Macro Environment

The second quarter of 2022 was when reality sank in. The global investing regime has changed fundamentally, and for the foreseeable future. This regime shift had been underway for a year or more, since inflation began to become unmoored in the post-pandemic recovery. But it hit home to financial markets in Q2.

Geopolitical tensions – notably between the US, China, and Russia – together with the impact of the pandemic on supply chains have reduced support for the open, global trading system and added to inflationary concerns. China's zero covid policy has exacerbated production and supply disruptions. Russia's invasion of Ukraine in February led energy and food prices to soar. In Q2, the Federal Reserve – the world's most important central bank – finally moved decisively to tighten monetary policy and clarify that inflation fighting was paramount.

Markets plunged, leading to the biggest half-year decline since 1962. Investors were gripped by alternating fears – of inflation and recession. Data releases added to the confusion, first indicating higher and more persistent inflation than expected, then suggesting an economic slowdown that could tip into recession as consumer and business sentiment fell, and then showing continued labor market strength and jobs growth. The energy crisis triggered by Russia's invasion of Ukraine threatened a return to 1970s style stagflation, with a particularly devastating impact in Europe.

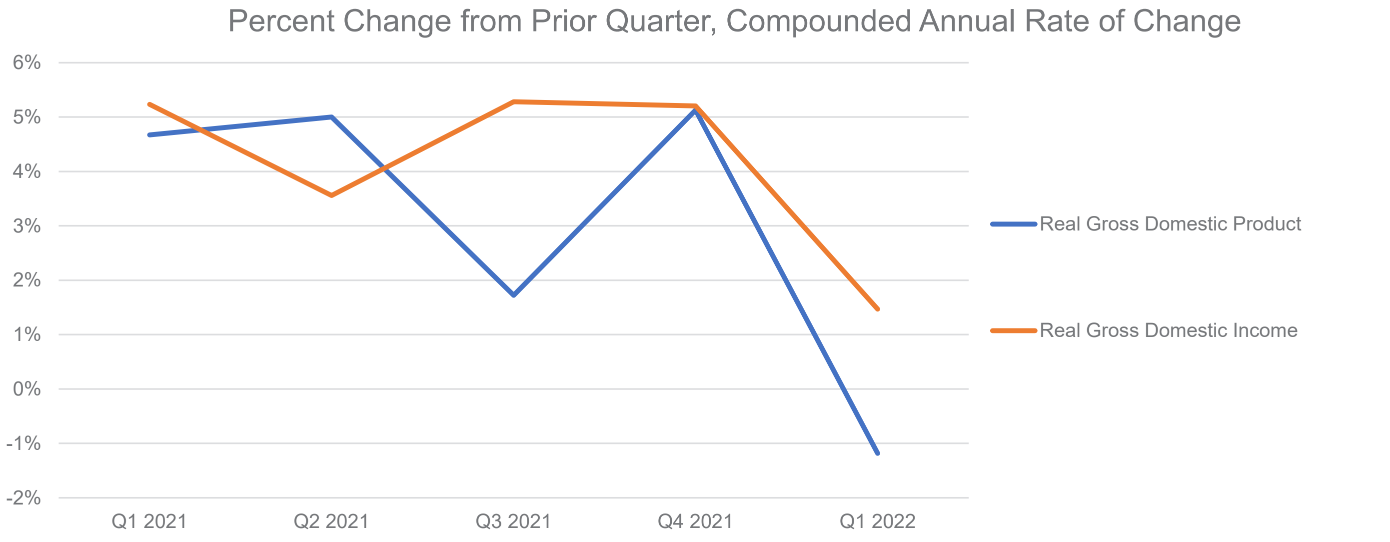
In the US, tightening monetary policy cast a shadow over equity markets, while reassuring those worried that the Federal Reserve and other major central banks had lost sight and control of inflation. The tech winners of the pandemic era of "low interest rates for longer" became the biggest losers. By the end of the second quarter, the outlook for fixed income investors had become brighter with interest rates having reset higher. However, we still expect volatility to remain elevated as central banks shift away from easy-money policies of the past.

It will take some time for the contours of the new economic, financial, and geopolitical world to become clear. Already in Q3, there have been political upheavals in the UK and Italy – with the resignation of Italian Prime Minister Mario Draghi particularly concerning for the European outlook. In the meantime, three key themes stand out: inflation, global slowdown, and a shift in trade patterns – notably of energy – that will have long-lasting impacts on growth, exchange rates, and geopolitical relationships.

Too Many Worries

For investors, Q2 began with inflation fears dominating. The inflationary impact of the war in Ukraine was becoming clear, as energy and food prices shot up in the wake of coordinated tough sanctions against Russia and the collapse of grain exports from Ukraine, one of the world's major wheat and fertilizer exporters. At the same time, monetary tightening was just beginning. How far and how fast it would proceed was unclear.

As spring turned to summer, the Federal Reserve and other major central banks stepped up their rhetoric – and then actions – against inflation. Fears shifted to the real economy. Would tightening overshoot and plunge the U.S and the rest of the world into recession? Data for Q2 growth will be telling, but interpreting these numbers may be a challenge. As Nobel-prize winning economist Paul Krugman has pointed out, different metrics for key indicators have been pointing in different directions, including for economic growth, which can be measured by output or incomes. Forecasting uncertainty – always particularly high at turning points – has been exacerbated by the unprecedented nature of this cycle.



