	28,792
Shanghi 300	-8.3%	-14.3%	-12.0%	4,223
International	0.7%	-5.8%	1.6%	2,182
MSCI China	-8.0%	-14.2%	-32.5%	526
Emerging Markets	-3.4%	-7.6%	-13.7%	45

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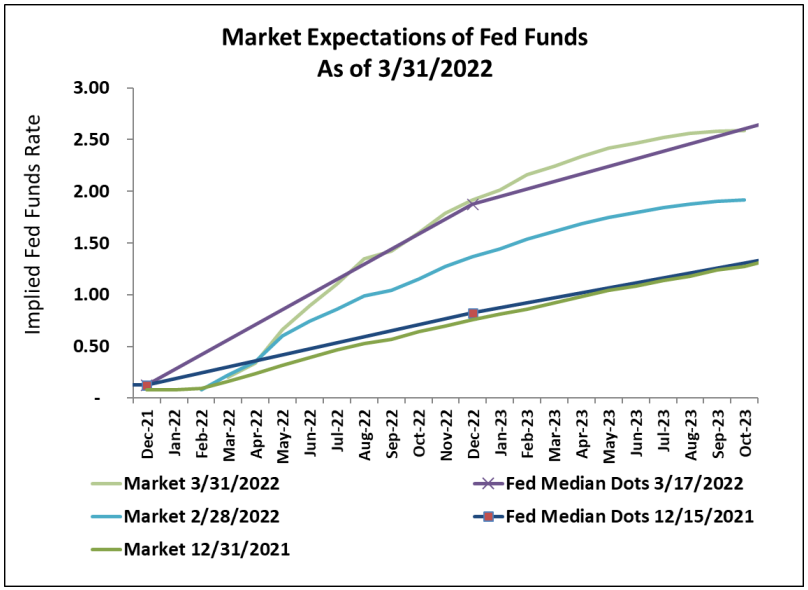
Market Review

Monetary/Fed Policy – March 2022

Federal Reserve Median Economic Projections As of 3/31/2022					
Change in GDP	**Actual**	**2022**	**2023**	**2024**	**Longer Run**
Mar. 2022 Projection		2.8	2.2	2.0	1.8
Dec. 2021 Projection		4.0	2.2	2.0	1.8
Actual Q4 2021 yoy/qoq	**5.5%/6.9%**				
Unemployment Rate					
Mar. 2022 Projection		3.5	3.5	3.5	4.0
Dec. 2021 Projection		3.5	3.5	3.5	4.0
Actual March 2022	**3.8%**				
PCE Inflation					
Mar. 2022 Projection		4.3	2.7	2.3	2.0
Dec. 2021 Projection		2.6	2.3	2.1	2.0
Actual February 2022	**6.4%**				
Core PCE Inflation					
Mar. 2022 Projection		4.1	2.6	2.3	
Dec. 2021 Projection		2.7	2.3	2.1	
Actual February 2022	**5.4%**				
Projected Policy Path- Fed Funds					
Mar. 2022 Projection	0.4	1.9	2.8	2.8	2.4
Dec. 2021 Projection	0.1	0.9	1.6	2.1	2.5

- The Fed hiked interest rates to a range of 0.25-0.5% in its March Meeting and ended New Bond Purchases in its Quantitative Easing Portfolio.
- The Fed did not indicate policy to reduce the balance sheet, thus reinvestments of MBS Paydowns and Treasury Maturities will continue at least until May Meeting.
- Governors have pulled forward timing of the future rate Hikes, with the possibility of a 50 bps Hike next meeting.
- The Fed is behind the curve and are playing catchup with both their outlook and policy.



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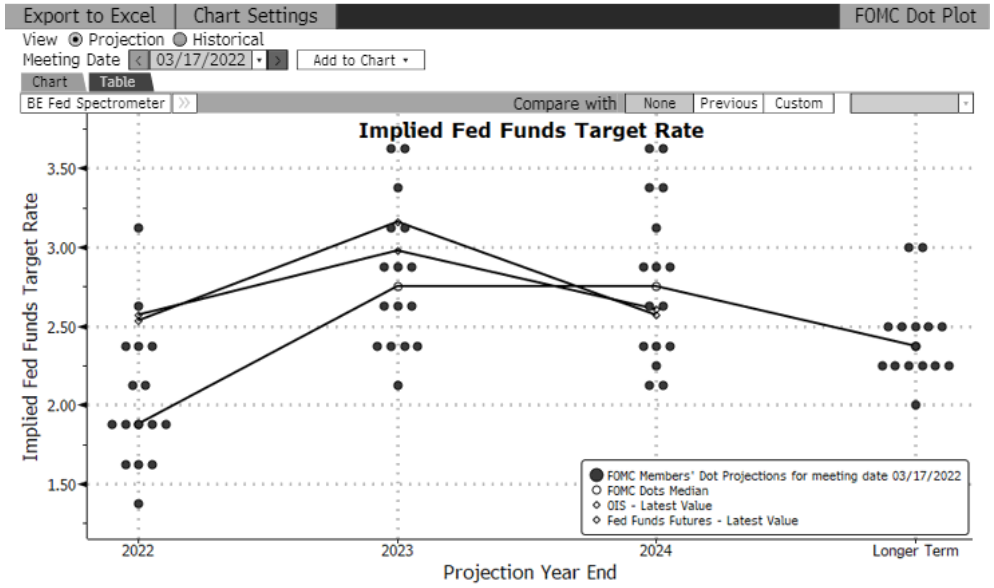
Market Review

Monetary Policy – March 2022

- All Governors agreed with the decision to raise interest rates, however 1 governor urged for more pushing for a 50bp hike. The Feds Dot Plot shows a range of possibilities for where the Fed Funds Rate may end the year, but the average suggests a rate just under 2% by year end 2022.
- Inflation expectations have risen but long-term inflation implied by TIPS remains well below actual inflation and our expectations.
- The strong economy, particularly the housing market, is leaving the Fed with little reason to continue the reinvestment of US Treasuries and MBS and needs to be addressed.



