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PING: Perspectives for the Second Quarter

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As we begin the second quarter of 2022, we chose the acronym PING to capture the factors and storylines that we believe have the greatest potential to influence the capital markets. Each letter represents a distinct topic, ranging from the ongoing war in Ukraine to global economic growth.

P - Putin
I - Inflation
N - Natural Resources
G - Growth

All of these themes are separate and distinct, but they come together to create the environment that we are navigating. What follows is our perspective on each of these critical topics.

Putin

Over the last two months, evidence is mounting that President Putin is transforming from an occasional geopolitical "bad boy" to unabashed war criminal. The images and stories coming from Ukraine evidence the humanitarian cost of the conflict brought on by Putin's ill-conceived plan to invade Ukraine. As a result of this conflict, we are seeing a significant shift in the geopolitical landscape — a shift that has far-reaching implications for the global economy and capital markets.

If we recall the peak of the Union Soviet Socialist Republics (USSR), there were two spheres of influence in the world: the USSR's sphere of influence and the Western sphere of influence, led by the United States. In the 1964 paper titled *The Stability of a Bipolar World,* Kenneth N. Waltz makes a very compelling argument that this "bipolar" conflict seen during the Cold War was less volatile and more easily understood than the multi-faceted conflicts we see today. In that paper, he notes four key reasons: [1]

1. With only two world superpowers, there are no "periphery" actors. The USSR is squarely focused on the U.S. and vice versa.
2. As the competition between two superpowers increases, the "range of factors included in the competition" grows. Small territorial disputes become increasingly important, and items outside the scope of war become part of the conflict. This may include factors such as economic growth and even social shifts which are perceived as ideological victories (Waltz notes that Vice

[1] Kenneth N. Waltz, *The Stability of a Bipolar World (link)*

President Nixon regarded the Supreme Court's move toward desegregation as our greatest victory during the cold war.)

3. Bipolar conflicts also bring about the "nearly constant presence of pressure and recurrence of crisis." And while this constant recurrence of crisis does not harken stability in the traditional sense, it also means that all parties remain on guard, and flashpoints may be less jarring for the superpowers involved (as well as nations observing from the sidelines).
4. Lastly, to arrive at a bipolar conflict on a global scale, two superpowers must hold the lion's share of global economic and military power. This means there are fewer variables to consider as it relates to the geopolitical balance of power and the cause/effect of conflict.

With the fall of the former USSR and the ascendancy of the People's Republic of China (China), we have seen a shift from a two-sided conflict to a multi-polar conflict. In these multi-polar conflicts, it is much more difficult to ascertain what allegiances exist and for what purpose. A prime example of this trend is the ongoing conflict in Syria which, by many accounts, has become a front for *no less than six other* international conflicts — including the U.S. and Russia.[2]

Today we see a similar narrative unfolding in Ukraine, and what started with Russia's invasion is rapidly growing in complexity, with Russia, Ukraine, NATO, the U.S., China, and numerous other actors involved to varying degrees — either directly or more indirectly, by way of among other things, economic sanctions.

Set against this backdrop, we have Putin, who harbors great resentment against the West (and the U.S. in particular) associated with the fall of the former USSR, which he views as a great catastrophe.[3] He has demonstrated that he is eager to do anything he can to facilitate Russia regaining at least some of its former expansive territory and glory. The latest manifestation of this is the invasion of Ukraine. While Putin is in control, the resolution of this conflict will only be possible if Putin is able to save face and frame the invasion as something other than an epic failure. Adding to the complexity is President Biden's decision to brand Putin as a war criminal.[4] In the meantime, this conflict, and the consequent impact it is having on among other things, the price of energy, is not just having geo-political ramifications but economic ones as well. This brings us to our next subject, namely inflation.

Inflation

In March, the inflation rate in the U.S. reached 8.5% — the highest rate observed since 1981.[5] This rise in consumer prices has been driven by factors related to COVID-19 (most notable being supply-chain disruptions, increases in the monetary supply, and government stimulus) and accelerated by Russia's invasion of Ukraine. While 8.5% inflation is certainly a concern, the policy response from the Federal Reserve remains the primary focus of the capital markets. Specifically, how aggressively will the Fed work to raise rates and reduce its balance sheet?

