We Do More By 9am Than Most…

It feels like it was only last week that we published our 2022 Market Outlook. Technically it has only been two weeks, but so much has gone on. The start of 2022 has kept everyone busy, not only dealing with significant market volatility, but also trying to figure out how a variety of issues are going to shape the economy and markets. I've wanted to focus on a couple of "thought" pieces, one on the ongoing inability to hire people and another on China's delinking, but markets have forced me to stick to other topics. So here we are on January 17th and I think that all we can do is highlight the biggest issues, many of which seem like they are at inflection points, so that we can prepare for the coming weeks and months. Maybe this is why those old Army recruiting ads said that "In the Army, we do more by 9am than most people do all day." Certainly, in 2022, January is forcing us to do more than we usually do in a quarter, if not a year!

End of Omicron

Markets have been way ahead of politicians and the mainstream media for some time.

The U.K., which was ahead of the U.S., is exhibiting a pattern very similar to what we saw in South Africa. The massive spike in cases is already declining. Hospitalizations, which never got to levels seen back in March 2020 (or during the Delta wave) seem to have peaked and the lag effect is being accounted for. Deaths have also remained extremely low.

I keep reading statistics that Omicron might be ½ as severe as Delta, but I bet that by the time final statistics come out, the number is going to be closer to 10% as bad (though it is difficult to tell, since we still often don't know which variant people had or have good details about what vaccines or boosters people had either). See Chalk and Cheese for the quality of data that we should have.

In any case, even the fear mongering side of the media seems to be running out of ways to twist the data, especially since almost everyone seems to ignore cases. A Tale of Two Omicrons highlighted how the same data can be twisted to tell very different stories. The data, to me, seems to be much more supportive of the "mild and almost over" scenario.

The good news is that the pandemic is becoming endemic, which will boost the economy over time. Some businesses, especially in travel and leisure, will benefit and it should help ease some supply chain issues. **That bad news is that much of this is already priced into markets.**

From Transitory to Four Rate Hikes?

Hmmmm….I have been in the higher inflation (at least 3% average) for longer (2 to 5 years) camp since the start of 2021. I spent the better part of the year banging my head into the word transitory and trying to argue that things had "changed" – namely the near- and medium-term inflationary aspects of sustainability and China's retrenchment to a more inward-looking society and economy.

Now it is like there is some race to be the first to call for more aggressive Fed actions! Some of those shouting "transitory" the loudest seem to be the ones screaming for hikes and aggressive Fed policy. I like the "hot hand" theory of coaching basketball – feed the ball to whoever is shooting well. We seem to be taking the exact opposite approach.

This cacophony of noise seems to help drown out the reality that the "inflation is a problem" issue only got real traction once it became a political soundbite.

Yes, inflation does cause some problems for many, with the poorest people bearing the brunt of the problems. However, we have jobs and wage growth is offsetting inflation for many! Also, there is no obvious path to a sustainable economy with "better" infrastructure and "better" supply chains without going through a period of inflation. So, do we give up on these initiatives?

Despite being in the "inflation will be higher for longer camp," the contrarian in me can't help but push back on a few things:

- **Inventory Glut**. Okay, glut is a bit extreme, but there is some evidence that consumers overbought late last year and responded to supply shortages by buying more than they would otherwise. At the other end, companies have been frantically trying to acquire goods to sell into this "demand spike." As supply chains normalize (which is occurring slowly, but surely) we are seeing inventories build. I expect that in Q1 there will be some chatter that companies have gotten ahead of themselves. **I will go out on a limb and bet that** it will be cheaper to buy a new car by the end of the year than it is today (including incentives, etc.)
- **How leveraged is the economy and the market?** Since Bernanke, I've been in the camp that we have kept accommodative and innovative policies in place for too long and central banks across the globe have been too slow to normalize, which has made markets and the economy even more dependent on that support. Accommodative policy has become entrenched in such a way that it is more and more difficult to extricate ourselves. Central bankers would argue that they were too quick to stop the accommodation and that is why we've never had the breakout, so we will just have to agree to disagree. **The one thing I think that we can all agree on is that our tolerance for "pain" is very low.** The slightest dip in markets or the first inkling that the economy is slowing will have people (especially the politicians) screaming for easier money! For many politicians, their attention span for soundbites seems to be that of a gnat (though that might be unfair to gnats). However, I don't think that politicians are more worried about inflation than jobs, growth, and wealth. If any weakness in those areas arises, inflation worries will go out the window. **I am clearly betting against four hikes this year** (while still believing that inflation is going to be higher for longer).
- **Jawboning!** I have seen surprisingly little on the theory that the Fed is just jawboning, i.e., jawboning the markets to push inflation expectations to an acceptable level and jawboning politicians to keep them happy. Jawboning has been one of the best tools of central bankers for decades and the fact that so few seem to be discussing that right now seems weird. **Expect the Fed to "Talk like a Hawk and Hike like a Dove."**

I expect the Fed to act, end QE quickly, start hiking, and even talk about QT. Markets seem about halfway through digesting this. But, by the time the market fully digests that, there is a real chance that we will see a pullback on hawkish activity as a confluence of events could spur some growth fears.

