Slocum, Gordon & Co. LLP
INVESTMENT COUNSEL • EST 1978
APRIL 2022

VIEWPOINTS

A QUARTERLY INVESTMENT JOURNAL

IN THIS ISSUE OF VIEWPOINTS, WE DISCUSS THE US DOLLAR'S STATUS AS THE GLOBAL RESERVE CURRENCY.

In response to last month's Russian invasion of Ukraine, the United States and its allies have imposed sanctions severe enough to trigger a lively debate among prominent figures in finance and economics about the future of globalization and the potential repercussions for financial markets. Somewhat counterintuitively, concerns arising from the sanctions have not been centered around the fate of the Russian economy, but instead the US dollar's status as the global reserve currency.

In his recent annual letter to shareholders, Larry Fink, the head of the asset management juggernaut Blackrock, decided to stir the pot by venturing into geopolitics and declaring Putin's actions as marking "an end to the globalization we've experienced over the last three decades." Around the same time, the preeminent Credit Suisse strategist Zoltan Pozsar published an inflammatory paper predicting a new global monetary system led by China and backed by a "basket of commodities." While we wouldn't dare to call ourselves geopolitical experts, this debate deserves attention and has highlighted many of the dynamics which will dictate the flows of financial assets over the long-term.

As the issuer of the currency used for the majority of international trade, payments and savings, the US has had a special role in the postwar era by serving as the ultimate authority over the global financial system. In more recent history the US has regularly flexed its muscle by enacting sanctions against rivals, but the only countries to have been hit with sanctions as strict as those which now exist in Russia are significantly smaller and less systemically important, namely Iran and Venezuela. Today, Russian banks are cut off from the interbank messaging system (SWIFT), conducting business with Russian corporations (ex. energy) is for the most part forbidden, and hundreds of billions of US dollars held by Russia have been effectively frozen. The effects of the sanctions were immediate and drastic: the value of the ruble plunged and the central bank raised rates from 9% to 20% in order to avoid a complete meltdown.

In the minds of some experts, these harsh sanctions will create seismic shocks that will compel many countries to wean themselves off the dollar, out of fear of one day sharing Russia's fate, and will ultimately balkanize the financial system. Those who believe the dollar's hegemony is doomed point to the fact that before the war, 88% of Russian exports to China were priced in either dollars or euros, renminbi-denominated reserves have been growing in numerous Chinese trading partners in Africa and South-East Asia, and rumors that Saudi Arabia and other OPEC members will begin accepting the yuan instead of the dollar as payment for oil sales.

While these trends do suggest decreasing reliance on the US dollar, we think the demise of the dollar and globalization is unlikely to be as dramatic as Fink, Pozsar, and others are suggesting. Nearly every other major democratic country has aligned itself with the US with respect to sanctions, and if the bar for getting kicked out of the global financial system is "don't start unjustifiable wars of conquest," most countries, whether they're run by dictators or not, shouldn't have much trouble avoiding that fate.

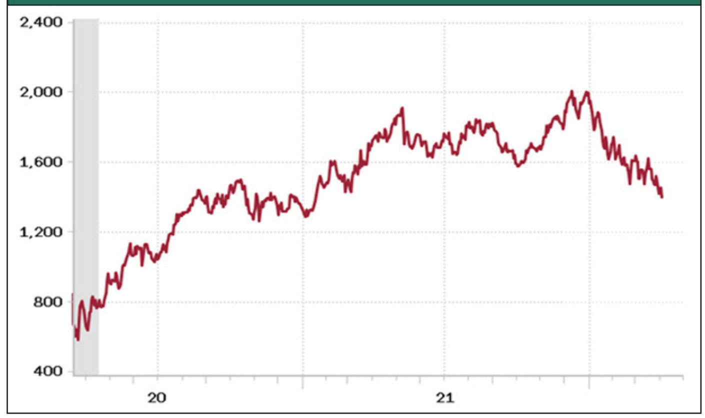
When compared to China, the US possesses two features that make the dollar a much more appealing global reserve currency than the renminbi: significantly deeper and more liquid capital markets, and a more clearly defined rule of law. Putin's behavior is a reminder that authoritarian leaders can act unpredictably when domestic counterweights are lacking. Although Chinese President Jinping has yet to interfere with the operations of the People's Bank of China, there's no guarantee that will continue to be the case. In addition, the Chinese financial system is structured to prevent crises and achieve macroeconomic goals, and the country's willingness to manage and backstop a less-regulated foreign financial system, as the Federal Reserve has done for decades, is questionable.

The question of whether we are at the onset of a new economic regime has introduced some fascinating and complex narratives, yet how it all plays out is as unpredictable as the effects of the movements of tectonic plates. What is clear to us, however, is that despite the hardening of borders that is likely to ensue, the current system has enormous inertia backed by network economies. Furthermore, the system has faced more intense challenges than what we are seeing today with respect to the credibility of the US government as the lender of last resort. That said, to the extent we transition to a more balkanized world with increasing protectionism, populism, and perhaps a parallel Chinese-led monetary system as some speculate, the deflationary tailwinds developed economies benefited from since the 1980s may no longer exist.