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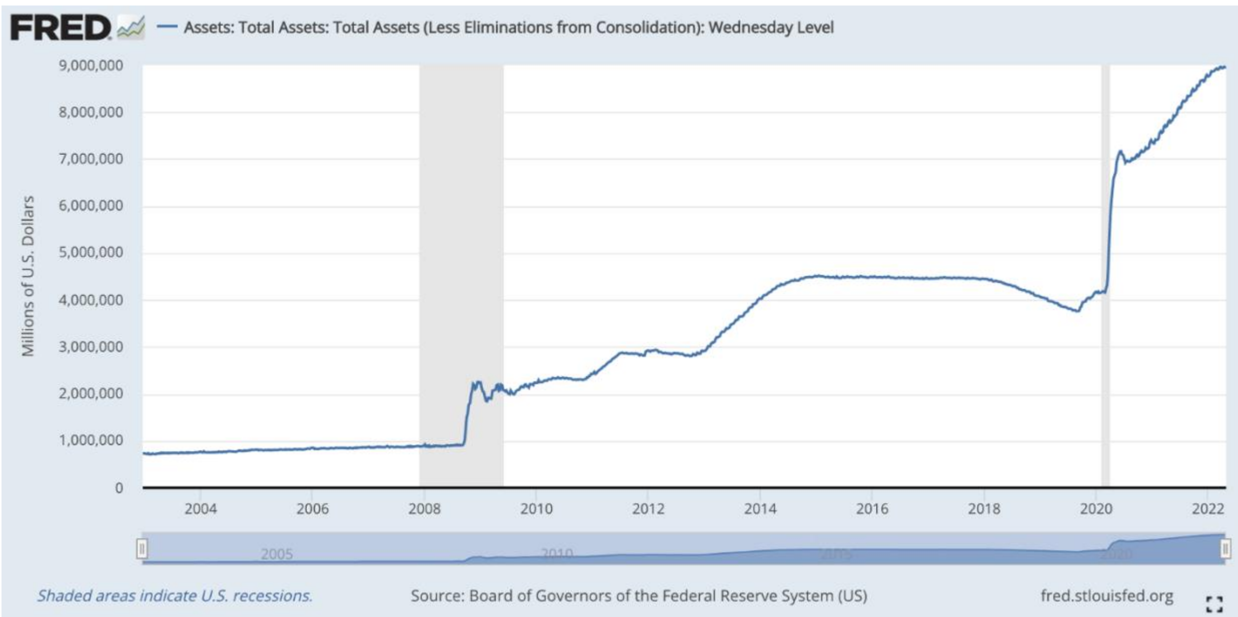
[2] United States Institute for Peace, *After Nine Years, Syria's Conflict Has Only Become More Complicated (link)*
[3] Reuters, *Putin rues Soviet collapse as demise of 'historical Russia' (link)*
[4] BBC, *Ukraine conflict: Biden brands Putin a 'war criminal' (link)*
[5] Wall Street Journal, *U.S. Inflation Accelerated to 8.5% in March, Hitting Four-Decade High (link)*

As it pertains to interest rates, the Federal Reserve announced a 0.25% rate increase at their meeting in March[6] and they will convene again on Tuesday and Wednesday of this week. Another rate hike is very likely at this week's meeting, with the baseline expectation being a 0.50% increase in the Fed Funds rate.[7] However with inflation running at 8.5%, a 0.75% increase is not implausible. From our perspective, the magnitude of the next rate increase is less important than the longer-term trend of rates and balance sheet management through the remainder of the year and into 2023.

