By Bill Spitz, Principal

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It **Is** Different This Time!

Our Investment Team's 2022 Quarter 1 Outlook differentiated between the waves and the tides in investing. The waves are short term fluctuations that drive the news cycle but do not really impact the fundamentals of investing. At Diversified Trust, we position our portfolios on the basis of our assessment of the tides which are the true long term determinants of investment performance. However, the team raised an interesting question: is there a point at which the waves become so large that they impact the tides? This paper represents a deeper dive into many of the issues raised in the Outlook suggesting that this just might be one of those times when the waves have a lasting impact.

I cannot remember a time during my long career in finance when both the financial and mainstream media did not bombard readers with articles regarding the level of uncertainty in the world and the volatility of financial markets. Financial services firms also jump on the bandwagon by advertising products that are sold on the basis of their ability to aid clients in coping with "a volatile and uncertain world." I have consistently dismissed all of this as fear mongering because recent decades seem quite tame in comparison to the Depression, two World Wars and a number of smaller conflicts, the Cold War, the Energy Crisis, and many other woes that plagued the majority of the twentieth century. And, my point of view is supported by data indicating that both the economy and financial markets have become much more stable over the past thirty years. I also frequently rail at those who postpone investment decisions until the outlook is "more certain" because it is never anything close to certain, and if it were, the markets would already reflect it.

Well, a cascade of recent events has forced me to utter what are considered the five most dangerous words in the investment lexicon: “it is different this time.” I believe we are in a period of heightened uncertainty and potentially significant volatility in the political, economic, and financial worlds. This paper documents three major categories of risk and uncertainty that cut across international relations, politics, economics, finance, and natural resources. I then consider a fourth issue, the potential for high and persistent inflation, which is actually interwoven with the other three. The level of uncertainty I describe is not necessarily dire and should not be a source of panic because there are also some very positive trends, particularly the fundamental strength of the U.S. economy and the potential impact of new technology. But, uncertainty and potential volatility do reinforce our firm’s commitment to diversification and risk management. These key tenets of our investment philosophy may have appeared overly conservative and somewhat passé during the roaring markets since the Great Financial Crisis, but I firmly believe they will be critical to financial security going forward.

INTERNATIONAL RELATIONS

I think it would be foolish to speculate on the ultimate impact of the tragic war in Ukraine, and China poses an equal amount of uncertainty with respect to its relations with the West. China’s position on the Ukraine War may further increase already strained relationships, and its severe Covid-19 outbreak is having a major impact on manufacturing and global trade. Tensions may also increase between those countries that have and have not chosen to condemn Russia’s aggression. If all of this were not enough, there are nuclear threats, concerns about the Baltic states and other potential Russian targets, and the question of whether Russia’s foray into Ukraine might embolden China with respect to Taiwan. In any case, I leave detailed analysis of global affairs to others and instead focus on some shorter term economic effects of both the war and conditions in China. More important, irrespective of the outcome of the current crisis, there are likely to be structural changes that we can identify in international relations, the definition of security, and national priorities for the U.S. and Europe.

The U.S. is the world's largest oil producer which has insulated it from supply problems. However, given that the price of oil is determined by global supply and demand, the retail price of gasoline has risen this year from $3.41 to $4.09 per gallon currently, an increase of 19.9%. Europe imports about 40% of its natural gas consumption from Russia. Russian gas continues to flow but there is considerable uncertainty regarding the possibility of either a ban on imports by Europe or retaliation by Russia in response to sanctions. This uncertainty is reflected in incredible volatility in the price of natural gas in Europe which rose from 88.89 Euros per megawatt-hour immediately prior to the invasion to a peak of 186.4 only to decline to the current level of 93.2 Euros. As will be discussed later, the war is also interrupting the supply of a large number of raw materials that are critical to the world's food supply as well as the manufacture of many consumer and industrial goods. A related issue is that the war is impacting global transportation. Many Ukraine ports have either been damaged or are inaccessible due to blockades, and Russian shipping is subject to targeted sanctions. This has resulted in rerouting ships to Northern European ports such as Hamburg and Rotterdam that are now experiencing severe bottlenecks. Similarly, Russia closed its airspace to Western aircraft which has rendered some routes either unflyable or uneconomic.

