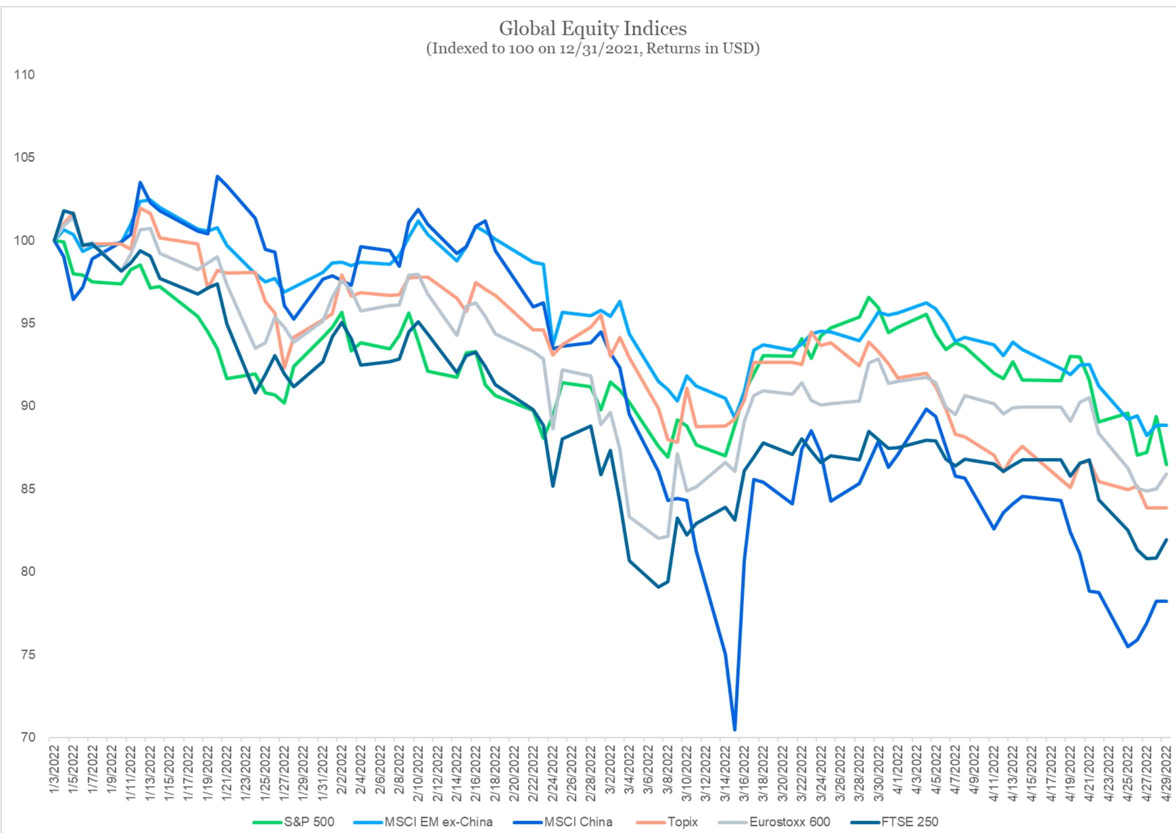
NOWHERE TO HIDE

April is the cruelest month, wrote TS Eliot. For investors, this month has certainly been difficult. Equities fell around the world. Bond markets continued to be roiled by central bankers' increasingly hawkish comments. And war in the middle of Europe – almost unthinkable a few short weeks ago – looks set to continue, with accompanying shocks to both growth and prices. Not surprisingly, there is debate about the best strategy for holding on to gains from the pandemic recovery while guarding against higher interest rates and a slowing economy. One positioning that has paid off: trusting in the US dollar. It climbed this week against all other major currencies to reach a twenty year high.



What Q1 earnings are telling us about the consumer

More than half of S&P 500 companies reported earnings this week, providing timely business insights from which to draw a picture of the economy. At a high level, profits and revenues have beaten expectations while future guidance looks shaky. Corporate earnings are supporting the narrative of a still resilient US consumer. The tight labor market and massive transfer payments during Covid have enabled consumers to absorb higher prices for goods. Companies see this and are taking advantage by passing along higher costs. Kraft Heinz reported strong numbers and raised its sales guidance for the calendar year. Coca-Cola, Pepsi, and Conagra were among the many other consumer staples companies doing the same.