Current Fed Funds Rate
0.33

10 Year Tip	10 Year UST	Implied Inflation Premium
(0.49)	2.34	**2.83**

5 Year Tip	5 Year UST	Implied Inflation Premium
(0.92)	2.46	**3.38**

2 Year Tip	2 Year UST	Implied Inflation Premium
(2.15)	2.33	**4.48**

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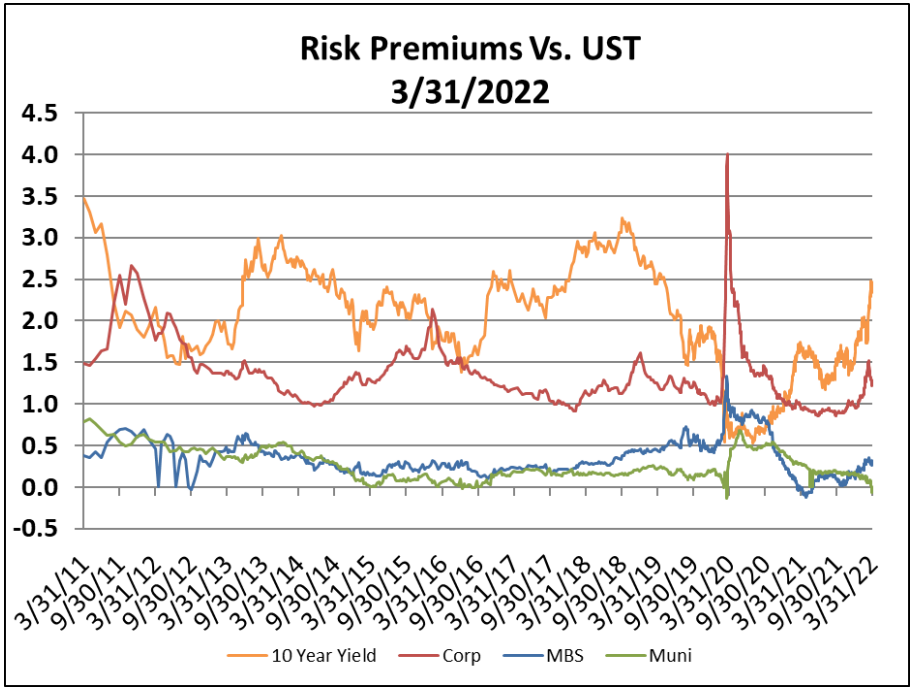
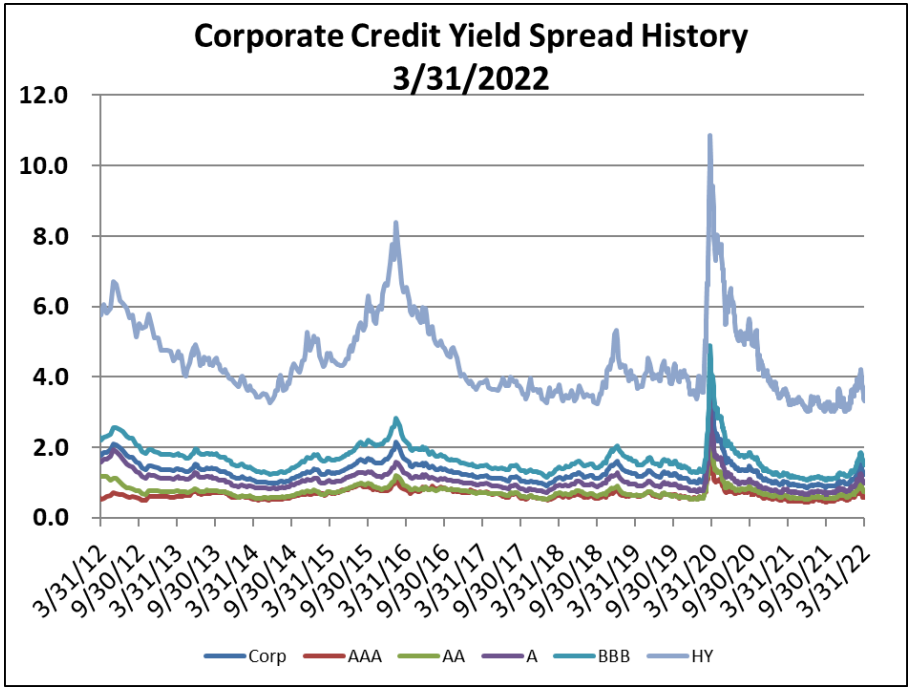
Market Review

Yield Spreads – March 2022

- Corporate, Muni & MBS spreads were slightly narrower in March after widening overall in Q1 2022 as rising rates proved to be larger contributor to performance.
- Corporate credit conditions have been strong; however, supply chain issues, increased costs (both financial/funding costs & operational costs), margin pressures, reduced operating ability, and or lower cashflow may increase risk.





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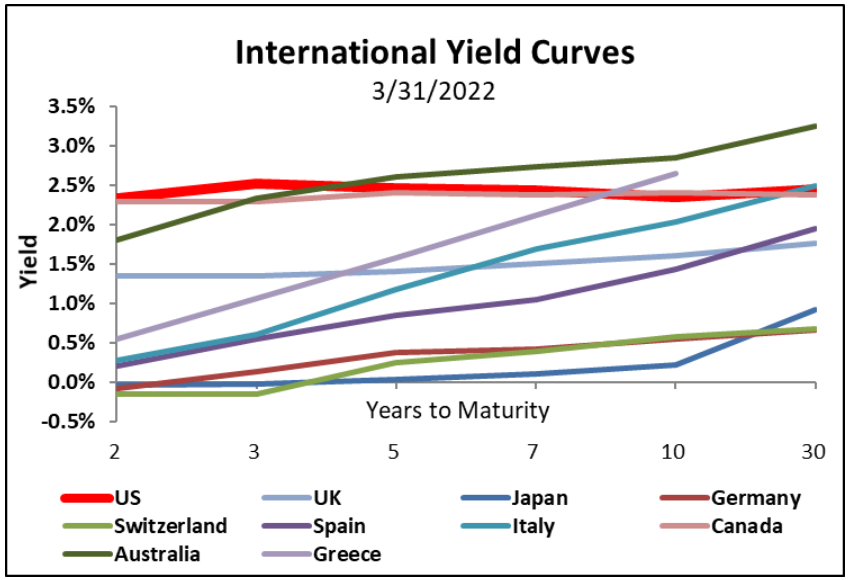
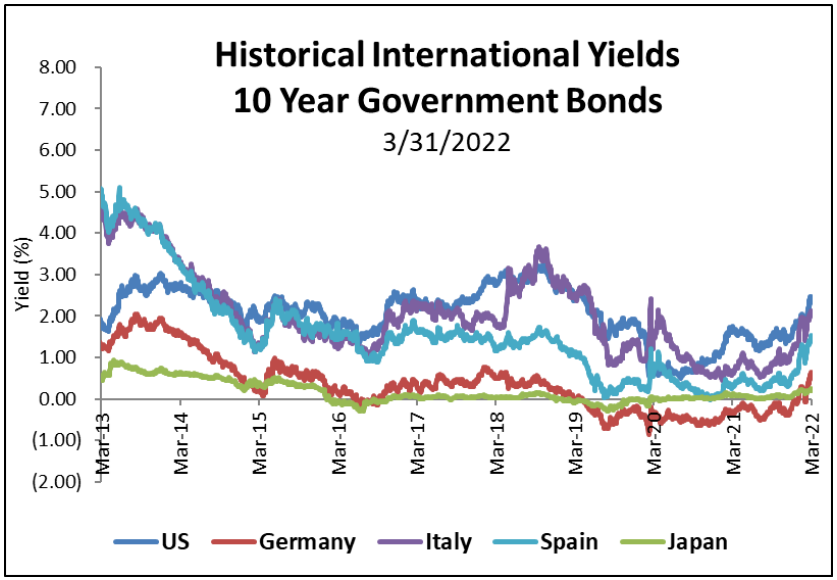
Market Review

