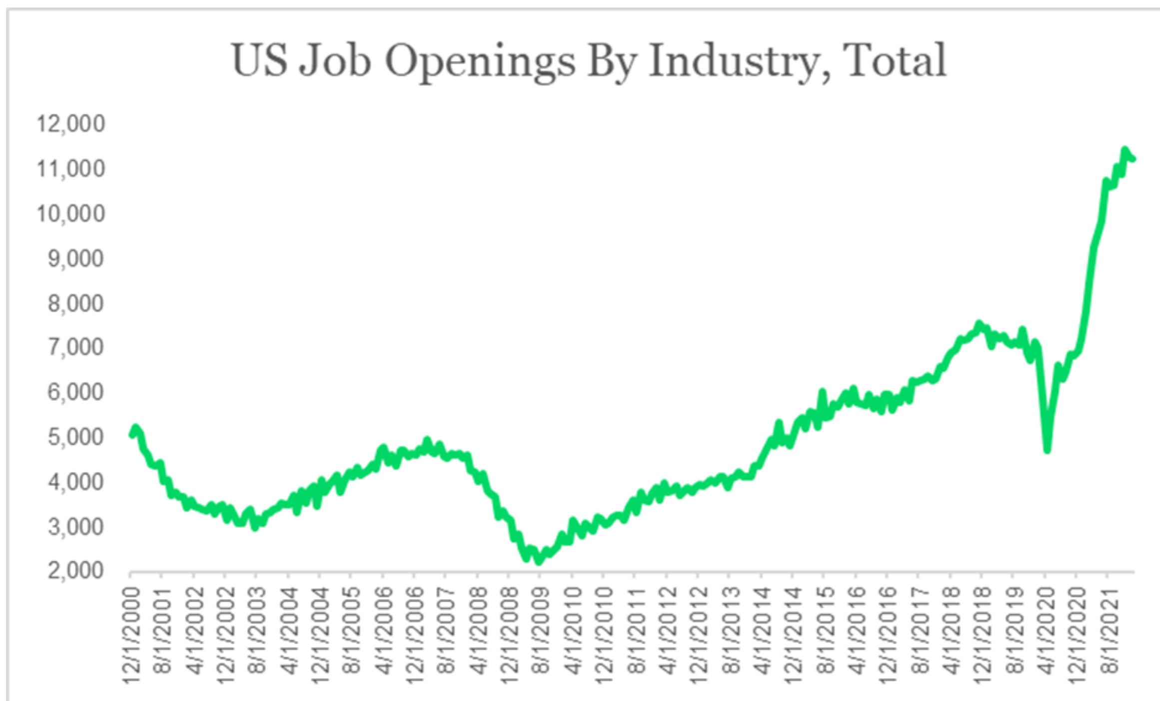
FRIDAY, APRIL 1, 2022

CAUSE OR EFFECT?

Stagflation fears got more attention this week. Not surprising as the US yield curve inverted, while the tragic war in Europe dragged on into a sixth week, and Russian President Putin threatened to cut off energy supplies to Europe unless payments were made in rubles. We know that inflation is high. Thursday's report of the Fed's favored core measure showed it far above target, at 5.4% in February. And European inflation jumped to a record 7.5% year on year. Much of the headline price pressures have been coming from energy. The war in Ukraine will only drive these prices up further, notwithstanding President Biden's decision to release 180 million barrels of oil from the strategic reserves. Do investors need to worry about stagnation, or even recession, as well as inflation?

This week's jobs numbers suggest that the answer is "not yet", at least for the US. Looking ahead, of course, growth will depend on how far and how fast the Fed tightens to bring inflation under control – more on that below. But the strong March labor report showed employers adding jobs, workers earning more, and – perhaps as a result – more people coming off the sidelines to join the labor force, particularly prime age workers. The unemployment rate slipped down to 3.6 percent and payrolls grew by 431,000, on top of upwardly revised increases for January and February that are now put at 1.25 million. The latest data for vacancies and quits told the same story. There were 11.3 million job vacancies at the end of February, compared to the 5.9 million Americans who said that they were unemployed and looking for work at the beginning of March. As we move into a new quarter, investors should keep an eye on how companies are weighing up prospects. Do they expect employment and earnings to stay strong in the face of headwinds from tightening monetary policy and global disruptions?



