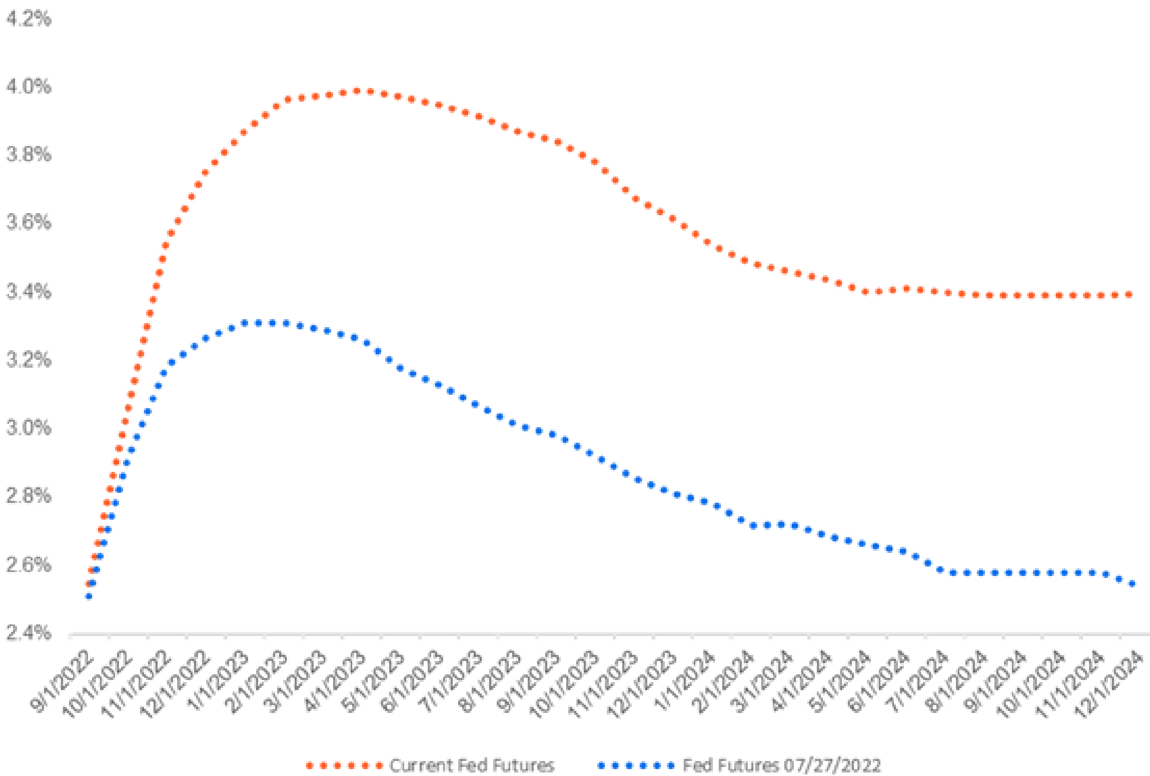
FRIDAY, SEPTEMBER 9, 2022

MARCHING ON

Queen Elizabeth II kept above the fray of politics, markets, and the economy. But her role in the UK, and the world, was remarkable. We therefore wish to note with sadness her passing this week and join with millions in embracing her message of service, duty, and compassion. The Queen's last official act – to appoint Liz Truss as the UK's new Prime Minister (the 15th prime minister the Queen appointed to lead the government) – was carried out bravely, just two days before she died.

Over 70 years as Queen, she both changed with changing times and held fast to her core values. An example for us all.

Market Pricing of Fed Funds



Source: RockCreek, Bloomberg

As to the economy: central bankers are back in charge, with all eyes on how far and how fast interest rates will rise in coming weeks. Leading officials from both sides of the Atlantic signaled firm resolve to combat inflation when they spoke two weeks ago at the annual Jackson Hole meeting.

Now, they are following through. This week, the European Central Bank (ECB) and, less surprisingly, the Bank of Canada moved to raise rates sharply by 75 basis points. The Federal Reserve goes next, on September 21, with the Bank of England following, after postponing its meeting by a week in observance of the mourning period for Queen Elizabeth. .