International Yield Curves – March 2022

- Inflation has become a global phenomenon and central banks have differed on their response as some, such as Europe remain passive, while others such as the UK are active.
- The US continues as one of the highest yielding developed countries as rates across the globe rise as the world battles Inflation.
- These interest rate differentials also contribute to a strengthening dollar.





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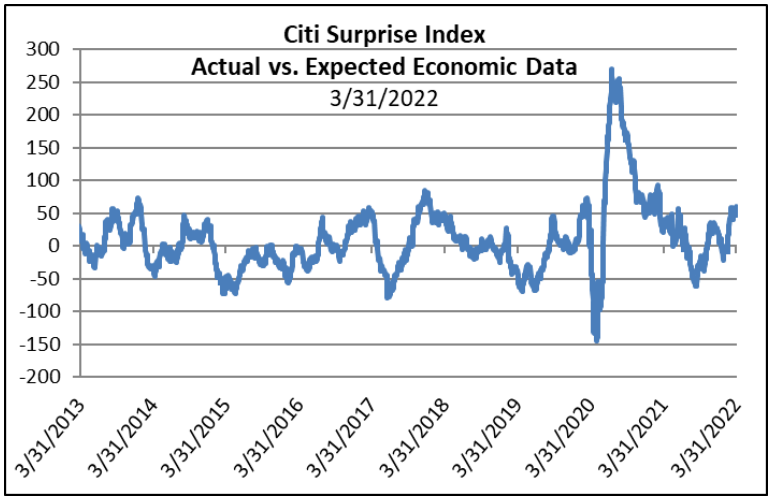
Economic Environment

March 2022

- Global GDP shows extreme swings in YOY growth as we move out of COVID-19. Moving forward it could be expected these value to normalize.
- Inflation has moved higher around the globe with expectations of future inflation continuing to rise due to significant stimulus and the increased cost of doing business.
- The Citi surprise index shows recent economic growth a bit stronger than expectations.



GDP YoY % Change			
	Q1 2022	One Year Ago	Change
US	5.50	(2.30)	7.80
Eurozone	4.60	(4.30)	8.90
Germany	1.80	(2.90)	4.70
France	5.40	(4.30)	9.70
Italy	6.21	(6.10)	12.31
UK	6.60	(6.30)	12.90
Canada	3.50	(2.80)	6.30
Mexico	1.10	(4.48)	5.58
Australia	4.20	(0.80)	5.00
Japan	0.40	(0.80)	1.20
China	4.00	6.40	(2.40)
Russia	4.30	(3.50)	7.80
Brazil	1.60	(0.93)	2.53

**Russia GDP as of 9/30/2021*
**Canada GDP as of 1/31/2022*

Inflation YoY % Change			
	Mar-22	One Year Ago	Change
US	7.90	1.70	6.20
Eurozone	7.50	1.30	6.20
Germany	7.30	1.70	5.60
France	4.50	1.10	3.40
Italy	6.70	0.80	5.90
UK	6.20	0.40	5.80
Canada	5.70	1.10	4.60
Mexico	7.28	3.76	3.52
Australia	4.20	(0.80)	5.00
Japan	0.90	(0.50)	1.40
China	0.90	(0.20)	1.10
Russia	9.18	5.67	3.51
Brazil	10.54	5.20	5.34

**US, UK Canada, & Japan, China, Russia, Brazil as of 2/28/2022*
**Australia CPI as of 12/31/2021*

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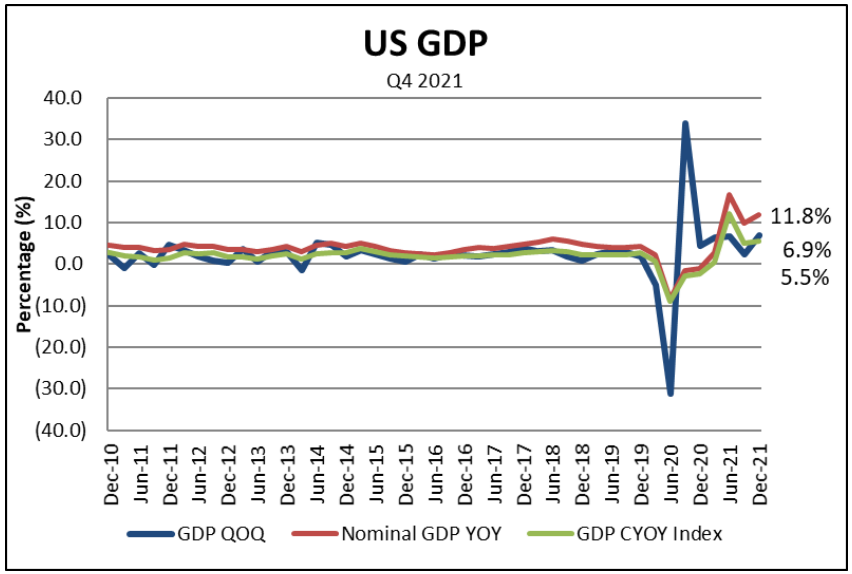
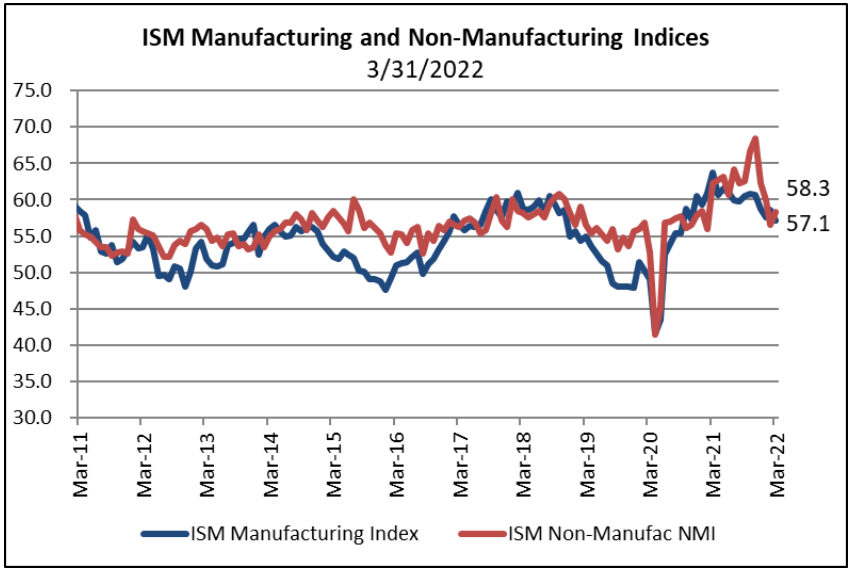
Economic Environment

