The Specters of War & Inflation grow

On Monday the tech-dominated NASDAQ entered a Bear Market, joining the small cap Russell 2000, while the S&P 500, the final arbiter of Bull & Bear Markets, remains in Correction territory, along with the Dow, which grabs far too many headlines for a poorly constructed index. While War is dominating the headlines, the looming specter of Inflation continues to grow. From the lead story in Friday's WSJ:

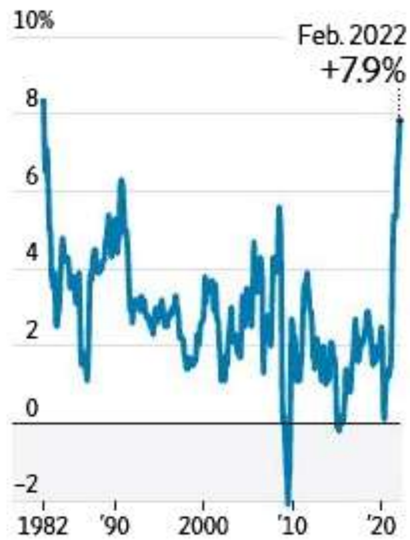
Inflation Reaches 40-Year High Of 7.9%

Gasoline jumped 38% in February from year ago as food rose 8.6%; war fuels price gains

BY GABRIEL T. RUBIN

Rising energy, food and services prices pushed already elevated U.S. inflation to a 7.9% annual rate last month—another four-decade high—with oil and commodity market disruptions from the Ukraine crisis expected to add more cost pressures.

Consumer-price index, change from a year earlier



Source: U.S. Labor Department via the Federal Reserve Bank of St. Louis

The consumer-price index, which measures the cost of goods and services across the economy, hasn't been this high since it was 8.4% in January 1982, when the nation was in recession and trying to tame what had been double-digit inflation. ...

Strong consumer demand and supply-chain constraints related to the Covid-19 pandemic have elevated inflation over the past year, with persistent shipping bottlenecks and shortages of supplies like semiconductors rippling across the economy. A tight labor market has pushed wages higher.

Economists expect additional price increases related to the Ukraine crisis after crude-oil prices in March hit their highest levels since 2008, and U.S. gasoline prices reached record highs. ...

Excluding volatile energy and food prices, the Labor Department reported Thursday that consumer inflation rose at a 6.4% annual rate in February, up from 6% the prior month. ...

Before the Ukraine crisis, economists and policy makers had been hoping for a peak in year-over-year inflation this spring as supply chains heal from pandemic-related disruptions and the Federal Reserve begins an expected series of interest-rate increases next week. But the outbreak of war has supercharged prices for oil, wheat and precious metals, threatening higher inflation for longer.

Economic disruptions from Russia's invasion of Ukraine and the global response could further stoke inflation, in part because Russia is a top global supplier of oil and natural gas. One rule of thumb, which Fed Chairman Jerome Powell referenced last week, holds that a $10-per-barrel increase in oil prices boosts overall U.S. inflation by 0.2 percentage point. Brent crude, the global oil benchmark, has increased by around $40 a barrel since the start of the year. Russia also is a major player in global markets for metals used in the production of cars and airplanes and for components in fertilizer, a big expense in food production.

Because of Russia's role in global energy and other commodity markets, "we're going to see upward pressure on inflation at least for a while," Mr. Powell told the Senate Banking Committee last week.

Mr. Powell has said he expects the central bank to raise rates by a quarter percentage point at its March 15-16 meeting with additional increases to follow later in the year. The plan was formulated ahead of Russia's invasion of Ukraine.

"I do think it's going to be appropriate for us to proceed along the lines we had in mind before the Ukraine invasion happened," Mr. Powell said. ...

On Sunday, the nation's average gasoline price surpassed $4 a gallon for the first time since 2008, according to AAA. By Wednesday, prices had hit their highest level ever, unadjusted for inflation. ...

From the front page of this weekend's WSJ:

Stocks Log Another Weekly Decline As War Risks Put Investors on Edge

BY CORRIE DRIEBUSCH AND CAITLIN MCCABE

Technology stocks extended their declines Friday, dragging broader indexes to weekly losses, as volatility reigned and inflation fears heightened.

Indexes opened the day higher, as traders bought stocks after Russian President Vladimir Putin said in televised remarks that there had been positive developments during talks with Ukraine, even as Russian forces continue to pound Ukrainian cities.

