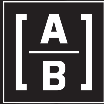

BERNSTEIN

Demanding Times

What a year the past three months have been. Just as the world was moving past the impacts of the pandemic, a new economic shock and humanitarian horror arrived.

Our hearts go out to all those affected by the Russian invasion of Ukraine, especially the Ukrainian citizens. The consequences of the invasion are radiating around the world and have been a driving force in the markets over the last quarter. Risk aversion rose as investors were stunned by Europe's first major war since World War II and the spiraling humanitarian tragedy. As civilian casualties increased and more than 4 million refugees fled Ukraine, fears mounted of a direct military conflict between Russia and NATO countries.

When emotions run hot, our job as stewards of capital is to remain objective, assess the current situation and the ways it could evolve, and then adapt our strategies accordingly. With that in mind, let's start with a high-level economic overview of where we stood before the invasion and where we stand today. Markets are forward-looking and much of the recent bad news has already been reflected in pricing of both stocks and bonds.

Factor	Before Invasion of Ukraine	After Invasion of Ukraine	Better/Worse
Inflation	High but expected to decline in coming quarters	High, more near-term inflationary pressures, but still expected to decline over time	Worse
Growth	Above-trend and falling to more normal level	Still above-trend (but by less), and slowing	Worse
Recession Risk in the US and Europe	Low and slowly increasing in both regions	Chance of recession in Europe in next 12–18 months now a coin flip, while chance of recession in the US is closer to 1-in-3 or 1-in-4	Worse
Emerging Markets	Post-COVID-19 macro challenges including supply chain disruption	New dividing line: exposure to rising food/commodity costs (either as a headwind or tailwind). Increased political risks due to potential food inflation and lower demand from developed markets	Worse
China	Possibly on the brink of government stimulus, eyes on zero-COVID policy	Focus on China's response to the Russian invasion. Potential for stimulus still on horizon with increased macro uncertainty	Worse

All Eyes on Inflation

When we first published our inflation white paper, after Labor Day last year, we knew the risks of inflation had risen and argued that inflation protection should be a core part of inflation-sensitive investors' long-term strategic asset allocations. The lingering supply chain issues from the pandemic, the rapid re-heating of the labor market, and most recently, the Russian invasion of Ukraine, have created a longer path to normalization that presents an opportunity that could take years, not months, to play out.

In February, headline inflation as measured by the Consumer Price Index came in at 7.9% year over year, setting a multi-decade record. A few days after we send this letter, we expect the March inflation figure to come in even higher, driven by gasoline prices, housing, food, and an increasingly tight labor market. Yet, barring new negative shocks, some improvement may be on the horizon. Much of the year-over-year changes are already baked in, and in the absence of new bad news, there is good reason to believe those numbers should start to decline in the coming months.

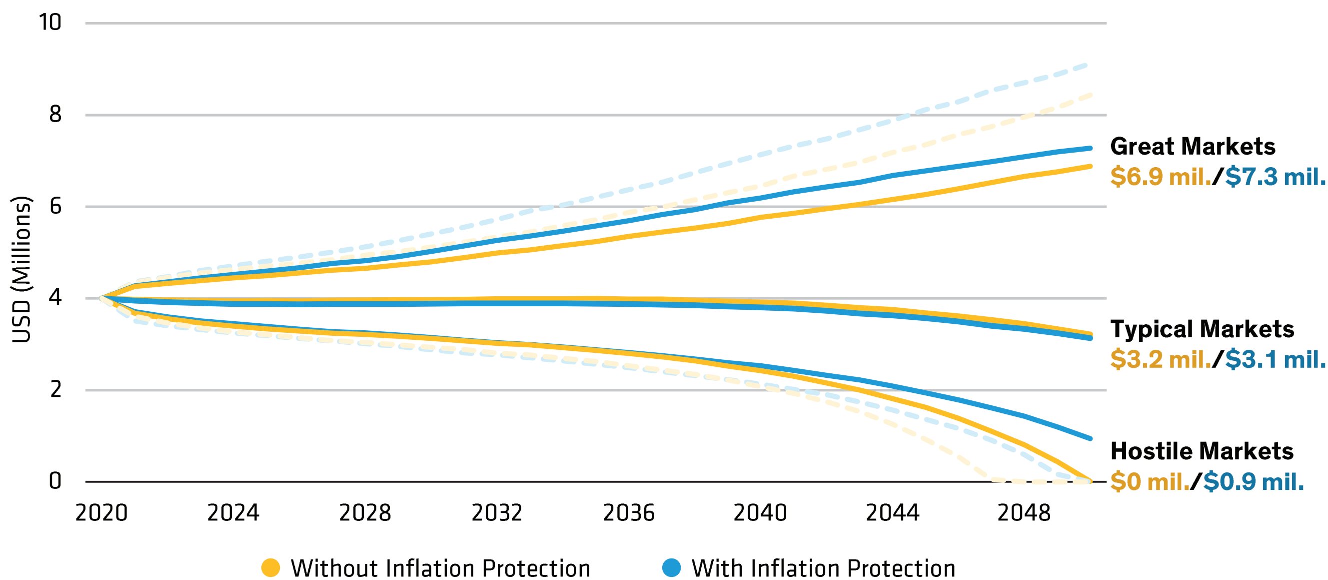
That said, for clients focused on their long-term financial goals, the direction of inflation over the coming quarter or two is much less important than inflation over their investment horizon, usually measured in decades. With an elevated risk of inflation coming in higher over that time frame than in recent decades, investors whose risk-reward balance is particularly sensitive to inflation should incorporate protection in their strategic allocations. That's not due to today's inflation but due to the risks in 2023, 2025, 2035, and beyond (***Display***).

