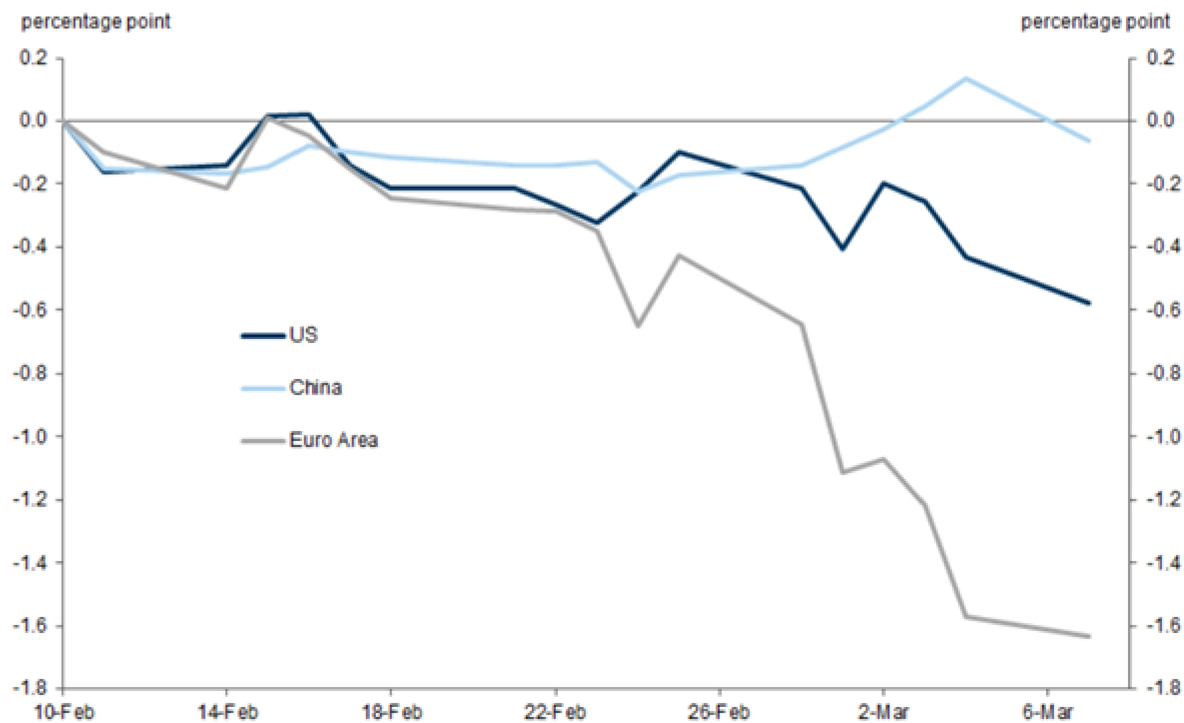
Week in Review

Friday, March 11th, 2022

1. Economic Growth Expected to Slow

The war in Ukraine is expected to have a negative impact on expectations for economic growth in the U.S. and the European Union, in particular. The primary drag on growth will be from higher energy prices, both directly and the flow through impact on finished goods. Disposable income will be reduced, negatively impacting spending. Goldman Sachs is now forecasting slower US economic growth in the year at 1.75%, down from 2.35%. Forecasts for the Euro area GDP are also being revised down to 1.6%, from 2.5%.



While surging commodity prices are seen as the primary driver of lower growth, other factors include tightening financial conditions, declining consumer sentiment, lower international trade, extended global supply chain disruptions, and shortages of key raw materials.

Given the high level of inflation even before the impact of the Ukrainian war, the Federal Reserve is expected to embark on monetary tightening later this month that was expected to moderate demand. The pace of tightening may be slower than expected given the geopolitical environment.

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Consumer sentiment typically falls during geopolitical crises and coupled with higher gasoline prices is likely to create a drag on consumer spending. Consumer demand is likely to not only be a domestic issue but impact international trade as well with lower demand for exports.

Finally, the global economy has been battling back from supply disruptions caused by the pandemic and new shortages in raw materials such as key metals may continue to exacerbate the ability to fulfill demand.

On the positive side, the U.S. and global economies have been on a path for solid growth from the pandemic with the labor market particularly strong supporting spending. While growth forecasts have come down, the outlook remains in positive territory.

