

Episode 26

Lara Rhame on the Ukraine conflict, macro implications

Chief U.S. Economist Lara Rhame shares her initial reactions to the Russian invasion of Ukraine and what it means for the global economy.

Kara O'Halloran (00:05):

Welcome back to Fireside, a podcast from FS Investments. My name is Kara O'Halloran. I'm a director on our investment research team here and I am currently sitting with our Chief US Economist, Lara Rhame.

Kara O'Halloran (00:17):

Lara, I am going to dive right in. It is midday on Thursday February 24th. We all woke up to news this morning that Russia had invaded Ukraine, something that had obviously been a possibility for a few weeks and of course, the first thing we want to do is really just acknowledge the gravity of the situation and first and foremost, there is a very real human toll. So while we are going to stick to some of the market and economic impacts, our hearts go out to anybody who has been impacted or has had family impacted by the events of the last 24 hours.

Kara O'Halloran (00:48):

Things are changing really quickly and evolving really quickly so we're going to talk about some of our initial thoughts on the initial market and economic impacts. Taking down a few of the things that we've seen in markets so far, equity's opened down pretty significantly this morning. Seen them pair some of those losses in a typical flight to equality. We saw the 10-year yield drop about 15 basis-points. Again, it's risen some since. We've also seen the Nasdaq up on the day, almost harkening back to that COVID trade of tech being a safe haven. But the big news, I think, also, is oil prices crossing \$100 for a barrel for the first time since 2014. So a quick list of the market impacts that we've seen but Lara, I want to know your initial thoughts right off the bat, gut reactions to what's going on.

Lara Rhame (01:38):

Yeah. I mean the humanitarian impact, obviously, comes first. Our hearts and prayers are with anyone who has family who's in danger this evening or is in danger this evening. My husband is of Ukrainian heritage. I know that there are relatives there and we're all just ... I think that has to be top of mind.

Lara Rhame (01:58):

When we really think about the direct economic impact for the US economy, just that old adage of when things are happening of this nature, you want to safeguard your home territory. And think about what impact we're going to see to the US, the reality is that the direct export market interaction with the US and Russia is really very limited already. We have heard President Biden discuss Draconian sanctions that are coming. We still don't have a lot of clarity about that. But right now, Russia only accounts for one percent of US imports and less than half a

percent of US exports. So unlike China, Canada, these big trade partners, even if we just stopped trading with Russia today, that is not a big impact on US manufacturers or US producers.

Kara O'Halloran (03:02):

Yeah. But so talk a little bit about Europe.

Lara Rhame (03:04):

Well, yes. I mean you want to talk about who is really going to face the initial impact of this, it's clearly the European countries who do trade much more significantly with Russia and rely on Russia for energy consumption and supply. So I think that is really where, when we think about economic impact, you look to Europe first and I think that's what we're seeing reflected in some of the big market moves today. The acute volatility you saw in Europe and of course gas prices in the UK, in Germany, up. 40% electricity price increases, very significant.

Kara O'Halloran (03:40):

Yeah. So let's dive a little more into the commodities you just brought up. Gas prices. So as I said, we did see oil cross \$100 a barrel earlier this morning. It has paired some of those increases. But I think Biden announced releasing some strategic petroleum reserves which did bring prices down a bit. But I want to know your impacts more broadly on these rising energy prices.

Lara Rhame (04:04):

Yeah. I mean we've seen higher energy prices fueling broader inflation for some time now. That clearly continues. I think for the entire commodity complex, we're seeing food commodity prices, gold, a lot of things are just going to be higher because of this uncertainty, because of this geopolitical event. So it continues to just be ... To elevate inflation in the US and to really probably drive significant inflation in the near term in Europe. And it's the kind of inflation that can lead to demand destruction. I think that's the unfortunate issue. When we're talking about energy prices, that is required consumption. And so we end up having to cannibalize demand in other areas.

Kara O'Halloran (04:53):

Yeah. Do you see impacts on our growth forecast?

