Market Review and Outlook
December 31, 2021

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Market Environment

December 31st, 2021

- Economic
  - The pandemic has evolved to an endemic state as the latest Omicron variant has set a record new number of cases while the fallout has been less severe.
  - There is now little to no willingness to shut down activity due to varying waves of COVID infection, but rather live with work around solutions.
  - After excessive stimulative policy had pulled forward consumption in 2021 resulting in multi decade high inflation of 7%, the flow of funds is being slowed as monetary and fiscal policy recede, and the economy will be tasked with transitioning to a self-supporting mode.
  - Continued return to work and employment growth, resulting in income growth will be necessary to sustain economic growth, subject to a wage/price spiral that may choke consumption and corporate margins and profits.
  - Despite the potential for a "policy hangover", there is a financial cushion from the excess stimulus of the past two years, and sufficient residual cash and energy in the system to carry the economy through the first half of 2022, as the supply chains need to flush out and inventories need to rebuild.
  - Home sales remain robust with 19% Home Price appreciation (HPI) amid still low rates from Fed policy and high prices from still low inventories.
  - The dislocations in the housing market 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 increase as government benefits continue to expire and there continue to be more jobs available than people looking for work.
  - We feel the current Omicron wave, while broadly spread and causing significant current disruptions, will be shorter lived than other waves due to increased immunity and treatment, but that adverse consequences of monetary and fiscal policy, economic disruptions, and inflation may be longer lasting.
- Policy
  - When the economy shut down, the Fed immediately and aggressively injected stimulus into the economy; however, has yet to remove any despite economic activity that exceeds pre-covid levels. The Fed has owned up to its policy mistake and is pulling forward its plans to unwind it due to rapid inflation.
  - The Fed will become more bias to tightening as the 4 new voters are hawkish relative to the four dovish members rotating off the voter status.
  - The Fed announced speeding up tapering to conclude bond purchases by March rather than June, and to potentially raise rates as soon as March.
  - The rapid inflation and excessive fiscal stimulus heretofore has put the brakes on another hotly debated round of stimulus of around $2+ trillion.
- Markets
  - Stocks ended the year at record highs on the heels of a well stimulated economy, high inflation, and strong profits of companies that passed through prices.
  - Bond market posted a negative return for Q4 and the entire year as short and intermediate interest rates have risen, reflecting the significant rise in inflation and pulling forward expectations of a Fed tightening.
  - Long term rates remain in a range as the Fed continues to buy long term treasuries, but may rise further as the market prices in higher inflation and tapering.
  - 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

December 31st, 2021

- We are in the midst of perhaps one of the greatest policy mistakes, simultaneously on fiscal and monetary policy, in history.
- The Fed has fallen behind the curve and recently acknowledged their policy mistake and are moving quickly to accelerate the unwinding of excess stimulus. We expect tapering to conclude in March with the potential for the first rate hike as well.
- 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.
- The Delta wave has given way to Omicron, that is more broadly distributed but less severe, however is currently having an impact as massive numbers of people call in sick, but are not being laid off. Society is showing less willingness to shut down as the pandemic has turned endemic.
- With government benefits expiring, children back in school, a high level of vaccination and new covid 19 treatment progress, employment and growth should begin to accelerate, subject to inflationary pressures pushing back.
- Debate regarding vaccine requirements and return to the office are currently at hand, which may slow job growth, but if jobs don't get filled and business continues to operate at limited capacity, the ripple effects may slow overall economic growth and profitability.
- Evidence is showing 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.
- Rising costs of labor, raw materials, transportation, and other input costs are being passed through, with CPI printing 7% for 2021. An open question will be the ability to pass through higher costs and maintain volume through all phases of production and delivery.
- Corporate profits were robust in Q3 and may be in Q4 amid successful price increases; however, if not sustained, corporate profit growth could disappoint amid a higher interest rate environment, all to work against stock prices.
- 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.

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Investment Strategy

December 31st, 2021

- We are at an inflection point in the markets and the economy, prompting some rebalancing in investment strategy.
- Despite the continued waves of COVID-19, the excessive monetary and fiscal stimulus 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.
- Continued stimulus and strong earnings drove stocks up in Q4, albeit with increased volatility within market sectors and higher interest rates. Markets ended up 20, 27, and 20% for the Dow, S&P 500, and Nasdaq respectively.
- Investment strategy has been fully invested but has been reducing risk by rebalancing back to a neutral strategic asset allocation overall, and reinvesting conservatively within equity and fixed income sectors.
- Investment strategy has been reducing overall equity allocation by harvesting gains/trimming core positions in strong performers at record highs and rebalancing to high quality dividend paying value stocks and fixed 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.
- We had felt that despite high current valuations, stimulus could push asset prices higher perhaps pushing the S&P 500 to 5,000 (likely driven by broader participation – it reached 4800) and 10-year treasury yields to 2.25% over the next few quarters.
- As we move into Q1 2022, higher interest rates, a growing debt burden, and the expiration of current economic stimulus provides risk of decelerating economic activity. Rates will likely move through 2%, and S&P 500 has a real risk of a 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.

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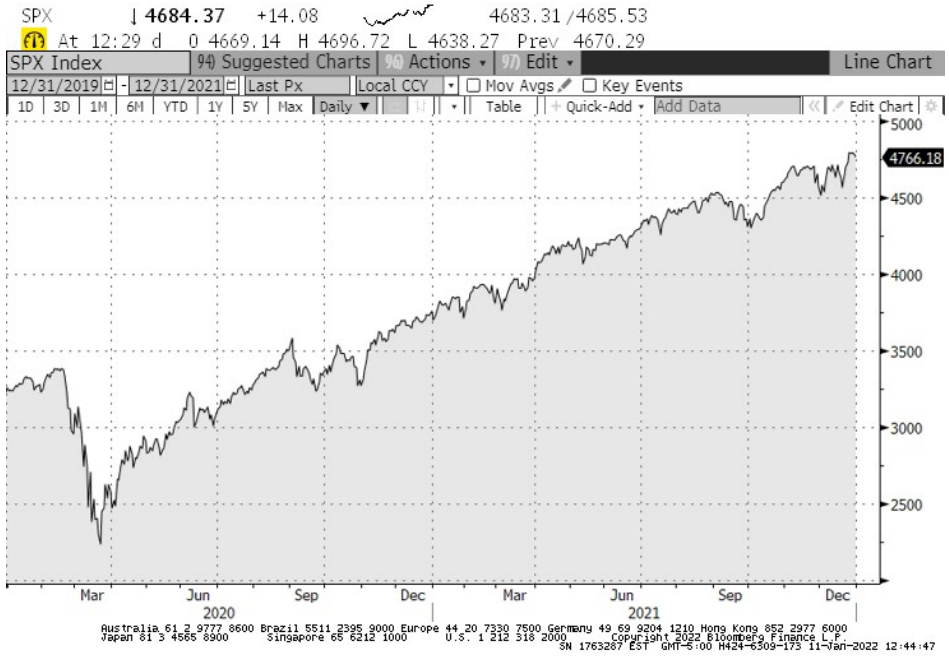
Market Review

S&P 500 – December 31st, 2021

- Equity markets closed the year near record highs as markets surged despite increased certainty of FED action and a massive new Omicron wave.
- The recent earnings season rewarded those companies that passed through rising costs and maintained or increased profit, while those that ate the increased costs declined.
- Interest rates have begun to rise amid inflation and shift in Fed policy, but the rise has been capped by overseas buying and short bursts of flights to quality.
- The rise in rates has caused volatility in equities that is surely to persist into 2022.



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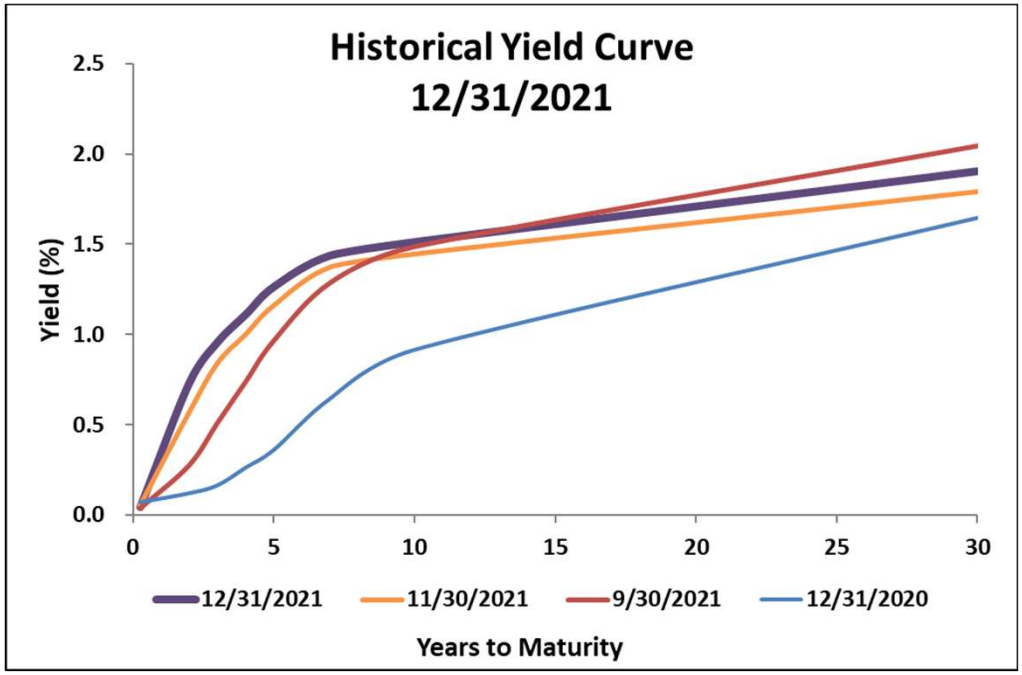
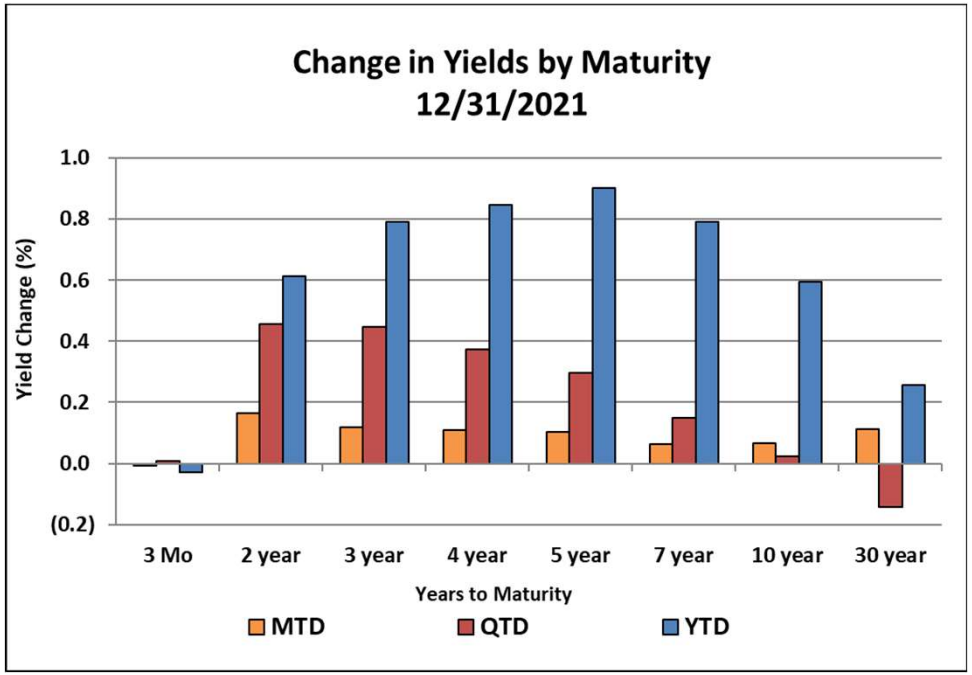
Market Review

Yield Curve – December 31st, 2021

- For the year 2021, interest rates rose across the curve, with the belly leading the way in classic fashion anticipating a shift in Fed policy. The rise driven by short rates in Q4 reflects ths increased certainty.
- The flattening of the yield curve in Q4 with short rates up and long rates down reflects potential for the Fed action to help reduce long term inflation.
- However in December, there was much more of a parallel shift up in rates, as the implications of stopping bond purchases, persistent high inflation, strong employment situation indicates more significant work needs to be done. Also, continued significant treasury debt will still be issued as the year progresses.





