Sunday Wrap

Happy Sunday,

Today is my eight day of quarantine after I tested positive for COVID last weekend. It's been a week with plenty of time to read, watch and think – and to appreciate the scientists who so quickly developed the vaccines, as well as the government structures, in my case the NHS, which made it available to us all in the developed world. I don't want to think about what this past week might have been like had I not had my three jabs.

One of the things I've been watching was the spectacle of the presidential election in Italy which, as you know, ended yesterday with the re-election of President Mattarella, thereby leaving Mario Draghi as PM. I didn't see anyone predicting this one, but as BlackRock's Isabelle Mateos y Lago so succinctly tweeted: "Why change a winning team?" I'll come back to this below. I also spent a good deal of Thursday, Holocaust Memorial Day, reminding myself of this dark chapter in history by watching a number of clips of survivors telling their stories while reflecting on today's life. It should be mandatory watching in schools across the world every year.

With that, let's move on to financial markets. It's been another wild week with huge intra-day swings in downward-drifting markets as nervous investors absorb the messages from the Fed and the escalating threat of a Russian invasion of Ukraine. In some segments of markets, changes in these two inputs lead to the same conclusion for the direction of asset prices, but more often than not they contradict each other – but this is before you incorporate the fact that, while Putin won't base his decision on Fed or ECB policies (I think!), the Fed and the ECB will surely base their decisions partly on what Putin decides to do…

But one step at the time: It's pretty broadly accepted that the pressure on US, particularly tech, stocks since late last year is little more than a healthy adjustment of excessively expensive segments of markets. If this is triggered by the more hawkish messages from the Fed, no drama. Importantly, weaker equity markets do not have the characteristics of growth concerns - if they did, the high-yield credit markets would not have fared as well as they did, for example.

The escalation in the stand-off between Russia and the Western world is a much greater concern. While this has begun to impact broader markets more recently, I'm far from sure that the risk of a bad outcome is properly discounted yet. I obviously claim no ability to predict what Putin may do, but if you exclude the possibility of a continuation beyond a few weeks of the present balancing on the edge of a knife between war and peace, you are left with either a clear de-escalation of the stand-off or some version of a Russian military invasion of Ukraine, which would trigger massive sanctions and (probably) counter-measures against Europe by Russia, maybe via a further cut in commodity supplies.

I sure hope (and want to believe) that it'll be the former - de-escalation – scenario that'll play out during the next month or two. Yet, in my assessment, the positive impact on markets of that happening will pale compared with the negative impact on markets of war and sanctions. But, even without knowing what probabilities to assign to the two outcomes, is the unknown properly priced in? I'm far from sure.

So, here's my agenda for today:

- **The characteristics of the recent market moves, and what it tells us.**
- **Why the Fed is likely to tighten more than is priced in, but not enough to kill markets.**
- **Short of being able to guess Putin's next move, I'll highlight one clear miscalculation he has made, namely his attempt to further split the West (while forcing his new friends in the US Republican Party to confront a newfound dilemma). Could that contribute to a decision to back down?**

1. The characteristics of recent market moves, and what it tells us.

My contention is that recent months' shift in the Fed's policy message and the increasing prospect of the pandemic now moving towards an endemic (bringing us back from internet shopping and entertainment towards real life activities) have triggered most of the market volatility so far. But these past couple of weeks, the geopolitical concerns have started to show up in markets beyond energy, if only marginally so. Yet, if there is a Russian invasion, sanctions will be introduced which, in turn, would very likely lead to counter-measures by Russia. While unquantifiable in any exact way, I'd suggest that the impact on markets of this dreadful scenario is so great that present market pricings imply that people think the invasion-scenario is very small indeed. I sure hope they are right.

Consider this: First, sovereign bonds were well bid this past week due to geopolitical concerns (10Y UST yields dropped to nearly 1.70% on Monday), but then came Jay Powell and his hawkish remarks, and 10Y UST yields were back at 1.85%. The price action clearly suggests that the underlying trend is for higher yields, as long as the geopolitical picture does not get more complicated. So, back to the eternal question: How will the expected higher UST yields affect equities?

I'm pretty relaxed. US yields posted an impressive rise of almost 50bp between mid-December and mid-January - and almost entirely driven by higher real yields! During this period, the S&P recorded a relatively modest 4% loss, while the more rate sensitive tech stocks were hit much harder, with a drawdown of 8.5%. Illustrating the market's relative comfort with weaker equities of this magnitude, there was very little feedback loop back into UST yields. EUR-USD traded sideways as Fed policy was by and large already discounted and the rise in 10Y yields was mainly a term premium story.

