2022 - The Burning Question

Fixed Income Macro View

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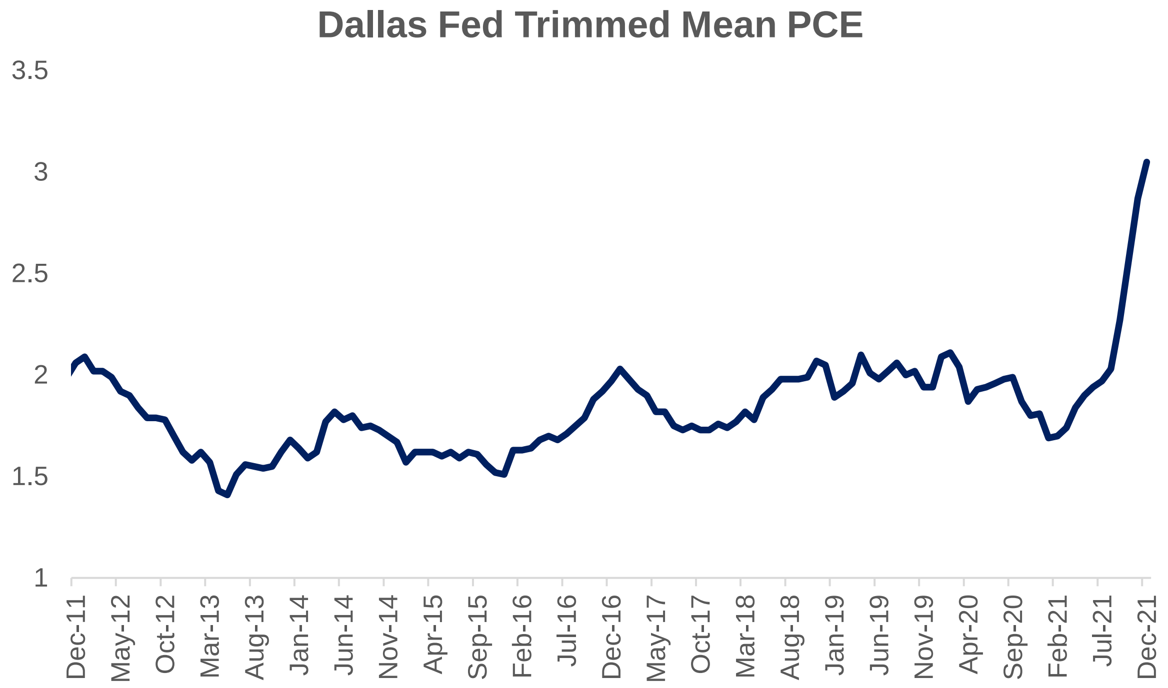
Introduction

Is long term inflation still anchored to post 2008 levels? This is singularly the most profound question of the coming market/economic cycle. If the answer is yes, the roadmap may not look entirely dis-similar to that which has gone before. If the answer is no, then the financial markets and the wider economy had better sit up and take notice.

