Volatility Returns

Fixed Income Macro View

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Rubrics Fixed Income Macro View

Central Banks Waking Up to Inflation

Well that escalated quickly, as one trader said to the next. Throughout the second half of 2021 the sight of higher and higher prints of inflation were largely ignored by both central banks and markets alike, to our total bemusement. It is interesting then that all of a sudden the hawks are driving the agenda from the BoE to the Fed and now, incredibly, even the ECB. To give the Fed their due they did announce the requisite actions to be taken in response to higher inflation. But they have been very slow in implementing them and the steps they have laid out barely involve any tightening of financial conditions. Without exception, central banks have been far too cautious in applying the breaks and that will have a cost. The question is how high?

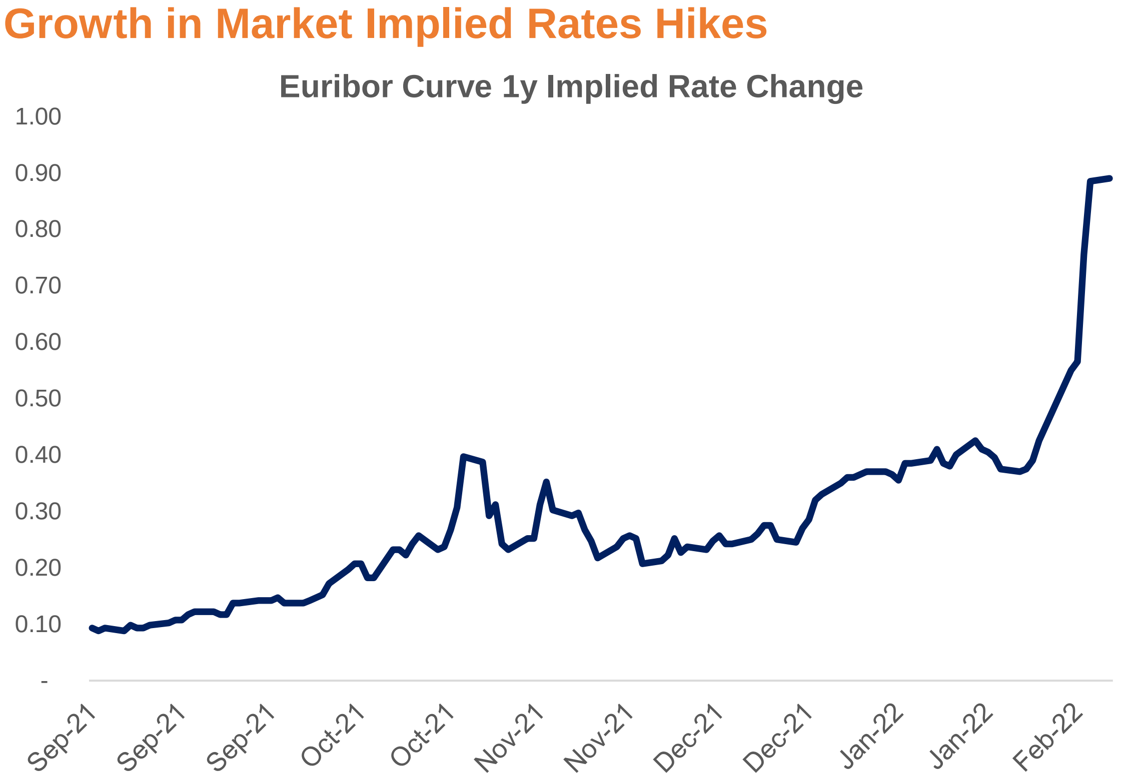
Markets are now unanimous in pricing in rate hikes across the board with little if any push back from even the more dovish policy makers among them. Perhaps most remarkable is the case of Europe where they are looking at the possibility of rate hikes this year and an end to QE. While financial conditions are still extremely loose globally, relative to history there is certainly a growing feeling in the markets that this change of positioning is something to be concerned about.