Lack of affordability does not yet seem to be a major problem broadly. Earnings from airline and credit card companies demonstrate that reopening trade remains alive, and consumers have cash to spend. Likewise, Apple's outstanding revenues illustrated robust consumer resilience...at least for those consumers who are able to buy high-end smartphones and computers.

Speaking of Apple, it was a big week for tech earnings, which proved to be a mixed bag. Amazon's AWS business is doing well, but a slowdown in its core retail business sent its shares sharply lower. Microsoft's strong results in its data center business also showed that business spending remains strong; however, many consumer-oriented internet businesses are struggling to maintain subscriber growth – Netflix and Spotify being the most obvious examples. Alphabet, which experienced some weakness in its YouTube platform, and Comcast, which saw a slowdown in broadband subscriber growth, were similarly sluggish. Meta Platforms posted solid subscriber growth and its stock rallied, but this came off disastrous fourth quarter numbers, and Meta's revenue growth is still its slowest since going public. Clearly, internet-related demand was pulled forward during Covid and there are now more alternatives for leisure time.

Companies are continuing to report, and markets and investors are watching closely for signs of economic strength or weakness. So far this season, of the 140 S&P 500 companies that have reported as of publication, 77% beat their earnings estimates and 65% of the reporters raised guidance for the full year. While markets may consider some of the reports rosier than expected, demand will have to continue to outpace input and wage costs for future earnings to not disappoint.

The next tightening twist

Financial markets were initially slow to price in the rise in US interest rates that most economists believe will be necessary to curb inflation, which was at 40-year highs in March. It is now clear that the world of "lower for longer" rates is over. Disagreement continues about the feasibility of the Fed's hoped-for "soft landing" where gradual rate rises and quantitative tightening squeeze out inflation without crashing the economy. That will require luck as well as skill. Some believe that Fed Chair Jerome Powell has deliberately dealt out the bad news only slowly in recent weeks to avoid a market upset. Markets will be watching his words carefully on May 4th, as well as actions taken at the policy meeting next week.

As central bankers' words have become more hawkish this year, markets have responded. Although the Fed Funds policy rate has only been raised by 25 basis points from its pandemic low of 0-.25%, markets have pushed up longer rates much further in anticipation of future Fed moves. What matters for economic demand is the cost of money for consumers and business investors. Mortgage rates are now 5.1% and investment grade and high yield bonds are yielding between 4% and 7%, on average, respectively. We will see another indication next week of the impact of this year's rate rise on unemployment.

Stag or Flation: a western question?

Are western central bankers in danger of overdoing tightening? Their counterparts in Japan and China are moving in the opposite direction, but for good reasons. Japan's inflation is not taking off – indeed the central bank clarified this week that it plans to continue to hold rates down, keeping its effective 0.25 cap on long rates, as inflation is still too low. In China, as detailed below, a combination of regulatory, economic, and lockdown policies have misfired and hurt growth – so much so that policy makers are now looking for ways to boost the economy, not slow it down. Sliding currencies – the Japanese yen and China's renminbi have weakened against the dollar – will help both countries to bolster exports.

In the US, a surprise contraction in GDP in Q1, reported this week, showed the flip side to this, as US imports surged. Domestic demand remains strong in America. The drop in GDP came as inventory buildup slowed and consumer and business spending pulled in additional imports and, perhaps, diverted potential exports to domestic sales. The report told a story of constrained supply more than weak demand. Meanwhile, inflation on the Fed's preferred measure – core Personal Consumption Expenditure (PCE) stayed uncomfortably high in March, at 0.3% month on month, or 5.2% on a year ago. Employment costs were up by 1.4% in Q1 from the previous three months – not enough to offset the impact on real incomes of price increases but still too high. Against this background, Federal Reserve policy makers are most likely to implement the 50 basis point jump in the policy rate that markets began to expect earlier this month.

