Stargazer
Asset Management

What to focus on in Global Macro for the week of February 28th, 2022

Unknowns abound as we enter week three with the Ukraine crisis center-stage. It is likely to be a decisive week as global pushback to Putin's actions gains momentum and weight, even as he faces a less than satisfactory outcome so far. We will see what comes of the plans for talks on the Belarus border in the coming days, but at this point it is hard to see how either side backs down. The situation is coming to a head. Over the weekend, Putin implicitly threatened nuclear escalation.

It is notable how the West has kicked up its reaction in the last few days as initial reluctance is replaced with a race to pile on sanctions and punishment. Even Germany, with its unhappy marriage to Russian energy, has gone from sending a disappointing 5,000 helmets, to promising anti-tank weapons and sophisticated and lethal weaponry. We seem to have hit a turning point for them, as they announce increased military spending and plans to build large LNG import terminals in northern Germany to replace Russian gas.

In recent weeks we have all had to brush up on our knowledge regarding the 11,0000 member, nearly 50-year old, financial payment messaging system known as Society for Worldwide Interbank Financial Telecommunication (SWIFT).

Totally cutting Russia off from SWIFT has been seen as the sanctions equivalent of the "nuclear option". So far Germany and Italy, the large European countries most dependent on Russian energy, have been loathed to agree to do so. At the end of the week there were headlines that they had come on board, but so far at least, the SWIFT exclusions do not include all Russian banks that facilitate payments for energy still being bought. I wouldn't be surprised if we get there, but for those countries at least that is a big step as it would mean some real hardship in the near term. Still, with Spring coming in Europe, politicians may take the leap.

It is starting to look like the crisis has broken Germany's long-standing co-dependent relationship with Russia. Here is former German Chancellor Gerhard Schröder with Putin. He is currently the chairman of the board of Nord Stream AG and of Rosneft and was recently nominated as a director at Gazprom.

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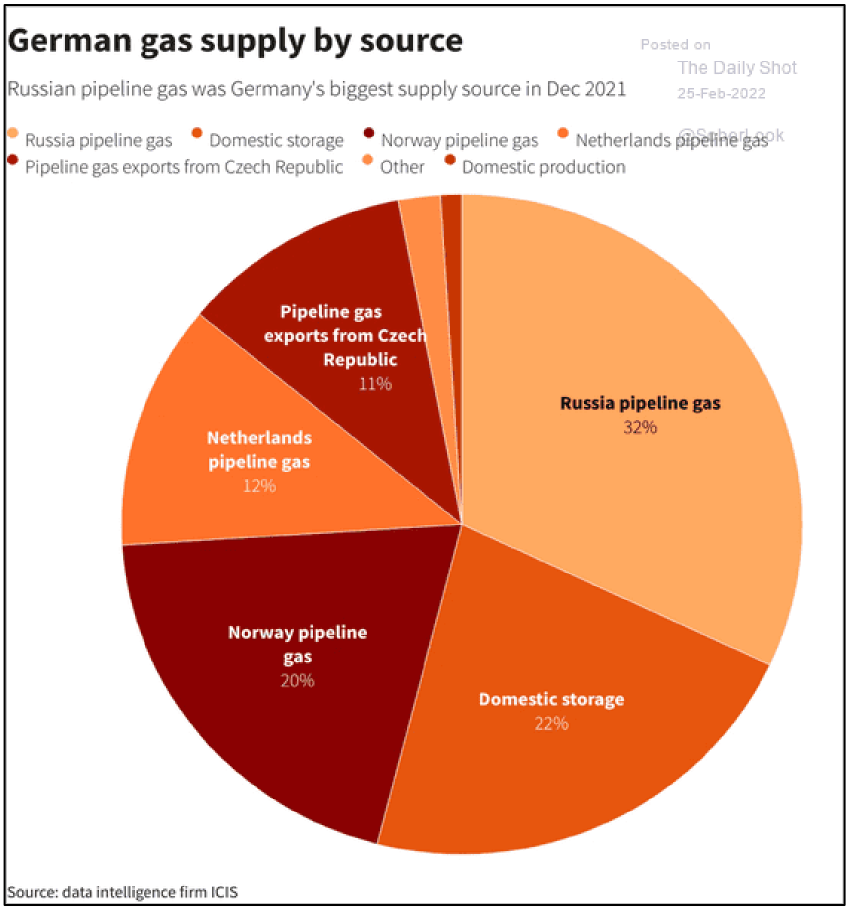


Russia is Germany's largest natural gas supplier, and the cancelation of the recently completed Nord Stream 2 is a huge step for them.

While we are not there yet, we are quickly moving in the direction of totally isolating Russia and funding a NATO proxy war with Russia via the Ukrainian resistance.

With the CB of Russia now under sanctions and European airspace closed to Russian commercial and private air traffic, it has to be starting to hurt. Add to that today's call from the UK to seize real estate holding and yachts from oligarchs.

The danger is that as Putin & Co get squeezed, and he can't back down without a victory, things escalate further.

Obviously, the human cost of the crisis is terrible, and growing, but <u>markets are focused on the intersection of energy prices and interest rates, via inflation and growth expectations.</u>

