Ukraine, Inflation and Interest Rates

March 2022

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As Russian advancements in the Ukraine continue, many countries, including the US and the EU, have imposed numerous stringent sanctions on Russia. The invasion and resulting sanctions have caused commodity prices to rise. Notably, oil has increased to its highest levels in a decade as the markets react to potential supply disruptions resulting from sanctions on Russian oil exports. The volatility in the energy market prices is likely to exacerbate inflation concerns.

US inflation has been a concern over the past year, having surpassed the 2% long-run target rate last March and continuing to escalate into 2022, as supply chain and labor shortages persist. Inflation reached 7.5% in January, its highest level in 40 years. However, expectations going forward, from both the Federal Reserve and consumers, are that inflation will decrease to a median 5.8% for 2022, with an even sharper drop over the coming three years to 3.5%[1]. The effect of the higher energy prices will likely increase pressure on inflation over the near term; however, the long term effects on growth are less clear.

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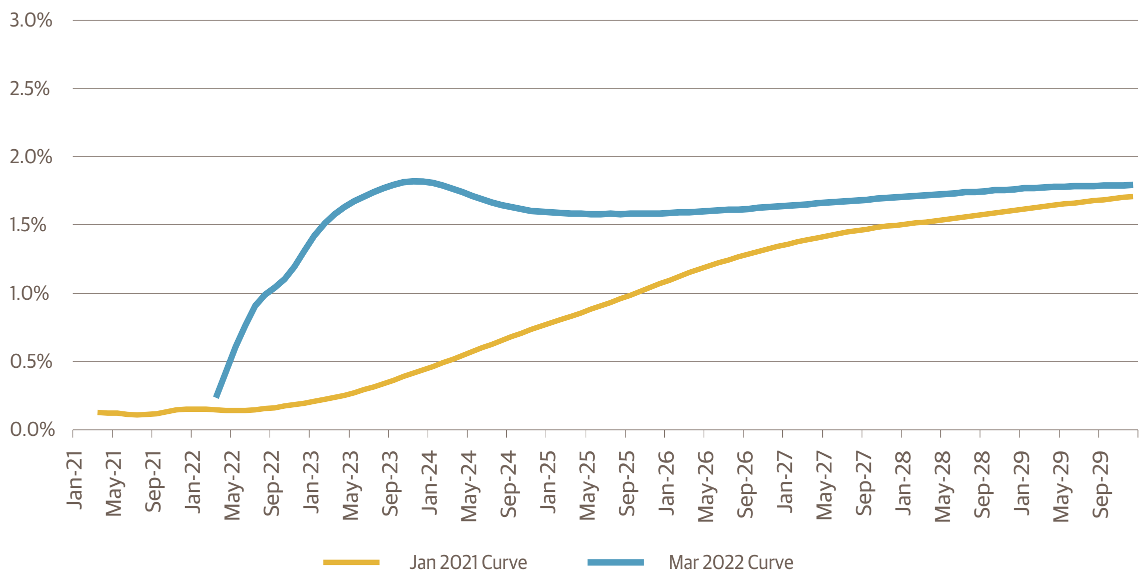
The Federal Reserve maintained its expansionary monetary policy throughout 2021 to support the economy's return to full employment. With February employment figures only 0.7% below pre-pandemic levels, market expectations for higher federal funds rate in the near term have increased. However, events in Ukraine may delay its implementation beyond the mid-March meeting. If elevated energy prices persist, concerns over escalating production costs and their effect on growth could slow down the pace of rate hikes during the year but are unlikely to dissuade the Federal Reserve from its current course.

The dot plot from the December 2021 Federal Open Market Committee meeting showed a median target rate for 2022 at 0.75% - 1%, pointing towards three rate increases during the year. Since then, indicators are showing more aggressive predictions for rate hikes. Short term interest curves have been reflecting the anticipated rate hikes in the medium term. The 1-month US LIBOR forward curve is steeper than it was a year ago. The market is still anticipating the same long-term interest rate, however, timeline for achieving this rate has been significantly brought forward. Additionally, the Federal Reserve's tapering plans are less defined, with no clear indication yet on curtailment of asset sales.

1-Month US LIBOR Forward Curve



Source: Chatham Financial

Considering an imminent shift in monetary policy, a few things need to be recognized about the current state of the US economy. Firstly, the Fed rate hikes are starting from a historically low rate, which allows for multiple hikes before rates exceed historically normalized levels. Markers such as mortgages rates remain notably low, hovering around 3.5%. Secondly, the continued return to the workforce will reduce labor costs, a larger contributor to inflation.

