April 2022 Market Commentary

It’s the End of the World as We Know It (And I Feel Fine)

That's great, it starts with an earthquake
Birds and snakes, an aeroplane, Lenny Bruce is not afraid
Eye of a hurricane, listen to yourself churn
World serves its own needs, don't misserve your own needs

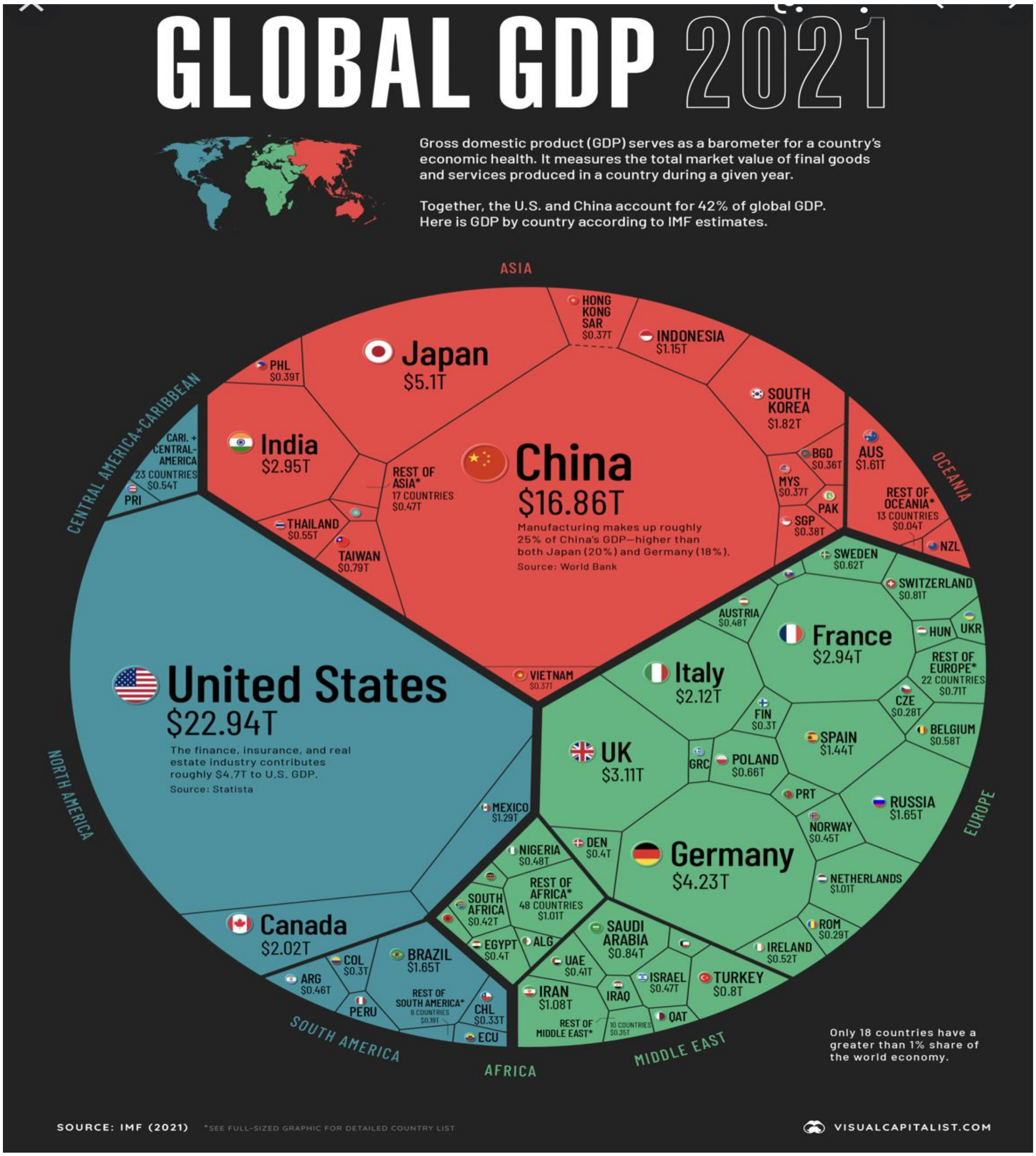
By R.E.M.
https://www.youtube.com/watch?v=Z0GFRcFm-aY

The world feels like it has fallen off its axis—everything seems beyond our control. Last week, paradoxically, was the Vernal Equinox—the first day of spring in the Northern Hemisphere. It marks the rare, perfect equilibrium—dark and light in exact balance when the sun crosses the equator.