By the afternoon, though, the S& P 500, Dow Jones Industrial Average and Nasdaq Composite had all turned lower, as investors weighed the risk of heading into the weekend holding stocks.

All three indexes finished the week in the red after Friday's selloff. The Dow industrials closed down about 2% for the period, its fifth consecutive weekly loss. The S& P 500 and Nasdaq Composite lost 2.9% and 3.5%, respectively, for the week, capping the fourth weekly loss in the past five weeks for both indexes. Of the three major indexes, the tech-heavy Nasdaq Composite is down the most this year, falling 18% through Friday's close.

Big swings are now commonplace for major stock indexes, but even by current standards this week's jumps and falls were extreme, some investors and traders said. On Monday, soaring oil prices sent stocks tumbling, with the S& P 500 posting its worst day in over a year. Two days later, the benchmark index jumped 2.6%, its biggest gain since 2020.

Next week could bring more choppiness. The Federal Reserve meets Tuesday and Wednesday to vote on whether to raise the base interest rate and by how much. Fed-funds futures, used by traders to wager on interest-rate moves, see a 96% probability of a rate increase of a quarter percentage point at the meeting. A month ago, they showed a roughly 50% probability of a rate increase of a half point. ...

Among the week's worst performers were technology companies. The Nasdaq Composite entered bear market territory on Monday, defined as falling 20% from its recent high.

Rising inflation has pressured tech stocks, traders said, because it can lead to higher interest rates and bond yields that make growth stocks' promised future cash flows less attractive. ...

Energy companies were standouts this week, rising along with the price of oil. Though energy stocks ... fell Friday, they were the only sector to end the week positive, up 1.9%. Brent crude futures, the international oil benchmark, were up 3.1% at $112.67. Earlier this week, they traded above $127. ...

In Europe, the pan-continental Stoxx Europe 600 added about 1%, notching a 2.2% weekly gain. Germany's DAX index jumped 1.4%, finishing the week ahead 4.1% In Asia, stock markets were mixed Friday, with Japan's Nikkei 225 down about 2.1%. Hong Kong's Hang Seng Index fell 1.6% to close at its lowest level since July 2016. ...

Morgan Stanley's Q&A presentations for clients with some of our country's top Geopolitical Experts continued this past week. On Tuesday Admiral James Stavridis, former Supreme Allied Commander Europe, gave a 60% chance that there would be a negotiated partitioning of Ukraine, leaving Russia in effective control East & South of the Dnieper river, and a 20% chance each that either Russia or Ukraine would win outright, without clarifying what "winning" would entail. Thursday's Q&A was with Ian Bremmer, the Geopolitical Strategist whose analysis we have often shared. He predicted that Russia will take Kyiv in 2 to 4 weeks, and will not enter serious negotiations until then. He considers the Invasion a "sea change" for Europe's relations with Russia, but is less certain that it will be for us. He added that Biden's bump in the polls will be short lived, and that the Republicans will gain control of both the House and Senate in November. Global Investment Strategy's take from Friday:

The Economic And Financial Consequences Of The War In Ukraine

Face-Off

In The Art of War, Sun Tzu argued that military success could be more readily achieved when the foe was given a way to back down while still saving face: "Build your opponent a golden bridge to retreat across."

For now, the West is averse to building Vladimir Putin a bridge with an easy off-ramp; and even if one were presented to him, it is doubtful he would cross it.

A return to the pre-war status quo is no longer a politically viable option for Putin. With thousands dead and the Russian economy close to ruin, the only way Putin can hope to salvage his legacy among his fan base in Russia is by achieving a thunderous victory in Ukraine.

