RockCreek

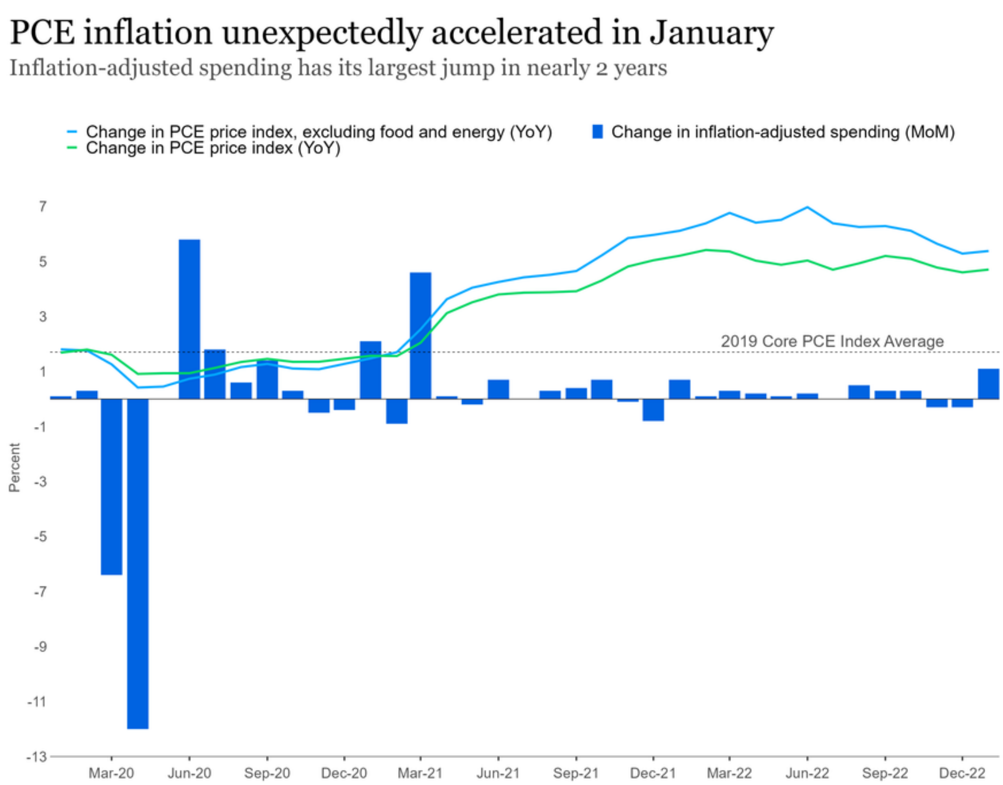
FEBRUARY 24, 2023

UNQUIET ON THE EASTERN FRONT

A year ago today, Russian President Vladimir Putin shocked most of the world by invading Ukraine. It was a tragic mistake. The resulting war has cost thousands of lives and upended the post-Cold War order in Europe. Bitter fighting along a concentrated 600 mile front echoes the trench warfare and misery of World War I. Wholesale Russian bombing of civilian homes and infrastructure echoes the devastation of cities in World War II.

Sadly, as we envisaged months ago, the conflict continues with no end in sight. That has important political ramifications, including in the US, as the 2024 election looms into view. But the initial economic turmoil has subsided, and a resurgence is unlikely. It seems that Europe, and the global economy, are affected more by the post-pandemic monetary cycle than by war.

On monetary policy, the battle against inflation also continues, with no easy victory likely. Friday's information on the Federal Reserve's favored inflation measure was disappointing. Both headline and core PCE (Personal Consumption Expenditure) indices ticked up in January, to 5.4% and 4.7%, respectively, from a year earlier, with a jump in January that surprised markets, with the S&P 500 down 2.7% for the week and the tech-heavy NASDAQ down 3.3% over the same period.