On the topic of the Fed's balance sheet, it currently sits at $9 trillion[8] and has been driven higher since 2008 through quantitative easing or "QE" — the Fed's strategy of buying bonds to pressure long-term interest rates lower and spur economic growth. However, a drawdown is rapidly approaching, and the Fed announced plans in early April to reduce this $9 trillion balance by $1.1 trillion per year moving forward.[9]



This translates to us entering an experimental phase as it relates to QE, and it remains to be seen how the capital markets will react to the Fed reducing the balance sheet by $1.1 trillion each year. We characterize it as experimental since there is only one other time when the Fed attempted to shrink its balance sheet in a material way, from 2017-2019.[10] During that period, the Fed was barely able to reduce the size of its balance sheet by ~$550 billion over a 2-year period. In September 2019, a dislocation in the Treasury Repurchase (REPO) market occurred, ultimately resulting in Fed intervention. While there were numerous variables at work, the Fed named its balance sheet reduction program as a contributing factor.

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6 CNBC, *The Federal Reserve approves first interest rate hike in more than three years, sees six more ahead* (link)
7 Wall Street Journal, *Fed's Powell Seals Expectations of Half-Point Rate Rise in May* (link)
8 Board of Governors of the Federal Reserve System, *Total Assets (Less Eliminations from Consolidation)* (link)
9 Bloomberg, *Fed Lays Out Plan to Prune Balance Sheet by $1.1 Trillion a Year* (link)
10 Board of Governors of the Federal Reserve System, *What Happened in Money Markets in September 2019?* (link)

Natural Resources

We would be remiss to discuss inflation and Fed policy within the current environment without mentioning natural resources. If we look further into the March inflation figures, we see that rising energy prices were some of the largest contributors to the 8.5% inflation rate, with the price of fuel oil and gasoline rising 70% and 48%, respectively, during the last year.[11]

As discussed in the previous edition of Gerry's Journal from February 24, we expect the war in Ukraine to keep energy prices elevated in the U.S. and E.U. for the foreseeable future. Longer-term, it remains to be seen how the U.S. and the E.U. will adapt energy infrastructure if Russia is no longer a viable provider of oil and natural gas (either because of sanctions levied against Russia that ban imports OR because of Russian sanctions banning exports to prospective buyers — as was seen last week when Russia announced a ban on selling natural gas to Poland and Bulgaria[12]).

The argument can be made that Russia is no longer a world superpower. However, from a natural resource perspective, it commands respect: Russia has the largest natural gas reserves in the world and is the second-largest producer of dry natural gas. Russia is also estimated to hold 25% of the world's oil supply and is the third-largest oil-producing nation behind only the U.S. and Saudi Arabia.[13] While the current narrative is largely focused on fossil fuels, Russia's hold on natural resources extends far beyond petroleum. All told, it is estimated that Russia holds 16% of the world's reserves of rare earth metals[14] and produces 9% of the world's nickel (a key input for electric car batteries), 30.2% of industrial-grade diamonds (used in computer chip manufacturing[15]), and 22% of the world's titanium sponge extraction occurs in Russia (used to produce titanium which is used in everything from airliners to nuclear power stations).[16] An economic decoupling between the West and Russia could have longer-term implications for supply chains around the world.

Growth

The world remains a very dynamic place. Part of our job is to understand what these distinct moving pieces mean for the growth of economies and capital markets.

On the one hand, there are reasons to believe that global growth will face headwinds: We see a multi-polar war in Ukraine which has added a risk premium to global energy and natural resources prices. We are entering a rising-rate environment in the U.S. as the QE-era ends and the Fed works to curb decades-high inflation. And we are still contending with COVID-19, which continues to complicate global supply chains (as we will discuss in the final section of this journal).

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[11] U.S. Bureau of Labor Statistics, *Consumer Price Index (link)*

[12] Forbes, *The Russian Gas Ban On Poland, Is It Blackmail Or A Step Toward A Solution For The War In Ukraine? (link)*

[13] GeoHistory, *A Guide to Russia's Resources (link)*

[14] S&P Global, *Russia invasion of Ukraine may drive EU back to China as source for rare earths (link)*

[15] ThermoFisher, *Industrial Diamonds - As Good As Gemstones, or Better? (link)*

[16] GeoHistory, *A Guide To Russia's Resources (link)*

While we don't believe the road ahead will be without bumps — last week saw first-quarter U.S. GDP contract by 1.4% following several quarters of outsized growth[17] — we also don't feel that these challenges represent insurmountable obstacles for the economy and capital markets. Contractions in economic output and recessions are an inevitable and enduring part of the ebb and flow of our economic continuum. Rather than fretting about them, we are considering what asset classes and economic sectors stand to benefit from these global shifts and are incorporating these insights into client portfolios.