Inflation doesn't affect everyone equally. Protection can be critical for inflation-sensitive investors, but many of our clients are in a position where hedging their portfolios is more a matter of personal preference than necessity. If you have not recently had a conversation with your financial advisor to determine which camp you're in, we'd urge you to discuss it.

Finally, one question we're often asked is if it's too late to buy inflation protection given how the markets have moved. For inflation-sensitive clients, we consider this similar to hurricane insurance. Imagine you bought a house on the East Coast, and it makes up a large portion of

INFLATION PROTECTION CAN BE VALUABLE FOR INFLATION-SENSITIVE CLIENTS

Comparative Return Patterns for Protected and Unprotected Portfolios



As of June 30, 2021. **Current analysis does not guarantee future results.** For illustrative purposes only. Hypothetical example based on 65-year-old client with 70% bonds, 30% equities, $4 mil. starting value, $120K spending in real terms. Inflation protection replaces 28 percentage points of nominal bonds with real bonds. Results will vary based on investor's circumstances and inflation sensitivity.
Source: Bernstein analysis

your net worth. Hurricane season just started and you got lucky with the first storm of the season—it destroyed properties near you but spared yours. Insurance prices have risen because of the storm and the outlook for the year. Would you hold off on buying that insurance until next year and take your chances this season or would you accept that higher premium for the protection starting today? For inflation-sensitive clients, the decision to forgo protection because of current prices is like passing on hurricane insurance for the year—it could work out or it could leave your finances materially impacted.

Rate Hikes—The End of the Beginning or the Beginning of the End?

It's official. The latest Fed rate hiking cycle has begun. At their March meeting, the Federal Reserve voted to raise their policy rate by a quarter of a percentage point. The bond markets have swung swiftly this year, as they switched from expecting a gradual rise in rates to a more aggressive response to elevated inflation, all in the first quarter alone! This rapid change in interest rate policy caused stress in the bond markets, resulting in one of the worst quarters in the fixed-income markets in over 40 years.*

The 10-year Treasury yield rose from 1.5% at the end of December to over 2.3% at the end of March. That's an enormous move in such a short period of time, especially off such a low base. Not only that, but with short-term interest rates expected to hit roughly that same level over the next two years, the markets are either pricing in a rapid transition to economic equilibrium or an approaching recession depending on how optimistic or pessimistic you wish to be in interpreting the pricing.

History suggests it isn't wise to fixate solely on the beginning of a rate hiking cycle. It's the end that gets you—either because the Fed misreads the strength of the economy and raises rates too far, pushing it into recession, or because some other cause manifests and the Fed must begin cutting rates swiftly to soften the blow. The caveats to bear in mind this time around are threefold:

1. The Fed appears set on raising rates quickly, but lots of uncertainty remains regarding the level they need to hit in order to stem inflation. If they go too far too fast, they could choke off economic growth.
2. Economic growth right now is still extremely strong and may offer some additional resilience in the face of rising rates and slowing demand.
3. When it comes to stocks (rather than the economy), the Fed is unlikely to soften its hiking stance if the market wobbles.