Many Chinese ports as well as manufacturing facilities are either closed or operating at reduced volumes due to the government's stringent approach to stemming the recent surge in Covid-19 cases. In fact, about 50% of exports are produced in, and 75% shipped from, areas experiencing major outbreaks.

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Global supply chains were just beginning to recover from Covid-19 in early 2022 and the system remains quite fragile. Combined with the natural resource constraints that will be covered shortly, renewed supply chain issues related to the war or China's problems are likely to result in shortages of some products. BlackRock President Robert Kapito pointedly stated "For the first time, this generation is going to go into a store and not be able to get what they want. We have a very entitled generation that has never had to sacrifice." That statement may be a bit harsh but his concern is legitimate. It is too early to gauge the economic impact of all of these factors, but one good indication is that the World Bank recently cut its forecast of global growth for 2022 a full percentage point from 4.1% to 3.2%. And, The Conference Board predicts U.S. growth of 3% versus 5.7% in 2021.

Of more interest than short term economic trends is the fact that we may well witness a material change in the world order as well as individual countries' approaches to diplomacy, defense, supply chains, capital spending, and security.

First, the Ukraine War, strained relations with China, and Covid-19 are likely to spur a major round of capital spending in many countries. Europe has already announced that it plans to eliminate its dependence on Russian oil and gas "well before 2030." That will require significant capital expenditures on green energy as well as spending on fossil fuel infrastructure to ensure a smooth transition. Similarly, four very large semiconductor chip plants are under construction in the U.S. in order to reduce reliance on fabricators in Asia. More broadly, many countries are likely to re-emphasize domestic production of materials and goods deemed strategic. Finally, many countries will increase defense spending. Germany, a country that has been largely demilitarized since the Second War, recently pledged to increase spending to 2% of GDP, and President Biden has proposed a 4% increase in the U.S. defense budget for the next fiscal year. The net economic effect of these trends is difficult to predict. Capital and defense spending will stimulate many economies but some of the gains may well be offset by declines in world trade.