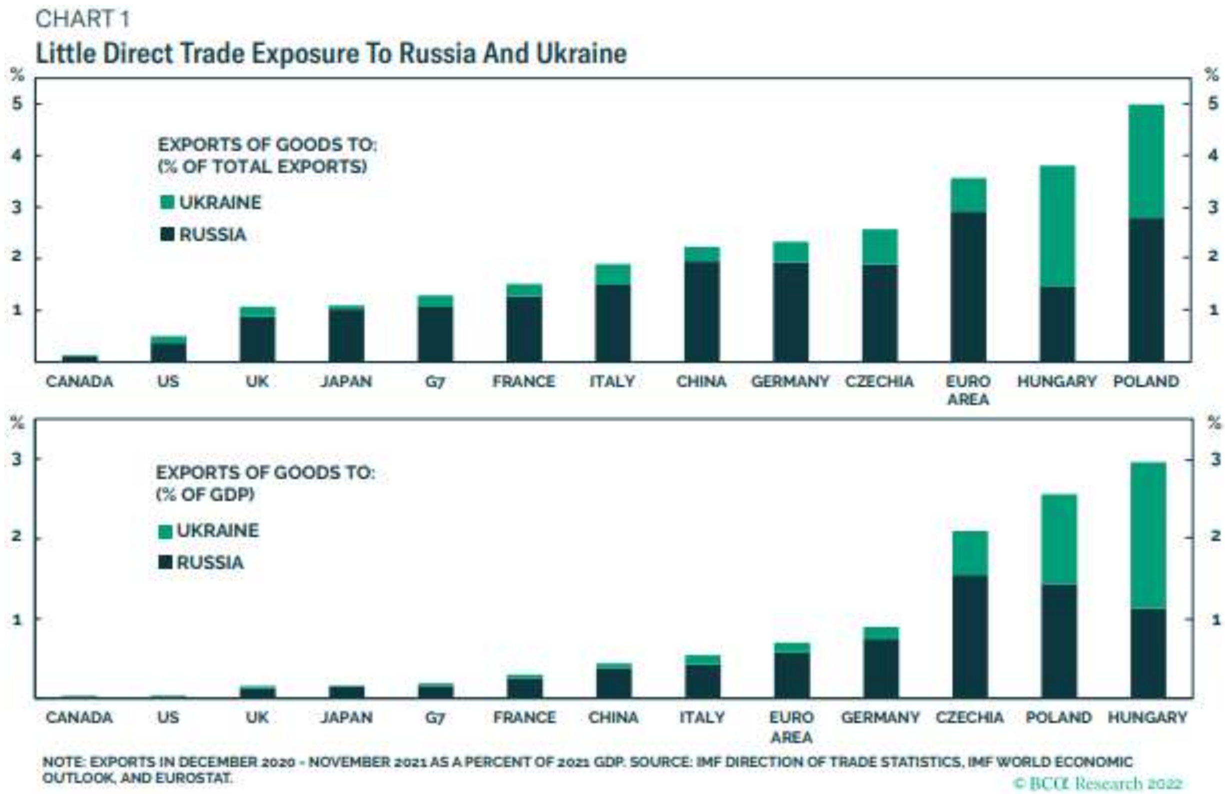
At some point, the reality will sink in that this will not happen, and Putin will seek a compromise. But for the next few weeks at least, BCA's geopolitical team expects the conflict to escalate.

Small Direct Effects on Global Growth, But Potentially Large Indirect Effects

The humanitarian toll of this horrific war takes precedence over all other considerations. Yet, as market strategists, it is our job to assess the financial implications, which is what we do in the remainder of this report.

The direct economic effects of the war are likely to be modest. Taken together, Russia and Ukraine account for about 3.5% of global GDP in PPP terms and only 1.9% in dollar terms. Even if the war reduces Russian and Ukrainian GDP by 10% and 30%, respectively, this year, this would only shave one-third of a percentage point off of global growth.

The direct impact on growth from decreased exports is also likely to be small. Exports to Russia and Ukraine accounted for only 0.2% of G7 GDP in 2021. Even Central European countries such as Poland, Czechia, and Hungary export only 2%-to3% of GDP to Russia and Ukraine (**Chart 1**).



Likewise, except for a few firms, most multinational companies have limited direct sales exposure to Russia. ...

Indirect Effects

In contrast to the direct effects on growth, exports, and corporate sales, the indirect effects of the ongoing conflict have the potential to be quite sizable.

Two indirect effects stand out: 1) the impact on commodity prices; and 2) the impact on financial conditions. ...