Broadening Inflation



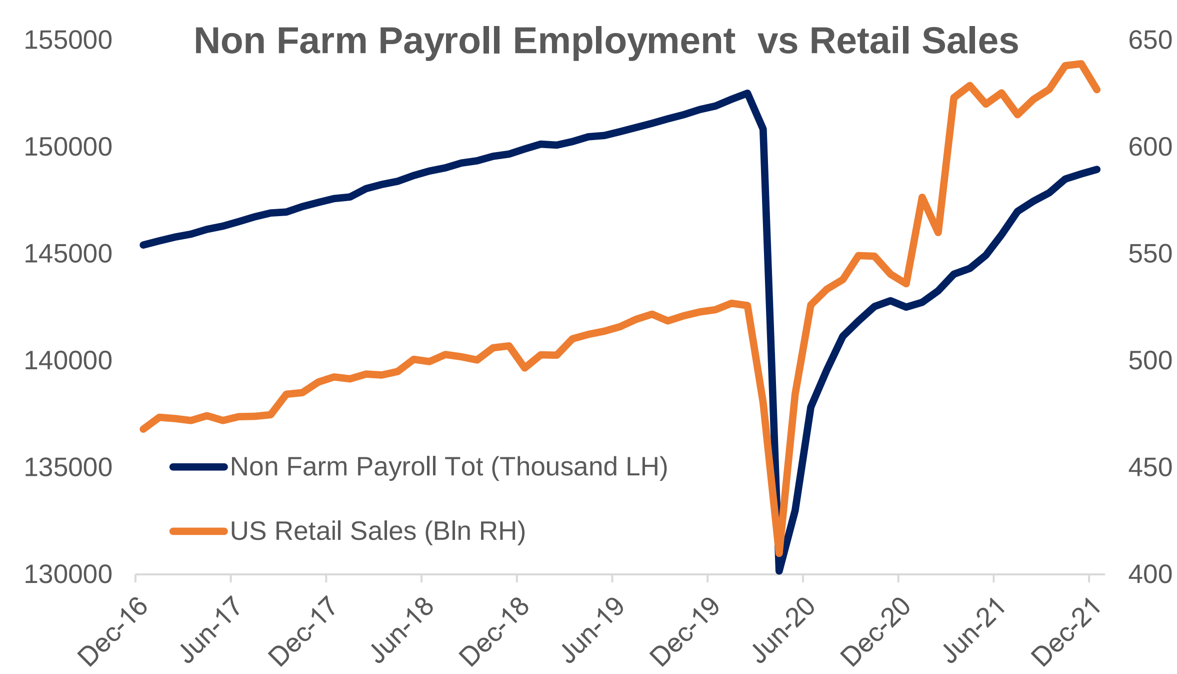
Source: Bloomberg as at 31/01/22

The fruits of the past decade of excessively loose policy are being borne out in the growing inequality and social/political turmoil. Over the years, policy makers have made any number of false pronouncements, from claiming that house prices don't drop on a national level to asserting that inflation is merely transitory. In spite of this, they have almost always had the political cover to plough on with policy. Increasing asset prices trumped all other concerns. Inflation however has the potential to change all of that. Should the current growth in inflation expectations continue, the old get out of jail cards might not be so easy to use.

Pandemic Impact on Economy and Inflation

The pandemic has transformed much of how we live our lives whether it be work, school or education. Away from this it also changed how we approached policy in respect of monetary, fiscal and labour. The two pronged approach of governments and central banks in dealing with the immediate fallout from COVID represented a more balanced strategy and certainly had a far greater impact on the short run in keeping the economy afloat. By the same token however, this also produced a different set of side effects which are now beginning to emerge.

Stimulus Effect – Jobs vs Retail Sales



Source: Bloomberg as at 31/12/21

Short-Term – Fiscal over Monetary Policy

The effect of fiscal policy on the economy during the COVID lockdowns was significant. While it sustained the economic expansion for most of the crisis it also sparked a structural shift in spending habits. As the global economy suffered a seismic supply side shock, a simultaneous increase in goods demand left a vast disparity between supply and demand. QED a pronounced increase in prices. While we do expect many of these supply side pressures to dissipate, it is evident that the global supply chain is not nearly as robust as we once assumed. This is likely to have consequences as we look further down the line.

