Investment Commentary

HANOVER ADVISORS

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The Flames of War Fuel Uncertainty

Russia's invasion of Ukraine upended the global economy, adding fuel to already heightened levels of volatility and waning optimism, and the conflict will have serious implications for the economy, inflation, and the markets. Volatility was on the rise prior to the invasion, as investors anxiously anticipated how the Federal Reserve would combat the worst inflation in 40 years. The bond market has seen big losses this year, with the Bloomberg Aggregate Bond index down more than 6% this year, putting it on track for the worst quarterly performance since 1980. Now, with the war adding more uncertainty to the markets, stocks have seen large losses. Both the NASDAQ and Russell 2000 entered bear markets, and the S&P 500 is in correction territory. Though we have seen a strong rebound from recent lows, much of this has been driven by the closing of puts and other hedging options rather than a rebound of optimism.

The direct impact of Russia's invasion, and the subsequent sanctions that seek to isolate Putin from the global economy, on the U.S. economy is likely to be limited. As of 2020, the most recent year for which we have data, U.S. exports to Russia were less than $9 billion, or roughly 0.4% of total U.S. exports, and imports from Russia were only slightly higher at 0.8%. However, the conflict has already had a profound impact on the global commodities market, which will mean higher prices and slower growth for the U.S. economy.

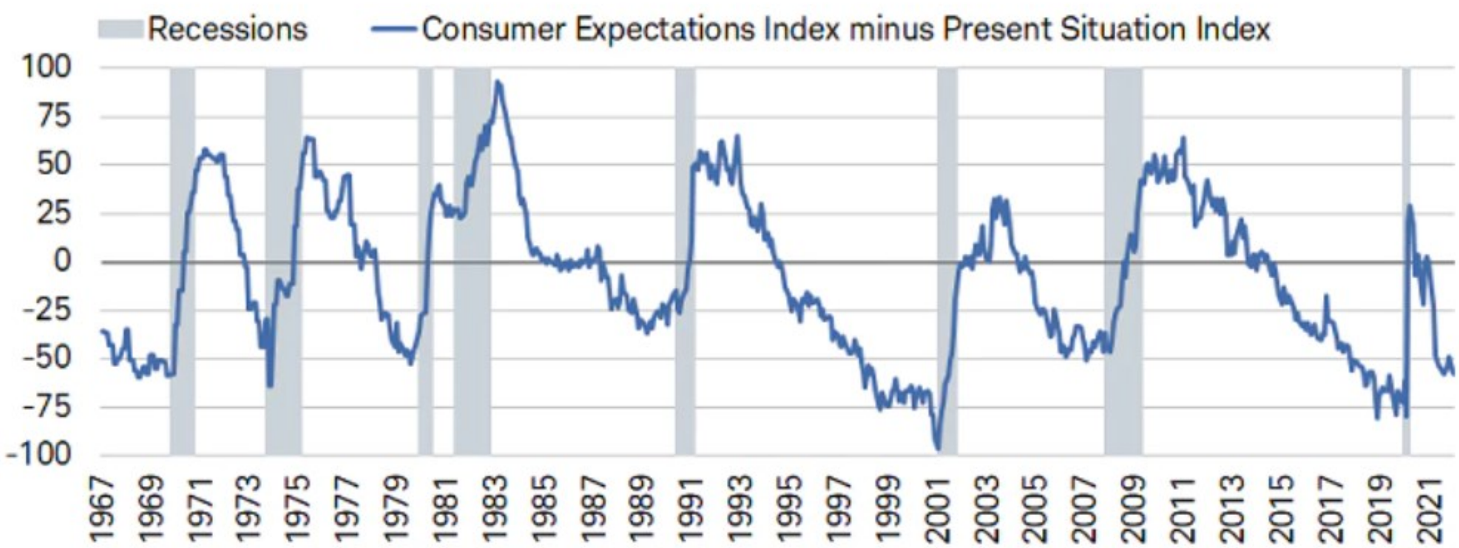
The war's most obvious impact for U.S. consumers has been surging gasoline prices. With much of the world cut off from Russia's vast energy resources, crude oil prices have spiked, climbing from about $90 per barrel in mid-February to more than $120 in recent days, and though prices have retreated somewhat, they will remain volatile until the conflict is resolved. Aside from energy, Russia and Ukraine account for roughly 30% of the world's wheat exports, and Russia's natural gas exports are key to fertilizer production. As the war and sanctions drag on, American consumers will likely see prices in the grocery store continue to climb.

Surging energy prices will hit Europe hardest, where consumers and businesses were already facing historic energy price increases prior to the invasion. As of February, prices for energy produced in Germany were up 68% from the year before, and the bulk of that data came from before Russia's invasion. Europe sources about 40% of gas imports and about 27% of oil imports from Russia, but Germany is more reliant on Russian energy than any other major economy on the continent, and higher energy prices are likely to be a major drag on the country.

Will Inflation Drag the Economy into a Recession?

Consumers were already feeling the pinch of higher prices prior to the invasion. The massive fiscal and monetary stimulus efforts enacted during the pandemic led to an enormous infusion of excess money into the economy, creating the conditions for the fastest inflation the nation has seen in 40 years. The consumer price index increased 0.8% in February and 7.9% from a year earlier, and this was before gas prices began to surge. Since the beginning of March, U.S. gas prices have risen nearly 20%, which would amount to a 0.75% contribution to the month's inflation from just this category alone. Surging prices, for not just oil, but most commodities, will have a negative impact on consumer spending, which accounts for nearly 70% of the nation's GDP.

