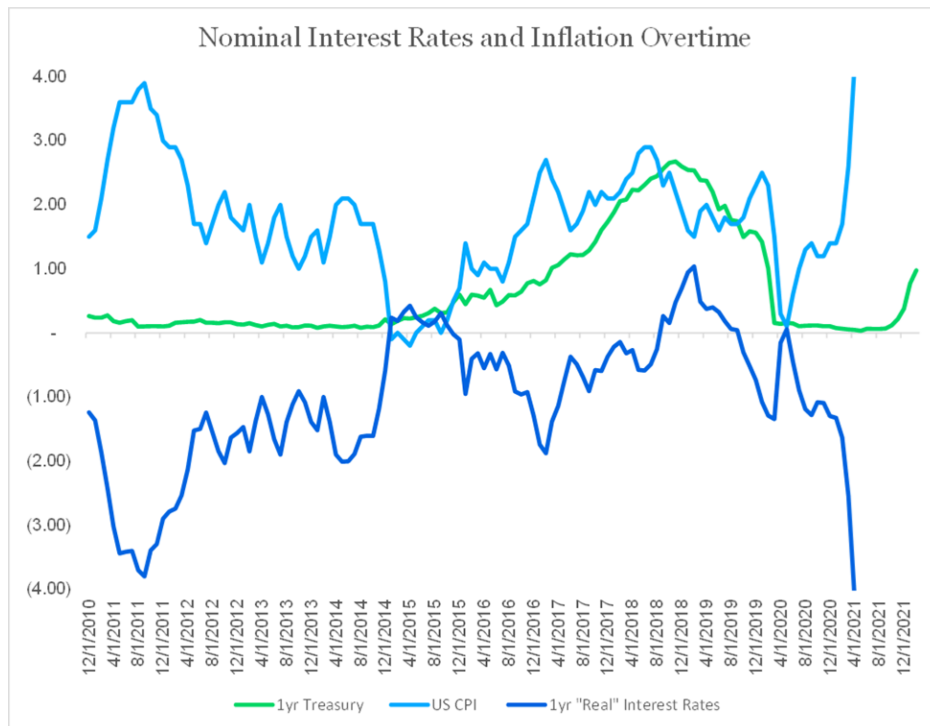
RockCreek

FRIDAY, MARCH 25, 2022

LET THERE BE NO DOUBT

Federal Reserve Chairman Jerome Powell's tougher message on Monday left no room for doubt. After his statement the previous week announcing the Fed's first rate rise since late 2018, when he commented that inflation was obviously too high and current labor market strength was "unhealthy", bond markets had remained relatively sanguine.

This week, markets understood the message. The Fed has begun a determined tightening cycle, intending that interest rates will be pushed up as far and as fast as necessary to squeeze down inflation. Bond traders have thus had a wild ride on the rollercoaster that we warned about a week ago. Investors should expect more of the same. Next week will see the release of the February data for Fed's preferred inflation measure, Personal Consumption Expenditures (PCE) and jobs reports for March. Expect inflation to be far above target and the labor market to be as strong as ever, as indicated by yesterday's lower than expected claims for unemployment benefits. The Fed's next formal move is not until May. But between now and then, bond traders – and investors more generally – should watch for hints from Powell and his colleagues on what they may decide.



One reason for growing concern about inflation comes from unexpectedly good news. Against all odds, and almost all predictions, Ukraine's military is holding its own – even going on the offensive this week – against the Russian troops invading its country. The downside? Rather than a quick resolution, a long and painful war in Europe seems most likely, despite the extraordinary support from the US and NATO allies, reinforced this week (see below). Continued war means a continued squeeze on global supply of energy and food, as well as further supply interruptions.

Observations and Takeaways for Investors

Markets react

The past several days have been interesting for equity markets. The S&P 500 and NASDAQ Composite have risen in six out of the last eight trading days and through Thursday had retraced 8% and nearly 13%, respectively, from their March 14th lows. This came despite Powell's hawkish comments and promises of higher interest rates. Other developed markets have seen a similar recovery over the period with Europe's STOXX 600 gaining more than 9% and Japan's Nikkei 225 rising 11%. One explanation: despite popular concerns that a hawkish Federal Reserve is bad for the economy and for equities, global shares have most often rallied during previous tightening cycles. This past week has shown some early signs of that movement.