But it doesn’t feel like that right now. Our reality runs contrary to this season we usually associate with renewal and celebration. Anxieties darken the skies. Imbalance is everywhere we look—at the forefront, the war in Ukraine and a geopolitical crisis that redefines the world.

The way the World works is changing, and while Putin’s war is foremost on our minds, there have been other significant changes percolating for many months. The two-year old Covid pandemic has revealed just how fragile and interconnected our globalized world has become.

For decades, the world has pursued globalization as a way to enhance growth and bring billions out of poverty. By and large this worked extremely well, with developing nations now accounting for more than half of global GDP. Globalization also promised a peace dividend, as more and more economies became intertwined there would be less poverty and less of a desire to go to war (either cold or hot).



At its core, globalization can be summed up as the liberalization of markets so that manufacturing and trade would take place wherever they made the most economic sense. The U.S. and Europe saw entire industrial sectors uprooted to Asia and elsewhere, as cheaper labor and raw materials meant increased growth and profitability. Concerns that this would put masses of people in the West out of work were swept aside with promises to retrain workers for the "knowledge" economy.

Another major globalization dividend was disinflation. The ability to outsource expensive labor and materials to cheaper countries led to a consistent downward pressure on prices and subsequently inflation. Corporations not only embraced cheaper foreign labor to enhance their profit margins, they also embraced the rising middle-class in these emerging markets to enhance their growth rates. Nearly every industry has benefited from globalization.

While globalization has clearly benefited billions, it has also revealed some less than rosy side-effects.

- The loss of manufacturing jobs in developed countries that haven't been fully replaced with "knowledge" jobs.
- Supply-chain vulnerability. The pandemic has illustrated how vulnerable we are to manufacturing disruptions around the globe.
- The erosion of state sovereignty and the rise of the global multinational corporation.
- The dependency on not-so-friendly nations for critical parts of our economy.

The End of Globalization as We Know It.

The two P's, the Pandemic and Putin, have put an abrupt end to globalization as we've known it. Countries and companies are rapidly rethinking their exposure to potentially unreliable supply sources, as well as "growth" markets that may be in countries with less than desirable regimes. Clearly no Western companies see Russia as a growth market, and in how many board rooms do you think they are discussing future growth initiatives in China?

