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MACROCOSM

War on Two Fronts: Ukraine and Inflation

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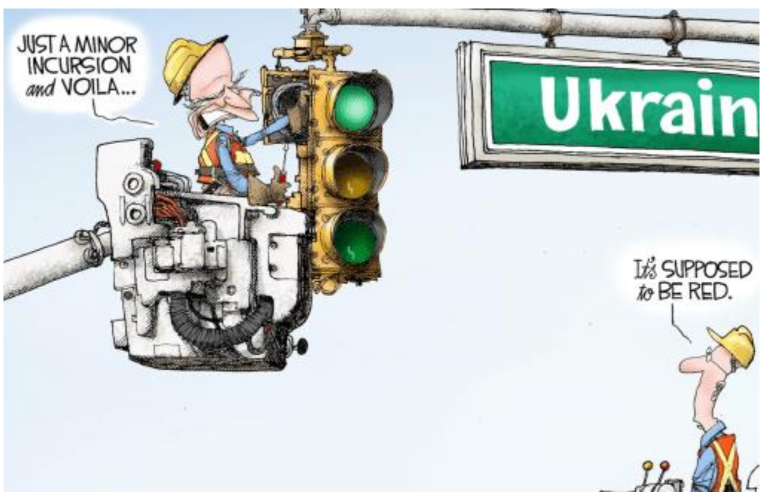
They come together in one bittersweet conclusion: no Fed lift-off in March.

Well, we said value would outperform growth in 2022 (see "Boom On..." January 4, 2022) – and it's happened in spades so far, not just among the few large-cap tech stocks that dominate the indices, but across all capitalization ranges. And we said that energy would be the best-performing US sector, and is it ever – indeed, it's the only sector to be up at all. We're not proud of it, because we sure didn't say it would take *the deepest equity correction since Q4-2020* to get there.

- *Two risks have come to the fore and are playing into each other now*.



- The potential for *a geopolitical shock triggered by a Russian invasion of Ukraine*, and a likely poorly coordinated response from the US, is bad enough.
- But it's all the worse because of the *risk premium it is building into global oil prices*. Bad enough Europe is so reliant on Russia for natural gas, but it also gets about 20% of its crude from Russia, too. European stocks of crude and refined product are near or at record lows, respectively, making this a particularly vulnerable moment to play chicken with a key supplier of key commodities (we'll have a separate report with more detail on the global oil picture tomorrow or the next day).
- Higher oil prices, in turn, *feed into a politicized narrative about inflation* heading into Wednesday's FOMC meeting, *increasing the risk that the Fed will make a policy error by lifting-off from near-zero policy rates too soon and too much, just when market-implied inflation expectations are practically collapsing*.
- Such an error will be all the worse when *the booming recovery from 2020's pandemic lockdowns wobbles in January and February*, as the enormous case-wave of Covid *Omicron-variant infections*

