

APRIL 2022

## The Wall Chapter 2: Beneath the Surface

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This year, many of us watched the Academy Awards, intently focused on whether CODA or Power of the Dog would be the first movie produced by a streaming service (Apple or Netflix) to win best picture. CODA won the award, also becoming the first movie with a predominantly deaf cast to attain this illustrious honor. Yet, while history was made that night, the buzz on Twitter and all over Hollywood for that matter, was about something else that happened at the awards show.

During a segment where the comedian Chris Rock was performing, Will Smith had come on stage and slapped Rock after the comic made an off-color joke about Smith's wife, Jada Pinkett-Smith. Will Smith ultimately apologized for his behavior, and the Academy Awards swiftly responded to the incident by banning Smith from attending the Oscars for ten years.

While most of the news focused on the incident itself, I was more interested in the personal history of the two individuals involved to see if there was an explanation for why Smith hit Rock and why Rock was seemingly unphased by the entire episode? Having just finished Smith's biography, Will, I knew what motivated his behavior in this incident. Smith frequently talks in his book about the abuse his mother suffered at the hands of his father and vowed to be strong enough and confident enough to stop such mistreatment. Knowing this about Smith, I researched Chris Rock's background to see if there were any clues to his reaction to Smith's surprise assault. It turns out that Rock was bullied as a child and, once, when he was embarrassed in front of a group of girls, he attacked one of the bullies with a brick hidden in his backpack, seriously injuring the boy. So, now that we understand what lies beneath these two protagonists, one potentially

has a deeper understanding of why Smith hit Rock and why Rock restrained himself.

In our work at MWM, we are constantly striving to understand what lies beneath a circumstance we are analyzing. Whether that is an estate planning question, a geopolitical event, or a business decision made by one of our portfolio companies, we seek to understand the deeper purpose or motivation for any of these actions to ensure that our advice is appropriate and thoughtful. Today, there are three issues we believe will shape markets in the near term and geopolitics for years to come: The strong U.S. economy with Covid-19 in the rear-view mirror, rising inflation which will usher in a higher interest rate environment, and a reduction in quantitative easing by the Federal Reserve, and the war in Ukraine with its accompanying humanitarian crisis and damning economic sanctions leveled on Russia.

### The U.S. Economy is Strong

A distinct advantage for the United States if we are headed into a rising rate environment and the uncertainty of a global conflict surrounding the Russia-Ukraine war is that the U.S. economy is much stronger than when facing past crises. While it is inevitable that the U.S. economy will slow from the break-neck pace it achieved late in 2020 and 2021 as it bounced back from the pandemic-driven lockdown, there is still solid evidence that the American economy is booming. For one, federal tax receipts were up 27% year over year in March, powered by a 51% increase in corporate tax receipts and a 29% increase in consumer income tax receipts. The consumer is also in exceptional financial shape. Consumer debt is among the lowest on record, jobs with wage increases are abundant, and the



### By Michael Merlin, Founder of Merlin Wealth Management

Michael's focus has always been on demystifying financial, estate, investment, and philanthropic planning for his clients. With extensive experience in multi-generational planning and advisory techniques, as well as asset management, Michael leads MWM and its clients to partner together and create customized wealth plans that are steeped in the values and best practices of each family. Having built an institutional-quality asset management practice inside MWM, Michael and his team can even align their clients' investment plans with these same best practices.

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American consumer possesses more than \$2 trillion in excess savings, primarily due to government stimulus.

Thus, today's economic landscape is entirely different from the 2008 financial crisis when the consumer was overleveraged, and the financial system was cracking in several ways.