Markets versus the Fed versus "the experts"

While few economists predicted the inflation surge now troubling voters, many are now lamenting that the Fed is behind the curve. Calls are mounting for the Fed's next move to be a 50-basis point increase, rather than 25-basis points. Powell himself recently hinted at such a move. If inflation continues at the current pace – as seems likely – RockCreek expects the Fed to heed the calls at its next meeting, in early May. Four experts from across the political spectrum – two former Fed governors, a top Obama official, and a former IMF economist – agreed this week that rates need to move further and faster than the Fed has so far envisaged in order to slow demand, or risk inflation spiraling upwards. Indeed, by many metrics – including the so-called Taylor rule – monetary conditions today remain accommodating. Interest rates are so far below inflation that they are more likely to hold up demand and prices than to slow them down. When inflation last reached 7.9%, as it did in January 1981, the Federal Funds rate was 15%. It is now 0.25%. Why does the Fed believe in the soft landing, these experts and others wonder.

Maybe one reason is that financial markets have also been buying into that narrative. As former Fed Vice Chair Donald Kohn mused, there is something mysterious happening in financial markets, which have weakened this year, but by less than might be expected given high inflation and a shocking and unexpected land war in Europe.

Bond prices show breakeven inflation coming down over time towards the Fed target, with implied interest rates close to the Fed's projections – far below the levels that seem historically appropriate. Meanwhile equities also moved up in March – notwithstanding a last minute slump on Thursday that made Q1 the worst quarter recorded for equity markets since the pandemic lockdown in March 2020. Even after three months of volatile markets, the S&P 500 ended the week only 6% off its all-time high.

With Q1 now behind us, investors will soon have a fresh round of earnings reports to digest. Until now the corporate sector as a whole has been able to raise prices more than enough to offset rising costs. Much is being made of 2021 being the most profitable year for US corporations since 1950, alongside Americans seeing inflation cutting into real wages. With earnings season coming, investors will be watching closely now for signs of profit margins starting to get squeezed. Last month's market rise would certainly indicate that investors expect profits to be fine; however, the real test is still to come as the impacts of monetary tightening and geopolitical disruption begin to be felt.

Observations and Takeaways for Investors

Growth worries

The Russian invasion of Ukraine on February 24th changed the world. It is still not clear how much it has changed the prospects for the global economy. Growth will be lower, especially in Europe. But by how much?

As usual, the policy reaction will matter as well as the impact of the initial shock. In Germany, there is a heated debate underway about the economic impact of a complete cut-off of Russian energy supplies. Business and unions have warned that the costs would be enormous. A study just out by the Center for Economic and Policy Research argues instead that the hit to GDP would be manageable, at no more than 3 percentage points, provided the government limits the second round impacts by supporting the most vulnerable households and firms. A drop of this size, while substantial, would be less than the growth impact from either the pandemic or the global financial crisis. As the authors note, the German economy and polity survived those recessions.

More broadly, fiscal support in Europe to limit the burden of energy shortfalls – and of the massive flows of migrants into some countries – is in the cards. This may follow the pattern of the EU-wide pandemic relief, with EU-wide fund raising. Europe's ability to agree to share the burdens of the war will be a test of EU solidarity in the face of Russia's aggression. The switch in attitudes to defense will also provide support for European economies, as new spending comes online.

Central bankers on both sides of the Atlantic were grappling with how to tackle inflation without killing the recovery even before the war. In the US, policymakers are in more of a bind. US Fiscal policy is now adding to downward pressures, exerting a contractionary force of some 3% of GDP as the 2020 and 2021 stimulus rolls off. But inflation is higher than in Europe.

