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Investment Commentary—April 2022

In 1957 British Prime Minister Harold McMillan was asked what would determine his new government's course. Knowing that plans and agendas can be rendered obsolete in a moment, he responded, "Events, dear boy, events." McMillan's comment came to mind when Russia invaded Ukraine in late February. The U.S. and Europe responded quickly but cautiously with measured sanctions and limited military support. Only a few days later, inspired by Ukrainian resistance to the onslaught and the courage of President Zelensky, Western countries and others moved more dramatically, invoking sanctions that had previously been reserved for pariah states like Venezuela, North Korea and Iran. Unable to take any large cities outside of the East and the South, Russia has repositioned all its forces there. No one knows how or when the horrific war will end, but it seems certain to mark one of the most important geopolitical turning points of the last 75 years.

The armed conflict has been limited to Ukraine, but NATO is providing significant military support and it's entirely possible that the conflict will expand. Russia has threatened to use nuclear weapons, and the possibility can't be ruled out. The situation is frightening, and it is natural to think that it should have a very negative effect on financial markets but that's not necessarily the case.

Consider the Cold War, which was full of armed conflict and geopolitical turmoil. People forget that three million people died in the Korean War. The threat of nuclear war with Russia hung in the air throughout the 1950s and 1960s. None of this hampered the U.S. stock market, which generated total returns over 10% per year between 1947 and 1967. Of course, the economic backdrop was essential. Following World War II, the U.S. had become the preeminent global industrial power. The GI Bill helped create a burgeoning middle class. U.S. stocks rode a powerful economic wave. The point isn't to draw an analogy between 1947 and 2022, but simply to say that in considering the impact of the Russia-Ukraine war, the economic context is supremely important.

Unfortunately, the economic context right now is complicated and challenging, with the fundamentals of inflation, interest rates and economic growth all in flux. When inflation began to take off a year ago, the Federal Reserve and many economists called it "transitory," expecting the rate of inflation to subside relatively quickly as supply chain issues improved. With inflation and supply chain issues continuing unabated, the Fed made a sharp pivot last December and signaled that it would

raise interest rates aggressively, hoping to cool the economy and bring down inflation. The question of whether the Fed can engineer a "soft landing," where the economy continues to grow but inflation moderates, looms over financial markets.

The path of inflation and interest rates over the next couple of years will have an enormous impact on both the stock market and bond market and no one knows what that path will be. For now, markets are pricing in a relatively favorable scenario. After pulling back around twelve percent in the initial aftermath of the Ukraine invasion, the S&P 500 is only six percent off its all-time high. So-called breakeven inflation rates imply an average rate of inflation of 3.26% over the next five years[1]. Given the very high starting point, that suggests inflation tapering to two to three percent in the relatively near future.

Even if the Fed does bring inflation down quickly there is the question of whether it can do that without triggering a recession. At one point earlier this month, ten-year U.S. Treasury bonds had a lower yield than two-year Treasury bonds. This is called a "yield curve inversion," and tends to signal a recession in the next 12 to 24 months. The inversion quickly reversed but investors will be looking for the unwanted possibility of a sharper and more persistent inversion as the rate hike cycle progresses.

It's possible that markets are too optimistic about how easy it will be to tame inflation. For starters, higher interest rates don't normally tamp down the economy until they at least exceed the rate of inflation. If that proves true, the Fed might need to push interest rates up five percentage points or more to make significant progress against inflation. Rate hikes of that magnitude are not being factored in by financial markets. To make matters worse, not only has the rate of inflation increased over the last several months but inflationary forces have gained steam, with the Russia-Ukraine war pushing energy and food prices higher and Covid-19 lockdowns in China threatening a new wave of supply chain problems.

Outside the U.S., if the Russia-Ukraine war is protracted, in addition to fueling inflation it could reduce economic growth among Russia's larger trading partners. That could happen by way of reduced exports to Russia or as a result of inadequate supplies of natural gas that manufacturers in countries like Germany rely on.

