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Inflation and geopolitics increase the pressure on markets

Kristina Hooper
Chief Global Market Strategist

There's a Billy Joel song from the 1980s that seems to capture last week rather well. It's simply called "Pressure" and the rhythm is, well, rather frenetic and oppressive. Every few seconds, he yells the word "Pressure!" loudly – apparently that's the simple chorus of the song. Let's put it this way: I don't recommend listening to this song while trying to meditate or simply de-compress. Needless to say, the song played as background music in my head all last week.

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Inflationary pressure

Last week we got the long-awaited US Consumer Price Index (CPI) print for January. The expectation for year-over-year headline CPI was 7.3%, but the number exceeded expectations at 7.5%.[1] As I wrote last week, I believe markets could have tolerated a 7-handle inflation print – so long as it was in line with expectations. But the January number exceeded expectations, sending US stocks hurtling downward in the pre-market. Headlines such as "worst inflation reading in 40 years" did not help matters.

Shortly after the initial plunge, stocks showed surprising resilience, brushing off the inflation data and rebounding within minutes of the market opening. But this was to be short-lived – within hours, "Fedspeak" sent stocks downward once again and the 10-year US Treasury yield climbed higher. St. Louis Fed President James Bullard shared his view that, in light of higher inflation, the Fed would need to become more aggressive than previously expected. He elaborated, "I'd like to see 100 basis points in the bag by July 1."[2] Those doing the math realized that, with three meetings before July 1, that meant a 50 basis point hike would need to happen at some point in the second quarter of 2022. Not surprisingly, expectations of a 50 basis point rate hike in March ratcheted up. Adding to anxiety was the fact that Bullard would not completely rule out an "emergency" rate hike in between regularly scheduled Fed meetings. The "gasps" that I had hoped we would avoid when I wrote my blog last week proved unavoidable.

Not surprisingly, this Fedspeak was too much for markets to bear, as imaginations ran wild about how much tightening the Fed would do for the full calendar year 2022. And so US stocks sank in Thursday afternoon trading, and European stocks followed on Friday. Driving "risk off" sentiment was the understanding that Fed tightening can't solve for a lot of the factors driving inflationary pressures, but it can potentially put an end to the economic cycle.

Geopolitical pressure

Things only got worse on Friday afternoon US time, when the White House announced that a Russian invasion of Ukraine appeared to be imminent. Most geopolitical issues have little impact on markets beyond creating very short-term volatility, but this could be different simply because of the potential impact on the price of commodities at a time when inflation is driving central bank actions.

Conventional wisdom suggests that the US and allies would not engage in a ground war if Russia invades Ukraine, but instead would impose crippling economic sanctions on Russia, and we subscribe to that base case. The good news is that war is likely to be averted. The bad news is that Russia is a major producer of oil and other commodities, and so economic sanctions are likely to drive up prices at a time when the last thing the US or other developed countries need is more inflationary pressures. Most directly affected would be the European Union given its heavy reliance on Russian energy products, but it would drive up energy prices elsewhere as well.

In addition, Russia and Ukraine are major wheat exporters and Ukraine is a major corn exporter (Ukraine has long been nicknamed “the breadbasket of Europe”), so food prices could be driven higher as well. Russia is also the world’s largest exporter of palladium, so there is the potential for more auto supply chain disruptions given that palladium is used in catalytic converters. And that would only add to auto supply chain disruptions that don’t appear likely to abate any time soon, given Toyota and Honda’s recent guidance that the semiconductor shortage in the auto industry doesn’t seem to be ending soon.

And don’t forget the “Freedom Convoy” protestors and blockade on the US-Canada border at the Ambassador Bridge, adding to supply chain disruptions and potentially increasing costs. While the Ambassador Bridge reportedly re-opened yesterday, the demonstrations are far from over. In fact, the movement has gone global and is popping up in other developed countries such as Belgium and France.

In other words, geopolitical events could add significant fuel to the inflationary pressures that central banks can’t really solve for but might damage their respective economies trying.

Falling COVID cases represent a bright spot

There is one factor that could help ease many of the inflationary pressures facing the global economy: winning the battle against COVID. As infections go down, economies can resume normal functioning, employees can return to work, supply chains can un-kink, and spending can rotate toward services and away from goods.

The World Health Organization announced last week that COVID-19 cases fell 17% worldwide versus the previous week, including a 50% decrease in the United States.[3] As I had hoped, the Omicron variant has crowded out the far more dangerous Delta variant – Omicron now comprises most COVID cases around the world. In Germany, Omicron represents 92.53% of COVID cases while in Japan, Omicron represents 95.31% of cases. In Brazil, the United States and the United Kingdom, Omicron currently represents more than 99% of cases.[4] Knock on wood, but the future looks bright when it comes to COVID, and I believe that should be far more powerful in combating inflation than anything central banks can do.

What to watch this week

Looking ahead, we will be following a number of releases this week that relate to inflation and central bank action:

- From the central banks: European Central Bank President Christine Lagarde and St. Louis Fed President James Bullard are scheduled to speak on Feb. 14. We will also see the minutes from the Federal Open Market Committee's January meeting, giving us a look into the committee's thought process.
- In terms of inflation:
  - US Producer Price Index
  - UK Consumer Price Index
  - Canada Consumer Price Index

Hot off the presses

As I was writing this blog today, we got a positive data release from the New York Fed — the Survey of Consumer Expectations. It revealed that while inflation expectations remain very elevated, they appear to have peaked (despite all the scary headlines). Median one-year-ahead expected inflation was 5.8% in January after a peak of 6% in both November and December.[5] The improvement in three-year-ahead inflation expectations was even more pronounced, dropping to 3.5% in January from 4% in December (the three-year reading peaked at 4.2% in September and October).[5]

Notes

[1]US Bureau of Labor Statistics, Feb. 10, 2022

[2]Bloomberg News, "Fed's Bullard backs supersized hike, seeks full point by July 1," Feb. 10, 2022

[3]World Health Organization, Feb. 8, 2022

[4]Our World in Data, as of Feb. 7, 2022

[5]New York Fed Survey of Consumer Expectations, Feb. 14, 2022