Quarterly Market Outlook

April 2022

Russia Upends the World Order

On February 24, Russia invaded Ukraine, shattering the peace that had prevailed in Europe since the end of World War II. The invasion is taking a devastating toll, and its implications for the world are just beginning to be felt. The NATO alliance has strengthened, Russia has been isolated, and the risks of a global and even nuclear conflict have become nontrivial. Western Europe and Germany are now looking to remilitarize, trends toward deglobalization and autarky have accelerated, and nations may by turns delay or hasten the clean-energy transition as they prioritize energy security alongside climate change. Foreign investment in Russia will likely be depressed for years, but other autocratic regimes including China's could also be affected, as companies think twice before putting their capital and businesses at risk.

Energy Prices Surge as Strong Demand Confronts a Potential Supply Shock

Russia is the world's largest exporter of natural gas, the second-largest exporter of crude oil, and the third-largest exporter of coal.[1] It supplied 25% of Europe's oil and 40% of its natural gas in 2021.[2] That supply is now at risk. The U.S., U.K., Canada and Australia have all banned Russian oil imports, and pressure is mounting for Europe to follow suit.[3] China and India are taking advantage of discounted pricing on Russian oil, mitigating the risk of a supply shortfall as the West effectively subsidizes Asia's purchases.[4] But supply could still decline if Russia is deprived of the investment and technology it needs to shore up production.[5] OPEC+ has thus far declined to increase output and is already undershooting its quotas.[6] And while the U.S. and allies are releasing record supply from strategic reserves, that stopgap may disincentivize higher-cost producers from bringing greater supply online.[7]

Given these dynamics, we see price risk as skewed to the upside. Oil remains well below 2014 highs in real terms. The investment backdrop likewise seems favorable, as investors clamor for inflation hedges. Most portfolios have minimal direct exposure to commodities and little exposure to the energy sector, which today accounts for only 4% of the S&P 500 and MSCI ACWI indices – about half its average weight over the past two decades.[8]

Finally, it's worth noting that the commodity fallout extends beyond energy. Russia is also the world's largest exporter of fertilizer, wheat, nickel and palladium, and a major exporter of iron, steel and aluminum.[9] Ukraine is a major wheat exporter as well and produces 50% of the world's neon.[10] Nickel is a critical ingredient in EV batteries, and neon and palladium are both essential to semiconductor manufacture and other metal products. The war thus poses risks to various industries as well as the global food supply.

Inflation at 40-Year Highs as Pressures Continue to Mount

U.S. inflation was already running at 40-year highs, and prices are now up 8.5% over a year ago. European inflation is similarly high at 7.5% – a rate not seen in Germany since 1973-74 – and rising quickly, fueled by increases in energy (+45%) and food (+5%).[11] With supply-chain pressures already high due to elevated shipping costs, longer delivery times, Covid shutdowns, and chip shortages, the war has only added fuel to the fire.[12]

Labor markets also tightened last quarter, as U.S. unemployment fell to 3.6%, nearing all-time lows, and European unemployment fell to 6.8% — a record-low since tracking first began in 1998.[13] Wages rose 5.6% in the U.S. and may soon pick up in Europe, though real wages (after inflation) in both regions continue to fall.[14]

Finally, U.S. home prices kept climbing, up 15-19% in January vs. a year ago.[15] Low rates, rising rents and strong household balance sheets have boosted demand, while rising construction costs, delays in bringing new homes to market and record-low inventories have constrained supply.[16] Houses are now more expensive than ever, even adjusted for inflation. We expect rising mortgage rates (up from ~3% to 5.1% YTD) to dramatically reduce affordability and slow the market in real terms, though with supply still so low, price increases may continue.[17]

Growth Expected to Weaken, with Risks to the Downside

U.S. growth has been robust, with spending on restaurants and travel now back at pre-pandemic levels, and overall consumption well above trend despite falling consumer confidence.[18] But with war raging in Eastern Europe and prices surging everywhere, growth forecasts have been cut. U.S. growth is now expected to be around 3% vs. 3.5% previously.[19] Germany expects a meager 1.8% real growth in 2022 vs. 4.6% expected as of November.[20] And China now faces weaker demand from Europe and highly disruptive Covid lockdowns in major cities like Shanghai and Shenzhen. Chinese growth is expected to fall below 5% – a low not seen outside the depths of the pandemic.[21]

Few Good Options for the Fed

Prices are rising because demand exceeds supply – for commodities, housing, goods and services and, critically, for labor. We see supply increases as unlikely for any of these in the near term, so prices may keep rising unless and until demand weakens. Which is where the central bank comes in. The Fed hiked interest rates 25 bps in March (from 0) and said it would "move more aggressively" and consider hiking in 50-bp increments if needed.[22] Markets are now pricing in 200+ bps in additional rate hikes in 2022 alone, as the Fed also looks to unwind its balance sheet.[23] But with real rates still negative, the question is whether that tightening will be enough – or possibly too much – as the Fed tries to bring prices in line while still achieving a "soft landing" for the economy.

Stocks and Bonds Sell Off

Equities suffered losses as markets ended the quarter down 5.4% globally.[24] The S&P 500 returned -4.6% while performance was worse in European markets, and Chinese stocks fell as much as 30% before recovering most of their losses.[25] Despite the modest headline losses, there was significant dispersion, as value stocks and sectors outperformed growth by 14.4% in the U.S., led by commodity producers.[26]

Rising inflation and a more hawkish Fed led bonds to their worst quarter since 1980, as the US Aggregate Bond Index returned -5.9%.[27] The 10-year yield has spiked from 1.51% to 2.83% YTD.[28] With the curve now flat to inverted, market participants are debating whether a recession lies ahead.[29]

Equity-Heavy Portfolios Look Vulnerable and Could Benefit from Better Diversification

Two years ago, the world faced a once-in-a-century pandemic. Despite Covid's toll, the economy quickly rebounded on the back of massive fiscal and monetary intervention. Today, with capacity tight, prices surging, and growth expected to weaken, governments have fewer levers at their disposal.