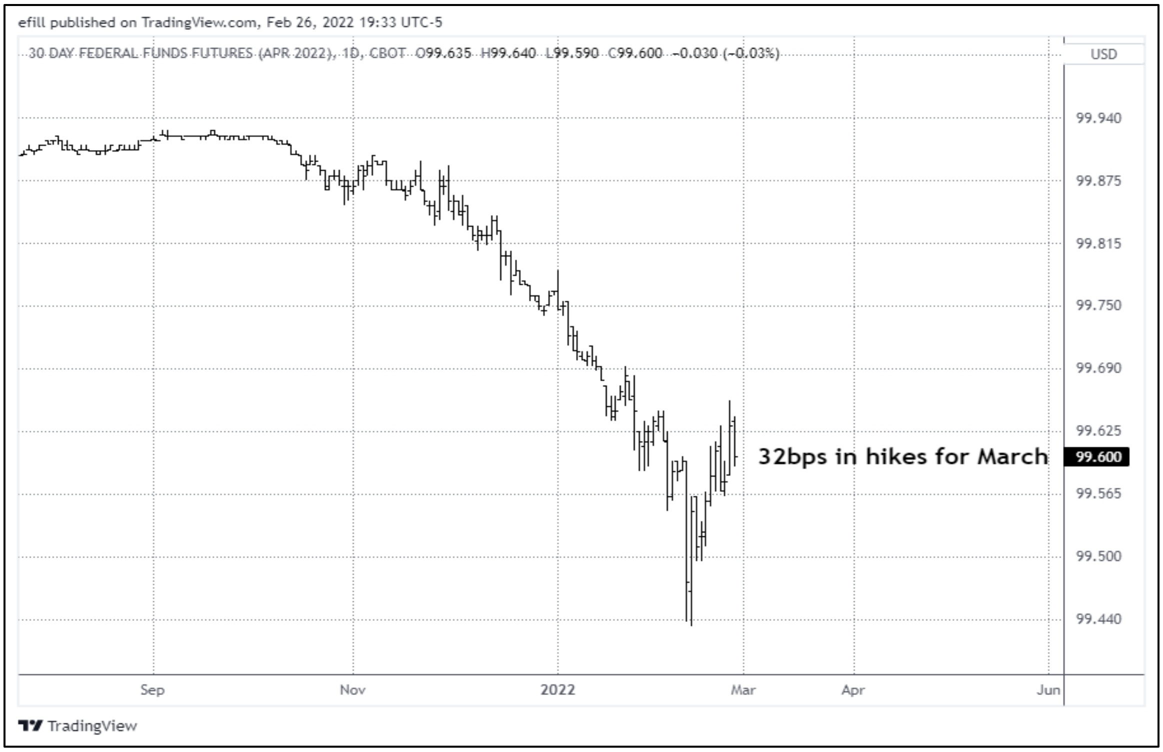
The Fed is now in an even tougher spot than only a few weeks ago, as the ramping of energy prices may delay the expected top in inflation, while potentially slowing global growth. The chance of a policy error has gone up.

So far, the Fed seems relatively undeterred, while acknowledging the change in the environment.

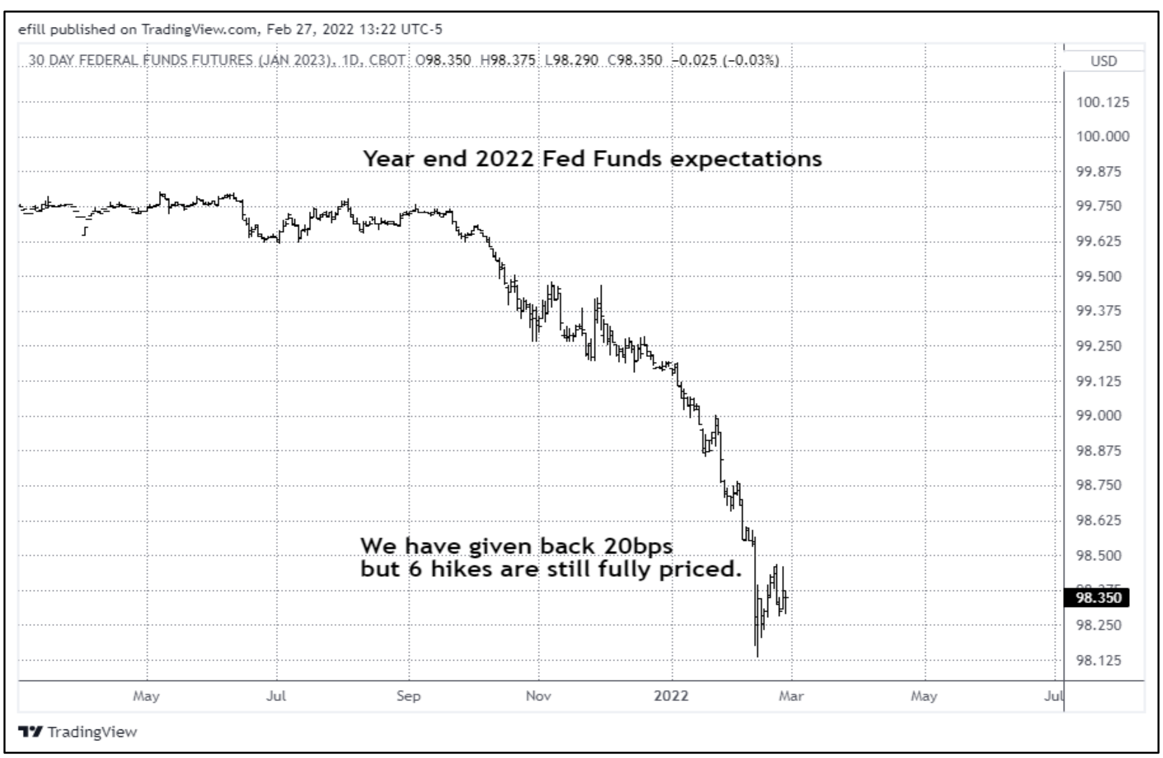
The Fed's Mester addressed the developments in comments last week at the University of Delaware:

"There are risks and uncertainty around the outlook, including those engendered by the geopolitical events unfolding today," "I don't think it changes the need of the Fed to remove accommodation from the emergency levels." … "Geopolitical events add upside risk to the inflation forecast even as they put some downside risk to the near-term growth forecast" … "The implications of the unfolding situation in Ukraine for the medium-run economic outlook in the U.S. will also be a consideration in determining the appropriate pace at which to remove accommodation."

