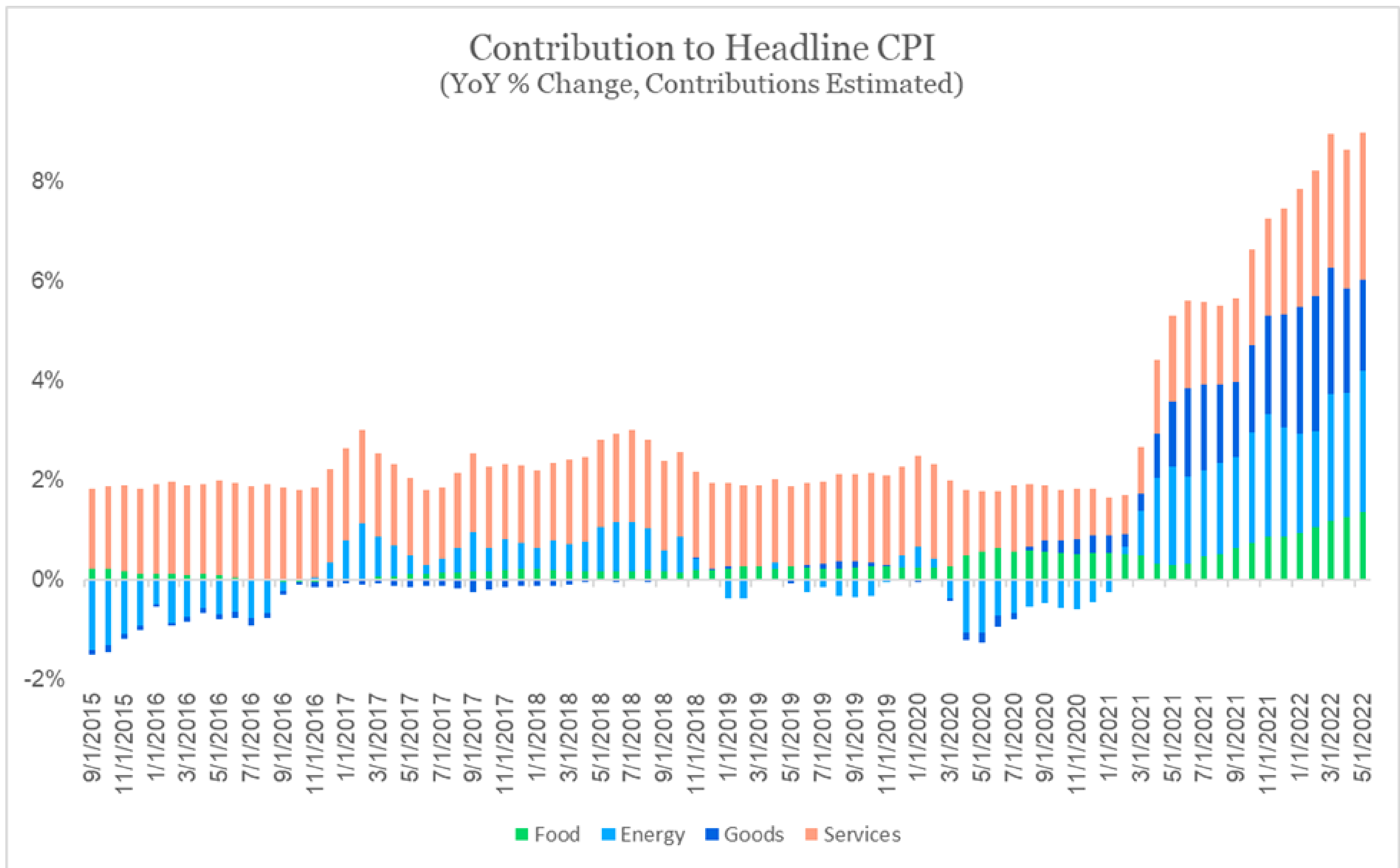
JUNE 10, 2022

OH NO...

As the Federal Reserve meets to decide its next move on June 15th and 16th, Friday's dreadful inflation number will haunt its deliberations. The headline jump of 8.6% in consumer prices was a shock. Many had expected the May number to demonstrate that inflation was past its peak. Instead, it rebounded, topping the previous peak in March.

Even more disappointing news was under the hood, as both optimists and pessimists on inflation agreed in a hastily arranged discussion on Friday morning. Core inflation – stripping out energy and food prices – was also high during May. Price increases that began last year with pandemic-related pressures on goods in short supply have now spread to the larger services and housing sectors. US Treasury Secretary Janet Yellen was unfortunately right when she told Congress this week that inflation would likely "remain high," although she was hopeful it would soon be in decline. Her successor as Fed Chair, Jerome Powell, is trying to make sure that happens. Investors are right to expect interest rates to continue to rise for some time to come, which is not good news for equities or bonds.