In last week's letter, we commented on the powerful rotation out of technology and that, while there remained substantial risk of another leg down, there were also opportunities emerging in some harder hit areas. Recent market action indicates that we may be starting to see a floor forming. Besides energy and materials, leading sectors have included technology and consumer discretionary over the past several days. Stocks driven up almost exclusively by hype and SPAC mergers with limited disclosures remain deeply out-of-favor. However, companies focused on turning a profit – or ones possessing a clear ability to do so – are looking more promising. At the same time, big technology companies operating with strong pricing power appear increasingly attractive in the current environment.

Although we're seeing many companies take advantage of pricing power across the economy, there is widespread hesitancy to go all in. Companies raising prices is one reason retail sales statistics continue to look as favorable as they do, even as the number of units sold is coming down. In the US, consumer health remains strong overall, given the strength in the labor market. But rising prices are eating into real incomes, especially at the lower end. One can't help but feel equity markets are exhibiting a certain complacency given the resulting shadow of lower than expected economic growth.

Fighting inflation: when is tight monetary policy still too loose?

One cost of unanchored inflation is that it becomes harder to interpret both economic data and the everyday prices we all face when deciding, for example, whether to economize on an otherwise gas guzzling vacation, whether to accept a pay offer, or even whether to take on a mortgage to buy a house.

Right now, interest rates are rising – but by how much? If the cost of money is rising no more than other price increases, then its economic impact will be limited. Gradually, the concept of "real" versus nominal changes becomes more meaningful as inflation creeps up. This has not been an issue for most analysts and economic agents in the US for over four decades. But it is now.

The distinction between real and nominal rates is why the Fed's proposed tightening path did not look so daunting to markets when announced last week. It is why US stocks managed their best week since November 2020, before moderating again this week. There is disagreement about how best to measure real interest rates. Should the short-term Fed Funds rate be deflated by the latest annual, monthly, or quarterly inflation rate? Or should policymakers and investors focus on longer-term rates that affect economic activity through their impact on business investment decisions and personal housing cost?

A simple comparison between current annual consumer price inflation – a backwards looking measure – and the one-year Treasury yield, suggests that real rates are deeply in negative territory, at -7 percent, and below where they were at the end of 2021, when the Fed began to shift towards a more hawkish tone. Taking a forward looking view, and using the implicit inflation rate from market prices for 10-year inflation protected securities (TIPs), real rates are still negative, but by much less than on the CPI comparison, and they have climbed this year. So, the Fed may have begun to tighten the cost of money, but the real cost of money remains cheap rates – a continued incentive for demand to expand rather than dampen to curb inflation. Powell has now signaled clearly that tightening will continue until inflation has been beaten down.

As analysts try to fathom how painful it will be for the Fed to bring inflation down, they turn naturally to the lessons of the past. Indeed, there is a mini industry of picking which historical episode is the best analogy for today. Optimists point to the late 1940s: demand rose in the aftermath of war, but supply remained constrained. Inflation jumped – only to be reversed quite quickly as market forces adjusted. Pessimists look at the 1970s, when US and global demand were powered by US fiscal spending on the Vietnam war and social programs. Then supply took a hit from the OPEC oil shock. It took the sharp Volcker recession to bring down the resulting inflation.

Powell has said he greatly admires Volcker, calling him "the greatest economic public servant of the era." Until this month, he did not follow the Volcker playbook. Inflation fighting and price stability were not at the forefront – inflation was seen to be short term, and as Covid supply constraints were expected to go away, so would inflation. For much of Powell's tenure – especially in the onslaught of the pandemic – it made sense to give weight to the Fed's other statutory goal of maintaining full employment. Acknowledging that job gains among the more vulnerable would support a stronger society and economy was also a valuable step.