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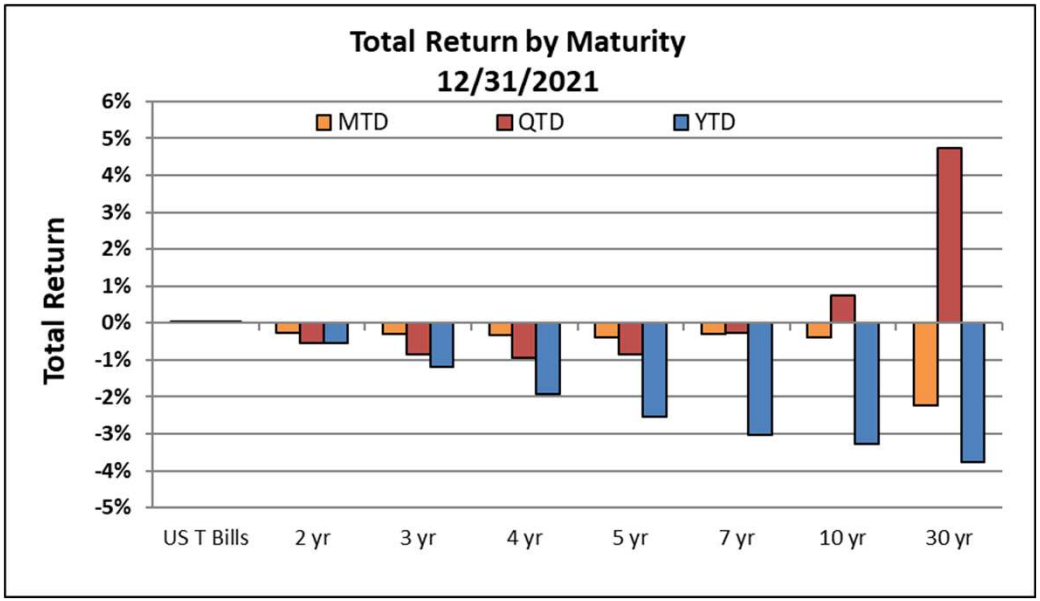
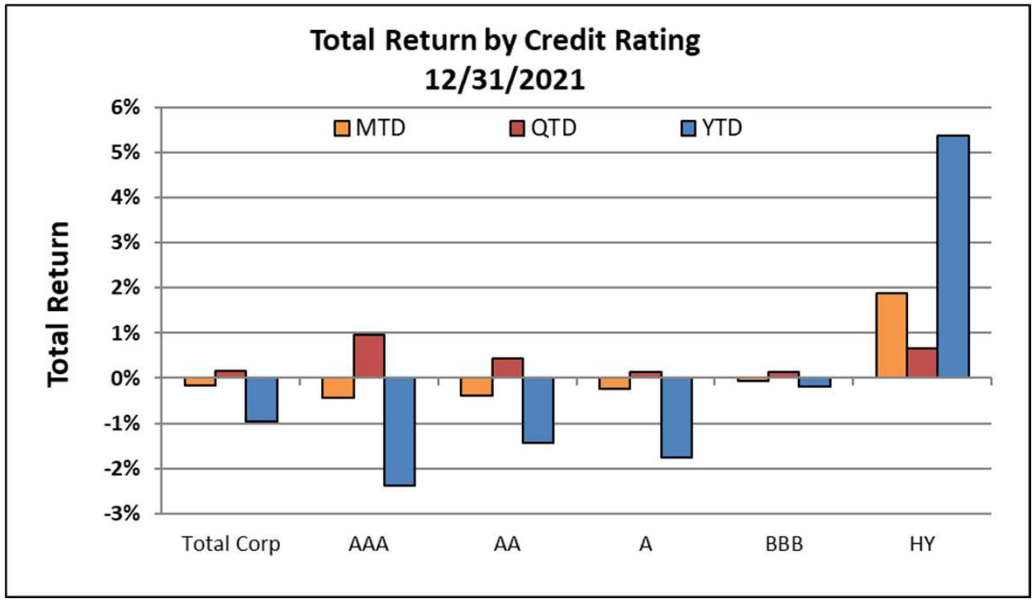
Market Review

Yield Curve and Credit Rating Returns – December 31st, 2021

- Total returns on Treasuries were negative in 2021, with longer maturities given their higher duration, or sensitivity to changes in interest rates.
- For the quarter, long duration assets were positive, given the curve flattening with rates falling on the long end; this helped offset some of the year-to-date losses for these assets.
- Investment grade corporate bonds generated slight negative returns in December largely due to price movements from rising rates offsetting any income generated. High Yield was the winner in December and for the year as tightening spreads & higher income helped offset the affects of rising interest rates.
- Longer term securities are still vulnerable with inflation accelerating and the Fed continuing to stimulate the economy through bond purchases and 0% fed funds until the end of Q1 2022.





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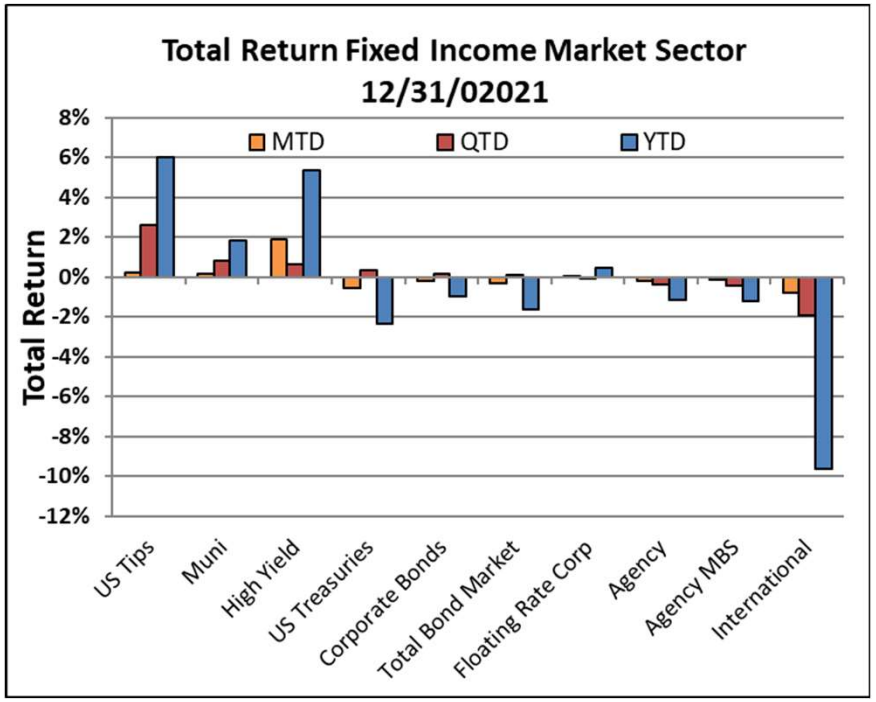
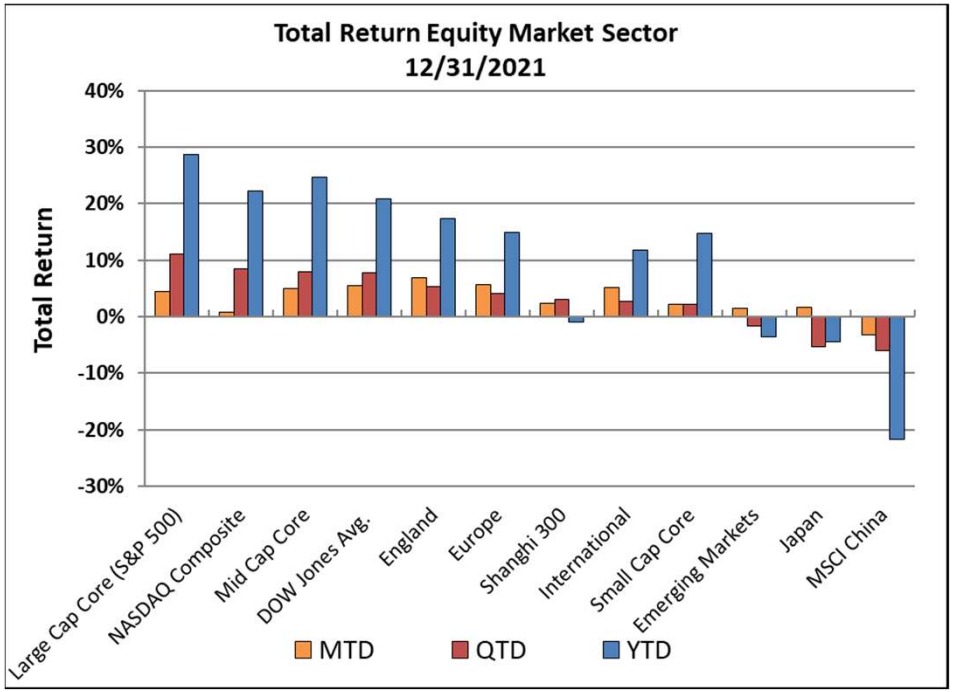
Market Review

Overall Market - December 31st, 2021

- TIPS (Treasury Inflation Protected Securities) were the best performing fixed income sector in Q4 and 2021 as inflation accelerated to reach 7% for the year, much higher than market expectations.
- International bonds struggled in 2021 with negative yields as a starting point, rates rising (prices falling), and a strengthening dollar made for a 3-pronged negative performance vehicle.
- Equity markets were positive in Q4. US Domestic investments lead global stock market returns.
- Japan, China and emerging markets continue to struggle as bursts of covid related regulatory restrictions hinder economic growth; while strengthening dollar adds additional hurdle to performance.