Market predictions of US rate rises have lagged the central bankers' own expectations since June. This week, they caught up. As Fed Chair Powell repeated his hawkish message from Jackson Hole, and other Fed policy makers joined the chorus, US markets finally moved to price in a third 75 basis point increase when the Fed meets on September 21st.

Central banks are making it very clear. They want to curb inflation, and this takes precedence over growth. The next issue for investors: how high will rates get and how long will they stay up?

How long is longer?

The pandemic era mantra when interest rates were expected to be "lower for longer" has been turned on its head. Even the most optimistic analysts and policymakers accept that rates are now set to go higher for longer in much of the world. But there is a growing divide over just how long the Fed and other major central banks will keep rates up.

Investors are still anticipating that the growth slowdown the Fed is deliberately engineering will lead to an early easing of monetary policy next year. We doubt that. Chair Powell – echoed this week by his more political Vice Chair Lael Brainard – has pointed to the danger as well as the temptation of easing too soon. In the 1970s, higher inflation gradually became embedded in wage and price setting as tightening policies fell short or were eased too soon. As we know, it took a dramatic rise in interest rates under Fed Chair Paul Volcker and a severe recession to break the dynamic and deliver price stability. The Fed does not want to repeat that experience. Its interpretation of "longer" is likely to mean rates stay up for a year or more. Investors will get a steer with the release later this month of the Fed's quarterly economic projections.

In Europe, the growth picture is gloomier, making the 75 basis point move all the more interesting. ECB President Christine Lagarde had tried over the summer to tamp down demands for a more determined fight against inflation, mindful no doubt of financial stability risks as well as the prospect of looming energy shortages and recession in Europe. But she was compelled to act forcefully this week, bringing rates back up from zero to their highest level in more than a decade, as inflation continued to accelerate across Europe. President Lagarde noted that a rate rise of this size was "not the norm." But she acknowledged that another move of this size might become necessary if inflation does not come down.

The "R" word

Some believe that with the priority given to fighting inflation there is no avoiding a US recession. On this view, a significant rise in unemployment and a slowdown in sales will be needed to convince workers and businesses to curb wage and price demands sufficiently to bring inflation back down to the Fed's 2% target.

The odds are certainly high that tight financial conditions will cause not only a slowdown but also some contraction in the economy. Recent US price and wage data hold out some hope, however: could today's inflation subside at lower cost than four decades ago – maybe even without a full-blown recession? The still strong labor market began to pull in more workers last month without leading to faster wage increases. Other supply constraints may be easing as pandemic-induced demand for goods shifts back to services and bottlenecks are gradually reduced. Next week's consumer price index (CPI) for August will be parsed for more clues on the inflation path. Watch, in particular, for whether service inflation continues to be uncomfortably high as consumers ventured out and away on vacation last month.

A warning: the global economy is vulnerable to geopolitics at this time of strained tensions. Another energy shock – as Russian President Vladimir Putin tries to get the upper hand in Ukraine – remains a key risk (see below).

Dollar Up and Up

Another reminder of the past: we are back in the world of an apparently irrepressibly strong dollar. That spells good news for the Federal Reserve as it fights inflation, helping to contain import price increases.

A robust dollar is less welcome for America's major companies, whose overseas sales and profits will translate into fewer dollars. Interestingly, the impact of the tightening Fed and rising dollar is being felt most strongly in other advanced economies, notably in Europe, and not only in less developed and more vulnerable nations. In a twist on recent experience, Europe's trade position is weakening this cycle adding downward pressure on the euro.

Markets Stuck in the Middle

Developed market equities ended the week higher. The S&P 500 gained 3.6% on rather low trading volumes as investors face more questions than answers. Signs point to lukewarm sentiment, which points to neither a sharp move down nor the beginning of a new bull market. We would likely need to see some combination of a trough in the economic cycle, inflation and interest rate peaks, severely negative investor positioning, and attractive valuations before we witness the beginning of another bull market. Even with year-to-date market losses, cyclically adjusted P/E remains in the 77th and 81st percentiles over the past 20 and 50 years, respectively. Meanwhile, reasonably healthy economic data is well and good, but appears to have more downside than upside potential given the tightening cycle and a possible recession. As it stands now, the equity market appears likely stuck in a trading range between its recent June lows and August highs.

