PFMAM Quick Takes:
Hot Topics in Today's Economy

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Several macroeconomic and geopolitical variables have led to significant volatility in the capital markets over the last few months. To better understand some of the challenges and opportunities in the current market environment, we have conducted the following question and answer session with Biagio Manieri, Ph.D., CFA.

Dr. Manieri joined PFM Asset Management in 2012 as the director of research. He has more than 30 years of experience in economics research, finance and investment management. Biagio currently serves as the firm's Global Chief Multi-Asset Class Strategist and is responsible for leading the firm's economic and capital markets research.

Do you think the increase in oil prices will have an adverse impact on the economy and consumer spending? How do you view this, and what can be done to alleviate that?

Biagio: Yes, I do agree that higher oil prices are impacting the economy and are likely to impact consumer spending. We typically say that higher oil and gas prices are like a tax on the consumer. In addition to negatively impacting consumer spending, higher oil prices are driving inflation, which was already elevated, even higher. Of course, elevated inflation is one of the major risks we face.

One's view on economic growth, monetary policy, capital markets, etc., is influenced by how one views the trajectory of inflation. Higher oil prices and correspondingly higher inflation will make the Federal Reserve's (Fed) job of engineering a soft landing much harder. The market is currently optimistic. While it sees rates rising in 2022 and 2023, the market expects the Fed to lower rates in 2024 as the economy slows, similar to 2019.

Whether this optimism is warranted remains to be seen. There are some reasons to be hopeful. While the labor market is tight and unemployment very low, which is driving up wage growth, labor force participation continues to recover from the effect of the pandemic. For example, if we examine labor force participation among prime working-age women of 25-54, it has recovered to 76.5%, down modestly from the pre-pandemic high of 76.9%. Recovering labor force participation combined with a slowing economy may lead to more modest wage growth, which of course, would be positive for moderating inflation. Inflation may also moderate as supply chains slowly return to normal. More modest fiscal spending is also a positive for moderating inflation. All of these factors provide us with some hope that inflation may peak in the near term and begin to come down. This may result in a less aggressive Fed.

Of course, oil prices went up because of the invasion of Ukraine. But we should keep in mind that oil prices were already increasing before the invasion. The price of oil declined significantly when we got hit by the pandemic, and as we began to re-start the economy, oil prices began to recover. But what drove oil prices above $60 into the $80s is policies discouraging investments in new oil production due to climate change concerns.

While we all agree that we need to make the transition to clean energy, what is important is the path we take. The way I like to think of it is that it is a process; there is a transition period. If we take Germany as an example, we see this. Germany had decided to emphasize clean energy from wind and solar. As a result, it found itself with rising energy costs even before the invasion of Ukraine. After the invasion, Germany did a 180-degree turn. The new chancellor gave a speech where he said: "The events of the past few days have shown us that responsible, forward-looking energy policy is decisive not only for our economy and the environment. It is also decisive for our security."[1] As a result of the invasion, Germany is now taking a more pragmatic approach to energy policy. It is my belief we need the same approach in the U.S.

1 "Nuclear, coal, LNG: 'no taboos' in Germany's energy about-face", Reuters.

Inflation (prices of various commodities, not just oil, are on the rise) is having an adverse impact on both consumers and investors. What is your outlook for inflation in both the near- and longer-term?

Biagio: As I noted previously, we think there are reasons to believe that inflation will moderate later this year and next. If we look at market expectations, inflation over the next two years is expected to average about 4.3%; this is up from 3.2% before the Ukraine invasion, but it is down from the current inflation of 7.9%.[2] The concern is that inflation, which started in the goods sector, has begun to spread to other economic sectors. Wage growth could also lead to prolonged elevated inflation. We believe that higher rates, a slowing economy, and recovering labor force participation will help to drive inflation lower later this year and next year.

As for the longer term, before the pandemic, few worried about higher inflation. The concern was that inflation was too low. You may recall that the Fed was so concerned about modest inflation that it undertook a research project to rethink its inflation framework and, right before the pandemic, redefined what it means by stable prices of 2%. The factors that were leading to modest inflation include demographics, high debt levels, technological improvements and globalization. These factors are still in place. That is why I think that market expectations for longer-term inflation is still in the 2-2.5% range and has not changed much in response to higher oil prices, the Ukraine invasion, etc.

Of course, modest inflation over the longer term is not guaranteed. Rising globalization was helping to keep inflation low, but globalization began to slow following the financial crisis and the pandemic made clear the fragile nature of supply chains. The Ukraine war, we believe, will further add to slowing globalization. In addition, more populist policies leading to tariffs, higher minimum wages, etc., may further add to inflation.

U.S. equities have rebounded from levels in early March. Are domestic stocks attractive right now, or should investors look to increase exposure to areas such as Europe or Asia?

Biagio: In our multi-asset class portfolios, we have been over-weight U.S. equities for an extended period of time. U.S. equities have performed much better than non-U.S. equities since the financial crisis due to better profit growth. While profit growth has been better in the U.S., U.S. equities have become more expensive vs. non-U.S. as a result of the strong relative performance. If we were in a normal environment, based purely on valuation and profit growth potential, I we would be adding to non-U.S. equities, including emerging markets. But the issue that we currently face is elevated geopolitical risk due to the war in Ukraine. The U.S. is more insulated from the negative consequences of the war vs. other regions such as Europe. Despite the lower valuation, we think that in an environment of heightened geopolitical risk, investors will continue to favor higher-quality assets and that includes U.S. equities. As a result, we continue to favor U.S. equities. As we gain greater clarity about the negative consequences of the war in Ukraine, we may add to non-U.S. equities. But for the time being, again, we continue to favor U.S. equities.