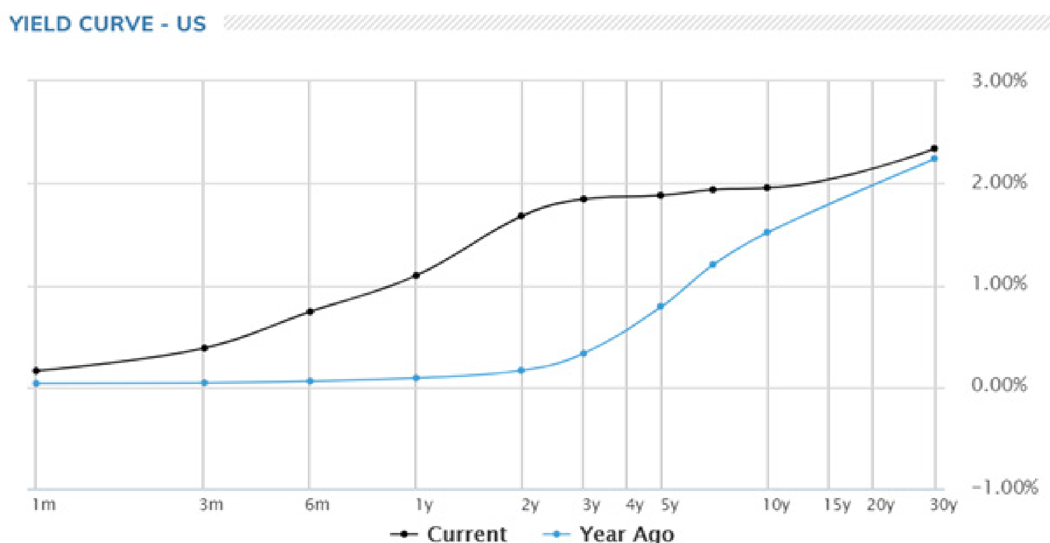
2. Yield Curve Flattening

A yield curve is a line that plots interest rates of bonds having equal credit quality with differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes, economic activity, and at times risk aversion.

Three shapes of yield curves are observed: normal, inverted, and flat. A normal yield curve slopes upward to the right representative of higher yields with longer maturities. An inverted yield curve slopes in the opposite direction with lower yields for longer maturities, and a flat curve, as its name suggests, has little differentiation between yields for short and long maturities.

A year ago, the curve was normal and suggestive of an expected recovery from the pandemic so pointing to economic expansion. However, the absolute level of short-term yields was also very low reflecting the ongoing easy monetary policy and stimulus.

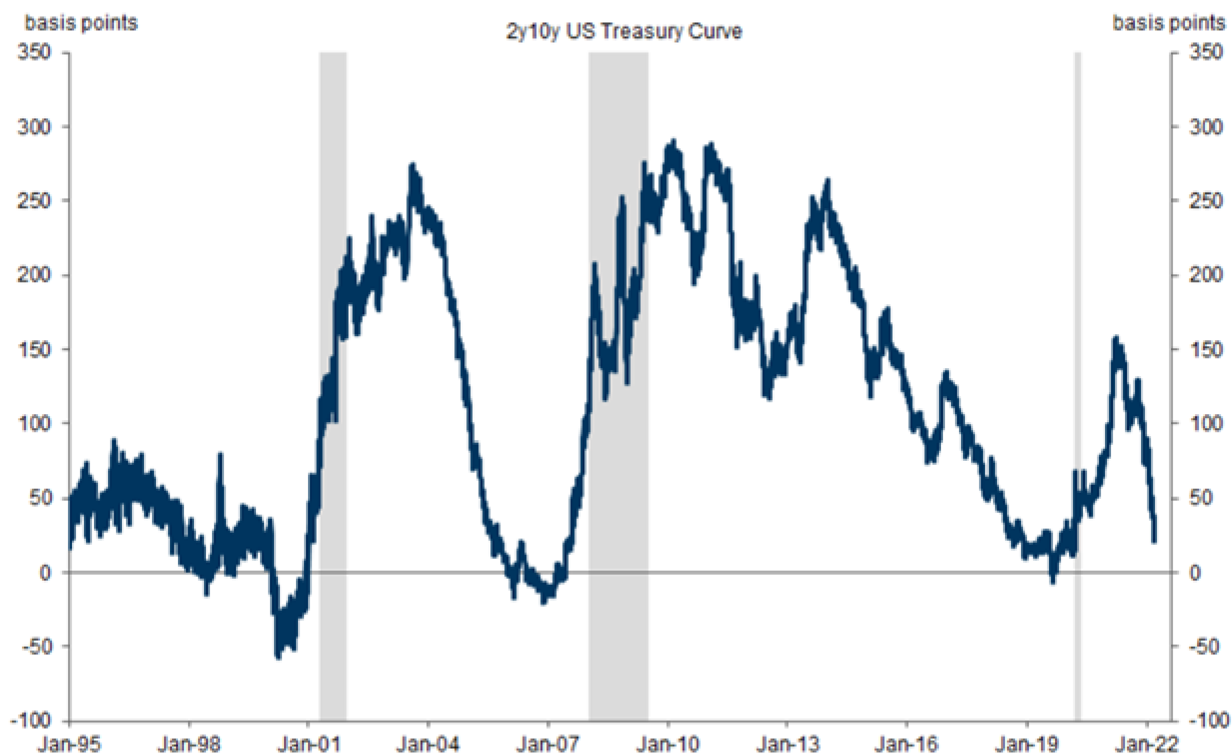
The current yield curve has moved to be defined as flat as the short-term has moved up as inflation supports the Federal Reserve raising rates, while long-term yields have moved to a much lesser degree.



