Invasion and Inflation- The Fed is Cornered

Chairman Powell will testify to Congress today and tomorrow and is likely to face many questions on how he intends to deal with inflation. As if the inflation problem were not enough, the Russian invasion provides a further inflationary impulse. Russia is a key exporter of oil, gas, and wheat and they produce key metals and minerals like titanium. Inflation pressures will likely increase if the invasion continues. For example, shown below, gasoline futures are up to $3.08/gallon, a 50% increase from a year ago. Further sanctions against Russia will cripple their economy as intended but have an inflationary effect for most other countries. Powell must balance rising inflation and weakening economic activity resulting from the invasion and do so without upsetting markets. Mr. Powell, good luck threading that needle!

[dmc]

What To Watch Today

Economy

- 7:00 a.m. ET: **MBA Mortgage Applications,** week ended Feb. 25 (-13.1% during prior week)
- 8:15 a.m. ET: **ADP Employment Change,** February (375,000 expected, -301,000 during prior month)
- 2:00 p.m. ET: **U.S. Federal Reserve Releases Beige Book**

Earnings

Pre-market

- **Dine Brands (DIN)&#2013266080;**to report adjusted earnings of $1.27 on revenue of $236.63 million
- **Dollar Tree (DLTR)**&#2013266080;to report adjusted earnings of $1.77 on revenue of $7.12 billion

- **Abercrombie & Fitch (ANF)**&#2013266080;to report adjusted earnings of $1.27 on revenue of $1.18 billion

Post-market

- **ChargePoint (CHPT)**&#2013266080;to report adjusted losses of 18 cents on revenue of $76.15 million
- **Snowflake (SNOW)&#2013266080;**to report adjusted earnings of 3 cents on revenue of $372.78 million
- **Veeva (VEEV)&#2013266080;**to report adjusted earnings of 88 cents on revenue of $480.24 million
- **Okta (OKTA)&#2013266080;**to report adjusted losses of 24 cents on revenue of $359.41 million
- **Splunk (SPLK)&#2013266080;**to report adjusted losses of 22 cents on revenue of $776.70 million
- **Victoria's Secret (VSCO)**&#2013266080;to report adjusted earnings of $2.63 on revenue of $2.14 billion
- **American Eagle Outfitters (AEO)**&#2013266080;to report adjusted earnings of 35 cents on revenue of $1.51 billion

Market Trading Update

Despite yesterday's selloff, the market remains above support but clearly confined to a downtrend. If the market breaks the October/January lows, there is a risk of a deeper correction which will suggest removing more equity exposure and hedging further. The increased bond exposure that we added over the last couple of months has provided a good hedge against the decline so far.

The market is not overbought as of yet, and investor sentiment is extremely negative which still argues for a short-term rally into the mid-month FOMC meeting. However, the headlines from the Russian invasion, inflation from surging oil prices, and the risk of a *"trapped Fed,"* certainly have our attention for now.

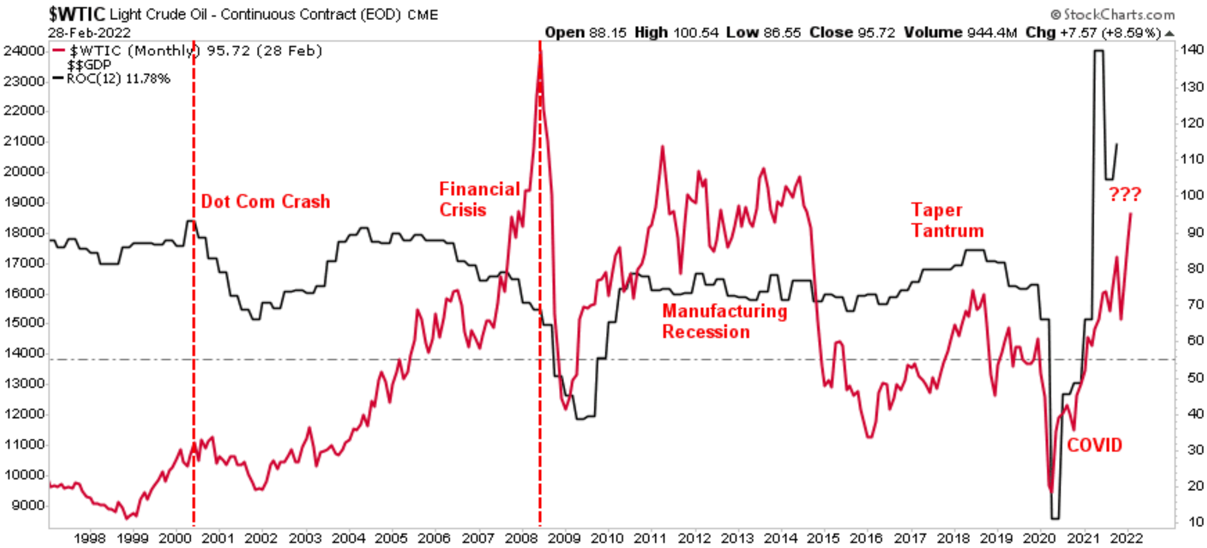
Speaking Of Fear

Throw in some invasion and inflation along with a healthy stock market correction and you get investors approaching the *"extreme fear"* levels.