Inflation worries are not contained to the US. The European Central Bank (ECB) kept interest rates steady this week. But ECB President Lagarde was clear that rates will be raised in July, with more – and sharper – increases to come as long as inflation stays high. Tighter money in Europe carries an additional risk, already showing up in spreads. Ever since the Euro crisis a decade ago, investors have had a residual concern that the bonds sold by weaker governments – from Italy and Spain to Greece and Portugal – may not be as safe as those of Germany. The fear of a euro breakup led to then-ECB President Mario Draghi's famous "whatever it takes" declaration. We need a similar promise now from Lagarde, with political backing from Germany and others, to stop a further dangerous blowout in spreads.



Source: RockCreek, Bloomberg

High inflation is not the only worry for investors. It is linked to concerns that the global economy, already weakening for other reasons, will be hit hard by the financial squeeze that central banks are setting in motion. As we have noted, markets have toggled for weeks between recession and inflation fears. This week, both the OECD and the World Bank added to growth worries, even before the Friday scare on inflation. They see a sharp slowdown in the global economy from earlier projections, coupled with a growing food crisis in the world's poorest countries. The OECD points to two culprits: the war in Ukraine – forcing up energy and food prices – and a slower growing China.

These factors are more damaging outside the US. Here, there is a paradox. Polls show that Americans have been fairly happy with their own financial circumstances but believe that the overall economy is bad. This week, consumer confidence plunged to a record low. Contrary to the popular view, the US economy has remained buoyant and with plentiful employment. How long can that last with rising inflation and rates? Next week's retail sales and industrial production reports will indicate whether the consumer is continuing to spend.

Monetary policy for the world

What happens in the US does not stay in the US. Pandemic-stretched supply chains and war in Europe have certainly played a part in pushing up prices everywhere. But strong demand from American consumers and investors, buoyed by pandemic fiscal and monetary policy, is also partly responsible for the rise in global inflation.

That stronger demand may make monetary tightening easier to swallow here than in Europe, as well as more urgent. This explains why the ECB turned first to words this week with its promise to tighten policy and raise rates in July and after. Growth concerns weigh heavily. But around the world, central bankers are seeing the need to tighten. Interestingly, the two Asia giants – China and Japan – are bucking the trend. For Japan, Central Bank Governor Kuroda has no desire to let up too soon on the decades-long effort to fight deflation. China is another story – as detailed below.

Markets: Calm before the storm?

It had been a relatively quiet week for markets up until Friday's CPI release. The US equity market was relatively range bound as investors grappled with the reality of both high inflation and softening economic growth outlooks. The energy sector continued its dominance with gasoline prices nearing $5 per gallon early into the summer driving season and the global oil market running hot on supply/demand imbalances. Exploration & production and refiners remained in strong favor, and in addition, solar energy stocks reacted positively to news early in the week that the Biden administration was suspending tariffs on solar panel components from Cambodia, Malaysia, Thailand, and Vietnam.

Of course, Friday morning's negative surprise on inflation only exacerbated investor worries and sent markets reeling. Losses were broad based, but technology stocks, which had already been out-of-favor, continued to underperform along with other growth sectors. As seen today – it will be difficult for the market to find a floor until we start to see clear signs of peak inflation. Europe also performed poorly, partly due to the detrimental effects that high energy costs are having on the economy, but also in reaction to the ECB's unexpected hawkishness. On the other hand, Japan was a bright spot. The Japanese yen reached a 20-year low versus the US dollar, which has contributed to higher inflation for the Japanese population but has been good overall for Japan's export-based businesses. However, even Japan gave up much of its weekly gains on Friday as investors braced for bad news.

Dollar dominates

Just as the Fed makes monetary policy for the rest of the world, the dollar dominates in the reserves held by other central banks, transactions, savings, and global capital flows. It has been referred to as an "exorbitant privilege." It enables the US to fund itself more cheaply, essentially selling its currency in exchange for goods that other countries make. And – important these days – it helps to make US-imposed financial sanctions the powerful tool that they are. As China's economy has grown and European nations have consolidated their currencies into the Euro, many wonder how long the US dollar can continue to be dominant. Once upon a time, after all, Britain's pound played that role. In retrospect, it was unsurprising that sterling ceded to the dollar last century as the US economy grew, along with confidence in its financial system. But sterling's decline was rapid and not expected and caused successive crises for the British economy.

