April 2022 – Investing Through Conflict

"There is no instance of a nation benefiting from prolonged warfare."
-Sun Tzu

The War and Inflation

It has been two years since the market bottomed during the coronavirus pandemic. Now, the market moves from being solely focused on COVID-19 to many other things including war, the economy, inflation, supply shortages and interest rate increases. Investors must navigate in the current environment just as they had to do with the coronavirus. We should stay disciplined and adhere to our core investing principles.

The effects from the Russia-Ukraine conflict are significant. Though Russia and Ukraine are not a large source of sales for most American corporations, their economies are heavily concentrated in commodities. Energy, industrial and agricultural sectors using oil, nickel, wheat, and potash fertilizer have all been negatively affected as Russia's economic sanctions are enacted and normal agriculture planting and industrial activity have been seriously impaired in both Russia and Ukraine. Since global supply chains had already been impacted from the pandemic, the war exacerbates this problem. From the gasoline pump to the grocery store, consumers are feeling the inflationary effects of higher commodity prices.

As interrupted supply lines frustrate consumers, companies and governments, pressure mounts to reduce dependency on imports for everyday goods. Since the Cold War, developed countries moved towards globalization and interwoven supply chains, with the United States benefitting from this trend. Through the combination of inexpensive manufacturing and labor costs abroad and a strong US dollar, American consumers enjoyed relatively stable prices for goods. Now, the world is acknowledging the risk of globalization and tilting towards deglobalization. If developed countries rely upon local labor and raw materials rather than global trade, production costs and goods are likely to become more expensive.

Commodity prices go up and down, but labor cost increases are seldom reversed. Thus we expect the increase in prices to be sticky. Interest rates will increase as well, adding financing costs to everything, but particularly to buying a house.

The Federal Reserve's Dilemma

Entering 2022, the Federal Reserve (Fed) forecasted steady increases in interest rates over the next few years. Interest rates had been near zero since the pandemic, and the Fed's plan involved a gradual and predictable move to normalize rates. In the midst of the Ukraine war and the highest Consumer Price Index increase in forty years in February, the Fed's path has become treacherous. During his Federal Open Market Committee press conference in March, Fed Chairman Jerome Powell reiterated his view of

(713) 572-3366 | (713) 572-8771 Fax
3555 Timmons Lane, Suite 600 | Houston, Texas 77027
www.callahanadvisors.com

raising rates with mostly 0.25% increases over the year's remaining meetings. Not more than a week later at an economic conference, Powell vowed to use more aggressive rate hikes if necessary to curb inflation. Markets are now predicting a 0.50% rate increase at the next meeting in April and subsequent meetings if needed.

The Fed is caught between a rock and a hard place. Raising rates too fast can tip the economy into recession while raising slowly will keep the inflation fires burning bright. Whether the Fed can successfully engineer a soft landing remains to be seen. Until then markets should be volatile.

In our newsletter in April 2021, we discussed inflation and its potential effect on stock prices. In the long run, our view is that moderate inflation should not have a material impact on stocks. If companies can efficiently incorporate rising input costs and pass higher prices on to customers, earnings and cash flows should rise with inflation. Alongside inflation should come wage increases for consumers, which may mitigate higher prices and changes in purchasing behavior. Inflation is forecasted to subside in the second half of 2022, though that may change if the war stretches on or worsens from here and supply shortages continue.

Our firm looks for well-managed companies with strong financial positions. These firms are able to adapt to supply chain disruptions and higher input costs. We look for management that can deliver dependable corporate earnings growth not just in the next year but for the foreseeable future. We may overweight certain sectors that stand to benefit in inflationary environments, such as energy and materials. There is uncertainty today, and this quarter's volatility illustrates that. The valuable lesson from the last two years is to identify what factors are temporary and what are permanent and react appropriately.

Thank you for allowing us to serve you and help you achieve your financial goals.

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