Source: RockCreek, Bureau of Economic Analysis

The core PCE price index, excluding energy and food, rose by 0.6% from December, the biggest monthly increase since last summer, and equivalent to an annualized 7.1%. Inflation is not running at such a high rate; January was affected by price resetting. But calculations on a three-month and six-month basis show that underlying inflation remains closer to 5% than to the Fed target of 2%. At the same time, consumer spending remains strong – above its pre-COVID trend – and the labor market is tight.

Facing reality - markets and the Federal Reserve

For much of last year, and again last month, financial markets downplayed the Federal Reserve's determination to fight inflation and the difficulty of that fight. Once Chair Powell reaffirmed that the central bank still saw a 2% inflation rate as the definition of price stability, it was clear that this would take time and would almost certainly involve a slowdown in the economy. Markets, instead, priced in a mid-year pause in tightening followed by a cut in rates before year-end. Monetary policymakers were more cautious than traders. In the Fed's December meeting, the consensus was that rates would top 5% and stay there throughout this year.

In keeping with the upbeat mood in markets in January, good news on the economy – such as strong consumption and low unemployment – was seen as simply good news. A soft landing might be within the Fed's grasp, with no need to crush the economy in order to bring inflation back to target.

The mood shifted in February. Good news – a still strong labor market, and rising sales – is now back to being taken as bad news. The February 3rd report that payrolls were continuing to rise marked the change in sentiment. Since then, claims for unemployment insurance have dropped week by week, rather than rising as those looking for the economic slowdown have expected. Most importantly, inflation numbers have disappointed. The result – investors have begun to believe that interest rates will indeed continue to rise, perhaps by another 75 basis points before the Fed pauses.

As we noted last week, the road back to the Fed's 2% target will be bumpy. A few good data points for Q4 on both prices and wages made disinflation seem easier than expected last month. Consumer price inflation in both Europe and the US started to surprise on the downside rather than the upside. But getting from 9% inflation – or double digits in the case of the EU – to 5% or 6% was always going to be easier than getting from there to 2%. It will probably take longer too. Even before the latest data for jobs and prices, Fed policy makers were worried about that. The minutes of the February 2 meeting released this week noted that they "*observed that a restrictive policy stance would need to be maintained until the incoming data provided confidence that inflation was on a sustained downward path to 2%, which was likely to take some time.*"

Thumbs down

Equity markets in the US began the week on a downbeat note when markets reopened on Tuesday after the Presidents' Day holiday. The S&P dropped by more than 2%, the worst one-day performance year-to-date. After a mid-week pickup, on the back of good news from Nvidia, the mood darkened again with macro concerns. Corporate earnings were also in focus with strong beats from Walmart and Nvidia somewhat offset by weak guidance issued by Home Depot. Performance across the pond was less dour but far from strong. Stronger-than-expected economic releases in the UK and Germany cheered up some, but this was mitigated by hawkish rhetoric from the ECB Governing Council and the prospect of elevated energy prices amidst China's reopening.

With the release of the Fed minutes, it would appear that interest rate and foreign exchange markets have come to accept that rates will be kept higher for longer. Fed Funds futures are currently pricing in a most-likely scenario of three consecutive 25 basis point hikes at the next three FOMC meetings, a decidedly hawkish outlook owing to stronger-than-expected economic activity and core inflation that remains above the Fed's long-term 2% target. Six-month T-Bill rates recently exceeded 5%, a level last observed in mid-2007, and show little sign of stopping their meteoric rise.

The rising tide of sovereign yields has not stopped with nominal rates, as real yields – measured as the spread between nominal yields and inflation expectations – have also continued to march higher, leading to reduced appetite for fiat alternatives, most notably gold.

Perhaps nowhere is the recent economic strength more evident than in the performance of the dollar. While still down from its late-September peak, the dollar index has risen for all but 2 days since the blockbuster labor release on February 3rd. In recent weeks, the hawkish Fed narrative has bid the greenback higher against other developed market currencies, namely the Euro, British Pound, Canadian Dollar, Aussie Dollar, and – especially – the Japanese Yen.

