ECONOMIC OUTLOOK

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unique investment insight

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War In Ukraine
Supply Shocks, Inflation, And A Soft Landing?

In late February, Russia invaded Ukraine in the largest military mobilization in Europe since the Second World War. Even though Putin has been denied a swift victory, the Russian army is resorting to indiscriminate bombing to raze cities such as Mariupol in similar tactics used in prior wars (e.g., Chechnya and Syria). The war is a major humanitarian crisis affecting millions of people and is creating a severe economic shock. Analyzing the situation and the effect on the global economy is challenging given the complex geo-political landscape of the war. Since the start of the pandemic two years ago, the economy has cycled through recession, the creation of an effective vaccine, an economic rebound, disrupted supply chains, inflation, and now war. Prior to the invasion, the global recovery from the pandemic was expected to continue in 2022 to 2023, with progress from global vaccination efforts, solid economic growth, favorable macroeconomic policies, rising employment, and improvements in supply constraints.

The war in Ukraine has disrupted the recovery's trajectory with a new supply shock for the world economy. Although Russia and Ukraine combined generate only 2% of global GDP, they are large producers of commodities. The war highlights how reliant Europe is on Russia for fossil fuels - Russia provides 45% of European natural gas and 25% of its oil. Energy prices were already rising prior to the war with oil up 50% in 2021 and another 33% in 2022. The war is exacerbating commodity shortages beyond oil/gas to areas such as agricultural commodities, as Russia and Ukraine together supply nearly a quarter of the world's wheat (Ukraine alone supplies 10%) and are also key suppliers of corn and barley. Prices this year for wheat are up 30% and corn 26%, adding to global inflation and food security concerns around the world. In the short-term, Europe needs to diversify energy supplies and increase liquified natural gas imports. Longer-term, the world needs to accelerate investment in energy efficiency, infrastructure, and renewable energy.

Before the invasion, the Federal Reserve was preparing to reverse loose monetary policy and begin multiple rate hikes to fight the spike in inflation due to pandemic induced supply-chain constraints, strong demand, a tight labor market, and rising commodity prices. Over the past year, the Federal Reserve and global central banks expected inflation to gradually drift lower as supplies ramped up, but factories, ports, and transportation are still catching up. Repeated waves of the virus have exacerbated supply problems along with rising wages and higher prices for food, rent and gas with inflation hitting 8.5% in March, a new 40-year high. By raising interest rates and ending asset purchases, the Fed aims for a "soft landing" by cutting enough demand to lower inflation without causing a recession. Raising interest rates sufficiently to cool inflation while not tanking the economy is a challenge as Fed Chairman Powell openly admits: "No one expects bringing about a soft landing will be straightforward in the current context – very little is straightforward in the current context."

U.S. Economy

GDP in the fourth quarter expanded by 1.7% and 5.7% for the full year 2021, the highest annual increase since 1984. The economic lift was driven by vaccination efforts, low interest rates, and another round of federal aid. The economy has been surprisingly resilient and even though few economists anticipate a recession, the global impact of the war on supply chains, soaring prices, rising interest rates, and labor shortages all pose headwinds to growth. Due to higher than anticipated inflation and an extremely tight labor market, the Federal Reserve raised the fed funds rate to 0.25%-0.50% in March, the first increase since early in the pandemic. Unfortunately, in order to lower inflation, the Fed has to slow economic growth by raising interest rates. The Fed forecast is now for six more increases this year. Raising rates carries the risk of stalling the economy, driving unemployment higher, and tipping the economy into recession. With the uncertainty due to the war in Ukraine, the Fed lowered the forecast for 2022 GDP from 4.0% in December to 2.8% in March.