The invasion of Ukraine, as you mentioned, is weighing on a lot of investors' minds. Are there any other geopolitical concerns that are looming or that you see as a potential threat?

Biagio: In our 2021 and 2022 outlook, we outlined a number of geopolitical risks, including Iran, Russia, China, North Korea, etc. Therefore, the answer to your question is certainly yes. Even if we get a resolution to the war in Ukraine, and currently, the war appears to be stalemating, Russia will continue to represent a geopolitical risk or concern as it may turn its attention to Moldova and other former Soviet republics. Ukraine is not the first and may not be the last former Soviet republic that Russia invades. Recall that Russia invaded Georgia in 2008.

2 Two year breakeven; sources include Bloomberg, FRED, etc.

China could also serve as a source of conflict and tensions. In my opinion, relations between the U.S. and China are likely to become less friendly going forward. Like Russia, China sees itself as a great power and is currently building up its military capabilities to be able to project its influence around the world. In addition to geopolitical threats, I would point to the possible use of nuclear weapons at some point as a grave concern. Currently, there are nine countries with nuclear weapons, and others are trying to develop them, such as Iran. Both India and Pakistan have nuclear weapons, and since the end of WW2, these two countries have fought numerous wars and skirmishes over territorial disputes. It is possible that in a military conflict, one side decides to use tactical or battlefield nuclear weapons. Once nuclear weapons are used, whether they can be limited to the battlefield or in a narrow region is highly uncertain.

Our national debt continues to climb each year. How will we, as a nation, get that debt under control?

Biagio: This is a topic that we have been discussing for quite a while. It's not just that debt has been increasing; it has been increasing at a higher pace than gross domestic product (GDP). As a result, gross debt to GDP is now about 125%, down slightly from the peak of 136% in the middle of the pandemic. As a reminder, gross debt to GDP was at about 60% before the financial crisis of 2008. I would also point out that it is also important to understand the use of the borrowed money. If one borrows and invests the proceeds productively, then future earnings would be higher, and those profits could be used to pay down the debt. But if you look at the federal budget, about half is social security and Medicare, Medicaid and other health programs; 16% other entitlements; net interest on the national debt is about 8%; national defense and everything else make up the balance.

That means that mandatory and entitlement spending makes up about three-quarters of the budget. We are borrowing money to over-consume, and we are underinvesting. There are proposals that would increase entitlements such as Medicare for all, free college education, etc. Based on Congressional Budget Office (CBO) projections, these additional programs would add to the national debt. Of course, the decisions about the federal budget and tax policies are political in nature. There is a theory called Modern Monetary Theory or MMT which basically says that if a country borrows in its own currency, there is no limit to what it can borrow. Most mainstream economists are not convinced by MMT.

In addition, I would point out that since we do not currently face a crisis, there is little political pressure to deal with rising debt. One proposal to deal with rising debt is to simply raise taxes on the highest earners. In my opinion, this is unlikely to work. If one examines history, one finds that taxes collected as a percent of GDP does not vary much even as tax rates change significantly. In my opinion, the solution is a combination of broadening the tax base to bring in more revenue but also constraints on the growth of entitlement spending. One often hears that social programs in Europe are more generous; this is true, but I believe that the tax base in Europe is much broader than it is in the U.S. In the U.S., the bottom half of households do not pay income taxes, while in Europe the tax base is much broader; that is how Europe is able to afford the social programs it has. To deal with the growing national debt as a percent of GDP, we should set as a goal that debt will grow slower than GDP and as a result, debt to GDP would decline over time. In order to achieve that goal, in my opinion, we need to look at both sides of the equation: revenue or taxes and spending.

Are there any potential upside surprises or positive events that have perhaps not been factored into stock prices or that investors are overlooking?

Biagio: As we discussed, we face the risk of elevated inflation, which is leading to a more aggressive Fed. As a result, the risk of recession in 2023 is higher than 12 months ago. The possible surprise is that inflation comes down faster than expected. I don't think equities are discounting that scenario. If inflation comes down faster than expected, then the Fed would likely ease off raising rates as aggressively as the market currently expects.

As a result, we would likely see equity valuations increase, i.e., private equity multiple would expand.

A second possible positive surprise is that corporate profits grow faster than expected. Currently, the risk is that higher inflation may pressure profit margins. One possibility is that productivity driven by the increase in cap-ex we have seen recently improves and more than offsets higher wages and other input costs. As a result, profit margins remain healthy and profits grow faster than what analysts expect. If both of these events were to happen: (1) inflation declined faster than expected and the Fed raised rates less than expected, and (2) profits grew faster than expected — we would have a true Goldilocks scenario of higher profits and higher multiples, driving equity prices higher than what we currently expect. We are not expecting this to happen and are not counting on it, but it is not completely out of the realm of possibility.

Should anyone have any questions, what is a good way for them to reach you?

Biagio: If clients are interested in hearing more, I suggest they contact their PFM Asset Management relationship manager, or they could email me at: manierib@pfmam.com. You can also obtain additional information on PFM Asset Management or contact information from www.pfmam.com.

Please note that a copy of the Capital Market Assumptions/outlook as discussed within this Q&A are available upon request.

To learn more or discuss in greater detail, please contact us:

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