Personal consumption was already expected to moderate this year as the impact of federal stimulus fades, and as households spend more on energy and food, they may spend less on other goods and services. As of February, real, inflation-adjusted wages had declined 2.6% from the previous year, and consumers are feeling the pressure. Consumer confidence in March fell to 67.8, the lowest level since 2009. Of particular note is the narrowing gap between consumers' feelings about the current economic situation and their forward-looking expectations, which declined to 54.4, the lowest level since 2011. Historically, the spread between the two components only narrows to such a degree during the lead into a recession.



Surging oil prices are also an indicator that there may be a recession on the horizon, and economists have raised the probability that we will see a recession this year. While it is certainly possible, we do not expect a recession in the near future. Recessions are almost always preceded by a flat or inverted Treasury yield curve, high real interest rates, and an increase in swap spreads, none of which are currently present. The yield curve of 2- and 10-year U.S. Treasuries did briefly invert recently, meaning that the yield of a short-term 2-year Treasury note was higher than on a longer term 10-year one, but the curve quickly returned to a positive slope. Real yields remain very low, and swap spreads, in the U.S. at least, remain within normal ranges. They are higher in Europe, which has a higher chance of falling into a recession than the U.S. does.

This all suggests that there is abundant liquidity in the financial markets, which lessens the likelihood of a recession. Despite the volatile swings the market has seen this year, abundant liquidity has allowed for an orderly and efficient shifting of risk onto investors who are willing to bear it, rather than the panic we may have seen in a market without sufficient liquidity.

It is worth noting that we may see a more prolonged 2-and-10 yield curve inversion in the future, and, since every recession since the late 1970s has been preceded by such an inversion, investors may panic. It is important to keep in mind, however, that an inverted yield curve is not the cause of a recession, and that the factors driving the current flattening yield curve are different than in recent recessions. Currently, short-term rates are higher because inflation expectations are at an all-time high, so investors are demanding higher yields for short-term fixed income. Investors also see inflation fading, eventually, so they are demanding less of a premium to hold long-term fixed income. Some analysts have also posited that factors like the Fed's massive balance sheet and low overseas bond yields have skewed the predictive power of the 2- and 10-year yield curve. Despite the flattening yield curve, the bond market is signaling that investors are relatively confident that we will avoid a recession, but much of that depends on the actions of the Federal Reserve.

Can the Fed Ensure a Soft Landing or Will it Trigger a Crash?

After insisting for the last year that surging inflation would be "transitory," the Federal Reserve finally acknowledged the reality of the situation by raising interest rates for the first time since 2018. The 25-basis point increase brings the new target range to 0.25%-0.50%, which is still extremely low on a historical basis, and though this is only the first of what we expect to be 5 or 6 more rate increases this year, it is likely that the Fed will have to be more aggressive than many expect to truly combat inflation.

The Fed's latest economic and interest rate forecasts show growth slowing to 2.8% this year and core inflation running more than double the Fed's 2% target. The forecast also shows that inflation is expected to run above that target through 2023 and into 2024, meaning that rate increases will likely continue well into next year. The general consensus from the forecast is that the rate increases will stop at a rate of 2.75%. The Fed considers a rate as high as 2.4% to be "neutral," so raising the rate to 2.75% in late 2023 will do little to address the current inflation surge. To truly address inflation, rates may need to climb as high as 4%-5%.

Fed Chairman Jerome Powell has acknowledged the need to act aggressively, leaving open the possibility for a larger 50 basis point increase at the Fed's next meeting. He has also indicated that as long as the labor market remains tight, he may be willing to allow a downturn in the stock market, and with valuation so high, the downturn could be quite sizable. The Fed abandoned its plans for further interest rate hikes in 2018 after the initial increase triggered a massive selloff, bringing the S&P 500 down nearly 14% in the fourth quarter. However, with inflation surging, it is unlikely that Powell will pivot away from his hawkish stance, even if it roils the market. Of course, by waiting so long to address inflation, the Fed is now tightening monetary policy on a slowing economy, meaning they may not be able to act aggressively without triggering a recession, and the added uncertainty of the situation in Ukraine makes the path forward even murkier.

There is some promising evidence that inflation may be at or near its peak. The M2 money supply—which tracks the total amount of money in the country, including not just currency but cash equivalents like

CDs and checking accounts—has leveled off somewhat in recent months. The money supply exploded after the Fed began its pandemic-era stimulus and created the conditions for the current inflationary surge. While the money supply is still growing at a rate faster than its historical norm, the pace is slowing, adding some credence to the economic forecasters who expect inflation to peak in late-spring or early-summer.

However, even if we do see inflation peak, we may remain in a high inflation environment for the next few years, which leaves investors with few options. Prices for traditional inflation hedges like TIPS and gold are at an all-time high, making them less attractive. Despite recent volatility, the stock market remains the best hedge against inflation. Climbing interest rates will put downward pressure on stretched valuations, but corporate earnings are likely to remain strong. Economic growth is moderating but is expected to remain robust by historical standards. American consumers may bristle at climbing prices, but they are well positioned to weather a period of elevated inflation. Household net worth is at an all-time high and jobs are plentiful. The war in Ukraine remains a massive risk for the global economy, but the fierce resistance of the Ukrainian people has given many foreign policy experts optimism that the conflict will be resolved sooner rather than later. Regardless of what resolution the conflict ultimately comes to, however, the direction of the economy will be determined primarily by the monetary policies set by the Federal Reserve.

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