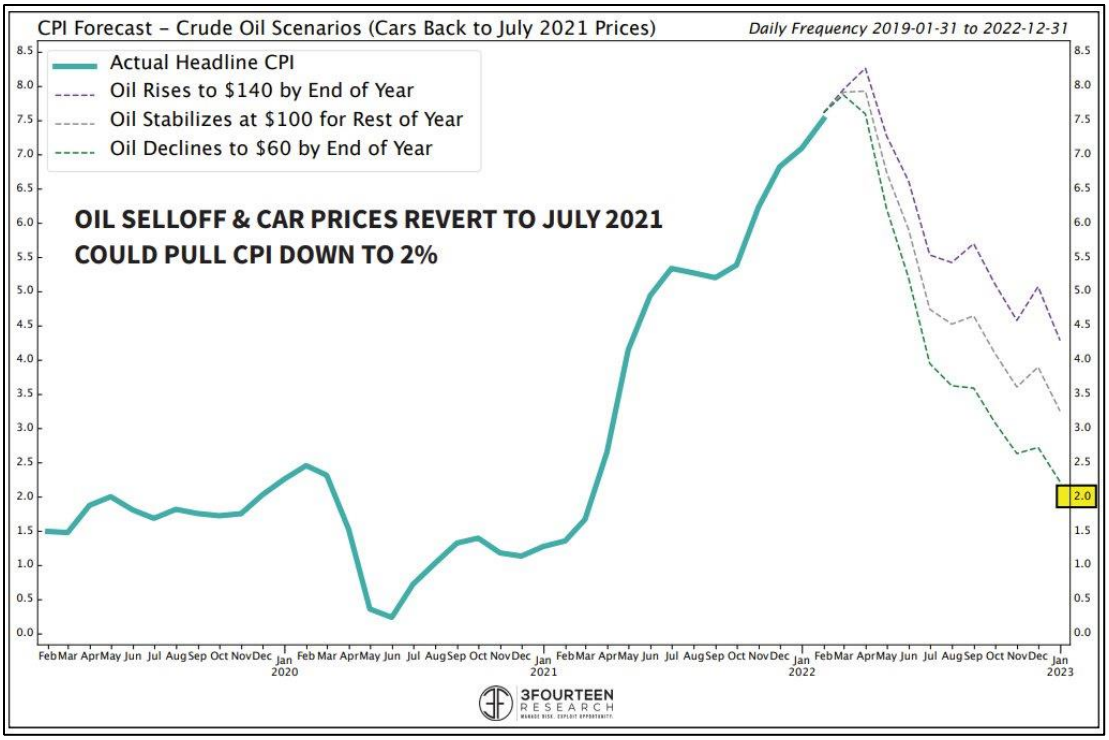
So far, the market has now mostly repriced the March Fed hike expectation back to 25bps.



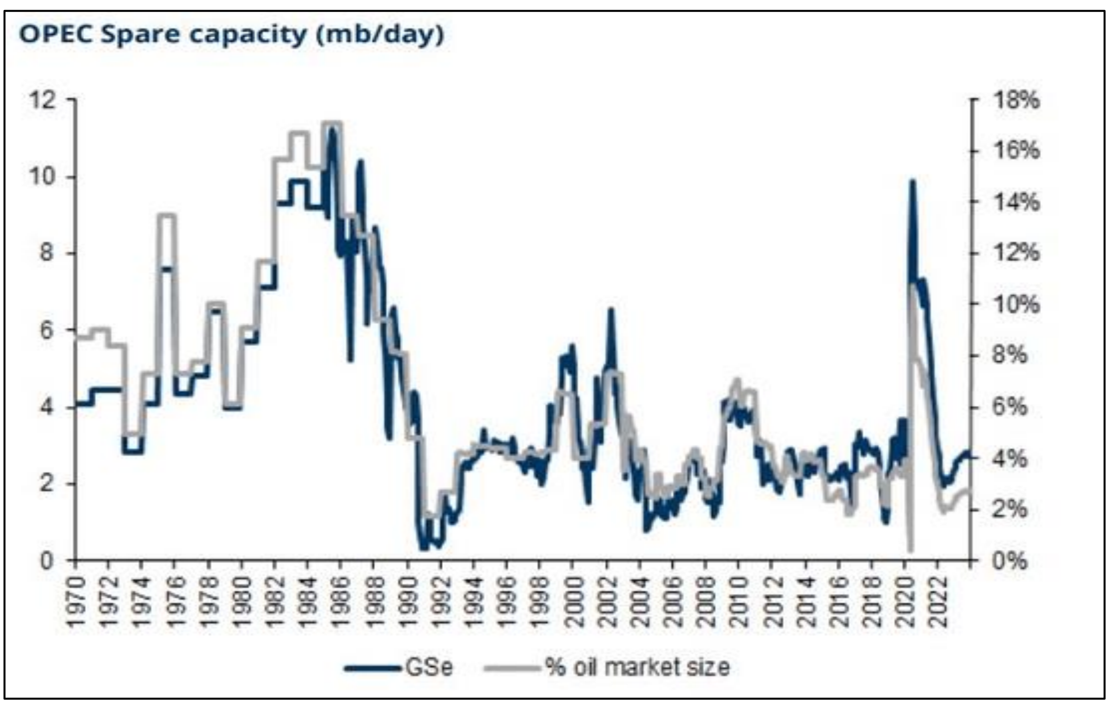
I think somewhat surprisingly, there are still 6 hikes priced by year-end. That could change next week.