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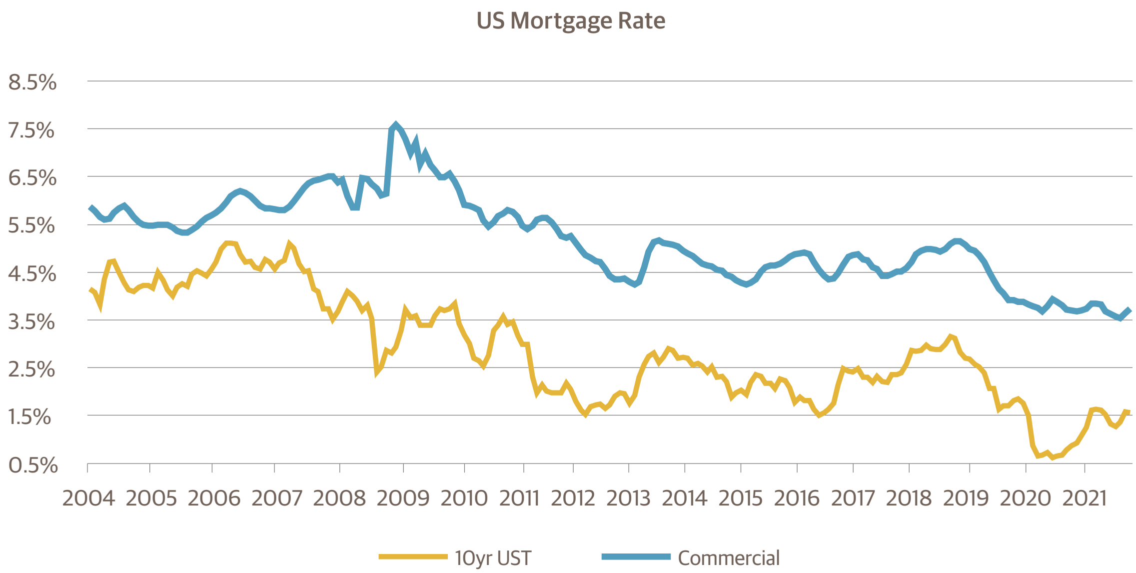
[1] Bloomberg - New York Federal Reserve consumer price expectations 31/1/2022



Source: Real Capital Analytics

The public markets have begun to reflect potential fed rate increases, leading to some sector volatility and the possibility of a value correction. However, the private markets have not had a similar response, primarily due to increased capital allocations to these markets. Real estate cap rates will typically widen as rates rise. Thus far, high global investor demand for US logistics and rental housing has resulted in steadily compressing cap rates. Rent growth can offset this compression, but it is clear investors required a lower risk premium for real estate investments in 2021 than they have historically. In private equity investments, highly levered companies with low EBITDA growth will face the most difficulties especially if they have tight profit margins and exposure to commodities. Conversely, mid-market growth assets, with double digit EBITDA growth will be able to contain the higher cost of financing. Arcapita's focus on companies that provide low cost mission critical services, but a high cost of failure, further insulate our portfolio from increases in inflation. The types of businesses we invest in can increase prices and do not depend on financial engineering to generate our investor returns. Service oriented businesses also do not have commodity exposure or high fixed costs, providing further insulation from these factors.

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The Russia-Ukraine situation will likely continue to affect commodity and energy prices as global sanctions cause supply disruptions. Despite inflation expectations dropping, and high energy prices having a potential effect on growth, the Federal Reserve is likely to tighten monetary policy in the coming months. It is apparent that the US economy is no longer in need of a highly supportive monetary policy, despite the recent geopolitical events, likely resulting in several moderate increases this year.

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With two decades of experience, Arcapita's management has built a global investment platform to access the opportunities that exist in our core markets of the US, Europe, Middle East and Asia.

Arcapita Overview

Arcapita is a premier asset manager offering diverse investment opportunities, focusing on private equity and real estate. At the center of one of the fastest growing wealth markets in the world, Arcapita's management has been serving an exclusive group of investors in the GCC region over the past two decades. With offices in Bahrain, Atlanta, London and Singapore, Arcapita's management team has completed over 90 transactions with a total value of approximately $31 billion and possesses a footprint to invest on a global scale. Arcapita focuses on defensive and counter-cyclical sectors supported by long-term macroeconomic and demographic trends.

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