*ON OUR MINDS*

# Breathing Through the Smoke and Fire

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A month ago, I suggested that President Putin would probably refrain from invading Ukraine; a week later, I learned once again why op-ed columnists and television talking heads rarely make specific predictions that can be proved or disproved within a matter of days. As the world reels in horror at the sight of Ukrainians fleeing from smoke on the water and fire in the sky, we have all had to question our assumptions about the world around us. Investment managers must rethink their positioning and expectations for market returns.

In times of stress, we tend to extrapolate the current situation indefinitely into the future: Stock prices are down this year, inflation is seemingly out of control, and the war has made a mess of global trade. It's human nature to fear more of the same, or worse. With Ukraine's wheat harvest probably lost and with Russian fossil fuel exports yanked from western markets, surely the world must brace for food and energy shortages and runaway prices – so how could I possibly still argue that markets will recover and even finish the year in the black?[1]

Before answering the question, it's important to acknowledge how much has changed in just the past few weeks. American and European sanctions have mostly cut Russia off from the rest of the global economy: Its stock market is in shambles, its currency is crumbling, its access to foreign exchange is seriously limited, its domestic industries are starved of critical parts and supplies from abroad; and its economy is plunging into a deep recession. Europe is struggling to meet its energy needs without Russian oil and gas; the supply shock and soaring prices could drive the Eurozone into recession. And this week we're learning that the western sanctions aren't buckling Russia's will to wage war, they are driving Russia to seek aid from China. These are undoubtedly severe strains on the global economy.

And yet the U.S. economy and financial markets are both astonishingly resilient. The economy was in danger of overheating two months ago, as consumers emerging from pandemic conditions were spending down some of the enormous excess savings that they had built up during the prior two years. GDP growth had been running at an unsustainable 6%, labor was in short supply with almost two open jobs for every unemployed person, and demand was pushing prices higher. Today, inflation – and not war in Europe – remains the biggest concern for U.S. investors, as high prices are beginning to dampen consumer appetites. We track dozens of economic indicators, and the vast majority suggest that the U.S. economy is slowing but not stalling. If a bout of high prices lets a bit of steam out of the kettle, that's not necessarily a bad thing, and it is also self-correcting.

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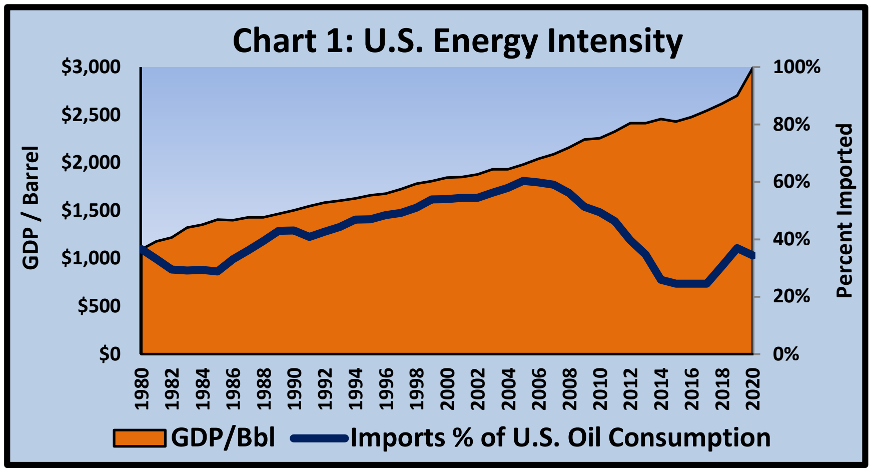
[1] Our view has been that 2022 would see small positive equity returns in U.S. markets; we first articulated this view in the *On Our Minds* commentaries "View from the Crow's Nest" (January 24, 2022) and reiterated it in "Playing Out the Ukraine Hypotheticals" (February 17, 2022).

