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May 2022

Colliding demand and supply shocks

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Introduction

Stephen Dover, CFA
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Franklin Templeton Institute

In our last Macro Perspectives, the inflation debate was front and center—that hasn't changed. But the drivers of it have. The war in Ukraine has driven energy and food prices higher, exacerbating COVID-19 supply chain fueled price spikes. I spoke with several of our economists to get their views on navigating the volatile geopolitical environment's impact on markets, and how the policy playbook may change based on growth and inflation expectations. Below are a few highlights of our conversation:

- The food and energy supply constraints from the war in Ukraine will probably exaggerate the inflation peak in the short term. Between now and the US Labor Day in early September, the focus of attention may shift from worries about inflation to worries about the economy.
  Francis Scotland, Director of Global Macro Research, Brandywine Global

- The war in Ukraine shifted the source of inflation from demand-led inflation to a more supply-led inflationary environment. Those are two very different things and require a different type of response from policymakers—including central banks.
  Gene Podkaminer, CFA, Head of Research, Franklin Templeton Investment Solutions

- Nominal rates have increased substantially in specific emerging markets, creating a significant yield advantage for bond investors. Some emerging economies with vast supplies of natural resources are also now benefiting from today's commodity tailwinds. For local-currency bond investors, that can mean positive commodity exposure plus carry.
  Michael Hasenstab, Ph.D., Chief Investment Officer, Templeton Global Macro

- Central banks are never too late in fighting inflation. The problem is the high cost from waiting so long. I've argued that the Fed has been behind the curve now for quite a while. The more behind the curve a central bank gets, the harder it is to bring inflation down.
  Sonal Desai, Ph.D., Chief Investment Officer, Franklin Templeton Fixed Income

- Do we need even tighter monetary policy to slow growth further if growth is already slowing on its own? Incomes are already a lot lower now compared to last year on a nominal basis because we don't have the government stimulus checks. It's even lower on a real basis now that inflation is eroding buying power. Historically, lower disposable income is not a recipe for good growth.
  John Bellows, Ph.D., Portfolio Manager, Western Asset

I hope the discussions in Macro Perspectives better inform your decision-making.

Stephen H Dover

Executive summary

The great collision

The daily news from Ukraine is heartbreaking. Beyond the mounting atrocities, the war and the sanctions imposed on Russia has sent economic ripples across the globe, including soaring commodity prices. War-related oil and natural gas shortages are pushing energy prices sharply higher, along with food prices for essentials like wheat and corn. With consumers and businesses paying more for fuel and food, governments worldwide are now tasked with managing a rapidly accelerating inflationary environment. Should countries hike interest rates to arrest inflation at the risk of slowing economic growth? While the European Central Bank (ECB) is taking a wait-and-see approach, the US Federal Reserve (Fed) has signaled that aggressive monetary tightening is in order.

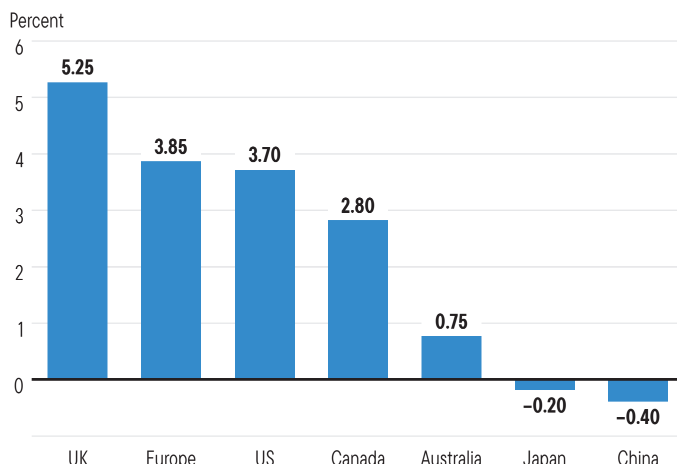
With this backdrop in mind, I recently gathered five of our economists to discuss the economic aftershocks of the war in Ukraine and the path ahead for central banks. Much of our discussion centered on Fed Chair Jerome Powell's notion in 2021 that inflation was merely transitory. In hindsight, last year may now be remembered for what Francis Scotland calls the "great collision"—when a wall of expansionary demand (led mainly by US fiscal stimulus and aggressive monetary policy) met global supply shocks caused by the pandemic. Faced with spiraling prices, Francis Scotland and Sonal Desai believe today's inflation picture is the byproduct of a meaningful policy mistake. They believe the United States didn't need the massive fiscal stimulus of the US$2 trillion American Rescue Plan, passed in March 2021, especially because the Fed was already in full expansionary mode with monetary stimulus and the economy was already rebounding with a robust recovery.