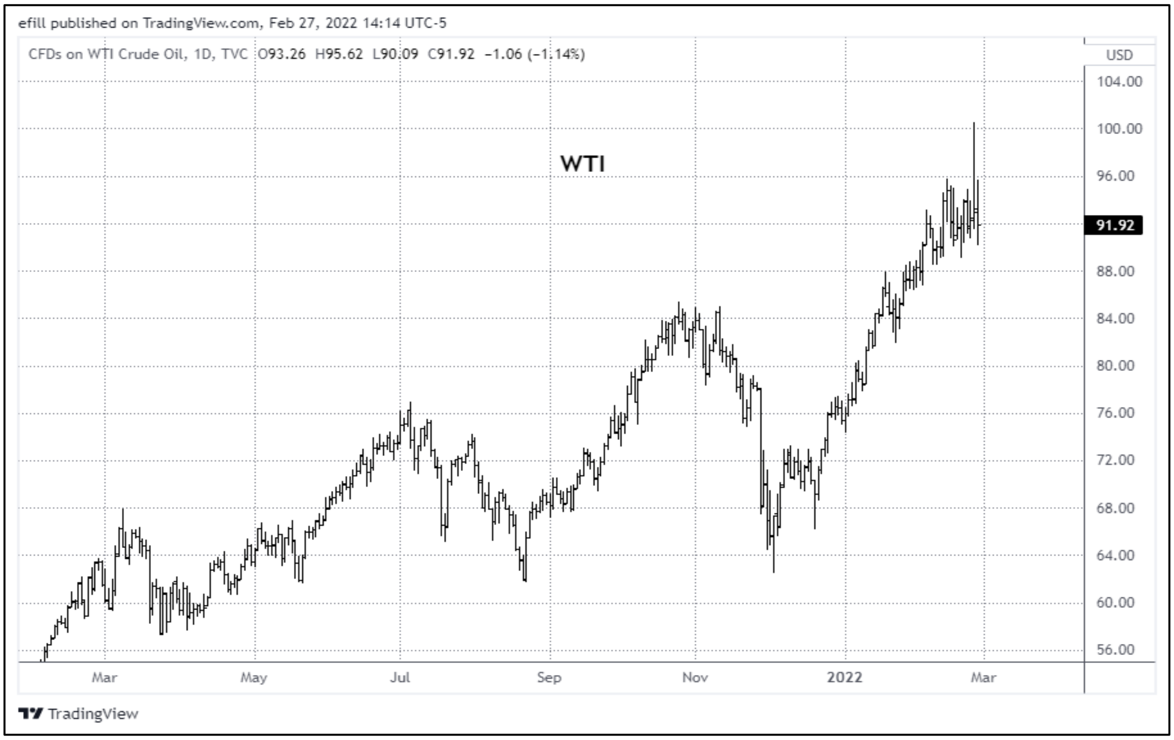
Regarding inflation, I thought this was an interesting thought experiment from 3Fourteen Research, on what has been driving inflation, bases effects, and what it would take to get inflation back to 2% by the end of the year.



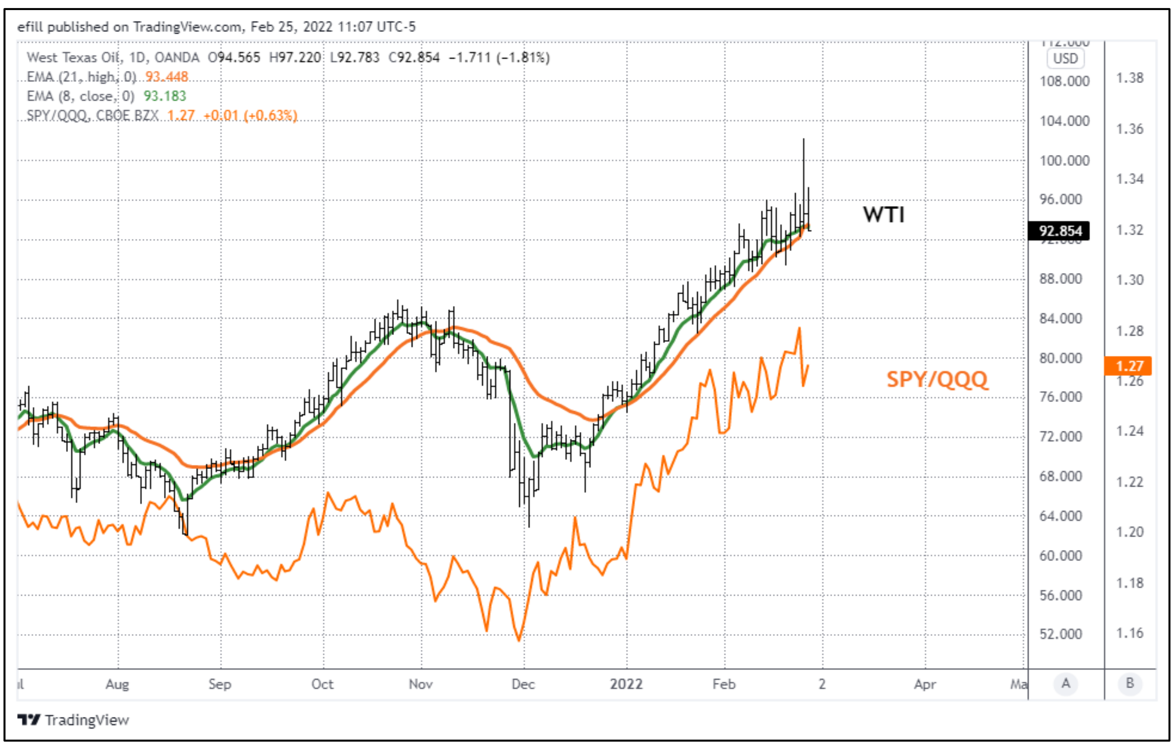
The hope for an Iran deal continues although progress is slow. Inventories remain low and excess capacity is tight. (Source: Goldman Sachs)



It is a bit surprising that while there have been spikes, the Ukraine news has now allowed Oil to make much headway in the last couple of weeks. I suppose a big premium is already priced.



The relationship of oil to rates has been driving other relationships across equity markets.