Source: CNN

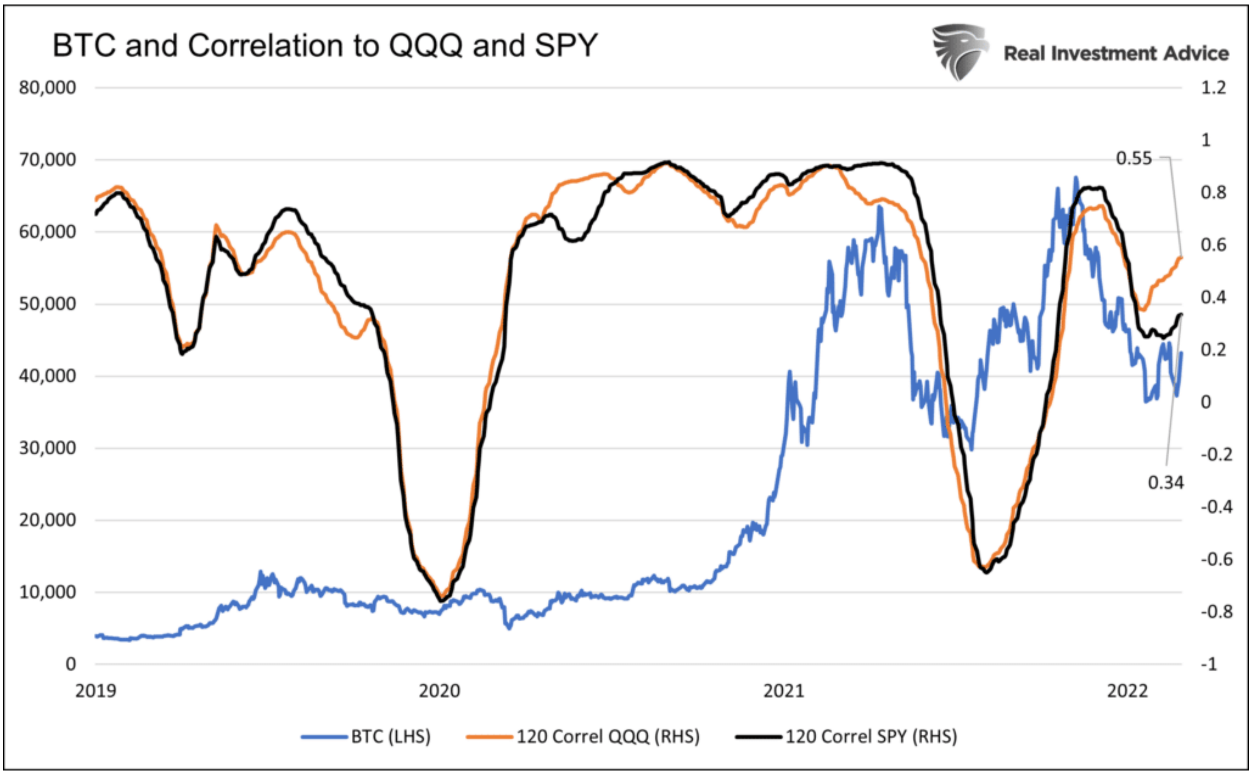
Oil

The best cure for high prices....is high prices. Surges in oil prices lead to demand disruption. Even as oil prices rose following the Dot.com crisis, economic growth was deteriorating quickly. When the Fed started hiking rates, it was game over. Now, with economic growth already slowing sharply, consumer confidence already declining, and a Fed looking to combat inflation, the risk of demand destruction is very high.



NASDAQ, S&P 500, and Bitcoin

The graph below charts Bitcoin (BTC) and its correlation to the NASDAQ (QQQ) and S&P 500 (SPY). As shown, the correlation between crypto and the large-cap U.S. stock indexes is generally very high. During most of 2020 and part of 2021, the rolling 120-day correlation between BTC and equities was over 80%, and at times nearly 100%. Recently it has come off a bit but still shows a decent correlation, especially to the NASDAQ. Unlike Bonds and, at times, gold, it's not clear that crypto is a hedge against market angst. In fact, it appears to be just another "risk-on" asset.