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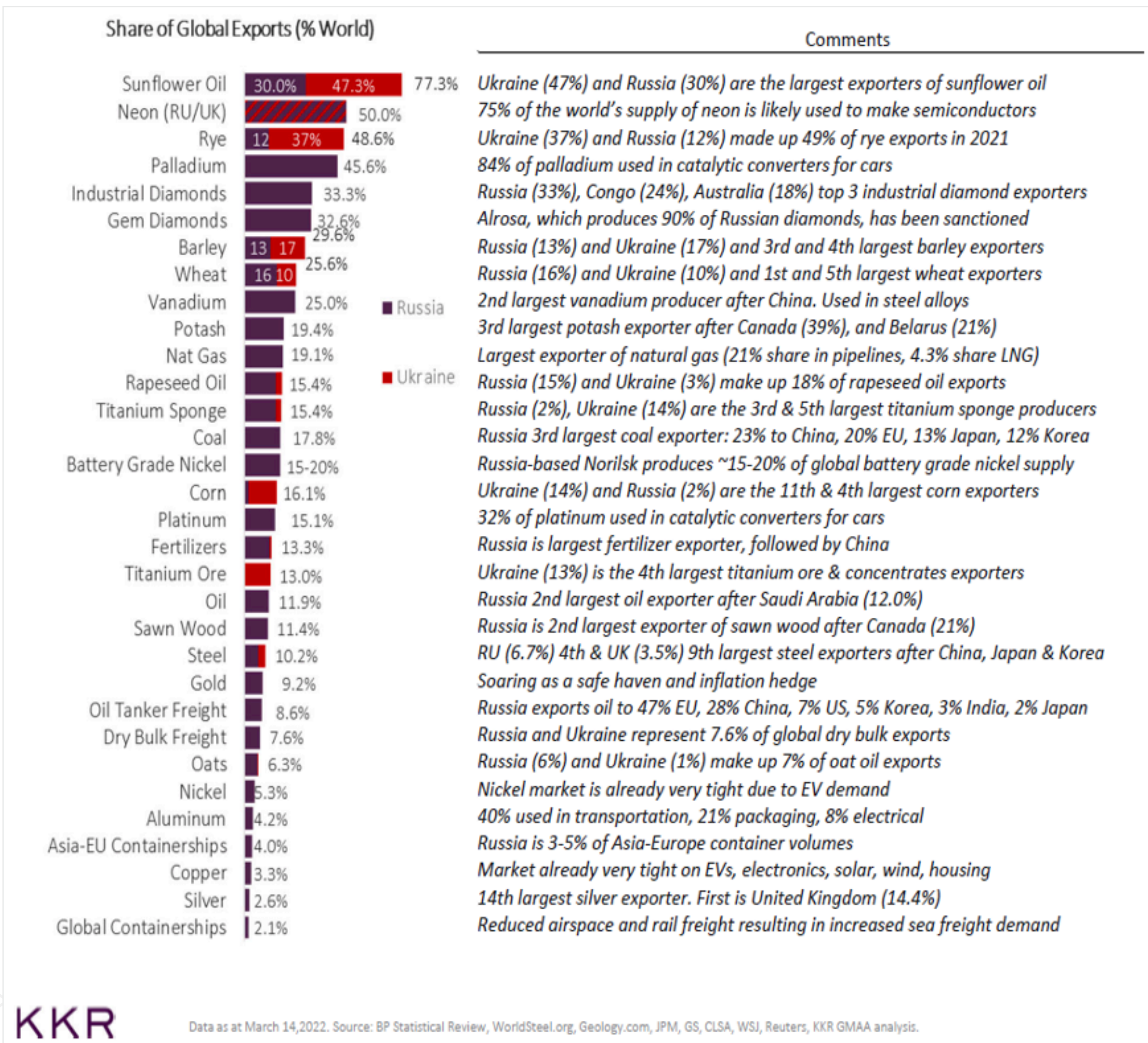
Recent events are also likely to change the definition of National Security which traditionally has been focused on protecting the populace through military strength. Every thoughtful leader is now concerned with the accessibility and reliability of natural resources including food, strategic metals, and energy, all of which have been taken for granted to some extent. As mentioned above, there is also considerable emphasis on secure domestic manufacturing capability. Although corporations have been focused on cybersecurity for some time, recent attacks clearly demonstrate that it has become a national security priority as well.

Finally, there may well be a shake-up in the world order. On the one hand, many countries are moving away from globalism toward isolationism and nationalism. On the other, recent indications that Sweden and Finland are considering joining NATO reinforce the importance of alliances. Will Russia and China become a new axis that spurs another Cold War? What will these trends mean for world trade and global economic growth? The world has enjoyed a "peace dividend" since the collapse of the Soviet Union; are we facing a new arms race that requires a major shift in budgets toward defense spending? All of this is way above my pay grade but it does reinforce my view that the level of uncertainty has risen materially.

NATURAL RESOURCES

One of the major lessons of both Covid-19 and the war in Ukraine is that the world is incredibly connected. As just one example, Covid-19 related plant shutdowns in Asia interrupted the supply of computer chips causing a shortage of new automobiles which in turn led to soaring prices for used vehicles and car rentals. And, both of these were major contributors to inflation in the U.S. for the last twelve months of 8.6% which is the largest increase in prices since 1981. The war in Ukraine has now shifted focus to the availability of natural resources. As shown in the following chart, Ukraine and Russia are major producers of a wide variety of critical raw materials.



