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Key Takeaways

- Global risks are indeed elevated. Yet, with inflation and volatility also at elevated levels, price signals become less reliable. The risk of making bad investment decisions has exploded higher.
- Another danger lies in investor complacency — refusing to change portfolio strategy to align with the new macro fundamentals of higher inflation and higher interest rates.
- Be alert to alternate scenarios, other than the ominous prognostications currently in heavy supply. Putin has unintentionally created a most rare thing in today's polarized world: a consensus. Unity is bullish for global growth

ASK FORSTRONG:

Risk seems to be increasing everywhere, with ongoing Russian attacks, a renewed China lockdown and central banks determined to raise interest rates. What should investors do here?

These are dark days. Noam Chomsky, the well-known intellectual and nonagenarian, warns the world that we are "approaching the most dangerous point in human history." A never-ending vista of dystopian images haunts the public consciousness: terror in the suburbs of Kyiv, Ukrainians preparing for an Eastern attack by piling sandbags along the beaches of Odesa and — bringing back memories of the early 2020 Wuhan lockdown — surreal photos now show Shanghai, the world's third most populous city and largest port, at a standstill. None of us can be completely impervious to all this.

Meanwhile, financial markets have darkened too. Consumer prices in America are rising at their fastest clip since 1981. The Bank of Canada, evidently no longer tiptoeing but moving in leaps, just blasted the market with their first super-sized 50 basis point rate hike in 22 years. Across the Western world, yield curves are threatening full inversion. By many measures, this economic expansion seems to be galloping toward its own expiration.

Sentiment is gloomy too. Bank of America's widely followed fund manager survey breathlessly tells us that global growth expectations plunged to an all-time low of net -71%. That is as bearish as it gets. A recent Bloomberg headline captures the mood best: "there's a bull market in macro doom."

The first impulse for many investors may be to run for

the hills. Yet there is a big problem with that strategy today. With inflation and volatility all at elevated levels, price signals become less reliable. The usual economic dashboard is blurry and distorted. If lockdowns did not break the rhythm of clear thinking, this will. That means humans start to make bad decisions.

Discipline is difficult to sustain under these conditions. And so a certain haste to toll the bell — to run for cover too soon — becomes a key risk. That may yet be proved right. But we are struck by the quantifiable data that suggests otherwise. The reality is that real interest rates across the Western world remain deeply negative. The US 10-year treasury bond yield is currently burrowed at the subterranean level of -5.9%. That makes a conservative posture in cash or government bonds a risky proposition (in the words of our new and erudite member of our investment team, Terry Shaunessy: "holding cash is a short position").

Looking ahead, humans will continue to be fascinated with the question of "what could go wrong?". Those headlines get more clicks and prophets of doom get more media exposure (they also make for lively guests at dinner parties, even though they rarely get invited back). This is not to dismiss the seriousness of today's key risks. The atrocities committed in Ukrainian communities mark a ghastly breach of international law. Yet a macro outlook is not complete without also asking "what could go right?" or, more importantly, where can we position portfolios to benefit from shifting trends. This is a central part of Forstrong's scenario analysis process and has served clients well in the last two decades.

The End Of Globalization?

Globalization was once sold as a bridge to peace and higher profits for all. Instead, it has become a new battleground. On the surface, the Russian invasion appears to be the end of the era of unfettered globalization — three decades of fitful progress thrown into reverse. The new type of warfare, a financial "shock and awe", amounts to the most aggressive unplugging of a financial and commercial system as one can imagine. Countries other than Russia could be next. And, perhaps most hazardous of all is Putin being seduced by his own messianic view of restoring Russia's "historic destiny", looking less like a master chess player and more like a maniac desperately throwing the dice. Nuclear options can no longer be ruled out. All this makes nations far more reluctant to engage outside their borders.

Where to next? As the German Chancellor, Olaf Scholz, has declared, we are indeed at a zeitenwende: a pivot point. But consider that Putin has unintentionally created a most rare thing in today's polarized world: a consensus. The invasion of Ukraine has done what nothing else, not even a global pandemic, could do: show the difference between right and wrong with such clarity that nearly everyone is in agreement. This has galvanized support right across the world. A divided America is now uniting. A fractured EU is fostering greater cohesion. The West is more unified and determined than it has been for decades. Putin has effectively delivered a shock to the democratic world that restored its heartbeat.