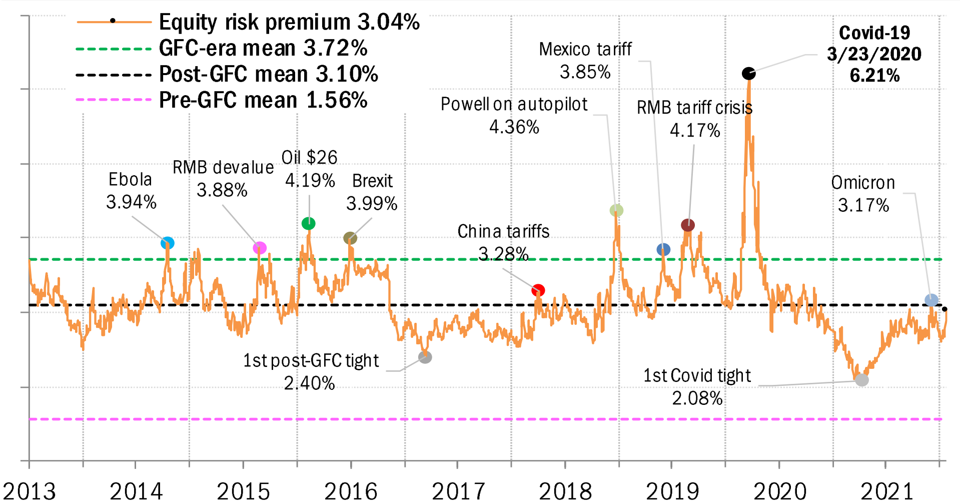
Update to strategic view

US MACRO, US STOCKS, US BONDS, EUROPE MACRO, FEDERAL RESERVE, OIL: An equities correction has been led by growth. Treasury yields and credit spreads are not echoing the risk-off mood. Tensions in Ukraine raise the specter of serious geopolitical risk, and are building a premium into oil prices, which in turn aggravate inflation concerns and the risk that the Fed will tighten too soon. Biden's low approval polling makes him hungry for a win, which points to a face-saving appeasement of Russia. Risk-averse NATO will want to avoid both military options and painful sanctions. The Fed will have to talk hawkish at Wednesday's FOMC because Powell hasn't been confirmed in the Senate yet, and the GOP requires a strong anti-inflation stance. Powell will likely temper it by citing "international stresses." By the March FOMC he will be reconfirmed and politically invulnerable. The Omicron case-wave will likely cause January and February jobs reports to be weak, and inflation and inflation expectations are already dropping. Clear of politics and with data weak, the Fed will not lift off in March.

drives employment absenteeism and reduces re-mobilization.

- That said, market reactions to all this have been very uncoordinated, it seems to us. The underperformance of growth is a classic risk-off symptom. But *Treasury yields didn't fall much in sympathy last week, even after a big back-up in the prior two weeks, and credit spreads barely widened*. Perhaps Mr. Market is saying it's time to correct the relative valuations of growth and value stocks – but that *all the things that seem to be going so wrong in the world really aren't as scary as they may seem*.
- Indeed *we can see ways through the present risks, while we understand why they command a risk premium in the meantime*. That said, because markets have become so uncoordinated, the US equity risk premium is actually narrower now than it was in early December after the Omicron panic (see "Video: What you're not hearing about the Omicron variant" November 28, 2021), even though stock prices are now 3.1% lower. It's because long-term Treasury yields are disproportionately higher – by 40 bp, in the case of the 30-year we use in our equity risk premium model (please see the chart below). *So we're not getting the same relative value assist now, which makes it harder for us to pound the table to buy the dip until the correction runs a little deeper*.

S&P 500 equity risk premium after recovery from the Global Financial Crisis



Source: Various, TrendMacro calculations

- In the meantime, here are our takes on the two big risk factors: Ukraine, and a Fed tightening error.

WHAT CAN WE SAY ABOUT UKRAINE? Russia took Crimea in 2014 (see "Crimea River" March 4, 2014) and China took Hong Kong in 2020 (see "How Worried Should We Be About Hong Kong?" May 28, 2020) and neither made a particular difference to the global economy or to the markets. We think that's because neither drew much of a response from the community of nations.

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[About us]

- This time might be different, because President Joseph R. Biden Jr., is currently the least approved-of president at the one-year mark in the history of approval polling – even worse than Donald J. Trump, who set a pretty low bar for such things.
- Russian President Vladimir Putin is arguably emboldened by this, seeing Biden as – let's be frank here – weak and befuddled, and his administration as uncoordinated. Biden's almost 2-hour press conference last week, which made some of Trump's seem short and snappy, surely feeds such impressions. The press, which normally papers over Biden's gaffes, eagerly reported that he had virtually given Russia a get-out-of-jail-free card on "minor incursions." To be fair to Biden, Russia has been making minor incursions in the Donbas region of Ukraine since 2014.

