Points to Ponder

March 18, 2022

The First Tee...

Russian Repercussions…while Russia reaps havoc on Ukrainian structures and lives, surgical bombing of the Motherland's economy is doing major damage:

- International sanctions have reduced Russian GDP by over 2% since the invasion began:
  - The economic restrictions equate to $30 billion already being erased from Russia's annual GDP:
    - Forecasts are currently predicting Russia's economy could contract by 10% or more this year, which would be the worst since Putin took power two decades ago…topping the 8% declined seen during the financial crisis in 2009:
      - If enough nations boycott Russian energy exports, their GDP growth could decline by as much as 14%...which would mark the worst economic downturn in the country's history…since the collapse of the Soviet Union in the early 1990's.
- **Economic Surrender**…comparisons are already being made to Russia's economic collapse following the country's default in 1998…decoupling from the world economy could paralyze Russian production and growth for years:
  - The Russian economy has a history of being short on investment and dependent on imports:
    - The share of foreign goods in non-food categories in Russia has consistently stood close to 75% of total market:
      - Russian auto manufacturing relies on 95% of imported parts for building vehicles (most foreign companies have ceased Russian operations):
    - Russia has spent 30 years trying to integrate into the global economy…now its heading into autarky (economic self-sufficiency).
- **Another Price of War**…Russian inflation is heading for one of its largest shocks in decades:
  - Forecasts are projecting Russian inflation to possibly hit 20% later this year (was targeted at 5.8% pre-invasion):
    - Prices are being pressured by a combination of a shortage of goods, a collapse in the value of the ruble, the Russian central bank hiking interest rates to 20%, internal trade restrictions, and a surging cost of raw materials:
      - During the first week of the invasion, prices for new domestic Russian cars rose 17%, while television prices jumped 15%:
        - Prices for most imported goods have increased by 20% to 30% since the invasion began…food costs have risen 5% to 7%.
- **With these 4, you don't get more**…sanctions have ignited four Russian financial crises (causing a deep recession):
  - **Bank Run**…sanctions have placed restrictions on Russia's largest banks, and froze over half of central bank reserves:
    - Bank panics can be self-fulfilling prophesies, as depositors rush to pull foreign currency from their accounts:
      - The response to the bank issue has followed historical modus operandi…the central bank doubled the deposit rate to 20%, promised to maintain ruble liquidity through repurchase agreements, and pressured businesses to stay with sanctioned banks:
        - Russians held about $200 billion in foreign-currency accounts at the end of 2021…depositor confidence dependent on ability to backstop holdings.
  - **Credit Crunch**…sanctions make it difficult for Russian banks to access their overseas assets, plus they are currently locked-out of the U.S. and European capital markets…problems raising capital, plus a run on deposits, could halt new lending (crunch-time!):
    - Russian officials have relaxed regulatory requirements to free-up capital, buying the banks some extra time:
      - The Russian central bank is behind the eight-ball as it was forced to spike interest rates to retain deposits and support the ruble…the move could push some businesses into bankruptcy, magnifying bank losses (when credit is no longer available, recession ensues)
  - **Currency Free-Fall**…the capitulation of the ruble is a catalyst to higher inflation, as well as an incentive to shift from the Russian currency into dollars…adding pressure for a run on bank deposits and a deepening of a credit crunch:
    - The Russian central bank has also banned asset sales by foreigners and hard-currency transfers abroad, exporters must convert 80% of their revenue to rubles, individuals must pay a 12% commission to purchase hard currency.
  - **Debt Default**…with overseas assets frozen, Russian government, bank and corporate debt has elevated default chances:
    - Russia defaulted on $190 billion in external borrowing during the 1998 crisis, which was bailed-out by the IMF:
      - Russia's external debt stood at $490 billion at the start of the year ($150 billion matures in next 12 months), the central bank had $640 billion is reserves backing the outstanding's, but this cushion has been diminished by sanctions…an IMF rescue is doubtful this time:
        - **Russia debt rating has been cut to junk status by Moody's, Standard & Poor's, and Fitch…classified as highly vulnerable to non-payment.**
- **Unhappy Ending**…any hopes of a Putin overthrow are at best a long shot (probably more of a pipedream)
  - The initial impact of sanctions mostly effects upper-income Russians (who can afford imported goods):
    - Even extended hardships on the masses would probably not result in a regime change…Iran and North Korea are examples of countries where the standard of living as declined dramatically, but the autocrats remain in power:
      - The opposition to Putin has been eliminated during his leadership (typically, through radiation poisoning in their clothing).

At the turn...

Capital Markets Group

The Back Nine…

Waning Wages…despite steadily rising over the past decade, salaries are losing the race against inflation as real wages turned negative in 2021 (and are off to a bigger deficit in 2022)**:**

- The wage recuperation following the Great Recession was the slowest of any economic recovery since World War II…but have been gain momentum over the past five years (especially since pandemic started):
  - Employee earnings have been given a boost due to the COVID induced worker shortages, combined with government pandemic stimulus payments (2020 average hourly earnings hit all-time highs since record keeping began in 2007)
    - Average Hourly Earnings have steadily increased over the past ten years, averaging 1.9% in 2012, 2.6% in 2017, and peaking at 4.9% in 2020…earnings slowed to an average gain of 4.2% last year (while averaging 5.3% so far this year).
    - Average Consumer Price Index increases remained sedated until the pandemic, failing to meet the Federal Reserve's 2% target rate six of the past ten years…2021 was an inflation shock, with CPI averaging a 4.7% increase.
- Boiling down the numbers…average hourly earnings have averaged annual gains of 2.9% over the past decade, while CPI averaged a 1.9% gain for the same period (a reasonable 1% spread between wage and inflation growth):
  - Labor shortages, supply-chain breakdowns, strong consumer demand and the war in Ukraine are pressuring wages and the price of goods & services higher (unfortunately, the latter is accelerating at a faster pace):
    - Real average earnings went negative in 2021, declining by .4%...2022 is off to a tough start with the gap widening to 2.6%.
- **Survey Says**…a worker poll by Capital One discerns how budgets of the various income groups are being financially impacted by the expanding differential in wage and inflation growth *(the race to keep pace)*:
  - Across all income levels, only 18% of survey respondents stated their earnings were keeping pace with the higher cost of living…62% said inflation had impacted their spending behavior, cutting non-essential purchases:
    - 42% of respondents said they had either saved less, took money out of savings, borrowed money, or took out a loan
  - **Lower Income** (defined as household income of less than $25k annually)…73% of lower earners indicated they have felt the impact of inflation, with only 9% stating their wages had kept pace with the cost of living:
    - 57% of lower earners are expecting a tax refund…indicating the payment was very or moderately important to their financial health.
  - **Middle Income** (defined as household income of $25k to $100k)…despite seeing underemployment rate fall to 7% from 21% in 2020 (defined as working for less money than desired), over half of the respondents in this category were making budget adjustments:
  - **High Income** (defined as household income exceeding $100k)…even this income sector has seen its ability to pay all their bills, diminishing from the 10% who had difficulty in 2020, rising to its current level of 22% (over-extension of debt is a factor):
    - About 25% of middle and higher earners are expecting a tax-refund that exceeds $1500 this year.
- **Wage/Price Spiral**…the Fed wants to avoid the cause-and-effect macroeconomic phenomenon of the 1970's that saw a cycle of wage Increases resulting in price increases, which in turn caused more wage increases, and so and so forth.

19th Hole...

Most of the trouble in the world is caused by people wanting to be important.

T. S. Eliot

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