INVESTMENT STRATEGY INSIGHTS

It All Comes Back to Inflation

March 28th, 2022

Inflation in the Fed's Crosshairs

- Near-term hikes are unlikely to disrupt markets, but the Fed should be careful not to overtighten later this year

War Response from the West

- Europe's reliance on Russian oil and gas may be a motivator in strengthening U.S.-Europe energy trade ties

U.S. Dollar & Inflation Interplay

- Cheaper imports via a stronger dollar may help soften inflation pressures for a net importing U.S.

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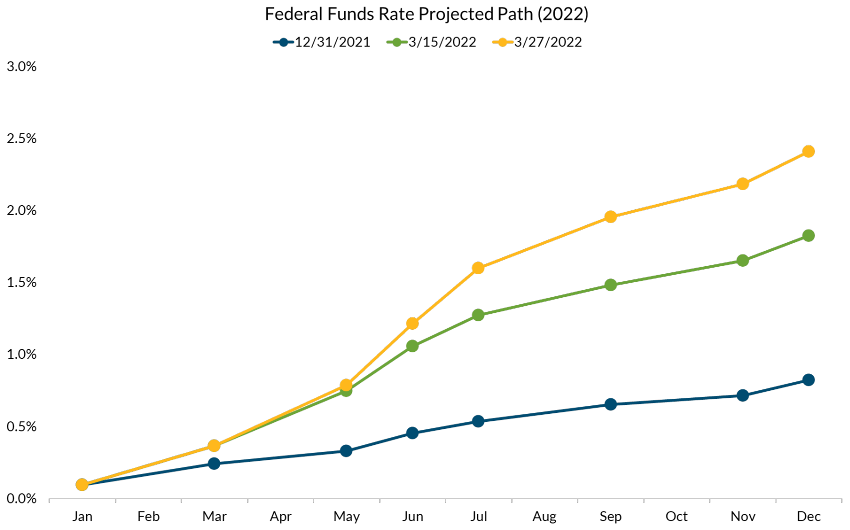
Inflation in the Fed's Crosshairs

- **Rates Higher.** Yields on 10-year U.S. Treasury Bonds have risen notably, up from 2.18% early Monday to 2.49% at the week's close. The main catalyst was increasingly hawkish rhetoric from Fed Chair Powell, who laid the groundwork for the possibility of half percent rate hikes to fight stubbornly hot inflation pressures. With initial jobless claims hitting a new all-time low as a share of the civilian workforce, the strength in the labor market is affording the Fed flexibility to tackle its price stability mandate head-on.
- **Pressure to Tighten.** Market expectations for the path of fed funds have steadily become more aggressive. In late 2020, the Fed introduced an average inflation targeting framework that implicitly invited higher inflation to offset years of undershooting its target. Now that inflation has returned in force, it has driven the Fed to tighten and prove their inflation-fighting convictions to the market and economic participants. It's likely the Fed will continue on this path until the inflation data and/or economy begin to soften and may be able thread the needle to avoid pushing the economy into recession.
- **Markets & Tightening.** Traditional risk assets have historically held up reasonably well in the early phase of monetary tightening, when policy rates are low but rising. However, the return environment typically becomes more challenging once monetary policy becomes outright tight and the Fed keeps tightening anyway. If inflation pressures begin to show signs of dissipating later this year, the Fed may not need to continue raising rates so aggressively. If the Fed is able to achieve this soft landing, monetary policy may not necessarily prove disruptive for markets.

Near-term hikes are unlikely to disrupt markets, but the Fed should be careful not to overtighten later this year

Chart of the Week:

Fed is turning more hawkish to defend its price stability mandate



Source: Glenmede, Bloomberg Data through 3/27/2022
Data shown are expectations for the federal funds rate through 2022 via pricing in fed funds futures, as of 12/31/2021 in blue, 3/15/2022 in green and 3/24/2022 in yellow. Dots along each line represent the dates of scheduled meetings of the Federal Open Market Committee (FOMC). Actual results may differ materially from projections.

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War Response from the West

- **High Alert in Europe.** As the war in Ukraine entered its fifth week, President Biden met with his NATO, G7 and E.U. counterparts last week to discuss further steps in punishing Russian military aggression. Some of the latest incremental steps included NATO announcing reinforcements for the already 40,000 troops on the alliance's eastern border, a call to remove Russia from the G-20 and the promise that action will be taken against Russia in the event of a chemical weapons attack on Ukraine.
- **Sanctions Pile Up.** Last Thursday, the U.S. announced new sanctions on the 328 members of the Duma legislative body and other Russian entities, including oligarchs and defense companies aiding the invasion effort. Other countries continued to ramp up sanctions of their own last week as well, such as Switzerland, the U.K. and Australia. In addition, the number of major companies self-sanctioning business dealings with Russia continues to climb, with the latest disclosures coming from Nestle, Renault and BNP Paribas.
- **Controversial Energy Policy.** E.U. leaders remained torn last week on taking the step to ban Russian oil and gas imports. Those in favor of an embargo, including Poland and Latvia, cited European demand contributing to half of Russia's revenue from oil exports. Those against, such as Germany and Hungary, cited the potential for significant near-term economic fallout from such a decision. An E.U. embargo requires unanimous approval from all 27 member states. In the meantime, the U.S. is supporting E.U. energy demand by routing record exports of liquid natural gas across the Atlantic.

Europe's reliance on Russian oil and gas may be a motivator in strengthening U.S.-Europe energy trade ties

U.S. Dollar & Inflation Interplay

- **The Strengthening USD.** Typically, when the global economy is hit with a crisis (much like the ongoing war between Russia and Ukraine), investors tend to favor safe-haven assets, for which U.S. Treasury Bonds have played a quintessential role. In addition to putting downward pressure on Treasury yields, this incremental source of demand can cause the dollar to appreciate as foreign capital must be converted to U.S. dollars to buy Treasuries. Accordingly, the U.S. Dollar Index (DXY) has strengthened considerably since mid-January, up 4.2% relative to the currencies of major U.S. trading partners.
- **Additional Dollar Tailwinds?** It's possible that the war in Ukraine could lead to continued strength in the dollar via enduring demand for safe-haven assets. In addition, the rapid rise in Treasury rates has the potential to attract new foreign capital into dollar-denominated investments. In addition, relative to many of its developed market peers, another tailwind could be ascribed to the U.S. economy's general insulation from the war's disruptive effects.
- **Currency-Inflation Interaction Effect.** All else equal, a stronger currency makes import prices cheaper for domestic consumers and makes the value of exports incrementally more expensive for its foreign customers. For a country like the U.S. that consistently operates in a current account deficit by importing more than it exports, a stronger dollar could help soften the blow of inflationary pressures induced by strong U.S. demand and supply chain bottlenecks. While this is unlikely to be a force that single-handedly brings inflation to heel, it's a factor that may help cool off price pressures on the margin.

Cheaper imports via a stronger dollar may help soften inflation pressures for a net importing U.S.

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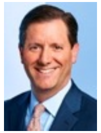

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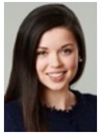

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