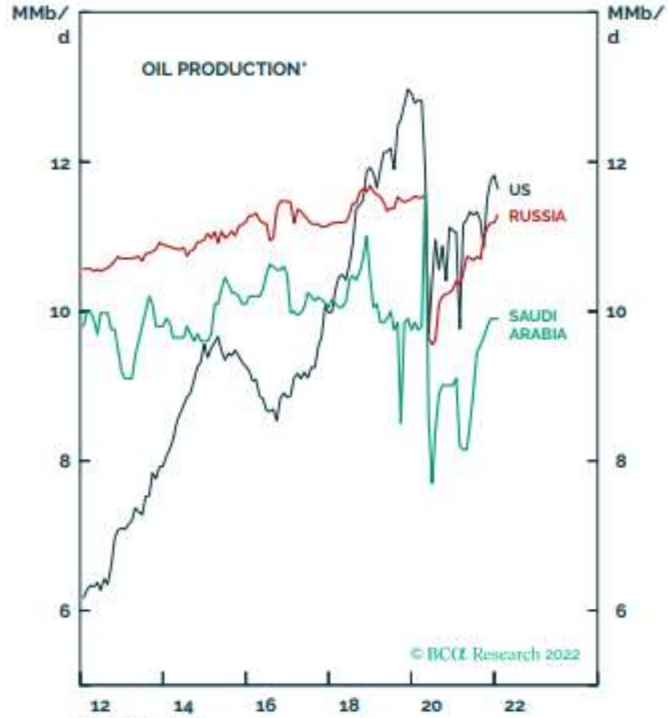
The Commodity Channel

The world is not as addicted to cheap energy as it once was. The global economy today produces about 50% more output per gigajoule of energy than it did in the 1970s. Nevertheless, rising energy prices can negatively affect growth, especially when prices rise quickly, as they have over the past few weeks.

Russia is the world's second largest oil producer, accounting for 12% of annual global output (**Chart 3**). It is also the world's top exporter of natural gas. Russian natural gas represents close to half of European gas imports.

Higher energy prices will depress household disposable incomes. They will also weigh on manufacturing activity. ...

CHART 3
Russia is The World's Second Largest Oil Producer



* SOURCE: US EIA.

Metals Mayhem to Hit the Auto Sector

Russia is a major player in the metals markets. It is the third biggest producer of nickel. Nickel prices soared this week due to threats of supply disruptions, compounded by a margin call on a major Chinese nickel producer that had accumulated a large short position through forward contracts in order to lock in a price for future delivery. Elon Musk has said that a shortage of nickel is the "biggest challenge" in "producing high-volume, long-range batteries."

Russia accounts for over one-third of global palladium output (**Table 1**). Palladium is widely used in catalytic converters, electrodes, and other types of electronics. Palladium prices are up 54% since the start of the year.

TABLE 1
Russia's Global Share In Various Commodities

COMMODITY	RUSSIA'S PRODUCTION AS A % OF GLOBAL CONSUMPTION
PALLADIUM*	35.6%
NATURAL GAS**	16.6%
POTASH, PHOSPHATE, AND NITROGEN CONTAINING FERTILIZERS***	13.0%
OIL**	11.4%
LUMBER****	11.0%
WHEAT*****	10.0%
PRIMARY ALUMINUM******	5.9%
THERMAL COAL**	5.0%
NICKEL******	4.4%
COPPER******	4.2%
STEEL*******	4.0%
ALUMINUM BOXITE******	1.6%

NOTE: ALL SERIES ANNUALIZED AND CALCULATED IN VOLUME TERMS.
* SOURCE: BLOOMBERG FINANCE L.P.
** SOURCE: BRITISH PETROLEUM.
*** SOURCE: AGWEB.COM.
**** SOURCE: FOREST ECONOMIC ADVISORS.
***** AVERAGE OF 2017-2021 PRODUCTION.
****** SOURCE: WORLD BUREAU OF METAL STATISTICS.
******* SOURCE: WORLD STEEL ASSOCIATION.

Russia and Ukraine both produce significant amounts of steel. ArcelorMittal and Metinvest suspended production at their Ukrainian plants last week. ...

Then there are the more esoteric commodities. The bulk of semiconductor-grade neon, used in high-precision lasers, comes from Ukraine. A dearth of this critical gas could exacerbate the semiconductor shortage.

Food Prices Set to Rise

Russia and Ukraine are major agricultural producers. Together, they account for a quarter of global wheat exports. They are also significant producers of potatoes, sunflowers, and sugar beets.

