FISCHER STRALEM

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Dear Client:

It's no secret that central banks and governments the world over are dealing with rising inflation and economic uncertainty, both of which need to be addressed head-on if they want to maintain social stability. But in doing so, some of the world's largest economies -- including but not limited to the U.K., Japan, and the E.U. -- have begun to defend their interests. While disparate monetary and fiscal policies are historically familiar, two-plus decades of globalization have tightly bound national economies to one another, lessening the interventionist effects this time around while creating unintended havoc for friend and foe alike.

Economies are less globalized than they once were, a trend accelerated by the Covid pandemic and made all the more apparent with the fallout over Russia's invasion of Ukraine. Even so, it's becoming clear that existing trade and technological dependencies limit the extent to which central governments can defend their interests, and all measures they take will affect other nations faster than they would have before. We have been monitoring several systemic challenges that world economies are facing at once.

The first and most consequential is the weaponization of economic ties. As we noted in an earlier communiqué, the sanctions imposed on Russia by the West were supposed to force Moscow into submission. Instead, they have balkanized the global economy. Another major systemic challenge is spiraling energy/commodity costs and certainty of future availability (in some sense Europe was lucky that the winter was unseasonably warm so that natural gas demand could be met even with reduced -- and more expensive -- supply; we cannot bank on being that lucky going forward). But, remember that the current energy crisis is not solely responsible for high inflation. In 2021, excessively loose monetary and fiscal policies, combined with pandemic supply shocks, caused prices to surge. The war in Ukraine only made things worse so that those same supply shocks are still distressing markets. China's economic uncertainty is likewise a major challenge. The country has been struggling, and the way it handles its recovery is a point of major focus. The relationship between China and the world, and specifically between China and the U.S., is dependent on Chinese politics and the outcome of its socioeconomic policies.

The longest running systemic challenge is European fragility. An economically weakened China and Russia are bad for Europe, which depends on both in different ways. The European economy never really got over the pandemic, so it never really found a way to mitigate the damage of supply chain shocks. So, while the ECB has echoed U.S. monetary policy with higher interest rates, it is unable to turn off its quantitative easing spigot to make sure countries in Southern Europe have the room to adapt to deteriorating conditions. Meanwhile, the U.K. and Japan are taking a different path. Instead of increasing interest rates, they are increasing government borrowing. They are, in essence, replacing an economic crisis with a currency crisis -- which explains the pound and the yen dropping to historical lows against the dollar last quarter.

And this brings us to the last and likely most important systemic challenge: the strength of the U.S. dollar. The Fed's hiking rates to bring down inflation is having spillover effects for the rest of the world through the appreciation of and demand for the dollar. The problem is this kind of weaponization doesn't discriminate. When the global economy is stable, this may give friendly countries a spark for increasing exports to the American market. But the global economy is not stable -- and all these countries are fighting back inflation and dealing with similar problems that the U.S. is.

Recession may be an old game, but deglobalization is not, and we anticipate that we will start to see the first signs of this restructuring processes in the coming months and quarters. With many businesses cutting down on operations and with governments becoming more active in shaping national economies, more government spending is to be expected. Further shocks will determine whether (and how) nations become more aggressive in protecting strategic assets and critical infrastructure. Protectionism will likely become a preferred trade policy, with all the populist and nationalist sentiment that comes with it.

Regards,

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U.S. Large Cap Equity Strategy

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