Japan followed the US market higher this week with the TOPIX gaining 1.8%. Japan's government eased its Covid-related cross border controls, and that, along with the rapidly weakening yen, helped boost stocks geared towards reopening and exports.

Europe's STOXX 600 gained 1.3% with the ECB's record rate hike helping lift European banks. Meanwhile, government-led moves to mitigate the impact of Europe's energy crisis this past week provided some encouragement to market participants, yet nobody really knows for sure how badly energy shortages will take hold of the continent.

Winter is Coming – Energy Scramble

The wild card for the global economy is energy, and the stranglehold still exerted by Russia over oil and gas supplies.

In Europe, governments are scrambling to address soaring prices that many consumers would be unable to bear, a shortage of supply that could cripple some industries reliant on gas for production, and a strange confluence of large windfall profits for some energy companies, with a liquidity squeeze on others that threatens to trigger bankruptcies (more on that below). In the UK, the new Prime Minister has announced two-year price caps for consumers' electricity bills – six months for businesses – that critics fear will encourage continued energy consumption at a high cost to the public purse.

EU nations are wrangling over a bold and complex five-point plan put forward this week by EC Council President Ursula von der Leyen. The plan would cap prices paid for Russia's oil (as the US wants), impose mandatory cuts in energy consumption across the EU, redirect the windfall profits of low-cost electricity producers and oil companies to subsidize consumers and businesses, while also allowing special funding and regulatory help for cash-strapped energy companies facing liquidity problems.

It remains to be seen whether the 27 EU nations can agree on coordinated steps to conserve and share energy in the coming winter. A recent paper from the Bruegel think tank in Brussels lays out the importance, including for a successful green transition, of cooperation.

Energy liquidity flare ups

Record power prices, driven by the soaring cost of gas as Russia chokes supply to Europe, are presenting European utilities with an existential problem: despite selling electricity at record prices, they are running out of cash because of spiraling margin collateral requirements.

As a normal course of business, utilities use futures markets to help guarantee the price they will receive, and they de-risk power sales to households and businesses by taking short positions in futures markets before selling the physical electricity. That way, if power prices fall, any losses on the contract will be mitigated by gains from the short position; if prices rise, the additional profit made on the physical delivery should cover the cost of the short position.

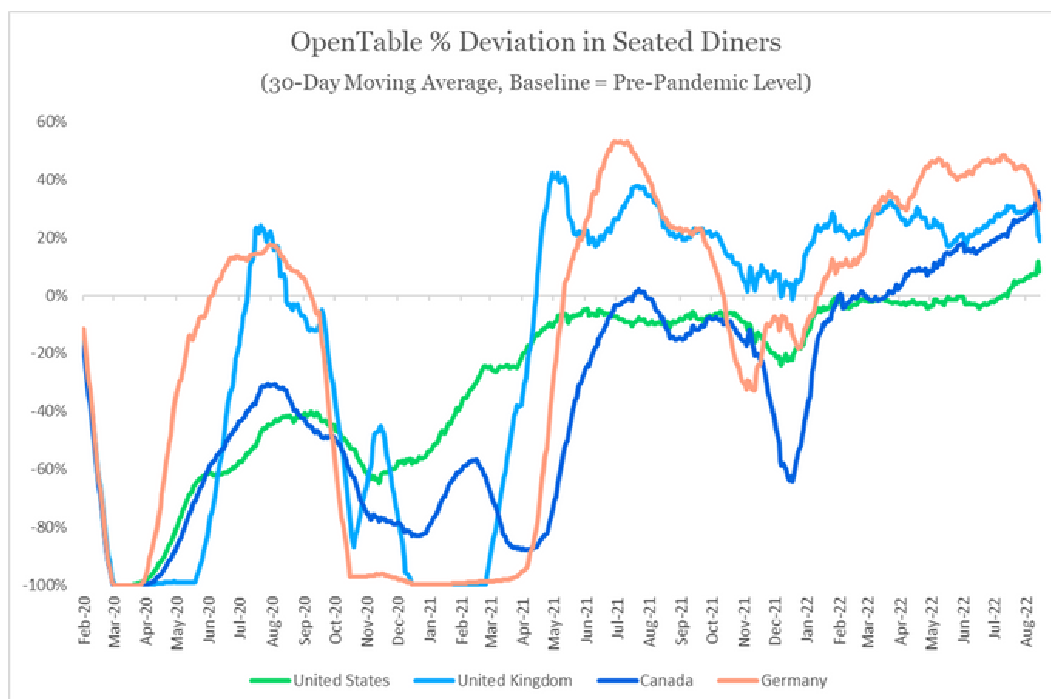
A short position, however, requires that the utility post margin or collateral in case the price of the underlying asset rises. In recent months, the soaring price of electricity has meant the collateral requirements that have hedged future sales have ballooned to such levels that it has created significant liquidity issues for the utilities. In fact, margin requirements have reached such exorbitant levels that European energy companies are now facing margin calls north of $1.5 trillion, wiping out most – if not all – of their existing commercial credit lines used to provide margin for their short position.