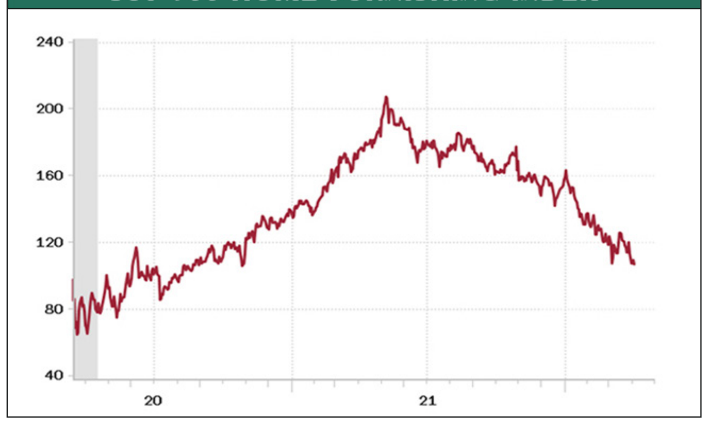
The war has also added a new dimension of national security to the supply-chain issues that began in 2020, and the market now expects the Federal Reserve will accelerate its new regime of quantitative tightening with more aggressive rate increases and bond sales to combat what has turned out to be persistent inflation. For the first time since 2007, with the dramatic increase in yield in shorter term Treasury securities, the 30-year Treasury bond yield is nearly identical to the 2-year Treasury. Historically, this type of flattening of the yield curve portends an economic slowdown.

Recent corporate earnings results have shown that inflation, so far, has served as an elixir for revenues and profits as companies have had little problem passing along higher costs to consumers. Yet the first quarter was a challenging environment for most equities, particularly growth stocks and cyclicals outside of the energy sector. Defensive equities, which typically pay larger dividends and are therefore less appealing in a rising rate environment, have in fact outperformed on a broader level despite the upward shift in the yield curve. The Q1 sell-off, therefore, can be explained by price-earnings, multiple contraction and a change in concern from higher rates to slower growth. The Dow Transports - one of our favorite leading economic indicators - has cratered in recent trading sessions and reiterated this concern. New car sales are also firmly in recessionary territory, contracting at a double-digit rate in recent months. Other leading indicators such as homebuilders, home furnishings, and specialty retail stocks are collectively in deep bear markets.

S&P 500 HOMEBUILDING INDEX



S&P 500 HOME FURNISHING INDEX



S&P 500 SPECIALTY RETAIL INDEX

S&P 500 AUTO COMPONENTS INDEX

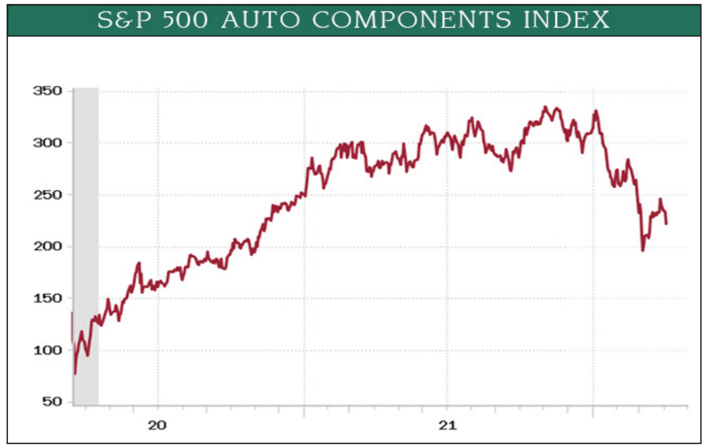


CHART SOURCE: HAVER ANALYTICS, ROSENBURG RESEARCH

The question of whether we are at the onset of a new economic regime has introduced some fascinating and complex narratives, yet how it all plays out is as unpredictable as the effects of the movements of the tectonic plates.

IN CONCLUSION

In addition to a less accommodative monetary policy, there are several other factors that suggest a looming economic slowdown and confirm our defensive bias: 1) inventory builds continue to outpace demand growth, as we examined in our previous issue of Viewpoints; 2) payback in demand from last year's fiscal stimulus; and 3) food and energy price hikes that have served as an tax on households. We think the short-lived bounce in higher-multiple risk-assets during the second half of March could be aptly described as a "bear market rally," and we would not be surprised if US equity markets experience fresh lows later this year as the market continues to digest some of the headwinds mentioned above. In the meantime, we're maintaining our core defensive equity exposure, are growing slightly more constructive on bonds, and are holding higher-than-normal cash balances to take advantage of higher short-term rates and a potential slowdown scenario we believe is likely.

Peter Hatfield, CFA, CFP®

Slocum, Gordon & Co. LLP was founded in 1978 to provide its clients with individualized asset management, advice, and counsel. We are an SEC registered investment advisor in Newport, Rhode Island. **Viewpoints** and **Our View From Mill Street** are informational only and not intended as advice on individual securities or investments. Our opinions are based on our current analysis and may change without notice. All investments have some risk associated with them and may lose some or all value. Past performance is not necessarily indicative of future results, and future performance cannot be guaranteed.