Russia/Ukraine FAQ:
Fiscal and monetary policy implications

March 17, 2022

This FAQ is designed to help provide perspective on the current Russia/Ukraine crisis.

Q. Given the sharp rise in oil prices, what is the market expecting on inflation?

A. Over the next 12 months, the market expects that inflation will rise above 5% followed by a sharp easing a year from now and in succeeding years. Five years from now, expected inflation is priced closer to 3%, which is still higher than the Federal Reserve's (Fed) 2% target; the implication is that while the current shock may continue for some months ahead, there is still a strong belief that inflation is transitory.

Q. What is the outlook for monetary policy from major central banks?

A. We believe that the crisis in Ukraine will not derail the U.S. Federal Reserve (Fed) from completely removing the accommodations that were put in place during the economic crisis. We anticipate rising interest rates and a reduction it the Fed's balance sheet as it sells the stockpile of bonds it previously purchased in order to keep interest rates low and provide liquidity to borrowers and lenders.

The Fed will likely take a middle course, moving monetary policy to a neutral setting while taking care not to exacerbate the demand destruction caused by the spike in commodity prices. The Fed, however, is likely to look through any oil-price spike and view it as transitory. The Fed's current dot plot (where each dot on a chart represents the view of a Fed policymaker) projects a federal-funds rate close to 2.0% in 2024 and 2.5% in the years following.

The Bank of England has already started to raise interest rates and reduce its holdings of gilts and other securities. The Bank of Canada has also raised interest rates. We expect the European Central Bank to lag in raising rates since the region's economy will be pressured more as a result of rising energy prices.

Q. Does the market view agree with the Fed?

A. The market is not currently aligned with the U.S. central bank's view on the terminal federal funds rate. A prolonged conflict in Ukraine that slows economic growth could slow the pace of projected Fed rate increases, although, at this point, such a path would be difficult to assess. The market currently estimates a federal-funds rate of just over 1.5% in 2024 and just under 2.0% in the longer term.

Longer-term, the current expectation that interest rates will remain well below the Fed's forecast leaves intermediate interest rates susceptible to further upward pressure should economic fundamentals remain robust.

The prevailing expectation further out is that Fed can't raise rates too much without causing a recession. The series of Fed rate increases in 2018 that drove equities into bear-market territory before the Fed reversed course in 2019 are still a fresh memory for investors.

Q. What is the outlook for fiscal policy?

A. In the U.S., fiscal policy flexibility is constrained. The U.S. government did a lot for consumers during the COVID-19 pandemic, which has driven heightened concern over the level of government debt. In the absence of a serious recession, we don't see the potential for much agreement in Congress on a major spending package (although President Biden could still employ executive orders aimed at encouraging oil and gas production).

The energy-inflation pressures facing European households and businesses are much more intense, and could lead to a forceful fiscal response; the big question is how quickly that support will come.

Looking ahead, there will be long-term pressure to ramp up military spending to bolster European defenses and dissuade China from taking actions against Taiwan.

Q. Once the crisis in Ukraine passes, how might things change?

A. The monetary and fiscal response to the crisis will likely be limited, but the odds of an aggressive tightening of monetary policy this year are now considerably lower.

The Russian invasion’s primary impact on growth will be felt via the commodity markets and will affect Europe the most, although the extent of any slowdown could be modest because previous disruptions caused by COVID-19 are rapidly fading (despite current rising concerns of a resurgence in China). After the war is over, we could see long-term shifts in Europe, which might look to reduce its exposure to Russian energy. Russia may also reduce its exposure to western sanctions by embracing China more closely.

In the years ahead, we may see more pressure on government budgets in the U.S. and Europe as they try to increase defense spending while maintaining social programs.

SEI portfolios generally remain positioned for continued economic growth and a reflationary economic backdrop that benefits companies exhibiting earnings momentum, attractive valuations, and strong financial characteristics.

Glossary

Bear market: A bear market refers to a market environment In which prices are generally falling (or are expected to do so) and investor confidence is low.

Monetary policy: Monetary policy refers to the set of tools a nation's central bank has to promote sustainable economic growth by controlling the supply of money that is available to the nation's banks, its consumers and its businesses.

Reflation: Reflation refers to a fiscal or monetary policy designed to expand output, stimulate spending, and curb the effects of deflation, which occurs after a period of economic uncertainty or a recession.

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