As a result, several European countries are being forced to provide billions of euros to support their utilities caught by the extra collateral payments. Finland, Sweden, and the UK have put out plans to support their energy companies that trade in the electricity derivatives markets by making available €10 billion, SEK 250 billion, and £40 billion, respectively, in liquidity guarantees.

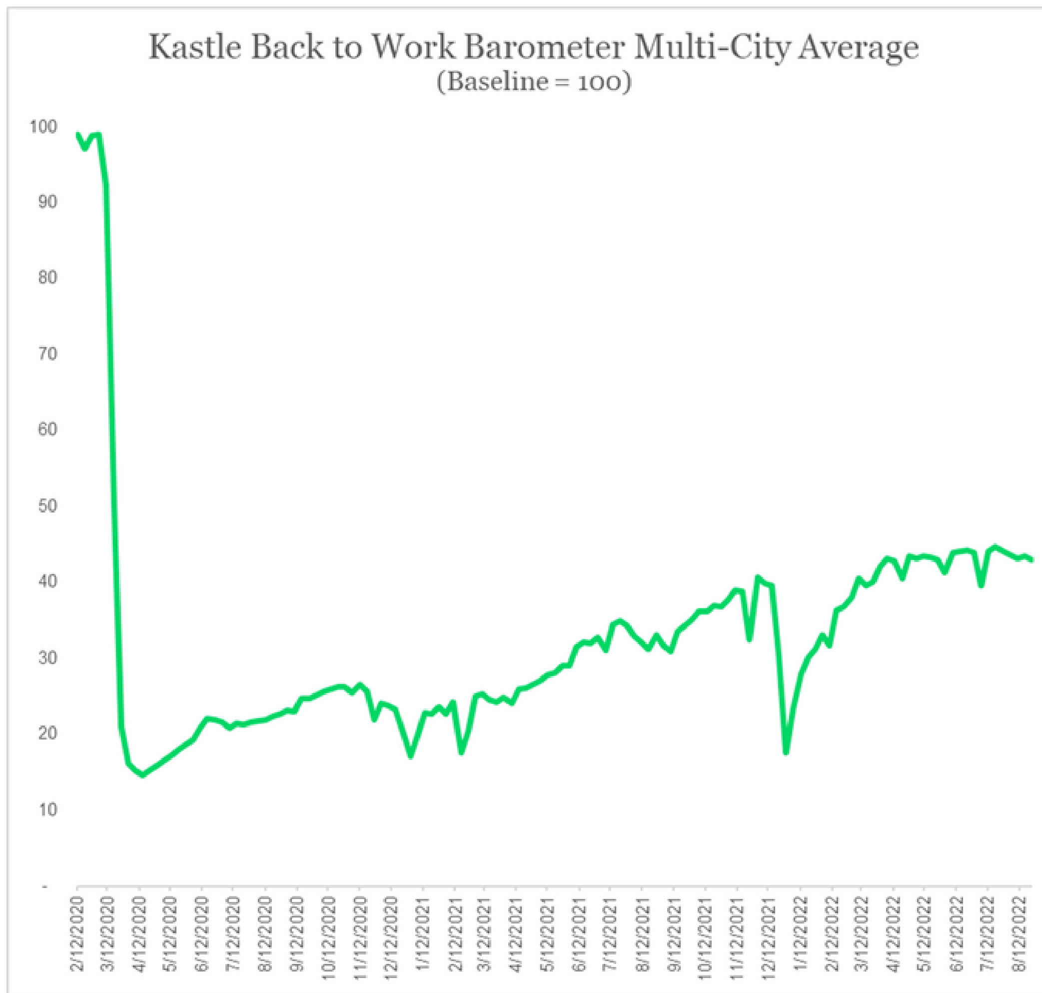
EU energy ministers are expected to meet today to discuss alternatives to ease the liquidity strain. At this point, there appear to be only two options on the plate – provide utilities with billions of euros of state-backed credit – as countries have already done – or modify rules around collateral margin requirements. Regarding the latter, the legal framework for margin requirements on derivatives does not distinguish between hedgers and financial speculators, but one solution being discussed is to reduce or remove the collateral requirement for hedgers such as the utilities, which would, in turn, alleviate the liquidity strain.