A panel of experts this week agreed that the dollar's demise was unlikely, in large part because there is no viable alternative, with deep financial markets, a fully convertible currency, and trusted legal and regulatory institutions. As for privilege, former Fed Vice Chair Donald Kohn noted that when Fed policy shifts – whether to ease or to tighten – it usually comes in for criticism from central bank colleagues overseas who resent the spillover effects. The main advantage for the US, panelists agreed, was in the foreign policy rather than the monetary arena. As the Biden Administration has recognized, winning support from allies and partners for the use of sanctions is essential to maintain its overwhelming power.

China bucking the trend

As financial conditions are tightening in much of the world, China is going in the opposite direction. Unfortunately, easier money will not do much to shore up demand in the world's second largest economy as long as the zero Covid policy stays in place.

As outside observers and investors have become more convinced of the risks of China's Covid policy, China's leadership seems only to have doubled down. It has been clear for some time that aiming for zero Covid in the face of an ever more contagious virus was going to hurt growth and living standards within China. Luckily for the global financial system, China's government and central bank will ensure that financial stability in the world's second largest economy will be maintained, according to experts convened to discuss "China's financial stability under the Covid-19 stress test."

But, as Chinese economist Tianlei Huang noted, perhaps the implicit bargain between China's leaders and its population – rapidly growing living standards ensured in exchange for political stability and unchallenged leadership – has altered. Maybe consistent rapid growth is not viewed as so important now compared to social issues of inequality. One social issue that is getting short shrift is public health. As we have learned in the US and elsewhere, lockdowns and pandemic-induced restraints on normal life increase risky and antisocial behavior, which can itself damage public health. There is also some evidence that a focus on caring for Covid patients can spill over to hurt outcomes for sufferers of other ailments. In China, the extreme measures to contain Covid infections have pushed aside other health concerns.

Pain at the pump

It's no secret that crude oil prices have shot up this year. They were climbing as the world climbed out of the pandemic recession and markets realized that planned increased production from OPEC+ would not be enough, even if member states could hit their production targets. Russia's invasion of Ukraine and the consequent sanctions imposed by the US and many of its allies drove up prices still further. Brent Crude is up 27% since the invasion. Notably, that international benchmark for oil has risen approximately $100 per barrel from the nadir in April 2020. Ironically, Russia's oil exports in April were little changed from before the war, although the destination had changed. We are even hearing reports that Russian oil is being blended about equally with other source crude by some traders as a way to circumvent current sanctions.

This is not all bad news: Russia is a major global supplier of oil and if its exports stopped altogether, the global economy would crater. As politicians wrestle with the fallout from higher energy prices, they are realizing that choking off the foreign exchange revenues financing Russia's war is easier said than done. This week, Secretary Yellen noted that she is working with G7 counterparts on a scheme to cut the price Russia can obtain – at present there is a discount of some $35 a barrel on Russian oil – while allowing the oil to flow into global markets.

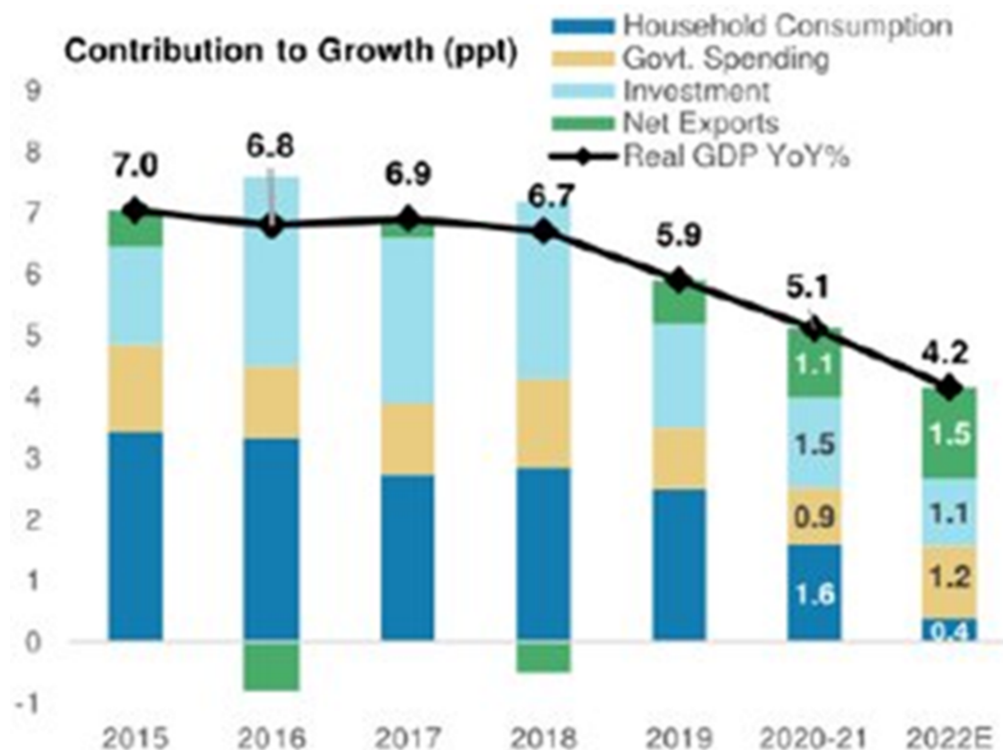
What has been less remarked upon is that prices of refined products – notably gasoline – have shot up by much more. This has put additional pressure on politicians, including US President Biden, as the price at the pump is what consumers notice and what hits their wallets.

