# What's Going On With Ukraine, Inflation, And The Global Economy: Q&A With Our Economist

ADVANCED ASSET MANAGEMENT ADVISORS

The past few years have brought a new source of worry and speculation into the average investor's mind—the global economy. Since 2008, most of our clients learned to stay abreast of economic trends in the United States. We all remember how painful an economic crisis can be within our portfolios.

But since COVID-19, followed closely by a Russian-Ukrainian war, investors are realizing just how interconnected the global economy has been. They feel the tangible impacts of supply chain disruptions, prolonged easy money policies, and wide-spread geopolitical uncertainty—in the way of market volatility and inflation.

For advisors, staying abreast of the economic factors at play within your portfolios is key to making more informed investment decisions and holding more productive client conversations. To provide clarity into the current state of the economy, we sat down with our resident Economist, Robert Williams, to answer some of today's most pressing questions.

## 1) We Saw Another Staggering Year-Over-Year Inflation Figure In February (7.9%[1]). Is This The New Norm? When Will Inflation Cool Off?

The short answer to the first part of the question is, "yes". However, there's a lot of nuance in the inflation conversation.

It's important to remember that inflation pressures were ramping up well before the Russia-Ukraine conflict. COVID-19 delivered a massive shock to the global economy, and the recovery has been uneven and tumultuous thus far. Government spending worldwide has been enormous, there have been supply chain disruptions during the recovery, the labor market is incredibly tight, and monetary policy has remained loose – all factors contributing to higher prices.

We saw an unprecedented increase in money supply from central banks during the 2008 financial crisis.  And before that liquidity was removed from the system, we saw another round of fiscal and monetary easing in response to the COVID-19 pandemic. When more money is chasing the same amount of goods, it's natural to see a rise in prices. But through the pandemic, we saw more money chasing even fewer goods.

It is no surprise to see inflation where it is today. But the real question is when will it subside?

It's my belief that inflation will remain elevated for at least the intermediate future. Here's why:

First and foremost, we haven't seen signs of relief to our supply chain woes. And with China's renewed talks of a COVID-19 shutdown and the disruption of exports from Russia and Ukraine, the prospects of supply chain normalization are even less likely.

One of the most often referenced areas of inflation is energy. But energy is a short-term and highly volatile issue (covered in question two). When looking at the normalization of price growth, we should focus on intermediate- to long-term issues.

Intermediate-term issues facing consumers include things like chip prices, car prices, and the cost of services. Chip prices remain elevated. Car prices remain elevated. Inventories for both are at new lows, lead time to production is high, and the cost of services are starting to accelerate.

Long-term issues facing consumers include rents and labor costs. A lot of low-cost money has been funneled into residential property. This has squeezed prices and pushed more and more buyers into the rental market—which in turn squeezes rental prices, which jumped more than 12%, annually, in January 2022[2]. On top of that, a tight labor market paired with inflation has led to strong growth in labor costs (which creates a sort of spiral—higher prices lead to demand for higher wages, which leads to higher costs, which leads to higher prices).

These intermediate- to long-term factors provide a solid foundation for sustained inflation. Additionally, we are seeing a trend toward deglobalization. If sustained, this would gradually reverse the 40 years of deflationary effects we have enjoyed from globalization.

## 2) You Mentioned Energy Is A Short-Term Issue. Gas Prices Saw Historic Increases In March, Followed By A Swift Reversion In Oil And Gasoline Futures. What Can Investors Expect With Energy Prices Moving Forward?

Energy prices are a real issue because they directly affect consumer purchasing power.

Obviously, if the average American is spending more at the pump, less of their dollars will be funneled to other areas of the economy. But while the energy market is affected on a daily basis by global events, most of the problems, at least domestically, could be resolved.

The United States has the ability to produce enough oil to cover our own consumption. In fact, the United States currently exports more petroleum than we import. Much of the speculation has centered around the Russia-Ukraine conflict, but the United States imports only about 8% of its oil from Russia. We have enough oil in our strategic reserves to cover an 8% decrease in supply for many years. And while Russian supply decreases create a ripple effect throughout the world, it’s important to note that energy prices were significantly elevated before the Russian invasion.

At year-end 2021, energy prices were already elevated by nearly 50% (compared to the previous year), partly because of our political stance on domestic oil production[1]. The current administration stands firmly against domestic production, in preference of climate-change-fighting green energy. This stance increases our reliance on foreign oil and signals an unwillingness to take advantage of our own reserves, which could easily sustain our needs.

If the government shifted their stance on domestic oil, we’d likely see a quick reversion in prices. There are realistic scenarios where this could take place—where domestic oil could be positioned as a greener alternative to foreign oil, due to the reduction of greenhouse gases emitted through transportation. But this, again, is speculation.

The United States, OPEC, and other oil-rich countries could ramp up production to meet the demand, and relatively quickly, but there would be a significant hiccup in short-term availability and prices. Domestic drillers are more conservative in selecting drilling projects with shifting regulations and the fracking fallout of 2015 fresh in mind.

In summary, domestic energy prices will likely be volatile, but probably won’t skyrocket—at least not much more than they have already. Important factors to watch are our government’s attitudes toward domestic production (does the narrative change to allow increased exploration and drilling?), the larger European economies’ response to the conflict in Ukraine, and what happens to the demand in China—in light of their new COVID restrictions.

## 3) Are We At Risk Of Entering An Economic Recession?

I believe there's a low to moderate chance we'll face a sustained economic recession in the near-term.

Historically, supply shocks like we've seen recently in gasoline typically lead to recessions. But that doesn't mean it'll necessarily happen this time—each situation is unique.

Looking at employment trends and the current trajectory of the economy (we've seen strong growth post-pandemic, even with inflation), I think it would take a significant change to see negative economic growth over multiple quarters.

It is important to remember we had nearly 7% GDP growth in the 4th quarter of 2021. Whether we can get back to that type of post-pandemic recovery, and how the Fed manages the inflation and money supply situation will go a long way in telling us how 2022 will end up. And for what it's worth, I think the Fed did a good job of signaling their intentions to raise interest rates by a quarter point. Removing uncertainty is key at this stage.

## 4) How Is Advanced Asset Management Advisors (AAMA) Managing Their Portfolios In Today's Economy/Market?

Overall, our stance on portfolio strategy remains consistent with **what we outlined in our 4th quarter commentary**. We see most of the developments in the world today as short-term, and while extraordinary and visceral, not overly consequential to the fundamentals.

As a recap, our equity portfolios are generally focused on large cap companies, making sure that more defensive sectors are represented. The Healthcare sector, in particular, continues to stand out in the over-valued market with a median valuation and above-market earnings growth forecast. Our fixed income portfolios are positioned in short-term and high-quality debt instruments to reduce the risk to principal that occurs in a rising rate environment.

We hope this overview sheds some insight into the economic factors that may impact your portfolio decisions. If you'd like to discuss any of this in greater detail, please **click here to submit a contact form**. We'd be happy to speak with you.

Want to stay on top of the economic trends that might impact your portfolios? **Check out our Economic Dashboard**—a scannable compilation of eight key economic indicators.

[1]Bureau of Labor Statistics, CPI

[2]CoreLogic.com, Single-Family Annual Rent Growth Off to a Fast Start in 2022



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