Quite right too that they should be considering the position that decades of excessively loose policy have left the global economy in. To be a fly on the wall at the Bank of Italy as the ECB announces a pull back of its QE programme…

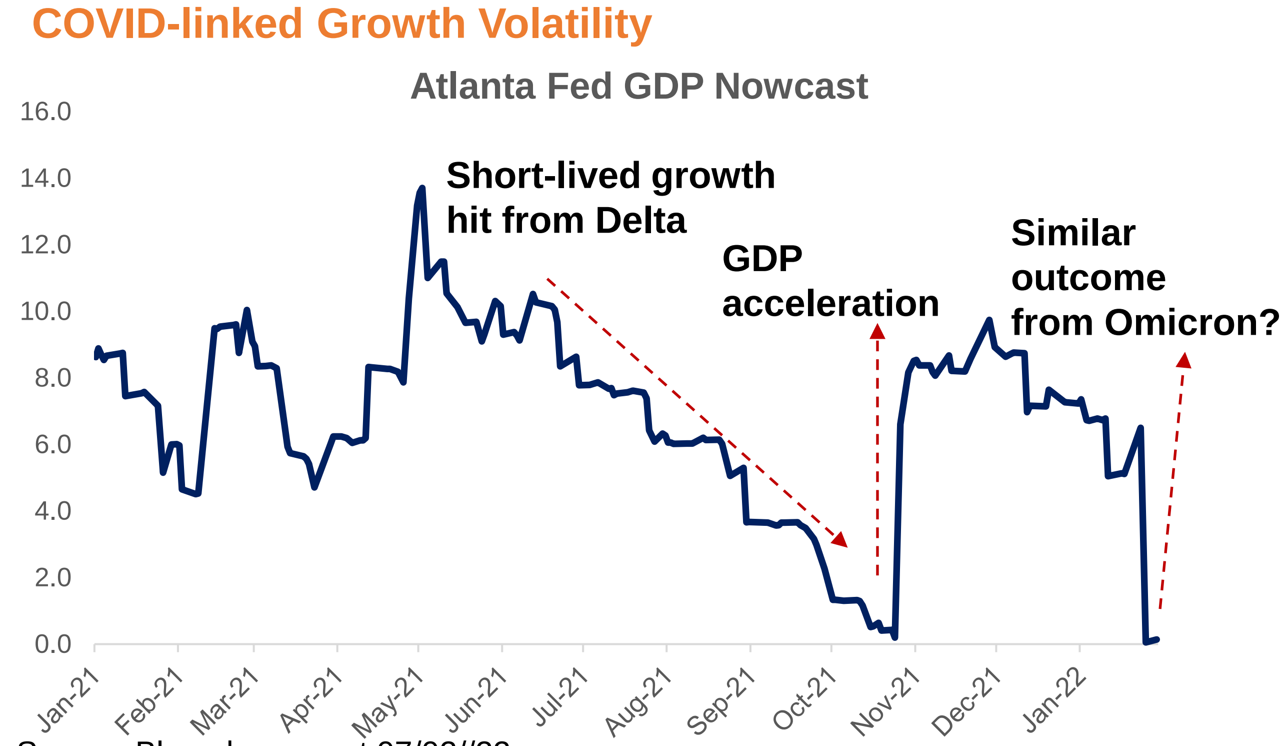
Critical Data Points Coming up

On Thursday we have the release of January's inflation data. The CPI is predicted to continue its ascent, this time to 7.3%. If we align this to the high wage growth of 5.7% from last Friday and the continuing rise of energy prices, the inflation picture for 2022 as a whole is looking increasingly worrisome both in the US and elsewhere. A quick resolution of the Ukrainian standoff or a major increase in production from Opec+ seems to be the only outliers that might assuage the situation, but both look like long shots right now. In addition, some of the weaker data prints of late, due to the spread of Omicron (e.g. ISM), might start to fade as they did post the short lived Delta driven slowdown in September. Central banks don't see as swift a resolution to the inflation problem as they originally hoped for – 'transitory' was transitory it turns out - and are starting to come around to the idea that they might have to do something about it.