Finally, there is the bigger picture question of whether it is possible to go back to the low-inflation, low-interest rate world that prevailed before 2021. Nearly four decades of disinflation have pushed interest rates lower and lower as shown in the chart on the next page. Some of the forces that pushed inflation down in recent decades, such as expanding labor markets and globalization, may be going in reverse. Developed market baby boomers are continuing to retire, which suppresses labor market growth. And after experiencing painful supply-chain bottlenecks, and wary of

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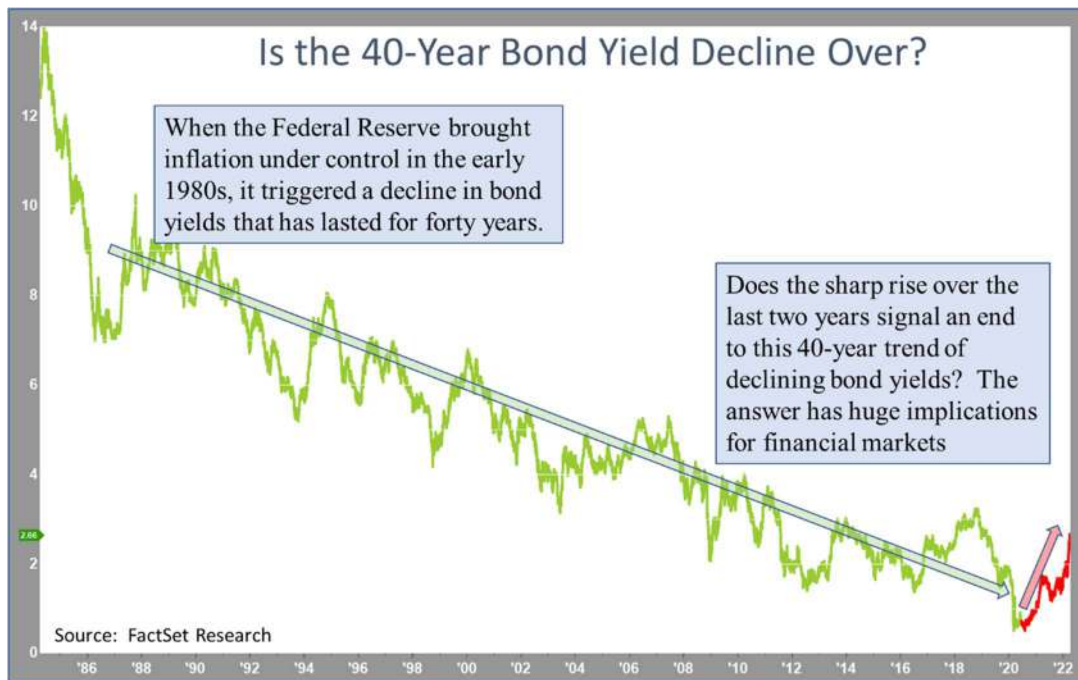
[1] Breakeven inflation rates are determined by comparing yields on U.S. Treasury bonds of the relevant maturity with yields on the corresponding inflation-protected security.

geopolitics, companies may be less likely to procure parts and produce goods in countries with the cheapest labor.

Pundits have heralded the end of the 40-year decline in bond yields before, but it must at least be considered that interest rates and bond yields will return to more historically normal levels. In the 45 years prior to the Great Recession of 2008-9, the yield on the 10-year U.S. Treasury rarely fell below 4.0%. If that is about to become the new normal, the bond and stock markets, which have been propelled by low interest rates and low bond yields, will have to go through a period of adjustment. Thomas Barkin, president of the Federal Reserve Bank of Richmond, alluded recently to this possibility, warning that, "our efforts to stabilize inflation expectations could require periods where we tighten monetary policy more than has been our recent pattern." His words were measured but the message was clear: interest rates and bond yields may be heading back to historical norms.



The truth is that just as no one knows how the Russia-Ukraine war will unfold, there is an unusual amount of uncertainty in how inflation, interest rates and economic growth will unfold over the next couple of years. If you don't plan on tapping into your investments for the next several years, the uncertainty of the next couple of years shouldn't make a significant difference in your portfolio. Longer term stock returns continue to look more attractive than bond returns regardless of any near-term volatility. For those drawing heavily on their portfolio or with big upcoming cash flow needs, the picture is more complicated, and some caution may be in order.

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