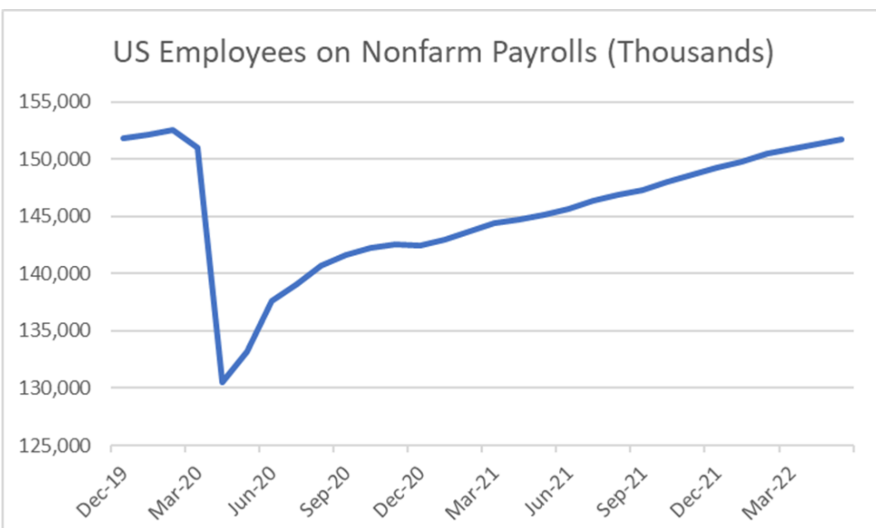
JUNE 3, 2022

SUMMER BLUES?

As summer officially kicks off, we can be grateful that the shadow cast by Covid is finally lessening. Even in China, there are hopes that the worst of the lockdowns may be easing, as Shanghai opens up. But widespread gloom persists. Even the continued strong labor market, as shown in the May payrolls report released today, has a downside, as market reaction showed. The S&P fell 1.6% on Friday and the Nasdaq tumbled 2.7%. The concern: will a tight labor market encourage the Federal Reserve to tighten monetary policy further than otherwise. The gloom voiced loudly this week by some corporate leaders may be overdone, even if monetary tightening has a way yet to go. The US economy is slowing, not crashing.

We began the quarter outlining five themes for investors to watch for: geopolitics, inflation, monetary tightening and jobs and growth – as well as Covid. Markets have swung between inflation and recession fears. But make no mistake: policy makers – and voters – are focused on inflation first and foremost.

In the US, President Biden made that clear this week, meeting with Federal Reserve Chair Jerome Powell and Treasury Secretary Janet Yellen and giving Powell his blessing to do what he needed to bring down inflation. Startling inflation numbers from Europe – with another record high recorded for last month – will put pressure on the ECB when it meets this week. President Christine Lagarde has readied markets for a July rate rise. Might she bring this forward?



Is inflation global?

American consumers and businesses facing unwanted cost and price increases may not care whether the pain is confined to the US or not. For policymakers, the distinction is important. If inflation is a global phenomenon, can domestic policies be blamed and, more importantly, can they fight it successfully?

Treasury Secretary Yellen's admission this week that she "didn't fully understand" last year the persistent forces behind inflation, when she predicted that it would soon subside, drew plaudits for honesty. But it didn't help the Administration's case that their policies have, as a whole, boosted rather than hurt the economy. Most commentary ignored Yellen's point that the inflationary forces were unusual and global, with supply constraints first from the pandemic and then from the war and sanctions. As hopes faded that the surge in US inflation would be transitory, blame has mostly fallen on expansionary US fiscal and monetary policy. Extraordinary government spending to fight the pandemic recession bolstered by liquidity from the Fed put too much spending power and demand into the US economy, the argument goes. How then to explain European headline inflation – which topped 8 % in May?

A new debate is underway among economists. If inflation rates are now similar in the US and Europe, why is monetary policy so much tighter on this side of the Atlantic? As former CEA Chair and Harvard economist Jason Furman put it this week: is the ECB too loose, the Fed too tight, or the context different. He has argued that inflation drivers in the US are different from those in Europe, centered here on strong demand for goods and housing during the pandemic lock-down, an extraordinarily tight labor market and upward price and wage pressures gradually spreading to other sectors. As tightening financial conditions have pushed up the dollar, this has also spilled US inflation overseas. In Europe, by contrast, much sharper increases in energy costs as well as higher food prices have led to the rise in headline inflation.

