Spring 2022

A month ago, the United States, adding to the slew of sanctions already imposed on Russia, banned imports of oil, gas, and coal in order to further punish President Putin for the bloody invasion of sovereign Ukraine. Those sanctions, along with the myriad that have followed, are based, according to the Biden administration, on the “Iran model.”

Which means this could be a long haul. The first sanctions on Iran were levied in 1979, after the student takeover of the American Embassy. Over a year later, the hostages were freed. In 1987, Iran was sanctioned again for state-sponsored terrorism. Those sanctions were added to in the 90s and again in 2005 in a bid to end the country’s quest for a nuclear bomb. It wasn’t until 2013 that a deal was reached, and sanctions were lifted, only to have them reinstated when President Trump pulled the United States out of the agreement. Through it all, Iran’s regime has stayed in place, and, according to the Biden administration, is on the brink of producing enough fuel for a nuclear bomb.

Sanctions against North Korea began after the Korean War, nearly 70 years ago. South Africa was first sanctioned in 1962 and didn’t release Mandela until 1990. Iraq was sanctioned in 1990, after invading Kuwait, but didn’t agree to a ceasefire until a second invasion led to the capture and execution of Saddam Hussein. And there’s Cuba, whose president is no longer a Castro, but was appointed by one.

While history indicates these sanctions are unlikely to lead to the ousting of a dictator, or change in their ideology or actions, Russian citizens are facing, and will continue to face, severe economic hardships. But as the world’s largest exporter of oil, and one of the largest of natural gas, the country’s decimated economy is having an enormous impact on the world’s energy markets, puncturing all our pocketbooks.

Crude oil prices are up around $40 since the beginning of the year. Europe imports 25% of its crude and 50% of its natural gas from Russia and is being pressured to join the United States in stopping or curtailing those purchases. With countries eschewing Russian oil in the open market, prices have been unstable, inflaming already rising inflation. To put that additional $40 in perspective, a $10 increase in the price of a barrel of oil increases inflation by 0.2%, according to a study by the Federal Reserve Bank of Dallas. That means the hike is expected to increase inflation this year by almost one percent. The study also concluded that economic growth will be retarded this year by 0.4% due to the increased cost of energy. Our readers in the United States and Canada are surprised by none of this, with the average price per gallon over $4 and $7 in the United States and Canada, respectively.

In response, President Biden announced last week the country will release 180 million barrels of oil from strategic reserves and hold accountable oil companies not increasing production from unused leases on federal land. The decision was made in coordination with United States allies and there’s reason to believe other countries will also be releasing barrels from their reserves. None of this has yet to have a significant effect on gas prices or inflation.

What’s more likely to have an impact, but come at a cost to consumers, is the Federal Reserve and Bank of Canada raising interest rates. Both began last month with a short-term interest rate hike of 0.25%. Expectations are rates will rise another 0.50% later this month, and both countries will continue the hikes through and into next year, topping out around 2.5% to 2.75%.

In addition, next month Quantitative Tightening begins – whereby central banks allow some of their bond holdings to mature without reinvesting the proceeds into additional bonds, pushing interest rates higher. The pandemic caused the central banks to stimulate the economy with lower rates. One solution they deployed was to increase their balance sheets – buying bonds (Quantitative Easing). It's time to unwind those positions.

This growth in money supply has been lost in conversations about rising inflation. Using the United States as a proxy for the world, central banks and governments have paid for their various stimulus packages by printing more money. The best way to exemplify this is by using the M2 measure, a calculation of the money supply that includes all elements of cash and checking deposits, as well as savings deposits, money market securities, and other time deposits in the amounts less than $100,000. The U.S. M2 expanded by over 40% since the end of 2019. The economy, in contrast, has only grown a couple of percent, with 2020 falling (-3.5%) and 2021 growing (+5.7%). When money grows faster than goods and services (the economy), inflation always follows. Current inflation has been caused by the factors we've mentioned, and a host of others, but until the central banks rein in the excess money, it's likely to persist longer than current forecasts.

The Russian attack on Ukraine has been a sudden reminder of something that's been at the heart of our investment strategy for 21 years: crisis can come at any moment, be prepared. To that end, your portfolios are well positioned to ride out the market bumps and rises. We've kept our bond investments conservatively shorter than average and paid close attention to your equity holdings in order to minimize damage when interest rates climb. Despite this brutal war and ongoing inflation concerns, this year should show solid growth as the global economy recovers from the two-year-old pandemic.