Weekly Market Flash

A Decade of a Week

March 4, 2022

There are times when the business of analyzing and writing about investment markets takes on the characteristics of a hamster on a wheel. Over and over again we cover the same ground – the Fed, the latest jobs report, the net inflows and outflows into bonds and equities – and our main worry is to make sure we're not repeating verbatim the thing we wrote about the week before.

Suffice it to say that this has not been one of those weeks. A whole decade's worth of news took place between the time we published our commentary last Friday and today. Seven days in which Europe collectively snapped out of a fog, tossing out the short-term calculus of natural gas prices in favor of the foundational philosophical principles on which the European Union was constructed. In which one man, Ukraine's president Volodymyr Zelensky, exhibited a level of personal bravery we may well have thought would never be seen again in a world political leader. In which Switzerland, a country that stayed resolutely on the sidelines throughout the entirety of the Second World War, pushed forward with sanctions of its own against the bank accounts of Russian oligarchs.

And, finally, seven days in which the set-piece backdrop of the social, political and economic order of the world we have known, to a greater or lesser extent, since 1991 is no longer something to simply assume is there. As hard as it may be, at some point we will have to look up from the map of Ukraine, Russia and Belarus and think hard about the implications for other parts of the world. This may be a time when the trusted old saw of "geopolitics don't affect markets" will be laid to rest. Not because of Russia and Ukraine specifically – outside the realm of energy, certain metals and agriculture these countries do not exert a major impact on the world economy – but very much because of those "other parts of the world" we just mentioned, none more so than China.

The Specter of Stagflation

So the set-piece backdrop has changed, but we will still be faced from week to week with the same kind of questions about economics and financial markets that we have always had. One question is very much on our minds today as we think about the potential economic consequences of the war, and that is stagflation. If you read the annual outlook we published back in January, you may recall that we talked about stagflation as less likely than other outcomes from the current inflationary cycle. That argument had two core components: first, that inflation resulting from the confluence of robust demand and constricted supply would likely unwind meaningfully over the course of 2022; and, second, that the Fed would attach its full efforts to a credible inflation-fighting program through systematic interest rate increases and winding down its inflated balance sheet.

The Fed is still committed to this goal, as Fed chair Powell affirmed in Congressional testimony this week. But the Ukrainian situation complicates matters due to the elevated level of uncertainty and certain risks that could impact global economic growth. The idea of a kind of "shock and awe" anti-inflationary program – say, by raising the Fed funds rate by half a percent in March rather than the more customary quarter-precent, or even raising rates in between FOMC meetings – is now completely off the table. The Fed will proceed, but it will proceed cautiously.

Unfortunately, the net economic impact of the war in Ukraine will likely be to push inflation even higher, as prices for those commodities which Russia exports such as oil, gas, aluminum and wheat respond to the encroaching effect of sanctions. This will likely happen even as the Fed has to dial down the intensity of its monetary tightening. If (and it is still a sizable if) growth turns out to be lower than expected then we potentially have the ingredients in place for stagflation – low growth and high prices.

We still believe, as we expressed in our annual outlook, that a prolonged cycle of stagflation is not the most likely economic outcome ahead. But we would also ascribe a higher probability to it than we did six weeks ago. The overall level of uncertainty is higher – and for now that is going to have to be an assumption we bake into our ongoing analysis.

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