# WEEKLY WISDOM

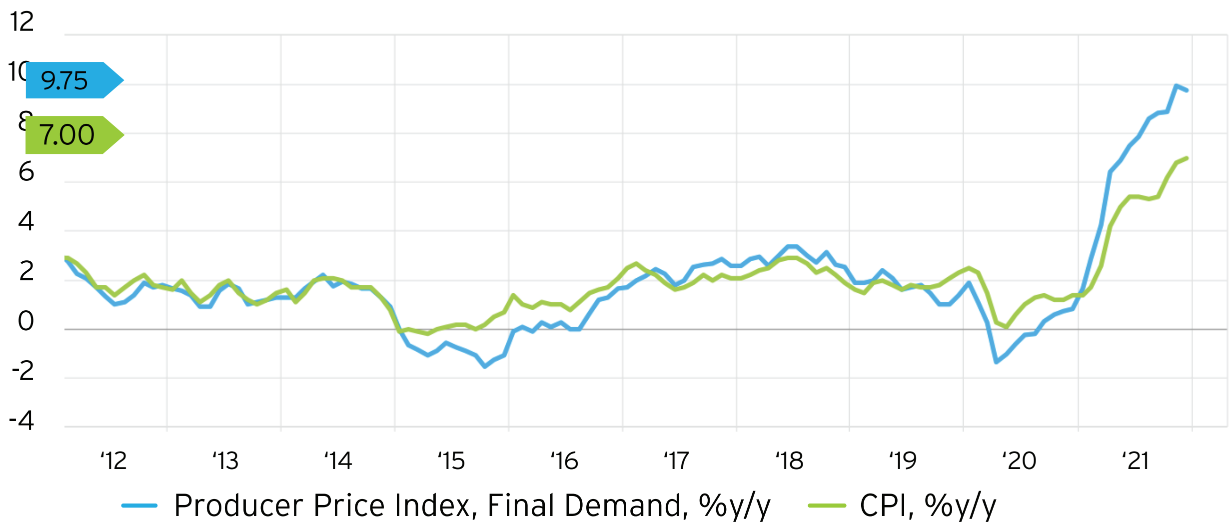
## R.E.F. (Rates, Energy, Financials)
January 19, 2022

### Tighter Monetary Policy and Prospect of Rate Hikes are Pushing Yields Higher

Last week, we received December CPI +7% y/y, PPI +9.7% y/y and hourly earnings +4.7% y/y.

Inflation is entrenched – from the pump to the supermarket, the repair shop to the vet, the hotel to the furniture store. Higher costs are pressuring businesses to raise prices to protect their bottom line. In particular, higher energy (Brent crude +55% y/y), labor (+8.3% y/y Q3 unit labor costs), food (Columbian coffee +72% y/y) and materials costs (copper +24%) have impacted the end consumer. The significant demand strained many industries that have, in recent years, underinvested in capacity and supply chains. Underinvestment and demand shifts resulted in supply shortages across the housing industry, energy sector and widespread labor shortages, specifically in the transportation and hospitality sectors. Add on the supply chain shortages that are not expected to improve until 2nd half 2022 or into 2023, and the inflation pressures will likely persist.

### Chart 1: Inflation Indicators[1]




[1] Source: FactSet (chart)

That is the demand side of the inflation story. There is also the monetary policy side that has added logs to the fire with interest rates near zero and excessive emergency stimulus policy that continues today. Nominal GDP has compounded at a +14.9% average annual rate over the six quarters beginning in Q3 2020. Sustained, double-digit nominal GDP hasn't been experienced since the high-inflation 1970s. The 10-year yield is currently 1.88% – more than 30% higher than its 1.44% level one month ago.

These two sides interact and create an inflationary spiral, as more money in the system generates higher savings and higher demand. More demand for goods and services in a low supply environment creates higher costs and higher demand for labor. Higher demand for labor creates wage pressure, which fuels more inflation.

As monetary policy begins to normalize, supply chain challenges and wage pressures will likely continue. And this is why the recent debate has been "when" not "if" the Fed will begin to raise rates…and how often it will raise rates. The bond market is pricing in three rate hikes, but four rate hikes might be likely. We will carefully watch the economic data throughout 2022.