- *Yet under these circumstances, how could Biden not be desperate for a win, or at least an opportunity to look like a strong leader? We can't rule out the possibility that if Russia were to invade Ukraine, Biden could do something more dangerous than even Trump would have (or, at least, than Trump wanted you to think he might have). It's called "wag the dog."*
- This morning, it's being reported that the Biden administration is "considering" sending "thousand of troops" – well, 1,000 to 5,000 – to Eastern Europe. Not exactly fire and fury, but a small bargaining chip.
- *Obviously we can't know Putin's objectives. But it would seem smart to us for him to exploit Biden's need for a win by wringing concessions from the US and NATO that he could never have gotten from Trump – and letting Biden portray it as a triumph of diplomacy.* Such concessions could be structured with public and private components designed to preserve everyone's dignity, as was the secret agreement to remove US nuclear missiles from Turkey that was, in fact, the key to John F. Kennedy's supposedly

brave victory in the 1962 Cuban missile crisis. In his press conference, Biden already conceded "we could work out" that "there will not be strategic weapons stationed in Ukraine."

- We think NATO is interested in little but appeasement. Biden said in his press conference, "the idea that NATO is not going to be united, I don't buy. I've spoken to every major NATO leader." Yet on Friday Germany blocked an Estonian weapons shipment to Ukraine.
- If appeasement – uh, rather, diplomacy – fails, then military options aren't the first fallback. The go-to response would be sanctions. As Biden put it, Putin has "never seen sanctions like the ones I promised will be imposed." The problem is that, as Biden himself observed later in the same press conference, sanctions such as banishing Russia from the SWIFT global payments system would "have a negative impact on the United States, as well as a negative impact on the economies of Europe."
- The real pain-point through, especially right in the middle of winter, is the fact that Europe gets about 40% of its natural gas, and 20% of its crude oil, from Russia. *We see the biggest risk in an uncoordinated bargaining failure as some combination of a Russian embargo and a European boycott, which would temporarily hobble European (and Russian) economic activity, and jolt global prices significantly higher. Again, we think the recent run-up in oil prices is largely a risk premium in anticipation of at least some likelihood of this happening.*

THE FED'S POTENTIAL POLICY TIGHTENING ERROR All of the foregoing is part of a constellation of reasons why *now would be a bad time for the Fed to tighten policy by lifting off from near-zero policy rates*. We're not worried about tapering asset purchases, or even running off the Fed's balance sheet – despite what seems to be a near consensus to the contrary, the balance sheet no longer supplies any support to the economy or the markets, so ceasing to make it bigger, or making it smaller, is meaningless (see, among many, "Video: What you're not hearing about the Fed's 'quantitative tightening'" January 7, 2022). To the extent that the present risk-off moment is driven by that, then we are very confident that this is a buyable dip. However…

…what worries us is that the money market curve implies a more than 100% probability that there will be lift-off at the March FOMC, which, if it happens, would send the signal that the Fed considers itself "behind the curve" and is eager to get started on aggressively catching up.

- *Despite the certainty of March lift-off implied by markets, we don't think it is going to happen. It's a matter both of politics and of economic reality.*
- *The Fed's rather sudden obsession with quelling inflation is driven by a political frenzy about it, occurring exactly at the moment Jerome Powell is up for Senate reconfirmation as Fed Chair* (see "Jay Powell: Inflation Justice Warrior" December 14, 2021). Powell needs Republican votes to be reconfirmed, and to get those votes he has to participate in Republican narratives, and at the moment

inflation is the most potent such narrative. *Inflation is Covid for Republicans*. By that we mean it is a great public fear that can be blamed on Biden, just as Democrats blamed Covid on Trump.

- *Powell will be confirmed by the Senate quickly, as soon as floor-time can be allocated.* Banking Committee Chair Sherrod Brown (D-OH) said last week it will be "early February," but there is no exact date yet. Technically, Powell's term as Chair ends on February 4. Under the Federal Reserve Act, a sitting Chair can continue in the role without reappointment and confirmation so long as he is a Fed Governor, which Powell is until 2028. So if it has to slip a couple days, so be it – but we think the Senate won't want to have the world's most important economic policy-maker serving under even the slightest stigma.
- *According to sources, we don't expect Powell's confirmation vote will be grouped with votes for Biden's other Board of Governors nominees, one of whom – Sarah Bloom Raskin for Vice Chair of Supervision – is especially controversial* (see "What you're not hearing about Biden's Fed nominees" January 14, 2022). In other words, Powell will not be held hostage to Raskin the way the bipartisan infrastructure bill was held hostage in the House to the Build Back Better bill (see, among many, "Infrastructure Was Just the Easy Part" November 8, 2021).
- *Once Powell is confirmed, he can stop repeating the narrative*, and instruct the other Governors and regional Presidents to fall into line in their public statements. Among other counternarratives, *Fed spokespeople can emphasize the rapid taper of purchases, and the accelerated onset of running off assets* by non-reinvestment of maturing bonds. Again, those measures are without economic consequence, so *it is costless to pretend to fight inflation with them. Under that cover, we think there will be no lift-off in March*.