Píng (平)

As mentioned previously, we chose the acronym PING to capture the key factors and storylines that we are monitoring as we move through the second quarter. In Mandarin, the word "píng" means level, flat, peaceful, or calm, and "píng" is something that China's leaders will be looking to see more of in the coming months.

To close out this edition of Gerry's Journal, we wanted to provide an update on China as it prepares to hold its Party Congress later this year to determine its President for the next five years. At this year's Congress, President Xi Jinping will seek an extension of leadership and, by some accounts, a blessing for a lifetime appointment. But at the moment, he is facing political pressure at home on several fronts, including Russian relations and COVID-19.[18]

As it relates to Russia, the Russian invasion of Ukraine comes at a challenging time for President Xi, given the fact that he has prioritized bringing Beijing and Moscow closer during his presidency. This work was highlighted in early February, just weeks before Russia's invasion of Ukraine, when President Xi referred to Vladimir Putin as "one of his closest friends and colleagues."[19] The war in Ukraine has now united much of the West and further isolated the Russia/China alliance from the rest of the world, leading some observers to call the war in Ukraine "arguably the most problematic international development for China in years."[20] One potential positive is that it may create some urgency for China to play a role in seeking a resolution of the current Russo-Ukrainian conflict. With the economic relationship between Russia and the West deteriorating rapidly, its economic ties with China are all the more important to Russia. This positions China to have a seat at the table in the ultimate resolution of this conflict and further positions President Xi's role as a global statesman.

On the COVID-19 front, President Xi is facing rare public dissent as a month-long lockdown in Shanghai continues.[21] This lockdown — which comes at a time when many other nations are making headway in living with the virus — has highlighted the ineffectiveness of Chinese-made vaccines that utilize inactivated versions of the virus (rather than mRNA like the Pfizer and Moderna vaccines[22]) to generate

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[17] The Wall Street Journal, *U.S. GDP Falls 1.4% as Economy Shrinks for the First Time Since Early Pandemic (link)*

[18] NPR, *China's 'Two Sessions' meetings commence, setting the political agenda for the year (link)*

[19] Center for Strategic & International Studies, *What's Next for the China-Russia Relationship (link)*

[20] New York Times, *China's Russia Problem (link)*

[21] Reuters, *'Entry only. No exit:' Beijing sees more COVID closures as anger grows in Shanghai (link)*

[22] Mayo Clinic, *Different types of COVID-19 vaccines: How they work (link)*

immunity. Data now shows that these vaccines — received by more than 88% of Chinese citizens (1.2 billion people) — are less effective at preventing COVID-19 infections than mRNA vaccines.[23]

The use of vaccines with lower efficacy rates, in conjunction with China's zero COVID policy, has created obstacles to China's "opening back up" as has much of the globe. In 2020, it was estimated that China accounted for 15.0% of all global trade (the U.S. makes up roughly 8%).[24] A key focus for the capital markets will be whether these lockdowns will impact China's ability to deliver imports, purchase exports, and contribute to the global economy moving forward.

Closing Thoughts

As always, today there are many factors influencing the capital markets. Some of these factors we have seen before, like inflation and armed conflict. Other factors are more unique, like the evolving state of the COVID-19 pandemic. We hope that this edition of Gerry's Journal has provided a look into the key factors that we are monitoring and how your team at GYL is working to navigate this evolving and complex period. If you have any questions about the markets or your personalized wealth management strategy, we invite you to connect with your Wealth Advisor.

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[23] Bloomberg, *China's Biggest Covid Failure Is Not Deploying an mRNA Vaccine (link)*
[24] Nikkei Asia, *China powers global trade boom but COVID still looms: WTO (link)*