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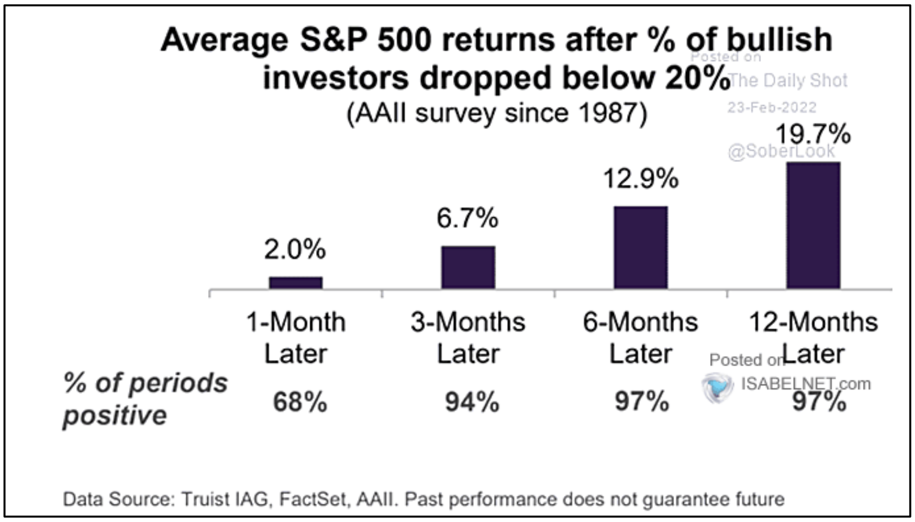
Higher rates and a relatively strong USD during an oil rally make for relationships that are worth keeping an eye on if we do get some relief from oil.

The equity rally into the end of last week has brought back to life the old quote attributed to Nathan Rothschilds, that you "buy on cannons. sell on trumpets".

The sizeable selloff from the highs, combined with very negative sentiment and some meaningful position reduction from institutional investors has people looking for reasons to buy. Here is one people are pointing to…



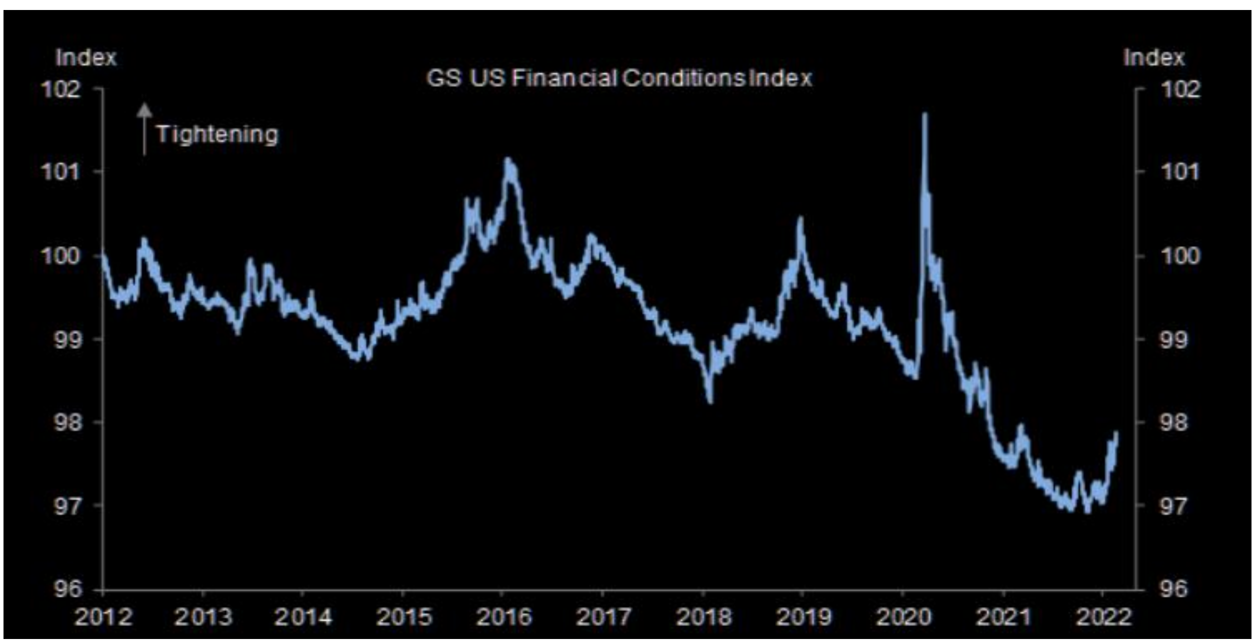
I mentioned this one last week, but to my eye, we still haven't hit extremes seen during previous periods that yielded lasting lows.

Back to buying on cannons … I would point out this isn't a US war (fingers crossed), and that the energy and superpower components are rather different, but here is a chart from Tier 1 Alpha looking at prior wars.

I doubt it will be that easy.