## Monetary Policy and Inflation

In his annual letter to shareholders, Jamie Dimon said that "persistent inflation will require rising interest rates and a massive but necessary shift from quantitative easing to quantitative tightening. The Federal Reserve and the government did the right thing by taking extraordinary steps to rescue the country from the chaos unleashed by the pandemic. While there is no doubt that the measures worked, in hindsight, the medicine (fiscal spending and QE) was probably too much and lasted too long." Because of the unprecedented challenge the Fed has in front of it- trying to achieve a "soft landing"

while raising rates and significantly reducing the size of its' balance sheet- this market and economic cycle will likely be studied for decades to come.

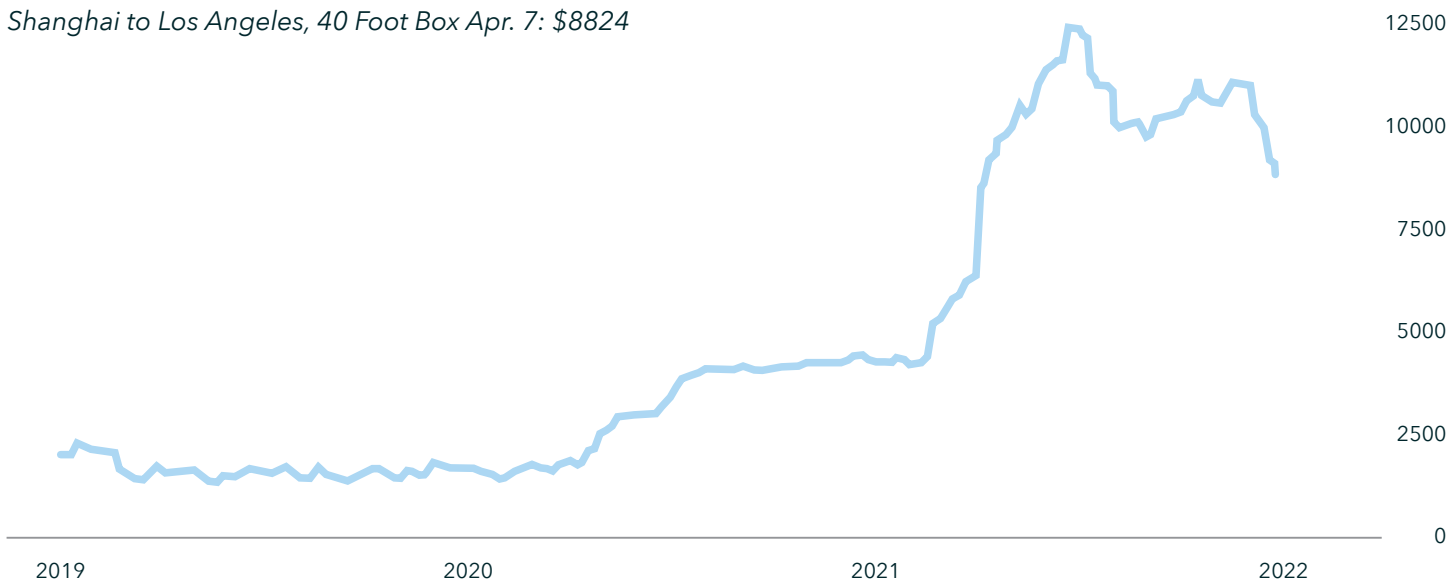
Another relatively unprecedented dynamic affecting inflation is the tight labor market, which may persist for longer than we expect. Between 2020 and 2021, two million people retired early, the supply of immigrant workers dropped by one million due to immigration policies, and available jobs skyrocketed to eleven million, while job seekers dropped to five million. Based on these statistics, it is not surprising that government data shows U.S. unemployment at one of the lowest levels ever. If such conditions continue, it will likely lead to further wage gains, which will filter into prices, possibly making core inflation more stubborn to remediate than the Fed currently expects.