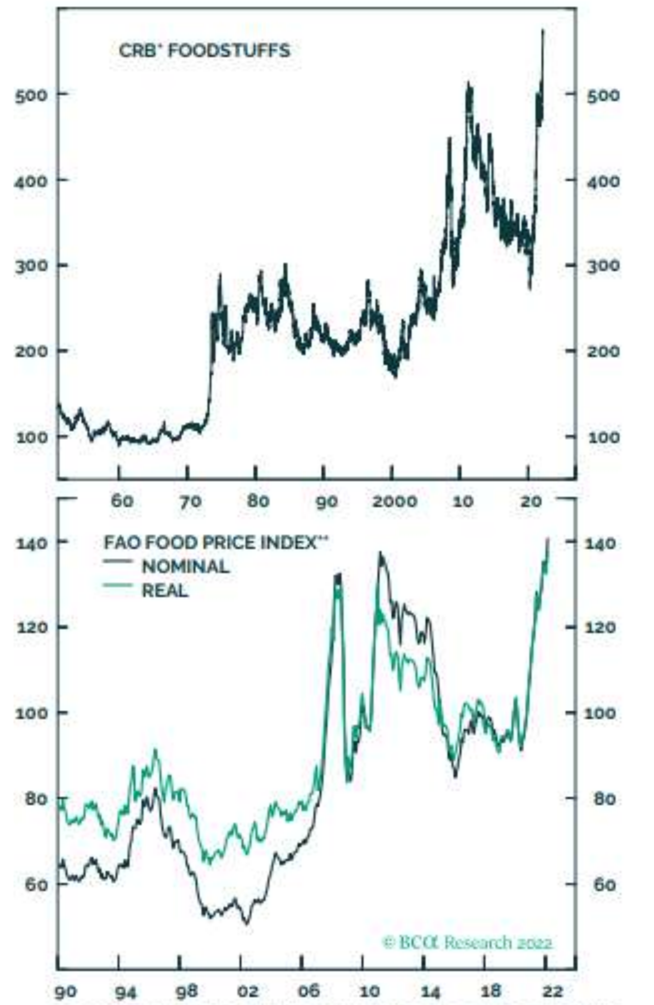
Global food prices were rising even before Russia invaded Ukraine. They have since gone parabolic (**Chart 5**).

Lenin famously called wheat the "currency of currencies," implying that those who control the distribution of wheat can control the political system. With countries such as Egypt desperately dependent on Russian and Ukrainian wheat exports, a shortage of this critical foodstuff could lead to political turmoil in a number of developing nations.

Fertilizer Shortage

The rest of the world could try to compensate for lost agricultural output, but there is a major snag: Russia, Ukraine, and Belarus are significant producers of fertilizer. There are three types of fertilizers, each based on a particular macro nutrient: potassium (K), phosphorus (P), and nitrogen (N). Together, Russia and Belarus account for about 40% of global potash production, a key ingredient in potassium-based fertilizers. Russia also produces two-thirds of all ammonium nitrate, the main source of nitrogen-rich fertilizers.

CHART 5
Conflict In Ukraine Supercharged
The Increase In Food Prices



* COMMODITY RESEARCH BUREAU. INCLUDES BUTTER, COCOA BEANS, CORN, OIL, HOGS, LARD, STEERS, SUGAR, AND WHEAT.
SOURCE: COMMODITY RESEARCH BUREAU AND BLOOMBERG FINANCE L.P.
** SOURCE: UNITED NATIONS FOOD AND AGRICULTURE ORGANIZATION.

Agricultural Autarky

Russia has barred the export of nitrogen fertilizer until April. For its part, China has prohibited the export of phosphate fertilizer at least until June.

Other countries are scrambling to block agricultural exports to ensure that their own citizens have adequate food supplies. The situation is reminiscent of the time during the pandemic when some countries barred vaccine exports.

Financial Conditions Starting to Tighten, But Falling Real Bond Yields Have Helped Soften the Blow

While global financial conditions remain quite loose in absolute terms, they have begun to tighten. The MSCI All-Country World Index (the All Cap version of which is our benchmark) is down 9% since February 9th. Corporate debt and bank CDS spreads have widened.

The only saving grace is that real bond yields have declined. Despite today's upward move, the US 10-year TIPS yield still stands at -0.91%, about 40 basis points lower than in mid-February. The 30-year TIPS yield has also dipped back into negative territory.

There is a noticeable correlation between real bond yields and the P/E multiple at which stocks trade. Falling real bond yields have cushioned the stock market.

