

“To us, the prime narrative [of 2022] will be about how long the economy can stay hot and how durable it is to changes.”

Doxa’s 2022 Outlook

As outlined in our note a few months back, the economy is very sound and its foundation is solid as we move through the economic cycle post-Covid. But all cycles face challenges along the way and our first is knocking on the door. Our fun title – *lions, tigers, and bears* – is referencing three not-fun problems the economy now faces simultaneously: a rising dollar, rising interest rates, and rising prices. These factors undoubtedly have a negative impact on our outlook, but by how much and what do we do about it? Let’s take a (*short*) dive in.

Quick Background

Economic cycles experience a number of shocks on the journey from recovery to peak. The problem is that you never know which shock is going to be the one to tip us over the edge into a recession. During the last cycle (2010s), we saw a dollar spike, an energy spike, energy collapse, debt crisis, taper tantrums, and plenty of rate hikes. But in the end, a global pandemic is the one that got us. It may sound obvious but how strong a shock is, how long it lasts, and where we are starting from all matter more than what the shock actually is.

In geopolitical events, anxieties are high, conflicting headlines are the norm, and everyone anchors to the worst-case scenario. Sometimes there are lasting effects, sometimes the world has moved on in 3 weeks. It’s really hard to know, and that’s why market volatility soars. Secondly, markets experience 10%+ drawdowns about every two years – and while it’s not enjoyable in the moment, the start of 2022 is delivering right on cue.

In our experience, while the direct effects of geopolitical events drive the narrative, the second-order effects are where more impactful themes usually emerge. We’ll start with on the first order:

- **Cutting Russia out of global GDP will have minimal negative effect.** Russia is a small portion of the global economy and since annexing Crimea circa 2014, they’ve become less and less integrated with the global financial system. Direct systematic financial stress will be contained. This is good.
- **However, Russia is was a pretty big player in the commodity markets.** They produced about 10% of the world’s oil, 40% of Europe’s gas, wheat and grain, palladium, nickel, etc. Higher food and energy prices will add to an already hot inflation environment. Think of this as a global tax hike that will surely slow down global growth. The direct question here is by how much?

- **Severity & duration matter.** The higher prices go and/or the longer prices stay at extreme levels, the worse the outlook becomes. However, be careful of extrapolating the prices of today into tomorrow. It's obvious that gas at \$5/gal for 6 months is worse than \$6/gal for 1 month, but rather think of the scenarios (and the probabilities) it would take to get us to the extremes. I won't game them out here, but I'd note that oil price contracts a year from now are a good bit lower than where they are today.
- **How strong is the economy when a shock hits?** Arguably, this point receives the least attention yet has the most impact. A weak/slowing economy hit by a normal shock (*probable*) can cause real damage. But a strong/growing economy has to be hit by a big shock (*much less probable*) to experience equivalent problems.

Think of the economy as a house that's just been storm proofed for hurricane season.

When hurricane *Arthur* arrives – the boards are sturdy, the roof looks good, and the sandbags are all in place. But by the time *Wilma* rolls in, the boards have been battered, shingles are missing, and half of the sand bags are out to sea. Too often it's hurricane *Wilma* that does the real damage rather than a stronger hurricane, like *Arthur*, at the start of the season because the house's **starting point before each storm matters.**

Luckily, we're starting from a position of strength. Again, from our [2022 Outlook](#):

"The backbone of our economy – the American consumer – is very healthy..... [Interest payments](#) are at an all-time low. [Home equity](#) is looking great. [Credit card delinquencies](#) are at a low. [Loans & leases](#) are on the rise."

I'll even add some extra data points: the [labor market](#) is strong, [consumer spending](#) is resilient, and [business investment](#) plans are solid.

Even looking under the hood at energy spending – it isn't the burden it used to be. With that said, **this isn't to say the economy is immune and everything will go on unaffected** – *it won't* – but we are saying that our house is looking well-prepared for the first hurricane.

ENERGY ONLY MAKES UP 4% OF U.S. CONSUMER SPENDING
Energy goods and services as a percent of total personal consumption expenditures (%)



Source: Bureau of Economic Analysis, Haver Analytics. Data as of December 2021.

Second-Order Effects

As long-term investors, knock-on effects often have more staying power than the direct ones – making them important not to overlook. It's still early but we think some key themes are starting to emerge:

- **Hello, Europe. Welcome to the world stage?** The swiftness and unification of all EU countries under the EU and NATO banners has been impressive. Their cohesiveness really picked up in the pandemic, and has only accelerated. They have the resources and people to be a superpower, but have previously lacked the “togetherness” to be leaders – it seems they’ve found it.
- **Has the tight fiscal regime in Europe finally ended?** Paired with the point above, Europe is finally moving away from austerity and into investing big into infrastructure, energy, and defense initiatives. After underinvesting for more than a decade, this is a very welcome shift that can boost productivity and *(finally)* provide a runway for growth.
- **Who makes up for Russia’s lost commodity production?** Oil, gas, and LNG production shifts are well-documented, but what about palladium? Nickel? Fertilizers? Copper? All are big Russian exports that need someone to fill the gap. Emerging markets like Argentina, South Africa, and Indonesia among others could see a big demand pick up (Canada & Australia, too!).
- **Will the power of Euro/USD/Yen sanctions usher in a new meaning to the concept of “reserves”?** Russia spent years saving and accumulating a war chest of financial reserves to protect them from an economic shock. Half of those reserves were wiped out overnight, along with their ability to import any strategic goods. Perhaps it would have been better to stockpile semiconductors, airplanes, parts, commodities, etc. rather than a pile of money that can be frozen? If state actors shift their view of reserves from capital (money) to goods (stuff), then the playbook has truly changed. This is something to watch.

How do we manage through this?

Market corrections and geopolitical risks are scary and volatility is high. There’s always a potential outcome that’s terrible, one that’s not so bad, and 100 others that you don’t really think about. When markets get highly uncertain, we focus on the basics which can limit mistakes and give us a much better chance of success.

Investing in stocks you can stay invested in is a super-power = the basics.

There are really two parts to this:

1. **Staying Invested.** Let’s say you know exactly when to sell out of the market. Do you also know exactly when to get back in? Market timing is incredibly tricky and adding extra layers of decision-making is a surefire way to increase mistakes. This isn’t to say that no action is always the right choice either, bringing me to the next point-
2. **Investing in companies that make it easier to accomplish point 1.** This is why we’re always writing about cycles and owning quality. In times of big uncertainty, we lean back on great management teams and world class businesses. And knowing where we are in the economic cycle keeps our big picture perspectives in check. Sometimes shifts are needed of course: companies lose quality, strategies change, cycles speed up or slow down, etc. This is where the art of portfolio balance and diversification come into play.

Uncertainty and corrections are never comfortable, but executing point 2 makes point 1 easier to achieve. **This is how we go back to the basics, and basics take over when times get tough.**

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