MORNING BRIEFING
March 22, 2022

More Inflationary Developments

Check out the accompanying chart collection.

Executive Summary: No matter how Putin's War is resolved, the global world order will continue to face new challenges by the autocrats governing China, Iran, North Korea, and Russia. These Axis of Evil countries won't stop trying to upend the post-WWII order established and implemented by the US. We look at the ramifications of that reality for globalization, inflation, and the investment outlook. … Also: New kinks in the supply chain mean that supply disruptions won't be abating anytime soon, which will only increase inflationary pressures. … And: Powell's speech yesterday confirmed his new, more hawkish stance. But an important yield-curve spread may be on the verge of inverting.

Monday Mornings with Dr. Ed. We've had a great response to my Monday video webinar discussions. They start promptly at 11 a.m. EST and last for half an hour. It's a good way to start the week. Here is a *link* to the replays, with the latest one at the top.

Inflation I: The Axis of Evil and the End of Globalization. On Sunday, Turkey's foreign minister said Russia and Ukraine "have almost reached agreement" on four critical points of a potential peace agreement. Turkey and Israel are mediating the talks. Sunday's *FT* *reported* that Ukraine and Russia had made significant progress on:

(1) Kyiv declaring neutrality and abandoning its drive for NATO membership.
(2) 'Demilitarising' Ukraine in exchange for collective security guarantees.
(3) What Russia calls 'denazification.'
(4) Lifting restrictions on the use of Russian in Ukraine.

Furthermore, "[a] possible agreement would require Russia to announce a ceasefire and withdraw its troops from Ukrainian territory to the positions they had been in when Russian president Vladimir Putin launched the invasion on February 24."

No matter how the conflict in Ukraine is resolved, one thing is clear: The global world order that prevailed prior to the invasion will continue to face challenges by the Axis of Evil. These are the nations led by autocrats who agree that the liberal post-WWII order established and implemented by the US must be upended. They include China, Iran, North Korea, and Russia.

The March 19 *issue* of *The Economist* explained that both China's president, Xi Jinping, and Russia's president, Vladimir Putin, "want to carve up the world into spheres of influence dominated by a few big countries. China would run East Asia, Russia would have a veto over European security and America would be forced back home. This alternative order would not feature universal values or human rights, which Mr Xi and Mr Putin see as a trick to justify Western subversion of their regimes. They appear to reckon that such ideas will soon be relics of a liberal system that is racist and unstable, replaced by hierarchies in which each country knows its place within the overall balance of power."

This new global order was clearly outlined in a 5,364-word *agreement* that the two presidents jointly issued on February 4, when Putin visited Xi in Beijing just before the opening ceremony of the XXIV Olympic Winter Games. Here are some of the key points of the agreement as well as the ramifications we see for inflation and financial markets:

(1) *Democracy.* "It is only up to the people of the country to decide whether their State is a democratic one," they said in the statement.

(2) *Alliances.* In the statement, China explicitly backed Russia's efforts to "oppose further enlargement of NATO," a reference to Ukraine's efforts to join the alliance. China also echoed Putin's earlier demands for "long-term legally binding security guarantees in Europe." The statement also criticized US military expansion in the Indo-Pacific and through AUKUS, a trilateral security agreement among Australia, Britain, and the US.

On the other hand, China and Russia do not have a formal alliance. The two leaders called their partnership "superior to political and military alliances of the Cold War era." There are "no limits" or "forbidden" areas of cooperation, according to the agreement.

(3) *Mutual support.* While China agreed with Russia's grievances against NATO, Russia sided with China by rejecting "any form of independence" for Taiwan and by opposing "politicization of the issues of combating terrorism," a term that Beijing often uses to refer to the controversy over its harsh crackdown on the Uyghur people in northwestern Xinjiang.

(4) *Inflationary consequences.* Globalization occurs during peacetimes. During such periods, global trade flourishes, leading to greater integration of national economies. We have frequently referred to it as "détente" and one of "the *4Ds*," the major deflationary forces that have kept a lid on inflation since the 1990s. The Cold War ended when the Berlin Wall fell on November 9, 1989, and China joined the World Trade Organization on December 11, 2001. These two major events heralded the latest period of globalization (*Fig. 1*).

Globalization is coming unglued as a result of various recent developments. They include former President Donald Trump's trade wars, the Covid-19 pandemic, the mounting Cold War between the US and China, the hot war between Ukraine and Russia, and the resulting sanctions imposed on Russia by the West. The global economy is likely to experience a widening schism between the democratic nations (the 30 *NATO member countries* plus Australia, Finland, Japan, and Sweden) and the autocratic ones (China and Russia).