However, not all our economists share this view. John Bellows began the year expecting growth and inflation would moderate by now. Few economists could have predicted Russia's invasion of Ukraine and the global impact on commodity prices. For Michael Hasenstab, the war is a hazardous accelerant adding more fuel to preexisting inflationary trends. Gene Podkaminer thinks the war's supply-driven shocks require different responses from policymakers; one example is state-level gas tax holidays, as demand-driven inflation is supplanted by supply-led inflation.

Current inflation leading to diverging monetary policy

Exhibit 1: Expected consumer price inflation relative to target inflation rate (Q4 2022)

As of April 26, 2022



Sources: Analysis by Franklin Templeton Institute, Bloomberg, Bank of Canada, European Central Bank, National Development and Reform Commission of China, Reserve Bank of Australia, Bank of Japan, Bank of England, US Federal Reserve, Macrobond. The chart represents the difference between the expected consumer price inflation rate for Q4 2022 (as per the surveys conducted by Bloomberg) and the monetary policy's prevailing targeted inflation rate. The inflation forecasts are submitted by various banks to Bloomberg. Central bank targets are defined as: US—Core Personal Consumption Expenditure Inflation; Canada—Total Consumer Price Index; Europe—Monetary Union Index of Consumer Prices, All Items; UK—Consumer Price Index, EU Harmonized; Japan—Core Consumer Prices Index; Australia—Consumer Prices Index; China—Consumer Prices Index. Important data provider notices and terms available at www.franklintempletondatasources.com. There is no assurance that any estimate, forecast or projection will be realized.

The pandemic recedes

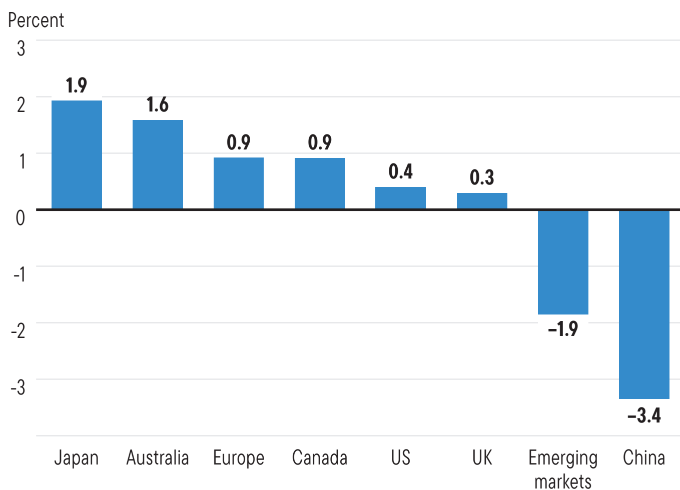
John Bellows' view that inflation trends are partly moderating on their own in the United States is based on the idea that the pandemic and large fiscal stimulus are largely behind us. John walked us through the positive changes he's seeing across supply chains, wages and housing. In terms of the growth picture, John thinks the US economy has the potential to slow down on its own, without much tighter monetary policy than the market currently expects (i.e., several 50 basis-point rate hikes this year). He reasons that US consumer incomes are a lot lower this year on a nominal basis because the federal government is no longer providing COVID-19 stimulus checks to individuals. And now with the war in Ukraine, accelerating inflation is eroding real disposable incomes. Historically, lower incomes are not a recipe for good growth. Consumers with less expendable income erode demand and make businesses more hesitant to hire. Therefore, inflation can end up being a self-defeating process that dampens growth, rather than a self-propagating one.

Gene is largely of the same thought as John, and notes that although US growth is certainly slowing, it's not slow enough to call it an economic stagnation. Rather, growth is still positive—not negative—and simply reverting to its previous trendline. Is this a disaster? Gene doesn't think so. In this scenario, the Fed may have less tightening to do. With inflation weakening consumer spending, growth may moderate on its own without the need for more aggressive rate hikes. That said, inflation is quite high right now, and it's important that the Fed sound sufficiently hawkish.

Above trend growth in developed markets

Exhibit 2: Expected GDP growth rate relative to 20-year trend (Q4 2022)

As of April 26, 2022



Sources: Analysis by Franklin Templeton Institute, Bloomberg, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com. There is no assurance that any estimate, forecast or projection will be realized.