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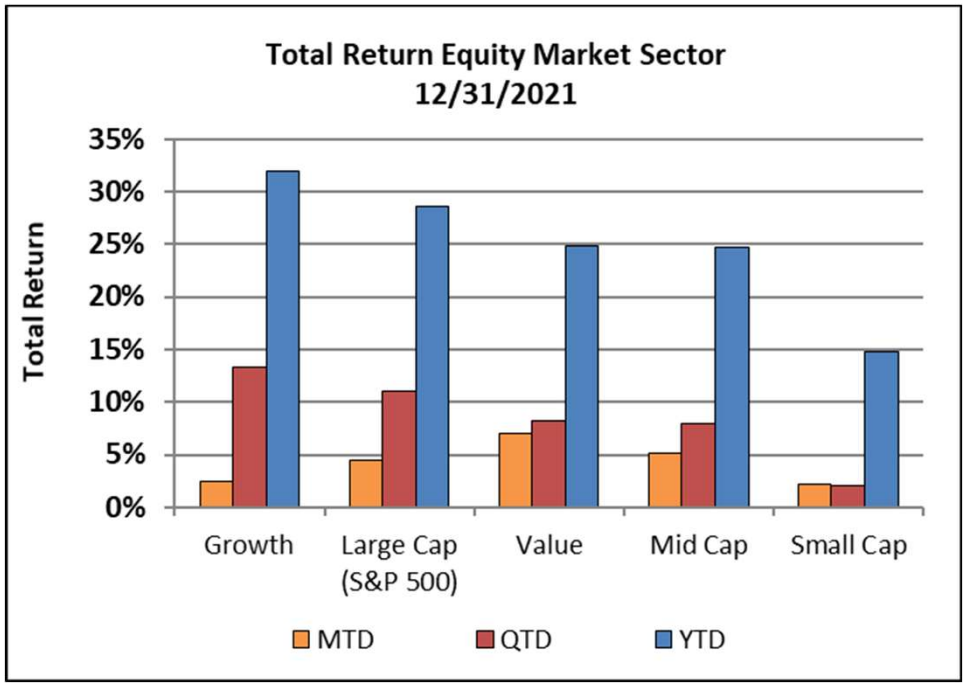
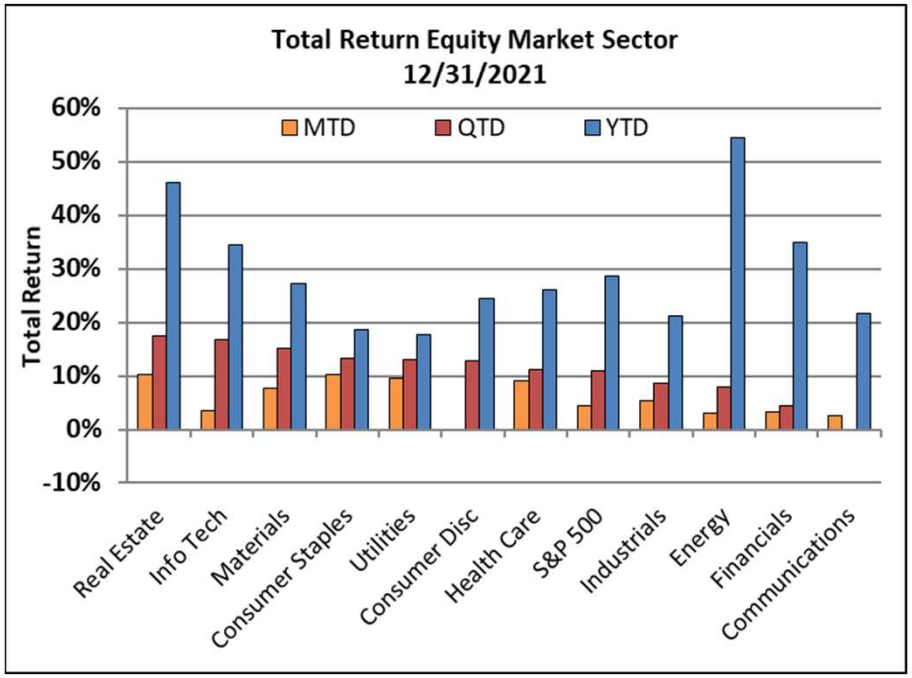
Market Review

Equity Market Returns – December 31st, 2021

- While growth stocks were the best performers for the quarter, they were quite volatile and exchanged market leadership with Value stocks often, likely driven by the rate shift.
- For the Quarter, Real Estate lead the way as property prices and rents continued to march higher.
- While financials and energy underperformed for the quarter, they led returns for much of the year.
- While Utilities lagged most sectors for the year, maintained relative stability and income, and put in solid returns for Q4.





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Market Scoreboard

December 31st, 2021

Market Summary - December 31st, 2021					
Bond Market	**MTD**	**QTD**	**YTD**	**1 Year**	**Yield**
Total Bond Market	-0.3%	0.1%	-1.6%	-1.6%	1.7%
US Treasuries	-0.6%	0.3%	-2.4%	-2.4%	1.2%
US TIPS (Inflation Prot.)	0.2%	2.6%	6.0%	6.0%	2.0%
Corporate Bonds	-0.2%	0.2%	-1.0%	-1.0%	2.4%
Floating Rate Corp	0.1%	-0.1%	0.4%	0.4%	0.4%
US MBS Index	-0.1%	-0.4%	-1.2%	-1.2%	1.9%
Merrill Muni Index	0.1%	0.8%	1.8%	1.8%	1.2%
High Yield Corporates	1.9%	0.7%	5.4%	5.4%	4.4%
International Bonds	-0.8%	-1.9%	-9.7%	-9.7%	0.3%
Commodities/Other	**MTD**	**QTD**	**YTD**	**1 Year**	**End Value**
Oil (WTI)	14.2%	2.2%	58.9%	58.9%	75
Gold	3.1%	4.1%	-3.6%	-3.6%	1,829
Dollar Index	-0.3%	1.5%	6.4%	6.4%	96

Market Summary - December 31st, 2021					
Stock Market Indices	**MTD**	**QTD**	**YTD**	**1 Year**	**End Value**
NASDAQ Composite	0.7%	8.5%	22.2%	22.2%	15,645
DOW Jones Avg.	5.5%	7.9%	20.9%	20.9%	36,338
Large Cap Core (S&P 500)	4.5%	11.0%	28.7%	28.7%	4,766
Large Cap Growth	2.5%	13.4%	32.0%	32.0%	3,377
Large Cap Value	7.0%	8.3%	24.9%	24.9%	1,548
Mid Cap Core	5.1%	8.0%	24.7%	24.7%	2,842
Mid Cap Growth	4.1%	8.0%	18.9%	18.9%	1,386
Mid Cap Value	5.9%	7.9%	30.6%	30.6%	889
Small Cap Core	2.2%	2.1%	14.8%	14.8%	2,245
Small Cap Growth	0.4%	0.0%	2.8%	2.8%	10,720
Small Cap Value	4.1%	4.4%	28.3%	28.3%	16,585
Europe	5.6%	4.2%	15.0%	15.0%	479
England	6.9%	5.3%	17.4%	17.4%	7,385
Japan	1.7%	-5.3%	-4.4%	-4.4%	28,792
Shanghi 300	2.4%	3.0%	-0.9%	-0.9%	4,940
MSCI China	-3.2%	-6.1%	-21.7%	-21.7%	613
International	5.1%	2.7%	11.7%	11.7%	2,336
Emerging Markets	1.5%	-1.6%	-3.6%	-3.6%	49

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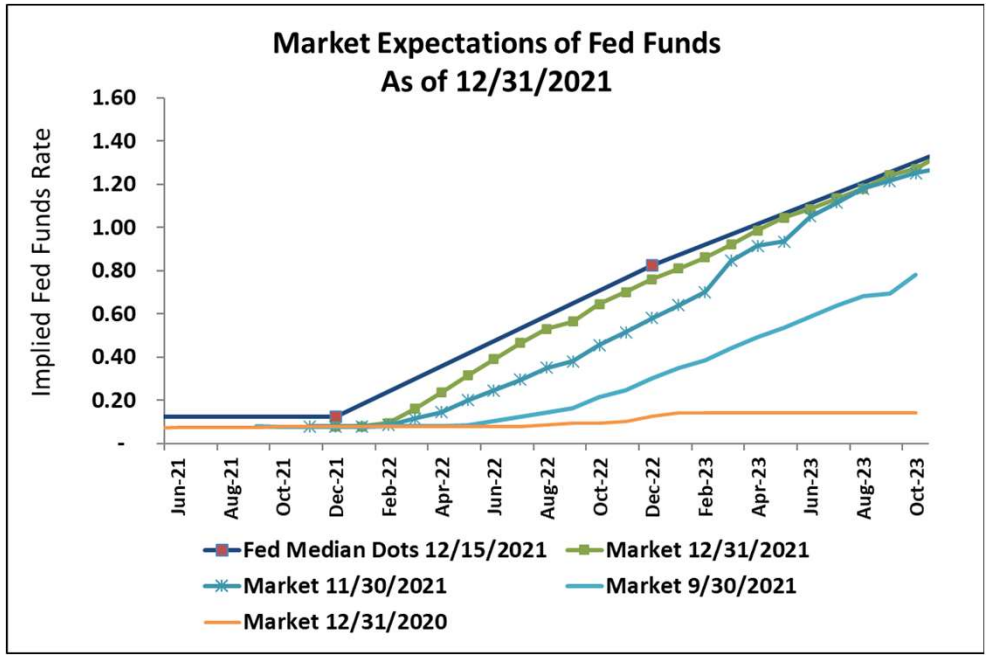
Market Review

Monetary/Fed Policy – December 2021

Federal Reserve Median Economic Projections As of 12/15/2021						
Change in GDP	**Actual**	**2021**	**2022**	**2023**	**2024**	**Longer Run**
Dec. 2021 Projection		5.5	4.0	2.2	2.0	1.8
Sept. 2021 Projection		5.9	3.8	2.5	2.0	1.8
June 2021 Projection		7.0	3.3	2.4		1.8
Mar. 2021 Projection		6.5	3.3	2.2		1.8
Dec. 2020 Projection		4.2	3.2	2.4		1.8
Actual Q3 2021 yoy/qoq	**4.9%/2.3%**					
Unemployment Rate						
Dec. 2021 Projection		4.3	3.5	3.5	3.5	4.0
Sept. 2021 Projection		4.8	3.8	3.5	3.5	4.0
June 2021 Projection		4.5	3.8	3.5		4.0
Mar. 2021 Projection		4.5	3.9	3.5		4.0
Dec. 2020 Projection		5.0	4.2	3.7		4.1
Actual December 2021	**3.9%**					
PCE Inflation						
Dec. 2021 Projection		5.3	2.6	2.3	2.1	2.0
Sept. 2021 Projection		4.2	2.2	2.2	2.1	2.0
June 2021 Projection		3.4	2.1	2.2		2.0
Mar. 2021 Projection		2.4	2.0	2.1		2.0
Dec. 2020 Projection		1.8	1.9	2.0		2.0
Actual November 2021	**4.7%**					
Core PCE Inflation						
Dec. 2021 Projection		4.4	2.7	2.3	2.1	
Sept. 2021 Projection		3.7	2.3	2.2	2.1	
June 2021 Projection		3.0	2.1	2.1		
Mar. 2021 Projection		2.2	2.0	2.1		
Dec. 2020 Projection		1.8	1.9	2.0		
Actual September 2021	**3.6%**					

- The Fed held rates at their "lower bound" near zero, continuing bond purchases; in December, the Fed purchased 60 Billion in US Treasuries and 20 Billion in Mortgages.
- The Fed plans to end its purchasing program by March 2022, then they will give more clarity on how they plan to reduce their balance sheet.
- Further, Governors have pulled forward timing of the first-rate hike expected around the March 2022 Fed Meeting.
- The Fed is behind the curve and are playing catchup with both their outlook and policy.