While wage inflation could persist, recent evidence suggests inflation could be peaking. Freight rates, used car prices, gasoline prices, and WTI crude oil prices all decreased in the month of March:

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## Freight Rates (WCI)

*Shanghai to Los Angeles, 40 Foot Box Apr. 7: \$8824*



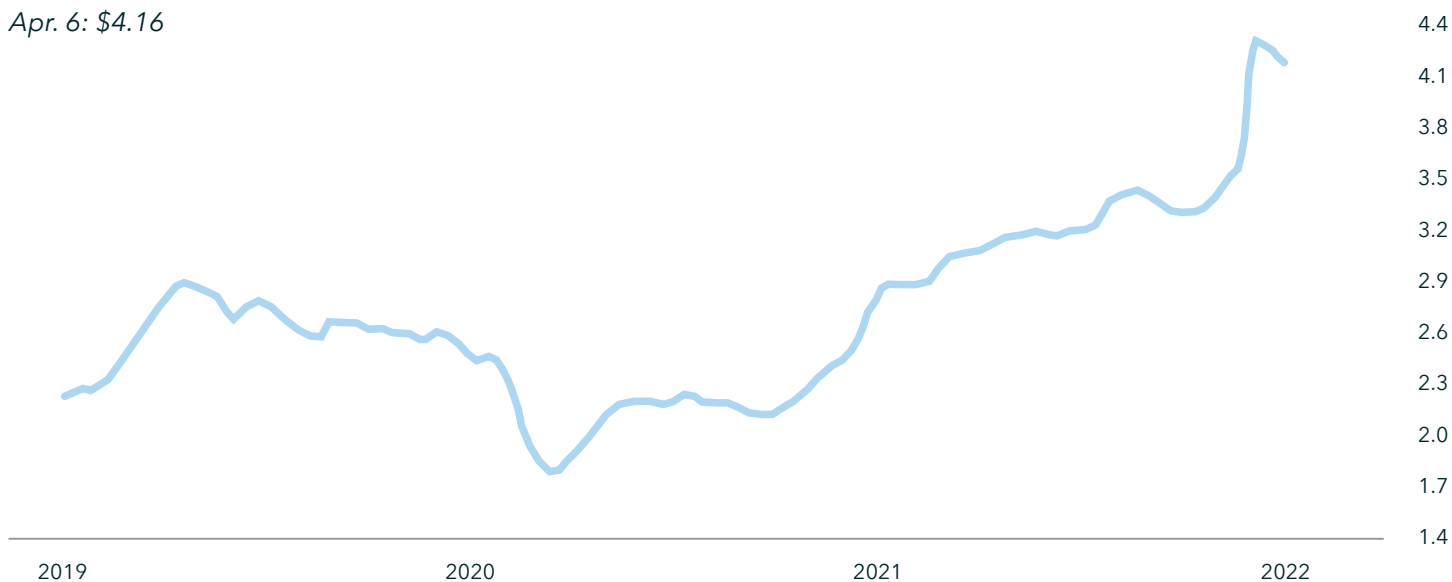
Source: Evercore ISI 04/08/2022

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## U.S. Retail Gasoline (AAA)