Continued Covid waves in 2021 hit production and transport, especially in China and Asia, jamming supply chains just as demand for goods soared. Fear of infection also contributed to labor shortages with the "Great Resignation", perhaps better labeled the "Great Retirement." As Powell noted this week, many of those leaving the labor force have been older – and more concerned about ill health.

And now the war in Europe is putting another nail in the coffin of the globalized system that has powered productivity and held down inflation for decades. It is past time for the Fed to act, even if its tools can only work on demand, not supply. That will slow growth, but it is too early to predict stagflation. The US economy

still has a lot of strength behind it. For once, however, what happens outside the control of policymakers and, indeed outside the country, will have a big impact.

Ukraine: good news brings downside risks

As the war triggered by Russia's invasion enters its fifth week, military analysts and foreign policy experts alike have been astounded by Ukraine's resilience. This week's sinking of a Russian ship off the critical Black Sea coast was just the most striking example of Ukraine's robust defense.

Just as surprising as Ukraine's battlefield strength is the unity and force with which the US, its G7 partners, and NATO allies have acted, rallied in part by Ukraine's bold and charismatic President, Volodymyr Zelenskyy, who continued this week to make well-orchestrated and specific pleas directly to parliaments. Zelenskyy's call for a no-fly zone remains a red-line. The US and NATO allies have made clear that they do not want to trigger direct hostilities with Russia. But President Biden's trip to Brussels and Poland this week for special meetings of NATO and the G7 was a deliberate show of support for Ukraine and demonstration of US commitment to the NATO alliance. The US and its allies and partners used the meetings to step up the two-pronged squeeze on Putin: more arms support for Ukraine and more sanctions on Russia and its prominent citizens, which Biden said would bite ever more deeply over time. The US President also this week called Putin a war criminal, a notable intensification of the war of words.

As Biden implicitly acknowledged, however, hopes of a quick settlement to the war are likely misplaced. Russia still has blunt and fearsome weapons at its disposal and a willingness to use them to bludgeon cities and civilians, even as its military struggles on the ground. Ukraine's citizens are bearing a terrible cost as Russia's war machine turns to indiscriminate bombing. The economic costs of higher energy and food prices caused by the war – which we foreshadowed in earlier letters – are growing, notably in Europe. Germany, Europe's biggest economy, is already hurting, and the businesses that power its industrial machine are calling for a limit to further sanctions, especially on oil and gas imports from Russia. Poorer countries that borrowed to survive the pandemic and now face possible food shortages may plunge into debt distress.

Moreover, while the west is mostly united in imposing and enforcing sanctions, there are large and important global players that are not so keen, most obviously China and India. Others are also on the sidelines, from Indonesia to Brazil, not to mention America's erstwhile close friends in the Middle East. As Ben Steil pointed out this week in Foreign Affairs, that will leave room for leakage from financial sanctions. Russia is also moving to divert its energy supplies, now banned from the US and the UK, to friendlier countries, such as India. Of course, if these sales take place at a discount, as seems likely, they will do less to ease the financial pressure on Russia.

Ramping up sanctions makes life more difficult for Putin, but as gasoline prices surge and food costs rise, others also suffer. Energy markets tore higher once again this week, with Brent Crude rising 11% to $118 per barrel. RockCreek's conversations with market participants point to $100 to $120 per barrel as oil's new normal in this short run. European natural gas rose to $36 per mmbtu, well off its recent peak, but still 8.5-times higher than it was at the beginning of 2020.

Helping those in need: governments, not central banks, have the tools

It's little consolation for those paying more for gas and other necessities, but as a significant oil and gas producer, the US economy is somewhat insulated from higher prices. Even for consumers, today's prices take a much smaller bite out of family budgets than after the 1970s price shock, in part because of much greater fuel efficiency in cars and generally less petroleum intensity in other goods.

Nevertheless, many will be hurting. The way to help the most vulnerable is to target them directly with financial support. Generalized fuel subsidies or gasoline tax cuts are inefficient and costly. Unfortunately, the child tax credit, shown yet again by recent research to be one of the most effective (and cost effective) measures to reduce child and family poverty in America, has been allowed to lapse this year with the failure of President Biden's Build Back Better legislation. Bipartisan support to revive it seems unlikely, at least for now.