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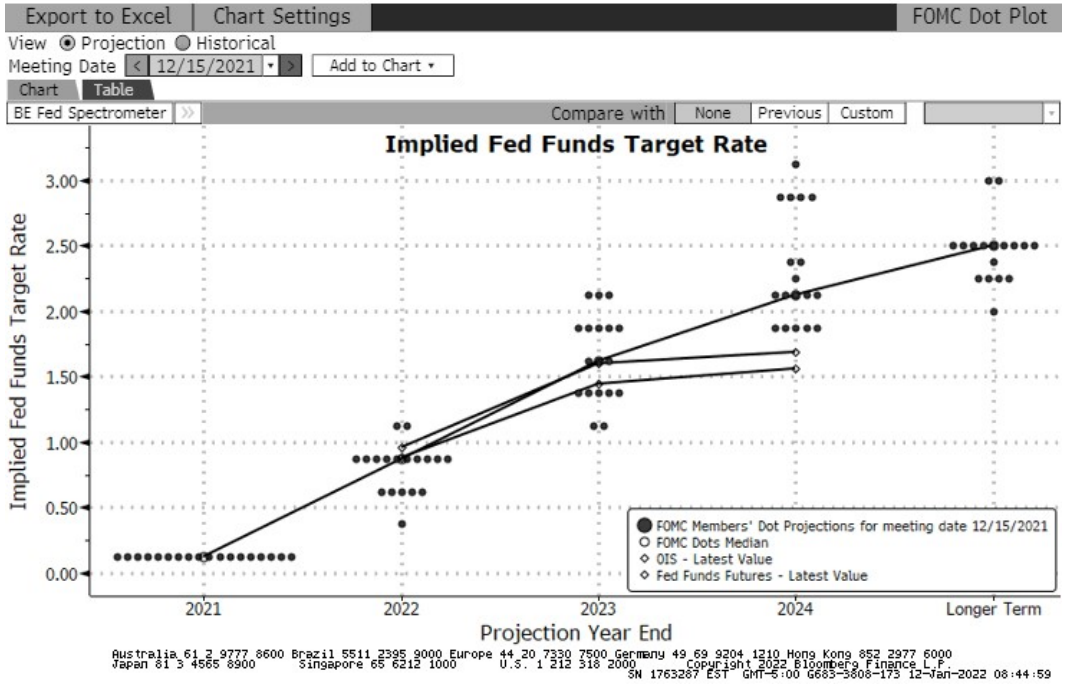
Market Review

Monetary Policy – December 2021

- Most Fed Governors pulled forward their expectations of the timing of the first tightening amid stronger than expected economic growth and rising inflation above expectations.
- Inflation expectations have risen but long-term inflation implied by TIPS remain well below actual inflation and our expectations.
- The strong economy, particularly the housing market, is leaving the Fed with little reason to continue to purchase US Treasuries and MBS.



Current Fed Funds Rate
0.08

10 Year Tip	10 Year UST	Implied Inflation Premium
(0.97)	1.63	**2.60**

5 Year Tip	5 Year UST	Implied Inflation Premium
(1.61)	1.36	**2.97**

2 Year Tip	2 Year UST	Implied Inflation Premium
(2.51)	0.75	**3.26**

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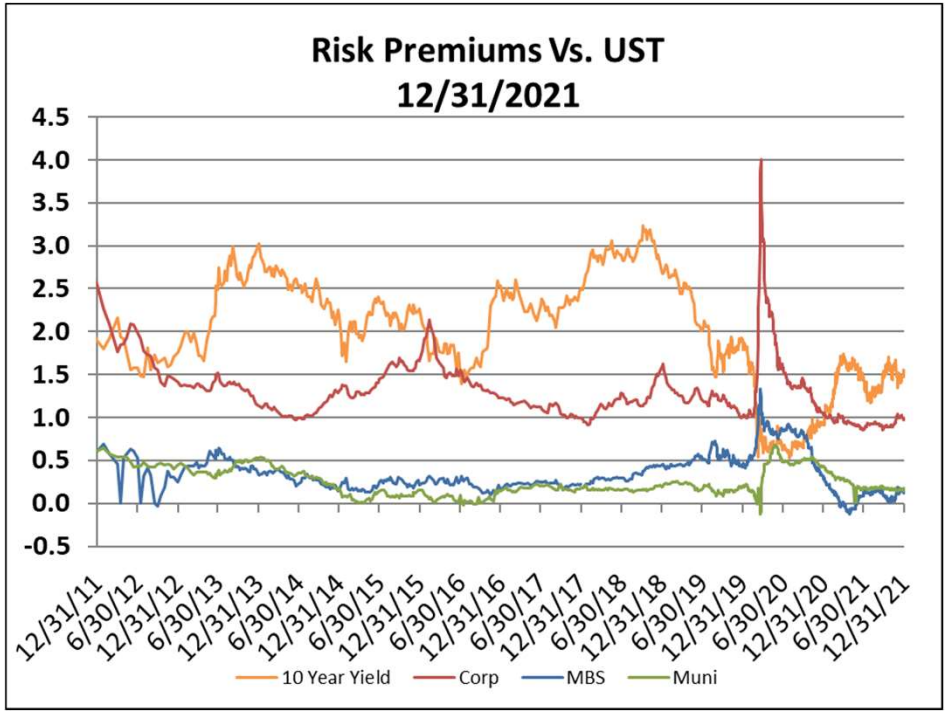
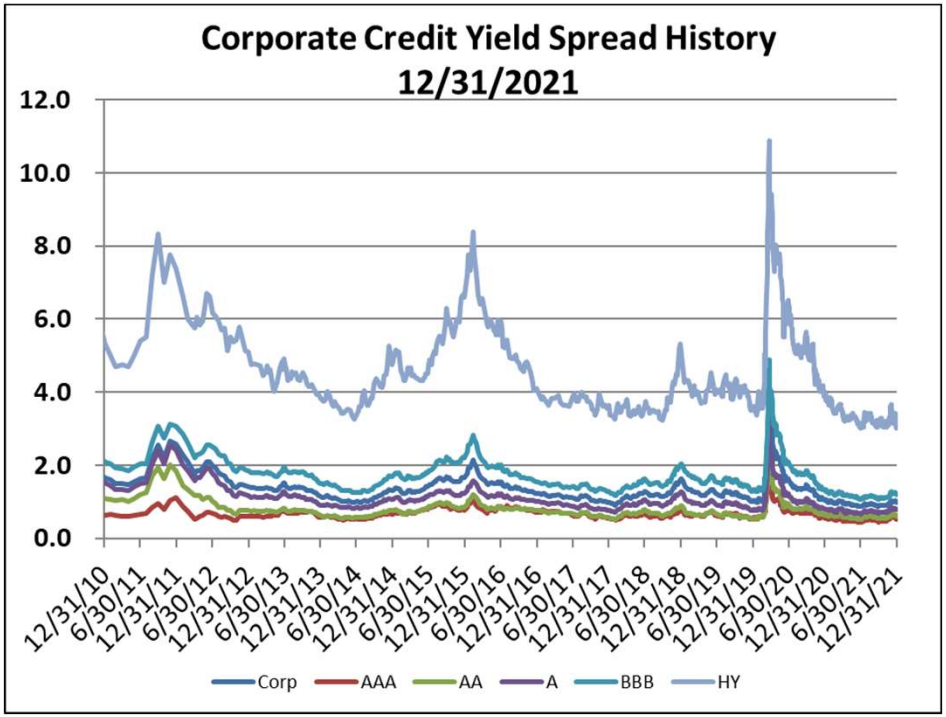
Market Review

Yield Spreads – December 2021

- Corporate yield spreads tightened in December; while Muni & MBS spreads were unchanged 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

Corporate Yield Spreads – December 31st, 2021

- Average Breakeven spreads maintain a low level as corporate spreads remain narrow.
- For the total corporate bond market, on average, it would only take 15 bps of spread widening to offset 1 year's worth of income in performance.
- Higher quality bonds show even more sensitivity to this spread risk, while lower rated and lower duration corporate bonds provide some cushion to widening spreads.
- To avoid the impact of this "risk" event, we have been working to "shorten" both investment grade and High Yield allocations.

Rating Summary	Eff. Duration	Avg. Spread	Avg. Breakeven
Total	7.3	88	15
AAA	8.1	36	5
AA	7.6	53	8
A	7.4	73	12
BBB	7.1	106	19
BB	5.0	217	55
B	4.2	360	114
Low	3.9	627	216

Rating	Maturity Summary	Eff. Duration	Avg. Spread	Avg. Breakeven
AAA-BBB	1-3	1.8	33	18
AAA-BBB	3-5	3.8	45	12
AAA-BBB	5-7	5.3	60	11
AAA-BBB	7-10	7.6	77	10
AAA-BBB	10-15	9.9	103	11
AAA-BBB	15+	16.6	109	7
BB - D	1-5	2.0	452	233
BB - D	5-8	4.1	378	94
BB - D	8+	7.0	374	58