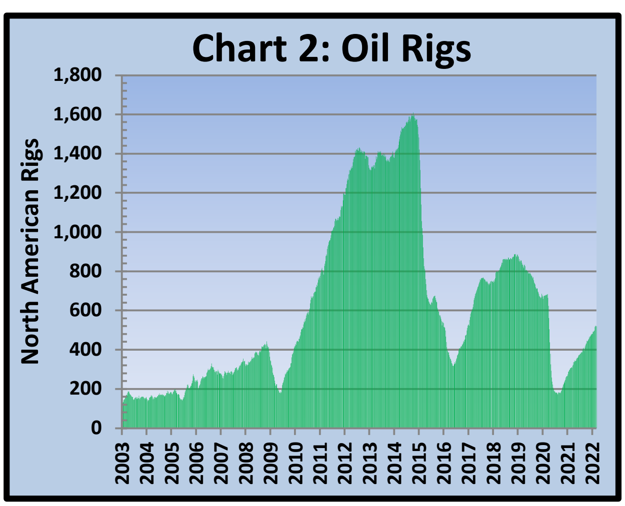
Some alarmists worry that we are in the early stages of a sustained wage-price spiral such as we saw in the 1970s. That's theoretically possible, but it seems highly unlikely to develop. Three factors in the U.S. economy make the current inflationary episode, oil market havoc, and war in Europe starkly different from the trauma of five decades ago: Energy, labor, and trade.

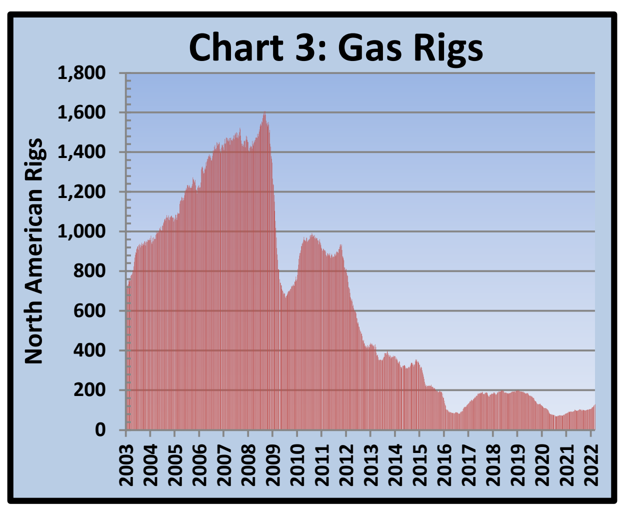


Sources: Commerce Department, CEIC Data, www.worldometers.info

**Energy.** First, the U.S. economy is far less dependent on energy than it was fifty years ago, and we rely on imports for a smaller percentage of our total energy needs. The orange area of Chart 1 shows that we produce nearly three times the output per barrel of oil today as we did in 1980, even after adjusting for inflation. Intellectual capital and technology have replaced oil as the main inputs to economic production. That transition has affected the energy industry itself, most notably in the fracking revolution that sent domestic production soaring faster than the economy could absorb output. As U.S. production rose through the 2000s and 2010s, oil imports fell from 60% of total consumption to about 25% (the blue line in Chart 1). The slight increase from 2016 reflects the sharp curtailment of production following the fracking-driven supply glut of 2014-2016.

Drillers have plenty of money to expand production again, especially since most of them refinanced their balance sheets with low-cost debt in recent years. Yet these companies have mostly refrained from expanding production, in part due to labor and some materials shortages. Charts 2 and 3 show the number of active North American rigs over the past two decades; for both oil and gas, mid-2010s supply gluts have led to severe reductions in rig counts.