Growth in Market Implied Rates Hikes



COVID-linked Growth Volatility



Source: Bloomberg as at 07/02//22

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Near Term Outlook

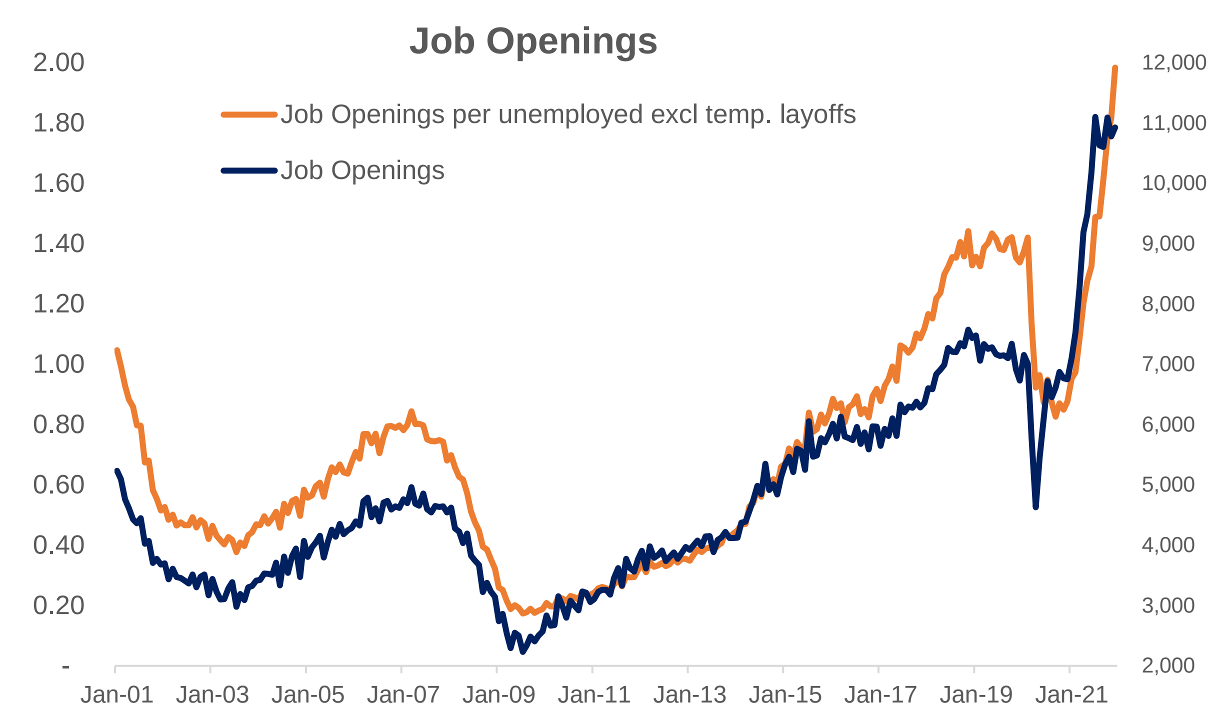
Although inflation fears it seems have reached something of a fever pitch, the likelihood that prices should start to fall later in the year remains quite high in our view. It's just that it may require a bigger push from central banks than originally thought. Critically, longer-term inflation expectations are yet to be unanchored, but for that to remain the case some heavy lifting is required. As a result, risk assets will continue to stay volatile for a time at least. While some of the market froth of the post COVID rebound has been unwound, a healthy development in our view, vigilance as to the broadening of market volatility will be required. Financial conditions have not yet hit the point where we would expect to see large market swings like March 2020 or even Nov/Dec 2018.

Positively, from our perspective, interest rates are now starting to reflect a more realistic economic outcome. Higher yields are always a plus when looking to build positive returns in a fixed income portfolio. Provided long-term inflation stays anchored the Central Banks will have some wiggle room should growth expectations begin to drop (outside of Covid related issues). It is critical from here for markets that the strong jobs growth in the US and even Europe continues so that higher rates from growing inflation concerns don't tighten financial conditions (real growth – real rates) any more than they have to. We have seen some Covid related weakness but a collapse in growth is not on the cards just yet.

