# INVESTMENT PERSPECTIVES

>>SECOND QUARTER 2022

## Is the dollar mightier than the sword?

**By Michael A. Tyler, CFA**
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When Russia invaded Ukraine, the United States responded with financial sanctions that crushed Russia's economy, even though Russia had been girding itself against such sanctions for nearly a decade. The reason is that the U.S. dollar is still almighty, still the world's singular dominant exchange medium and store of value. About half of all foreign exchange transactions involve dollars, and 60% of all central bank reserves around the world are denominated in dollars. Nearly all international oil sales are priced in dollars.

Ever since Russia was sanctioned following its annexation of Crimea in 2014, President Putin has been trying to insulate his country from its reliance on dollars. He sold half of the dollar-denominated reserves held by the Russian central bank, substituting euros and gold. Some of Russia's oil sales to China are now priced in yuan instead of dollars.

Yet President Putin discovered that "fortress Russia" was hardly impregnable; Russia's exclusion from the SWIFT financial messaging network deeply undermined its ability to conduct foreign trade and rendered its remaining dollar-denominated reserves illiquid and unusable.

No other currency can challenge the dollar today. The euro's apparent importance is inflated by intra-eurozone cross-holdings, but its actual share of global transactions has been fading. The British pound and Swiss franc are too small to matter, and neither the Japanese yen nor the Chinese yuan is held in sufficient volume by other central banks. China's currency is particularly ill-suited to challenge the dollar's supremacy because it is not freely tradeable and its value is not set by market forces. (Don't even *think* about bitcoin as a reserve currency, since it is not typically accepted as a medium of exchange and its extreme volatility makes it a poor store of value.)

It is likely that the yuan can make some inroads in foreign exchange, but so far those gains have come mostly at the expense of the euro, the pound, and the franc. Until more central banks want to hold yuan and until that currency trades freely, it will remain marginal. *Everybody wants to rule the world*, as Tears for Fears knew, but only the U.S. dollar can reign supreme over the global financial system.

>> PERSPECTIVES ON THE ECONOMY

## Despite a hot jobs market, consumers are worried

**By Timothy Garvey, CFA**
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The U.S. economy is running hot, with the strongest jobs market in decades and healthy consumer spending. But you would never know it from looking at consumer sentiment, which is approaching levels of pessimism not seen since the Global Financial Crisis in 2008. Does this data accurately reflect the financial condition and outlook for the U.S. consumer?

The main issue is inflation, which is at levels not seen in four decades. Mounting price pressures, particularly for food and gasoline, have been amplified by the war in Ukraine. Wages are not keeping up with inflation: Average hourly earnings have only increased 5.6% from last year. Consumers know they are losing purchasing power. Approximately a third of consumers expect their financial condition to get worse over the next year. Lower real (after inflation) discretionary income and worsening spending attitudes are potential threats to economic growth.

On the other hand, GDP growth has exceeded 6% in three of the last four quarters. Although unsustainable, this is a remarkable pace. Consumer spending is indeed slowing, but it is still positive. And business investment has been impressively healthy over the past year. The U.S. economy is also significantly less reliant on energy than it once was. The oil supply gap caused by Russia can mostly be closed using the U.S.'s available production capacity. Meanwhile, the labor market is on fire. Monthly job gains have been very strong, and the unemployment rate is the lowest it has been since before the pandemic. Workers are very confident in finding better jobs with higher pay. This is not a recipe for recession, so perhaps consumer sentiment can recover this year.

CONSUMER SENTIMENT INDEX


Consumers are more worried now than at any other time since the global financial crisis.

Source: University of Michigan

>> FOCUS ON EQUITIES

## *Investors adjust portfolios in light of inflation, war, and higher interest rates*

**By Jia Min, CFA**
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*Eastern Bank Wealth Management*

For the second time in three years, events in late February and March have forced fund managers to toss out the investment strategies they had so carefully developed just two months earlier. With elevated inflation, the war in Ukraine and its attendant impact on global supplies of energy and food, and an uncertain Fed policy, investors have had to rethink their analysis and positioning of client portfolios almost day-to-day.

At the outset of this year, we acknowledged that stocks were priced at historically high valuations; we believed a critical factor that would determine 2022 performance would be the interplay between shrinking market valuation multiples and growing corporate earnings. We anticipated a volatile market, which has certainly played out so far. However, the dynamic nature of world events means that the full impact of inflation, war, and higher interest rates will likely take time to work through the global economy. We are highly attuned to the increasing risk of a slower earnings environment over the coming year—an environment that is not currently priced into current market valuations.

Consumers have been gradually depleting the excess savings they accumulated during the pandemic; they are also feeling inflationary pressures on gas, food, housing, apparel, and everyday supplies. The personal savings rate is now back down to pre-pandemic levels near 6.4%. Wages are rising more slowly than inflation. Meanwhile, corporations are testing their ability to increase the prices of their goods to offset the cost pressures from input commodities, freight and shipping, and employee wages. For how long can corporations continue to raise prices? When will higher prices materialize into demand destruction and an earnings recession?

To compensate for this risk appropriately in our clients' equity portfolios, we are taking a slightly more defensive posture. We invest in companies that possess not only the pricing power to pass through inflationary pressures in the near-term, but also a stable earnings profile, relatively inelastic demand, strong capital returns, and a profitability profile that is less adversely impacted by fluctuations in energy and agriculture commodities. We believe these relatively "safer haven" investments will offer us the protection we seek for our clients in these times of turbulence.

>> FOCUS ON FIXED INCOME

## *The Fed can't fight inflation alone*

**By Tom Bussone**
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For the first time since 2018, the Federal Reserve has embarked on a path of raising interest rates – but unlike in 2018, this rate cycle may be both steep and prolonged. Inflation is running extremely hot with the Consumer Price Index hitting 8%; investors are convinced that the Fed will be forced to increase rates at a pace that many were not expecting as the year began. Interest-rate futures suggest that the Fed will take the benchmark fed funds rate to about 2% by year-end, front-loading the process with two half-point moves before the second half of the year.

The debate amongst investors, however, is whether inflationary pressures flow from easy monetary policy and ultra-low rates or from supply chain disruptions. If it is the latter, then raising rates would not help mitigate inflation, but the impact of higher borrowing costs might still slow economic growth. The disruption of Russian and Ukrainian food and energy exports exacerbates the problem.

The Fed is in a bind because it needs supply chains to improve; interest rates alone would not solve the inflation problem. We do expect that the Fed will be aggressive with rate hikes, but we do not think it will sacrifice growth just to push inflationary pressures significantly lower. For now, we think the Fed would be content with just a moderate inflation slowdown. With several rate hikes on the horizon, we are comfortable holding short-duration securities, most notably floating-rate assets, which should perform well in a rising rate environment.

FEDERAL FUNDS RATE


Investors anticipate a steep and prolonged period of rising interest rates.

Source: Federal Reserve, Eastern Bank Wealth Management