At least for now, forward earnings estimates have remained resilient in most economies. In fact, global EPS estimates have edged slightly higher for 2022 and 2023 since the start of the year.

This has left global stocks trading at a reasonably attractive 16.2-times forward earnings (**Chart 11**).

Earnings Estimates Will Be Cut Unless Commodity Prices Come Down

The forward curves for oil, natural gas, and wheat are heavily backwardated. While forward prices do not provide unbiased estimates of where investors expect commodity prices to be in the future, it is fair to say that most investors expect prices to fall significantly over the next 12 months. If that were to happen, global growth should rebound, helping to support corporate earnings.

The risk is that it takes longer for commodity markets to stabilize than investors expect, a risk laid bare by Putin's decision to suspend some commodity exports at least until 2023.

Will Inflation Expectations Become Unglued?

An additional worry is that inflation expectations could rise so much that the Fed and other central banks are forced to hike rates by more than investors are expecting.

While such a risk cannot be ignored, we would place low odds on this happening within the next 12 months.

The recent rebound in long-term inflation expectations has been driven by rising oil prices (**Chart 13**). Although it does not make much sense from a theoretical point of view,

CHART 11
Global Stock Valuations Are Not Too Demanding

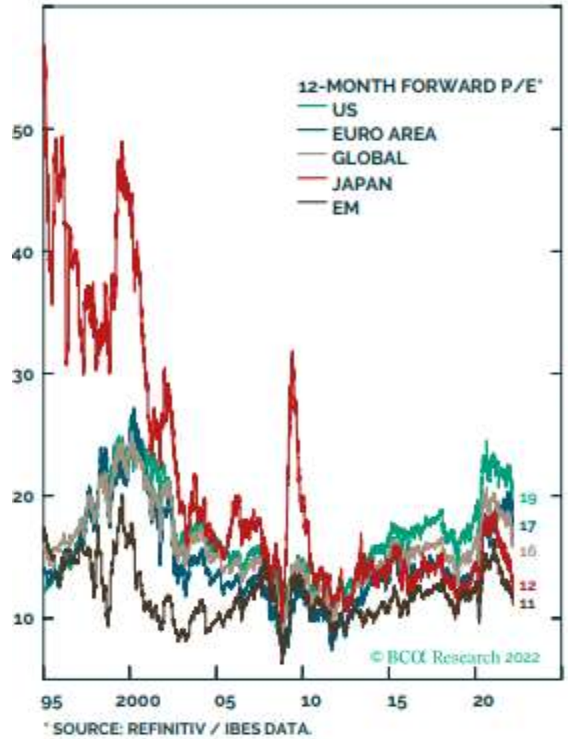
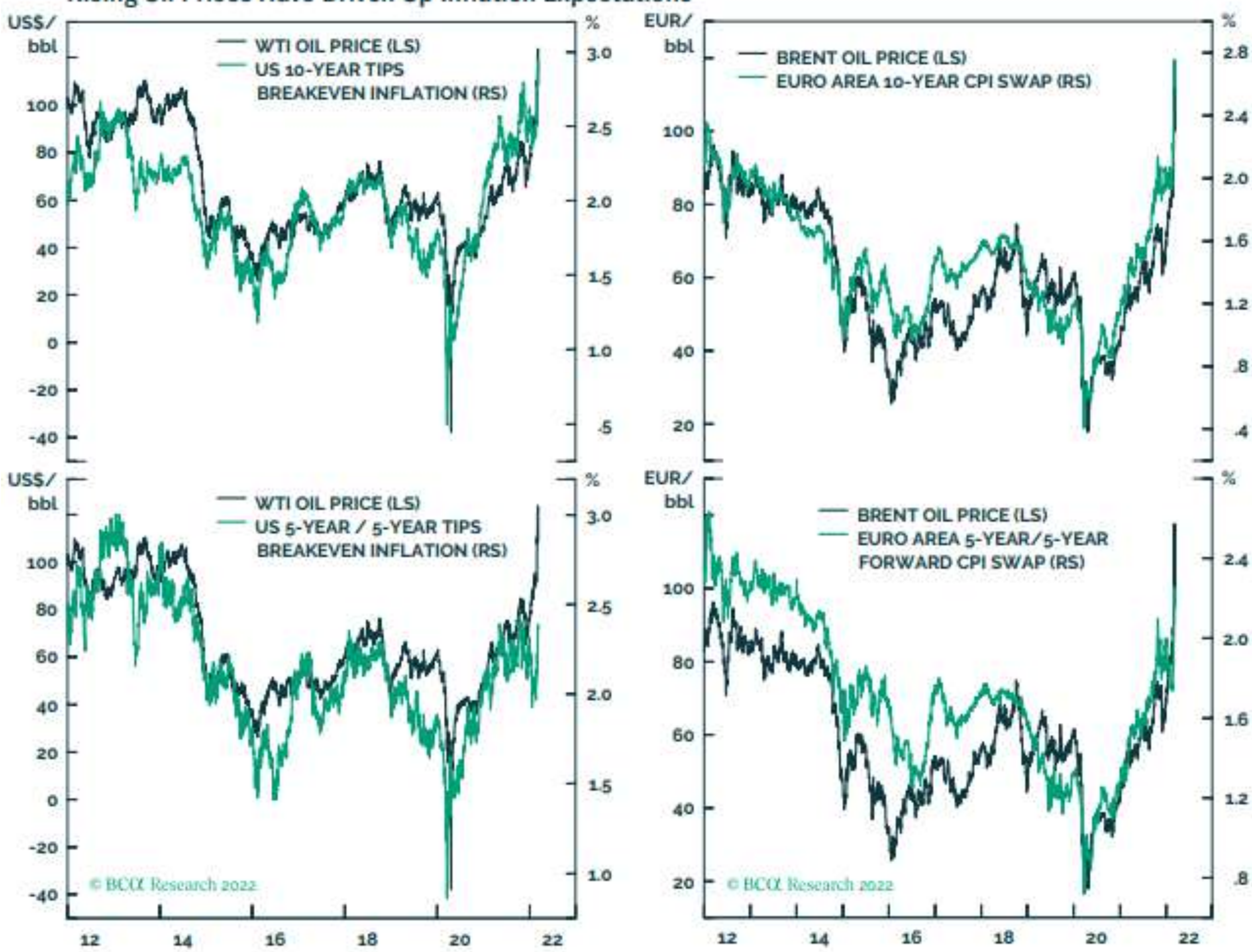


