



Fed Fights (Non-Transitory) Inflation and Russia Invades Ukraine April 2022

My Dear Client:

Last year the equities markets were exceptionally good, marked by one all-time high after another (70 days in total!). The market was always heading higher. Three months into 2022 has shown this to be a much different year.

It's been a flood of negative economic news: inflation at a 40-year high, interest rates higher and rising, nationwide gas prices around \$5/gallon, food prices up and supply chain issues getting worse. The Fed has pivoted sharply in its language and actions to now slay the record-breaking inflation. Some of its members could have whiplash – indicating that it will aggressively tighten by reducing its balance sheet that was expanded in response to Covid, and hike short-term rates until significant progress is made on inflation.

4,391	5,192
61,660	57,410
7.1	9.0
3,495	2,724
3,863	3,783
1,125	1,051
1,451,569	1,381,416
98,020	99,091
1,695	1,876
31,389	26,751
5.4	6.5
980	6.5

Yet all the economic news this quarter is the secondary headline behind the brazen Russian invasion of Ukraine. Russia and the developed markets are now waging a battle across the world's energy fields, pipelines, and shipping lanes. In carbon-fueled economies, everyone feels some impact: industries, manufacturers, agriculture and, at the top, the households that must ultimately manage the shortages and absorb the costs inflicted by disrupted supply.

In the near term, Russia is Europe's primary source of energy – which gives the Kremlin a slight advantage. Despite the harsh sanctions imposed to shut down Russia's war machine, the European Union daily pays Russia hundreds of millions in hard currency for the energy its economy cannot do without.

Closer to home, inflation numbers and energy prices led domestic equities downward, with the Standard & Poor's 500 Index ending the first quarter at (-4.6%). Outside the U.S., international developed markets were a bit worse, at (-5.8%), while emerging market equities lost even more (-6.9%) as they were impacted by all the above and new Covid lockdowns in China.

A combination of high valuations for many names and the jump in interest rates in the U.S. propelled Value stocks to significantly outperform Growth in every asset class. Within Large Cap equities, Growth outperformed Value; in Small Cap equities, Value trounced Growth. Continuing the trend from last year, Large Cap (-4.6% S&P 500) was stronger than Small Cap as a whole (-7.5% Russell 2000) even as both were negative in first quarter of 2022.

In the U.S., the labor market continues unabated towards full employment, with the most recent unemployment rate now touching 3.6%. Payrolls rose in March to 431,000 as available jobs continue to outpace workers by a healthy ratio. This ratio does look to narrow in the coming quarters as many

“early retirees” return to work government Covid benefits end and hyperbolic returns in crypto assets and meme stocks (like GameStop) have waned.

Historically full or near-full employment would have everyone cheering except that the scorching CPI inflation measure of 8.5% at this level of employment and worker shortages guarantees continued increases in wages. The war could become the tipping factor to the global economy, as it is likely to dampen growth and simultaneously push inflation even higher – which creates the worst-case scenario of higher inflation and slower (or no) growth.

The equity market can expect little support from the Fed near-term and we will see how it performs without the beloved “Fed Put” that for a decade has rescued a declining market.

Domestic equity market



The first quarter of 2022 saw Value handily beat Growth in every market cap size across the equities market. In fact, as we went down from Large to Small Cap, we saw double-digit losses in growth stocks increase. The Russell 1000 Growth Index was down (10.6%) compared with its Value peer, which was down a scant (0.29%). The Russell Mid Growth Index dropped (12.8%) compared with the Mid Value Index coming in at (-.66%) and, worst of all, Small Caps via the Russell 2000 Growth Index fell (13.2%) as opposed to their Value counterpart falling just (2.6%). The influence of the Fed’s increasing talk and actions about corralling inflation clearly threw cold water on the multi-quarter post-Covid rally in growth stocks.

Within the S&P 500, we saw further clear evidence: Nine of 11 sectors were negative or very negative, with interest rate-sensitive Energy trouncing everyone with a gaudy (39%) rise and Utilities up a solid 4.4% for the quarter. Communication Services led the way downward (-11.25%), followed by Consumer Discretionary (-9.3%), Technology (-8.5%) and Real Estate (-6.2%) among the most notable laggards. Materials (-2.3%), Consumer Staples (-1.3%), Health (-2.6%), Industrials (-2.4%) and Financials (-1.5%) lagged more modestly for the period.