March 2022

- US Economic activity increased in Q4 as the economy went back to work; the unemployment rate fell and demand for goods remained strong on the heels of significant government stimulus.
- Supply of goods, materials, workers, and services continues to be in short supply relative to demand, which has led to supply chain disruptions and increased costs getting passed through.
- Consumption has been robust amid significant stimulus, including cars and homes, and associated goods and services, to the degree they have been available.
- Manufacturing has ramped up to rebuild inventory however has been hampered by limited raw material supplies and labor. Services have picked up as Covid fades; however also face labor issues.





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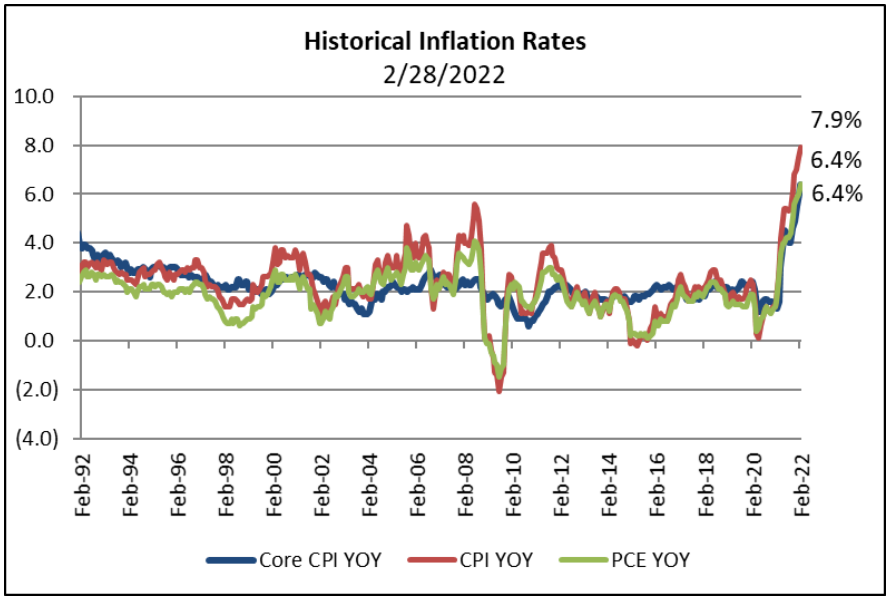
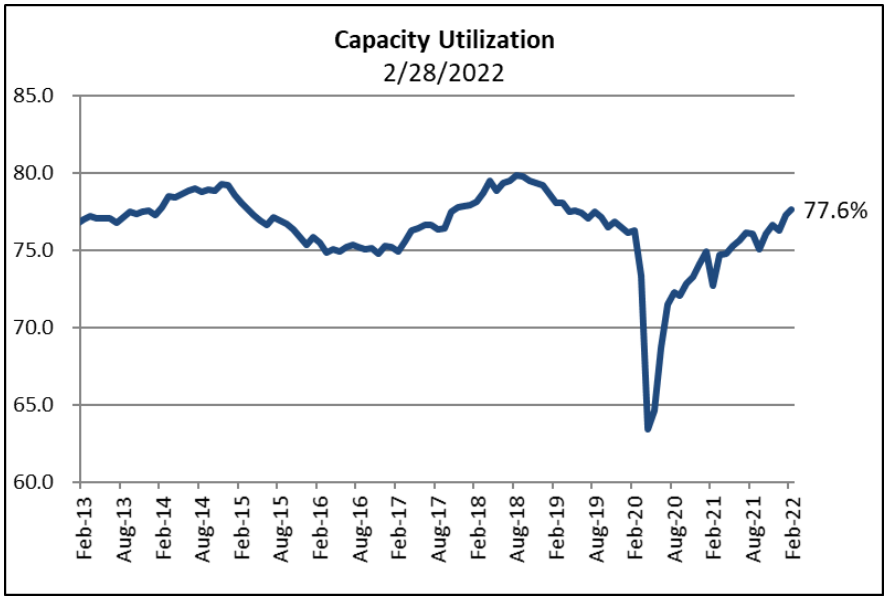
Economic Environment

Employment and Inflation – March 2022

- Inflation levels continue to rise amid continued strong demand and supply disruptions. Demand for higher wages by a tight labor force is contributing to higher costs, as are energy and other input costs.
- Expectations of inflation are increasing as input costs are being passed through at an increasing rate, resulting in demand for higher wages – potentially sparking a classic wage-price spiral.
- Capacity utilization has steadily increased as factories come back online; however, overall capacity is limited by worker and material shortages.