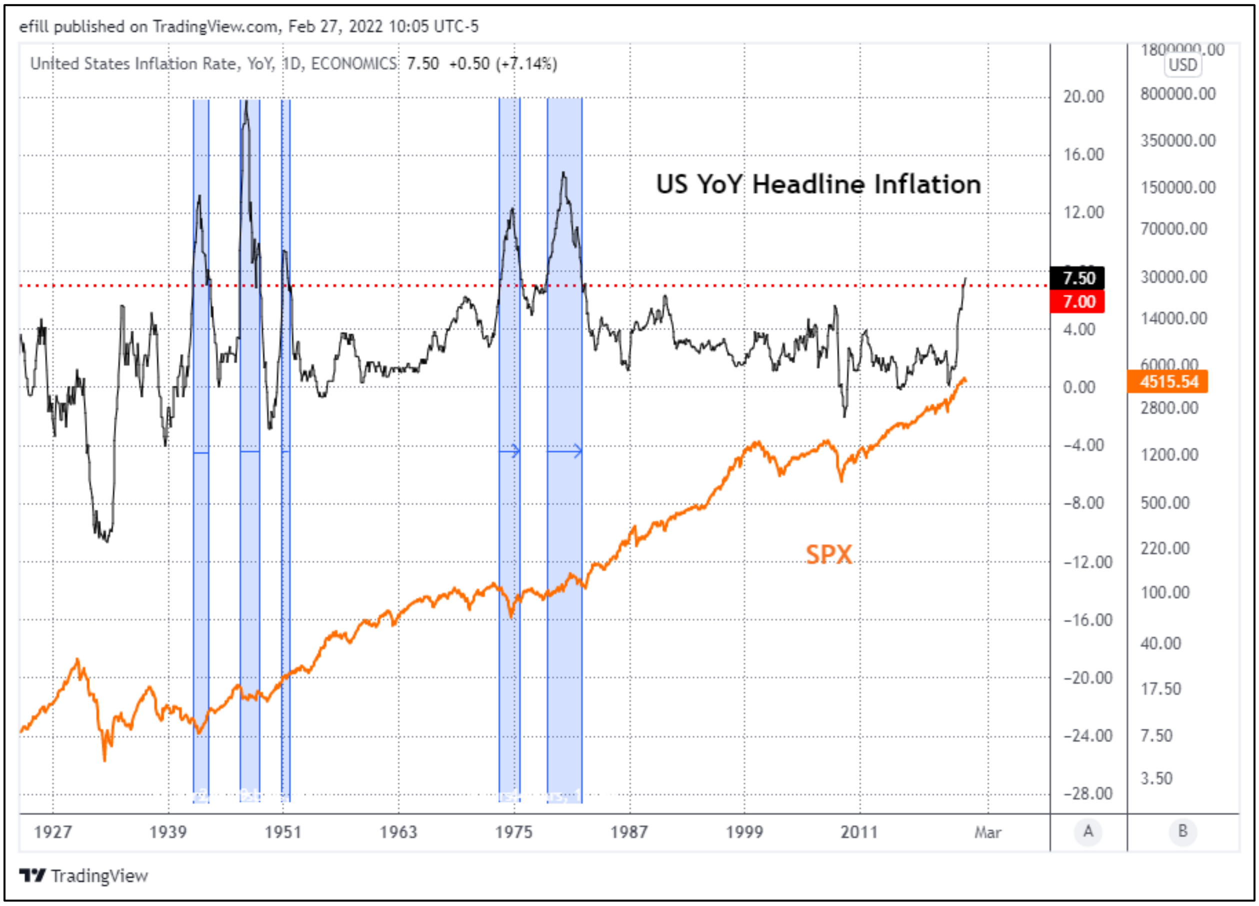
Add the already high global inflation, and central banks that are starting to react from still emergency interest rate levels, and things quickly get complicated.

Financial Conditions have started to tighten, albeit from record levels of looseness.



This chart really illustrates how very unusual it has been for headline US inflation to get to these levels.

Prints above 7% have tended to produce choppy equity markets, and/or meaningful selloffs.

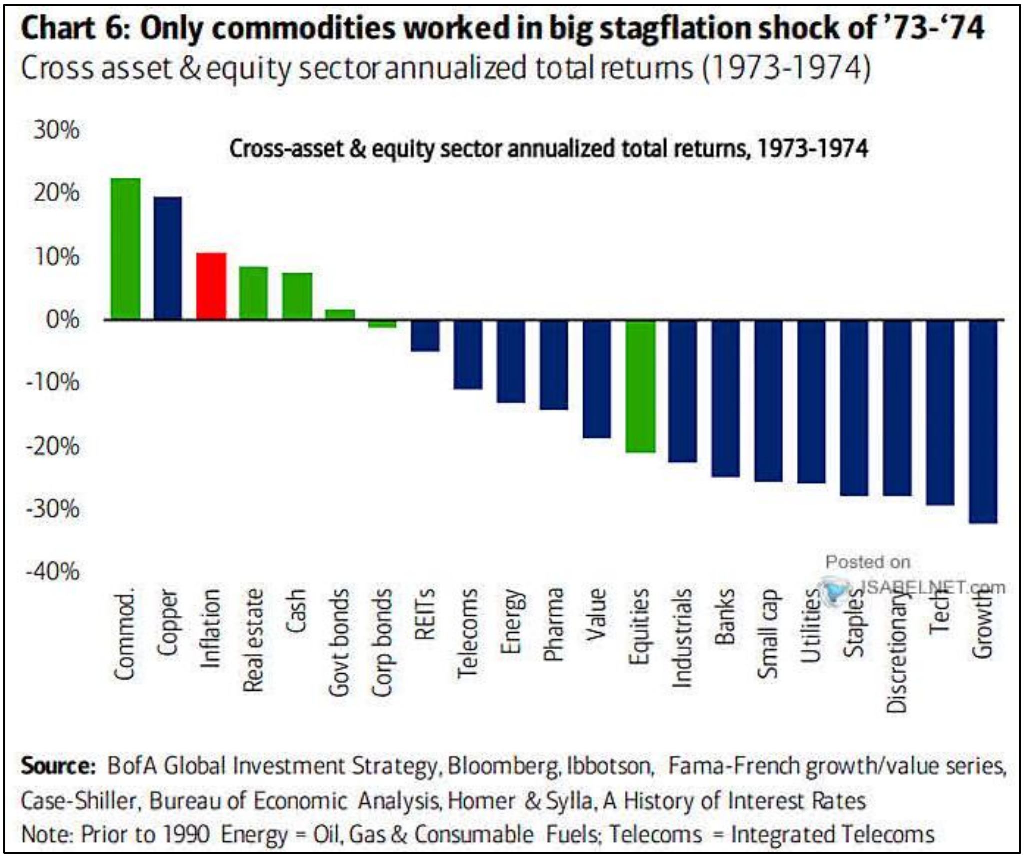


Markets are very bullish on commodities and investors are positioned as such. However, at the same time, rates are telling us that front-loaded Fed hikes will fix the issue. It is debatable whether the unusual flatness of the yield curve at this point in the cycle is telling us that the terminal Fed Funds rate remains very low, or whether it is reflective of foreign buyers looking for alternatives to European and Japanese bonds.