Lara Rhame (04:56):

For the US growth forecast, no. But I think looking globally, and I don't want to put numbers on it right now because it's just too early. But I think this does cause uncertainty about growth, certainly this quarter in Europe. And I think it will impact policy as well.

Kara O'Halloran (05:17):

Yeah. Well speaking of policy, let's talk about central banks.

Lara Rhame (05:19):

Yes.

Kara O'Halloran (05:20):

All of this comes at a time when we're seeing central banks globally start to tighten policy. We've talked about fed rate hike expectations really moving very quickly over the past few months. They've moved possibly even more quickly when we're talking about the ECB. So we saw I think one rate hike priced in a few months ago, then it went to five. Now we're back to

about three rate hikes. So walk us through what you're watching when it comes to central banks.

Lara Rhame (05:46):

I mean there's no doubt that whereas the fed has very clearly signaled that they intend to raise rates and we still have six rate hikes priced in for the US, the ECB was a more awkward hawk for lack of a better way to phrase it and I think this really is now a situation where it's hard to imagine the ECB racing to hike rates given current uncertainty related to the economic impact of the invasion today. So I think one of the long-run impacts of that after the dust settles, we could actually see more ECB rate hikes getting priced out of expectations. So we could see the ECB moving back to maybe one rate hike. I would think that in this situation, the ECB would err on the side of caution. The UK still has five more rate hikes priced in. They just did a second rate hike. Again, depending on what energy prices do on the ground in the UK, there may be also room for the Bank of England to pull back on their rate hikes.

Kara O'Halloran (07:01):

Yeah. And then I think in the US, we saw that 50 basis-point hike that some people have been talking about. I think that got priced out of markets pretty quickly today.

Lara Rhame (07:09):

And it's still there which is surprising to me. I've been in camp 25 basis-points in March for some time now. And I think, listen, things are moving fast. A year is a long time horizon right now. The fed has clearly signaled they want to go and markets still have that priced in. But we really have to see the impact of these higher energy prices on demand and that will, I think, determine the feds conviction later in the year.

Kara O'Halloran (07:43):

So I said this situation is evolving very, very quickly and we really just wanted to come on and talk briefly about the near-term, the really immediate market and economic impacts so I'm going to ask you kind of a tough question, against what I just said we were going to do, but what is this longer-term? What impacts do you see of this situation?

Lara Rhame (08:05):

I think there's no doubt we're going to be talking about this in history class for decades. It's really a destabilizing move. And I think what it does, the way that connects to the economy is really accelerating the move away from globalization. And we've seen COVID impact and push global supply chains and break global supply chains such that we're now talking about deglobalization, right? That's the new trend in investment, in strategy. And I think as far as markets go and company investing goes, we're going to need to continue to pick winners and losers when it comes to regionalizing supply chains and when it comes to really repatriating some of that production. So I think that's going to continue to be ... This has really accelerated that trend in my mind.

Kara O'Halloran (09:04):

Yeah. And I think just to wrap it up, the really short-term, that old adage, you can't control the situation just how you react to it. So I just always think back in time to these times of volatility, this is why we've designed diversified portfolios. Selling into weakness doesn't help. I think even really tactically, some of the moves we've seen in the 10-year today might boost your core fixed income. Could be a nice time to diversify away from those duration assets or duration sensitive assets. But ... Yeah.

Lara Rhame (09:35):

Yeah. I think exactly to your point, Kara, we're still looking at a US economy that has a lot of tailwinds. That's still really strong and solid. I think we forget that when markets are this volatile, they can still be anchored to a really solid economy and that's the situation we're in today. The market volatility may well continue and certainly, all of the uncertainty that we had been worried about in 2022 has now only ramped up and that could continue for some time.

Kara O'Halloran (10:05):

Yeah, absolutely. All right, Lara. We'll leave it there. As I said, we are really closely watching this situation along with the rest of the world so I'm sure we'll be back on to get some more updates soon. Thanks for joining.

Lara Rhame (10:16):

Thank you.