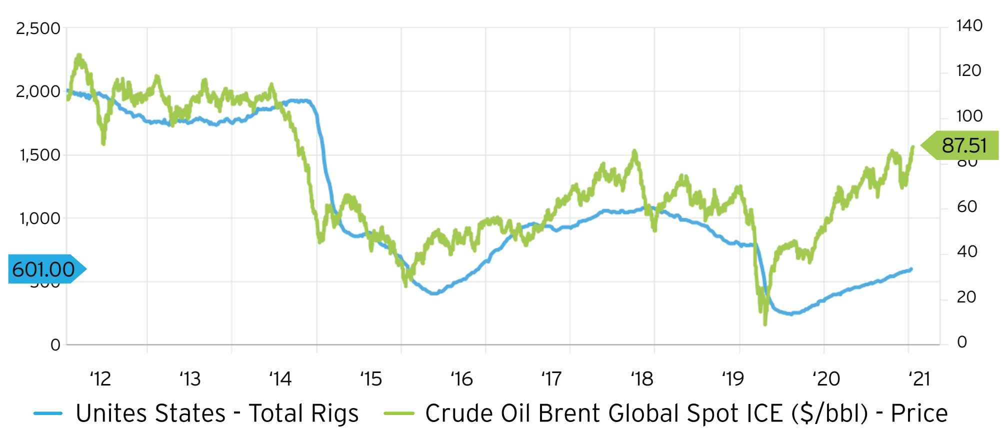
## Crude Prices Continue Reaching New Record Highs

Energy prices are a critical component to inflation and an example of the impact that limited supply can have on rising prices amid a shift in demand. Natural gas and Brent crude oil have increased +50% and +60% over the past year, respectively, and +15% and +20% over the past month. Limited investment in infrastructure capacity over the past decade, a result of increased activism and government pressure to divest from fossil fuels and reduce carbon emissions, has led to a significant reduction in supply over the past year and has resulted in the low inventories we experience today amid strong demand.

We are overweight the energy sector as companies can capitalize on the favorably priced environment by either investing in additional capacity or developing new energy alternatives for the future. In addition to these investments, energy companies are returning cash to shareholders. Sales, EPS, buybacks and dividends have all increased over the last twelve months for the sector.

For perspective, during the six years, 2010-2015, active U.S. rotary rig count averaged 1,655. Contrast that to the most recent six years, 2016-2021, the U.S. rig count has averaged 712 rigs (with 2021 totaling just 475 rigs). Operating additional rigs requires investment in infrastructure and labor. New exploration requires government lease permits and corporate investment. There has been a steady uptick in the number of active U.S. rigs since August, but nowhere near the levels needed to meet demand.

## Chart 2: Number of Active U.S. Rigs, Price of Crude Oil[2]




[2] Source: FactSet (chart)

Higher infrastructure costs, resulting from higher labor and equipment costs also impact the cost of production. The CEO of oilfield services company Schlumberger (SLB) commented during their Q3 earnings call that, "with oil and gas price attaining recent highs, inventory at their lowest level in recent history, a rebound in demand and encouraging trends in the pandemic containment efforts – this strengthening in industry fundamentals, combined with the inaction of OPEC+ and continued capital discipline in North America, have firmly established a prospect of an exceptional multi-year growth cycle ahead." We tend to agree. Inventories are lower and prices are higher today, compared to when Olivier Le Peuch first made those comments on October 22, 2021. SLB reports their Q4 earnings this Friday, January 21.

## Financials Benefit from Steepening Yield Curve – What We've Heard so Far…

As we noted above, there is a broadly held expectation that inflation is entrenched and will remain so through 2022. Financials tend to be beneficiaries of a rising rate environment. A steeper yield curve contributes higher profitability for their lending programs. YTD, financials and energy are the only positively performing sectors.

The big six banks – BAC, WFC, MS, GS, JPM and C – have reported. The highlights have been strong revenues in Investment Banking, Investment Management, loan growth, Net Interest Income contribution and better Return on Tangible Common Equity. Earnings were partially offset by elevated expenses. Some names have navigated this better than others and we continue to be selective in this sector – although remaining overweight.

## Stephanie Link: CNBC TV Schedule

| DATE | SHOW | TIME |
|---|---|---|
| Wednesday, January 19 | Squawk Box | 6:00 AM ET (time to be determined) |
| Thursday, January 20 | Closing Bell | 3:00 PM ET |





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