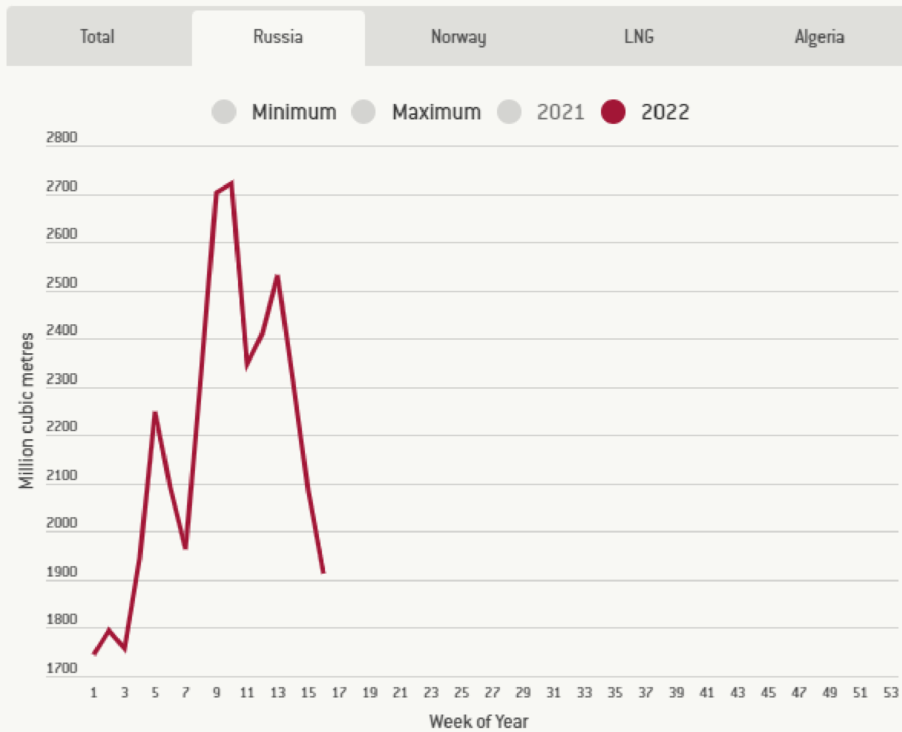
The Bank of England faces a more difficult choice in its early May meeting. The UK economy is weaker – hence the dissent from Deputy Governor Sir Jon Cunliffe against last month's rate rise. The spill-over from the war will be bigger, given UK trade ties with Europe. And the costs to the real economy from Brexit continue to be a drag. But these factors are also pushing up prices.

The European conundrum is even trickier. As Russia's war in Ukraine continues, and President Vladimir Putin fights back against Western sanctions – cutting off gas supplies to Poland and Bulgaria this week – Europe faces sharply higher energy prices and a hit to its economy from supply shortages. European Central Bank President Christine Lagarde acknowledged at last week's World Bank and IMF meetings that the ECB may need to move sooner to tighten money, given inflationary pressures.

Today's flash indicator for April, showing another record for Eurozone inflation of 7.5%, underlines the problem. At the same time, there is recognition that cutting off access to Russian energy will weaken growth substantially across the eurozone, with Germany among the hardest hit. The Bundesbank put out estimates of a 5% hit to German GDP relative to baseline from giving up Russian energy imports. Most other estimates are less, and any reduction would be spread over two or more years. While Europe has been wrestling with whether and how to reduce its energy imports from Russia, price increases since the war began have pushed up revenues for President Putin, despite reductions in volume. Russia has received 46 billion Euros ($48 billion) from Europe in the two months since it invaded Ukraine, according to research released this week from the Helsinki-based think tank Center for Energy and Clean Air. That comes despite a 20% drop in oil export volumes and 40% decline in coal exports to the EU. European gas imports from Russia climbed over the period.

Figure 1: EU Natural Gas Imports (by source)

Last updated: 26/04/2022 (updated every Tuesday)



Source: ENTSO-G, https://transparency.entsog.eu/#/map

These data showing that European payments to Russia far outweigh its support to Ukraine have led to growing calls for an energy embargo, despite recession fears. There is a new-found urgency in Europe, spurred by the daily horrors from Ukraine, to act sooner than later to reduce dependence on Russian energy and accelerate the transition to a green economy. This week showed a strengthened resolve to unite across the EU to resist Russian aggression even at a domestic economic cost. Germany moved to support a ban on oil imports from Russia, negotiating alternative supplies, and other European countries vowed to help backfill gas supplies for Poland and Bulgaria. In a sign that the green economy has become more mainstream, traditional private equity firms are scrambling to buy renewable assets, especially in Europe.