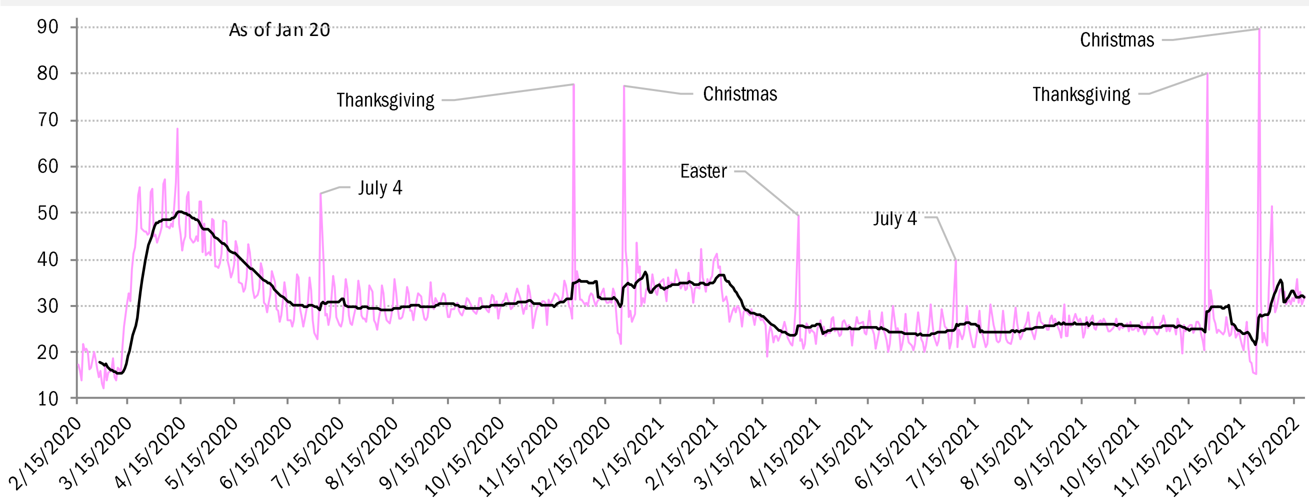
None of this will happen in time for Wednesday's FOMC, which is likely to be hawkishly tinged when it comes to inflation-fighting. Thank goodness a January meeting doesn't require the FOMC to publish its "dots" indicating the future path of the funds rate. It wouldn't be pretty, give the rhetorical requirements of the politics of the moment. *But if we're right that Powell's inflation rhetoric is just political, then a way for him to give a hint of that on Wednesday is to pay special attention to the uncertainty of "geopolitical tensions" or "international stresses"*

- *And by March*, Powell will be politically invulnerable for four years and, just as important, *we think the economy will be showing some signs of short-term weakness* that will be the *coup de grace* for March lift-off.
- Weakness? Wait – aren't we the ones who claim we are in a productivity-lead post-pandemic boom (see, again, see "Boom On...")? Indeed, but within that secular framework there can be some cyclical variation. *We think the data incoming prior to the March FOMC will show a significant slowing both of jobs growth and inflation.*
- There will be two jobs reports before the Fed meets in March – January (released in early February) and February (released in

early March. *We wouldn't be the least bit surprised to see payroll contractions for both.*