This week's yield curve inversion worried many, capping much conversation and concern in recent weeks. In particular, the 5s30s closed March inverted with the 2s10s segment of the curve close behind, as the spread between those two issues narrowed to 1.4 basis points.

It is understandable that investors would begin to worry, as this is generally taken as a sign of an impending recession. Since 1977 there have been six instances of 2s10s inverting (seven if you separate the June 1998

inversion in 2s10s from its February 2000 counterpart). Each time a recession has followed, and on average it begins about 20 months after the initial inversion.

But it is important to disentangle causality. In the worst case, inversion is symptomatic of an impending recession; in the best case it is coincidental – or an expectation that the Fed will indeed master inflation and so be able to reduce rates. The fundamentals driving the shape of the yield curve are expectations of future Fed policy. The yield curve flattens on expectations that the Fed will raise short term interest rates higher than is sustainable over the long-term (possibly causing a recession) so rates will need to be reduced over time (possibly eased sharply in response to a recession). In an environment where the Fed has indicated, via the Dot Plot, that it will likely tighten above what it considers to be the long-term neutral rate, before reversing once inflation has stabilized, it is not surprising to see the yield curve take this shape.

Consumers still spending

Even as inflation has been eating away at average household incomes, consumers have continued to spend. That is the message from the personal income and spending data released by the Commerce Department on Thursday. After adjusting for inflation, consumer spending – which accounts for the bulk of GDP – recovered last year to its pre-pandemic trend and has continued to rise this year, with January's big bump only partially offset by a small decline in February. The effects of the pandemic are still with us: goods spending remains far above trend, while spending on services is still some 4% below its pre-pandemic path.

Where are the workers – and will they come back?

The juxtaposition of tight labor markets and still below trend employment and labor force participation is a puzzle. Researchers are now digging into why. Of course, Covid plays a big part. There are an estimated 3 million Americans who say right now that they are off work because they have Covid or are caring for someone with Covid. This figure moves with the waves of infections. But there are a further 2 million who are staying away because of a fear of Covid, whether of catching it themselves or of being assaulted and abused when they try to implement safety measures – think security guards, airline workers, retail employees. Childcare is another problem that affects low wage male workers as well as most women.

There is a bright spot. Tight labor markets have been narrowing inequality across wage earners. Worker shortages are most evident now for those in low paid jobs. And wages and employment are more responsive to shortages of demand and supply at the low end of the scale. As a result, low-skill, low paid workers have seen their wages climb by 4% to 6% annually in the two years since the pandemic began, compared to just 1.5% for the average wage earner. This, of course, does not take account of the gains that those at the top have made through asset price increases.

The IMF researchers rightly put as a goal making today's tight labor markets "a blessing and not a curse." Relieving labor shortages and attracting more back into the workforce would spread the gains and limit the risk of a spillover into higher prices and wages. Addressing Covid, relieving childcare and elder care duties, and providing training are key.