SEC aims for clarity and consistency in climate disclosures

On March 21st, the Securities and Exchange Commission approved a landmark proposed rule requiring all publicly-traded companies to disclose risks from climate change, including – for the first time – detailing their greenhouse gas emissions. According to the Commission, the rule would provide "consistent, comparable, and reliable—and therefore decision-useful—information" to enable investors to make informed judgments about climate-related risks for investments.

"The Commission's proposals with respect to climate-related disclosures are a major improvement," said RockCreek Senior Managing Director Kenneth Lay, a former SEC enforcement lawyer. "The new regulations should bring much-needed clarity and consistency to disclosure of what we've all come to understand are issues central to our investment decision-making."

Under the proposed rule, companies would have to detail their climate-related risk in four areas:

- Governance and relevant risk-management processes
- How climate-related risks have had or are likely to have a material impact on its business
- How climate-related risks have, or are likely to, affect a company's strategy, business model, and outlook
- The impact of climate-related events such as severe weather

The rule would also require companies to disclose their direct Greenhouse Gas (GHG) emissions (Scope 1), indirect GHG emissions from purchased electricity or energy (Scope 2), and in some cases GHG emissions from upstream and downstream activities in its value chain (Scope 3). Disclosure of Scope 3 emissions would likely be the hardest to calculate and control, and some business groups have objected to their inclusion in the rule. But the Commission believes that detailing Scope 3 emissions is also where companies (especially large ones) could have the largest impact on climate change by steering their suppliers to meet higher emissions standards.

"As Chair Gensler has said, these proposals are fully grounded in the SEC's nearly 90-year effort to ensure that investors have access to all of the material information affecting their investments," Lay said. "And they can set a useful standard for climate disclosures elsewhere in the international community."

Looking elsewhere from China's stormy seas

Chinese markets treated investors to the roller coaster ride in the last ten trading days, in particular Hong Kong, which at one point sold off 24% in the span of a couple days, only to rally 23% in subsequent trading. Tech names including Tencent, Alibaba, Pinduoduo, Baidu, and Meituan, led the volatile series of sessions. We know foreign investors were, in large part, responsible for exiting Hong Kong listed exposures, perhaps fearing the consequences of China's thinly veiled support of President Putin's adventurism.

