MACRO REVIEW & OUTLOOK

The beginning of 2022 was a time of firsts. War in Europe, inflation at 40-year highs, and the start of a monetary tightening cycle across major economies coincided to knock equity markets back and trigger a sharp correction in bond prices in Q1. The traditional bond market hedge against stock market declines did not work to safeguard portfolios.

Looking ahead, investor caution remains warranted. Opportunities can, nevertheless, be found. Russia's shocking invasion of Ukraine has accelerated the energy transition that is urgently needed to address climate change, increasing the focus on sustainable investing. In addition to the clean energy space, investors can find opportunities in real estate, infrastructure, food and water related areas, and minerals, which *will increasingly be in short supply.*

Three macro themes *emerged in Q1 that will dominate going forward:* geopolitical tensions*;* inflation and monetary tightening*; and a* softening of the global economy*, caused in large part by the first two factors as well as by continued weakening in China. All have been widely discussed in gatherings of finance officials in Washington for the Spring Meetings of the International Monetary Fund (IMF) and World Bank.*

The unprovoked Russian invasion of Ukraine triggered the first major war in Europe after seventy years of peace. Brutality unleashed by President Vladimir Putin led the United States, Europe, and many other countries to impose punishing sanctions more swiftly than ever before. For the first time, many private companies went beyond legal requirements to sever their economic ties with Russia.

Even before the invasion and sanctions accelerated energy and food price inflation, central bankers on both sides of the Atlantic were grappling with record high price rises. During Q1, warnings of earlier and steeper monetary tightening grew stronger. Unsurprisingly, financial markets – which had stayed upbeat through the end of 2021 – did not like what they heard. In the US, Treasury yields backed up dramatically in the quarter – the 2yr yield rose 160 basis points, the biggest quarterly move since the early 1980's. The curve also flattened – and inverted briefly – as markets bet on tight conditions that will need to be eased eventually. Equity markets also broke their winning streak, with the worst quarterly decline since the onset of the pandemic two years ago**.**

Monetary tightening and the further hit to supply chains from the war and sanctions will dampen – and could even extinguish – recovery from the pandemic-induced recession, pushing up unemployment. The most direct hit to growth is likely to be felt in Europe. High commodity prices will also hurt many emerging economies. Growth in China is also being marked down significantly on the back of Q1 developments. In addition to the impact of the European war on commodity prices and trade, Covid outbreaks across China have led to new drastic lockdowns in major cities. The hangover from last year's steps to curb the property sector and high-flying private companies in consumer tech continues to dampen demand. For the global economy as a whole, the IMF marked growth down significantly in its semi-annual outlook, published April

19th, to 3.6% this year and next, after the 6.1% post-pandemic jump in 2021. Other forecasters are similarly bringing down their growth forecasts.

Investor concern is understandable. Shocks to the global economy – first from the pandemic, and now the war – have reminded us that "unknown unknowns" can quickly render obsolete even well-grounded expectations. To borrow the words of Fed Chair Jerome Powell – it's a time to be both humble and nimble.

But not all the surprises have been bad. Most strikingly, the staunch resilience of Ukraine's fighters, armed and resupplied with modern weapons by the US and allies, thwarted Russia's advance on the capital, Kyiv. Ukraine's President, Volodymyr Zelensky, is proving to be an extraordinary war-time leader. Putin's initial military plan failed and has shown Russia to be a less formidable rival – or helpful ally – than most thought. As the war moves to the East, where terrain may be more advantageous to Russia, the US and others are stepping up arms shipments.

Fears of recession and "stagflation" may also be overdone, at least in the US. The rapid demand growth that has pushed up inflation has also led to more jobs and higher wages for the lower paid, more in the US than elsewhere. Unemployment has dropped sharply, almost down to pre-pandemic levels, and is now pulling more vulnerable workers into the labor force. So the Fed is tightening into a strong economy without visible signs so far of the financial cracks that have exacerbated recessions in the past.

GEOPOLITICS AND THE GLOBAL ORDER: REGIME SHIFT?

Many believe that we're living through a regime shift, accelerated but not created by Russia's invasion of Ukraine. President Putin's aggression has brought together European countries and the US and other allies. But the war also illustrates the divide between these nations and other major economies – notably China but also India, Indonesia, and Brazil, as well as Saudi Arabia and the United Arab Emirates (UAE) – who have been reluctant to join in Western criticism of Russia or impose sanctions. This distancing has implications for the global financial order, as evidenced by a walkout from this week's meeting of G20 finance officials led by US Secretary Janet Yellen and Canada's Chrystia Freeland when the Russian finance minister joined virtually to speak.