Consumer and Manufacturing

Consumer confidence was up slightly in March after declines in February and January. Consumers continue to spend and consumer confidence remains healthy supported by strong employment growth. However, the war in Ukraine and rising prices, especially at the gas pump, may dampen confidence as well as cool spending in the months ahead. The U.S. Manufacturing Purchasing Managers Index (PMI) was revised higher to 58.8 in March, pointing to the strongest growth in factory activity in six months as domestic and foreign demand ticked higher. Firms noted that supplier delivery times improved and there were fewer supply bottlenecks which allowed production to expand at a faster rate. Even though costs continued to soar, firms were encouraged by the stronger demand conditions and continued to hire. Auto sales have recovered from pandemic lows and are growing again, but with few cars on the lot, low incentives, and high prices, sales will be stuck at the current level until there is more inventory.

Employment

Wage growth continued in March, but the pace cooled slightly suggesting employers feel less pressure to raise wages as more people, including recent retirees, return to work. Demand for workers remains brisk with employers posting 11.3 million job openings in February and the number of unemployed at 6.3 million. Americans continue to switch jobs at near-record rates with 4.4 million leaving their positions in an historically tight labor market. Net immigration has fallen from about 1 million in 2015 to 247,000 in 2021. The U.S. economy added 678,000 jobs in February, above the consensus forecast of 450,000. The unemployment rate dropped to a pandemic low of 3.6%. Average hourly earnings are up 5.4% from the prior year, but inflation is eroding wages, leading to a growing unease about the economy.

Real Estate

Mortgage rates have moved steadily higher in 2022 with rates recently at 5.0% for 30-year fixed mortgages. Pending home sales in February were down 4.1% compared to January, the fourth straight month of declines. Existing home sales fell 7.2% in February from the prior month as rising home prices have discouraged some buyers. Low inventories, spiking mortgage rates, and record high home prices are likely to continue weighing on the market. Although the housing market is cooling, housing prices remain hot. In a sign of the housing boom, Zillow estimates the value of a U.S. home increased 19.6% in 2021 to $321,634 or an increase of $52,667. This amount is slightly higher than the median annual wage of $50,000 in 2020.

World Economy

Europe

In March, the European Central Bank (ECB) lowered its GDP forecast for 2022 to 3.7%, down 0.5% from December, due to the impact of war in Ukraine on energy prices, consumer confidence, and trade. Inflation in the euro zone hit 7.5% in March up from 5.9% in February. While the ECB in the past would have raised rates quickly to fight inflation, there is fear that this might tip the region into recession. In the near-term, economic growth is expected to improve based on the diminishing impact of the pandemic and fewer supply chain issues. Longer-term, Europe's economy is increasingly strained by the war as growth slows, confidence plummets, and inflation spikes. Germany, heavily reliant on Russian energy, will be among the hardest hit – the government recently cut their 2022 economic growth projection by half to 1.8%. In Spain, inflation accelerated to 9.8% in March, the fastest pace since 1985. In the U.K., even with little direct exposure to Russia or Ukraine, the economy is experiencing downward pressure as inflation hit 7.0% in March, due to soaring global commodities and energy prices.

Japan

The world's third largest economy expanded by an annualized 5.4% in the final quarter of 2021. Japan rebounded as falling coronavirus cases helped drive consumption. The Japanese central bank is leaving interest rates unchanged even though the 10-year U.S. Treasury yield is nearly 2.5% and the equivalent Japanese bond is 0.25%. Since inflation remains relatively quiet in Japan, there is little pressure to match U.S. rates. A weaker currency means Japanese manufacturers have lower costs in dollar terms and auto makers in particular benefit since the dollars they earn are now worth more in yen terms.

China

China's target GDP of 5.5% in 2022 may be difficult to reach with periodic lockdowns and rising oil prices. While the Fed is raising rates to fight inflation, economists expect China to resume monetary easing to revive an economy hit by a resurgence of the pandemic and a faltering real estate market. China remains committed to a zero-tolerance strategy to fight the pandemic. In late March, Shanghai, a city of about 25 million and a major hub of the economy, imposed an extended lock down. China's repeated virus flareups cause logistical headaches and inflationary pressure on the world economy. China is the world's largest importer of oil and is exposed to rising crude prices. In March, due to the uncertainty created by the war, the OECD lowered its global GDP forecast by 1.0% to 3.5% in 2022 with inflation 2.5% higher than if there were no war.