Supply chains are likely to be moved closer to home in most countries. That is bound to be costly and add to inflationary pressures, though the offset is likely to be faster productivity growth.

(5) *Investment implications.* Joe and I believe that these geopolitical developments should continue to favor overweighting the US in global equity portfolios, a.k.a. the Stay Home investment strategy as opposed to the Go Global alternative. There has been a solid upward trend in the ratio of the US MSCI stock price index to the All Country World (ACW) ex-US index since 2009 (*Fig. 2*). It was tested during January but held as a result of the war in Ukraine.

Forward P/Es have been falling for the major MSCI stock market indexes since early 2021 (*Fig. 3*). Here are their latest readings as of the March 10 week: US (19.1), Japan (12.0), EMU (11.9), Emerging Markets (11.0), and UK (10.9). The rest of the world—i.e., the ACW ex-US index, with a forward P/E of 12.2—is cheaper than the US index, but it may be cheaper for a reason, i.e., the increasing odds of more deglobalization. The US economy is likely to outperform other economies if this is the outlook for the world.

The geopolitical schism discussed above may already be showing up in the spread between the forward P/Es of the S&P 500 Value index and the ACW ex-US MSCI (*Fig. 4*). In the past, they've tracked one another closely. Rarely have they diverged by much. However, the valuation multiple of the former currently exceeds that of the latter, by a record 400bps.

Inflation II: More Disruptions to Global Supply Chains. Supply-chain disruptions had been expected to abate in coming months. That was before the fallout from the war in Ukraine and a coronavirus outbreak in China's manufacturing heartland put fresh kinks in global supply chains, boosting inflationary pressures:

(1) The March 18 *WP* *observed*: "Allied financial sanctions and the closure of Russian airspace are forcing cargo planes to fly longer, costlier journeys from Asia to Europe. Dozens of Chinese factories and port warehouses that supply the United States remain

shuttered amid the country's worst coronavirus flare-up since the original wave in Wuhan. And triple-digit oil prices are inflating fuel bills for ocean carriers and truckers." More than 50 Chinese factories in the electronics, automotive, and consumer products industries were shut down last week.

(2) The crises in Russia and China emerged as some of the worst global backlogs appeared to be easing. The logjam of ships off the coast of Southern California, which peaked last year above 100, has been cut in half, according to the Marine Exchange of Southern California. However, on Thursday, Maersk, the world's second-largest cargo carrier, warned that waiting times have been lengthening for ships trying to dock at China's main southern ports.

(3) The March 20 *WSJ* *reported* that the war in Ukraine is already taking its toll on global food supplies: "With wheat already in the ground, and only a few weeks left to plant corn, farmers in Ukraine can't get needed fertilizers and chemicals. They are low on fuel for tractors and other farm equipment. Workers are quitting to join the fight or to leave the country, leaving farms short-handed."

According to the US Department of Agriculture (USDA), Ukraine accounts for 10% of global wheat exports, 14% of corn exports, and about half of the world's sunflower oil. Ukraine is the world's fourth- and fifth-largest exporter of corn and wheat, respectively, according to the USDA, and 85% of its crop exports travel by sea. With its ports closed, the country is trying to shift some exports through its western borders.

(4) The March 18 Bloomberg *reported*: "The Green Markets North America Fertilizer Price Index jumped almost 10% Friday to an all-time high as the market worries that potential sanctions on Russia, a big low-cost shipper of every major kind of crop nutrient, could disrupt global trade. The country accounted for almost a fifth of 2021 fertilizer exports, according to Trade Data Monitor and Bloomberg's Green Markets." The war also is pushing up the cost of natural gas, the main input for most nitrogen fertilizers, forcing some producers in Europe to cut output.

(5) What can we see in the available data on the pandemic? New cases of Covid-19 have plunged in the US to just 18,000 on average over the 10 days through March 18 (*Fig. 5*). They've similarly fallen in Brazil, to 46,700 through March 18 (*Fig. 6*). Europe had been making good progress but is now showing setbacks in Germany and the UK (*Fig. 7* and *Fig. 8*). India's new cases, on a 10-day basis, have plummeted in recent weeks down to just 3,000 through March 18 (*Fig. 9*).

China's zero-Covid policy had been working remarkably well until recently, when new cases rose to 1,278 per day on average during the 10 days through March 18 (*Fig. 10*). The surge has triggered targeted lockdowns in affected cities throughout China. Melissa and I can't see justification for placing nearly 30 million people on lockdowns just because of 1,278 new cases; we wonder whether the actual case count is much higher than that. Our hunch is that China's authoritarians are germophobic. Their homegrown vaccines are useless, and they are fighting Mother Nature by thwarting the development of herd immunity with their obsessive lockdowns. Of course, authoritarians have often been germophobic and hostile to Mother Nature.