Then the escalation of the military threat entered on stage, putting additional pressure on equities, driving the VIX up and the dollar stronger. USTs received support from flight to quality (ca. 20bp peak to trough), but it all faded again after the FOMC meeting. Bunds decoupled from Treasuries only up to a point during both phases. On Friday, 10Y UST yields were at 1.77%, 10Y Bunds at -0.05%, the S&P 500 is down 7% YTD while the Nasdaq 100 is down 12% and VIX is close to 28. In comparison, the pressure on European equities has been less pronounced, supported by their lower valuations, but also their greater reliance on good old growth industries. The Euro STOXX 50 is down 3.8% YTD, but within the European index, Energy, Banks, Basic Resources and Insurance are all up 5%-9%. This is also reflected in the MSCI Europe Value index, which is up 4% YTD, while its US cousin is down 5%.

As my colleague, Christian Stocker, Sr. Equity Analyst with one of the finest track records in the market, has pointed out, it's quite remarkable – indeed unusual - that Europe is doing better than the US in times of rising geopolitical tensions. Normally, the US as a safe haven is performing better in such periods. Tricky times indeed, but my colleagues in our Strategy Research team have done a considerable amount of work on all this. Do reach out to any of them if you want to discuss it in greater detail.

My bottom line – to whet your appetite for the next two sections - is this: The market story is still predominantly a Fed-adjustment story, rather than a geo-political story – and I'm not sure that markets have gotten this one right! Any likely amount of Fed tightening is unlikely to become a problem for financial markets, while Russia could easily become a major problem!

2. Why the Fed won't overdo the tightening.

As I argued in this note two weeks ago on the back of the remarkable attack on the Fed by former NY Fed President Bill Dudley, the odds have recently swung significantly in favor of monetary tightening in the US beyond the roughly 100bp tightening priced in for this year. In my view, this past week's Fed statement was the first instalment of this more measurable shift.

I'll make two additional comments on this today: First, I'll argue that such additional tightening beyond present indications is not really called for by the presently available data, but there is a lot of uncertainty in the forecast, and the pressure on the Fed by important influencers is having an impact. Second, I'll argue that even so, the odds of the Fed moving beyond the removal of monetary accommodation to start to implement an outright tight stance remains low. If the overall monetary policy stance remains accommodative, even if less so than in the past, financial markets are unlikely to be too troubled.

First why additional tightening is not really justified by the data:

I'll first quote "Team Transitory Captain" Martin Sandbu of the FT: The week before last, he lined up three key arguments against panicking about the December CPI print of 7.0%: (i) When trying to spot a turn, don't look at year-on-year numbers; on the relevant month-on-month, seasonally adjusted, basis, the December number was down and provided comfort that we are through the worst; (ii) all the main expenditure categories of the CPI, bar one, had lower month-on-month increases in December than in November, further supporting the "past the peak" argument; and (iii) while wage (and wage cost) growth has gone up measurable, one should remember the dip early in the pandemic, which means that the average cost of employees is still up only a relatively modest 6.2% over the past two years. Sandbu's piece is here: It's still wrong to panic on US inflation

In addition, as our Chief International Economist, Daniel Vernazza, has pointed out, two important data releases since Martin's piece lend further support to the "temporary" argument: While Thursday's Q4 GDP number of 6.9% annualized qoq (or 1.7% in the European way of not annualizing the quarterly numbers) is impressive, the details behind the number are much less so. Most importantly, the increase in inventories contributed a massive 4.9pp to the 6.9% increase. Roughly speaking, this means that the growth rate in GDP in Q4 that the Fed should focus on as a sign of potential overheating is no more than 2.0% (annualized qoq), or 0.5%, as we call that in Europe. Under no reasonable estimate is that an underlying growth rate that should worry the central bank. And Friday's Employment Cost Index for wages and salaries (the Fed's preferred measure of wage growth) rose at an annualised rate of 4.4% qoq in Q4, down from 6.0% in Q3. Again, not a whole lot of reason for concern here.