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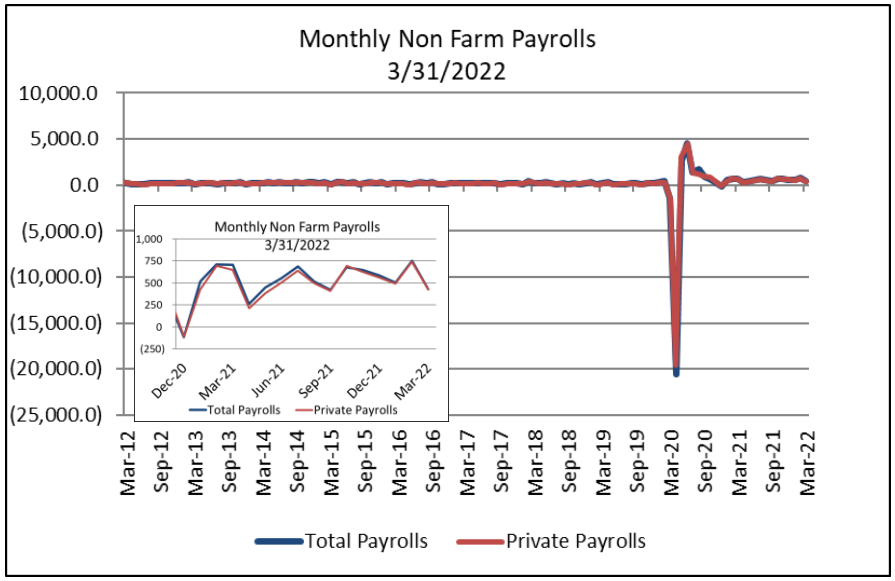
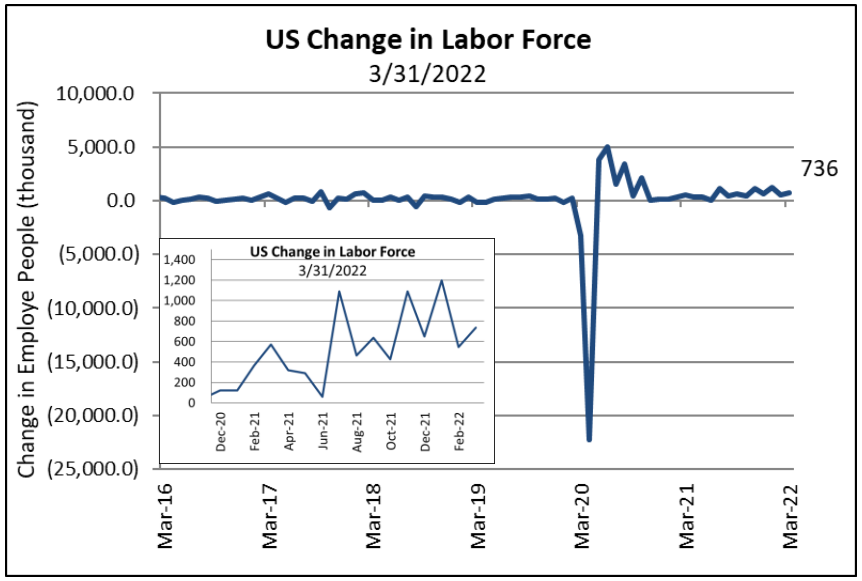
Economic Environment

Employment – Monthly Payrolls – March 2022

- Monthly payrolls continue to increase at over 400,000 per month as workers get back to work and unemployment packages have rolled off.
- There are currently about 1.8 jobs available for every person unemployed, increasing employee turnover and pushing up wage pressures.
- The labor force continues to grow as people continue to return to work. Much work is still needed to fill available jobs.





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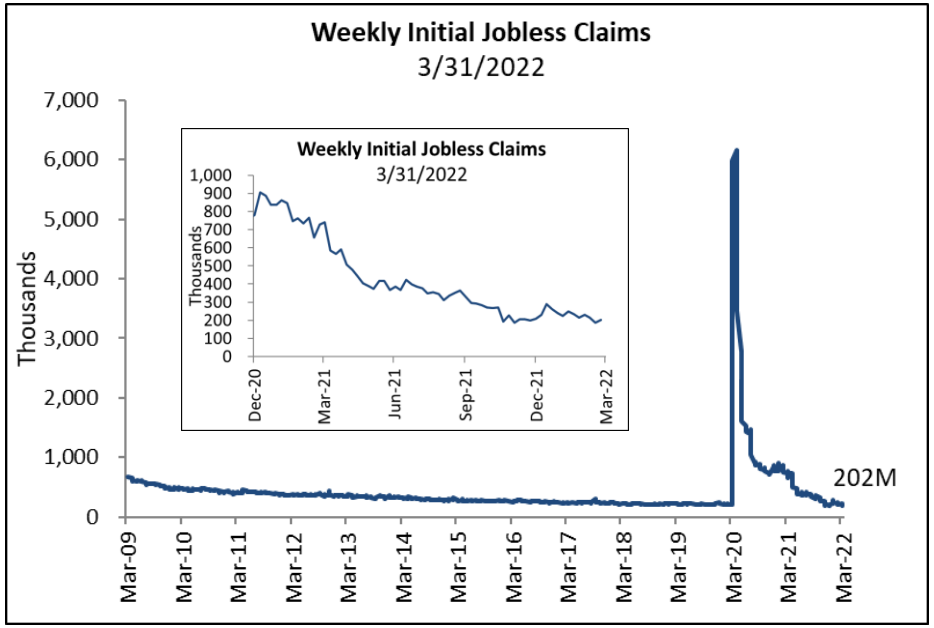
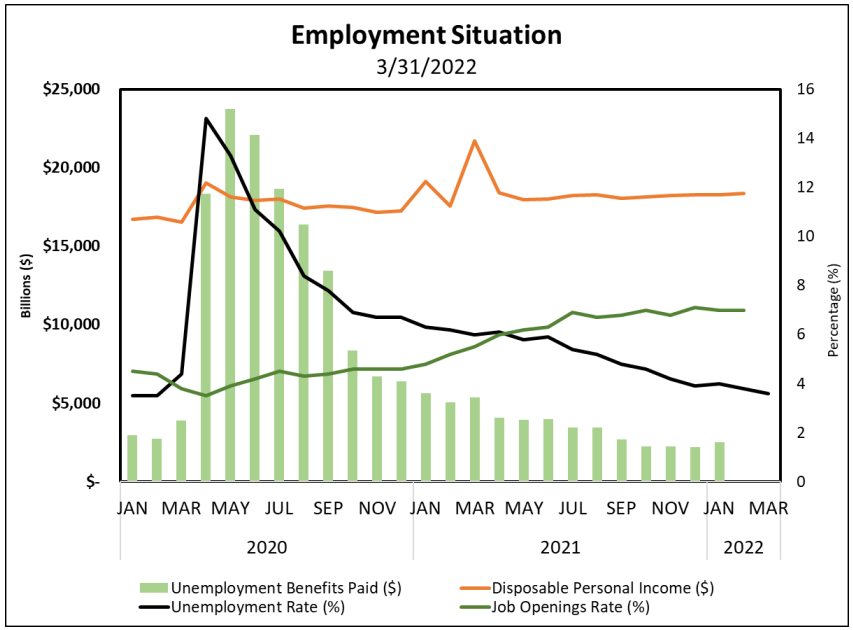
Economic Environment

Employment – Monthly Payrolls – March 2022

- Initial claims for unemployment have come down to levels consistent with levels pre-pandemic as employers are keeping workers on the payrolls amid a tight labor market.
- The unemployment rate has fallen to 3.6%, stabilizing under 4%, all while the US maintains a significant number of job openings; showing the tight labor market.
- The unemployment rate was at 3.5% just before the pandemic.