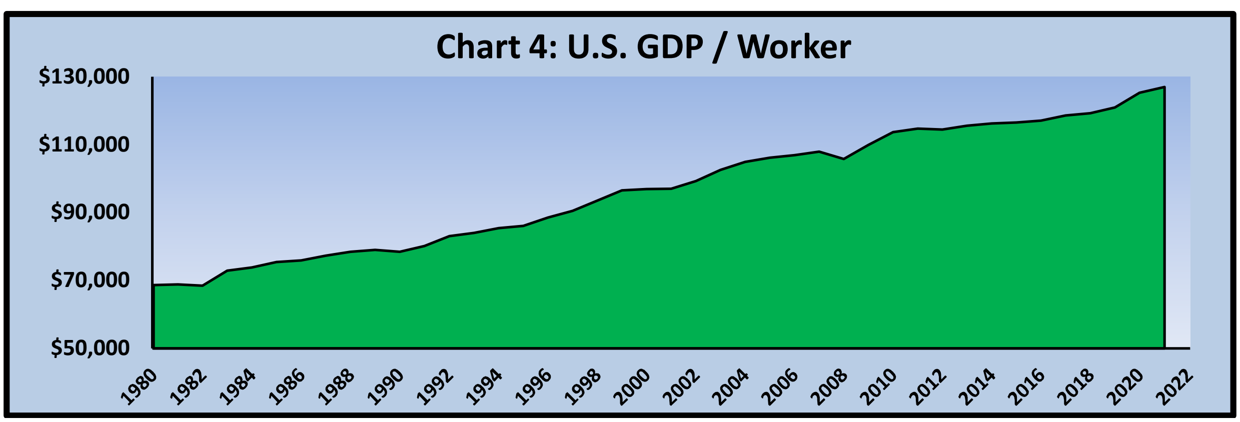

Source (both charts): Baker Hughes

Russia constituted about 8% of U.S. oil imports last year. Although Russia is a member of the OPEC+ group, the rest of the oil cartel has stayed on the sidelines, neither boosting output nor attempting to squeeze Russia's political adversaries. While an 8% supply gap is too large to offset overnight, it is within the grasp of U.S. producers to close most of it. Sooner or later, the combination of high prices, high demand, and deep pockets will lead some U.S. companies to re-open plugged wells or to drill new ones. This may occur over the course of months, not weeks, and it will depend in part on the companies' ability to re-hire workers. But Charts 2 and 3 still demonstrate that the U.S. has substantial untapped production capacity to reduce the impact of the ban on Russian oil on our economy. In short, oil prices, by themselves, can't drive the U.S. into recession as they did in the 1970s. In a capitalist system, the best cure for high prices is high prices: Supply and demand will adjust to a new equilibrium.

**Labor.** Second, structural changes in the U.S. economy over the past half-century also argue against a wage-price spiral. The economy is far more diversified today, and unions play a much smaller role. In 1973, about 60% of all employees were union members, compared with only 10.3% today.[2] When President Nixon's 1971 wage and price controls were lifted, union and non-union workers alike negotiated wage agreements that included both cost of living adjustments and merit increases; these agreements forced wages to rise faster than the consumer price index – a virtual guarantee of spiraling inflation that simply does not exist today. That's a major reason that consumers in 1973 anticipated permanently higher inflation, while consumers today expect inflation to fall meaningfully in the next couple of years.