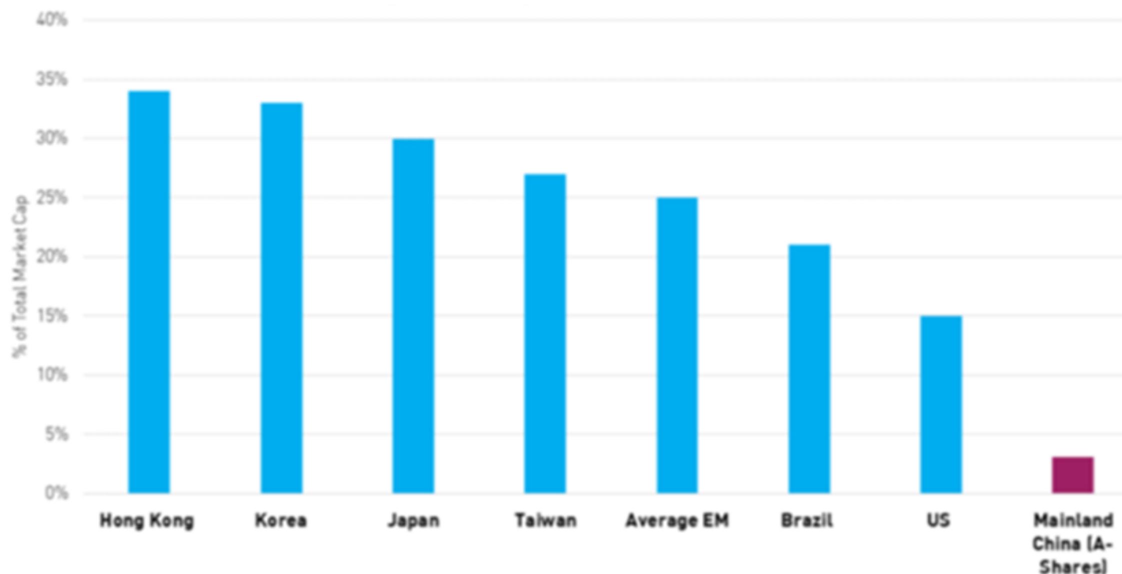
China's Roller Coaster Markets

Source: Google Finance

There may be an element of China's so-called 'national team' at play here. In past market routs of China's domestic A share market, authorities in Beijing have marshaled the country's institutional investors, private, and state-owned entities to step in and support the market. It has also either suspended or made it quite difficult to short the market from time to time.

The Hong Kong market typically has not been subject to this type of manipulation, but times are changing. As Beijing consolidates its hold on the former British colony, it may not want to see a capital market so beholden to the whims of foreign investors. In addition, as the country's tech giants increasingly come under the influence of the central government, we may see the percentage of foreign ownership drop steadily, giving Beijing ultimate control over all the country's capital markets.

Foreign Ownership of Domestic Stock Markets



Source: Bloomberg, HSBC

The consequences may prove transformative for foreign institutional investors looking for ways to capture the next phase of emerging market growth. With Russia out of the picture for the foreseeable future and South Korea potentially being upgraded to developed market status, India, Latin America, and the ASEAN markets will increasingly take center stage. Frontier markets too will likely get a closer look. As Eastern Europe further integrates into the European Union and, along with fellow Western European members, shifts away from Russian energy, there will be opportunities – this, however, will take time and will not be cost-free.

To varying degrees, all of these markets offer a mix of tech supported, consumer driven growth opportunities and commodities the world is in dire need of – particularly food, energy, and base metals. Getting ahead of this trend may prove fortuitous.

RockCreek Update

RockCreek's Senior Global Strategist Caroline Atkinson joined the Deep State Radio podcast, to discuss sanctions against Russia. "Sanctions don't stop tanks," Atkinson said, "but today's unified and forceful measures can affect the war." Catch the episode here.

As part of RockCreek's continued celebration of International Women's Month, Atkinson led a discussion with Equality Fund Co-CEO Jess Houssian about the intersection of investment, philanthropy, and government funding to marshal resources to advance women's economic empowerment. The Equality Fund combines gender-lens investing, government funding, and multi-sector philanthropy to unlock new capital for women's rights organizations and movements. RockCreek serves as the OCIO for the Equality Fund's investment portfolio and a partner on new financial innovations. See the discussion here.

A giant passes

As International Women's month draws to a close, the world heard the sad news of the death of America's first female Secretary of State, Madeleine Albright. As we have seen in tributes this week, Secretary Albright was a friend to many women, including at RockCreek.

On the eve of Russia's invasion of Ukraine – just a month before her death, Albright wrote one final piece in the New York Times. "Ukraine is entitled to its sovereignty, no matter who its neighbors happen to be," she wrote. "In the modern era, great countries accept that, and so must Mr. Putin…It defines the difference between a world governed by the rule of law and one answerable to no rules at all."

Madeleine Albright was a trailblazer. She was a fierce fighter for human rights and strong US leadership. She is already sadly missed.

Upcoming Events

RockCreek's celebration of International Women's Month continues with discussions with leaders in investment, advocacy, and philanthropy who are helping create economic opportunities for women throughout times of turmoil and change.

Monday, March 28th, 1:00 pm
Margot Brandenburg, Senior Program Officer for Mission Investments at the Ford Foundation, will speak with RockCreek Managing Director and Chief Compliance Officer Sherri Rossoff on the role of impact investing and philanthropic innovation in creating economic opportunities for women.

Register here

Thursday, March 31st, 1:30 pm
Maggie Arvedlund, CEO and Managing Partner of Turning Rock Partners, will speak with RockCreek co-CIO for OCIO Alifia Doriwala on building momentum in gender lens investing.

Register here