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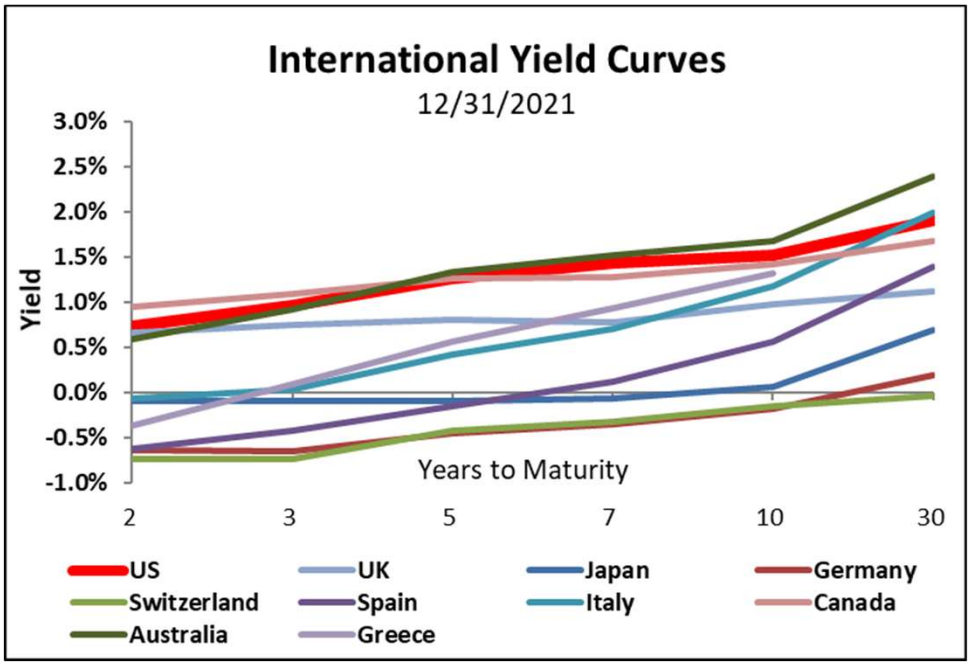
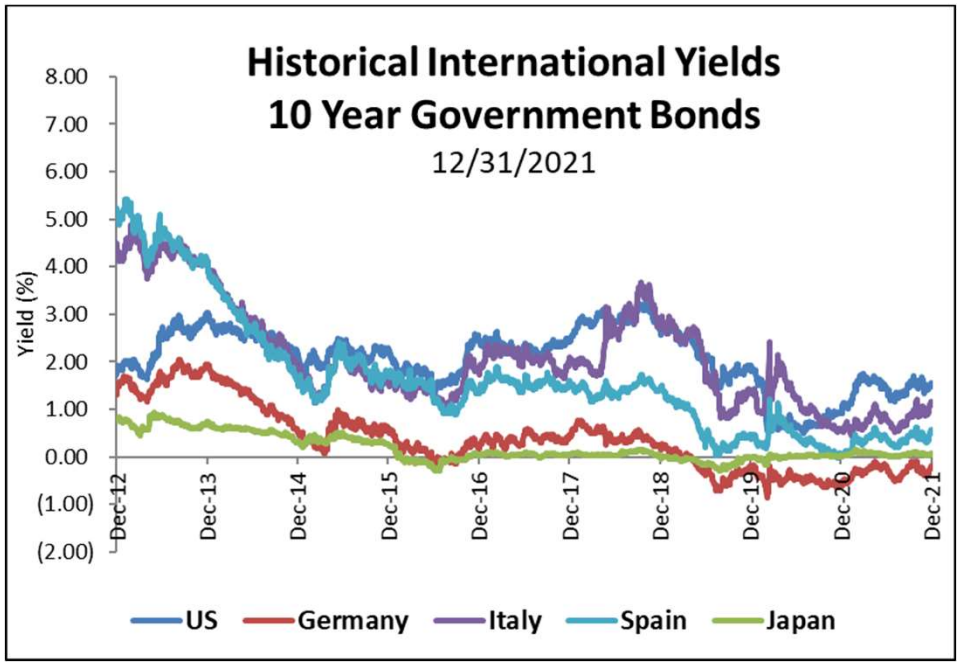
Market Review

International Yield Curves– December 2021

- Tides have started to shift globally as inflation grips global markets; Most central banks have indicated an end to their purchasing programs while indicating rate hikes are in the future.
- The US continues as one of the highest yielding developed countries as rates remained negative in Europe and flatlined at 0% in Japan.
- These interest rate differentials also contribute to a strengthening dollar.





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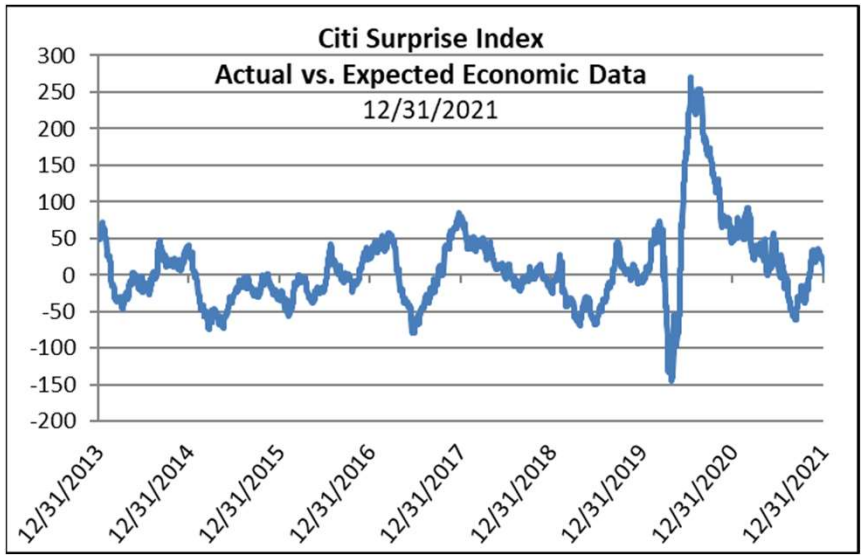
Economic Environment

December 2021

- Global GDP shows extreme YOY growth as we move out of COVID-19 trough valuations, moving forward it could be expected these value to normalize.
- Inflation has moved higher with expectations of future inflation continuing to rise due to significant stimulus and the increased cost of doing business.
- The Citi surprise index has come down from its highs as economic results moderated amid the resurgence of the Omicron wave, that is now fading.



GDP YoY % Change			
	Q3 2021	One Year Ago	Change
US	4.90	(2.90)	7.80
Eurozone	3.90	(4.10)	8.00
Germany	2.50	(3.80)	6.30
France	3.30	(3.60)	6.90
Italy	3.95	(5.42)	9.37
UK	6.80	(7.80)	14.60
Canada	3.80	(3.40)	7.20
Mexico	4.53	(8.74)	13.27
Australia	3.90	(3.50)	7.40
Japan	1.20	(5.40)	6.60
China	4.90	4.90	0.00
Russia	4.30	(3.50)	7.80
Brazil	4.00	(3.70)	7.70

**Canada GDP as of 10/31/2021*

Inflation YoY % Change			
	Dec-21	One Year Ago	Change
US	7.00	1.40	5.60
Eurozone	5.00	(0.30)	5.30
Germany	5.30	(0.30)	5.60
France	2.80	0.00	2.80
Italy	3.90	(0.20)	4.10
UK	5.10	0.30	4.80
Canada	4.70	1.00	3.70
Mexico	7.36	3.15	4.21
Australia	3.90	(3.50)	7.40
Japan	0.60	(0.90)	1.50
China	1.50	0.20	1.30
Russia	8.39	4.88	3.51
Brazil	10.06	4.52	5.54

**UK Canada, & Japan as of 11/30/2021*
**Australia CPI as of 9/30/2021*

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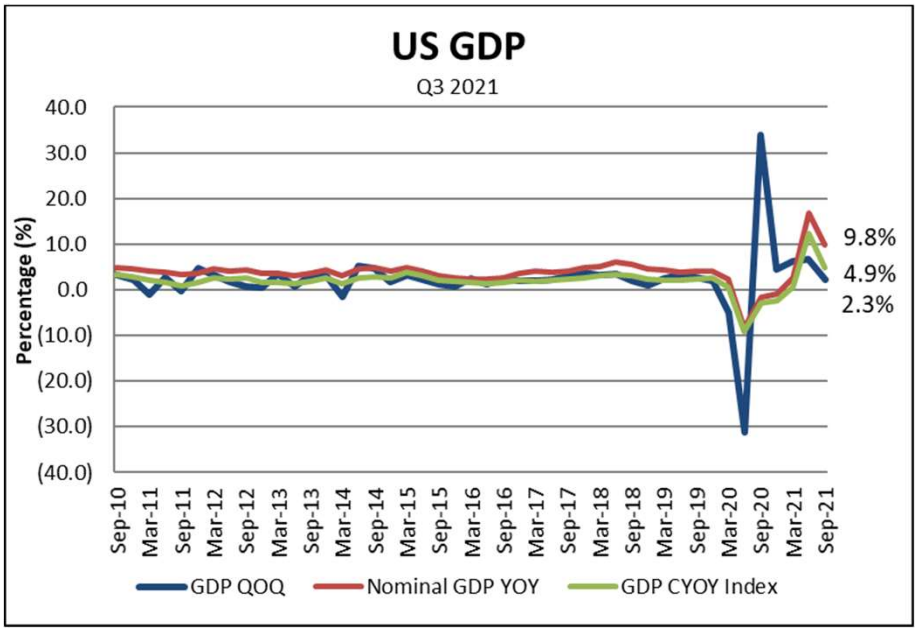
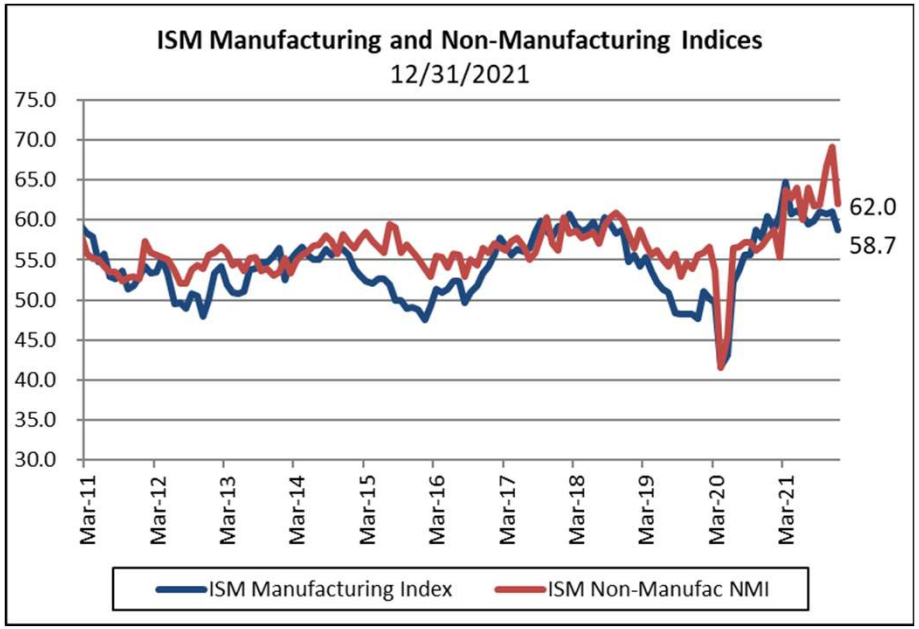
Economic Environment

December 2021

- US Economic activity retracted in Q3 as the economy was impacted by waves of covid-19 & inflation which created a unique situation of increased demand with falling supplies and not enough effective capacity to satisfy demand. Moving forward, the economy will need to find ways to maintain this growth as government stimulus falls as we work out of the pandemic.
- Consumption has been robust amid significant stimulus, including cars and homes, and associated goods and services, to the degree they have been available.





