Global Conflict and the Current Macro Environment:

Evaluating Markets in the Near-Term

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With summer in full swing and the first half of 2022 behind us, it's a good time to take stock of recent events. As we look ahead to September and October - typically the two most volatile months for markets - I am reminded that according to S&P, there is little if any historical correlation between the first and second halves of the year.[1] I start with Russia and the war in Ukraine, a theme that will come up repeatedly throughout this letter. I then talk about potential ramifications for China and Taiwan, after which I take a close look at macroeconomic factors in Europe and the US. Finally, I'll discuss my view on ways the war might come to some kind of resolution and I summarize my predictions for the remainder of the year.

What's Up with Putin?

Rumors have circulated for months (and recent video evidence seems to indicate) that Putin is suffering from Parkinsons, or cancer. In either case, it's possible he could have as few as six months left to live. Recent footage lends credibility to these rumors; his performance could potentially be explained by heavy medication.

So let's say Putin is sick. Furthermore, let's assume that when he dies there are fifty-fifty odds that either a dove or a hard liner is installed. Not being a Russia expert but having seen enough to know that it's tough to call internal Russian politics, this seems like a reasonable assumption to me. Let's further assume that there's a 25% chance Putin dies in the next six months. That leaves a 12.5% chance that a dove is installed in the next six months. I would consider those long odds that much really changes in the next six months. In any case, we don't really know, so investing on the basis of anything other than the status quo seems ill-advised.

As Goes Ukraine, So May Taiwan

The G-7, and Germany in particular, are in a tough spot.

I think the general consensus among the G-7 is that the West's show of backbone in Ukraine will send a strong signal to China. Too weak a showing and China is almost certain to invade Taiwan. Too strong a showing could save Ukraine but it could also precipitate World War III. So it doesn't seem likely that the G-7 and Germany will fold entirely.

I call out Germany specifically because it's going to be near impossible to make it through the winter on current energy supplies. Russia knows this and will squeeze accordingly.

Military analysis indicates that China has a limited window in which to act. Taking a page from the Ukraine playbook, the US may give Taiwan ever-more sophisticated military hardware which would similarly reduce the likelihood of success in an invasion scenario. Add to that the stunning example Russia is providing of what can happen to an inexperienced, non-battle-tested force, and China's chances could get dicey. Suffice it to say, there is a great deal of pressure on Germany to hold the line in Ukraine in order to deter the Chinese from moving on Taiwan in the short term.

[1] Analysis by S&P Dow Jones Indices finds that, historically, there has been little to no correlation between the index's performance in the first and second half of the year: https://www.bloomberg.com/news/articles/2022-06-30/brutal-first-half-for-s-p-500-has-little-bearing-on-the-future

Economic Consequences in Europe, the US and Beyond

But the only way for Germany to hold the line (and probably Italy too) is to suffer the economic costs of energy attrition and rationing for at least another year. That in turn will put pressure on other European economies and on the Euro itself. We're seeing this a bit in the form of bond market vigilantes who are trying to split Italy BTBs off from the pack. Given Italy's relative weakness in governance and economic growth along with a lack of alternatives, I suspect this vigilantism will continue.

Add to this the tensions created within wealthy European countries as they ask their people to make additional sacrifices in order to bail out poorer countries with little fiscal discipline. It seems like an impossible stretch to me. It was hard enough to be team players when the wealthy countries of Europe didn't have their backs to the wall. That said, although I don't think the Euro will come apart entirely, it doesn't mean markets won't keep trying. In the process they may force the Europeans to make fundamental changes in order to stave off what the bond markets seem to think is inevitable.

Ukraine won't be able to bring most of its grain production to market, a supply shock that unfortunately can't be offset faster than the 1-year growing cycle. Sadly, food and fuel inflation have an outsized impact on poorer economies and on the ability of their citizens to meet their basic needs. All of this likely creates at least some social unrest globally. Yet another contributor to the kind of uncertainty no investor wants to see.

Labor markets are no better. I recall that in past inflationary periods, wages tended to be sticky. And up until a few months ago, labor in the US didn't seem to be affected much. In Europe, almost not at all. However, recent wage growth both in the union world and in the broader labor market has been precipitated by labor shortages which derive from increased production and consumer demand. Anecdotes such as airlines not having enough baggage personnel and/or pilots to keep their flights running on schedule have become commonplace. In Europe, organized labor is asking for large increases of 5-7%. They won't get all of it but even half would be a significant increase.

Inflation in Europe just can't be less than that in the US. The Fed continues to lead the way in its fight against inflation, which it has made clear is the number one priority (even if success leads to recession). The war in Ukraine will continue to inflate the cost of energy and food. In an attempt to economize energy supply chain constraints, production will slow, leading to shortages. There really isn't spare capacity anywhere in the world that can service European demand. This means that rates will continue to rise in order to: 1) keep the dollar from destructively appreciating and 2) quell inflation.

