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## FOMC, Geopolitical Risk and Post-Peak-COVID-19 Blending Machine

Business cycles tend to have a pattern displaying distinct phases. *Recessions*, characterized by contracting growth, weak demand and higher unemployment tend to be followed by an *early recovery* where supportive policies persist and prices remain low allowing the weak economy to heal. Next is the *mid-cycle* period where the growth recovery broadens, confidence builds, prices reflate and employment rolls grow. Finally, the *late-cycle* period tends to be characterized by slowing growth and increased competition for the labor, energy and materials required to support a continued expansion. This results in higher input costs alongside higher rates and this all begins to put the brakes on the economy. A new recession then starts the cycle all over again. When all is said and done, the cycle may ordinarily take seven to ten years to complete.

Now to the real world of today. We are not too distant from the COVID-19 pandemic induced recession and probably in many ways are still in an early recovery phase. Yet, headline CPI inflation is running hot and it may move higher over the next few months before it ultimately subsides. The size of the workforce is still below that of the pre-COVID-19 era, yet some signs point to certain industries finding it difficult to find workers. It is hard for consumers as well as business enterprises to rise out of a recession in a healthy manner, if the real costs of necessary food and energy prices among everything else is getting in the way. Late-cycle dynamics are seemingly blending with early and mid-cycle characteristics to confound businesses, consumers and investors alike due to this uncertain stew.

The FOMC (Federal Reserve Open Market Committee) has conducted its March meeting and has begun the process to tighten financial conditions using the main policy lever of raising short-term interest rates. They have further signaled that they see growth and labor markets strong. They have indicated that they also plan to reduce the size of the Fed Balance Sheet and will announce plans for that action in the next meeting. This would amount to an additional unwinding of an earlier accommodative policy of buying assets and swapping them for reserves. In lay terms, this simply describes another form of tightening beyond their main interest rate lever.

After decades earning a peace dividend post-Cold War, geopolitical risks have elevated quite significantly due to the invasion of Ukraine by the Russian Federation. Beyond the human tragedy, this matters to the extent that we will observe over the coming quarters and years a possible withdrawal of global cooperation and with it a reduction in the atmosphere of increasing global trade and growth which has defined the past several decades. No outcomes are certain as yet, but some elevation of geopolitical risks may begin to be priced into global asset markets. Where past growth opportunities are fading, others may also be born albeit in a changing world.

*Bulls* are likely to focus on a few things. Even against the uncertainty of the geopolitical tensions and uptick in hostilities, there still may exist a backdrop of growth. Labor is tight and the economy can work through the friction between labor supply and demand and a vector where more people are working in an economy means more people are consuming. The higher prices of commodities and materials will ultimately incentivize supply which in turn will ultimately alleviate the cost pressures. When the inflation does fade, workers will feel an increase in real wages. In short, the early recovery has been difficult due to a variety of shocks, but we may still be headed towards a period of some duration where a mid-cycle economy dynamic reigns. In that world, declining inflation and continued growth can perpetuate corresponding risk asset gains in stock and bond markets.

*Bears*, while they may understand the bull argument, are likely to discount it and focus more on the uncertainties of the moment and the potential for further shocks in an increasingly vulnerable economy. They may feel that the price inflation will continue further than is currently anticipated and, when combined with the Fed now in a tightening mode, will ultimately slow growth and hasten the downturn.

As of right now, it does not appear that longer term inflation expectations are rising and are elevated to such an alarming degree to warrant immediately declaring the bear case a clear winner. The uncertainties of the moment both in growth and inflation outcomes as well as the kinetic actions inside of Ukraine warrant a posture of prudence and reserve. Upside risks would come from any gained clarity indicating positive growth and inflation dynamics and/or a cessation of hostilities.

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