Though the move in Energy and Utilities can easily be correlated to the spike in oil and natural gas prices that were further inflamed by Russian aggression, long-term trends are also at work. Oil and other environmentally unfriendly assets have been under pressure to reduce their expansive footprint for nearly a decade. Now that the idea has taken hold, the global system experiences a removal of additional, needed supply.

That we saw high-flying growth sectors such as technology and sectors favorable to rising rates such as financials both retreat during the quarter speaks to the broad confluence of Fed policy changing direction, the Ukrainian invasion, supply chain issues, and the end of government payments to individuals and businesses propping up the economy and stock market.

While cheap money stimulates both borrowing and growth – as seen in strong stock market gains since March 2020 – tightening of money available will have the opposite effect. The median forecast for U.S. inflation is 4.3% in 2022, 2.7% in 2023, 2.3% in 2024 and 2.0% in the long run. Meanwhile, the median forecast for U.S. interest rates is 1.9% in 2022, 2.8% in 2023 and 2024 and 2.4% in the long run. To get a handle on inflation, the Fed may require a total of seven rate hikes to bring the Fed funds rate to 1.9% by the end of 2022.

The stock darlings of 2020 and 2021 have fallen 50% to 70% from their prior highs as investors aggressively repriced these types of investments based on rising interest rates and inflation projections. Investors may be well advised to remember the slogan, *Don't Fight the Fed*.

International markets

International equities likewise were impacted by inflation, supply chain concerns and of course the war, with Developed equities down (5.8%) and Emerging Markets down (6.9%). Like market leadership in the U.S., both Developed Small Caps and Emerging Markets Small Caps trailed their Larger Cap peers. International equities Developed and Emerging Markets, in similar fashion to the U.S., saw Growth-style underperformed Value-style for Large, Mid, and Small Cap equities this quarter.



The U.S. and its Western allies have imposed a wide array of economic penalties to punish Russia, which President Biden said was designed to weaken the ruble, crash the Russian stock market, and erode the Russian economy. But the effects may not be confined to Russia alone.

Russia is the 11th largest economy in the world; Europe is experiencing the brunt of the invasion's economic fallout. The price it pays for natural gas, more than 10 times above prices in the U.S., highlights its vulnerability. According to the European Union, Russia supplies 34% of its natural gas, 25% of its oil imports and 45% of its coal imports. The extent of exposure varies country to country, but Russian imports furnish nearly half of Germany's and Italy's natural gas. In the smaller EU countries farther east, the figure approaches 100%. Russia is also an important source of metals, fertilizers, and wheat worldwide.

The European Central Bank (ECB) has warned that the war can significantly dampen economic growth and simultaneously push inflation considerably higher. Eurozone inflation reached 5.9% in February, compared with the ECB's target inflation rate of 2%. The ECB reduced its bond-buying program, in an unexpected move to respond to higher inflation. The Bank faced a difficult choice, given the rapid deterioration of the economic situation, but containing inflation has become the priority. This situation will be particularly challenging since the European economy was slowing even before Russia invaded Ukraine.

The central banks of Singapore, Hong Kong, Taiwan, and South Korea have already begun raising interest rates to stem inflation and have signaled even more tightening ahead. Some of these central banks needed to tighten to keep pace with the Fed to maintain currency exchange rates with the U.S. dollar.

China, and Japan are not expected to tighten any time soon, but a strengthening U.S. dollar adversely impacts their markets, too. As if the inflation and supply chain issues were not worrisome enough, China, in continuation of its Zero-Covid policy, has placed 45 of its major cities and industrial hubs on lockdown. The impact of this action emerged as unemployment across 31 major Chinese cities rose from 5.4% in February to 6% in March – the highest on record per official data going back to 2018.

Combined, these pose significant challenges for the international and the global economy for the coming quarters and would seem to favor Value-style over Growth-style investments.

Bond markets



Bond market returns were negative for all fixed income sectors in every part of the globe this quarter.

The Bloomberg U.S. Aggregate Bond Index saw its worst quarterly decline since 1980, ending the first quarter down (-5.9%). March was the Index's worst month since July 2003. U.S. Corporate Investment Grade was the worst-performing bond sector, down (-7.7%) for the quarter. The beginning of rate hikes, the end of quantitative easing and other Central Bank efforts to expand the supply of money and make credit cheap, along with assertive talk about fighting inflation, made for a damper period for bondholders.