Housing Canary

The housing market continues to slow, which in time will dent spending. And the worst is likely not yet over. Mortgage rates climbed back up this week, stalling demand for purchases and refinancings that are the lifeblood of mortgage companies. Wells Fargo, for example, has laid off 500 employees in the mortgage unit, following a 70% drop in mortgage volumes in Q4 2022 from a year earlier.

As house prices have declined – unusual in the US – so has the value of the housing market. This week, Redfin reported estimates that the "value of the US housing market shrunk by the most since 2008 as the pandemic boom fizzled out." Equity peaked at $47.7 trillion in June and has fallen by $2.3 trillion – or 4.9% – in the second half of 2022.

Right now, only 55,000 homes in the US can currently be refinanced for a lower rate, signaling that the music has stopped on the housing market and people may be locked into their current mortgages.

A lack of liquidity in commercial real estate lending has cooled transaction volume, giving valuation agents limited comparable transactions to point to current values. Capitalization rates have widened as buyers and sellers wait for stabilization before transacting. Traditional bank lenders have limited liquidity available for loans and have reserved that capital for their largest and most established relationships. As such, real estate investors without strong banking relationships also have limited options to access debt capital markets to make their projects feasible. Debt funds are available, but at rates exceeding 10%, and with no certainty of permanent financing available in the near term, borrowers are reluctant to go to market.

Surprisingly, there has been an emergence of liquidity from life insurance companies that have been adding flexibility in their solutions, offering shorter duration, floating rate loans at more attractive rates. Some real estate investors have used this solution to make projects feasible, albeit at lower leverage levels, while paying up on the front end for flexibility to refinance early or swap to fixed rate debt as markets adjust. There may only be a limited window for this capital structure, as the life insurance budgets are constrained, but it has been a promising opportunity for real estate investors while uncertainty remains in the traditional bank lending markets.

Ukraine spill-over: so far, so limited – except...

President Biden's appearance in Kyiv this week – an unprecedented visit for a US President to a war zone under foreign control – demonstrated his support for Ukraine. That is genuine. As Vice-President when Russia seized Crimea, Biden was always a voice for a muscular stance against Russia and its scarcely hidden support for "independence" fighters in the eastern Donbas region of Ukraine. But it also stops short of supplying Ukraine with the weapons and materiel needed to push Russia back definitively to Ukraine's original borders – a goal of many now surrounding President Zelensky.

Council on Foreign Relations President Richard Haass has written that wars end in one of two ways: one side defeats the other and is able to impose peace terms; or both sides compromise rather than continue a war neither is strong enough to win. Neither condition applies to the war in Ukraine now. "The good news (if there is any) is that the war may well become less intense as both sides will have difficulty sustaining the magnitude of losses that has characterized this past year," Haass wrote this week. "The bad news, though, is that the war will almost certainly continue. The year ahead promises to be dismal, not decisive, more reminiscent of World War I than World War II."

A long, frozen conflict with continued heavy casualties is not what Biden wants, particularly in the runup to the 2024 election. Opposition from some Republicans to the war and its continued expense has the potential to turn Ukraine into an election issue.

Russia's initial aim of toppling the government and returning Ukraine to its sphere of influence failed quickly last year, in the face of strong resistance in Ukraine, exceptional leadership from President Zelensky, and united US-led support for Ukraine from NATO and other allies. But while Putin has been robbed of victory, he has not – and will not – easily cede the territory Russia controls nor concede defeat. In a war of this kind, the ability to produce weapons and manpower will increasingly matter. Russia has shown its willingness to throw both into this battle. Ukraine's military and western supplied weapons have proven their high quality. But there is a military saying "quantity becomes quality." Russia has two and a half times as much ammunition capacity as Europe.