Apr. 6: \$4.16

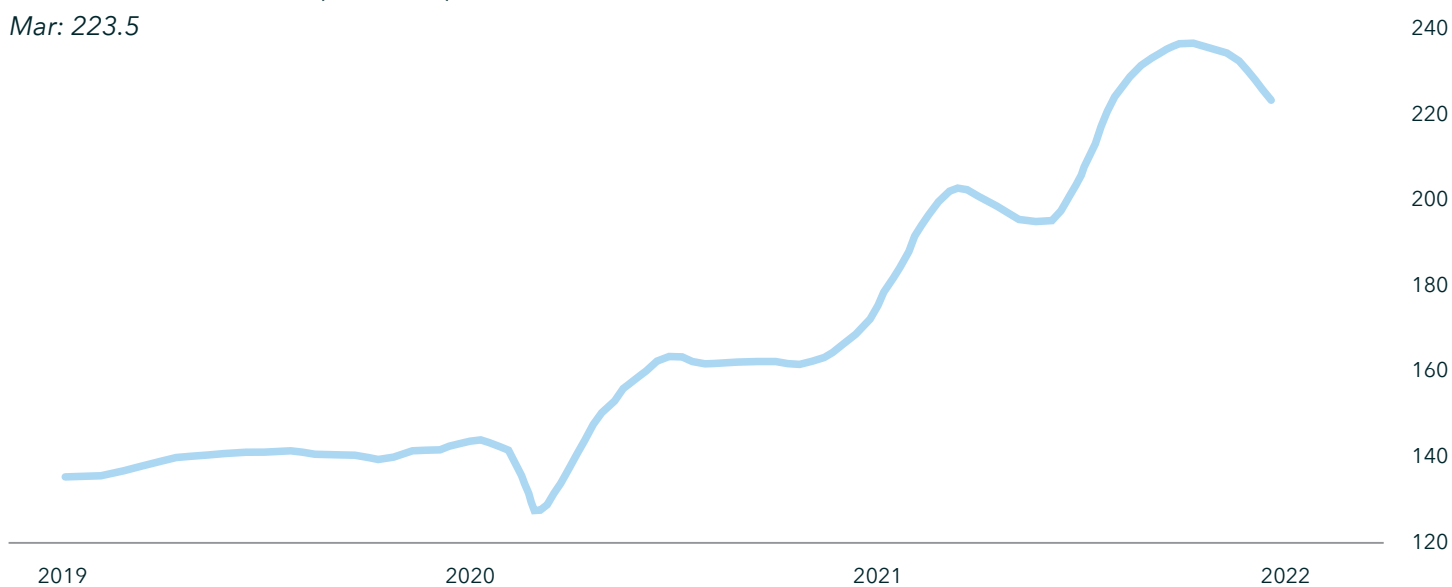


Source: Evercore ISI 04/08/2022

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## Used Vehicle Price Index (Manheim)

Mar: 223.5



Source: Evercore ISI 04/08/2022

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Unfortunately, drags from continued challenges within the supply chain continue to threaten the supply/demand imbalance. Shanghai factories are closing again as new Covid lockdowns spread throughout China. Each week we seem to hear of another rationing of an essential consumer staple (last week it was baby formula, the week before, eggs). Lastly, with the war in Ukraine unlikely to end anytime soon, energy prices may not hold their recent price reduction, and other raw materials, like metals, which require energy for refinement, could be affected.

In all, it is only safe to assume that uncertainty and, therefore, volatility will continue to be the only common theme across markets and geographies over the next quarter. As such, while we have gotten more constructive on fixed income, we will make our way into those markets gingerly with the likelihood of further rate increases providing better entry points. With equity markets, we continue to favor companies we feel have the characteristics to withstand a rising rate and rising wage environment while also contemplating whether the gains we've achieved in inflation-specific sectors, like metals, have run their course.

## The Russia-Ukraine War and Western Sanctions on Russia

The impacts of geopolitics on the economy are hard to forecast. For as much interest as it gets, geopolitics over the past 50 years have rarely disrupted the global economy in the short run. "The 1973 Organization of the Petroleum Exporting Countries, or OPEC, oil embargo was an exception when the sharp jump in oil prices pushed the world into a global recession."<sup>1</sup>

As I write this piece, the war in Ukraine has been intensifying for well over a month and is creating a major refugee crisis. While we do not know its outcome ultimately, it is already clear that the conflict in Ukraine and the sanctions on Russia are having a strong economic impact. Most severely, they have roiled global oil, commodity, and agricultural markets. "The fallout from the war and resulting sanctions are expected to reduce Russia's GDP by 12.5% by midyear (a decline worse than the 10% drop after the 1998 default). Further, the euro area, which is highly dependent on Russia for oil and gas, will see GDP growth of roughly 2% in 2022, instead of the elevated 4.5% pace expected just six weeks ago."<sup>2</sup> By contrast, the U.S. economy is expected to expand approximately 2.5% versus a previously estimated 3%. It is worth noting that these estimates are based upon the status of the war in Ukraine today and the current sanctions now in place.