What's happened? There is always a margin between the price of crude and the post-refinery costs of diesel, gasoline, and other products. But this gap has recently widened far beyond its usual range. The longer-term energy transition, which has been both hastened and complicated by the Ukraine war, is partly to blame. Climate

concerns have reduced investment in refineries as long-term prospects for profitable oil and gas production have dimmed. Some companies had been moving out of the business, and shuttering old plants, with a net reduction in global refining capacity in 2021.

On top of this trend, the upheaval in oil markets and supply routes with the war in Ukraine shifted the geography of demand and supply. It turns out to be harder to shift production and sales of products than of crude. At the same time, markets for products – which may often feed into specific industrial use and supply chains – are not as fungible as those for crude oil. Instead of increasing output in response to shifting demand, older refineries that can supply the right markets have been boosting prices and profits. The resulting pain at the pump is expected to continue for a while. The Paris-based International Energy Administration (IEA) notes that the summer driving season is the time when oil supplies are squeezed. Slower global growth will ease demand and prices over time. But not for this holiday season.

Breakdown of Contribution to China's GDP Growth



Source: RockCreek, NBS, MS

We are seeing signs that the government is taking the necessary steps to promote consumption. For example, authorities recently announced the sales tax for new auto purchases would be slashed by 50%, from the current 10% to 5% for all vehicles with engines under 2L displacement and with a retail price under RMB300K – this represents by far, the largest segment of Chinese vehicle sales. According to the China Passenger Car Association, a Shanghai-based consultancy, the tax incentive that will remain in place until the end of 2022 may boost China's new light-vehicle sales by 2 million this year.

Beijing is also signaling a lighter touch when it comes to regulating the country's tech titans. In announcing the closure of its investigation into ride-hailing behemoth Didi and approving a flurry of gaming licenses, authorities seem to have reached an armistice of sorts with China's tech ecosystem. It's perhaps no coincidence that this letup in pressure coincides with the country's college graduation season. Indeed, a record 11 million college graduates are expected to enter China's labor market in the coming weeks – tech

platform companies' traditional role as major employers of young talent may have convinced Beijing to reduce the costly burdens of excessive regulation. Time will tell if these measures suffice to spur growth or, at the very least, lessen the negative externalities of China's lockdown policies, which, although less draconian than earlier this year, remain very much in place.

Outside of China, it was a difficult week in EM, as Brazil, South America, Saudi Arabia, and South Africa all lost significant ground despite rising commodity prices. Indian markets fared little better as sentiment turned on the back of growing inflation pressures. Rising rates in the US and the ECB's announcement that it would scale back its bond purchasing program led to a de-risking of EM assets. Foreign investors were net sellers of equities and bonds, putting pressure on local currencies in the process. We can posit that the 'advantage' many emerging markets central banks had over their developed markets peers in tightening monetary conditions has narrowed, making developed markets yields more attractive on a relative basis.

RockCreek Update

Afsaneh Beschloss gave the Adrian Fernando Memorial Lecture, hosted by Oxford University's Smith School of Enterprise and the Environment, where she spoke about the role of markets in developing more renewable energy sources and in the wake of Russia's invasion of Ukraine, the importance of sustainable sources of energy in redefining energy security. Watch the lecture here.

As part of our celebration of World Oceans Day, RockCreek hosted discussions with leading experts on ocean conservation and building a sustainable ocean economy.

Caroline Atkinson spoke with Margaret Spring, chief conservation and science officer of the Monterey Bay Aquarium, about the Aquarium's research and conservation efforts. RockCreek is proud to partner with the Monterey Bay Aquarium as their Outsourced Chief Investment Officer to advance the Aquarium's critical mission, "to inspire conservation of the ocean." Watch the video here.

Key Lay spoke with investor, documentarian, and environmental expert Adam Wolfensohn about the role of markets in aquaculture, sustainable fisheries, and the climate fight – including the role of carbon credits and how the climate debate has evolved in the 21st century. Watch the discussion here.

Alifia Doriwala joined Bloomberg News to talk about global markets, diversified investment strategies in volatile environments, and how second quarter earnings reports will shape investors' portfolios moving forward. Watch the segment here.

Team RockCreek