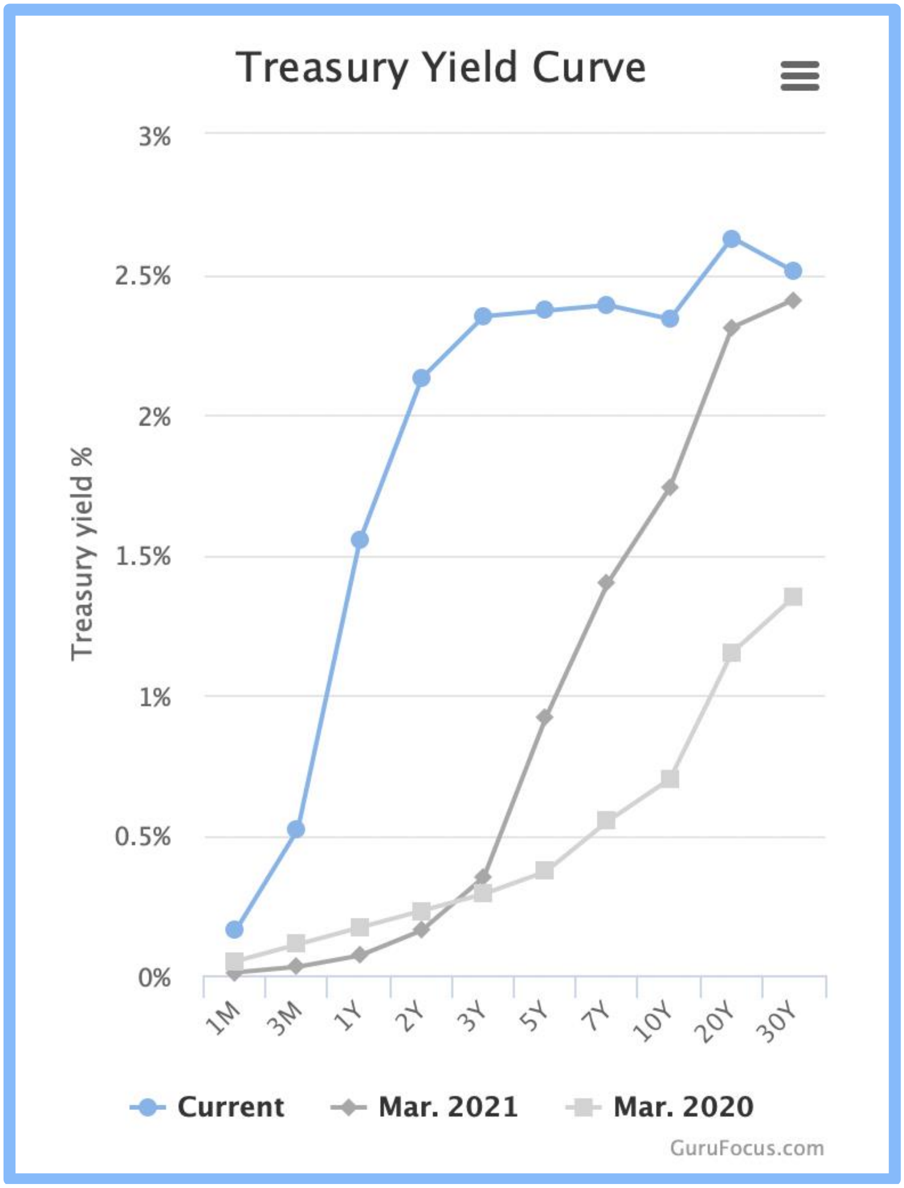
Yes, globalization as we knew it is ending, but it's not going to totally disappear. It will probably become much more bifurcated between the East and the West, those countries aligned with the U.S., Japan, and most of Europe versus those aligned with China and Russia. There will be two immediate outcomes from this realignment:

- Higher costs and subsequently higher inflation.
- Lower profits and subsequently slower GDP growth.

In a speech last week Fed Chairman Powell said that ***"for years we had a perfect storm of disinflationary forces; globalization, technology, peace, and demographic factors. But now we've had a pandemic – a fiscal policy response – and war. I'm not sure what comes next, but nobody is sitting around the Fed just waiting for the old regime to come back."***