To better understand the potential long-term implications of the war, I think it is interesting to dig into the history and understand the catalysts and likely unintended consequences of Vladimir Putin's recent actions.

### Beneath the Surface: The War in Ukraine

In 1997, while Russia was still reeling from the disintegration of the Soviet Union, Aleksandr Dugin, a Russian ultranationalist, published a groundbreaking book, *The Foundations of Geopolitics: The Geopolitical Future of Russia*. The book laid out a blueprint to rebuild the Russian empire by leveraging its natural resources and various divide-and-conquer strategies to pressure Europe and isolate the U.S.

While we have been focused on many different crises since 1997- Long Term Capital Management, the DotCom Bubble Bursting, 9/11, The Great Recession, and most recently the Covid 19 Pandemic, to name a few- Vladimir Putin has been quietly (and not so quietly) following the tenants of Dugin's missive to reestablish Russia as a superpower. Russia created meaningful trade relationships with major European countries, cutting out the U.K. and the U.S. Most of those relationships centered around exporting Russian natural resources, making

many of these critical European allies dependent on Russian oil, natural gas, metals, and agricultural products. Putin also turned his attention to Islamic states, creating alliances with Iran, Syria, and other U.S./Israel nemeses to attempt to counter the U.S. influence in the Middle East. Lastly, Russia tried to bring instability, separatism, and isolationism directly to U.S. soil by manipulating social media and other mediums to sway U.S. political elections, foster division among American citizens, and create distractions at home that would prevent us from responding to threats abroad.

Then, it should not be surprising that the last initiative in Dugin's strategy was the annexation of lands, including Ukraine, to recreate an "Eastern Block." While the catalyst for Putin's actions seems to lie in Dugin's book, I believe he was caught off guard by three developments that have roiled his plans to date. The first surprise was the shockingly poor performance of the Russian military. Many attribute this disastrous showing to decades of corruption that stole much of the budget earmarked for modernizing the military. Combined with the feeble standing of the Russian economy, Putin made a colossal miscalculation on funding and executing this war. Perhaps he felt that the Ukrainian army would stand down. Still, in any event, his foundation of leadership is weakened with every Russian soldier left to die on a Ukrainian battlefield.

The second surprise was the strong and cohesive response from the world, including Putin's supposed "friends" in Europe. After years of condoning Putin's bad behavior with weak sanctions and condemnations, European leaders joined with the West to enact crushing sanctions on the Russian Central Bank, Russian oligarchs, and even on Putin himself. G-7 countries froze roughly 60% of Russia's \$630 billion in foreign exchange reserves. Late last month, the West also banned gold transactions with the Russian central bank to further limit its ability to support the ruble and international trade. While these sanctions have set the Russian economy back decades, there will likely be collateral damage to the global economy and stress to the global financial system that we have yet to see. It is not unlikely that a financial crisis of limited scope could unfold based on the consequences of the Russian sanctions. While there is no predicting what will happen, this is yet another reason why having complete transparency into one's assets and owning quality is almost more important than absolute performance in times like these. Markets will sway based on the day's news, but genuine fear should be in the hearts and minds of those who are overleveraged or who own wildly speculative assets. What will the effects be on those playing with that kind of fire if there is a sovereign debt default or cryptocurrency collapse? I'll stick with my Apple stock, even though it may not be performing as well today.

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## Regardless of how the Ukrainian crisis gets resolved, it is hard to see how the West can return to business-as-usual with Russia still ruled by Putin. The likely outcome will be a new "Cold War" with three distinct geopolitical camps.

