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Evolving Trouble

- **War in Ukraine continues to weigh on asset markets**
- **Global growth now expected to falter and inflation becoming a monumental issue**
- **Unlike during COVID, governments and policymakers have far fewer levers to pull**
- **The sell-off of high yield and Emerging market debt may have further to go**
- **We share thoughts on the extent of regime change in global geopolitics**
- **Could the Chinese government spring a positive policy surprise?**

War in Ukraine continues to overwhelm asset markets globally. Consequently, economists' forecasts for inflation and growth continue to evolve, with growth expected to decline and inflation projected to go up. However, investors should see every forecast with the lens of caution because nobody knows the future.

The global economy is on course for lower growth and higher inflation. Changes in economists' forecasts remain incremental, with analysts hoping that the negotiations between the two warring sides yield better results. Things evolved similarly in the wake of the onset of COVID – denial, hope and then resignation. But then the forecasters at the time were bailed out by the policymakers; these times are quite different. The scale of the geopolitical regime change is the largest since the Berlin Wall went up in August 1961.

There are some significant underlying differences in how policymakers will face the current crisis compared with COVID. This time governments and central banks have far fewer levers to pull. Unlike during COVID when interest rates went down, policymakers are likely to raise rates in the coming months. Inflation – another thorny issue – fell sharply when the pandemic was raging. We now face a possible monumental increase in inflation. During COVID, governments instituted tax cuts and massively increased spending across industries. Today, governments are spending on defence budgets and supporting immigration, and asking the population to take hardships in their stride.

The market expects the US Federal Reserve and the Bank of England to increase interest rates by 25 basis points this week. Both central banks are expected to keep a tightening bias. The Fed will communicate its outlook through a press conference and the so-called dot plot, which outlines the expected path for interest rates in the coming years. We should remind ourselves that central banks have the right to change their minds in the future.

Last week, the ECB made a surprising shift in stance from dovish to hawkish. It decided to accelerate the tapering of bond purchases, in a departure from the announcement made at the previous meeting in December. Clearly, the risk of inflation has so spooked the ECB that it is prepared to take a risk with growth. The coming wave of price increases in energy and food will create pressure on consumers not seen since the energy crisis of the 1970s and 1980s. The conditions are ripe for a policy error – push too hard now to reduce inflation, and growth could fall off a cliff later; waver and the inflation surge could trigger a recession anyhow.

Global bond markets are struggling to get to grips with the war in Ukraine. US 10Y yields are back above 2%, with 7Y and 5Y yields also at that level, likely presaging a curve inversion quite soon. After the ECB's announcement on Thursday, German 10Y yields surged to 0.25% from around -0.4% in December.

Credit spreads continue to widen, although, in our view, they have yet to reflect the current geopolitical risks fully. The US HY spread as calculated by JP Morgan is currently 456 basis points above government yields or 6.4% in outright terms compared with the long-term average of around 525 basis points.

Emerging Market bonds are under stress. Retail sellers of EM Bonds have pushed year-to-date returns deep into the negative territory. ETFs from JP Morgan (-12.25% YTD) and Invesco (-17.35% YTD) illustrate the problem. While some countries will benefit from higher commodity prices, the overall impact of a supply shock on the global economy is a serious risk for EM, as is the strong performance of the USD and the rise of US domestic interest rates.

Economists' growth forecasts are on their way down. Governments and central banks will have to remain flexible and tweak policies as matters evolve and as consumer sentiment remains dimly low. Last week's US Michigan consumer confidence numbers came in at one of the lowest levels seen in the history of the data set. The March reading of 54.4 compared with February's 59.4 and January's 64.1. We suspect that confidence will drop further in a month, given the geopolitical backdrop, a likely further sharp increase in inflation and the announcement of a Fed funds rate increase.

Sentiment in equity markets is at an extreme low, technically speaking. Markets are quite oversold, so conditions are suitable for a sharp recovery in markets. However, note that the recent 'recoveries' in the S&P500 have been no more than 5-6% over two to five days. At the same time, realised volatility (risk) is up 43% year on year. In simple terms, we don't believe the trading opportunity in US equities looks sufficient for the risk one is likely to take.

Pause for thought on the regime change in global geopolitics

We would ask investors to reflect on how much the global geopolitical scene has changed in these past weeks and their consequences for markets. Keying off some of the geopolitical commentaries, we would highlight the following:

1. It is the end to the post-cold war expansion of markets into nearly every corner of the world. The Ukraine crisis is pitting major blocs against each other.
2. The globally integrated financial system has been weaponised. It is now implausible to return to what it was earlier.
3. There will be a price to pay – a potentially significant decline in living standards.
4. Sanctions will be stickier than ever before. Sanctions were previously the domain of governments. Now companies reinforce those sanctions by avoiding associated reputational risks.
5. Heightened geopolitical risk is here to stay for some time to come. The commitment of many European and some Asian countries to increase defence spending naturally raises the risks between nations.
6. Broken product supply lines and conflict will lead to governments targeting heightened levels of strategic reserves of key energy and food needs.
7. Technology will be retained in trading blocs and is less likely to be shared. China had already been frozen out of specific technology by the US trade embargoes. Russia now finds itself completely blocked from accessing US technology.
8. The virtual economic hunting down of the oligarchs puts the uber-rich on watch. It was the general mood of countries that forced governments to chase down the assets of the oligarchs after years of turning a blind eye/or because of abject competition to attract them to different countries.

China – a source of hope?

With much of the developed world pre-occupied with the Ukraine-Russia conflict, commentators are turning their attention to China for some hope of better news. Looking back to 2008, China embarked on a massive policy easing that acted as a catalyst for a global recovery. The stimulus announced in 2008 was equivalent to 12.5% of China's GDP, nearly three times that of the US effort at the time. The early signs are that China's stimulus will be incremental rather than ground-breaking. The fiscal trust in 2022 at present amounts to just 0.8% of GDP. Easy monetary conditions are likely to be the most significant source of support for the economy. Total social funding growth is targeted at over 10%, ensuring an adequate supply of credit growth in the market.

Whisper it very quietly, but there is also a sense that Xi Jinping's common prosperity initiative may have been pushed back. The Nikkei newspaper observes that the recent speech to open the annual parliamentary session mentioned President Xi Jinping's 'Common Prosperity' theme just once. There was also no reference to the "third distribution" system with calls for giant tech companies to make voluntary donations.

A less dogmatic approach to 'Common Prosperity' and less antagonism towards the private sector giants such as Alibaba would be helpful developments in ensuring a stable performance of Chinese equities.

For the global economy, that would also provide a somewhat much needed boost. While we doubt that China will provide a significant stimulus to the global economy, just chipping in with around 5-5.5% GDP growth would be a source of comfort.

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