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Zeitenwende

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There are decades when nothing happens and weeks where decades happen.

-Vladimir I. Lenin

Shortly after the invasion of the Ukraine, the new German Chancellor Olaf Scholz told the Bundestag that February 24th had marked a 'Zeitenwende.' In English the translation is quite simple – (Zeit = time, Wende = turn). Thus, a turning of the times. But the term carries more gravitas in German. For them 'Zeitenwende' would only be used for 1871, 1933, 1945 and 1989. The correct English connotation is 'watershed.' To the American psyche, that might seem hyperbolic. In our consciousness, Ukraine is quite far away. Maybe not as far as Syria, but remote. Germans know that Lviv-Warsaw is like our Boston-Philadelphia. Indeed, Poles and western Ukrainians are culturally as close as are residents of Brookline to those of Chestnut Hill. So, while Americans may have experienced a vague sense of Cold War déjà vu – the European mind is drawn instantly to the 1940s. Chancellor Scholz was not exaggerating.

The shifts in the European political front in the last two months have been remarkable. Finland and Sweden – neutral at least by name for 70 years – are now actively entertaining NATO membership. Finland was never a hospitable territory for Russia, but now it may become a hostile border. Countries with long-standing pacificist leanings – Denmark, Belgium and Sweden – have supplied weapons to a war zone. The UK – which had become the persona non grata of Brussels – is now the prodigal son. And Poland – a country on the verge of being ostracized by the European Commission – is now our bulwark. The splintered Atlantic alliance has discovered a unity of voice and purpose in eight weeks that had been going astray for 20 years. Nothing focuses the mind like an existential threat.

Some hold that financial markets can become inured to the war. That is, the conflict can settle down into a gruesome stalemate like India/Pakistan in Kashmir. A 'contained' armed conflict like the one running in Eastern Ukraine since 2014. I think this is a mistake. First, the West will not lose interest in the humanitarian tragedy, because the European conscience will not let this go lightly. Ukraine is increasingly perceived as a vital interest for liberal democracy. If we are seen to lose this, there will be consequences for the political order. The spectacle of Annalena Baerbock – a pacifist Green party comrade - sending *Panzerfauste* to combatants is evidence that Europeans are experiencing this war quite differently. Second, the refugee wave that sweeps across Europe will be a constant reminder of our collective moral duty to Ukraine. So, the formal sanctions regime is bound to escalate. Opinions are rapidly shifting in favor of accepting the necessary economic damages in order to harm the perpetrators. So the 'self-sanctioning' behavior, whereby private interests voluntarily stop trade with Russian counterparties, is likely to intensify.

The loss of energy and foodstuffs will exacerbate inflation everywhere. Some of the oil that Russia produces will find outlets. India has been happy to purchase cargos from Russia. But I am quite concerned about agricultural markets. Ukraine accounts for only 3% of the global wheat harvest but 9% of global exports. Last year's inflation was about a demand shock coupled with supply problems. At the beginning of the year, we were hopeful that those issues would abate, so that inflation could gently recede to tolerable levels. The Ukraine war and the western sanctions now bodes for a supply shock. Financial markets have recovered all the ground lost since February 21st. I think that reflects a false hope that the costs of the war can be comfortably accommodated. They cannot.

Consumer prices in the US rose 8.4% year-over-year in March. Prices are spiraling in Europe as well. There is a strain of belief that the US Federal Reserve will either (a) not have the stomach to increase rates to the extent required to slow inflation or (b) have to quickly reverse course at the first sign of a reduction in economic

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growth. To me, this is a dangerous reductionist view of the institution. I have a lovely, mild mannered goldendoodle. She's ultra-submissive and quickly rolls on her back around dominant dogs. But curiously, when she has a stick in her mouth, she becomes a ferocious snarling beast when another dog approaches. The Fed has suffered the justified opprobrium of economists like Larry Summers for being complacent about inflation. But ultimately, I believe that they take their mandate quite seriously. At the beginning of the year, we believed that markets had priced in the Fed's hiking sufficiently. The additional pressure on prices from the Ukraine war has made that calculus more fraught. A starting point would suggest that the Fed needs to hike rates above inflation to dampen demand. Before the war, it seemed plausible for inflation to gradually subside to a 3% range. Given the impacts of the war and a Covid outbreak in China now foreseeable, we would be fortunate to see consumer price inflation below 5%. In the two months since the war began, market expectations for the Fed Funds rate in one year have moved up 0.90%. It would not be out of the question to see it move up another 1.50% - 2%.

This set-up of increasing costs driving the Fed to hike rates to dampen aggregate demand is not the most sanguine scenario. However, its our most realistic outlook. Against that dire backdrop stand a number of formidable positive attributes. Employment is strong and wages are rising. So household incomes are in rude health. There is substantial savings built up from the pandemic. Corporate profitability is very strong. Despite all of the supply chain challenges, US corporate earnings have continued to rise above expectations. Corporate balance sheets are also in good health. In other words, the global economy rests on very solid fundamentals. The shocks we perceive on the horizon are tolerable. Recessions have a toxic reputation among financial markets. But a downturn in output that punctures inflation, makes housing more affordable and deflates market valuations need not be a mortal blow to wealth. Watersheds or 'turns of the times' penalize strategies that wager aggressively on narrow outcomes. We try to construct portfolios that are resilient to untoward shocks by balanced allocation across asset classes, complemented by intelligent planning and implemented by specialist managers who deploy capital thoughtfully. A 'turn of the times' can be negotiated by careful attention to risks.

Brad Conger is Hirtle Callaghan's Deputy Chief Investment Officer. He leads the firm's asset allocation process and is responsible for the firm's private credit investments. Brad serves on the Investment Committee, which is directly responsible for the firm's asset allocation strategies and the selection of investment managers for client portfolios.

Brad has over 25 years of senior international portfolio management experience managing global multi-asset strategies. Prior to joining Hirtle Callaghan, Brad was Director & Investment Committee member for the $10 billion Global Equities Fund at the $50 billion Clearbridge Advisors for four years; was General Partner & Managing Member of the Narragansett Overseas Fund of the $1 billion Narragansett Asset Management for four years; was Managing Member & Investment Committee Officer of the Global Investors Fund for the $7 billion HBK Investments for four years; and was Vice President & Portfolio Manager of AIM International Equity & Global Growth funds for four years. Brad began his career with Goldman Sachs as Vice President, European Equities (NYC & London) for five years and with Credit Suisse First Boston (NYC) as an Analyst, Asset Backed Securities.

Brad received his M.B.A from Harvard Business School and B.A. in Economics (Highest Honors) from the University of North Carolina at Chapel Hill, where he was a Morehead Scholar. Brad is a CFA charterholder.