Outlook for March 2022

KEY MARKET DRIVERS

- The Russian invasion of Ukraine is raising the specter of coordinated retaliation against the Putin regime in the form of sanctions that have the potential to cause a further spike in commodity prices, particularly in the energy complex. This is occurring at a time when the Omicron wave of Covid-19 is declining dramatically throughout most of the world, as measured by infection and hospitalization rates. These crosscurrents will have varying effects on regional economic performance with the expectation that the global economy will continue to expand if the conflict is limited to Ukraine.
- Unless energy prices increase notably from current levels (say roughly $125 per barrel on West Texas Intermediate crude oil), the U.S. economy is somewhat insulated from the turmoil due to its broad diversity and general skew to the services sectors, which are poised to greatly benefit from the oft-delayed full economic reopening. Higher than expected inflation at the beginning of the year may somewhat constrain GDP growth, but the economy should be able to still grow in the 3-4% range for the full year.
- The European economy is much closer to the center of the Russia/Ukraine conflict with rising energy and other commodity prices potentially having a greater impact on Germany, their largest economy, which relies on manufacturing and industrial production to a much greater extent than many of its neighbors. France is relatively less affected as the country generates the bulk of its energy from nuclear power. Economic reopening should greatly help the southern countries in Europe where the travel/tourism sectors account for a large portion of these economies.
- China is loosely aligned with Russia during this geopolitical crisis and concerns are growing they can make a similar move by annexing Taiwan. While this would elicit similar sanctions to those being imposed on Russia, there is little indication in the near-term that the government is preparing to move. China is likely more interested in providing support to an economy being impacted by trade wars, weak demographics, and the ramifications of a "zero Covid" approach to the pandemic.

OUR PERSPECTIVE

Equity Markets

- Fear of excessive central bank tightening was the initial catalyst driving U.S. equities to their first 10% correction in over a year. The recent hostilities in Ukraine are adding further pressure, but stock prices have declined in an environment of continued strong earnings growth. While slowing, earnings are expected to continue to be comfortably positive for the remainder of the year as the economy fully reopens. With recent global events keeping the Fed measured and moderate and bond yields from spiking, U.S. equities appear attractive at current levels.
- Developed market international equities, particularly in Europe, are more exposed to the economic weakness caused by higher commodity prices emanating from the Russian invasion of Ukraine. However, the outperformance of these markets over the first two months of the year is indicative of their relative leverage to the reopening of the economy as the pandemic fades. The more cyclically structured markets should benefit from a global economic rebound and continued accommodative monetary policies.
- Emerging market equities are squarely in the crosshairs of the Russia/Ukraine crisis as U.S./EU sanctions will be felt most in eastern Europe. Higher commodity prices should help the Latin American regional markets while monetary ease in China will provide some support in Asia.

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OUR PERSPECTIVE

Bond Markets

- The economic implications of higher energy prices and a war in Ukraine serve as near term headwinds for bond yields despite the signals coming from the Fed about the beginning of short-term rate increases. The subsequent flattening of the yield curve and less treasury issuance due to greater tax receipts in a strong economy should lead to only a gradual increase in intermediate bond yields from current levels.
- Given the fluid nature of geopolitical events as investors entered the month, credit spreads on investment grade and non-investment grade bonds remain rather calm and not indicative of an upcoming recession. However, continued narrow spreads leave the high yield market rather expensive and not lucrative enough should default rates increase even slightly.
- With Russia beginning to suffer from sanctions and investor money flowing into haven currencies such as the U.S. dollar, emerging markets debt has experienced a selloff. While yields appear relatively attractive, they are compensating investors fairly for the risk of intensified conflict and weakening currencies.

Monetary Policies & Currencies

- The higher-than-expected January inflation print sparked calls for a 50-bps rate hike at the March FOMC meeting. The hostilities in Europe may cause even worse commodity inflation over the coming months, but the Fed and other central banks understand that this kind of supply constraint inflation can become quickly deflationary if a monetary tightening cycle is too aggressively imposed, accelerating already weakening demand. The Fed will do only a 25-bps increase in March and then follow up with another in May which will give them ample time to assess whether prices are beginning to come down more naturally.
- The Bank of England has already begun its rate increase cycle as their economy is arguably among the strongest in Europe, and we expect them to continue raising their benchmark rate at approximately the same cadence as the U.S. The ECB is currently led by Christine Lagarde, a much more dovish president, who will likely defer tightening until next year to better assess the economic impact of war and supply driven inflation on the continental economy.
- The Bank of Japan has tried unsuccessfully for years to revive a certain amount of inflation so they will be hesitant to react to any inflation not driven by Japanese domestic demand.
- The People's Bank of China is moving against the global central bank grain by slightly easing monetary conditions to offset weakness in certain sectors of the economy. The Chinese central bank has traditional rate cutting tools at its disposal but will also use targeted liquidity injections to support real estate and their state-owned enterprises.
- The dollar is normally included in the basket of safe haven currencies that outperform during times of global unrest. While fundamentals remain relatively favorable in the U.S, any delay or moderation in the expected Fed tightening cycle could at least prevent further appreciation against other developed market currencies.

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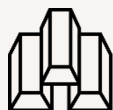
OUR PERSPECTIVE

Commodities



- Oil price volatility should continue and be driven primarily by the ebb and flow of the Ukrainian crisis and potential sanctions on Russian supplies. Longer term, the issue of energy dependency is exposing vulnerabilities that may allow for greater supply to be released and transported by allied countries.
- Gold is proving an effective hedge against the developing Russian hostilities and the ultimate invasion. While a steady increase in real rates can be a potential headwind to this non-interest earning asset, any delay or moderation of the central bank tightening stance could be beneficial to the price.

WHAT THIS MEANS FOR INVESTORS

- The outcome of the tragic Russia/Ukraine conflict and the ramifications for the global economy of the sanctions placed on Russia are highly uncertain. Central banks around the world remain relatively accommodative and may have to slow or delay rate increases and balance sheet run offs to better assess the economic impact.
- The rapid decline in Covid cases should lead to a full reopening of most of the global economy and an effective handoff in consumer spending from goods to services.
- Goods inflation should decline over the course of the year as supply chains loosen although energy price volatility should remain.
- Equity prices have declined to attractive levels given the expectation of continued economic and earnings growth in a relatively low interest rate environment.

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