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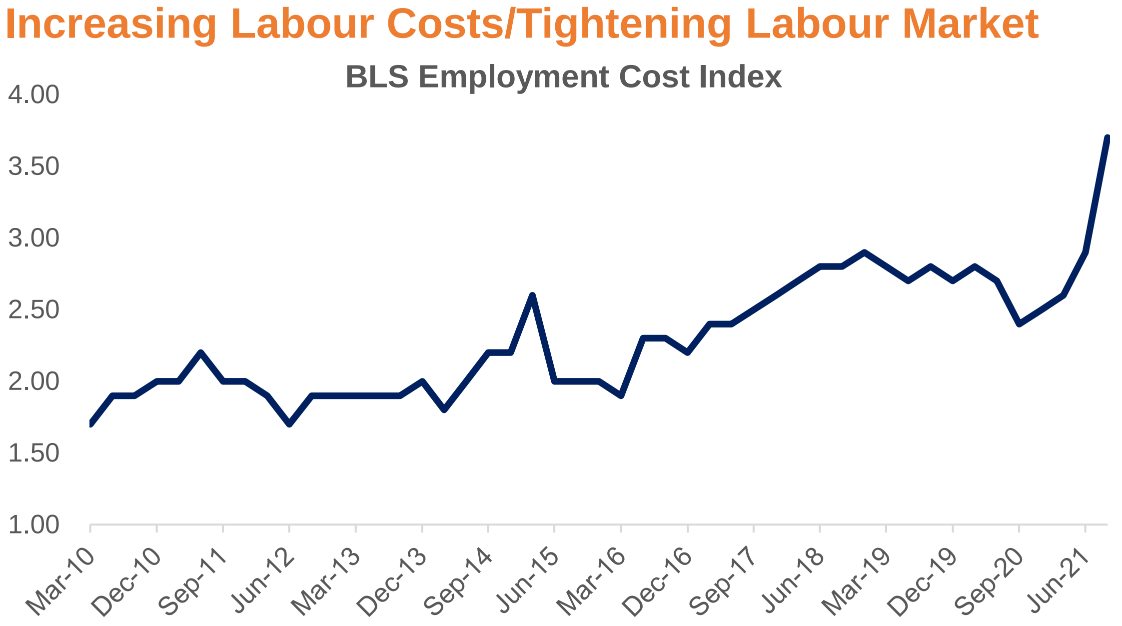
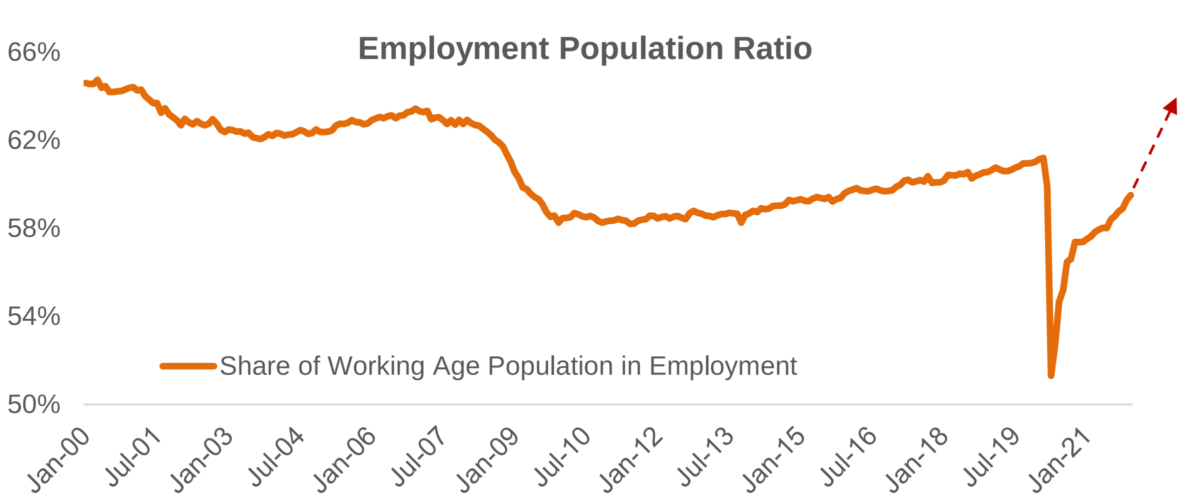
Medium-Term – Labour over Capital

While the extraordinary price pressures of the past 6/12 months has seen many politicians sit up and take notice, we should not forget this has come on the back of a decade plus of growing inequality that has driven many societies to the brink of a cost of living crisis. It seems now that it is no longer politically feasible to prioritise the needs of the few over those of the many. Whilst the top 1% have enjoyed a remarkable increase in NAV since the pandemic began, the rest of the economy have been squeezed harder than at any point in the last 40 years (energy, food, housing). This does not make for a happy electorate. As a result it is possible that the balance of power may be slowly shifting away from the owners of capital (top 1%) and towards the workers. Evidence of this nascent move can be seen in the increase in wages at the lower end, difficulty in hiring and an uptick in unionisation at large corporations. How this dynamic develops in the coming years will have a major bearing on future policy.

