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February 28, 2022 – Weekly Notes

Economic Commentary:

Inflation concerns have fallen into the background as geopolitical tensions mount. However, economic fundamentals remain central to investor behavior and inflation is certainly one of the key variables. It is quite possible that the outlook for inflation is easiest economic issue to scope out in the near term, as more disruptions of supply chains can be anticipated from the economic sanctions emanating from Russia's invasion of Ukraine; at minimum, upward pressure on prices will not abate any time soon. Yet, perhaps the more immediate focus of markets is economic growth, company profitability and market stability (i.e. liquidity). The full impact of sanctions will take a number of weeks to be revealed, and the effects will be various and disparate, both at the global macroeconomic growth level and microeconomic company level. Russia is a large country with a surprisingly small economy, representing a tiny amount of direct trade with the US. But in Europe, there are countries like Italy and Germany with substantial interrelationships, and, of course, a heavy reliance on Russian energy exports. India has a large dependence on Russia for fertilizer, Egypt imports large amounts of grain from Ukraine. And, supposedly, Ukraine and Russia together account for 80% of the world's supply of sunflower oil!

In this highly uncertain, largely unprecedented environment, the Federal Reserve is most likely to raise the fed funds rate 25 bps in March, as planned, and then adopt their afore-stated "data-driven and flexible" approach to further increases. US economic growth in 2022 may be better envisioned as being approximately 3%, rather than 4%, especially if the growth hit to European markets is large. The bottom line is that, for the moment, the very large, dynamic, resilient US economy is best expected to continue along an expansionary path.

Data to Watch:

- US Institute of Supply Management Purchasing Managers Index for Feb, released Tuesday, March 1
- Congressional Testimony by Federal Reserve Chairman Powell, Wednesday and Thursday, March 2 and March 3
- US Unemployment Rate and NonFarm Payrolls, released Friday, March 4.

Suggested Reading:

- https://www.wsj.com/articles/u-s-positioned-to-withstand-economic-shock-from-ukraine-crisis-11646083994
- https://www.nytimes.com/2022/02/27/business/economy/price-increases-inflation.html
- https://www.reuters.com/world/europe/putin-forces-germany-step-up-role-global-power-2022-02-27/

Investment Commentary:

Russia's invasion of Ukraine adds new support for persistent inflation and potentially slower growth. It also highlights the importance of energy self-reliance and the challenges of transitioning to renewables. Energy investments returns for several years were weak, including two oil price collapses since 2014. However, Russia and Ukraine are both major commodity producers. Russia produces about 10% of the world's oil, and Russia and Ukraine together account for 1/3 of the world's wheat and 1/5 of the world's corn production, according to the U.S. Department of Agriculture. The price of wheat is up about 18% since the end of January. Bloomberg estimates that Russia supplies roughly 1/3 of Europe's natural gas, while analysis by the Financial Times estimates that Ukraine supplies roughly 1/3 of China's corn. Russia produces about 40% of the world's palladium, a key component for catalytic converters, and about 6% of the world's aluminum. But because Russia also provides the energy for a good portion of Europe's aluminum production, the impact could be even larger on aluminum prices than Russia's market share would indicate.

As uncertainty continues to disrupt markets, investors are seeking safety in government debt, such as U.S. Treasuries and German Bunds, which we consider among the safest global assets. The 10-year Treasury yield has fallen to approximately 1.8%, down from a high of more than 2%, while equivalent German yields declined to 0.1%. However, Emerging Market debt is increasingly a challenged asset class given the potential Russian invasion contagion risks.

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Wealth Planning Commentary:

Inflation's impact on retirement

Inflation has the highest negative impact on retirees who rely mainly on fixed income sources. Income from pensions, annuitized annuity income, and bonds held to maturity lose purchasing power each year. Note that about half of US state pensions link benefits with inflation for some or all their retired workers. Sources of income that typically rise with inflation include Social Security, rental income, and dividends. Over the past 150 years, dividends paid by U.S. companies have grown 3.7% a year compared with 2% inflation.

For most people spending, adjusted for inflation, declines in retirement even when considering medical and long-term care expenses. This is true for all wealth levels.

Generally, inflation does not have as much of an impact on the long-term plan as you may think…unless of course you are dependent on fixed income sources to fund retirement.

Short term inflation is not a reliable predictor of retirement experience. Here is one of many examples: the last time the US saw three or more months with inflation at or above 6% was the fourth quarter of 1990. Soon after this period investors experienced a decade of a 15.9% annualized performance of the S&P which enabled retirees to withdraw a significant amount from their portfolio without negatively impacting their retirement.

For retirees relying on portfolio withdrawals the real problem is prolonged periods of low inflation-adjusted returns or real returns. One of the worst times to retire was in the 1960s: markets were flat, inflation averaged around 3%, and from 1973-1982 the economy experienced very high inflation. During this time retirees who relied on portfolio withdrawals depleted principal far more quickly than they expected to maintain their lifestyle.

We can't know for sure if current high inflation will last and pair with a sideways market. It's important to monitor returns and economic conditions consistently and as frequently as your circumstances may require. We can test your wealth plan against inflation and market scenarios to understand potential weaknesses, adjust and develop contingencies.