Second-round effects

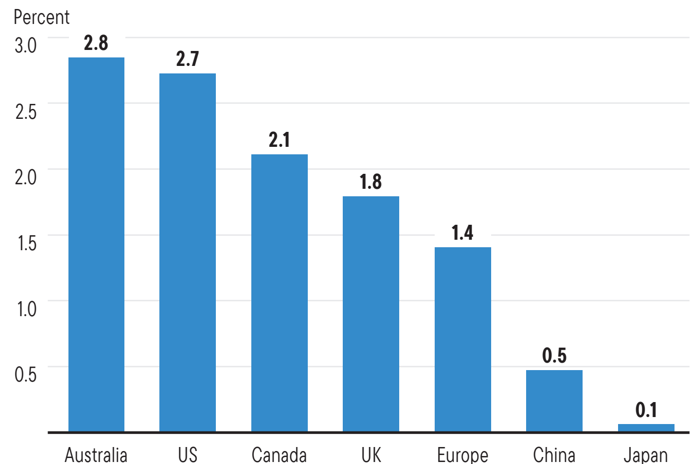
Sonal thinks the massively accommodative policy lasted too long and laid the foundation for a dangerous wage-price spiral to potentially take hold. Given higher energy and food costs, we could see workers demanding higher wages. This can produce "second-round effects" that bestow price-setting companies and wage-setting labor with incentives to increase consumer prices and wages. Sonal points to tangible factors like higher fuel prices and rent inflation from a red-hot housing market that are potentially making goods and services far more expensive. This dynamic dovetails with Michael's economic research that shows labor shortages and the indexation of wages tend to produce more permanent inflation. If these effects take hold, the Federal Open Market Committee (FOMC) will likely need to push interest rates much higher, potentially upending the soft economic landing many are hoping for. Currently, the Fed's expected "neutral" rate, the fed funds rate that neither fuels nor restricts economic activity, is around 2.4%. Now that inflation appears persistently higher than some market observers care to admit, Sonal thinks a more forceful approach to pushing inflation downward may be needed.

For Francis, the prospects of a wage-price spiral, while dangerous if it happens, are less likely since the US monetary policy's dramatic 180-degree pivot toward tightening. In his view, the Fed made a major blunder in 2021 by thinking inflation was merely transitory. Now even Lael Brainard, who is on the Fed's board of governors, appears to be drinking some newly hawkish Kool-Aid. Francis quips that perhaps Brainard's change of heart came because she does drink Kool-Aid and noticed that Kraft had increased its price by 20%. It's ironic that just as the Fed is embarking on a more hawkish trajectory, the real economy may be already slowing.

Developed markets expected to see accelerated rate hikes

Exhibit 3: Expected rise in policy rate (12 months forward)

As of April 25, 2022



Sources: Analysis by Franklin Templeton Institute, Bloomberg, Macrobond. The chart represents the difference between the market-expected interest rate over the next one year and the monetary policy's current policy rate. Important data provider notices and terms available at www.franklintempletondatasources.com. There is no assurance that any estimate, forecast or projection will be realized.

Opportunities outside the United States

For investors looking for opportunities outside the United States, Michael points out that central banks in Latin America have already been quite hawkish, increasing nominal rates significantly prior to the war. Additionally, countries like Brazil and Chile are also rich in natural resources, such as energy-related metals and agriculture. This means they stand to benefit from strong commodity tailwinds, which have only increased in the wake of Russia's invasion.

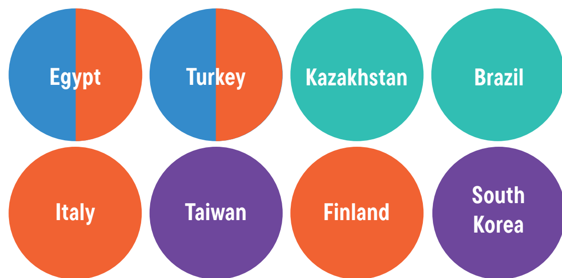
For investors, select Latin American economies offer the benefits of commodity exposure plus higher yields (i.e., carry). Typically, one might think of Latin America as a region that would sell off in risk-off environments. But earlier this year, the reverse was true due to the unique dynamics of hawkish emerging market central banks and a new commodity supercycle.[1]

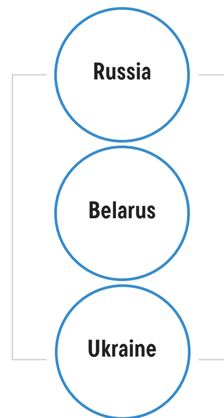
One area of the globe that we'll dive into more deeply in our next Macro Perspectives is China. With lower vaccination rates and a zero-COVID policy of city-wide lockdowns, China has the potential to dent global growth and disrupt just-in-time supply chains. It's entirely possible we'll see more companies and governments relocate some, or all, of their supply chains back onshore.