The data are not yet dispositive. The latest US labor report had good news on wage pressures. The pace of wage increases moderated to 0.3% in May, an annual rate of 3.8%. In Europe, it has taken time to accept that the inflationary environment has shifted dramatically there too. In the words of French economist and former head of the Breugel think tank, Jean Pisani-Ferry, policy makers "have been caught off-guard by the sudden transition from a deflationary to an inflationary environment".

What's bad is good – and vice versa

The investing environment changed this year. That much is clear. No longer can investors rely on a monetary policy regime of "lower for longer" interest rates. As is usual in a period of change, it is harder to separate signal from noise and to sort good news from bad. The economic data have not been helping, as analysts try to decipher the strength of underlying global growth and inflationary pressures. Just a few weeks ago, Russia's invasion of Ukraine led to a rash of downgrades to official forecasts for global growth. But the data have continued to suggest unexpected strength in the US and resilience in Europe. When the economy looks strong – market worries shift to inflation and the risk of higher interest rates. When the data are weaker – the opposite happens. The result? Volatility.

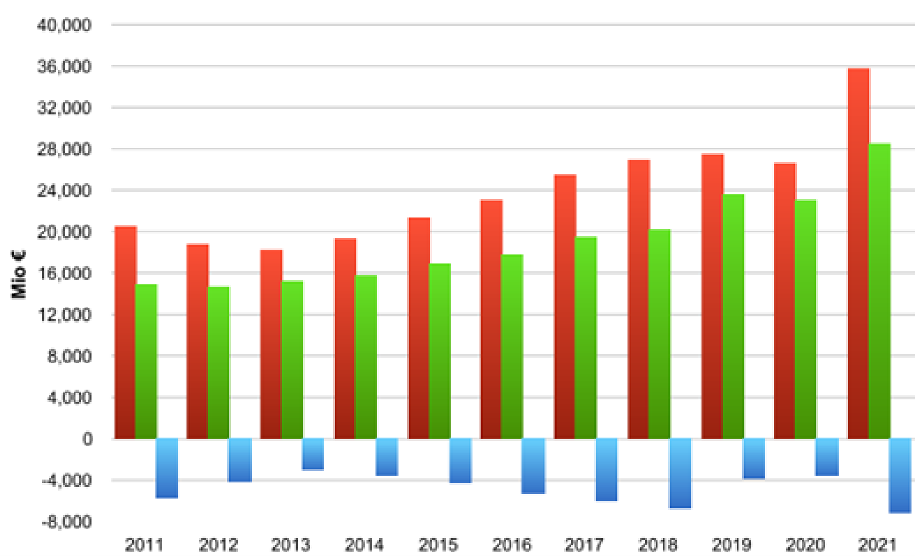
Equities are little changed today from a month ago. But that masks dramatic moves day to day and intra-day that have led to a see-saw effect for market players. Bonds picked up in May, as 10-year yields drew back from the 3 % level.

The S&P 500 appeared poised for a weekly gain following Thursday's rally, however, investors treated the labor market's good news as bad news for markets given continued wage pressures. Cybersecurity company CrowdStrike's stock was a good illustration of the changing sentiment dynamics. The company's stock rose 7.8% on Thursday ahead of its Q1 earnings report and after the close, management proceeded to report a 61% surge in revenue, a 3x increase in non-GAAP earnings, and a 46% increase in cash flow from operations over the prior year. Results were well ahead of analyst expectations. Despite this, CrowdStrike's stock traded sharply lower going into Friday's open, at one point giving up all of Thursday's gains early that morning. The message was clear that good economic data and good corporate fundamentals are continuing to be outweighed by inflation and interest rate worries.

The big news this week in emerging markets was China's decision to modify its zero tolerance lockdown measures, including in the country's financial capital, Shanghai. Residents rejoiced as did local equity markets, but in a sign perhaps that not all is well, the market's euphoria proved ephemeral by week's end. The CSI 300 Index is still down close to 22% YTD and isn't showing obvious signs of an inflection point. Time will tell if the hoped-for boom in consumer spending spurs growth – in the meantime, the problems that triggered the market's downturn earlier in the year remain, including a troubled real estate sector, a semi-nationalized tech sector, and geopolitical tensions. It's unclear if looser credit standards, renewed infrastructure spending, a cheaper Yuan, and a reinvigorated consumer will be enough to get China out of its current predicament. Multinationals are not taking any chances, and Apple's announcement this week that it would shift production of its iPad products to Vietnam was just the latest example of how corporations are hedging their China risk.