Covid divide

As summer retreats in the rear-view mirror, Americans are mostly saying goodbye to Covid concerns. Few places now require masks, with even the New York City subway easing its rules. This is mostly good for business, especially for those companies in the service sectors that suffered most acutely from Covid. But while eating out and going on vacation are now back above pre-pandemic levels, and schools and colleges are back to normal, there is a different picture in the office workplace.



Source: RockCreek, Bloomberg



Source: RockCreek, Bloomberg

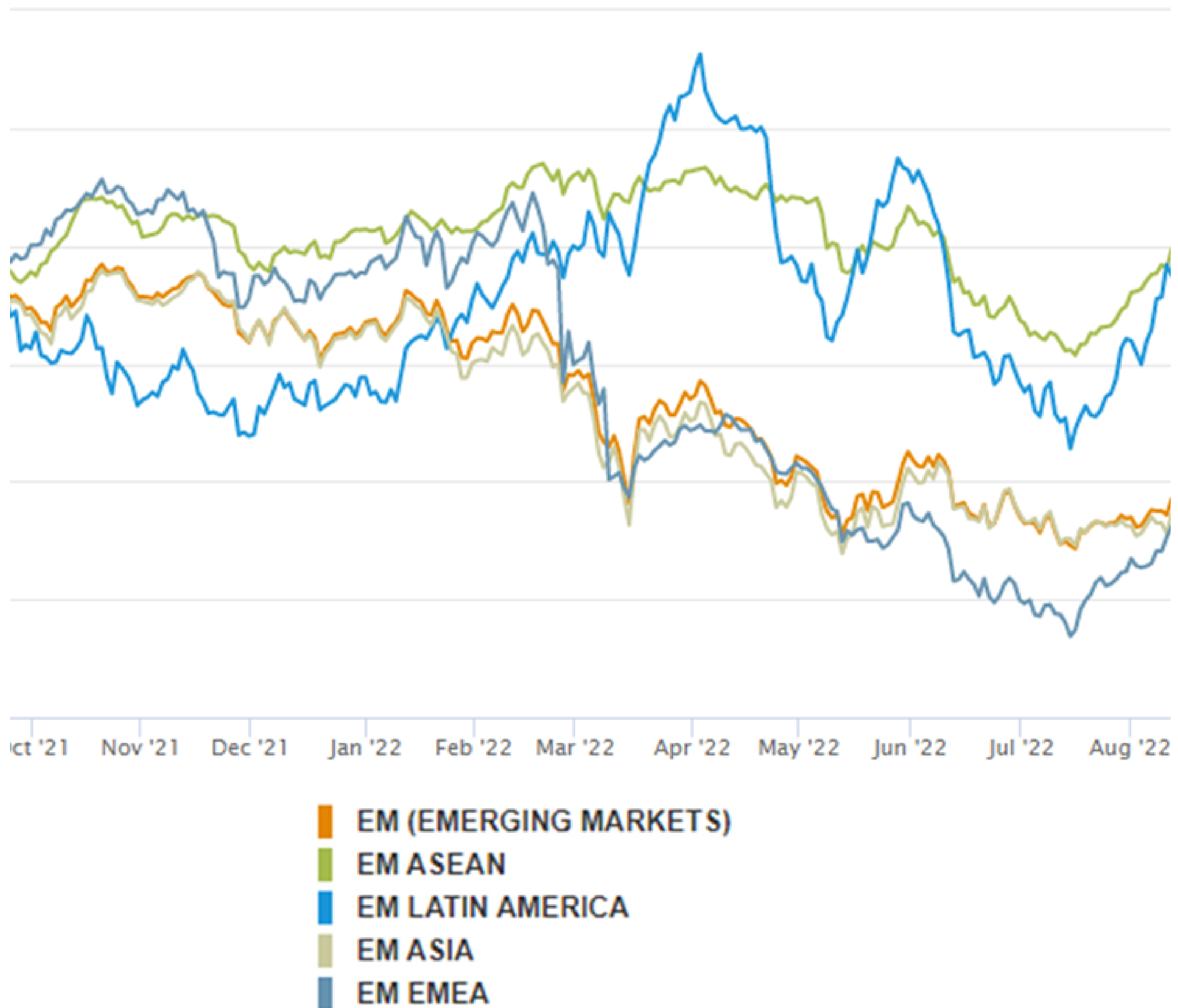
That divide became clear this week. Many CEOs hoped that finally, this year, the third attempt at a fall return to work would be the charm. But many workers remain reluctant, even as employers request, cajole and in some cases plan to require attendance in the office – at least for some days a week. The CDC last month aimed to streamline its Covid-19 guidance. Among the updates, the CDC no longer recommends testing for asymptomatic people with no known exposure in most community settings.