Even before the invasion, there were signs that the world was moving into a more divided, more protectionist, higher inflation regime. US policy – think "Buy American" and continued tariffs on China – may even be exacerbating the move towards more nationalist policies, which in turn will dampen productivity growth over time.

The globalized world that took shape this century, including China and Russia, as well as other big emerging economies, held down inflation and interest rates and buoyed financial markets and incomes more broadly. It fueled an unprecedented reduction in global poverty, notably with the growth unleashed in China by the leadership's decision to allow private enterprises to prosper and export, and private citizens access to consumption goods and property ownership. As China joined the global economy, productivity and living standards grew worldwide. Emerging markets were helped by the commodity

boom from China's surging demand for raw materials. European industry, notably in Germany, benefited from Chinese imports of industrial inputs. Consumers, especially in the US, enjoyed lower prices for many goods.
But globalization also led to strains. In advanced economies, inequality grew as the labor share of income declined and company profits climbed. The other side of the coin of cheap imports involved concentrated job losses in certain industries and regions, especially in manufacturing. Slow recovery from the Global Financial Crisis – itself a demonstration of financial excesses – left many workers and their families feeling left behind.

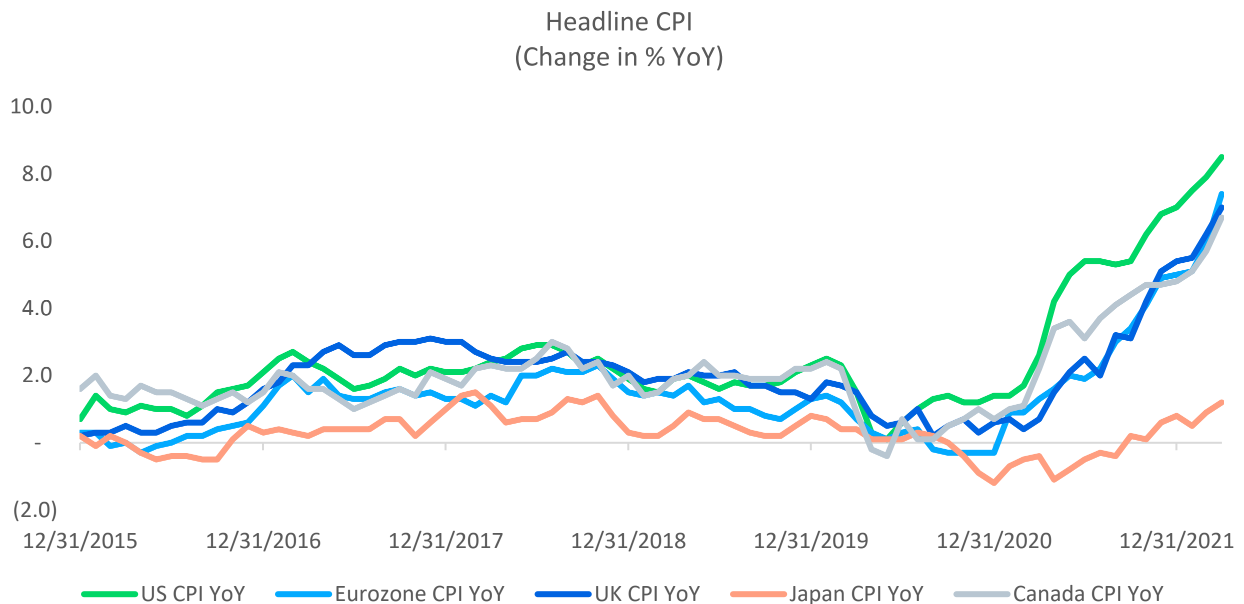
Increasingly, blame has fallen on "globalization" and politicians have sought ways to bring jobs back home and keep foreign workers at bay. Covid, war, and financial sanctions have solidified these trends, as argued by Adam Posen, President of the Peterson Institute for International Economics, in the latest issue of *Foreign Affair*s. Richmond Fed president, Thomas Barkin, agrees. Like Posen, he sees dangers for global growth and inflation, noting in a recent speech, "We're likely to see some deglobalization, as countries rethink their trading relationships and firms redesign their supply chains to prioritize resiliency, not just efficiency."

At RockCreek, we expect that the terrible war in Europe is unlikely to end swiftly. Even if President Zelensky can find common ground on peace terms with Putin, the latter would demand an end to sanctions. That decision rests with the US, not Ukraine. An American Administration and Congress that are wary of being seen as soft will be reluctant to welcome Putin's Russia back into the fold. Companies and investors need to build Russian isolation and continued sanctions into their expectations.