One factor that proved a boon to Taiwan's equity markets this week was investors coming to the view that China's potential invasion of the island is unlikely, at least for the time being. Taipei's local index was up 3% for the week, led by its large cap growth stocks. It wasn't just the prospect of peace that buoyed markets however – in a sign Taipei is eager to work with the world's democracies, this week Taiwan and the EU formally agreed to collaborate on enhancing semiconductor supply chain resilience by boosting bilateral trade. It's worth noting trade between the EU and Taiwan surged 32% last year and this week's announcement is intended to build on this.

Total Goods: EU Trade flows and balance



Source: European Commission, May 2022

Geopolitics and commodities

Geopolitical tensions have not eased, and nor are they likely to. The war in Ukraine drags on and its impact on energy and food prices grows. To add to complexity, the rift down the middle of Europe has pushed the US to mend fences in the Middle East. As has happened so often in the past, Saudi Arabia's oil dominance is winning out over US reluctance to show warmth to the country. Expectations of a Biden visit and meeting with Crown Prince Mohamed bin Salman paved the way for this week's Saudi pivot on increasing oil production. Biden has not seen any reward as yet as oil prices spiked again. In the US, gasoline prices have risen by even more.

As for Europe, Russian President Putin now has some military victories to celebrate in Ukraine’s eastern Donbas region – albeit far short of his initial ambitious goals. He has described as "confrontational" Biden's decision to send longer range artillery to Ukraine, reminding the world that he has nuclear weapons at his disposal. Even with additional arms from the US – and the UK, and maybe Germany – Ukraine's outnumbered forces will struggle to withstand Russia's steady advance on the flat land of the Donbas. Ukraine’s astonishing early successes in beating back Russia’s army encouraged many, including US Defense Secretary Lloyd Austin, to speculate that Putin could be weakened dramatically as his military adventures went awry. This looks less likely now.

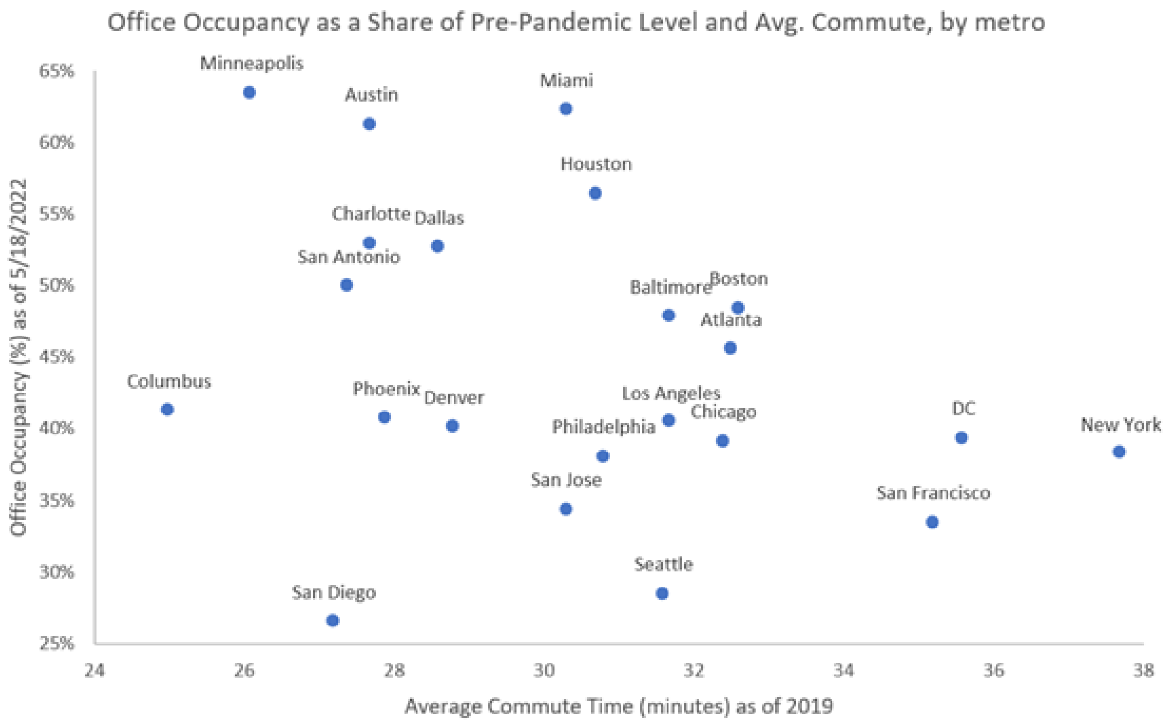
At the same time, the costs of resisting Russia are rising. Unlike in the US, Europe’s inflationary surge almost entirely reflects increased energy and food costs. Despite that, the EU displayed impressive unity – well, almost unity, as Hungary resisted – in agreeing to phase out 90 percent of Russian oil imports by end-year. This decision will hurt Europe as well as Russia. But it is a good step on the path of energy transition and a sign that European unity has been bolstered even as its economy has suffered from the war. Some speculate that in a post-war world, where Ukraine reconstruction will cost billions, this unity could result in another step towards fiscal integration, as noted by Jacob Kierkegaard of the Peterson Institute this week. This would have been inconceivable in the pre-pandemic and pre-war world, where former German Chancellor Merkel resisted sharing debt burdens and favored continued economic links with Russia.