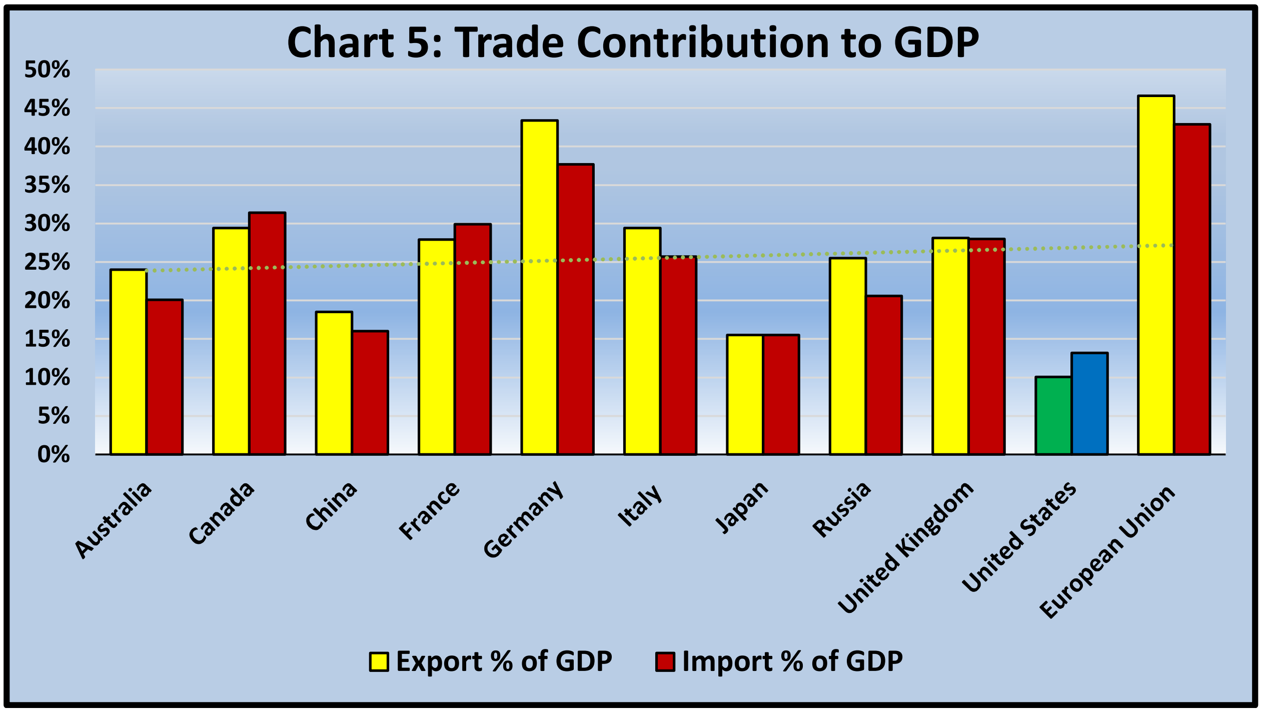
Further, when wages were rising by COLA-plus-merit in the 1970s, productivity growth was abysmal: Inflation-adjusted GDP per employed worker grew by only 0.3% annually over the decade from 1972 to 1982. By contrast, productivity over the past dozen years has averaged 1.4% per annum, as shown in Chart 4. Unlike in the 1970s, rising wages today are offset by higher productivity; unit labor costs are steady. Structural factors in the 1970s labor market supported a continuous and multifaceted trend of higher prices unsupported by productivity improvements, while today's environment feels more like a one-time step-up adjustment.




Sources: Commerce Department, Bureau of Labor Statistics

[2] Bureau of Labor Statistics data on union membership only goes back to 1983. However, High Frequency Economics and other researchers have established the numbers of jobs covered by union contracts going back at least through the 1973 oil crisis.

**Trade.** Finally, the U.S. economy is insulated from inflationary pressures caused by supply shocks in global trade. Although we talk (seemingly endlessly) about tariffs and trade deficits and energy imports, the U.S. is actually among the most self-contained major economies in the world. Chart 5 shows exports and imports as a percentage of GDP for several major global economies. The U.S. has the lowest reliance on global trade: We are economically affected less by events beyond our borders than any other industrial country; what does affect us is mostly related to Canada and Mexico, not to China or Europe or Russia.




Source: World Bank

The contrast with Europe, in particular, is sharp: While exports and imports account for only about 10% and 13% of U.S. GDP, they are both more than 40% of the European Union's economic output. Germany will have a much more difficult time replacing 27% of its energy imports heretofore sourced from Russia than we will have replacing 8% of ours. The war in Ukraine and the resulting disruptions in energy and food markets may be enough to push Europe into stagflation or worse, while the U.S. economy will scarcely feel any direct impact beyond temporarily higher gasoline prices.