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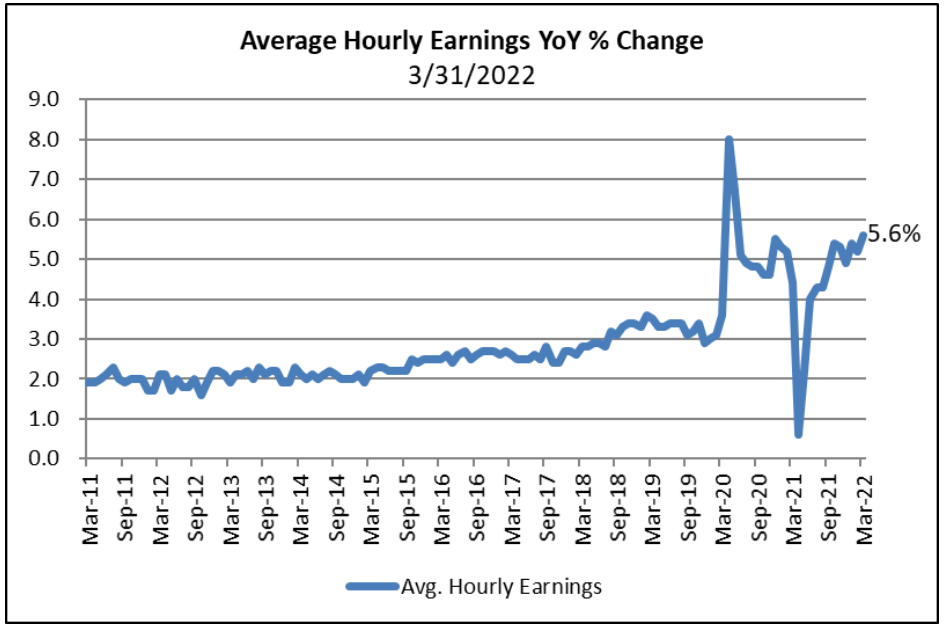
Economic Environment

Employment and Inflation – March 2022

- The prime working age participation rate has been increasing but has further to go.
- There are several pandemic related frictions in the labor market including remote work and required vaccination mandates that are impacting worker choices.
- Average hourly earnings have risen amid the need to provide incentive to bring people into the workforce; real hourly earnings are negative given a 2021 inflation rate of 7%.



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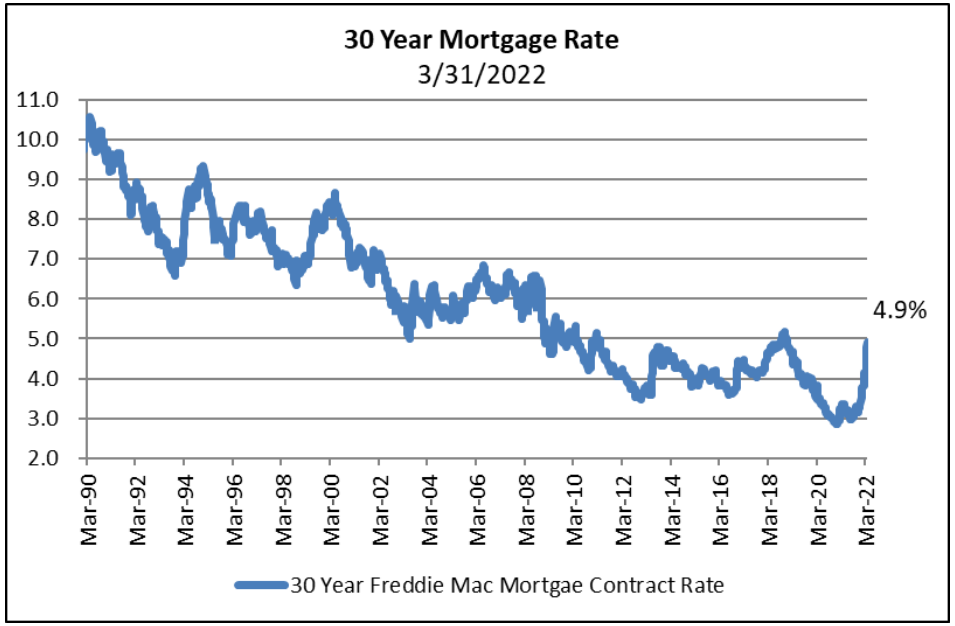
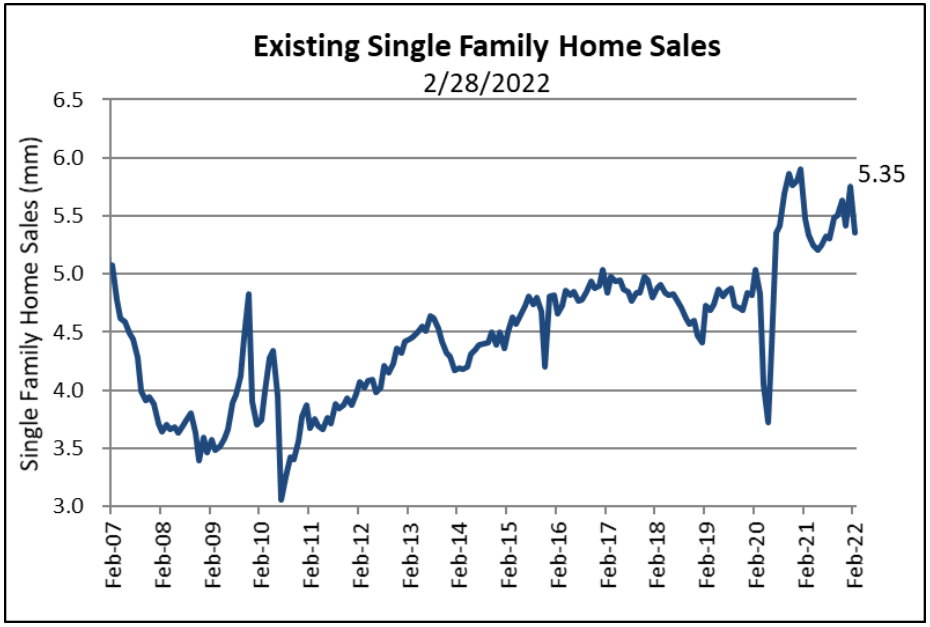
Economic Environment

Mortgage Rates and Housing – March 2022

- Mortgage rates have been rising but are still at historically low levels.
- Lower mortgage rates have supported home sales, and the significant migration to suburbs from cities has been a driving factor, which has also pushed housing prices higher.
- Single family home sales remain robust despite the surge in home prices. Home sales are being held back to the degree there are not enough homes for sale.