Shifting commodity availability is reorienting global trade flows

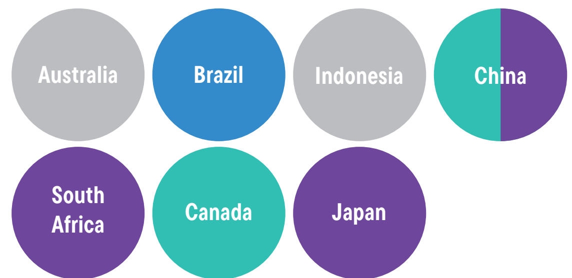
Exhibit 4: Impact of Russia/Ukraine war on selected countries
As of 2019

Countries negatively impacted





Countries positively impacted



Selected key imports
Agriculture, Fertilizers, Base metals, Neon gas, Coal

Sources: Analysis by Franklin Templeton Institute, Observatory of Economic Complexity (OEC). The countries selected are for illustrative purposes only. There could be more countries affected directly or indirectly by these specific commodities.

Wildcards—worries and optimism

Here are some key themes our economists are watching closely:

Supply-driven conundrum
The war in Ukraine is shifting inflation from a more demand-driven event (i.e., fiscal stimulus) to supply-driven commodity shortages—leading to potential global food shortages. One big problem: monetary policy can't boost commodity supplies.

European recession
A 2022 recession in the United States appears unlikely, but it's possible in Europe given its dependence on Russian natural gas. As the implications from the war escalate, prospects for a more painful energy shock are increasing.

Hard landing
Soaring energy and food prices ("Putin's inflation") could accelerate a classic wage spiral, making goods and services more expensive. The Fed's monetary path toward a "soft landing" is clearly shrinking.

Latin America
While the Fed was slow to raise rates, hawkish central banks across Latin America and Asia raised interest rates during 2021 and into 2022. We believe this nicely positions their economies for the new commodity supercycle.

Zero-COVID quagmire
China has intensified its zero-COVID policy of extreme city-wide lockdowns amid low vaccination rates. This increases the prospect of heavy economic damage, not only for China but global supply chains.

Expanded viewpoints from the roundtable

The great collision

Francis, what are the implications of the war in Ukraine on global inflation and growth?

Francis: We entered 2022 in the wake of a great collision between expansionary policies. On one hand, federal stimulus in the United States resulted in a boost to demand, while the pandemic constrained global supply. Russia's war, in my view, has exacerbated the supply constraint we were already grappling with, and caused sustained higher inflation. I think the war is intensifying and extending many of the macroeconomic trends we saw in 2021 into this year.

In hindsight, what looks like a colossal US policy mistake could be followed this year by a significant hangover. In my view, the United States didn't need the Titanic-sized fiscal stimulus of the US$2 trillion American Rescue Plan, passed in March 2021, especially because the Fed was already in full expansionary mode with monetary stimulus.

The United States came flying out of 2021 with booming nominal gross domestic product (GDP) growth. But even before the year ended, the real economy was slowing rapidly because real purchasing power of households and businesses was being eroded by the rise in prices and inflation.

Michael, how do you view the political and economic impacts of the war in Ukraine on the European Union (EU)?

> **"There are many economic implications from the war, but certainly the impacts on food and energy markets are significant. I think the food implications are going to be felt for some time. Ukraine was the breadbasket for most of Europe. Ukraine has not been able to export commodities and farmers have been unable to plant for next season."**
>
> Michael Hasenstab

Michael: The geopolitical landscape in Europe has been meaningfully altered by the invasion of Ukraine. This is a unifying moment for the West after years of challenges to the coalition. We're likely to see more European unity in the years ahead and a renewed commitment to NATO across the continent. There's a recognition that despite some ongoing differences among countries and some drifting apart in recent years, each country is stronger as a cohesive unit. There will also be a move toward greater energy independence for Europe. It cannot be changed overnight, but the course of the next five to 10 years of energy policy is likely to shift substantially. Germany had advocated a policy stance of "peace through trade" for decades, leading to the expansion of its energy partnership with Russia for both economic and security reasons. Those beliefs have been splintered by Russia's breach of Ukrainian sovereignty.

Regional proximity to the conflict in Europe correlates with a higher magnitude of impact from the economic and humanitarian crisis. Europe will likely continue to see the most significant economic consequences, with other regions such as Asia and Latin America seeing more variation among individual countries depending on varying linkages to impacted sectors. Generally, the magnitude of impact dissipates based on distance from the epicenter of the crisis in eastern Europe.