Conventional, equity-heavy portfolios are a bet on positive earnings surprises and falling inflation that may be vulnerable in the current climate. And with inflation increasingly driving performance, stocks and bonds have become more correlated, leaving portfolios even less diversified. In a world with so many unknowns, we think it is vital to ensure that portfolios are robust to a wide range of outcomes. While inflation might fall, for example, it might not, in which case investors could benefit from hedges like commodities, inflation-linked bonds and gold. In addition, we think alternatives that rely on manager skill can offer a compelling risk-reward in this environment, particularly where they are less sensitive to the economic cycle.

Notes

[1] https://www.eia.gov/todayinenergy/detail.php?id=51618.
[2] https://www.nytimes.com/2022/02/23/business/economy/russia-ukraine-global-us-economy.html.
[3] https://www.msn.com/en-us/money/markets/poland-to-end-russian-oil-imports-germany-warns-on-gas/ar-AAVElV0, https://www.politico.eu/article/follow-my-lead-on-scrapping-russian-energy-poland-tells-the-eu/, https://www.cnn.com/2022/03/21/energy/russia-oil-embargo-europe/index.html.
[4] https://oilprice.com/Energy/Oil-Prices/Russian-Oil-Is-Too-Cheap-To-Resist-For-China-And-India.html.
[5] https://oilprice.com/Energy/Crude-Oil/No-One-Really-Knows-Whats-Next-For-Russian-Oil.html, https://www.jpmorgan.com/insights/research/russia-ukraine-crisis-market-impact, https://www.upstreamonline.com/production/russia-facing-growing-possibility-of-deep-cut-in-oil-production/2-1-1192096.
[6] https://www.bloomberg.com/news/articles/2022-03-31/biden-weighs-record-release-of-u-s-oil-but-opec-holds-line.
[7] https://www.nasdaq.com/articles/u.s.-crude-oil-fuel-stockpiles-fall-last-week-spr-at-2002-low-eia; see also, e.g., https://oilprice.com/Energy/Oil-Prices/How-A-Biden-SPR-Release-Will-Send-Oil-Prices-Even-Higher-In-2022.html; https://www.wsj.com/articles/western-nations-allies-to-release-oil-from-reserves-11648826913?mod=business_minor_pos13.
[8] See, e.g., https://www.cambridgeassociates.com/insight/is-private-equity-energy-dead/; Source: Bloomberg: SPX Index, ACWI Index.
[9] https://www.atlanticcouncil.org/blogs/econographics/beyond-oil-natural-gas-and-wheat-the-commodity-shock-of-russia-ukraine-crisis/; https://farmdocdaily.illinois.edu/wp-content/uploads/2022/03/fdd031722.pdf.
[10] Ibid.
[11] https://www.yahoo.com/now/euro-zone-inflation-outstrips-estimates-090000431.html; https://www.stltoday.com/business/european-inflation-soars-to-record-7-5-on-fuel-food-costs/article_b0f5763e-e4bf-59b6-bb1d-f2afd8e55dc2.html.
[12] https://think.ing.com/articles/the-war-in-ukraine-is-putting-global-supply-chains-to-the-test-again/; https://www.wsj.com/articles/mexican-factories-gain-in-supply-chain-revamps-11648831914.
[13] https://www.nasdaq.com/articles/euro-zone-unemployment-at-record-low-of-6.8-in-feb; https://www.reuters.com/world/us/us-job-growth-solid-march-unemployment-rate-falls-36-2022-04-01/
[14] https://www.reuters.com/world/us/us-job-growth-solid-march-unemployment-rate-falls-36-2022-04-01/; https://www.ft.com/content/ed477fe9-46fa-43d0-b315-4170763261c2.
[15] https://www.cbsnews.com/news/home-price-miami-tampa-spglobal-phoenix/; https://www.wsj.com/articles/home-price-growth-accelerated-in-january-11648558827.
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[17] https://www.dallasfed.org/research/economics/2022/0329; https://calculatedrisk.substack.com/p/housing-dont-compare-the-current?s=r.
[18] Source: Bloomberg (OPENCOUS Index, TSATTPCY Index, CONCCONF Index, RSTATOTL Index).
[19] https://www.conference-board.org/research/us-forecast; https://www.reuters.com/world/us/goldman-sachs-cuts-us-growth-forecast-commodity-prices-bite-2022-03-11/.
[20] https://www.digitaljournal.com/business/german-economists-slash-2022-growth-outlook-on-ukraine-energy/article
[21] https://www.ft.com/content/31cd538a-5f31-4c00-a7fd-493dc7752c28.
[22] https://www.cnbc.com/2022/03/21/powell-says-inflation-is-much-too-high-and-the-fed-will-take-necessary-steps-to-address.html,
[23] Source: Bloomberg (WIRP US).
[24] Source: Bloomberg (ACWI, WEI).
[25] Ibid.
[26] https://www.morningstar.com/articles/1087146/us-value-funds-beat-growth-in-the-first-quarter; Source: Bloomberg (M1USOCMP, M1WDCOMP).
[27] Source: Bloomberg (LBUSTRUU).
[28] Source: Bloomberg (USGG10YR, USGG5YR)
[29] https://www.wsj.com/articles/economists-seek-recession-clues-in-the-yield-curve-11648891802.

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