The US Administration is proud of its leadership in regards to Ukraine. It has certainly fostered unexpected cohesion among countries in Europe, a strengthening of NATO, and Germany's willingness to break ties with Russia – despite its decades of energy dependence – and to reconsider defense spending. At the Council on Foreign Relations this week, Deputy Treasury Secretary Wally Adeyemo said that US-led sanctions have "degraded Russia's ability to replace more than 9,000 pieces of military equipment lost since the start of the war…Russia is also running out of ammunition and has lost as much as 50 percent of its tanks." On the one-year anniversary of the war, the Treasury Department added new sanctions targeting Russia's metals and mining sector, financial institutions, military supply chain, and individuals and companies globally that are helping Moscow avoid existing sanctions.

But the messaging employed for most of the past year has been divisive in the global community, as may be more obvious from outside than inside the US. John Chipman, CEO of the respected London-based International Institute for Strategic Studies (IISS), which this week released its one-year view of the war, has noted that an early framing of the conflict as Russian imperialism and disregard for an independent, smaller neighbor would have been easier for countries from India to Brazil to support than the "democracy versus autocracy" pitch favored by the Administration. That has tended to alienate many historically non-aligned emerging markets and even some traditional US allies, such as Colombia. In Asia, the desire to avoid choosing between the huge market of China and the strength of the US has made some countries wary of lining up behind Ukraine.

Such tension over how to view the conflict was on display this week at the G20 Finance Ministers' meeting in Bengaluru, India, which neither Russia's finance minister nor central bank governor attended (Russia was represented by senior economic officials). Prime Minister Narendra Modi avoided mentioning Ukraine in his welcome remarks, and there are reports that India, this year's host of the G-20, will not want the bloc to discuss sanctions on Russia or use the term "war" in any G20 communique.

China complications

Ukraine was the focus of new US concerns about China that surfaced at the Munich Security Conference at the beginning of this week. Secretary of State Anthony Blinken warned publicly of the danger that China might supply arms to Russia, after cautioning his Chinese counterpart, top diplomat Wang Yi, in a private meeting. The Administration may decide to declassify information that lies behind its concerns, as it did a year ago in the run-up to Russia's invasion. That did not dissuade President Putin, although it helped to bolster Europe's willingness to follow the US lead in swift support for Ukraine and opposition to Russia last year. The White House hopes that public warnings will discourage China from arming Russia now.

Some hoped that after abandoning zero-Covid, China would move cautiously towards a rapprochement with the US and a reopening to the global economy to spur growth. Instead, China, has this month reaffirmed ties to Russia with a visit of Wang Yi to Moscow and reignited fears among business leaders that success can bring problems, as evidenced by billionaire tech financier Bao Fan's disappearance, according to his company. Many still believe that an invasion of Taiwan – the biggest risk for markets – is highly unlikely anytime soon. But could there be smaller aggressive steps, as described in a paper this month by the Asia Society Policy Institute?

Emerging Markets

It was another largely negative week in emerging markets, with both major and smaller markets giving back gains generated in the euphoria of the new year. Rising geopolitical tensions between the US and China and a resurging dollar fueled country-level dispersion and volatility in EM.

Year-to-date, the MSCI EM Index is still up close to 3%, but it was up 8% at the end of January. Much of this give-back can be attributed to an eventful few weeks, including the Adani scandal in India, China's alleged spy balloon, and one of the largest frauds in Brazilian corporate history.

This type of noise is part and parcel of investing in emerging markets and underscores the need for active stock selection combined with tactical positioning.

Good for the World Bank, good for climate, good for the US

President Biden's nomination of Ajay Banga as the next President of the World Bank is an inspired and excellent choice. He is a gifted leader in finance who can be counted on to put the Bank at the front of the struggle against global climate finance and inequality. The nomination comes at the same time that Treasury Secretary Janet Yellen laid out a vision for World Bank reform that highlights the need for action on climate.

With more to come,

Team RockCreek

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