There are many economic implications from the war, but certainly the impacts on food and energy markets are significant. I think the food implications are going to be felt for some time. Ukraine was the breadbasket for most of Europe. Ukraine has not been able to export commodities and farmers have been unable to plant for next season. So, this isn't just an effect that we feel this year, but it's an effect that I think we are going to feel into 2023. The demand for alternative grains and soybeans is evidence that the reduced supply will have a big ripple effect, and it's putting additional inflation on top of preexisting inflationary trends. Many of these dynamics are accelerants of inflation that were already underway—and now they have made it worse.

The war's impact on energy markets has obviously had a significant impact as well, and that probably poses one of the biggest risks to broader markets. If the war continues to

escalate, natural gas could be shut off to Europe, posing huge economic risks. Having energy reliance on a place like Russia highlights broader concerns about globalization. I think the trend toward regionalization, which was already underway before the war, has been further exacerbated by the war. So, we expect to see greater economic regionalization as one of the war's consequences.

Sonal, how do you see the war impacting EU trade relations, particularly in relation to the energy supply?

Sonal: The economic impact of embargoes, sanctions and the contraction of the Russian economy will be a significant headwind on EU growth for the next several quarters, but with important differences across EU countries: Central and Eastern Europe (CEE) and Baltic countries trade significantly more with Russia, while among the "big4" countries Germany and Italy have more trade exposure to Russia than France and Spain. The energy channel is the most relevant and impactful, as the EU is highly dependent on Russian energy supplies—accounting for approximately 38% and 23% of its total gas and oil imports, respectively, in 2020.[2] Energy dependence on Russia varies substantially across member countries in terms of both the import share (adjusted for intra-EU re-exports) and gas intensity in primary energy use. When taking both into consideration, Germany and Italy appear most dependent on Russia among the "big4" countries.

Gene, what's your take on last year's collision between fiscal stimulus and supply shocks and this year's war in Ukraine?

Gene: Although inflation was difficult to forecast due to COVID-19, I believe it was largely demand-led in 2021. A lot of people wanted to buy a lot of stuff, and it was hard to deliver that stuff given supply chain disruptions, to put it in simple terms. The war in Ukraine shifted the source of inflation from demand-led inflation to a more supply-led inflationary environment. Those are two very different things and require a different type of response from policymakers—including central banks. The interest-rate environment was relatively benign in the United States and Europe over the past couple of years. And, as we saw recently in reading the latest FOMC meeting minutes, there's now a more hawkish tone. There are now market expectations of quantitative tightening and interest-rate hikes that could be 50 basis points, multiple times this year.

> **"We are already in a stagflationary environment—potentially below-trend real economic growth with above-trend inflation. The food and energy supply constraints from the war in Ukraine could exaggerate the inflation peak in the short term. My view is that worries about inflation will shift more toward worries about the economy between now and the US Labor Day in early September, given that the Fed is only now starting to drain the punch bowl."**
>
> Francis Scotland

From a supply chain perspective, in addition to what Michael talked about with agriculture and energy markets, the war is starting to impact many different sectors and industries—some of which are only tangentially related. For example, wiring harnesses from Ukraine go into autos, and neon gas from Ukraine goes into semiconductor production. All these seemingly unrelated areas could augur a retrenchment from global just-in-time supply chains to more regionalized just-in-case supply chains. Clearly, the world's supply chains need to be more robust and less brittle, perhaps with a bit more onshoring as well.

Francis, you've said we face elevated risks of stagflation. How will this impact US policy responses?

Francis: The last two quarters of real final sales—that's looking at GDP without inventories—slowed to a 2% annualized rate, according to our assessment of US Bureau of Economic Analysis' national economic accounts data. Real GDP expanded at a roughly 1% annualized rate in the first quarter of 2022. Looking at other economic indicators, US real retail sales have been flat and durable capital goods orders, in real terms, have also been flat since last September. Real disposable income has been contracting since March 2021. In other words, the real economy has already slowed very significantly. All of this deceleration has taken place even before the Fed's 180-degree pivot in policy stance.

We are already in a stagflationary environment—potentially below-trend real economic growth with above-trend inflation. The food and energy supply constraints from the war in

Ukraine could exaggerate the inflation peak in the short term. My view is that worries about inflation will shift more toward worries about the economy between now and the US Labor Day in early September, given that the Fed is only now starting to drain the punch bowl.

Gene, before Francis talks about the Fed's pivot, explain growth versus "real growth" after inflation.