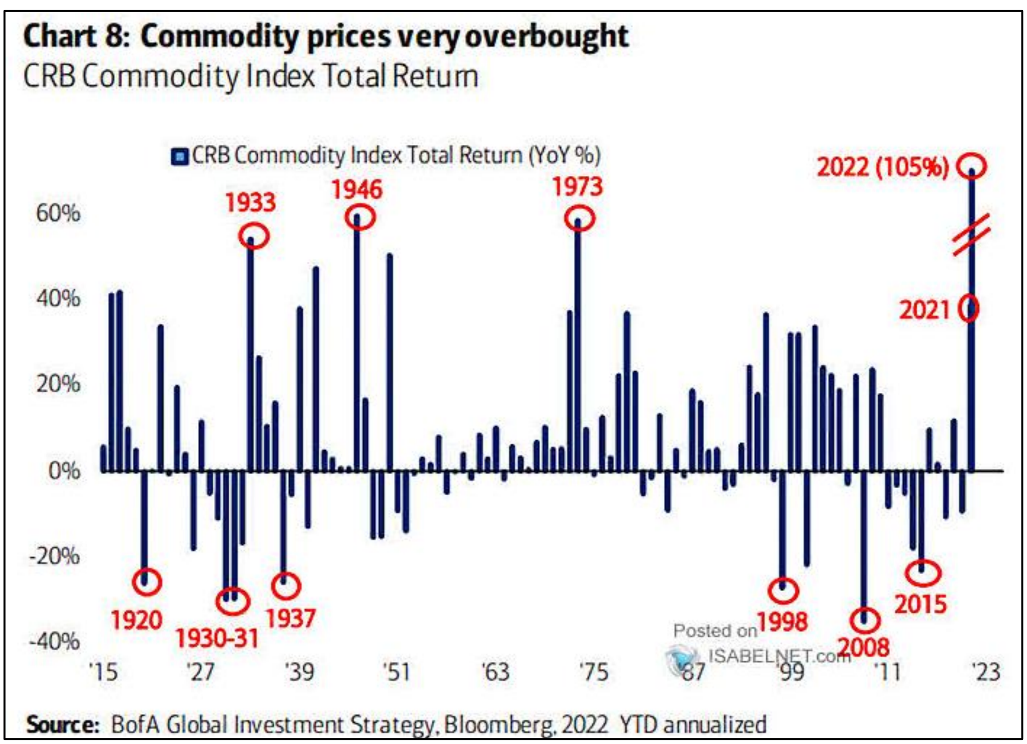
Is there a case of cognitive dissonance between what commodity and interest rate markets are pricing?

There are lots of people looking at the current period and trying to compare it to the late ‘60s or very early ‘70s.

BoA had this chart looking at what worked during that period.



At the same time, commodities are arguably already very overbought.



A big trade in the coming quarters will be the validation of either commodities or rate/bonds. In either case, we are now back in a boom/bust environment that we haven't seen for a while. Trading opportunities in Macro markets will abound.

With the current situation in flux and the endgame unknowable, it is worth contemplating different scenarios going forward. Assuming no catastrophic escalation, Europe is still likely to take the brunt of the economic consequences. Again, as CBs are faced with massive uncertainty and tough choices, they are likely to delay action as they wait for more transparency. The ECB in particular, given how important bond spreads are, may have a hard time ending QE on the timetable they have talked about.

While I don't agree with all the inputs, I thought this was a handy table from Bloomberg to get the thought process going.

Scenarios For Economic Impact of Ukraine Crisis

Possible paths for the Russian, European and U.S. economies

Severe Moderate Mild

Scenarios	**Oil and gas keep flowing, markets settle**	**Energy supply disrupted, oil and gas prices up, risk-off in markets**	**European gas supply halted, oil disrupted, significant global risk-off shock**
Sanctions	Broad. Sanctions on major banks, curbs on FX transactions and access to tech components.	Universal. Russian corporates and banks cut off from global markets, with carveouts for oil and gas.	Maximal sanctions or Russian retaliation cut off flow of gas to Europe.
Russia Impact	Falling ruble and rising inflation force big rate hikes. Sanctions hit trade, economy shrinks.	Combined impact of weak ruble, market turmoil, and disruptions to trade trigger deep recession.	Deeper crisis as Russia's budget and energy sector take an additional hit.
Europe Impact	Higher energy prices and moderate negative spillovers to growth. End-2022 ECB hike still in play.	Energy price surge, negative spillovers, and financial turmoil prompt mild downturn. ECB hike postponed to 2023.	Combined impact of energy shortages, negative spillovers and elevated uncertainty triggers a recession.
U.S. Impact	Higher energy prices and tighter financial conditions take most hawkish seven hike path for Fed off the table.	Higher energy prices and global risk off shock mean more dovish Fed heading into second half.	Worst case: energy spike combines with unanchored inflation expectations and Fed has to tighten as demand slows.

Source: Bloomberg Economics

Lots of volatility…

FX continues to get whipped around by opposing forces. Continued aggressive rate rise expectations, and recent safe-haven flows, are opposed by the continued interest in “cheap” foreign markets and the potential for rate expectations to fall.

The result has been a series of violent moves, that in aggregate haven’t changed the prices all that much from where we were in December.

Gold and precious metals more generally have been very volatile as well.

The recent breakout on risk-off Ukraine fears saw a big reversal on Thursday/Friday as equities rallied back strongly.

This could go either way here as potentially large flows are looming.

Russia and its Gold hoard are a wild card.

Over the last 10-years, Russia has been steadily exiting its US Treasury holding while it has been converting its reserves into Gold.

On one hand, there is fear that if they are locked out of the global financial system, they will have no choice but to sell large amounts of Gold.