A much greater risk for the global order is growing tension in the world's key relationship: China and the US (read more on this in the spotlight section). It's clear, eight weeks into the war in Ukraine, that China is maintaining close ties with Russia, despite US and European entreaties. If the world is dividing into different camps, China will not be on the US side. So far, Chinese firms and banks have observed the letter of the sanctions. There are still links between economic and financial officials of the two countries. But with little to no productive contact between diplomats and national security officials, Secretary Yellen is hard pressed to maintain a working relationship with President Xi Jinping's key adviser Liu He. Ahead of the IMF and World Bank meetings, Yellen delivered a stark warning that the world's "...willingness to embrace further economic integration may well be affected by China's reaction to our call for resolute action on Russia."

US-China relations matter for the global economy, as well as for peace. Joint action by China and the US helped the world to come together after the global financial crisis, under the auspices of the G20, to rescue the international system and preserve open trade. Contrast that with today's G20 divisions over Russia. This split comes on top of the failure of major countries to take joint action on issues ranging from pandemic preparedness to unsustainable debts across the developing world, much owed to China. It's hard to see this year's G20 meeting in October, under Indonesia's presidency, bringing leaders together to confront the current macro threats of rising global inflation amid energy and food shortages.

INFLATION: BACK TO THE 1970s?



Q1 marked the start of a critical tightening cycle for major central banks, challenged by an upward shift in inflation for which none of them was prepared. Markets have also been slow to catch up. At RockCreek, we agree with the view now espoused by economists from across the political spectrum – from Harvard's Kenneth Rogoff to New York Times columnist Paul Krugman – that rates will have to rise further and faster than now priced in, if inflation is to come down as the Fed projects. The message is feeding through to some markets: mortgage rates on 30-year loans hit 5% in mid-April. It's too soon, however, to conclude that the post-pandemic inflation shock heralds a regime shift back to a high-inflation world like the 1980s.

It was clear some months ago that the continued easy monetary policy in place in the US, Europe, and the UK was no longer appropriate. Federal Reserve chairman Jerome Powell acknowledged back in November that the word "transitory" should be retired. Fed action was, nevertheless, delayed until March, when policy rates were increased by 25 basis points and quantitative easing finally stopped. Since then, and including this week, Chair Powell has signaled that the Fed will move more decisively when it meets in early May, with a bigger rate increase, and a switch from asset purchases to sales likely. Powell's support this week for "front-end-loading" the removal of monetary stimulus suggests multiple 50 basis point moves are coming.

RockCreek believes that these potential actions are appropriate. In recent months, the US data have shown price increases broadening beyond the initial sectors impacted by the pandemic and beyond the most volatile elements of energy and food. Today's inflation is a global – or at least a western – phenomenon. By the end of Q1, US headline CPI reached a 41 year high of 8.5%, while eurozone inflation hit 7.5%, the highest recorded during the life of the single currency. The financial shockwaves in Q1 only worsen the outlook. The IMF now projects US inflation at 7.7% percent this year, up from 4.3% expected last fall, and well above the latest Fed forecast released a little over a month ago, for a 4.1% rise in their preferred inflation measure, personal consumption expenditure (PCE).

Not surprisingly, economists who were almost – though not quite – unanimous in downplaying inflation risks a year ago are now examining where they went wrong. As one analyst put it in a recent mea culpa, "I unfairly dismissed the most boring, Econ 101 explanation for why inflation happens" – too much demand for the supply that the economy could produce. Another way to look at it, as former US Treasury Chief Economist Karen Dynan put it, "The models really let us down." Perhaps most importantly – the conditions that central banks and investors have been facing in the past two years have been extraordinary. In such times, it's wise to remain vigilant and not to rely too heavily on one model or one interpretation of events.

The trajectory of three key factors in the coming months will determine whether the Fed and other central banks can bring inflation down with a "soft landing": rising demand, curtailed supply, and shifting inflation expectations. Optimists point to the still anchored long-term inflation expectations from market data to argue that once supply bottlenecks ease and the Fed has tightened financial conditions moderately, wage and price setters will bring down their expectations of future price increases. Demand and supply conditions may well improve during Q2, with the annual inflation rate peaking and beginning to decline on this side of the Atlantic. Headline inflation in Q2 will be based on comparison with a period of large price increases in April-June 2021. Will that facilitate the Fed's job?

Pessimists note that once inflation becomes a concern, households and businesses lose track of how best to ensure the increase in real wages or profits that they seek. In other words, the anchor of price stability is lost. It's true that investors need to look for ways to guard against continued above target inflation and rising interest rates – not just this year, but into 2023. With the Fed now focused firmly on fighting inflation, the odds are against further acceleration of price increases. What monetary tightening will mean for economic growth and jobs is more in question. The Fed is aiming for a soft landing, but that will require not just skill but luck – which has been in short supply in recent times.