Gene: Absolutely. Nominal growth is top-line GDP growth without adjusting for the effect of inflation (simply reflecting current prices). Real growth is corrected for inflation, taking into account the effect inflation has had. For example, if we've seen nominal global growth of 4.4% over the last year, and we've also seen inflation as measured by the Consumer Price Index (CPI) at 4.4% over the same period, then real global growth is zero. So, the difference between nominal growth and inflation gets you real growth, which is important.

Looking at nominal growth, the momentum is slowing, but not necessarily what we'd consider to be economic stagnation. Our view is US growth is slowing to trend. I want to deconstruct that sentence because the components are important. Growth is slowing, but it's still positive and not negative. Trend growth in the United States over the past 20 years has been healthy, but not a gigantic number (sure, we've all wished for higher). And this is important because we're not saying that growth is slowing to zero, but rather, slowing back to trend. The US growth trend starts at two-and-change-percent GDP growth, and that's down from the fours and the fives that we've recently seen. Is it a disaster? I wouldn't call it that.

Thanks Gene. Francis, back to you and the Fed's big pivot on rate hikes.

Francis: The Fed's pivot is significant because, in my view, the Fed administration made a major blunder by hanging onto the "transitory" story most of last year. Now, everybody on the Board seems to have flipped and gone completely hawkish. Even Fed Governor Lael Brainard, who remained stubbornly in the "inflation is transitory" camp, is drinking the new hawkish Kool-Aid—ironic, since Kraft recently raised the price of this popular powdered drink by 20%. Her change of view highlights the extreme switch in the Fed's attitude with respect to inflation and the need for tighter monetary policy, just as the real economy is already slowing.

So, in my view, the first leg of the economic hangover has already started with a meaningful slowdown in the real economy. If nominal GDP growth is still at a peak, it's only because of a high inflation level. With the real economy slowing, and a Fed that becomes as hawkish as it sounds, we may see a fed funds rate at 1.5% or higher by Labor Day in early September along with a smaller balance sheet. By then, the focus on the outlook may turn out to be less on inflation and more on the economy itself.

COVID-19 recedes

John, what is your outlook on growth, inflation and monetary policy tightening?

John: Thanks, Stephen. The last time we spoke, our team expected to see growth and inflation moderating in early 2022. In our view, a lot of the inflation in 2021 had pandemic-related forces behind it, and as the pandemic receded, we anticipated those forces would normalize. Thus far, growth has been decent, while inflation's been sticky on the upside—I compliment Sonal for forecasting the sticky inflation. We continue to see a compelling case for growth and inflation to moderate. The pandemic appears to be moving further and farther behind us.

Therefore, we are also moving away from the fiscal support spurred by the pandemic and some of the supply-related constraints. As discussed, we now have substantially higher energy and food prices tied to the war in Ukraine, which points to higher inflation. Higher inflation is a growth risk because it erodes real disposable incomes, which can slow growth. We haven't gotten the inflation moderation we expected to see early in 2022 and inflation accelerated by the war adds to growth risks on the downside.

> **"In our view, a lot of the inflation in 2021 had pandemic-related forces behind it, and as the pandemic receded, we anticipated those forces would normalize. Thus far, growth has been decent, while inflation's been sticky on the upside—I compliment Sonal for forecasting the sticky inflation. We continue to see a compelling case for growth and inflation to moderate. The pandemic appears to be moving further and farther behind us."**
>
> John Bellows

What impacts are you seeing in supply chains, US wages and housing?

John: I'll discuss these three pandemic-related factors and explain how each is receding. First, let's look at supply chains. We all know the story of auto production and shortages of microchips causing a sharp rise in auto prices last year. The auto price increase was a big contributor to the CPI, but it looks like we may have turned the corner. Auto inventories have been going up and used car prices are starting to come down. It's not happening in any one month, but it is happening.

Next, let's look at US wages. The labor market has been very tight—with high wage gains, high resignation rates and very high levels of job openings. These are tentative signs that peak tightness may be behind us, in my view. Resignation rates have come down a little bit, while job openings are coming down and labor-force participation rates are going up. It appears that the growth of wages may have moved past its peak. Specifically, if you look over the last six months, you see a declining trend in average hourly earnings. So, the labor market was very tight, but as we go forward that's unlikely to persist, and it may already be loosening somewhat.

Last, a lot of pandemic-specific factors impacted housing. Last year, everybody wanted more space at home, and many people wanted to move to different locations because of the ability to work remotely. This also coincided with the US government's dissemination of checks to individuals. There was a sudden rise in demand for housing and not enough supply to keep up.