- *The reason is the unique dynamic of the Omicron variant of Covid –* extremely large numbers of cases, but with very few fatalities as a share of cases.
- *For jobs, it's the number of cases that matter*. When you test positive for Covid, even nowadays, with Omicron, which generally has very mild symptoms, you nevertheless stay home for a while – you self-quarantine – say five days. That doesn't mean you lose your job, but *anyone who can't work from home can't work at all – and stuck at home you are not participating fully in the consumer economy*, which spills over into employment prospects for others.
- *The Omicron case-wave is as much as fifty times greater than the wave that shut down the economy in Q2-2020.* To be sure, this time governments are not imposing stay-at-home orders on the mass of workers, but with 50 times the cases, Omicron-positives are nevertheless a lot of people, in the aggregate, who are staying at home. This is clear in the TrendMacro Social Distancing Index which made new post-pandemic lows just when Omicron burst into the headlines in December, but now in January, with 1 million cases not an untypical day, immobility has sharply risen, to levels not seen since early 2021 before mass vaccinations (please see the chart below).

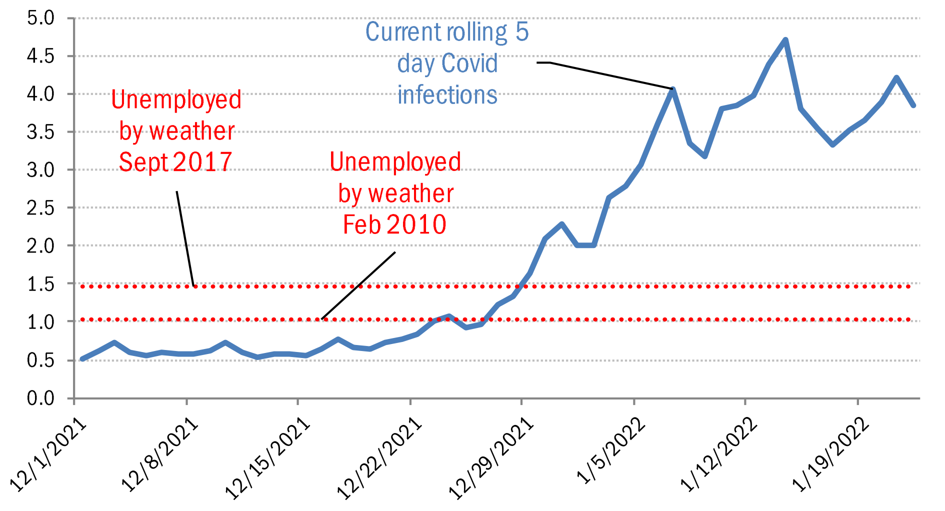
Social Distancing Index from mobility data



Source: Google, after University of Maryland Transportation Inst, TrendMacro calcs

- Perhaps you don't appreciate *the enormous potential magnitude of Omicron-driven absenteeism*.
- Think of each day's new Omicron cases as part of a rolling five-day wave of absence from work. *At peak in the second week of January, it was 4.72 million people – and that's the* "reference week" *used to calculate the January jobs report*. As of yesterday, it was 3.85 million people (please see the chart on the following page).
- We can think of this as similar to the temporary joblessness that occurs after a large weather event – but much bigger. In

Current Covid infections versus peak weather-related unemployment (millions of persons)