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The last surprise to hit Putin was the strong stance the private sector has taken against Russia. Western companies are unwinding their businesses in Russia quickly and unabashedly. While Putin is likely unphased by Starbucks closing locations across Russia, he must be concerned with boycotts from industrial, technology, energy, and transportation companies. These boycotts are having immediate impacts on the Russian economy and military. For once, cancel culture has been put to good use!

Regardless of how the Ukrainian crisis gets resolved, it is hard to see how the West can return to business-as-usual with Russia still ruled by Putin. The likely outcome will be a new "Cold War" with three distinct geopolitical camps. "One would be the Authoritarian Axis linking Russia, China, Iran, North Korea, Venezuela, and their satellite states in Central and Southeast Asia, Africa, and Latin America. On the opposite side is the Liberal Democracy Alliance comprised of the G7 countries, most of Europe, Australia, New Zealand, and other pro-Western nations. The third camp would consist of the so-called Non-Aligned nations, including India, Brazil, South Africa, and Saudi Arabia."<sup>3</sup>

This new geopolitical repositioning will likely reverse many benefits of globalization that we have taken for granted during the last few decades. "In the new world order, the Authoritarian Axis and the Liberal Democracies will rework their supply chains to reduce interdependency, likely leading to less efficiency and higher structural inflation. Each camp will also use its comparative advantages - commodities, technologies, or cheap labor - for geopolitical leverage."<sup>4</sup>

In short, profound changes are unfolding before our eyes, and some of the impacts will only be felt over time. Shifting supply chains, finding new raw material and labor sources, and reimagined military partnerships will undoubtedly shape a new age. Whether this new era will be defined by tension and hardship or by innovation and a renewed determination rests squarely on the shoulders of our political leaders. This is someone's time to shine- I just hope it's not President Xi.

## Let's not forget China...

While we have spent most of these pages discussing Russia, the most significant relationship will be the one between America (and its allies) and China over the next several decades. To get this essential relationship right, American leaders must have a clear view of our strategic, economic, and national security interests.

Because we are dealing with a pattern of circumstances that we have never encountered – the rise of a similar-sized country that promotes unfair trade practices and ever-changing investment rights while providing state-sponsored subsidies to manipulate competition – we will need to respond in equally unprecedented ways. First and foremost, we should stop moaning about these unfair methods and just take action. Both countries can take the measures they see fit in the economic sphere, and we should do so when warranted.

To counter unfair competition on China's part, we will need to develop thoughtful policies and strategies that work. We also need to establish 'industrial policies' that help industries essential to national security (semiconductors, 5G, rare earth metals, and others) flourish. I believe this can be done judiciously but will require increased government R&D focused on activities that businesses cannot do alone – advanced science, military technologies, and others.

There are compelling reasons for a more extensive restructuring of global trade, as discussed above. It is quite clear that supply chains need to be reorganized for three different reasons:

1. The U.S. supply chain must be domestic or open only to amicable allies for any products or materials essential for national security. ***"We cannot and should not ever be reliant on processes that can and will be used against us, especially when we are most vulnerable."***<sup>5</sup>
2. Activities (including investment activities) that could lead to a national security threat – i.e., sharing critical technology with possible enemies – should be restricted for similar national security reasons.
3. Companies will diversify their supply chains to be more resilient.

Along with reconfiguring our supply chains, we must create new trading systems with our allies. Our relationship with China cannot subsist as outlined above if we do not make these changes in partnership with our allies worldwide, especially if historical trading partnerships with countries like Russia are forever altered. I spent the weekend reading the Trans-Pacific Partnership (TPP). While I understand the prior opposition to this agreement, considering today's geopolitical environment, I think it provides an interesting framework for what our new trading partnerships could (and potentially should) resemble.