Since then, housing prices have moderated month-over-month. Moreover, housing supply is expected to increase over the remainder of the year. Single- and multi-family housing supply are both up recently. Single-family construction is up approximately 50% in terms of construction volumes relative to February of 2020.[3] We also have higher mortgage rates now, which will slow house price appreciation. So, housing shortages seem like a pandemic-specific thing, very significant to be sure, but unlikely be repeated again this year, in our view. Overall, a lot of what happened in 2021 was unique to the pandemic and is unlikely be repeated this year.

Against this backdrop of growth and inflation moderating, are markets underestimating the magnitude of the Fed's hawkish pivot?

John: I think you've hit on the important point, which is the interaction between monetary policy and growth. Most standard economic models suggest that monetary policy works through growth. Raising interest rates reduces the amount of economic activity by disincentivizing borrowing, for example. This takes some demand out of the economy, which in turn lowers inflation. That's the traditional way that monetary policy affects inflation—by moderating growth.

So, really the question is, how much is growth going to slow? Do we need even tighter monetary policy to slow growth further if growth is already slowing on its own? Incomes are already a lot lower now compared to last year on a nominal basis because we don't have the government stimulus checks. And they are even lower on a real basis now that inflation is eroding buying power. After inflation, real disposable income is a lot lower today. Historically, lower disposable income is not a recipe for good growth. Indeed, it's a recipe for slowing growth. Consumers with less expendable income make businesses more hesitant to hire, which can also slow growth.

If growth and inflation moderate on their own, then inflation ends up being a self-defeating process that dampens growth, rather than a self-propagating one. The Fed may not need to take steps to force growth to moderate if it's moderating on its own. Maybe you see this in terms of a fewer number of rate hikes, but I also think you would see their rhetoric shift. Right now, inflation is high and Americans want the Fed to fight inflation. So, the Fed sounds hawkish. And in some sense, that's the easy thing to do. However, if growth is already moderating and inflation is falling on its own, it starts to become a lot harder for the Fed to maintain a uniformly hawkish message. You may start to hear policymakers talk about growth risks. Right now, a substantial amount of hikes are priced into the front part of the US Treasury yield curve. That could be right. But if growth moderates, the Fed may change its tune.

Second-round effects and opportunities outside the United States

Sonal, you view the Fed as behind the curve and late to tackling inflation. What is your take on John's scenario?

Sonal: Central banks are never too late in fighting inflation—as long as they are willing to tighten monetary policy enough. The problem is the high cost from waiting so long. I've argued that the Fed has been behind the curve now for quite a while. The more behind the curve a central bank gets, the harder it is to bring inflation down. At the end of the last Fed meeting, the Fed Chair's comments were interpreted by some as hawkish when all he did was validate market pricing of seven 25 basis-point rate hikes over the course of a year. At the time, I thought the interest rate hikes weren't

nearly enough. Since then, the Fed's rhetoric has become a bit more hawkish, with talk of potentially a few 50 basis-point rate hikes. These rate hikes are needed at a bare minimum. Inflation expectations have already risen significantly, and we see the beginning of a wage-price rise spiral—bringing inflation back under control will be a lot harder now. The Fed can do it, but I believe it will need to tighten policy more than it's currently planning, and more than markets expect even now.

When I think about unpleasant inflation arithmetic, I do a very simple calculation. I look at the current amount of inflation, and I look at what's baked into assumptions about year-end inflation. Over the last 12 months, inflation has averaged 0.7% month-on-month.[4] If it keeps running at this pace, we will end the year with inflation of around 9.5%; even if monthly inflation drops to a much lower 0.4%, we would still end the year at about 6.5%. This means real interest rates will remain substantially negative for the rest of the year, which means monetary policy will remain expansionary. The Fed still seems to assume that inflation will come back to target by itself; I don't think it will, I think the Fed will have to tighten even more.

To Gene's prior point, soaring energy and food costs from the war accelerated inflation. Do rate hikes solve this supply-led inflation?

Sonal: When it comes to supply shocks, monetary policy can't address those directly. But it can address the second-round effects that those supply shocks produce. Like Francis, I think the 2021 US fiscal and monetary stimulus lasted way too long and laid the seeds of what could be a dangerous wage-price spiral. I also agree with John—we are not there yet.

> **"When it comes to supply shocks, monetary policy can't address those directly. But it can address the second-round effects that those supply shocks produce. Like Francis, I think the 2021 US fiscal and monetary stimulus lasted way too long and laid the seeds of what could be a dangerous wage-price spiral. I also agree with John—we are not there yet."**
>
> Sonal Desai

We don't have a full-fledged wage-price spiral yet. But we are seeing the early signs of one. As workers see escalating prices at the gas pump and at grocery stores, they will demand higher wages. And are companies able to offer them? So that's one reason why I continue to have concerns about the legs that inflation could have. Monetary policy can't directly solve the energy supply shocks from the war in Ukraine. But to the extent that we see second-round effects of a wage-price spiral, you'll find that inflation could last much longer—and that's something that tighter monetary policy can address. Unfortunately, that may require an economic slowdown. So, the soft landing that everyone talks about will be harder to engineer in the current environment than it might have been in 2021.