Increasing Labour Costs/Tightening Labour Market





Source: Bloomberg as at 31/01/22

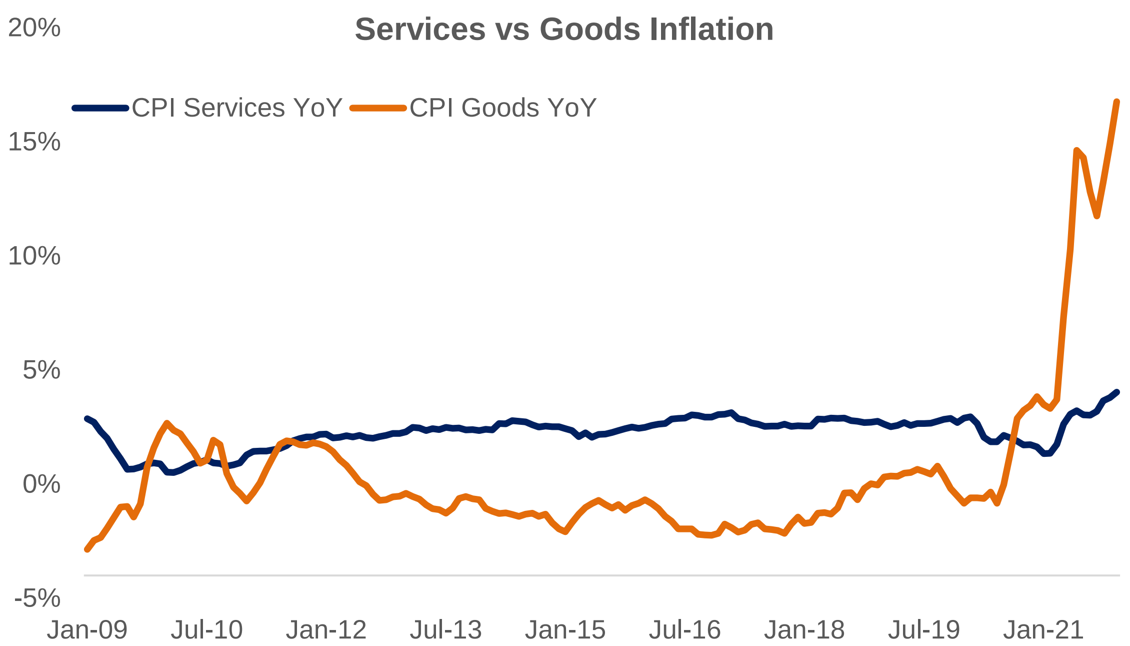
Long–Term - Structural Shifts

Over the last 40 years the global economy has benefitted from several strong tailwinds. With continued economic expansion came globalisation and the supply of cheap labour. Lower costs fed into lower prices which helped encourage lower interest rates and higher debt levels. With globalisation in many respects looking to have peaked, some kind of a reversal of this pattern may be forthcoming. Additionally, there is a growing realisation that previous policies are no longer feasible from a political standpoint. Whether the upshot of this means re-shoring of jobs, higher wages, increased costs as a result of climate change, remains to be seen. What we can say is that the global economy appears to be in a very different place to that of the post GFC world.

Deflationary Tailwinds of Globalisation

The longer term outlook must be examined in the context of current economic events and not through the lens of the last cycle. The inflationary challenges we face today are far greater than those of 2008. A prolonged period of goods deflation defined the last 30 years, with service based prices coming in slightly above target most of the time. Interest rate policy was set accordingly. If we can imagine an uptick in some of the aforementioned structural costs a vision of non-zero rates going forward looks eminently plausible.