Source: Marketwatch

The current flattening of the yield curve is likely indicating expectations that the Federal Reserve will be raising rates but into an environment with heightened uncertainty about long-term economic growth.

While the current curve is flat, the absolute spread between short- and long-term durations is worth watching. A comparison of 2-year to 10-year treasuries is often used for this comparison. A year ago, the spread between the 2-year and 10-year treasuries was 135 basis points and that has now declined to approximately 30 basis points.



Grey bars indicate recession

Source: Bloomberg, Federal Reserve Bank of St. Louis, Goldman Sachs Global Investment Research

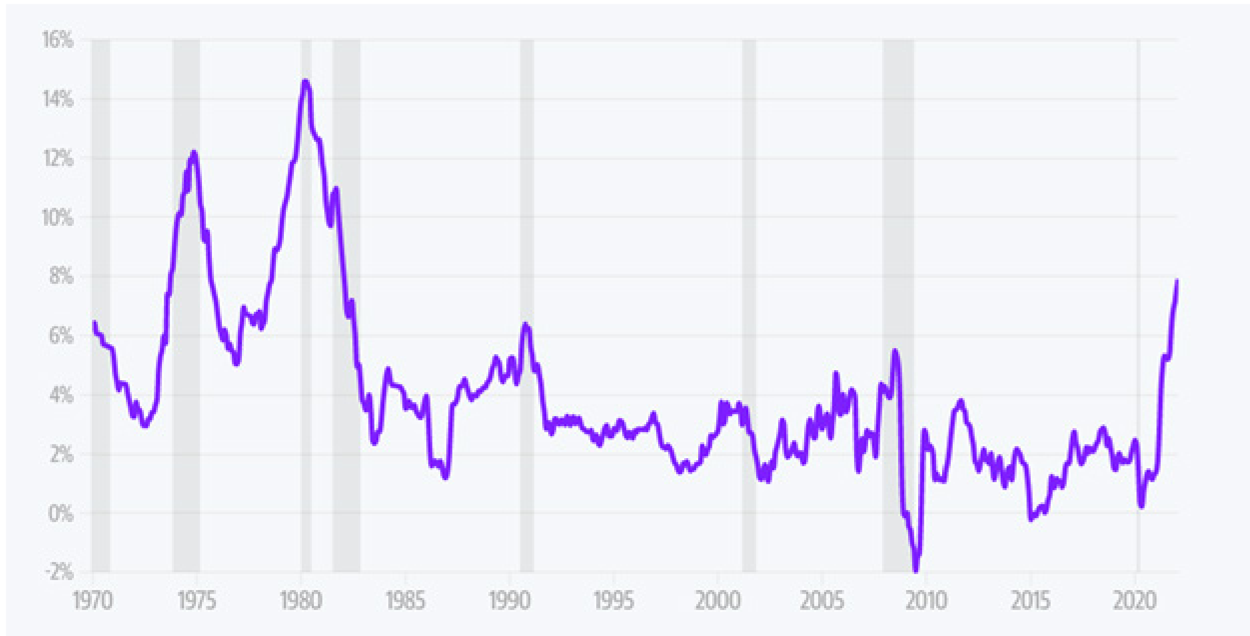
The importance of the absolute yield spread has been its historical correlation in predicting recessions. In the past, an inversion of the spread, a condition in which the long-term rate is less than the short-term rate, have preceded economic recessions.

While recent forecasts support an expectation for slower growth, mostly driven by higher commodity costs as discussed above, the current geopolitical issues are also likely driving investment dollars to defensive positions pushing down yields on long-term treasuries and causing a portion of the diminished yield spread. A lessening of these geopolitical concerns would conversely likely see upward pressure on longer-term rates and a widening of the spread. This would be a positive development for risk assets such as equities. At this time, concerns about recession are relatively low. For the time being, the yield curve is supportive of this positioning.

3. Inflation Continues to Run Hot

The Bureau of Labor Statistics' Consumer Price Index (CPI) rose 7.9% in February compared to last year, marking the fastest annual jump since 1982. The CPI is a measure that examines the weighted average of prices of a basket of consumer goods and services such as transportation, food, and medical care.

U.S. Consumer Price Index, Year-Over-Year Change



Source: U.S. Bureau of Labor; Yahoo Finance

The latest inflation reading comes as no surprise and was in line with expectations. A surge in energy prices was one of the key contributors. The further rise in energy prices since February after the invasion of Ukraine will likely result in further inflationary pressures going forward.

Following the release, Treasury Secretary Janet Yellin commented that inflation is a problem, and that the U.S. was likely to see another year in which year-over-year inflation numbers remain very uncomfortably high. However, Secretary Yellin also predicted that the Federal Reserve could achieve a soft landing for the economy and ultimately tame inflation without triggering a recession.

Thinking Ahead

Economic drivers such as growth and inflation have come under further pressure because of the Ukrainian war. This has resulted in lowered expectations for the financial markets and an increased defensive posture at least for the near term. Longer-term, confidence exists that the current headwinds will be overcome. The underlying strength in the labor market and economy will be supportive for corporate earnings, which will ultimately drive financial markets. Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.

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