(6) What can we see in the data on supply chains? The latest for March show delivery times and unfilled orders remain elevated in the regional business surveys of the New York and Philadelphia Federal Reserve Banks (*Fig. 11*). Their prices-paid and prices-received indexes also remain near recent record highs (*Fig. 12*).

The auto industry has been particularly hard hit by parts shortages. In the US, motor vehicles assemblies remained depressed at 8.4 million (saar) during February (*Fig. 13*). Auto production in the European Union and Japan also were weak during January (*Fig. 14*).

Inflation III: Soft or Hard Landing? Debbie and I have some bad news for Fed Chair Jerome Powell. History shows that the only sure way to bring down inflation is with a recession. In his March 16 *press conference*, Powell acknowledged that "[i]nflation remains well above our longer-run goal of 2 percent." He blamed it on strong aggregate demand at a time when "supply constraints are limiting how quickly production can respond." He also blamed Russia's invasion of Ukraine for boosting energy and other commodity prices.

Additionally, Powell said that the best way "to promote a long expansion" is to achieve "price stability." The Fed will use its "tools" to do so. He mentioned this word 18 times during the presser. The "plan" is to raise interest rates to "gradually slow down demand .... just enough ... to better match with supply."

The only tool that the Fed has ever had to bring down inflation is to raise the federal funds rate. More often than not, doing so has caused a credit crunch and a recession that brought inflation down. That's the lesson of history. Inflation has always declined as a result of recessions, i.e., hard landings (*Fig. 15*). If the plan is to slowly raise interest rates to gradually slow demand, resulting in a soft landing, then good luck with that!

The yield-curve spread tends to signal that monetary tightening is sufficient to cause a recession and bring down inflation when it inverts. The traditional yield-curve spread between the 10-year bond and the federal funds rate is still widening (*Fig. 16*). It is one of the 10 components of the Index of Leading Economic Indicators, which remained near its recent record high during February. The yield-curve spread between the 10-year and 2-year Treasuries, on the other hand, has narrowed significantly so far, from over 150bps at the start of this year to only 21bps on Friday (*Fig. 17*).

Until yesterday afternoon, we would have said odds are that the Fed will tighten gradually, reducing the risk of an imminent recession and increasing the risk of higher-for-longer inflation. But yesterday brought a surprising development—read on.

Inflation IV: Powell's Soft-Landing Scenario. We wrote most of the above just before Fed Chair Jerome Powell spoke yesterday afternoon before the National Association of Business Economists. His *speech* was titled "Restoring Price Stability." He acknowledged: "The labor market is very strong, and inflation is much too high." The Fed's goal now is "restoring price stability while preserving a strong labor market."

Powell hopes to do that by engineering a soft landing. We are skeptical, as noted above. While we have observed that all recessions have brought inflation down, Powell rightly countered that there have been a few times when the Fed tightened and inflation has moderated without causing a recession. He noted: "Soft, or at least soft-ish, landings have been relatively common in US monetary history. In three episodes—in 1965, 1984, and 1994—the Fed raised the federal funds rate significantly in response to perceived overheating without precipitating a recession." (See Figure 6 in his *slide show*.)

The bottom line is that Powell has pivoted from a dovish stance during most of last year to an increasingly hawkish one now. He is ready to raise the federal funds rate by more than just increments of 25bps: "In particular, if we conclude that it is appropriate to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings, we will do so. And if we determine that we need to tighten beyond common measures of neutral and into a more restrictive stance, we will do that as well."

Meanwhile, by the close of trading on the day of his speech, the yield-curve spread between the 10-year and 2-year Treasuries had narrowed to only 18bps, becoming even closer to inverting, i.e., turning negative. This implies that market participants believe that the economy is already nearing a soft landing that could turn into a hard landing if the Fed tightens too aggressively. Fasten your seat belts!

Calendars

US: Tues: Richmond Fed Manufacturing Index 2; API Weekly Crude Oil Inventories; Williams; Daly; Mester. **Wed:** New Home Sales 810k; MBA Mortgage Applications; Crude Oil Inventories; Gasoline Production; Powell; Daly. (Bloomberg estimates)