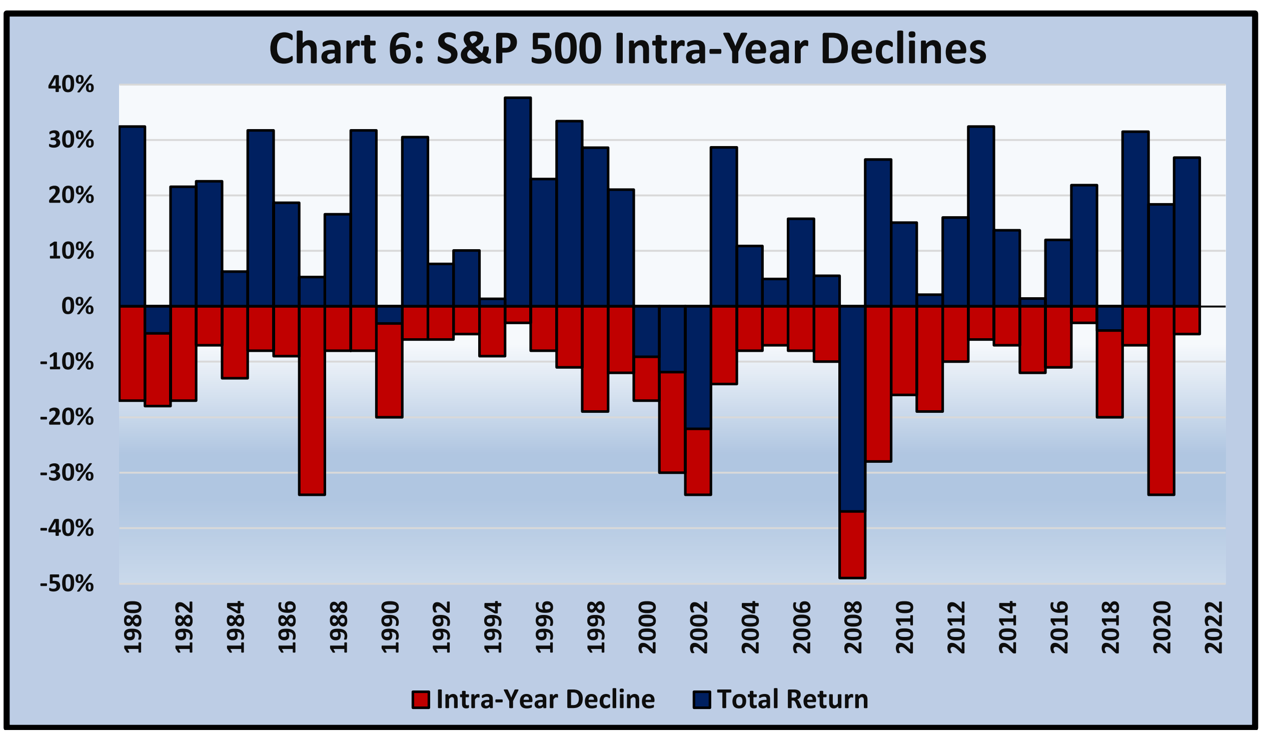
Putting all these pieces together, it doesn't feel like a stretch to suggest that U.S. stock markets can still produce positive returns for the full year. The events in Europe, tragic as they are, seem unlikely to have any lasting impact on profits or dividends of American companies. While the Fed is certain to raise interest rates this week and probably several more times through the course of the year, it's possible that investors have already fully reflected those rate hikes into their valuation work. Stock prices probably haven't hit their point of maximum pessimism – the headlines are still ugly! – but that point may be closer at hand than many investors believe.

At this moment, the S&P 500 index is down 11.0% year-to-date. The equivalent large-cap index for international developed markets, the MSCI EAFE index, is down 11.9%. Investors, in other words, are not yet making any meaningful distinctions between the U.S. and non-U.S. stock markets, apparently believing that the combination of higher interest rates, higher inflation, and the Ukraine war will be just as bad here as in Europe and other major markets. We think that this performance comparison has created an opportunity to shift some money from international markets back to the U.S., and we have done so in relevant client accounts.

Many of our clients have reached out to us in recent days, concerned about the outlook for U.S. stocks. As I noted at the outset, it's human nature to for us extrapolate current trends and quake at the prospect of further losses. But stripping emotion out of the discipline suggests that stock prices could begin to recover in the next few weeks, unless the war in Ukraine explodes into a global conflagration.

In any event, the double-digit decline in U.S. stocks this year is hardly unusual. The red bars in Chart 6 show the largest intra-year decline for the S&P 500 in each year since 1980, while the blue bars show the total January 1 through December 31 return for each calendar year. In 21 of the past 42 years, the S&P 500 had declined by at least 10% at some point during the calendar year – on average, in half of all years. Yet the blue lines show that the market posted a positive return in all but 7 of those years.

*Downturns happen!* When they do, it takes discipline and fortitude to stick with a long-term investment strategy rather than sell in fear. Ultimately, the secret to investment success is not to give in to our fears, but instead to stay the course. *Markets recover!*




Source: BNY Mellon