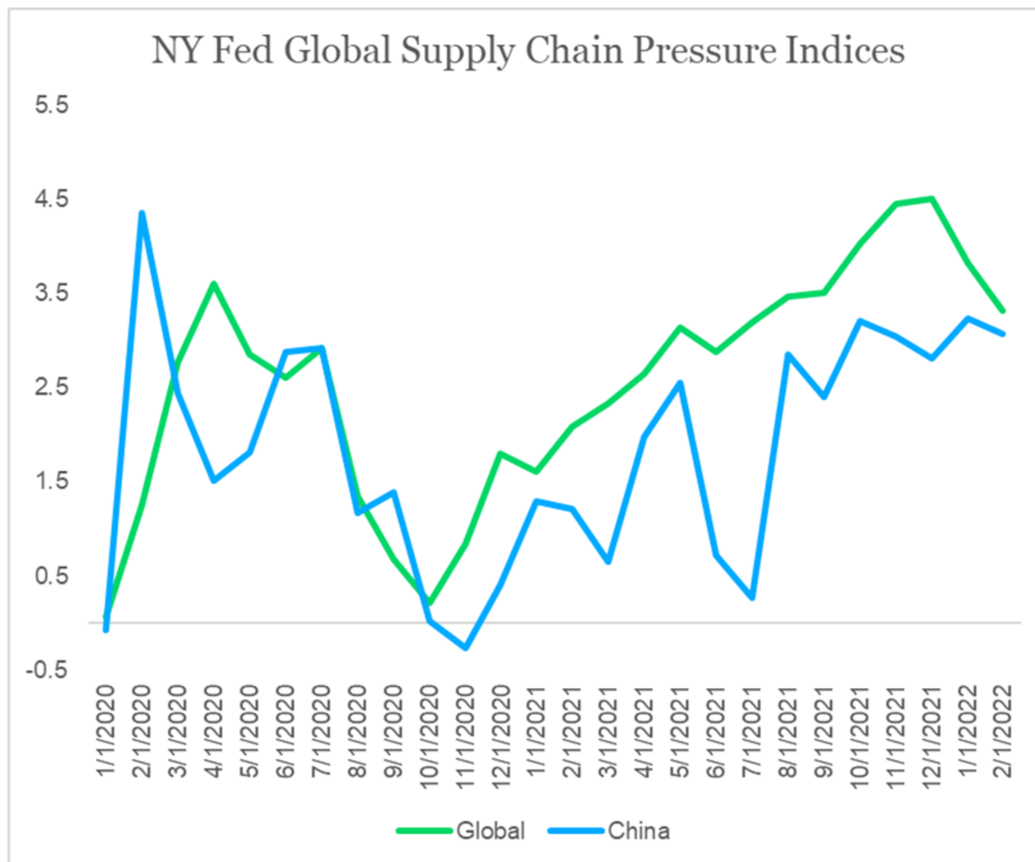
The tight labor market is far from universal or equitable – something the Fed must deftly handle as it balances fighting inflation with its mandate for "broad based and inclusive" employment, but may also be better dealt with by government, rather than central banks. The Black unemployment rate in the US is double that of whites, and Hispanic unemployment is one point higher than the white unemployment rate.

With interest rates set to take off, there is hope that the Fed has learned lessons from history: Paul Volcker's rate hikes in the 1970s drove the national jobless rate up to around 10%, while the unemployment rate for Black workers skyrocketed to 22%. Rate hikes have always been a blunt tool. There is hope they can prove sharper this time.

China's lockdowns quarantine trade

The recent outbreak and spread of Omicron in China is sparking worries about its potential impact on the global economy. Notwithstanding China's relatively low number of reported Omicron cases, its zero-Covid policy has prompted emergency measures in key urban centers including lockdowns, enhanced travel bans, school and public transport closures, and widespread restrictions on business activities. These measures have quickly impacted both manufacturing and trade, as factories, domestic transport, and port facilities – both shipping and air-freight – have all seen widespread disruptions. Despite official statements that China's ports are operating as normal, the hundreds of ships anchored outside port facilities in Shanghai and Shenzhen awaiting cargo processing are a telltale sign that lockdowns are affecting trade and that global supply chains remain impaired.

While it may be too early to assess the long-term impact of China's current Covid crisis, it is instructive to cite the IMF's assessment that supply chain problems constrained global GDP growth by between 1% and 1.5% in 2021. The chart below shows the intensity of supply-chain pressures on the global economy.



The rise in supply chain pressures resulted when global cyclical recovery met pandemic-hobbled global manufacturing and industrial production. The pressure started to ease in Q3 2021 due to the success of widespread vaccination and the tapering of the Delta outbreak, then rose again due to Omicron in Q4. However, one other factor exacerbated the sharp spike in supply chain pressures in Q4 – the lagged impact of mid-summer 2021 lockdowns in Guangdong that led to shut-downs of regional ports. While this was a short-lived event, it led to months of disruption that continued to be felt in the autumn as depleted China-sourced inventories of intermediate goods were hard to replace.