On the other hand …

There was this piece from Bloomberg today:

The Bank of Russia said it will start purchasing gold again, just under two years after it ended a long-running buying spree that helped prop up bullion prices last decade.

The central bank will start buying gold again on the domestic precious metals market, it said in a statement. The move comes after the central bank and several of the country's commercial banks were sanctioned in response to Russia's invasion of Ukraine.

The Bank of Russia spent six years rapidly accumulating gold, doubling its holdings and becoming the biggest sovereign buyer. It stopped in March 2020 as prices spiked at the onset of the pandemic and has largely kept its stockpile steady since. The Russian purchases provided a key pillar of support for the market at a time when demand from investors was muted.

Gold prices swung wildly last week, surging as investors turned to haven assets after Russia invaded Ukraine and then tumbling back again as western nations acted to impose sanctions. Prices closed on Friday at $1,889.34 an ounce, up about 5% since the start of the month.

Central bank buying has been a key source of demand for gold in the past year, alongside reviving appetite from Asian jewelry consumers. Central banks added 463 tons to reserves in 2021, an increase of more than 80% from a year earlier, according to the World Gold Council.

Russia had more than 2,000 tons of gold at the end of December, according to data from the International Monetary Fund, accounting for just over 20% of its reserves. It's the fifth-biggest sovereign gold owner globally. - Bloomberg

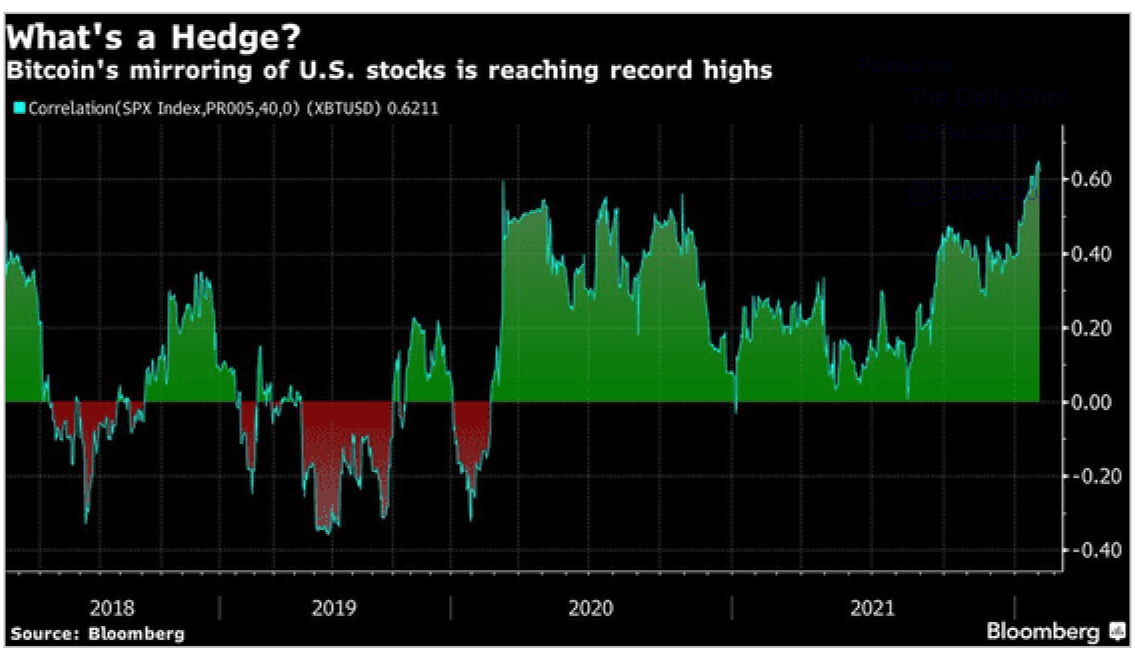
And from Goldman last week:

"Gold has rallied 7% from the start of the year and therefore has acted as an effective geopolitical hedge against the Russia-Ukraine conflict. While the rally has been swift, we think that it could have a lot further to go if a resulting commodity price spike leads to concerns of a material DM growth slowdown. Gold ETF holdings have only just begun to build and could potentially increase by 600 tons this year if concerns about US economic growth become more widespread. This could lead gold to spike to $2,350/oz above our current 12-month forecast of $2,150/oz. With rotation out of risky assets still in early stages, we believe gold is uniquely positioned to absorb some of these flows" (Goldman)

Either way, my view is that there will be tradeable volatility here that can be monetized with the proper strategies.

BTC

Bitcoin continues to be very correlated to US equities and the NDX in particular. This stands in contrast to pre-pandemic correlations. Now just another risk asset?



Important Macro Data Releases and Events for the Week

Monday 2/28/2022	Chicago PMI (Feb)
	NBS Manufacturing and Non-Manufacturing PMIs (Feb)
	Caixin Manufacturing PMI (Feb)
	RBA Interest Rate Decision and Statement
Tuesday 3/1/2022	Markit Manufacturing PMIs across Europe (Feb)
	Markit and ISM Manufacturing PMIs (Feb)
Wednesday 3/2/2022	HICP YoY (Feb)
	ADP Employment Change (Feb)
	Fed's Bullard speech
	Fed's Chair Powell testifies
	BoC Interest Rate Decision and Policy Statement
	Caixin Service PMIs (Feb)
Thursday 3/3/2022	Markit Service PMIs across Europe (Feb)
	Markit and ISM Service and Composite PMIs (Feb)
	Initial Jobless Claims
	Initial Jobless Claims 4-week average
	Continuing Jobless Claims
	Unit Labor Costs and Productivity

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		Factory Orders
		Fed's Chair Powell testifies
		Fed's Williams speech
Friday 3/4/2022		Retail Sales (Jan
		US Employment Data: Nonfarm Payrolls, Unemployment Rate (Feb)
		Average Hourly Earnings and Labor Participation Rate (Feb)

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