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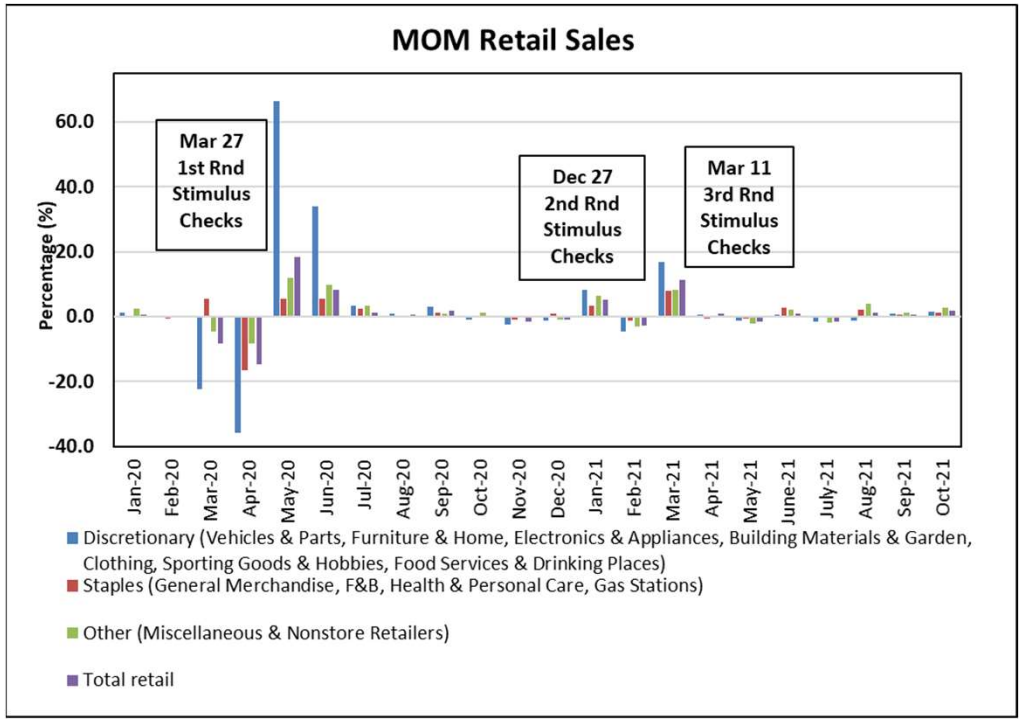
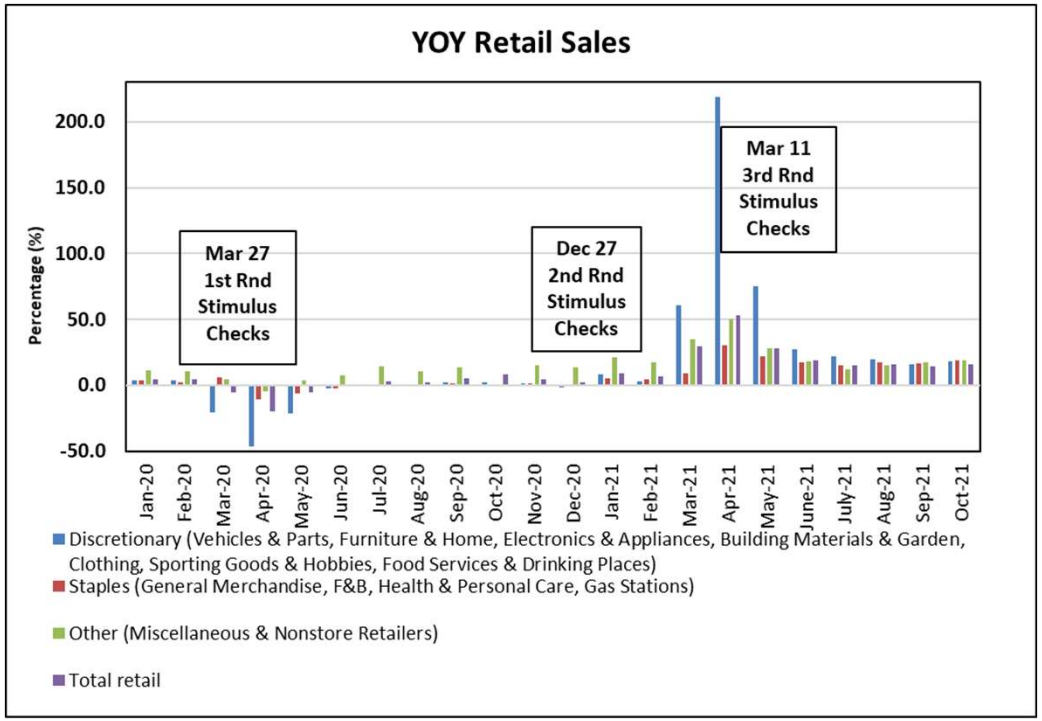
Economic Environment

Retail Sales – December 2021

- Spending on discretionary items followed closely in-line with stimulus payments, proving much more volatile than any other grouped category.
- Month-over-month data shows a sluggish consumer as unemployment benefits roll off and consumers are forced to seek employment, lowering MOM spending.
- The significant YOY comparisons due to base level comparisons will soon roll off.





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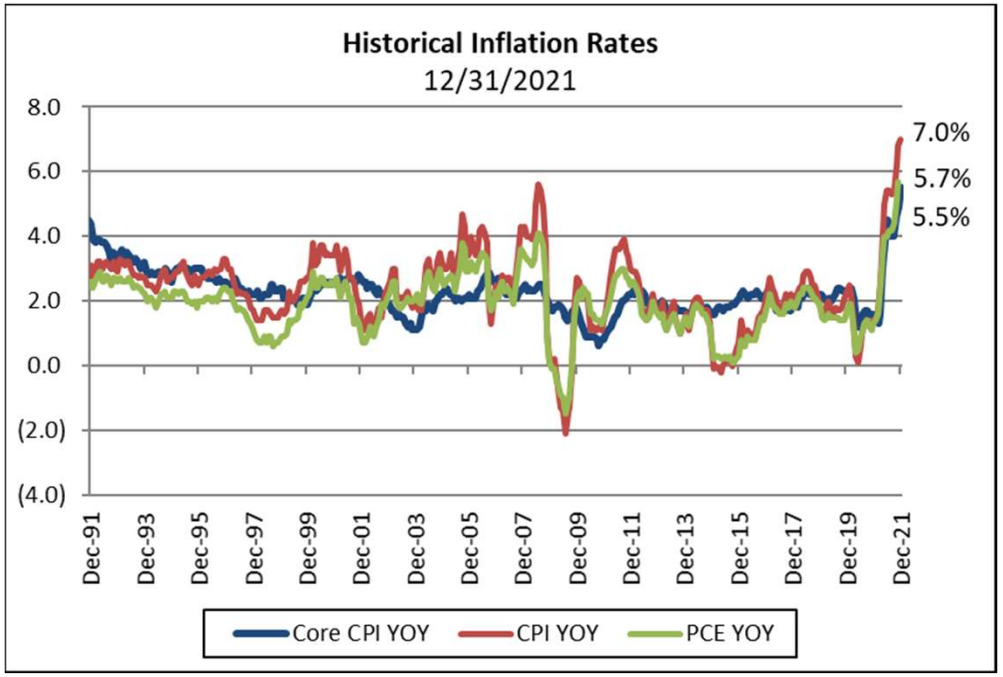
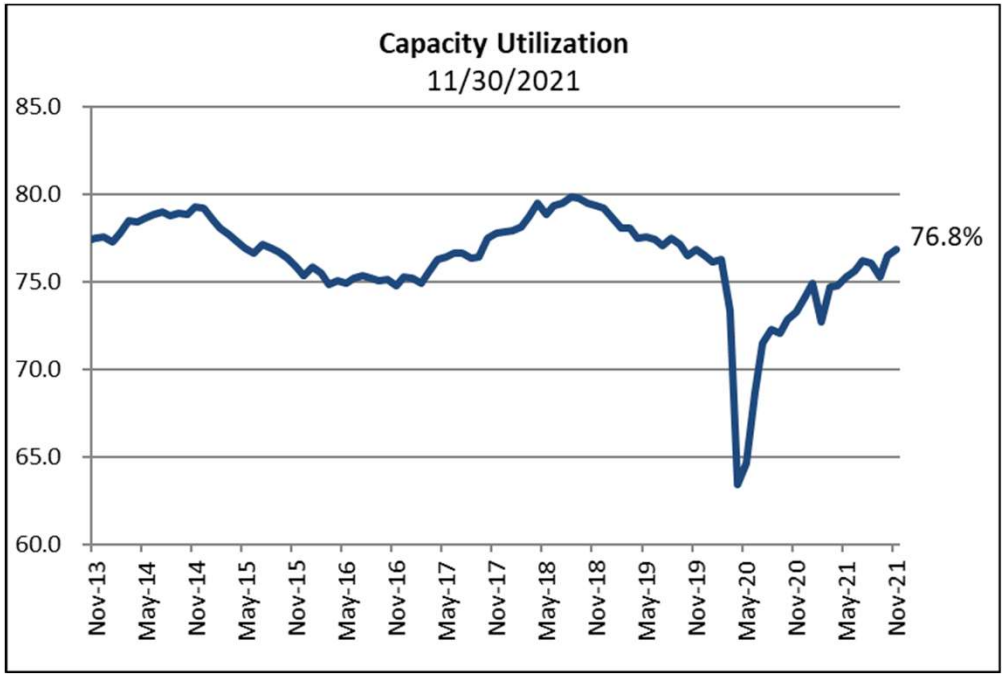
Economic Environment

Employment and Inflation – December 2021

- Inflation levels continue to rise amid resurgence of growth and supply disruptions & stimulative government policy. Demand for higher wages by a tight labor force is contributing to higher costs.
- Expectations of inflation are increasing as the realization of the increased costs associated with working, living, and operating in a post-pandemic world with increased health and safety measures.
- Capacity utilization has steadily increased as factories come back online; however, overall capacity is limited by worker shortages due to new variants and material shortages.