What happens in China, doesn't stay in China

Should Americans fear China's strength or China's weakness? There is apparent political consensus in the US that a strong China is to be feared, and that America should seek to undermine China's economic and technological progress. But the two economies are closely linked – and both countries have an interest in a stable international economy.

China's attempt to adhere to a zero-Covid policy, despite Omicron, is having an impact on the rest of the world, as well as on its own economy. Dramatic and apparently chaotic lockdowns affecting Shanghai and major cities have interrupted production and supply chains. This comes on top of the damage to economic confidence and growth from last year's regulatory moves against successful private companies and real estate.

There is now a serious question about whether China's policies and consequent growth troubles over the past year presage a weaker and less innovative country in the future, albeit one under firm control of President Xi Jinping, as Daniel Rosen argues in Foreign Affairs. Such an economy would not threaten the economic superiority of the US. A different view comes from Fred Bergsten, the distinguished founder and former President of the Peterson Institute for International Economics. In his new book, Bergsten argues that China will continue to grow at a much faster rate than the US, overtaking it in size, and that a policy of "containment" is bound to fail. Instead, the US should seek to work with China on economic issues, as with climate and other shared goals.

Friday's surprise announcement from the Politburo that China will boost stimulus and support technology platforms to meet its growth targets for this year cheered many investors. But it was light on details and coupled with continued commitment to the zero Covid policy which has been interrupting production and growth in recent weeks.

Currencies react

Meanwhile, the US Dollar has continued its appreciation against the world's major developed market currencies. In the last six months alone, the Euro and Yen have lost 9% and 12% respectively against the greenback, reflecting a more hawkish Fed and rising rates in the US. Perhaps taking note, and dealing with a sluggish economy, Chinese authorities have let the Yuan devalue against the USD Dollar. It is only a matter of time before the 'currency manipulator' rhetoric returns. But a weaker Yuan would be a positive for the US consumer and provide a much-needed deflationary effect.

In the rest of emerging markets, Latin American currencies have had a phenomenal run against the US dollar. Historically, rising rates in the US have coincided with weaker currencies in the high Beta markets of Latin America, but a series of aggressive interest rate hikes by the regions' central banks last year and a resurgent demand for commodities have inverted this maxim. While higher commodity prices and hawkish monetary policy are fundamentally supportive for Latin America against other emerging markets, we are cognizant of valuations getting stretched. A slowing China (despite a cheap Yuan and government stimuli) and a de-escalation of the conflict in Ukraine could spell an end to an otherwise impressive run. There are also important referendums and legislative and presidential elections coming up in the next few months. One needs little reminding that in Latin America, an ounce of copper is by definition always worth less than an ounce of political theater.

BRL / USD	0.2020	+0.0246	↑13.87%
PEN / USD	0.2613	+0.0105	↑4.18%
CNY / USD	0.1513	-0.0048	↓3.07%
JPY / USD	0.0077	-0.0011	↓12.17%
EUR / USD	1.0536	-0.1019	↓8.82%

RockCreek Update

During the Spring Meetings of the International Monetary Fund and the World Bank, RockCreek team members took part in meetings with central bank and treasury officials from across the globe on addressing challenges from inflation to war to combating climate change. "We cannot wait for a new normal," Afsaneh Beschloss said while moderating a discussion on financing the energy transition hosted by the Bretton Woods Committee. "We need much more resources, and we should be counting them in trillions instead of the billions that are getting spent."

RockCreek hosted economic journalist Sebastian Mallaby, the Paul A. Volcker Senior Fellow for international economics at the Council on Foreign Relations, to discuss his new book, The Power Law: Venture Capital and the Making of the New Future. Sebastian discussed the history and evolution of the venture capital industry, why Silicon Valley became the hub of innovation, and how Elon Musk's early startup scrapes help explain the Twitter takeover. Watch the video here.

Alifia Doriwala joined Bloomberg Daybreak – Asia on television and radio to discuss investment strategies during the start of a chaotic week in markets. Watch the video here, and listen to the radio interview here.

The day after Afsaneh moderated a discussion hosted by the White House Office of Science and technology Policy on natural capital accounting, President Joe Biden signed an executive order to strengthen America's forests and combat global deforestation, where natural capital accounting will play an important role. With the new actions, President Biden said, "We're showing this moment of Maximum threat and urgency can also be a moment of enormous hope and enormous opportunity."

Team RockCreek