## **"Lead me, follow me, or get out of my way." - General George Patton**

If we are headed to a more bifurcated global economy, there is clearly a path forward for the U.S. if we can agree on what we want and then execute. To do this, we need more leaders who can create consensus, inspire the citizenry, and then execute to get it done. The "wants" are not new, nor are they particularly complex- The world's leading economy with a strong reserve currency; consistent regulations and policies that foster growth and do not cripple business innovation or investment; a new strategic plan for global trade, devised in conjunction with our allies; the strongest military in the world with a renewed commitment to peacekeeping in conjunction with our NATO allies; and a country whose strength is underlined by respecting all citizens, and providing proper support when our people are in need.

The war in Ukraine has shined a light once again on the changing geopolitical landscape. Whether it is Russia this time or China next time, there are clear and present

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**By taking emotions out of the decision-making process, Merlin Wealth Management looks at market disruptions as opportunities to own great businesses that rarely go "on sale," given their competitive leadership and resiliency. This mindset- a core tenant of our investment philosophy- has allowed us to look past market noise and deliver consistent results for over 13 years.**

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dangers that dictate we move forward to protect our interests and needs. We must restore effective long-term leadership in our country, or else it is easy to envision darker days ahead economically and geopolitically. But with great leadership and the kind of resolve shown by our allies during this most recent conflict, there is a path forward that can lead to a brighter future for us all.

## **Voting Machine v. Weighing Machine**

Warren Buffett is often quoted from his 1987 letter to Berkshire Hathaway shareholders that "in the short run, the market is a voting machine, but in the long run, it's a weighing machine."<sup>6</sup> Buffett's quote suggests that the market can act like an (often irrational) electoral race in the short term, subjecting a company's share price to its constantly vacillating public popularity. When markets work like a voting machine, they ignore a business's underlying fundamentals and are driven by speculation, sentiment, and CNBC.

While even the strongest businesses can experience bouts of indiscriminate selling as the "voting machine" overlooks the company's long-term potential, Warren Buffett believed that the market would act as a weighing machine in the long run. By this, Buffett meant that equity prices would eventually reflect the fundamental characteristics of a business, including a company's earnings growth potential, financial strength, competitive advantages, and management quality. Similarly, we believe that our portfolios' performance will track the fundamentals of our underlying holdings- even if, in the near term, the two have become temporarily disconnected.

As we progress through the remainder of 2022, we believe that grasping the differences between the two market "machines" will be critical to navigating the current investment environment. With expectations of higher inflation and interest rates, it is worth noting that today's market is profoundly different from that of the past two years. In our view, an active management approach will prove most effective going forward, given that the current backdrop is likely to draw a more expansive line between winners and losers. Even though sudden market fluctuations can be difficult to endure emotionally, remaining patient through periods of increased volatility can help investors avoid making impulsive (and often costly) investment decisions. By taking emotions out of the decision-making process, Merlin Wealth Management looks at market disruptions as opportunities to own great businesses that rarely go "on sale," given their competitive leadership and resiliency. This mindset- a core tenant of our investment philosophy- has allowed us to look past market noise and deliver consistent results for over 13 years.



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1. Chairman & CEO Letter to Shareholders by Jamie Dimon, Annual Report 2021, [www.reports.jpmorganchase.com](http://www.reports.jpmorganchase.com)
2. Chairman & CEO Letter to Shareholders by Jamie Dimon, Annual Report 2021, [www.reports.jpmorganchase.com](http://www.reports.jpmorganchase.com)
3. Dawn of a New Order by Jimmy Chang, 04/01/2022, [rcm.rockco.com/insights\\_item](http://rcm.rockco.com/insights_item)
4. Dawn of a New Order by Jimmy Chang, 04/01/2022, [rcm.rockco.com/insights\\_item](http://rcm.rockco.com/insights_item)
5. Chairman & CEO Letter to Shareholders by Jamie Dimon, Annual Report 2021, [www.reports.jpmorganchase.com](http://www.reports.jpmorganchase.com)
6. A Metaphor for Investors and Speculators by Polen Capital 04/01/2022, [www.polencapital.com](http://www.polencapital.com)

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