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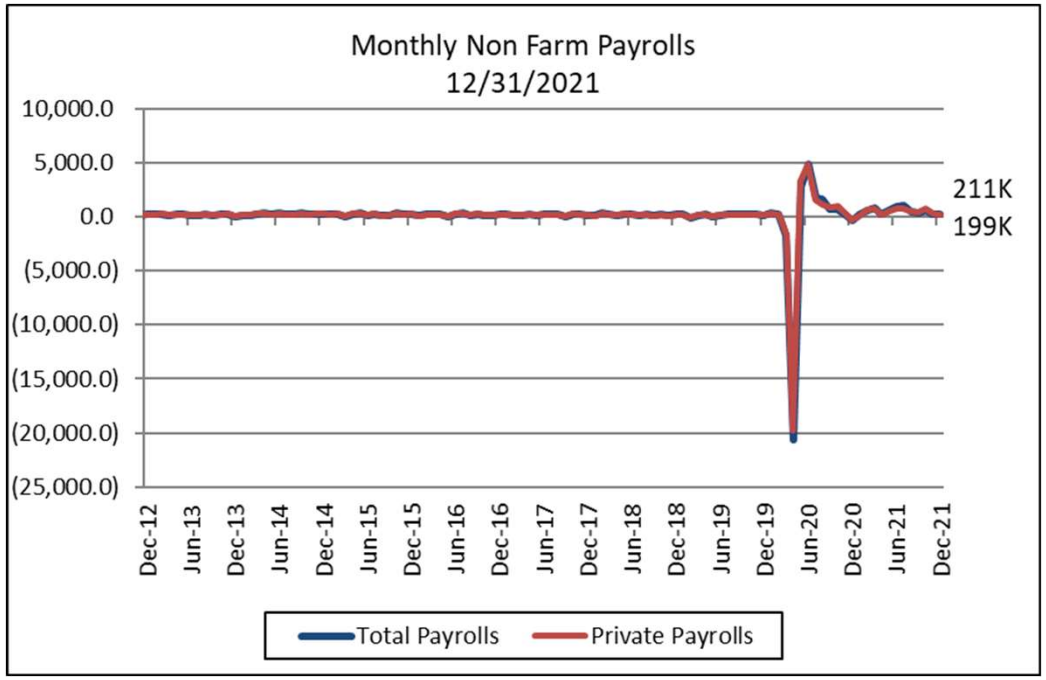
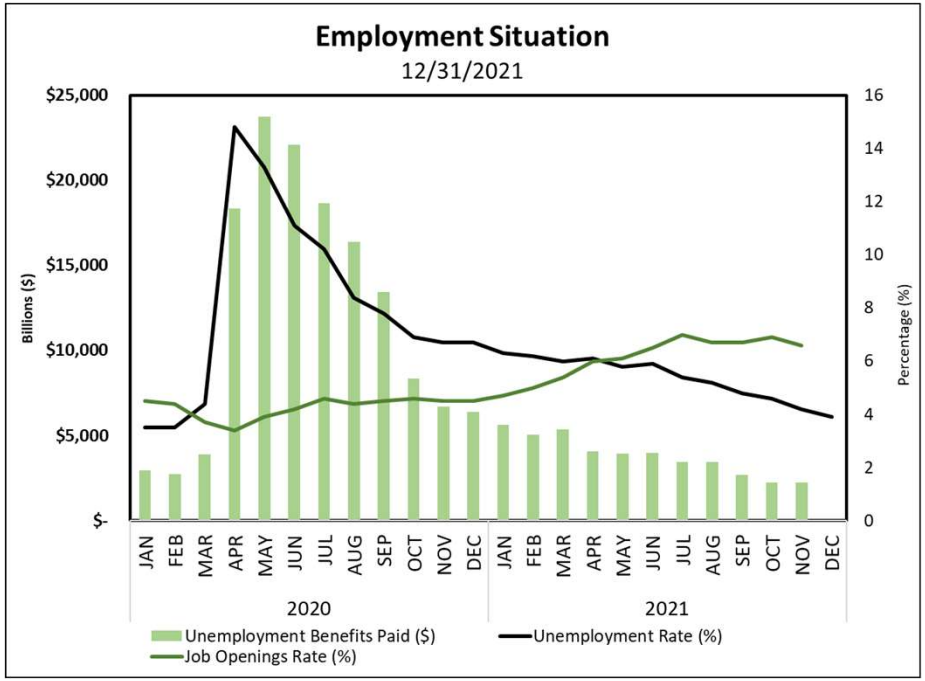
Economic Environment

Employment – Monthly Payrolls – December 2021

- Monthly Payrolls have not been as robust as expected and are normalizing with pre-pandemic levels as inflationary pressures begin to weigh on firms' ability to pay higher wages.
- The unemployment rate has fallen below 4% for the first time since before the pandemic induced shutdown; all while the US maintains a significant number of job openings.
- There are significant additions to the working world per the household survey, while the monthly payroll numbers understate additions, then provide increased revisions.





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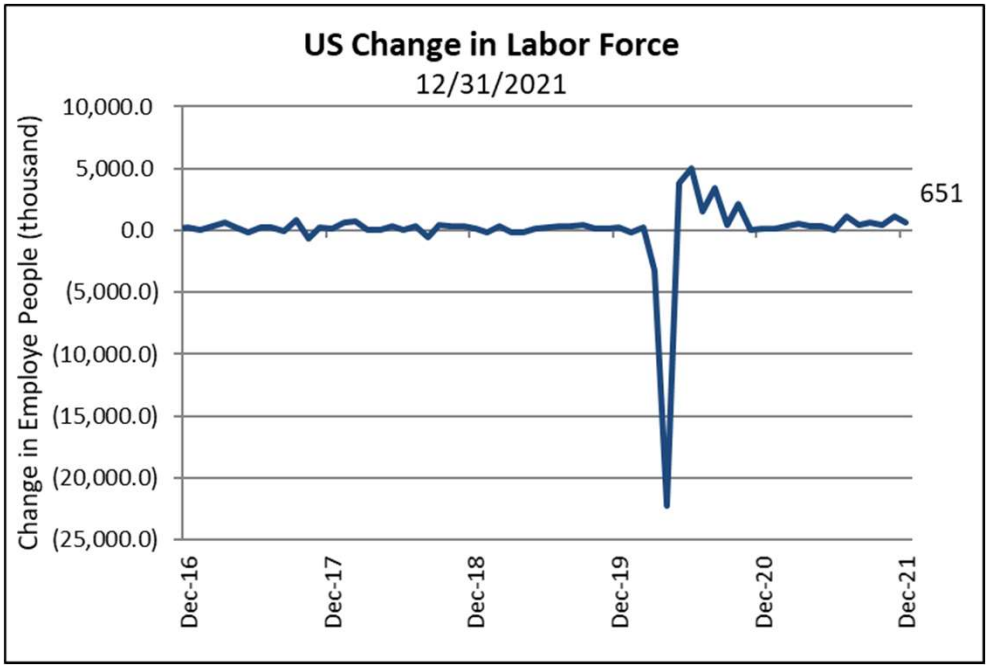
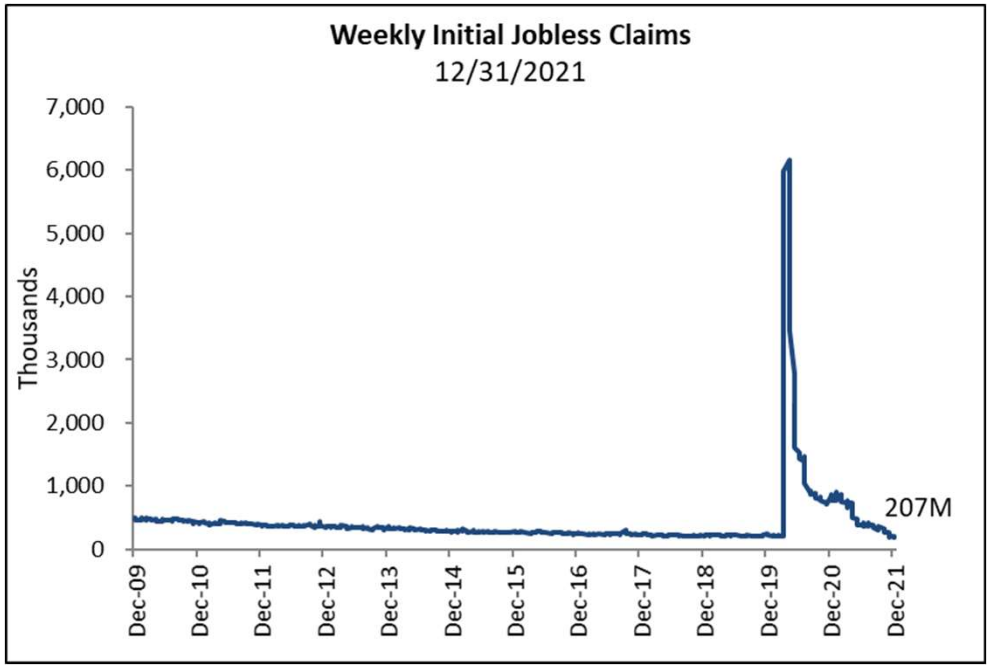
Economic Environment

Employment – Monthly Payrolls – December 2021

- 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.
- Amid the current Omicron wave, workers are calling in sick but not getting laid off amid a tight labor market.
- Job gains per the household survey are growing significantly as people come off the unemployment rolls and off the sidelines.





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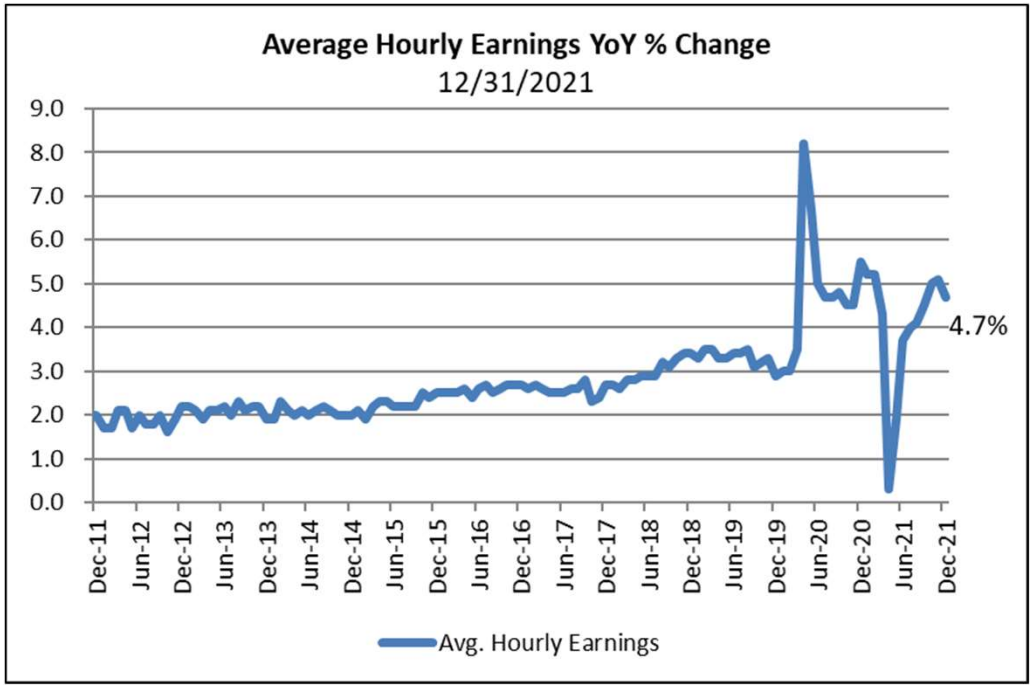
Economic Environment