Let's begin with food. As shown in the chart, Russia and Ukraine together supply 49% of the world's supply of rye, 77% of sunflower oil, 29% of barley, 26% of wheat, and 16% of corn. Some 13.5 million tons of wheat and 16 million tons of corn from last year's harvest are trapped because of sanctions, damage to ports and grain elevators, and transportation snarls. Moreover, the war is taking place during the prime planting season which will surely reduce this year's harvest. Should the war continue, a number of countries that rely on these sources will face food insecurity which tends to foster political instability as was the case with the Arab Spring in 2010. As a larger food producer, the U.S. is largely insulated from shortages but the prices of corn and wheat, which are set on world markets, have risen approximately 22% since the initiation of the conflict. Food prices represent 14% of the Consumer Price Index.

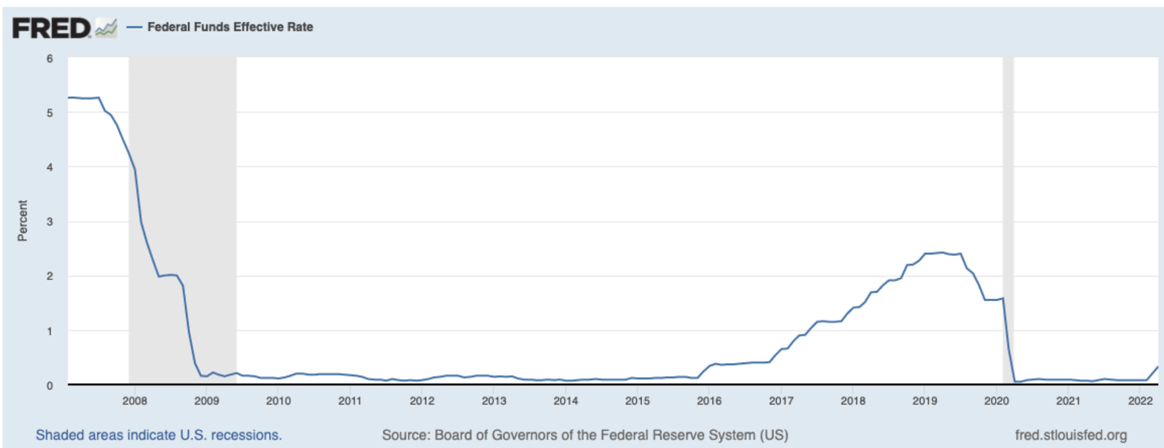
Russia is the world's largest source of fertilizer accounting for 13% of all production. As was the case with the foodstuffs mentioned above, the U.S. is a large producer but that has not insulated farmers from price increases of 40% to 150% depending upon the actual fertilizer in question.

Finally, these two countries are major producers of a number of strategic commodities. Ukraine produces 50% of the world's supply of neon which is critical to the manufacture of computer chips. Russia produces roughly 15% of the supply of battery grade nickel which is used in the manufacture of lithium-ion batteries that power electric vehicles. And, Russia produces large quantities of palladium, industrial diamonds, platinum, titanium, and a variety of other rare minerals.

As it relates to natural resources, this war is likely to have both short and long term effects. It certainly is contributing to inflationary pressures around the world and there may well be disruption to manufacturing due to raw material shortfalls. As mentioned above, there may also be food shortages and some observers have gone so far as to predict a global food crisis which has both humanitarian and political implications. Finally, as discussed in the international relations section, countries are scrambling to build internal production capacity as well as establishing what are known as "friendshoring" agreements which refers to locking in supply from friendly, stable nations.

THE FEDERAL RESERVE

In response to the Great Financial Crisis (GFC) and the Covid-19 pandemic, the FED provided unprecedented stimulus in the form of near-zero interest rates and what is known as Quantitative Easing which involved purchasing bonds of various types to support the economy and provide liquidity to capital markets. Immediately prior to the GFC, the FED held bonds valued at roughly $900 billion which it quickly increased to $2 trillion as the 2008-2009 recession unfolded. It continued to purchase securities through early 2020 increasing its position to just over $4 trillion. The FED then responded quickly to the economic havoc associated with the pandemic lockdown by increasing its holdings to just over $7 trillion, and the balance has continued to drift upward to its current level of $9 trillion. The FED's other primary tool is its ability to control short term interest rates that are depicted in the following graph:



Note that the rate has been very close to zero for the majority of the past thirteen years. In 2017 and 2018, the FED did attempt to "normalize" rates, but a very negative reaction on the part of stock investors caused it to reverse course with several decreases which were then followed by a dramatic cut in early 2020.