A shift in work patterns for the one-third of Americans who work in offices may be a lingering result of the pandemic. Will it show up in productivity over time – and in which direction?

Emerging Markets

It's been a tough start to September in the emerging markets universe, with most regions down 2-4%. Latin America and the ASEAN region, however, continue to stand out this year. While it is true Latin American markets benefited from the commodities boom earlier in the year, there's more to the story. After all, in periods of global inflation, higher US interest rates, and a strong U.S. Dollar, Latin American markets have usually been at the forefront of economic crises, often cited as textbook examples of what not to do in terms of monetary and fiscal policy. It seems, however, that in 2022 Latin America is not following academic precepts. Inflation is increasingly under control, fiscal spending as a percentage of GDP is well below historic averages, and currencies are appreciating versus the U.S. Dollar. Perhaps the lessons of decades past and the experience dealing with hyperinflation has belatedly come in handy.

ASEAN & LATIN AMERICA OUTPERFORMANCE



Source: MSCI,RockCreek,

In the case of the ASEAN region, the things that will drive regional economies going forward are the same drivers that we have been focused on since increasing our exposure last year. First is private consumption, second is FDI, and third is gradual recovery in tourism. All three are happening in real time and driving South Asia's growth. And demand for commodities is a bonus in the post Russia-Ukraine world.

In the case of the ASEAN region, the drivers for regional economies going forward remain the same as those that we have been focused on since increasing our exposure last year. First is private consumption, second is FDI and third is gradual recovery in tourism. Demand for commodities is a bonus in the post Russia – Ukraine world. Of course, uncertainty in North Asia, USD strength, rising inflation/interest rates, volatile energy/commodity prices and slowing demand from developed markets and China are headwinds. And, if these factors persist into 2023 growth will slow in the region - but the rate of growth will probably continue to sustain at levels over and above what we will see in North Asia. Markets are still cheap despite forward earnings estimates for MSCI's Southeast Asia index gaining nearly 4% since the start of the third quarter, compared to a 1.5% decline for the world index. Notwithstanding their relative performance against world indices, however, ASEAN is basically flat over the last year.

RockCreek Update

With more to come,

Team RockCreek