Goods vs Services



Source: Bloomberg as at 31/12/21

If we see a fall in aggregate demand with such a sizeable debt overhang then we must conclude that in spite of the unprecedented levels of support the economy cannot be sparked into action. As such instead of re-rating our inflation outlook we must instead re-visit our growth and earnings expectations.

Outlook for 2022

Extreme market valuations have come against a backdrop of excessively loose financial conditions. Given its starting point, 2022 will be much more of a challenge than 2021 – taking into consideration the tightness of credit spreads and equity market valuations. Below are some different scenarios, each of which can result in profoundly different outcomes for economies and markets

(1) Inflation quietly comes down and growth stays high –given current valuations upside potential is risk asset flat to small negative

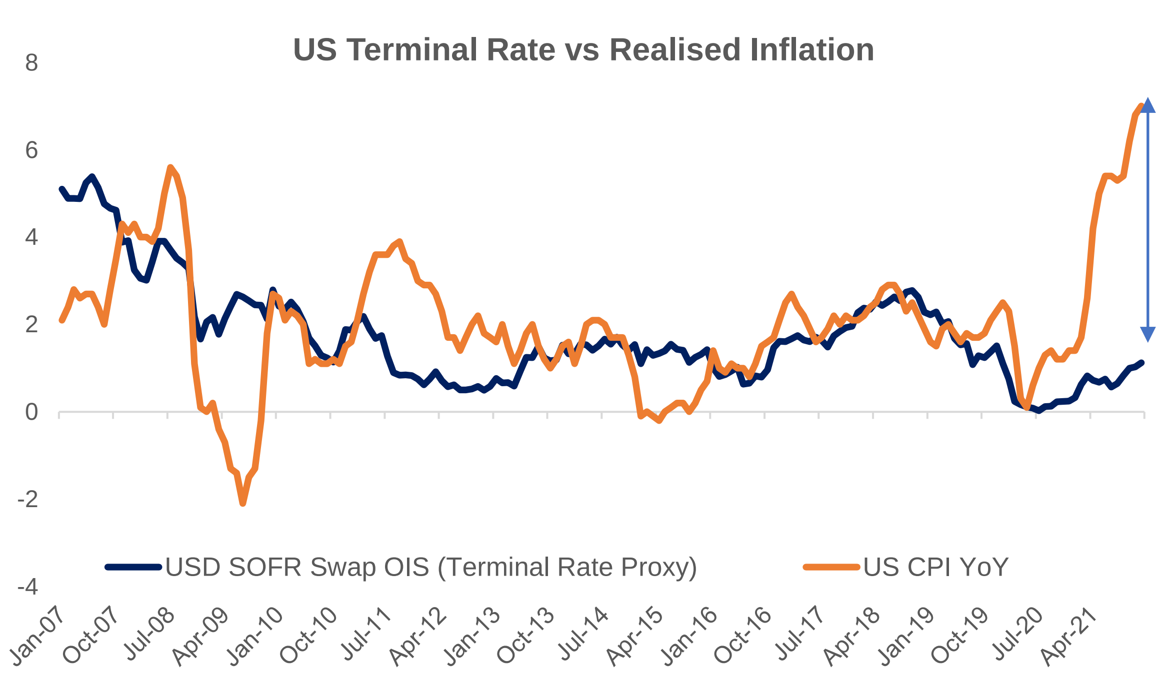
(2) Inflation is sticky and central banks need to push on the inflation breaks hard – very damaging outcome for markets in the short and long term

(3) Growth collapses and takes with it inflation and financial conditions tighten – this will hurt in the short run but will allow monetary policy to protect the markets to a certain degree.