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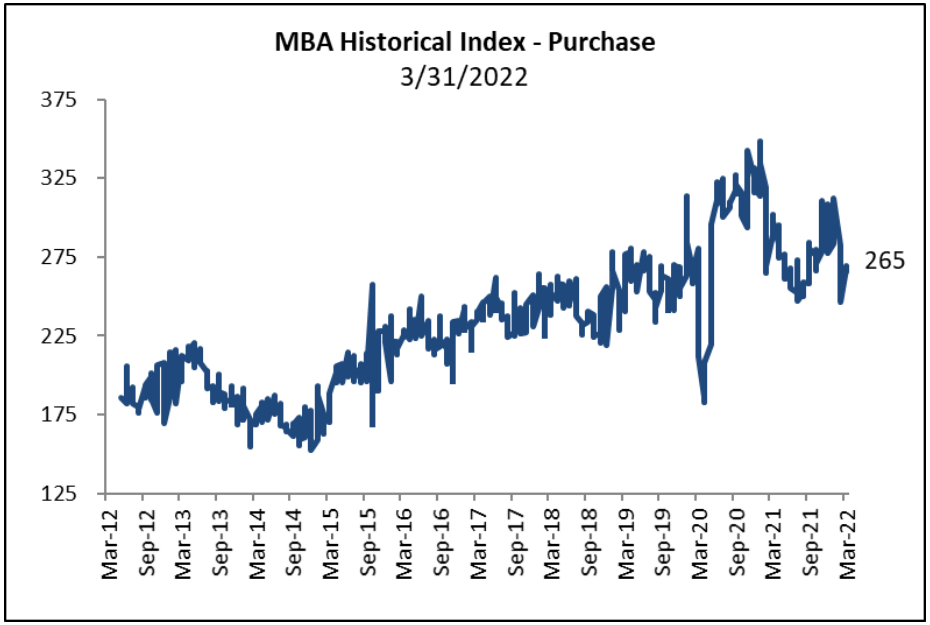
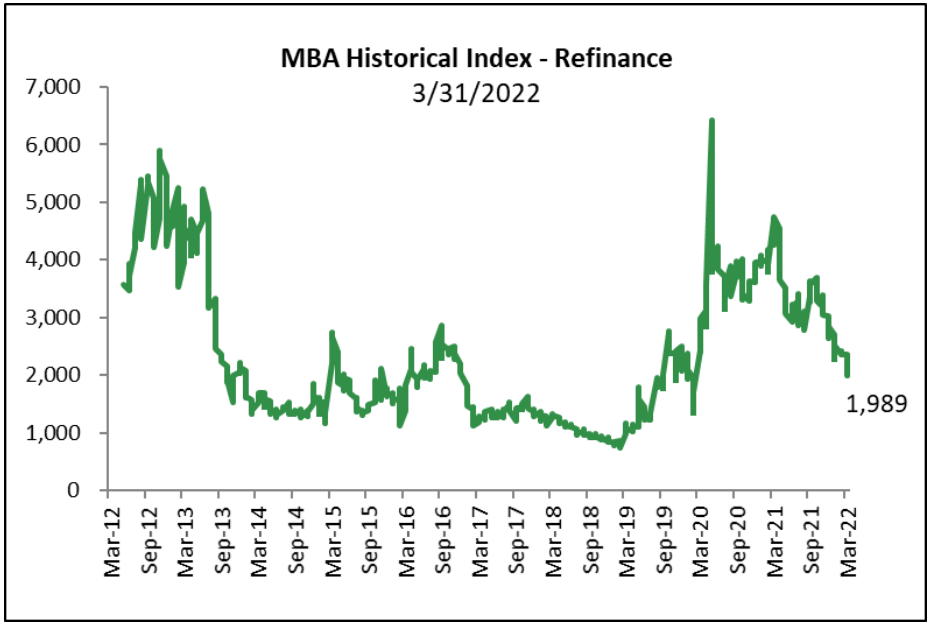
Economic Environment

Mortgage Rates and Housing – March 2022

- Mortgage Purchases have decelerated over the past 2 years as a lack of inventory and low interest rates have created an environment with no houses to buy with a strong demand.
- Mortgage Refinances have slowed over the past year as rising interest rates make it less economic to refinance mortgages.