It's hard to see a world not in recession (if we aren't already there). And it's increasingly hard to think of this inflation cycle as a brief interlude that can be addressed by a few 75 bps rate hikes. The Fed's current 2.5% inflation projection for 2023 is just as dreamy as was Powell's comment about "transitory" inflation. The equity respite in May seemed early and optimistic. As earnings are revised down and more importantly as it becomes clear that the Fed has to keep raising rates for longer than expected, more declines will loom.

It's very hard for me to figure out how all this affects credit markets in the US, Europe and in emerging markets. IG may behave differently than HY. China may behave differently than the rest of the emerging complex. I say the former because IG seemed to have uncoupled from HY on the first leg, going further and faster than HY, an unexpected result that may have been quite technical. In China investors are quite negative, and China has been decidedly unsupportive as it has continued to enforce its zero covid policy.

In addition, the recent strength in the housing market is likely to flatten out, and prices could even decline in some markets. This will also create consumer angst, offset by a strong consumer balance sheet. Corporate balance sheets are in a weaker position and the rise in rates will make refinancing tricky for some companies. This could lead to stress and eventual defaults. This just means more volatility for credit

The “End” of the War

How does the war in Ukraine end? Of course we don’t know, but here is a synopsis of the best theory I’ve read: NATO continues to supply Ukrainian forces, keeping them battle-ready until Winter. This will include more sophisticated capabilities to push the Russians back from their current position. As such, the stage will be set for negotiations which will allow for Ukrainian “victory” with the Russians gaining some territory. There won’t be a peace treaty but instead something closer to the Korean territorial limbo.

In Summary…

We may already be in recession. If we are, and inflation is still increasing, rates will stay higher for longer.

Recession in Europe is a near certainty; China isn't up for a bail-out and the US will have limited capacity of its own given rising domestic inflation slowing growth.

The European bond market will be volatile but the Euro will remain intact.

The US dollar will remain strong, at least for a while.

It’s hard to see a deflationary agent on the horizon other than interest rates which could slow growth and in turn reduce demand, causing a price reaction. Japan could actually see real inflation, making it possible that the JGB and Bank of Japan relent in order to make Japan competitive in the market for global investment. This would put additional pressure on rates as they would need to rise in other countries competing for funds. Inflation from rising wages in Europe seems just as likely as it does in the US.

Although the Fed may have confidence in the US consumer’s ability to sustain growth albeit at a lower rate, this so-called “soft-landing” is extremely tricky. It requires consumers to continue spending even as job prospects are uncertain, or to spend into price levels that feel unsustainable. Furthermore, the Fed has this soft landing view (although Powell made it clear that this could be changing) because it doesn't think inflation will be that persistent which would cause them to push rates even further and for longer, significantly increasing the chance for more than a growth slow down.

We haven’t seen the bottom in US equity markets or in others, perhaps with the exception of China. Within Europe, Germany seems to face the greatest challenge followed by Italy and France. The UK, although weak, will be least affected by these conditions. Investors will struggle to get individual country exposures right.

Predictions about Putin are largely irrelevant as the probability of a good outcome is low (but a game changer if it happens).

I think there is a high likelihood that the war and its attendant consequences will continue through the end of the year.

What to Do?

What to do with such a gloomy outlook?

It might surprise you to hear that I recommend investors begin planning to deploy cash into equities. I think that equity markets are more than two thirds of the way to the bottom. And no one I know of has ever been able to call the bottom consistently. So you need to start deploying on the way down, by definition. If you have no cash, selling now unless required to do so is a very poor idea.

In credit, I am making the same recommendation. Many investors are waiting for distressed assets to appear. This will certainly occur, but it will likely be short-lived. So again, you’d have to be an excellent market-timer to get this one

perfectly right. And at present, it seems sensible to me to take advantage of low liquidity and widened spreads over the next few months.

Lastly, private credit and private equity may presently provide some very interesting opportunities. In credit, it may not be bankruptcy but instead refinancing that drives opportunity. Rates are now materially higher during a period of economic weakness, so if borrowers cannot convince existing lenders to extend refinancing then there will surely be attractive opportunities in the market. Investors will need to be careful underwriting companies under these conditions - they certainly won't be able to rely on ratings. But significant returns will be available for those willing to do the work.

In private equity we may be seeing a period of maximum stress in the markets for growth companies that were aggressively over-valued. Of course, if companies have enough cash for the next two years they will likely be unaffected. If not however, funding needs for ongoing operations will drive distressed equity issuance. And LP investors may need liquidity so buying LP interests at significant discounts will be possible.

So it's time to buy assets at a discount. One way to do that is by investing with managers who have excellent historical performance but who can also be purchased at a discount.

Thank you for following us and we look forward to connecting soon.

Best,

Peter Kraus

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