There are nevertheless signs of disagreement within Europe and between Europe and the US on what the endgame in Ukraine should be. Should Russia be ostracized until it acknowledges defeat? Or is that a dangerous and unrealistic goal? All governments note the importance of Ukraine’s President Zelensky being in the lead. But in practice, French President Macron and German Chancellor Scholtz irritated smaller European countries, more fearful of Russia's proximity, by conducting a long phone call with their Russian counterpart. The call was ostensibly in the interests of averting a global food crisis with discussions on lifting Russia's blockade of Ukraine's ports to allow grain exports. In practice, France and Germany – and Italy – likely want to find a way to live with Putin's Russia.

The impact on inflation and growth is set to increase as the conflict in Ukraine continues into its fourth month. This week’s inflation report showed how vulnerable Europe is to higher energy and food prices.

Covid and work

While some high profile employers are insisting on workers returning to the office, many others are accepting that Covid has changed the calculus. Working from home is here to stay for many so-called “office workers”. As discussed in the RockCreek Q1 quarterly commentary, big cities including New York, Chicago, San Francisco, and Washington, DC are struggling to attract workers back to the office, in part due to reliance on public transit for commuters. While mask mandates and restrictions have diminished over time, the length of commute for workers has not. The pre-pandemic 2019 census recorded average commute times for each major metropolitan city. Comparing May 2022 office occupancy data from Kastle Systems in the chart below, it is clear that cities with longer commutes and more reliance on public transport tend to have lower office occupancy rates.



Source: US Census Bureau 2019 American Community Survey, Kastle Systems

For investors in office properties , this means cities that are commuter-friendly will present an increasingly compelling investment opportunity while other metros may struggle to attract and retain jobs. When evaluating office needs, tenants have responded in several different ways: some have relocated to sunbelt cities, others have implemented or expanded the availability of options to work from home.

A more recent trend is tenants undergoing “downsize upgrades.” In this scenario, tenants shrink their physical office space footprint as fewer employees come into the office each day, while taking the opportunity to improve the quality of the space for the in-office employees at a similar cost.

The best opportunities for investors to explore are at the bottom and top ends of the market. In the top 20% of office product, high quality tenants are still willing to pay top rents. In the bottom 20%, a repositioning to better use, such as conversions to residential or mixed-use communities, could provide opportunities. The structural evolution of the office sector will take many years to unfold, requiring investors to be highly selective – and to keep an eye on the lingering effects of Covid on where people work.

RockCreek Update

__Happy Pride Month! For the month of June RockCreek is planning a variety of activities showcasing the LGTBQ+ community, including organizations in the DC area that provide advocacy programs and economic resources for the LGBTQ+ community. Follow our social media pages for updates throughout the month!

Team RockCreek