Clearly a variety of scenarios could yet unfold. But the economic battle lines have already been drawn. Energy and food independence, enlarged military

budgets and a quickening pace of decarbonization are now firmly entrenched as top global policies. Heavier government spending is winning the day. In fact, the war extends and catalyzes several investment themes that had been building prior to the invasion.

China: No Longer A Deflationary Force Upon The World

What about China's role in all this? For all the feverish talk about Russia's attack ending globalization and reshoring, there is far less action than substance. What is far more likely is that existing regional trading blocs will be further developed, with some minor regions of these systems cut out. With China, the facts on the ground are that the rest of the world remains tightly linked with the world's second largest economy. Western business has never been closer to the Chinese economy. Apple, if we can pick on the most prominent example, actually increased its reliance on China over the last year. This makes sense for multinationals. China will continue to be the fastest growing market for nearly everything for the foreseeable future. China's retail sales are larger than America's, and China is the largest market for nearly all consumer goods, from autos to personal electronics and luxury goods. Foreign business will not abandon the Chinese market any time soon.

To be sure, the current lockdown in key Chinese cities will slow growth over the next quarter. But, as we have seen, the resulting supply chain snarls and demand destruction simply creates more volatility and growth surges further out.

Today, the most important facts about China are not lockdowns. Rather, they are the policy turns and longer-running inflationary dynamics that have already been set in motion. After China's heavy-handed intervention and austerity drive last year, regulators are now adopting a far more constructive tone, aiming to restore confidence in domestic capital markets. A decisive turnaround in China's fiscal and monetary policy is now underway. Consider also that China's 2001 entry into the World Trade Organization was profoundly deflationary, unleashing 500 million new workers into the global economy. But domestic wages have risen to the point where China is no longer exporting deflation to the rest of the world. This is a steady tailwind supporting higher global inflation.

Higher Interest Rates Ahead

Lastly, let's deal with the newfound hawkish religion among central bankers — a remarkable volte-face on monetary policy. The last decade was all about ZIRP and, in the recent past, monetary frameworks that allowed inflation to run hot to compensate for past undershoots. Today, there are no doves left and policymakers are hell bent on raising rates meaningfully (somewhere, Volcker is smiling).

Last year, we wrote that there would be more blood in bond markets. This was based on the view that the world was witnessing the beginning of the end of the disinflationary era. Bonds, insanely over-priced for that outlook, would face chronic headwinds for years to come. We still believe that.

But markets have priced in a lot of Fed fear. And "don't fight the Fed" isn't always useful advice. the The Fed cut rates by 500 basis points in 2007 – 08. Stocks plummeted by nearly 50%. Then, the Fed raised rates 9 times from 2015 to 2019 and shrunk its balance sheet. The S&P 500 more than doubled over that period.

What's more, emerging market central banks, many of which have pursued aggressive monetary tightening over the last year, are starting to signal pauses or even lower rates ahead. Brazilian policymakers recently communicated that an interest rate hike slated for May will be its last (after lifting rates by nearly 10 percentage points over the last 13 months). Strengthening local currencies, which are suppressing imported inflation, are also giving Latin American policy makers scope to cut rates.

Finally, the rate of inflation is set to decrease in the period directly ahead. Why? First, base effects. Inflation started accelerating last March, which argues for a peaking out in the coming months. Secondly, growing evidence points toward easing of lockdown-triggered bottleneck issues. The supply side is catching up and shortages are being resolved. All of this will tug prices lower, even as inflation stays elevated relative to the last decade. Still, markets react to changes at the margin. Once the market perceives that inflation has topped out, performance in select asset classes can improve dramatically, even with the raw inflation number at a relatively high level.

Investment Implications

Former Australian prime minister Kevin Rudd recently declared that the 2020s will be the "decade of living dangerously". The real danger, however, lies in investor complacency — refusing to change portfolio strategy to align with the new macro fundamentals. The bias for many is to run back into the investment leadership that worked in the past decade. But if those macroeconomic trends of the last decade have been punctured, then it would be highly unusual for leadership not to change as well.

Investment classes dependent on low interest rates are now the most vulnerable: US growth stocks, the tech sector, cryptocurrencies and — look away homeowners — residential real estate. Broad-based index strategies are also vulnerable as they are all now heavily-concentrated in the winners of the last decade. Outperforming assets will be those that thrive during periods of higher inflation and higher interest rates. The left-for-dead international value stocks are particularly compelling.

Investors need to recognize the investment environment has changed and the road has forked. It is time to choose.