A final consideration in this cycle will be how the Fed handles all the assets it bought to provide liquidity to the market during the pandemic. Like any other bond or loan, these assets have maturity dates. As those dates arrive and the Fed is paid back, it can decide how much of the proceeds to reinvest. It could also opt to sell some early to even out its assets or balance out different parts of the market. In addition to interest rates, how aggressively the Fed unwinds its balance sheet will also impact financial conditions and in turn, the broader economy and markets.

A More Chaotic World?

There's an old saying, "May you live in interesting times." While its origins are unknown, many consider it a curse. After the past several years, we suspect most of our readers wouldn't mind living in less interesting times. Yet the world often seems more chaotic than ever before, and rarely is.

In the post-WWII heyday, consider the following:

Decade	Events
1950s	Cold War, Korean War, Cuban revolution, McCarthyism, beginning of the Civil Rights Movement, Sputnik and the space race
1960s	Prime of Civil Rights Movement, assassinations of John F. Kennedy, Robert F. Kennedy, and Martin Luther King Jr., the Vietnam War, the Cuban Missile Crisis
1970s	President Nixon and Watergate, Nifty Fifty collapse, Global Oil Crisis, end of Bretton Woods and remnants of gold standard, Iranian Revolution
1980s	Attempted assassination of President Reagan, Iran-Iraq War and Soviet-Afghan War which left millions dead, Savings & Loan crisis, fall of the Berlin Wall
1990s	Desert Storm, bombing of the World Trade Center, Asian financial crisis, Russian default, and failure of Long Term Capital Management
2000s	Burst of dot-com bubble, 9/11, wars in Iraq and Afghanistan, Global Financial Crisis
2010s	European debt crises 1.0 and 2.0, Tea Party and Occupy Wall Street, Arab Spring, Syrian Civil War, rise of ISIS, Brexit
2020s	Coronavirus pandemic, Russia-Ukraine War, … (and it's only 2022!)

* For the Bloomberg Barclays Aggregate bond index of Treasuries, corporate bonds, and mortgage-backed securities, it was the largest quarterly loss since 1980. For municipal bonds, it was the worst quarter since 1981.

The table above shows that, even in the midst of today's frightening headlines, humanitarian horrors, and geopolitical uncertainties, in the history of markets and world evolution, we've unfortunately seen versions of these headlines before. The world is constantly changing. Global institutions and rules are always in flux. Will this current situation threaten the critical global institutions created in the wake of WWII, designed to prevent another world war? Or will it merely force those institutions to adapt? We don't know, but we do know that either way, we'll have to invest through it.

A Shifting Landscape for Policymaking and Responsible Investing

The stresses of the last two years are creating the next investment trends. On the other side of the current turmoil, the long-awaited "re-opening trade" remains. But before the world can truly re-open, we must get our global supply chain in order. There are multiple ways to invest in the theme of supply chain normalization. And a focus on sustainable energy is no longer only of interest to environmentally focused investors, but now front and center for those focused on national security, another investment opportunity.

Responsible investing and green energy policy may change quite rapidly given current events. We're seeing simultaneous needs emerging for countries to ensure reliable energy from fossil fuels in the coming decades while also pushing toward power grid fuels, transportation technologies, and industrial feedstocks that ensure energy and industrial security along with sustainability. In addition, investment managers must consider geopolitical risk in a new light. What are the economic impacts of these types of events? How do they affect consumers and businesses outside the conflicted region? How do companies around the world respond? Do investors need to divest their stakes or force companies to unwind or divest major business units? We are focused on converting these questions into answers that are investable for our clients.

Investors' Magic Carpet Ride

It's a whole new world. But that's always the case. It just seems to be moving faster now than in the past.

This is why we stress-test our strategic asset allocations. Regardless of the path the future takes, we work to ensure our clients can enjoy the best of times while riding out the worst of them. That balanced and disciplined approach to investing is the core of how we steward our clients' capital and advise them through challenging markets.

Thank you for trusting us in that endeavor.

Alex Chaloff

Beata Kirr

Alex Chaloff and Beata Kirr are co-heads of the Investment Strategy team at Bernstein, a group of senior investment professionals who develop our investment advice and are responsible for investment outcomes. The team oversees Bernstein's investment offerings, ensuring that our asset allocation advice, suite of strategies, and development of new investment ideas are continuously focused on moving our clients forward with strong after-tax risk-adjusted returns. Both Alex and Beata have spent their Bernstein careers refining our investment platform, listening to clients, and conducting deep research into investment topics that are critical to achieving clients' goals.

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