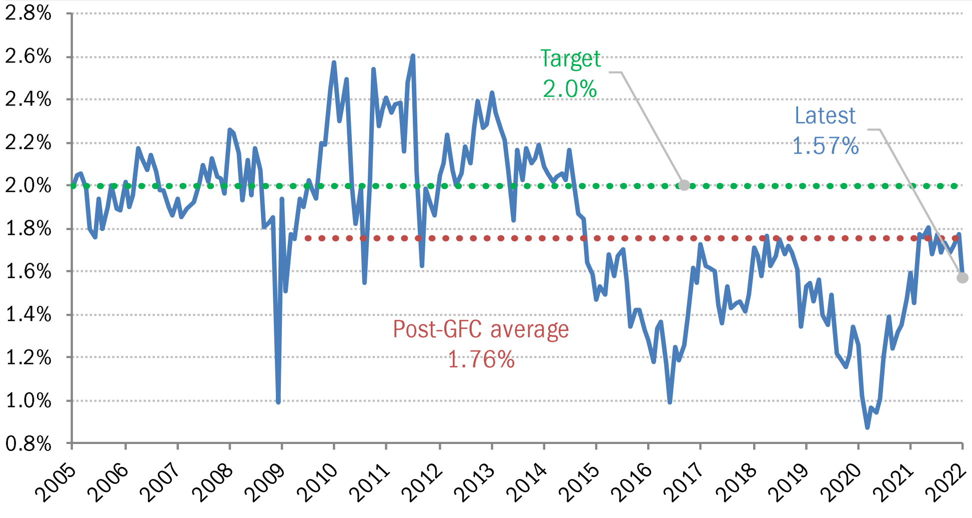


Source: Johns Hopkins, BLS, TrendMacro calculations

September 2017, the month when two Hurricanes – Irma and Harvey – hit. Neither hit in the "reference week," yet 1.47 million were jobless as a result. That's the worst in the history of the data, and that month showed overall payroll contraction in the middle of an expansion as a result – yet January's Omicron absenteeism is more than three times greater. The second-worst weather event was the winter storm activity of February 2010, which left 897,000 jobless. That was another month of overall contraction of payrolls in an economic expansion, yet January's Omicron absenteeism is more than five times greater (again, see the chart above).

- To be sure, Omicron absenteeism can be "sick leave," which creates very different joblessness dynamics than storm-related business interruptions.
- *But the sheer magnitude of Omicron infections insures that there will be an effect on joblessness* – and it's not like the last several jobs reports have been barn-burners anyway (see, among others, "On the December Jobs Report" January 7, 2022).
- *So we think the FOMC will have two weak jobs reports in hand when it meets in March*. Yes, the committee could look through that, just as they would look through temporary weather-related joblessness. *But why take a chance, when the politics of inflation-fighting will have cooled down?*
- *Indeed, there's a good chance inflation itself will have cooled down by the March FOMC*. The committee will have both January and February CPI and PCE inflation data in hand.
- The Ukraine-premium in oil, if it lasts, won't help, and that's been the single biggest driver of the present wave of above-target inflation. But even at today's premium prices, oil is up only 62% year-over-year, as opposed to 134% just three months ago.
- Overall, even as year-over-year CPI has been moving higher on base-effects for the better part of a year, *month-over-month CPI has been declining for the last two months – suggesting that inflation is already slowing down*.

Five-year five-years forward TIPS breakeven (downward adjusted 50 bp for PCE basis)



Source: Bloomberg, TrendMacro calculations

- Perhaps most critical for the Fed, *market-based inflation expectations*, which have remained very well behaved throughout the inflation-scare that started last year, have actually been in decline for seven months, and now *have virtually collapsed* (please see the chart above).
- In his prepared testimony in his confirmation hearing in the Senate Banking Committee last month, Powell's slogan on inflation was "We will use our tools to…prevent higher inflation from becoming entrenched." We'd say that a 5-year 5 years forward TIPS CPI breakeven at 2.07% – which translates into just 1.57% in PCE terms, set against the Fed's target of 2% in those same terms – is "mission accomplished" for Powell.
- *Just what is the argument for lift-off, then?*

Bottom line

An equities correction has been led by growth. Treasury yields and credit spreads are not echoing the risk-off mood. Tensions in Ukraine raise the specter of serious geopolitical risk, and are building a premium into oil prices, which in turn aggravate inflation concerns and the risk that the Fed will tighten too soon. Biden's low approval polling makes him hungry for a win, which points to a face-saving appeasement of Russia. Risk-averse NATO will want to avoid both military options and painful sanctions. The Fed will have to talk hawkish at Wednesday's FOMC because Powell hasn't been confirmed in the Senate yet, and the GOP requires a strong anti-inflation stance. Powell will likely temper it by citing "international stresses." By the March FOMC he will be reconfirmed and politically invulnerable. The Omicron case-wave will likely cause January and February jobs reports to be weak, and inflation and inflation expectations are already dropping. Clear of politics and with data weak, the Fed will not lift off in March.