Source: RockCreek, US Bureau Of Economic Analysis

In the US, we expect the summer months to see the peak in headline inflation, but not necessarily in the core wage-price dynamics that central banks are focused on when they set interest rates. Monetary tightening will therefore continue apace, with interest rates rising and the Fed balance sheet shrinking. The rest of the world is also tightening. The IMF calculates that 75 central banks globally are now also in a tightening cycle.

In the US, the labor market remained strong in Q2, with unemployment ending the quarter still close to its pre-pandemic low at just 3.6%. Employers added more than 1.1 million jobs during April-June. There are some tentative signs that the labor market is losing steam, with unemployment insurance claims creeping up from post-pandemic low levels, although employer reports of job vacancies remain at record levels in relation to the number of job-seekers. Labor market dynamics will be key to what happens to spending and growth – and inflation – in the coming months.

A slowdown is inevitably coming, in the US and elsewhere. The question is whether there will be a crash landing, or just a bumpy few months. Rising rates will curtail demand and growth, working most immediately through the traditional housing channel. Mortgage rates climbed 93 basis points in Q2, ending the quarter at 5.83%. Falling stock prices will also depress household wealth and spending.

More generally, consumers already seem to expect the worst, according to survey data. Expectation of recession could encourage a pullback in spending even as the jobs picture stays rosy.

Can the Fed, against the odds, succeed in cooling the economy sufficiently to bring down inflation without a sharp rise in unemployment? This remains a possibility, although success requires luck as well as skill. After all, today's economic challenges are the result of two non-financial events that have shaken the global economy since 2020: a global pandemic and a war in Europe.

Economic prospects are gloomier across the Atlantic, and around much of the world. In Europe, the energy shock is already weighing heavily on growth, prices, and trade. Germany – the economic powerhouse of the region – is suffering from long dependence on Russian energy, and on its export dominance to a now weakening China market.

Back to the Future?

In the 1970s (just like this year) inflation – and the fight to curb it – dominated the macro background. An energy price shock, at that time triggered by the jump in oil prices engineered by OPEC, was again responsible for a surge in consumer prices. And as central banks, notably the Federal Reserve, tightened policy sharply, recession warnings abounded. We know how that story ended. It took years – and Paul Volcker – for US policymakers to address inflation convincingly. And the resulting rise in interest rates led to deep recession. At the same time, President Ronald Reagan in the US and Prime Minister Margaret Thatcher of the UK began a regulatory shift that opened markets, notably in the financial sector, moved power away from unions, and ushered in big changes in their economies.

Might we be heading back to the future? The strong US labor market is an important difference between now and 45 years ago. Apart from today's still low unemployment rate, indicators of a tight market include job vacancies at record levels in relation to job seekers and staffing shortages evident all around, from chaotic air travel to forced closures of public swimming pools. Increased employment, together with savings built up from 2020/21 stimulus packages, may keep up consumption, at least in the US.

Another difference from the 1970s is that – despite this labor market strength – wages, and wage and price expectations, have remained relatively contained. Hourly earnings rose by 1% during April-June, well below headline price increases. The resulting drop in real incomes has hurt workers and families and compressed their spending power in recent months. But it could lead to a quicker return to price stability and less costly disinflation overall than following the wage price spiral of 50 years ago.

Central Banks Got Serious – Better Late than Never?

Why was it only in Q2 that central banks in the US and Europe acted to convince markets and economic actors that the battle against inflation was, in Fed Chair Jerome Powell's words, "unconditional"?

As we have written in our weekly newsletters, central banks in the US and Europe were slow to recognize, and therefore to react to, the inflationary surge now dominating economic concerns. Uncertainty in the wake of the pandemic recession was reasonable, as was the fear that new waves of Covid would hit the real economy – remember Delta in 2021?

But even after the problem was recognized, and the phrase "transitory" retired, action continued to be delayed. As outlined nicely by Sebastian Mallaby in the latest issue of Foreign Affairs, the Fed's commitment to forward guidance meant that it moved only slowly, once it decided to move. Officials were reluctant to accelerate the pace of tightening beyond what they had signaled through forward guidance, until the CPI release for May shocked them into a 75 basis point rate rise in June. Mallaby also noted that signaling from asset prices showed monetary policy was too loose.

The moment of apparently all-powerful central banks has gone. Confidence in the efficacy of monetary policy in delivering price stability at little or low cost in terms of jobs was perhaps always overdone.

Expensive Energy: Settle in for the Long-Term

The war in Europe goes on. By the end of Q2, the heady days of unexpected Ukraine wins against the much larger Russian army were over. As Russia was making slow, bloody, and uncertain progress in conquering Ukraine's East in June, the US and NATO allies promised more, and more sophisticated, weapons to bolster the Ukrainian army.

The war will go on for months, as we predicted from the outset. This will underpin high energy prices. As Germany prolongs coal use and the US Administration presses oil producers and refiners to increase output, what happens to climate concerns and the much-needed energy transition away from fossil fuels?