Michael, your team's economic research supports Sonal's concerns over a wage-price spiral. Can you elaborate and share where you see opportunities?

Michael: It's important to note that inflation dynamics currently vary country by country quite dramatically. Some places are getting a pure energy shock, causing a temporary inflation spike. In places like the United States, we think the inflation drivers could have more permanence, which we wrote about last year.[5] When we look through US history, or more contemporarily at other countries in the world, when inflation is primarily driven by labor shortages and the indexation of wages (i.e., a wage-price spiral), inflation tends to be more permanent.

It's also important to remember that inflation dynamics have been very different globally. Many countries were very aggressive at responding to the early stages of inflation. Typically, you would see the world following the Fed. But in this case, other parts of the world saw inflation go up and responded, with central banks making very proactive and aggressive interest-rate hikes—well in advance of what the Fed only recently started talking about. I think this creates a lot of opportunities as an investor if you go outside the United States.

In countries like Chile, for example, aggressive central bank hiking in 2021 increased nominal rates quite significantly, providing bond investors with a significant yield advantage. Additionally, some emerging economies with vast supplies of natural resources are now benefiting from today's commodity tailwinds, which Russia's invasion of Ukraine magnified. For bond investors, that can mean positive commodity exposure plus carry. Some investors see Latin American economies as risk assets that sell off in turbulent

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>
> Gene Podkaminer

macro environments. But last year, we saw the reverse, because of these unique dynamics. The same applies to parts of Asia with relatively higher growth, relatively better fiscal accounts, relatively better trade accounts, and relatively higher rates versus Europe or the United States.

Gene, where do you see opportunities over a three- to five-year time horizon and what factors does your team monitor?

Gene: It’s important to mention that at the top line and across all the different asset classes that we look at around the world, we’ve reduced risk based on the greater uncertainty with wages and supply-led inflation. Also, different countries are reacting to inflation differently.

And that moderation at the top line also means we’re reshuffling portfolio components. Within equities, we see opportunities in the United States, Canada and Japan, but for different reasons. In the United States, consumer and corporate balance sheets are the main driver. Canada benefits a lot from the US and the commodity story. And Japan is a region where we’ve seen strong growth and attractive monetary policy, in addition to attractive sector exposures.

We’re still examining the impact of China’s zero-COVID policies and the impact of those lockdowns on global growth and supply chains. We are also analyzing relatively restrictive monetary policies coming out of the People’s Bank of China. So, we’re not as optimistic on that market. Regarding Europe, the region faces some real headwinds from higher energy prices and inflation uncertainty around the war.

Consequently, that’s caused us to shift around our equity portfolios a bit to favor regions that have parameters that are really primed to either deal with inflation or to help with growth. In fixed income, we see opportunities in sovereigns and a bit in corporate credit, including select emerging market debt. And in thinking about duration, we’ve been taking that risk down as well. We’ve seen volatility in both the equity markets and the fixed income markets, so really, there’s nowhere to hide.

Commodities have seen a meteoric rise over the last couple of quarters. And if you track commodities over long periods of time, say since the 1960s or so, you’ll see that when inflation spikes the way it is now, commodities tend to perform well, because they are tied to what happens in the real economy. The challenge is that during those periods of benign inflation, commodities don’t perform well. An investor pays a premium for holding them in benign inflation environments, but when a dislocation or market shock happens, commodities act as sort of an insurance policy. It takes a bit of nuance to figure out how to structure that into a portfolio that makes sense, depending on the desired goals and risk tolerance. Commodities are not a panacea though. They have real risks and can be very volatile, and there are many times when commodities will likely detract from performance as well. That’s why the belief that investors will be protected by holding commodities in an inflationary environment isn’t always true.

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1. Commodity supercycles are generally defined as extended periods of boom and bust in the commodities markets, with prices falling significantly above or below their long-term trends. These movements may even outlast the business cycle and typically persist for well over a decade.
2. Source: Eurostat.
3. Source: US Census Bureau.
4. Source: Bureau of Labor Statistics. As of March 2022.
5. Source: Global Macro Shifts, “The inflation debate: Will price pressures persist or start to recede?,” November 4, 2021.

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