Finally, what if we end up with an inflation rate of maybe, say, 3%? As I discussed two weeks ago on occasion of ECB's Isabel Schnabel's green speech and the risk to inflation, also the US risks having its central bank put a brake on the green transition if it does not allow enough room under the average inflation index for relative prices to adjust in a way that facilitates quickly enough this critically important transition. I won't repeat myself here, but I recommend BlackRock's Elga Barsch's very detailed (and persuasive) work on this as well: A world shaped by supply.

That all said, one thing is the fact of the data and the inherently elevated uncertainties associated with the forecasts at this time, a different thing is the increasingly loud choir of prominent people calling on the Fed to tighten, sharpening their calls on a near daily basis. As I noted two weeks ago, Bill Dudley's call certainly raised the temperature at the Fed, putting them on alert of the reputational downside should they get it wrong. This past Monday, Mohamed El-Erian, of ex-Pimco (and much other) fame penned a piece in the FT with this self-explanatory headline: "Bold policy response needed to restore Fed credibility on inflation" (it's here: Document link).

Hearing Jay Powell this past week – and reading yesterday's FT interview with Atlanta Fed President Bostic in which he mentioned the possibility of hikes every meeting, or of 50bp hikes - make me wonder if what we are seeing now is not the Fed taking out some insurance policy against the risk that a post-mortem review of its policies could conclude that they didn't do enough.

With the first instalment of such an insurance policy this past week, I tip my hat to the Bloomberg's Editorial Board, which on Friday, on the one hand, endorsed the slightly more hawkish line while, on the other hand, also noting the risk of going too fast or too far (here: Europe's Big Two to Deepen Split on Inflation Response) (In Europe, the – mostly German – relentless hawkish choir received a similar reminder of the cost of doing too much by Isabel Schnabel in her interview with Süddeutsche Zeitung a couple of weeks ago.)

My second and maybe more important point here is that even if the Fed is setting out to tighten policies by more than the 100bp priced in for this year (i.e. one per quarter), that's not the same as introducing an outright "tight monetary policy stance", which certainly would raise the risk of a recession, and a sharp market correction, rather significantly.

To illustrate, I go back to a conversation I had this past week with my colleague, Daniel Vernazza: To remind you, "Team Transitory" argues that inflation will come down to about target levels at around the policy-relevant 2-year horizon without the Fed having to run "tight monetary policy". In contrast, "Team Permanent" argues that for inflation to return to target levels on a sustainable basis, the Fed will need to introduce "a tight monetary policy" for some time.

What's the difference here between "tight" and "tighter"? For the policy stance to become "tight", quite simply, the fed funds rate would have to rise above its neutral rate. The Fed thinks the neutral rate is around 2.5% in the longer run (definitely lower in the short run because of the headwinds from the pandemic), although, personally, I think the neutral rate is even higher in the longer run – maybe even 3.0%-4.0%. Once the fed funds rate exceeds the neutral rate, I think it is fair to assign a reasonably higher probability to a (probably brief and mild) recession and a more profound market correction – but then again … fed funds rates above 2.5% or 3.5%? It'll surely be a different world then.

So here's my bottom line: The Fed is very unlikely to trigger a bigger negative market reaction – but Russia may do it:

3. Russia may have overplayed its hand, but is there a way of climbing down?

I'll offer the following possible objectives for Putin's threat of a military invasion of Ukraine: (i) A genuine feeling that he has been betrayed by the West following the collapse of the Soviet Union more than 30 years ago, and that the perceived "encirclement" of Russia by NATO needs to be halted and pushed back; (ii) and obviously related, a desire to puncture perceived US global hegemony and restore Russia as a comparable global power; (iii) a fear of developments which could lead to well-functioning democracies in former Soviet republics which – in turn – might inspire similar developments in Russia, and (iv) a desire to split Europe in as many ways as possible, including away from the US, between individual European countries and within coalition governments, most prominently in Germany.

From what I understand, there is no way for the West to be willing/able to adequately address the three first objectives. I suspect the written replies to the Russian demands from the US and from NATO include some diplomatic language to that effect, but whether there is enough for Putin to declare victory and climb down I don't know. Maybe – just maybe - Ukrainian President Zelensky's surprise statement on Friday that the threat of war now is not greater than it was last year, and that Western leaders are causing panic by overstating the likelihood of war, could be part of a greater effort to provide an acceptable compromise and a climb-down? So long as the parties talk, there is hope, but it feels difficult to be an optimist here.