Conclusion

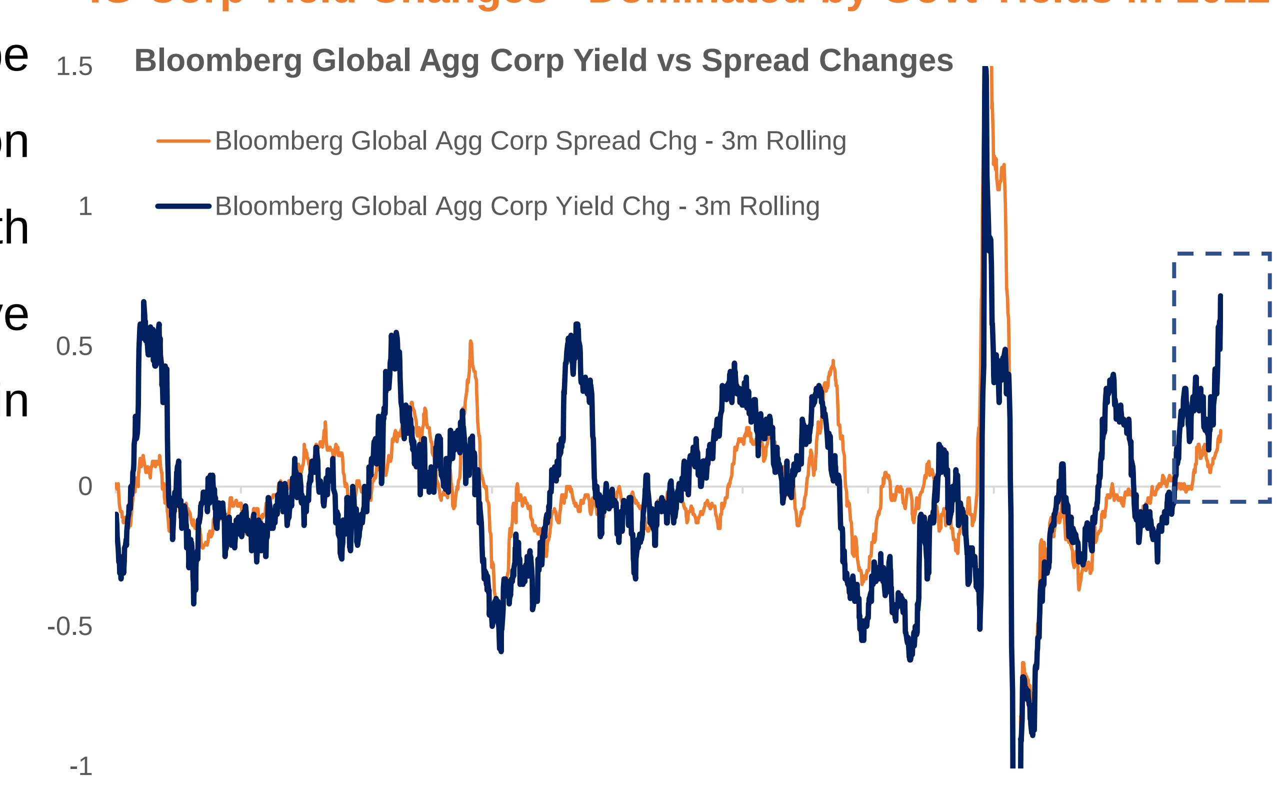
It is our experience that a failure in growth more than anything else is required for a severe market dislocation to take place. These conditions have not yet been met. It is important to appreciate that over the coming months some very attractive investment opportunities will appear, while at the same time the need to manage overall risk and liquidity will also be critical. Rubrics' active approach to investment management allows for this flexibility. What seems like a dreadful start to the year, might just create the conditions for a much better ending thanks to higher yields and cheaper valuations.