Hedging Higher Gas Prices with Energy Stocks

David Rosenberg shares a way to hedge higher prices at the gas pumps.

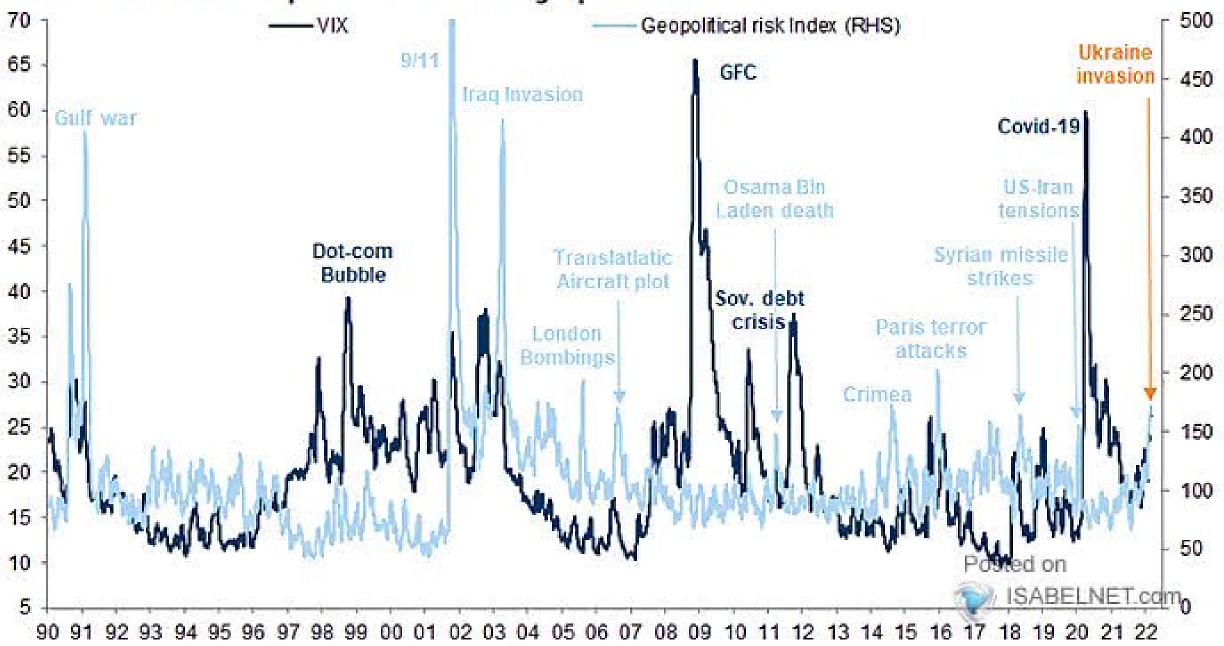
David Rosenberg
@EconguyRosie

WTI just popped above $100 per barrel. Going back to all the times this threshold was pierced in the past 14 years, the E & P stocks went on for a nice ~20% rally in the next four months. Best way to compensate for those higher prices at the pumps.

Volatility and Geopolitical Events

The graph below from Goldman Sachs compares VIX (volatility index) to a measure of geopolitical risk. The two most significant spikes in the VIX since 1990 occurred due to non-war events (financial crisis and Covid). Some of the more prominent invasions/wars (Gulf War, 9/11, Iraq Invasion, and Crimea) resulted in elevated volatility, but, in general, they were below spikes related to financial crises. The current level of VIX, 31, appears in line with prior invasions and wars. What makes this instance a little more complicated in assessing how high VIX can go is the Fed's coming change of stance.

Exhibit 8: The VIX often spikes as a function of geopolitical risk



Source: Bloomberg; Dario Caldara and Matteo Iacoviello, Federal Reserve Board. See also https://www.matteoiacoviello.com/gpr.htm, Goldman Sachs Global Investment Research

Chairman Powell Visits Congress

Fed Chairman Powell will provide congressional testimony today and Thursday. After his testimony, we hope to understand better how the Russian conflict affects the Fed's decision to hike rates and end QE at the coming March 16th FOMC meeting. Economic data has generally been weak since the last meeting, but inflationary pressures are not relenting. Will he start to talk back rate hikes due to economic slowing or stay firm on multiple hikes this year and QT due to inflation? We presume Powell will get bombarded by legislators from both sides of the aisle pressuring the Fed to reduce inflation. He will likely answer in a hawkish manner, which may scare markets.