Whichever way it'll play, I'll suggest that Putin has failed rather miserably in his attempt to drive a wedge between the US and Europe, and between European countries, including within NATO:

First, following President Obama's shift to orient US foreign policy more towards the Pacific than Europe, which was both turbo-charged and utterly confused during the Trump years, the US policy response to the Russian threat against Ukraine and Europe more broadly has been nothing but impressively robust.

Second, while there certainly has been a degree of conflicting statements between several European countries, including France and Germany, this is really nothing beyond the normal, and expected, and subsequent clarifications by President Macron put any such concerns to bed. Moreover, it was German Foreign Minister Baerbock, who more than anyone else articulated – in Moscow at the press conference with her Russian counterpart Lavrov – the clearest European reply of all to the Russian demands. And when the German head of the navy expressed a degree of sympathy for the Russian stance, which was interpreted by the foreign media as a sign of the true thinking of the German elite, he resigned in a rush. Other usual so-called "Putin-versteher" in the German public debate, but also the far-right political parties in France, Italy and Austria, have been remarkably quiet in this debate.

Third, yesterday's outcome in Rome, i.e. a "re-appointment" of President Mattarella and PM Draghi, must be just about the least favored outcome from Putin's perspective. Looking across the Italian political landscape I struggle to find anyone more deeply committed to European integration anchored in Atlanticism, than Mario Draghi.

Fourth, the reactions to Russia's demand that NATO pulls back from its borders have so far included a statement that NATO's policy of being open to new members is non-negotiable and a public debate in Finland and Sweden whether they should join NATO as well. Without a doubt, an invasion would surely lead to further NATO build-up in Europe, possibly even via new members.

The combined lesson for Moscow so far must be that a Russian invasion of Ukraine, however limited, would significantly shift European public opinion and politics further towards a common response around sanctions. In addition to the price in casualties and money, and the headache of keeping a foreign country occupied, how does Putin evaluate the bi-product of an invasion in the form of a measurable shift towards unifying Europe, while strengthening NATO commitments across the Atlantic and maybe seeing it expanded further into Scandinavia, after all these years of working on the opposite outcome?

Furthermore, while the much anticipated (by the usual sceptics) of a visible split within the new German coalition towards Russia has not happened, the dilemma across the Atlantic, within the Republican Party, of how to react to Putin's threat has been brought to the fore. The GOP always had an isolationist wing, but the leadership has remained strongly internationalist and committed to NATO – until Trump tore all that up with his embracement of Putin and attacks on NATO.

Trump's hold on the party, and his demand of total loyalty by every elected Republican to even his most wacko views, has, of course, created this horrible picture of a GOP in disarray as its rushing for a dark place beyond the normal definition of democracy. But then comes Putin's threat of military action, placing a very long list of GOP leaders and pundits between a rock and a hard place - between their loyalty to Trump and his obedience to Putin vs long held GOP commitments to foreign and security policies - threatening to throw a spanner in the GOP-wheel ahead of mid-term elections, if not even in the juggling for the next presidential campaign.

This all leads me to conclude that the West's reaction to the Russian threat against Ukraine has been stronger and more unified than Putin is likely to have expected. This, in turn, may have contributed to the further, and more recent escalation. But whether we have reached a point of no return (Anton Chekov's gun has certainly entered the play), or whether there is an acceptable path on which Putin can climb down, I don't know. But I think we'll find out within the next few weeks; the present state of affairs is not sustainable.

If, against all hope, it leads to an invasion, we should assume it'll lead to a new set of comprehensive and deep-reaching sanctions on Russia, which may very well lead to further restrictions by Russia on Europe as well.

The elephant in the room is gas, of course. Europe gets roughly 40% of its natural gas from Russia and while – with a bit of help on the weather front during the remaining winter – stored gas and other sources will get us through to the spring, should the Russian taps be closed longer-term there would be a very substantial economic price for Europe to pay, as laid out in this brand new, excellent paper by Bruegel: Can Europe survive painlessly without Russian gas?

Importantly, however, Gazprom has never cut its gas deliveries to Europe below existing contracts. Were they to do so as part of this conflict, thereby explicitly politicizing gas, there can be little doubt that the Rubicon of European public and political attitudes towards Russia as a commercial partner will be crossed, with long term damage inflicted on this already complex relationship. We shall see…

And on that note, I'll move from my desk to a different chair and look out of a different window – as I have done this past week. With a bit of luck, I'll test negative tomorrow or Tuesday, and normal life will return.

Best

Erik

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