Historically Strong Labour market



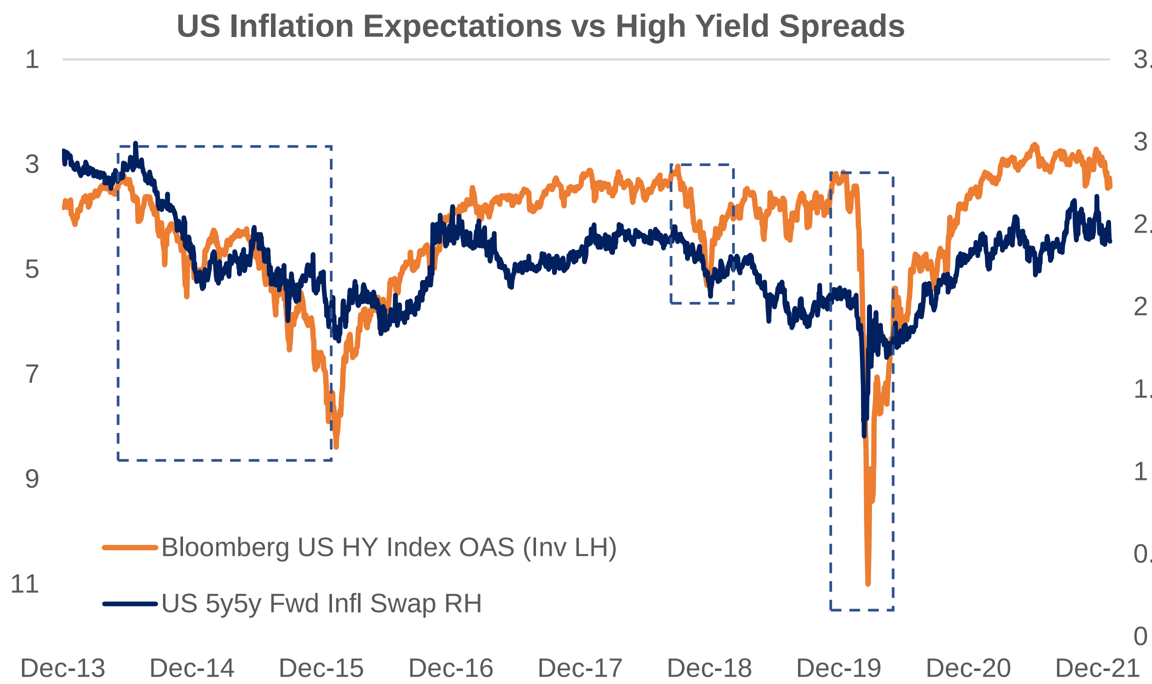
Source: Bloomberg as at 07/02//22

IG Corp Yield Changes - Dominated by Govt Yields in 2022



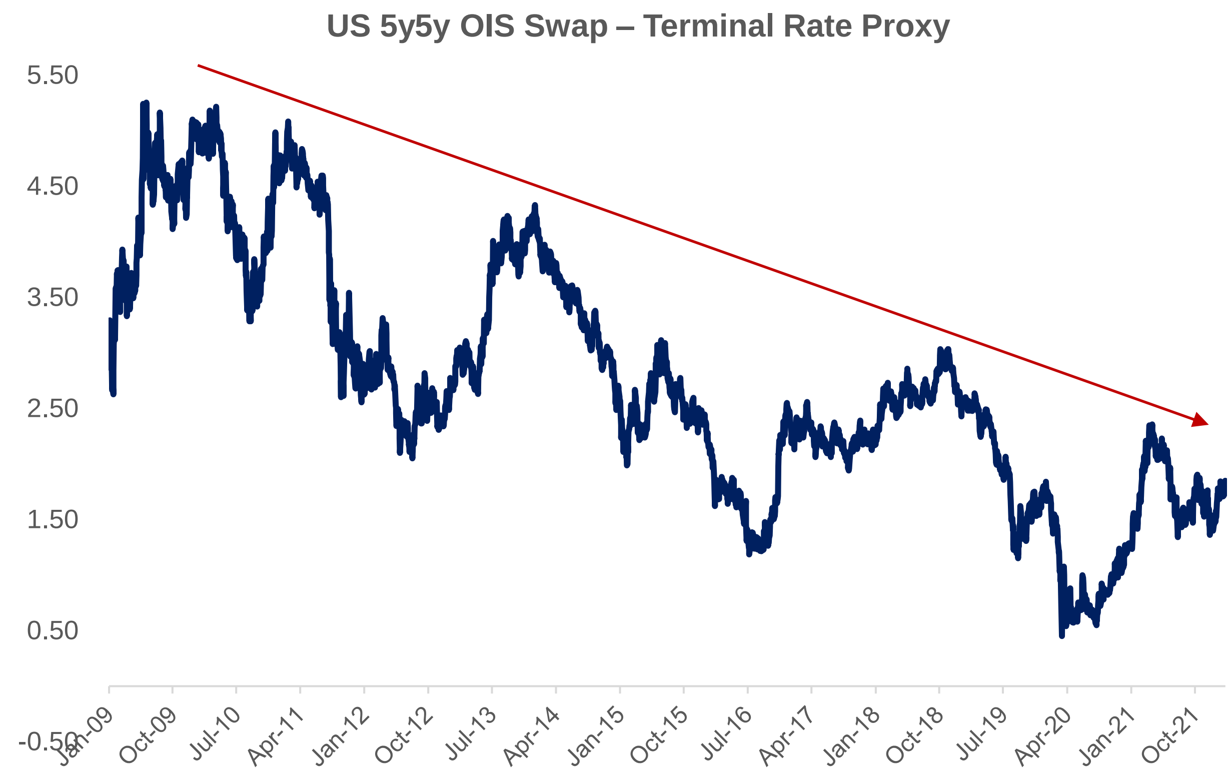
Source: Bloomberg as at 07/02//22

Deflation Historically a Driver of Major Credit Weakness



Source: Bloomberg as at 07/02//22

Anchored Long Term Expectations



Source: Bloomberg as at 07/02//22

We have been concerned for quite some time that markets were mis-pricing risk assets relative to economic conditions, those times might just be coming to an end. We would certainly see US 10-year rates in the 2.25-2.5 range and equity markets a good 20% lower from here. Credit spreads will be most closely related to financial conditions but some of the more leveraged areas of credit we would expect to see considerable spread widening. Overall however our biggest concern continues to be market liquidity. Central banks have provided a significant backstop for asset prices, the reversal of this will have an impact for sure. However this does not stop markets understanding the difference between good assets and bad ones. Active management just might have the upper hand for the first time in a while.

IMPORTANT INFORMATION

February 2022

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