Employment and Inflation – December 2021

- 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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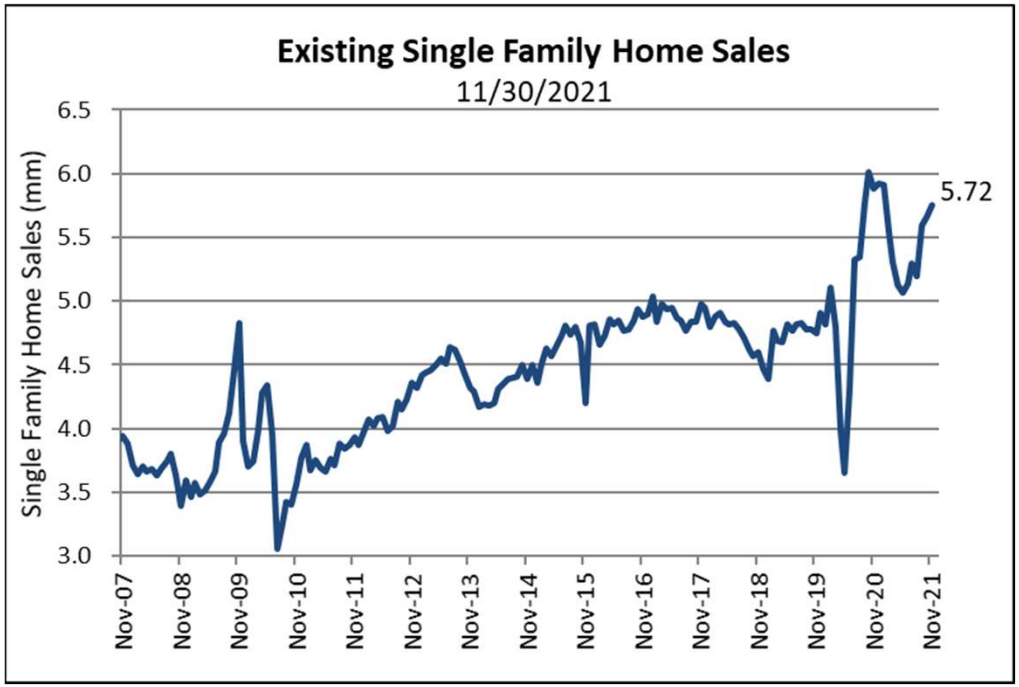
Economic Environment

Mortgage Rates and Housing – December 2021

- Mortgage rates are still near record lows; however, are on the rise along with interest rates. Commitment rates ended the year around 2.6%.
- Lower mortgage rates have supported home sales to some degree, but the significant migration to suburbs from cities has been a driving factor, which has also pushed housing prices higher.
- Single family home sales continue to surge as home price increases slowed towards the end of 2021, providing a window for new home buyers to enter the market.



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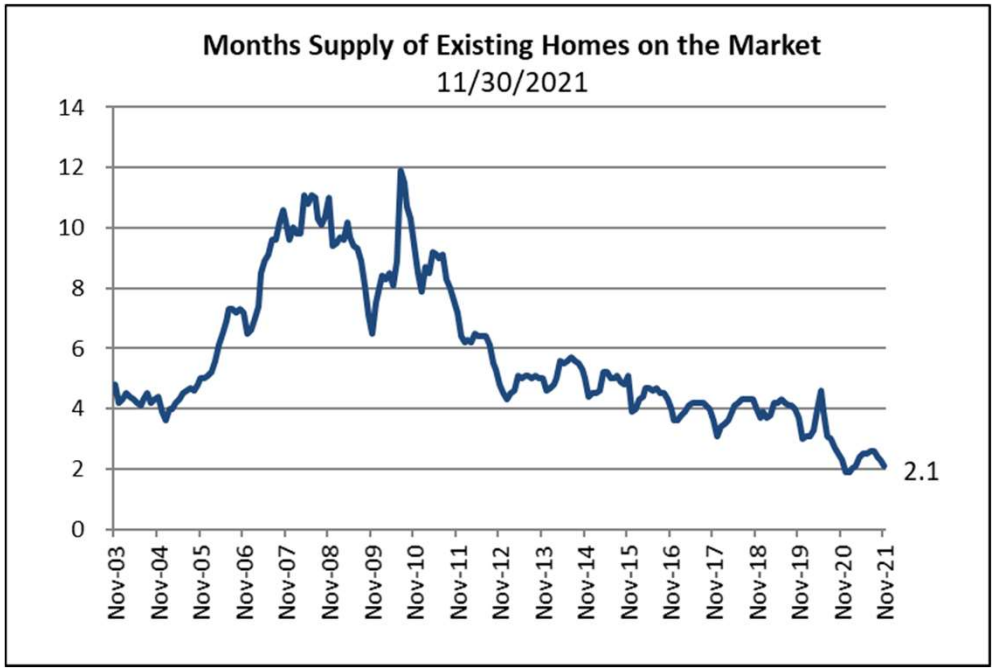
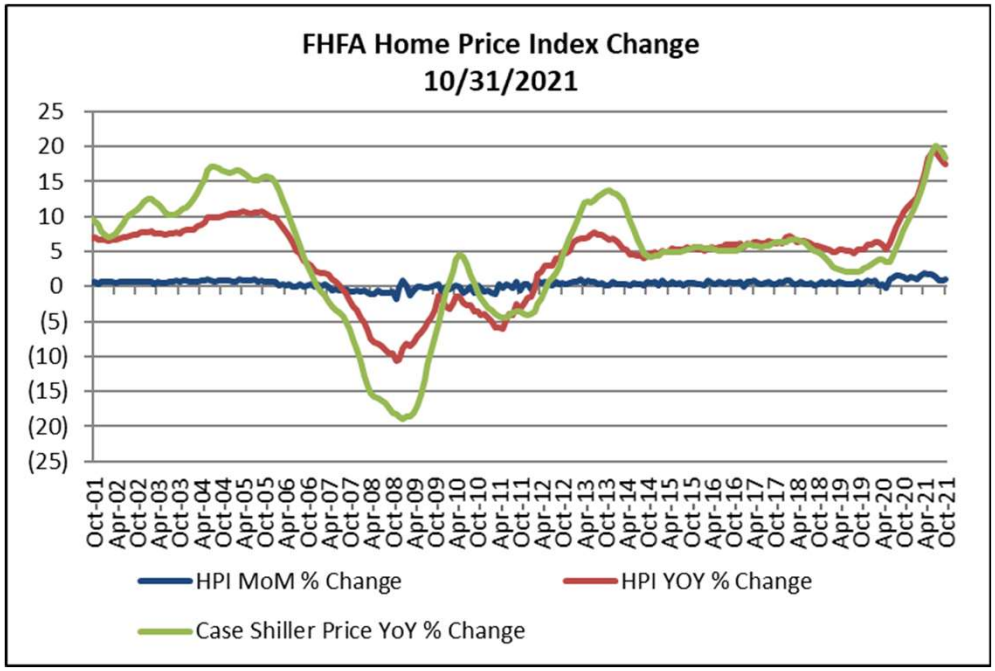
Economic Environment

Mortgage Rates and Housing – December 2021

- With home sales surging and the price of materials and labor rising, it has been difficult for existing home supply to increase; currently stuck around 2 months of supply.
- 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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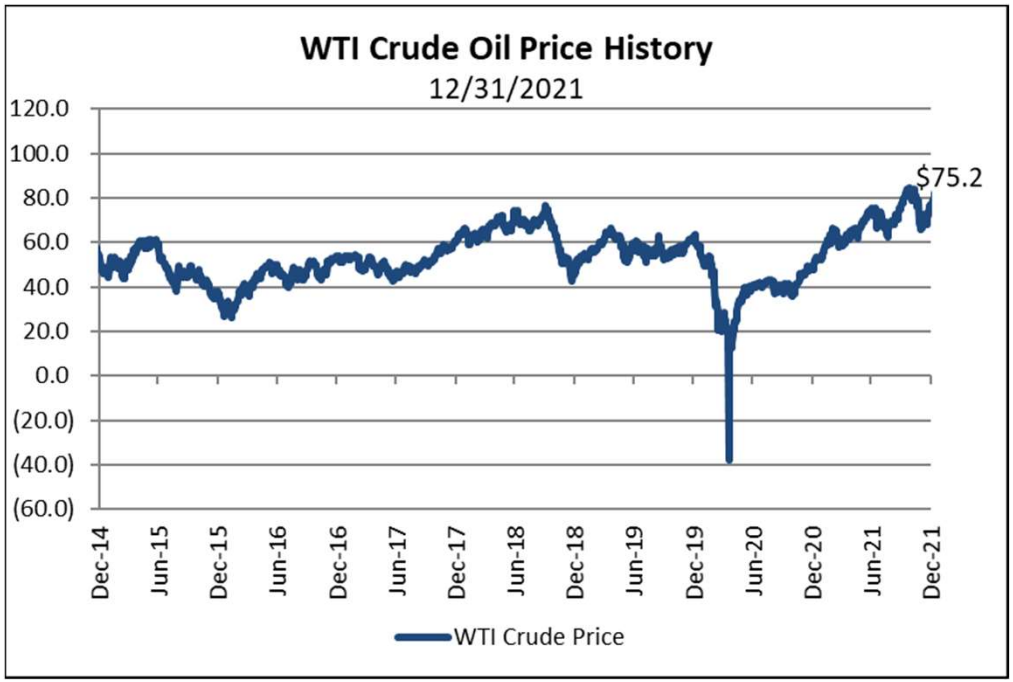
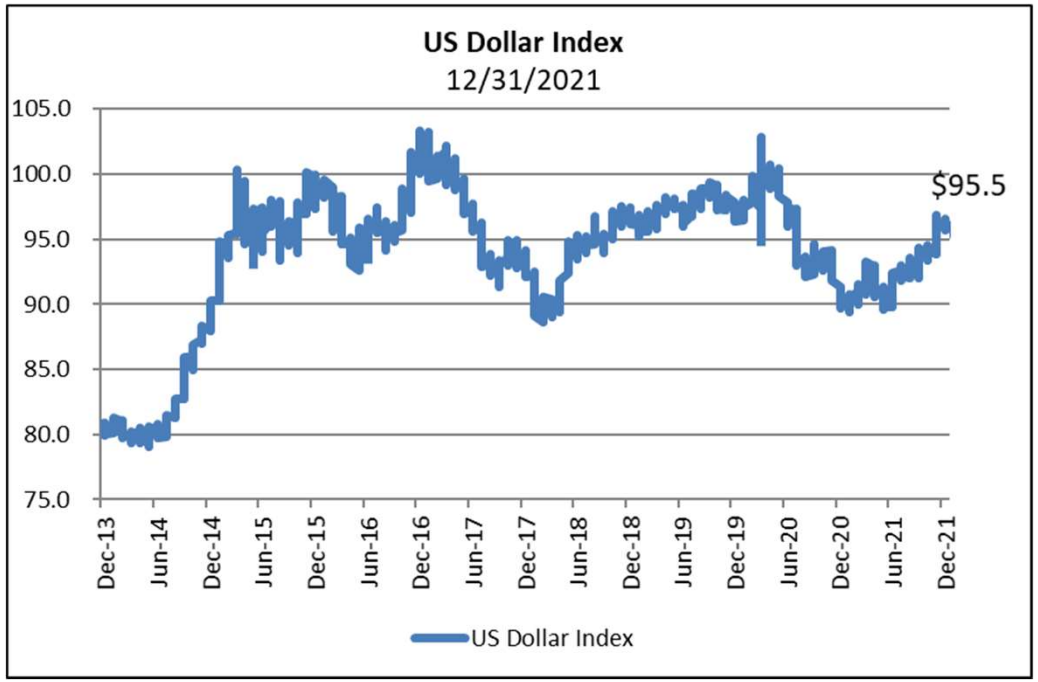
Economic Environment

December 2021

- As economies come back online and oil supplies work down, the price of oil has stabilized above $75. There is an interesting dynamic of government policy pushing industries to "green" energy production; which has had an impact of reducing the supply of oil, however the demand for energy surges; pushing prices higher as "green" energy alone cannot passably support current energy needs.
- 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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