Looking ahead, the chart would suggest that global supply chain pressures are abating, and this has undoubtedly been true since late 2021. With the exception of China, global industrial countries have largely reopened for business. But the combined impacts of China's current lockdowns and the ongoing war in Ukraine present real challenges to the global economy. Volatile energy and commodity markets are now being joined by disruptions to Chinese manufacturing and logistics. How long China's problems last is uncertain, but the transmissibility and persistence of the Omicron variant suggest that China will need to sustain its lockdown strategy to contain the current outbreak. Currently, China's key ports remain open, and most factories are operating – but all are running at reduced capacity. With no likely easing of the government's zero-Covid policy, these facilities remain at risk of being temporarily shut down if outbreaks occur among workers.

Who are those economists anyway?

A fascinating new study co-authored by one of this generation's smartest young economists – Anna Stansbury of MIT – shows that economists are among the least diverse groups of academics, with fewer first generation college students and more graduates from Ivy league and private colleges. That's a problem worth addressing as well.

Ronin Hack and Blockchain Bridges

Ronin Bridge, the sidechain connecting Axie Infinity to Ethereum, was exploited with hackers making off with 173,600 ETH and 25.5 million USDC, a haul valued at more than $565 million. The heist didn't take place this week, but on March 23rd – despite its scale it took six days for the breach to be caught. It was just February when another blockchain bridge*, Wormhole, was taken for 120,000 wETH (about $395 million at today's prices). In that case Jump Crypto stepped in to make the community whole; it's still unclear if and how Sky Mavis, the creator of Axie Infinity, will rectify this situation.

Vitalik Buterin, a co-founder of Ethereum, wrote about the vulnerabilities of bridges in January, arguing that "security limits of bridges are actually a key reason why while I am optimistic about a multi-chain blockchain ecosystem" and that "cross-chain activity has an anti-network-effect: while there's not much of it going on, it's pretty safe, but the more of it is happening, the more the risks go up." It seems, though, that crypto VCs still believe in a cross-chain future. This week Sequoia, FTX Ventures, and a16z co-lead a $135 million Series A+ in LayerZero Labs which has the bold ambition to be the one bridge to connect every Layer 1 blockchain through its Stargate protocol.

**A blockchain bridge makes it possible to operate across blockchains by locking assets from one chain and issuing an equal value of tokens on another.*

RockCreek Update

Capping RockCreek's celebration of International Women's Month, we welcomed women leaders in impact and gender lens investing to discuss the power of finance in strengthening economic opportunities for women around the world.

Margot Brandenburg, Senior Program Officer on the Mission Investments team at the Ford Foundation, spoke with Sherri Rossoff about how philanthropies and impact investments can work hand-in-hand to create new opportunities for women. Watch the discussion here.

Maggie Arvedlund, CEO and Managing Partner of Turning Rock Partners, spoke with Alifia Doriwala about accelerating gender lens investing and maximizing returns and impact. Watch the discussion here. (TK-LINK WHEN LIVE)

RockCreek's celebration of International Women's Month began with Afsaneh Beschloss' interview with **Mary Barra**, CEO of General Motors, where they discussed Barra's groundbreaking career and her efforts to steer the 114-year-old automaker toward a zero-emissions future. See a recap of the interview here.

And **Jess Houssian**, Co-CEO of the Equality Fund, spoke with Caroline Atkinson about the intersection of investments, grants, and government funding in strengthening women's economic empowerment. Watch the discussion here.

As International Women's Month comes to a close, we commend women across the globe who have carried the weight of Covid-19 at work and at home, and who will lead us through this period of recovery, war, and uncertainty. The discussion about creating a more equitable future – and the work to achieve it – will continue in the months and years to come.