The combination of low interest rates and bond purchases was effective in reducing the impact of these two economic crises, but the FED is now faced with a serious challenge. After hovering between zero and two percent for the past fifteen years, inflation is now running at an 8.6% annual rate which compares with its stated target of 2%. Along with maximizing the level of employment, controlling inflation is the FED's main priority which is likely to result in as many eight hikes in short term interest rates this year. Second, it has announced the intention to reduce its $9 trillion balance sheet by approximately $1.1 trillion per year.

The major challenge and risk lies in the possibility that it will commit what Wall Street calls a policy mistake which could take two forms. First, either raising interest rates or reducing its balance sheet too quickly could choke off economic growth or worse, push the economy into a recession. Alternatively, the FED's approach could be too measured thereby allowing high inflation to persist. Their task has been described as "threading a needle," and there is risk of either a recession or prolonged inflation if they fail to get it just right. One particular concern is that the nature and size of FED stimulus is unprecedented which means that the central bank is operating without a well-proven roadmap.

INFLATION

The potential for high and/or long-lasting inflation ties all of these topics together. A recent Bloomberg poll of economists forecasted inflation of 6.1% in 2022 falling to 2.8% for 2023. The market's expectations on inflation can be gauged by comparing the yield on US Treasury Bonds with those of Treasury Inflation Protected Securities. Currently, this analysis suggests an inflation rate of 3.4% for the next five years, 2.9% for ten, and 3.4% for thirty. Obviously, both economists and the market expect the current high rate of inflation to be temporary with a gradual tapering toward a level that is higher than recent experience but still manageable. However, many of the uncertainties discussed above could render these expectations overly optimistic. A drawn out conflict in Ukraine would generate continued upward pressure on prices due to raw material shortages. Similarly, as the world's third largest oil producer, sanctions or other supply disruptions that reduce Russian oil and gas exports would maintain or increase high energy prices that have already significantly impacted consumer prices. Continued supply chain problems attributable to either the war or virus flareups would be problematic given their potential to reduce the supply of goods in the face of very strong consumer demand. A longer term concern is that a return to domestic manufacturing may be inflationary given higher wage rates in the U.S. versus many other countries. Finally, the FED could easily misfire allowing what was initially deemed "transitory" inflation to become quite sticky.

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PERSPECTIVE

So, there are valid concerns regarding world affairs, the availability of natural resources, the functioning of supply chains, and Federal Reserve policy. Those inclined toward pessimism could easily identify other worries such as the high level of U.S. debt, high valuations of both stocks and bonds, evidence of speculation on the part of retail investors, and potential volatility from the mid-term elections. On the other hand, U.S. consumers are in great financial shape and demand for goods and services is very strong. Employment trends are also quite strong which should serve to support consumer demand despite inflation concerns. Corporations are exceedingly profitable and their balance sheets are generally healthy. And, the world is flush with liquidity which provides support to financial markets. Netting out the pros and cons, we come to the following conclusions:

- There is more uncertainty than has been present in recent years. This is not a cause for panic or major changes in investment strategy. However, it should lead investors to affirm their time horizon and risk posture.
- Diversification and risk management are more important than ever and all but those with the longest time horizons should maintain portfolio hedges of various sorts.
- Investors should be prepared for bombastic headlines that lead to short term volatility.
- Investors should emphasize high quality securities in every segment of their portfolios and avoid the temptation to reach for return.

A fitting quote for today's world comes from British economist Elroy Dimson who said, "Risk means more things can happen than will happen."

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