Treasury yields rose sharply during the quarter for 2- and 10-year maturities, up (1.6%) and (.83%) respectively. But the curve flattened significantly and ended the quarter with the 2- and 10-year yields near equal. More troubling: During the last week of the quarter, the yield for the 2-year exceeded the yield for the 10-year, creating an "inverted yield curve." Past yield curve inversions, where 2-year yields exceed those of 10-year maturities, have preceded a slowdown in the U.S. economy.

In response to ongoing inflation, the Fed concluded its tapering of asset purchases in March and raised its policy rate 25 bps, its first hike since 2018. Chairman Powell and several other Fed Governors announced that subsequent 50 bps or even 75 bps hikes, and an earlier start of run-off from the Fed's nearly \$9T balance sheet could be coming to stem inflation this year and next.

Strong job creation coupled with sub-4% unemployment has pushed wage increases above 5%, compared with the general 2%-3% increases during the past decade. This is a clear sign of a very tight labor market. Oil prices, which had been on the rise for months, climbed another 9% from the time of invasion on February 21 through quarter's end. As a result, President Biden pledged to release 1 million barrels of oil per day from the strategic petroleum reserves (SPR) to lower prices. Many states followed



suit, passing emergency legislation to slash state gas taxes to stop \$5-plus per gallon prices before the busy summer driving season.

U.S. housing has been booming for nearly two years. Recent data, however, has turned a bit more mixed, with existing home sales, new home sales and mortgage applications all declining. Mortgage rates spiked and as the quarter closed were hovering nationally around a 5% level not seen in many years.

The U.S. dollar has enjoyed a bull run for the past decade and appears overvalued by many metrics. At some point, the currency will shift into a bear cycle. Yet with the Fed's intention to wage a campaign of tighter monetary policy to tackle inflation, it is less likely that a dollar downturn will arrive anytime soon. The dollar's path will depend in part on how aggressively other central banks around the globe fight their own inflation battles. Still the Fed has only so many methods, tools, or tricks – such as jawboning – to move or influence markets.

Taming the inflation, created by the abundance of dollars and debt it and the U.S government have pumped into the economy, will not be an easy or quick fight.

A Look Ahead

A “soft landing” (ideal) scenario, where the Fed raises interest rates to moderate demand and bring down inflation without causing a recession, is now coming into view for investors.

So, if the Fed raises too slowly, it risks inflation getting even further out of hand. If it raises too aggressively, it likely triggers a recession. Real interest rates are already deeply negative. Negative real rates (aka cheap money), entices more borrowing, which leads to more spending and higher demand. The ideal scenario is also more endangered by escalating sanctions on Russia, higher energy and commodity prices and recent pandemic lockdowns in China.



The straight-up market of mid-2020 through last year, powered by negative rates with ample cheap money, has collided with the projected market, where much higher interest rates are needed to get inflation back down to 2%. So far, the result has seen stock high-flyers like Peloton and Netflix (among others) get crushed.

Last quarter I wrote: *“When the Fed is not worried about inflation, the market should be worried.”* The Fed is now worried – and we better pay attention.

My portfolio recommendations for your asset allocation reflect additional modifications to last quarter. Maintain a risk-balanced focus, multi-asset class approach, evaluate opportunities and be ready to



invest when larger short-term declines occur. Declines are occurring as are asset allocation adjustments. Consider:

- Rebalance overall asset allocation to target ranges – and when assets aren't cheap, Cash inside your portfolio is still a good idea until assets get cheap;
- Reducing overall U.S. equity allocation to mid-range of portfolio targets;
- Increase cash by reducing U.S. Large Cap growth stocks and keep Private Equity distributions on hand.
- Continuing to increase allocations to Small Cap value, core and Mid Cap value core, Emerging and International stocks to the bottom range of portfolio targets;
- Maintaining underweight of high quality fixed-income holdings with Short-duration (1-5yrs) paired with proven opportunistic private credit strategies for yield; reduce high-yield bonds;
- Patiently reviewing niche alternatives, including early and late-stage venture capital and co-investments, as well as opportunistic and secondary private investments (don't pay premium prices);
- Use cash to opportunistically initiate Real estate and Real Asset investments, both equity and debt, in private and public space (logistics, warehouses, data centers, infrastructure, commodities, multi-family, and farmland).

Many investors' interests in the "E" for environment (as well as in "S" for social and "G" for governance) of ESG continues to grow. Please know that this has and always will be a deeply imbedded part of our firm's philosophy that we can happily talk about at length.

It is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

With appreciation,

Walid L. Petiri

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board, CNBC sites China National Bureau of Statistics.