CHART 13
Rising Oil Prices Have Driven Up Inflation Expectations



expected inflation five years out is highly correlated with today's level of oil prices.

The 5-year, 5-year forward TIPS breakeven inflation rate is currently within the Fed's comfort zone of 2.3%-to-2.5%. If oil prices drop by $25/bbl over the next 12 months, which is what the forwards are discounting, inflation expectations could easily fall back below the Fed's comfort zone.

In the euro area, expected inflation five years out is running only slightly above the ECB's target of 2% (**Chart 13**). With the ECB having officially implemented a symmetric inflation target last year following its comprehensive monetary policy review, investors should downplay the popular narrative around Christine Lagarde's "hawkish pivot."

Our view is that the bar for long-term inflation expectations to become unmoored anytime over the next 12 months is still quite high in the US, and even higher in Europe. Going into February, many of the factors that drove up inflation had begun to recede. For example, the number of ships anchored off of LA and Long Beach has been declining since the third week of January. The supplier delivery components of the ISM indices have also come off their highs.

As long as the situation in Ukraine stabilizes, there is a high probability that inflation will be lower at the end of this year than it is now.

Investment Conclusions

We downgraded global equities from overweight to neutral on a tactical 3-month basis last Monday. Despite the risks described above, we are reluctant to abandon our bullish 12-month view on stocks because of the strong possibility that the conflict could abate over the next few months.

If the situation in Ukraine does improve, the trends we envisioned at the start of the year should pan out: Non-US equities (especially Europe and EM) (Our long running recommendation to avoid EM remains.) will start to outperform their US peers; value stocks will outperform growth stocks; and small caps will outperform large caps.

Bond yields should move back up later this year, with the 10-year Treasury yield rising to 2.25% by year-end. Credit spreads will narrow from current levels.

On the currency front, the US dollar will weaken over a 12-month horizon, even if it does continue to strengthen modestly in the near term. Despite a dovish ECB, a revival in euro area growth should propel EUR/USD to 1.19 by the end of the year, bringing it closer to its long-term PPP fair value of 1.44. Gold will also give up some of its gains, as real rates edge higher and the geopolitical risk premium fades.