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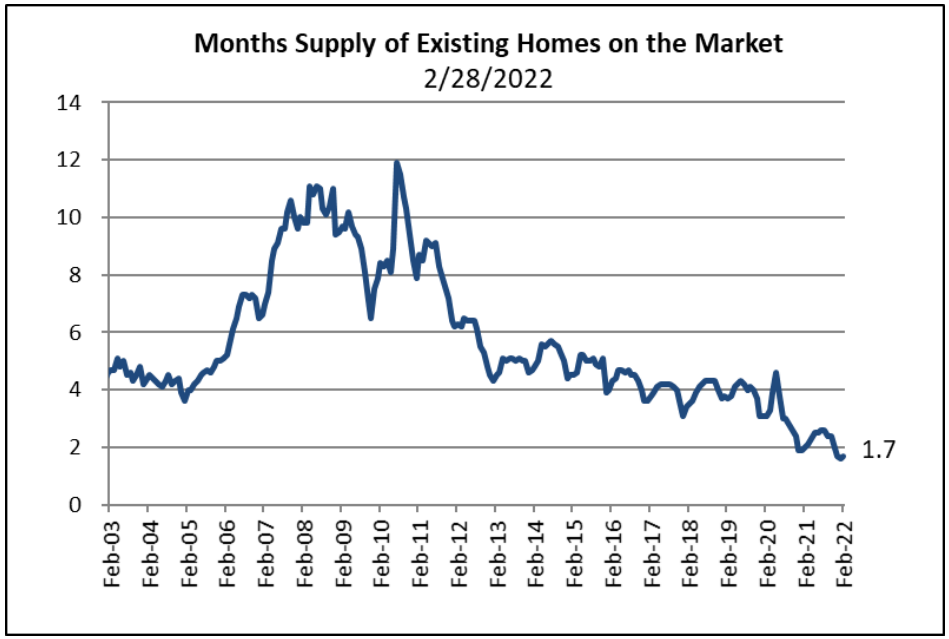
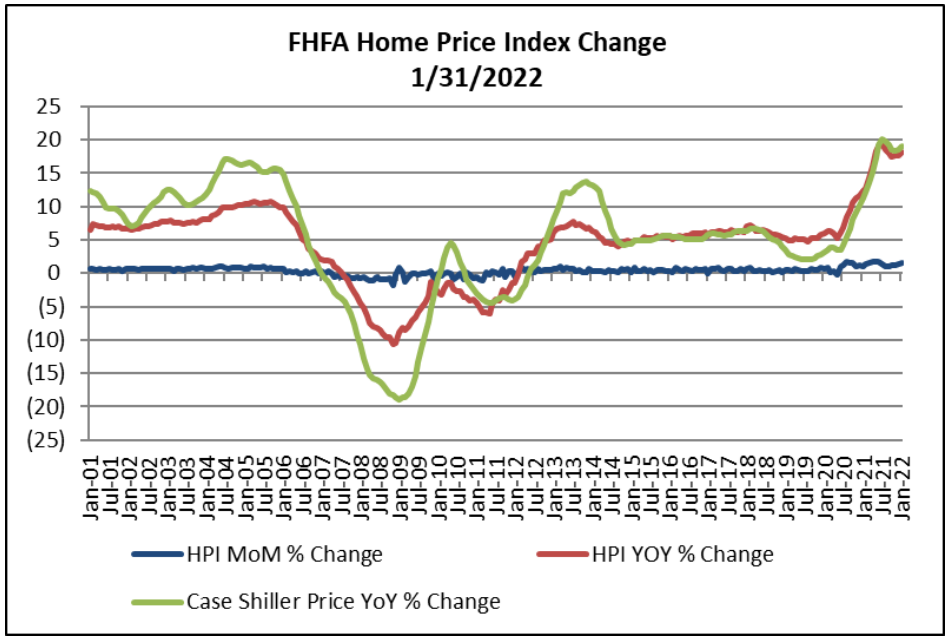
Economic Environment

Mortgage Rates and Housing – March 2022

- With the shortage of materials and labor, it has been difficult for existing home supply to increase; housing inventory fell under 2 months supply in the recent report.
- The high demand for housing has also pushed home prices up over 20% vs. year ago levels. The pace of home purchases and price gains has been broad based.
- Prepayment levels remain high; however, have stabilized below record rates recorded in mid 2021.





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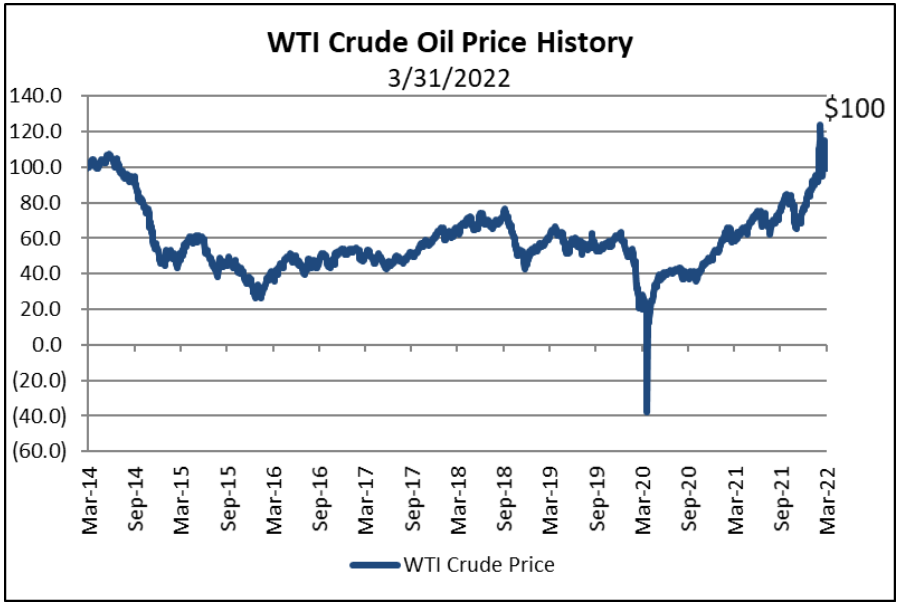
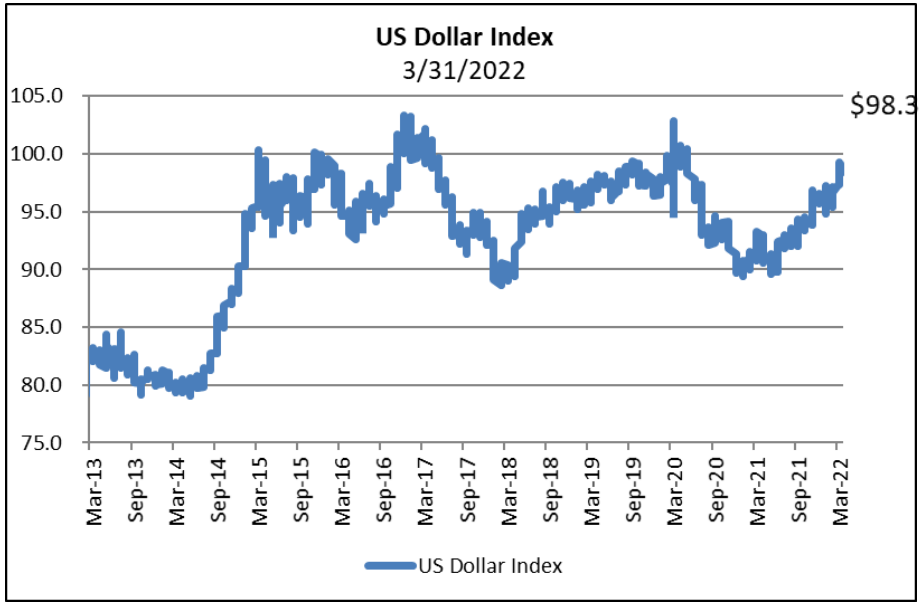
Economic Environment

March 2022

- The shift in policy to limit exploration, production, and distribution of oil and gas has led to a supply/demand imbalance and increasing energy prices, with oil above $100.
- The increase in energy prices has been exacerbated by the Russian invasion of Ukraine.
- The drive toward "green" energy is actually being hampered by supply chain disruptions and the accelerating costs for all energy, impairing investment and development.
- The Dollar has strengthened off its lows last year and may continue to do so as the US economy is the global leader of economic recovery.





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