Geopolitical Risks

In early December, Academy published [Will Russia Invade Ukraine?] We also discussed Russia, China, Iran, and cyber-attacks in our latest [Around the World]. On Thursday, we published our latest [Geopolitical Flashpoints Podcast,] which examines some interesting scenarios (not all of which are bad, though there is a tilt towards the negative risks).

We are all watching the accumulation of troops on the Ukrainian border with trepidation. There are ongoing negotiations, but they have done little to resolve the issue.

A few things to highlight regarding our current thinking on the subject:

- Putin needs a "win" for his own domestic standing and while a negotiated victory is good, taking back a piece of land is better.
- Putin truly believes that red lines have been crossed by NATO with troop and missile deployments near Russia's border.
- Putin's request for security guarantees from the West (including agreeing never to allow Ukraine to join NATO) is a non-starter.
- The energy crisis in Europe (cold weather, too little wind in Germany for their windfarms, and botching the transition to sustainable sources) is a "perfect storm" that may well not exist next year. The current energy crisis gives Russia more leverage and they cannot depend on this mix of ineptness and weather to occur again.
- Putin does not appear to be deterred by the threat of "start high, stay high" sanctions because he feels that they might not all be enforced (some could economically impact U.S. allies) and he has built up a $620 billion reserve to lessen the impact of any sanctions.
- The reality is this crisis goes far beyond Ukraine and is part of an elaborate plan to not just push back NATO and bring former Soviet nations back under Russian influence, but could be the beginning of further projections of power and expanded Russian nuclear weapons deployments closer to the U.S.
- Negotiations have a chance, but my sense is Academy's GIG is far less optimistic on that front than our politicians seem to be.
- We do NOT believe that any incursion would extend to Kiev. It would be restricted to Eastern Ukraine.
- My base case, from all our discussions, is invasion/incursion into Eastern Ukraine will occur with a pretext as to why it was necessary (even "humanitarian") and Europe will cave in exchange for the flow of energy and some promises that "Russia has no further interest in advancing, etc." I can't help but think about Neville Chamberlain's "peace in our time", but some strong language in some new agreement probably appeases enough politicians that they can acquiesce to the incursion.

Somewhat sadly, from a human perspective, that base case seems to be what is priced in. A negotiated settlement would probably be a pleasant surprise for markets, but an invasion followed by a relatively quick (within a week) acceptance with some promises, is unlikely to move markets too much.

In the unlikely event this becomes a full-scale invasion of Ukraine (with the West defending Kiev), some things I would be watching for include:

- **Does Europe start to splinter?** Do we see a "pragmatic" side (that accepts this outcome in exchange for energy and promises) face-off against an "idealist" side (which pushes hard to defend the sovereignty of Ukraine)? Where does the U.S. fit in? We have an easier time being idealistic as the energy crisis is more remote. This is all against a backdrop of Brexit, proving the European Union is not as solid as many believe. It is also against the backdrop of Turkey, a NATO member, buying Russian made missiles. This could turn out to be a divisive issue for Europe and

NATO. **That is not the base case, but if this scenario starts to play out, it will hurt the global economy and markets.**

- **Does it encourage China to act?** General Spider Marks, our Head of Geopolitical Intelligence, is quick to point out that geography makes it much easier for Russia to take part of Ukraine than it would be for China to try to take over Taiwan militarily. Having said that, China has other hot spots that they are involved in, and they may choose to flex their muscles. The comment one of our Generals has focused on is that China may like to prove that their military is as good on the field as it seems to be on paper. In any case, China's response if there is an invasion will be telling and may do more to change the global economy than a Russian invasion would. This remains an issue for us to figure out even if Russia doesn't invade, but an invasion would be such a catalyst that we'd get answers much quicker.

Markets

We have seen some pressure on markets and some wicked rotations within the equity markets.

As we have traded to lower levels, I am slightly less bearish.

I continue to believe that FOMO/TINA type of assets (those asset classes and stocks that most benefited from aggressive monetary policy) will underperform safer/simpler/dividend/reopening types of assets. (See FOMO's Engines are Stuttering or the 2022 Outlook for more details on the sectors/asset classes).

We lay out the shifts to our outlook in How the Year Changed in Minutes. The big shift is that the underperformance/outperformance will occur in a weak market rather than in a strong one.

Weirdly, despite Russia and Ukraine, I like Europe to outperform and I still think that EM (ex-China) has a lot of upside.

Credit should be relatively stable and I continue to think that structured credit will be a key driver to any alpha in 2022.

What would make me bullish risk assets?

I want to see one traditional "risk-off" day. A big flight to safety day where Treasuries (at the long-end) rally while stocks (despite lower yields) keep selling off. We had some of that on Thursday, but then on Friday we saw stocks trade well with bonds trading weak.

From a market's perspective, this is what I think we need.

As data comes in, the Fed speaks, and geopolitics play out we will have to adjust, but for now, we are not finished adjusting to a less supportive central bank.

The one caveat is that China's central bank is acting aggressively, but I suspect that is because the real estate debacle there is worse than we realize and their policy towards Covid is causing them more problems so I am not overly excited about China's accommodative central bank policy. It is something that I could be overly pessimistic on since it goes against the recentralization and delinking of China theory that I have, but I'm just not that excited (this is where I try to remind everyone that Lehman wasn't a moment).

In any case, let's keep navigating 2022 and always try to "**Be all you can be!**"

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