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Markets gripped by geopolitical and inflation risks

- **Inflation keeps surprising on the upside**
- **Ukraine conflict adds upward pressure via the energy channel**
- **Inflation markets may not be fully discounting the risks**

The persistence of inflation against expectations and the ongoing surprises to the upside have overwhelmed the markets somewhat. Inflation has already been high for sometime now, but there were hopes that some of those increases would start rolling off in the coming months. However, the geopolitical events in Ukraine still keep those risks firmly to the upside. Last week, US inflation came in significantly above expectations at an eye-watering 7.5%, the steepest year-on-year rise in 40 years. Economists at JPMorgan now expect UK inflation to hit potentially 10% year-on-year due to the rise in energy prices and likely tax increases.

A recent article titled, "The Return of Global Inflation" by Carmen M. Reinhart and Clemens Graf von Luckner warns central banks to move quickly and emphatically to head off inflation. "In the absence of global policy options to resolve supply-chain disruptions, the task of addressing inflation is left to central banks". The authors stress that the problems of persistence of inflation in the 1970s were exacerbated by the "US Federal Reserve's tendency to do too little too late (until Paul Volker's arrival)".

The inflation crisis in the 1970s started with oil but assumed deeper proportions as corporates pushed prices higher across the board. The authors argue that inflation has already become more embedded in the system than commentators give credit. In 15 of the 34 countries classified as advanced economies by the International Monetary Fund, 12-month inflation through December 2021 was running above 5%. Such a sudden, sharp jump in high inflation has not been seen in the past 20 years.

A similar wave of inflation has hit emerging and developing countries. Of the 109 emerging economies, 78 face annual inflation rates above 5%. That share of emerging/developing economies (71%) is about twice as large as at the end of 2020.

The authors point out that the emerging world is not facing the same overheating as is prevalent in the developed world. Indeed, many emerging economies have not seen the same level of fiscal and monetary stimulus to their economies and hence are not witnessing a demand-side overheating. As we saw in the 1970s, two common factors this time are the significant commodity prices inflation and the surprising pick up in food price inflation. In 2021, the 12-month rise in food prices exceeded 5% in 79% of the emerging and developing economies.

Recent comments from some FOMC members suggest that there is at least some support for the "shock and awe" approach: hit hard and hit early. While this looks unlikely to come to pass in March, investors will be well-served to keep that scenario in mind.

When news broke that the risk of a Russian attack on Ukraine had materially increased, the bond markets' initial reaction was to reduce the probability of any immediate Fed interest rate increases. While that may be a knee jerk reaction, the long-term view might be less sanguine. Ukraine is an important source of vegetable oil and cereals, it is Europe's fourth-largest food supplier, and is a key supplier to the Middle East and North Africa. Eighty-eight per cent of Europe's sunflower oil, 41 per cent rapeseed, and 26 per cent of honey come from Ukraine. One can't forget the impact of higher bread prices in poorer Middle East countries that led to the Arab Spring.

Oil prices had already spiked due to the existing supply-demand imbalances but the geopolitical tensions from Ukraine risk prices pushing through \$100. Late last week, Russian fuel supplies to Slovakia via Ukraine had dropped 40%. The major concern is that if Russia were to invade Ukraine, there would be a disruption to energy supplies from Russia in the first instance. This, followed by the likely retaliatory sanctions on Russia by the Western world, could exacerbate supply-demand imbalances, forcing gas and oil prices higher. The US is trying to ramp up exports to Europe. LNG cargoes are on their way to Europe, where the continent's natural gas prices have soared to six times the US benchmark Henry Hub price.

As we noted last week, the once-off nature of an energy price shock turns into a "twice-off" phenomenon once the initial spike becomes embedded in the economy. In this context, one indicator to watch out for is the labour market: wages, employment levels, and the like. Likely, wage pressures are already becoming entrenched across economies; the next few quarters will be telling.

Furthermore, we are a little puzzled by the US 10Y breakeven inflation measure, and specifically its failure to budge in the face of actual CPI running at 7.5%. True, at shorter maturities (2Y), the rate has risen to 3.5%. Even so, these levels would appear to reflect a degree of complacency in the market. Perhaps there is still some remaining belief in the "transitory" narrative. Certainly, a level of 2.5% looks too low if one accepts our view of inflation risks persisting.

From a portfolio positioning point of view, exposure to the longer end of the breakeven curve makes sense at the moment. The risk for the nominal market is the 10-year yield breaking past 2%, causing more grief for investors who are already nursing losses in government bond portfolios. As the market potentially re-prices the embedded inflation, linkers will at least help reduce the pain.

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)