Global: Tues: Eurozone Current Account €24.3b; UK CBI Industrial Trends Orders 16; Japan Leading Index -1.0%; Lagarde; Guindos; Cunliffe; Lane; Panetta. **Wed:** UK Headline & Core CPI 0.6%m/m/5.9%y/y/0.5%m/m/5.0%y/y; UK PPI Input & Output Prices 1.2%m/m/13.9%y/y/0.9%m/m/10.1%y/y; UK Annual Budget Release; ECB Non-Monetary Policy Meeting; BOJ Monetary Policy Meeting Minutes; Nagel; Bailey; Kataoka. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three indexes had forward earnings at a record high last week. LargeCap's was at a record high for a 12th week after dropping for a week earlier due to index changes. MidCap's was at a record high for a 15th straight week after dropping 0.1% below at the end of November. SmallCap's rose for the first time in three weeks to 0.6% below its record at the end of February. It had been steadily making new highs until mid-December, but since then it has done so in only nine of the 13 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 91 of the past 95 weeks, with the down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings shortfall last August, and index changes in September and December. MidCap's forward earnings is up in 89 of the past 93 weeks, and SmallCap's posted 86 gains in the past 94 weeks. Forward earnings for these indexes had been on an uptrend from November 2019 until February 2020, before tumbling to a bottom by June 2020 due to the Covid-19 economic shutdown. LargeCap's forward earnings has risen 63.6% from its lowest level since August 2017; MidCap's is now up 124.5% from its lowest level since May 2015; and SmallCap's has soared 181.9% from its lowest point since August 2013. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings remained steady at an 11-month low of 28.1% y/y; that's down from a record-high 42.2% at the end of July. That's up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings dropped to an 11-month low of 43.9% y/y from 44.3%. That's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's rate rose to 47.5% y/y from an 11-month low of 46.9%. It's down from a record high of 124.2% in late June and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season, causing analysts' consensus earnings forecasts for 2021 and 2022 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2021 and 2022: LargeCap (49.4%, 9.0%), MidCap (85.4, 10.2), and SmallCap (128.9, 10.0).

S&P 500/400/600 Valuation (*link*): Valuations were broadly higher for these three indexes last week. LargeCap's forward P/E surged 1.0pt w/w to 19.2 from a 23-month low of 18.2. That's down from a six-month high of 21.5 in early November, and compares to its prior 11-month low of 20.3 in early October. LargeCap's forward P/E also compares to a 19-year high of 22.7 in January 2021 and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's rose 0.7pt to 14.5 from a 23-month low of 13.8. That's down from a 13-week high of 17.1 in early November. That also compares to a seven-month high of 20.5 in March 2021 and is 8.4pts below its record high of 22.9 in June 2020. SmallCap's improved 0.5pt w/w to 14.0 from a 23-month low of 13.5 from 13.7. That's down from a 13-week high of 16.1 in early November and is now down 13.2pts from its record high of 26.7 in early June 2020 when forward earnings was depressed. During March 2020, MidCap's 10.7 and SmallCap's 11.1 were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017; MidCap's current 25% discount to LargeCap is up from a 28% discount on February 2, which was its biggest since September 2000. SmallCap's P/E was below LargeCap's for an 82nd week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 27% reading has improved from 32% on February 2, which was its biggest since February 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 38th straight week; SmallCap's current 3% discount to MidCap's is up from a 9% discount in December, but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q2-2020 earnings season—which came in substantially better than greatly reduced forecasts—analysts as a whole have been raising their consensus forecasts for all future quarters instead of lowering them as is the norm. Those gains endured through the latest Q4 earnings warnings season, when forecasts typically decline. The S&P 500's Q4-2021 earnings per share is nearly final now at $54.05, down 1 cent w/w, and compares to a $51.08 estimate at the beginning of the quarter. That $54.05 actual represents a gain of 26.9% y/y on a frozen actual basis and a 32.0% y/y gain on a pro forma basis. Q4 marked the fourth straight quarter of double-digit percentage earnings growth, but growth slowed for a second straight quarter. Ten of the 11 sectors posted positive y/y earnings growth, down from all 11 doing so during Q2-2021 and Q3-2021. Double-digit growth occurred for nine sectors; that's down from 10 sectors doing so during Q3. Looking ahead to Q1-2022, the earnings-per-share forecast rose 5 cents w/w to $51.74, but is down from $52.22 at the start of the quarter. If that decline holds up until the end of the quarter, it would be the first drop in seven quarters. Analysts expect S&P 500 earnings growth to weaken substantially to 5.3% y/y on a frozen actual basis and 6.5% on a pro forma basis. Double-digit growth is expected for just five sectors in Q1-2022, and three are expected to record a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q1-2022 versus their Q4-2021 growth rates: Energy (226.6% in Q1-2022 versus 12,718.7% in Q4-2021), Industrials (36.8, 43.6), Materials (35.1, 64.2), Real Estate (15.7, 17.7), Health Care (10.4, 28.0), Information Technology (8.5, 24.6), Utilities (6.6, -1.3), S&P 500 (6.5, 32.0), Consumer Staples (1.1, 7.7), Communication Services (-4.9, 16.5), Consumer Discretionary (-10.7, 53.4), and Financials (-20.3, 10.0).

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