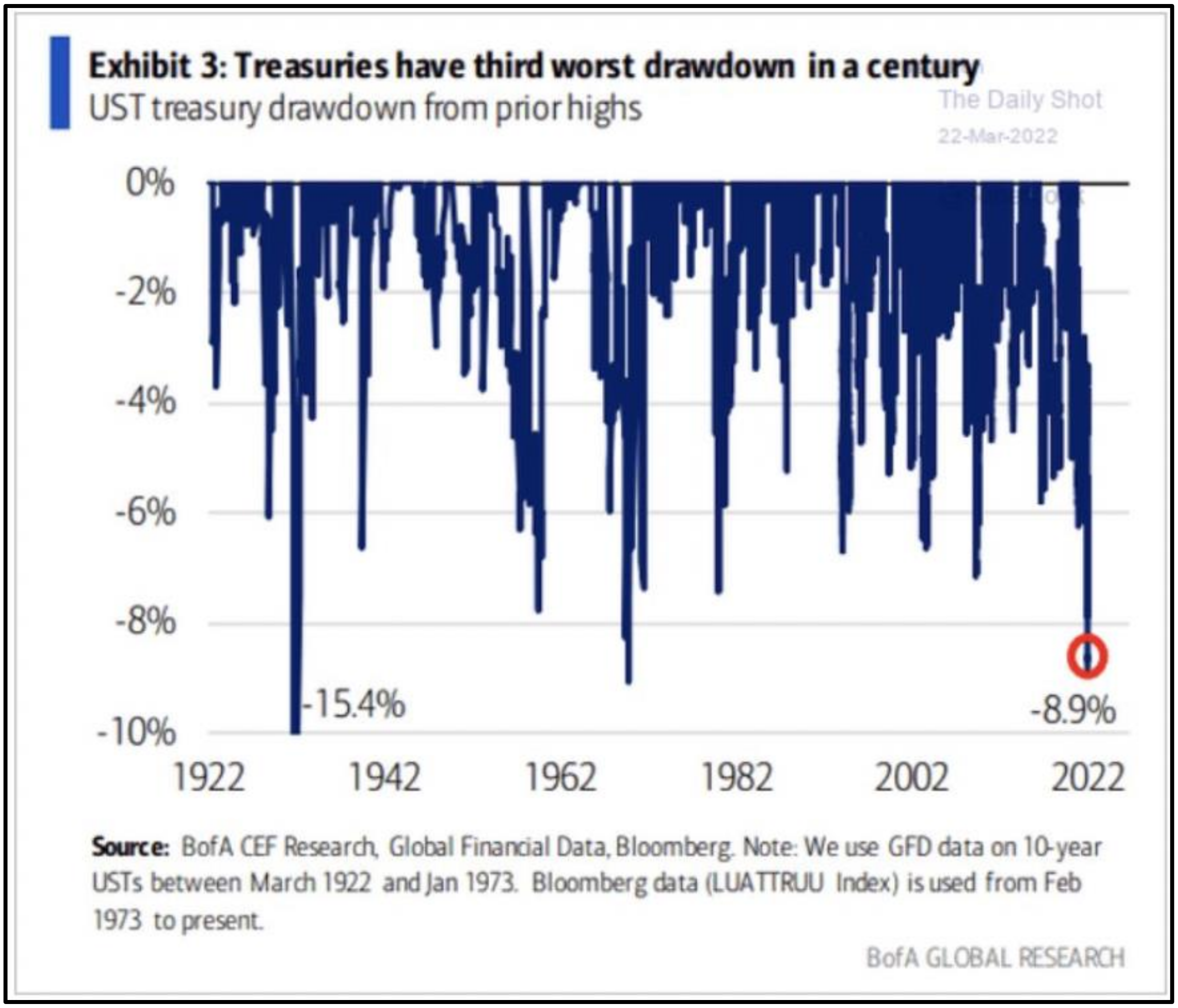
The Fed has finally recognized inflation as a clear and present danger and is finally going into full inflation fighting mode. Powell hinted that he is not opposed to 50 basis point hikes in the Fed Funds rate, and has fairly strongly articulated that he will do what is necessary to bring inflation back to the 2% range. What most likely is necessary is much higher short-term interest rates and most likely a recession over the next several years.

Clearly the bond market hasn't been oblivious to rising inflation, as the Treasury Yield Curve below shows.



What may be somewhat surprising is that longer-term yields (10-30 years) haven't risen very much. This is the market telling us that it expects the Fed to be successful in slowing both inflation and economic growth. In other words, long-term rates don't need to rise much because growth is going to slow dramatically.

Just because long-term rates haven't risen much doesn't mean that Treasury investors haven't had a rough go of it. In fact, this is the third worse sell-off in Treasuries over the last 100 years.



(And I Feel Fine)

Yes, the world is changing and some of these changes will be painful, but we'll survive. With change comes opportunity. A less globalized world may be more inflationary in the near-term, but that may also result in a more resilient economy longer-term. Advances in technology and health care are accelerating and those disinflationary forces will help off-set our current inflationary spike.

I’m not being a Pollyanna here, we’re in for some tough times; rising inflation and rising interest rates mean it will be a difficult environment for fixed-income investors. But eventually there will be some good opportunities to lock in some higher yielding bonds. And a slowing economy will make it tough for overall corporate earnings to grow, but those companies able to navigate this environment will still be rewarded.

As always, be careful out there,
Chris Wiles, CFA

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