Commodities

Oil closed at $100 at the end of the quarter, up 33% this year. Oil output in the U.S. is limited by supply chain issues, wary investors, and low well inventory. Oil companies and investors have been burned repeatedly by the boom-and-bust cycles over the past decades and are wary of overinvesting. Although the number of rigs is up by 20%, much of the activity is making up for depleted inventory of wells that were drilled before the pandemic. With high oil prices, a longer-term worry for oil producers is demand destruction - consumers will find ways to cut or replace consumption. The price of solar power has dropped in the past decade from $7.53/W in 2010 to $2.65/W in 2021 and is now competitive with fossil fuels. On the positive side, switching energy sources can help reduce carbon emissions and energy security. In other commodities, world food prices hit a record high in March with a year/year gain of 33.6%. Gold rose 6.7% in the first quarter with strong demand. Precious metals continue to offer a safe haven in times of geo-political stress and protection from unlimited money printing.

Investment Perspective

The global economy faces the daunting trifecta of pandemic, inflation, and now war. Considering all the turmoil, the U.S. equity markets held up fairly well in the first quarter. Although the S&P 500 fell into "correction" territory (a drop greater than 10%) in March, it recovered some of the losses even as the Federal Reserve outlined more aggressive rate hikes and raised its benchmark rate above 0% for the first time in two years. Low rates over the past decade pushed investors into riskier investments, drove real estate prices higher, and increased the amount of debt governments/corporations can issue or hold. Since the Fed's easy monetary policy or quantitative easing drove asset prices higher, investors should expect that tighter policy will reverse the process. For corporations and governments, rising rates will translate into higher interest payments and lower profits.

The trick for the Fed is raising rates by enough to slow the economy and reduce inflation without causing higher unemployment and a recession - the so called "soft landing." There are features of today's economy that support the case for a soft landing. Labor markets are booming with growing payrolls and an unemployment rate of 3.6%, a pandemic low. Wages grew 5.1% in February although workers are still losing ground to inflation. Demand is robust and confidence remains high, but businesses face supply chain issues and higher costs. One positive result of strong demand and higher labor costs is an increase in productivity as companies seek more efficient alternatives. The U.S. economy continues to expand with GDP of 1.7% in the 4Q2021 with the Fed forecasting growth of 2.8% this year. Earnings for companies in the S&P 500 are estimated to rise a healthy 6.4% this quarter. Consumers expect the economic expansion to continue despite the headwinds of higher prices, the pandemic, and the war in Ukraine. Lastly, investors feel that the Fed may not raise rates too much for fear of a market downturn. As we experienced in late 2018, the Fed raised rates to 2.25% then quickly reversed course when markets wobbled.

Engineering a soft landing in today's environment will be a difficult task. The Fed is hiking rates during a time of elevated geo-political risk, rising costs, supply issues, an inverted yield curve, and over-valued bond/stock markets. With rates rising quickly this year, U.S. bonds had their worst quarter in more than forty years. Cash and fixed income yields are still negative after inflation. An inverted yield curve (short-term rates higher than long-term) signals that the market believes future growth will be lower and is one gauge used by economists to predict recessions. Rising commodity and labor costs are a challenge - companies can pass along some of the costs to consumers, but eventually profit margins are squeezed. For equities, we favor investments in materials, healthcare, energy, and technology. Dividends are an essential part of total return. Investing in high quality businesses, with strong management teams, solid financials, and in growing markets remains our focus. We expect more market turbulence with the war, pandemic, stressed food supplies, inflation, and higher interest rates. Ultimately, we will find or develop new energy sources and technology, the pandemic will end, productivity will rise, and supplies will balance with demand. We remain vigilant.

March 31, 2022
DJIA: 34,678.35
S&P 500: 4,530.41

About Bounty Management
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If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.

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