Outlook for the Longer Term

2022 presents many challenges for policy makers. The question posed at the outset regarding whether inflation expectations stay anchored is central to everything. As it stands today the Federal Reserve don't expect to tighten financial conditions very much to bring inflation under control. By the Fed's own analysis, they expect interest rates to stay equal or below inflation over the longer term, in spite of the hype around a hawkish Fed. Regardless of what many in the market might say to the contrary, tightening faster and harder now would prevent the central banks having to be far more heavy-handed later down the line. This is exactly why it was a mistake for the Fed not to have tightened financial conditions in 2021, and why a slow rollout of tightening policy in 2022 is a mistake. It is not that we see a breakout of inflation as more likely than not – it is that we believe the risks to a shift in inflation are real and a delay in acting upon this will cause far more problems in future than tightening policy now. Inflation is not something to be trifled with.

Fed Willingness to Tackle Inflation

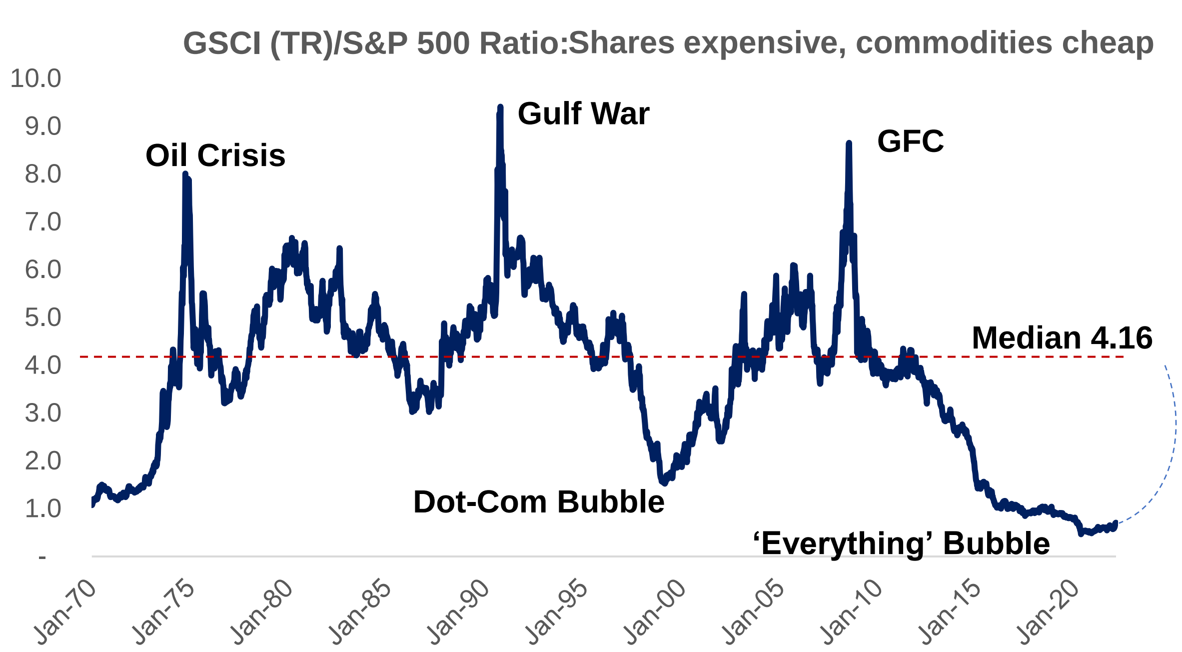


Source: Bloomberg as at 31/12/21

Arthur Burns believed the inflation of the 1970s was confined to the energy market and that monetary policy was an inappropriate tool to counteract it. He was ultimately proved wrong as inflation fed its way into other areas until the Fed could no longer control it.

The reality, of course, is that there will at some stage be another economic crisis. Who knows what the catalysts might be, inflation, collapsing demand or heavens help us another credit crisis. One thing is certain - the appetite for another round of 'Wall Street only' bailouts looks well and truly dead. Policy makers will therefore need to garner public support through fiscal policy to keep social stability in tact. Reliance on a monetary only solution leads only to rising inequality, mal-investment and ultimately slower growth. A more balanced response on the other hand allows for a broader economic recovery which itself would be more inflationary. If this is a case, past market performance will be not good indicator of future results. The outperformance of financial assets over the real economy may be a thing of the past.

Commodities vs Financial Assets



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