GROWTH IS SLOWING: BUT SHOULD WE FEAR RECESSION?

There is increasing doubt over the strength and sustainability of the global recovery, in the face of monetary tightening and the shock of the war in Ukraine on demand, as well as on prices. Private and official forecasters agree: global growth will be slower and inflation higher this year than seemed likely just a few weeks ago. The rise in energy and food prices triggered by Russia's invasion acts as a tax to dampen demand, as well as pushing up inflation. Germany, the usual engine of the European economy, is particularly vulnerable to the impact of the war on the economies of Ukraine and Russia and of sanctions. Weakness in the Chinese economy is also damaging to Germany's traditional export machine.

By now, it's well understood that Europe's energy dependence on Russia is hobbling the attempt by the US and others to stop the flow of funds into Russia that Putin needs to wage war. What is more controversial is whether it would be feasible for Germany, and to a lesser extent Italy, to absorb the economic costs of halting energy imports from Russia. Increasingly, economists agree that the damage to Germany's economy would be significant, perhaps 1-2% of GDP, but it would by no means be catastrophic or unprecedented in recent times. Officials in key European capitals are now working quietly but

intensively to plan for the distribution of scarce supplies of oil and gas, together with a rapid buildup of stocks to cushion the blow of a halt to energy imports from Russia.

The main political difficulty for German Chancellor Olaf Scholz is the distributional aspect: the core of German industry depends on gas supplies, and job losses could be up to half a million. A halt to oil imports would be less damaging economically than cutting off gas, while also crippling to Russia. Either way, the German government – and the ECB – would likely look to offset some of the costs for the vulnerable, even if this means accepting looser fiscal policy, usually a red line for Germany.

The picture is different in the US. Consumers helped keep growth going in Q1, dipping into savings from the 2020/21 rescue packages. The first official GDP release for the quarter, due in late April, is likely to show a weaker economy than was expected late last year, as indicated in the Nowcast from the Atlanta Fed and the blue chip consensus of professional forecasters.

Investing in today's environment

Against this background, it's clear that volatility across equity and bond markets will continue for the foreseeable future. The question remains whether curbing inflation will require the Fed to raise interest rates to such a degree that recession is inevitable. And how will Europe, the rest of Asia, and other parts of the world fare, given such a confluence of factors?

At RockCreek, we're mindful of cautious investor sentiment in this environment even as we look for opportunities. We remain focused on long-term themes, diversification across asset classes, and robust portfolio positioning for a higher inflation, higher interest rate, slower growth world.

The dilemma for investors is determining what has been priced into the market and whether fundamental analysis will be rewarded in the long term. All signs point to markets being driven more by macro/thematic factors than at the single name level. This dampened the returns of even the strongest active managers during Q1. Looking forward, balancing portfolios across equity factors (value, growth, momentum, cyclical and non-cyclical) and being mindful that, in this market, there is no single silver bullet will be important.

Fixed income failed to serve as a buffer during Q1, as the Bloomberg US Aggregate Bond Index underperformed global equities (ACWI Index) during the period. Off-benchmark sectors that are less interest rate sensitive were least affected. As the Fed tightens policy, investors must be mindful of the downside risks within fixed income, while also looking for shorter term opportunities that may arise in areas such as emerging market debt, high yield, and structured credit. Overall, investors might benefit from prioritizing liquidity and maximizing the probability of outperforming in different interest rate scenarios.

The economic uncertainty and volatility that have been the hallmark of 2022 are likely to remain in the next few quarters. Opportunities may be more defensive in nature to safeguard portfolios against persistently elevated inflation, including through careful positioning in areas such as gold, real estate, and infrastructure. At the same time, we believe there are themes that will be long-term sources of return and diversification. For example, food and agriculture – part of the sustainable investments we have sought for many years – are looking even more attractive now. Recent events and, more importantly,

expected future trends have highlighted the need for more investment in this sector, given increasing food prices; food security issues; and the need for new technology to improve the efficiency, sustainability, and effectiveness of agriculture. This has translated to ideas across the public and private space that can generate strong returns alongside positive impact.

The coming weeks will offer new data points from businesses' future guidance on earnings calls. Investors should look out for data on inflation, inventories, manufacturing, and labor reports for insights into the eventual direction of the global economy and what it means for markets. Given the heightened uncertainty about global prospects, flexibility to pivot with new information will be rewarded. Many factors – US and UK central bank meetings, China's continued struggle with Covid, military developments in Ukraine – may affect the longer-term direction of the sectors, geographies, and markets that investors need to consider.