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Newsflash: Loose Financial Conditions Won't Stop Inflation

Fixed Income Macro View

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Market Reaction

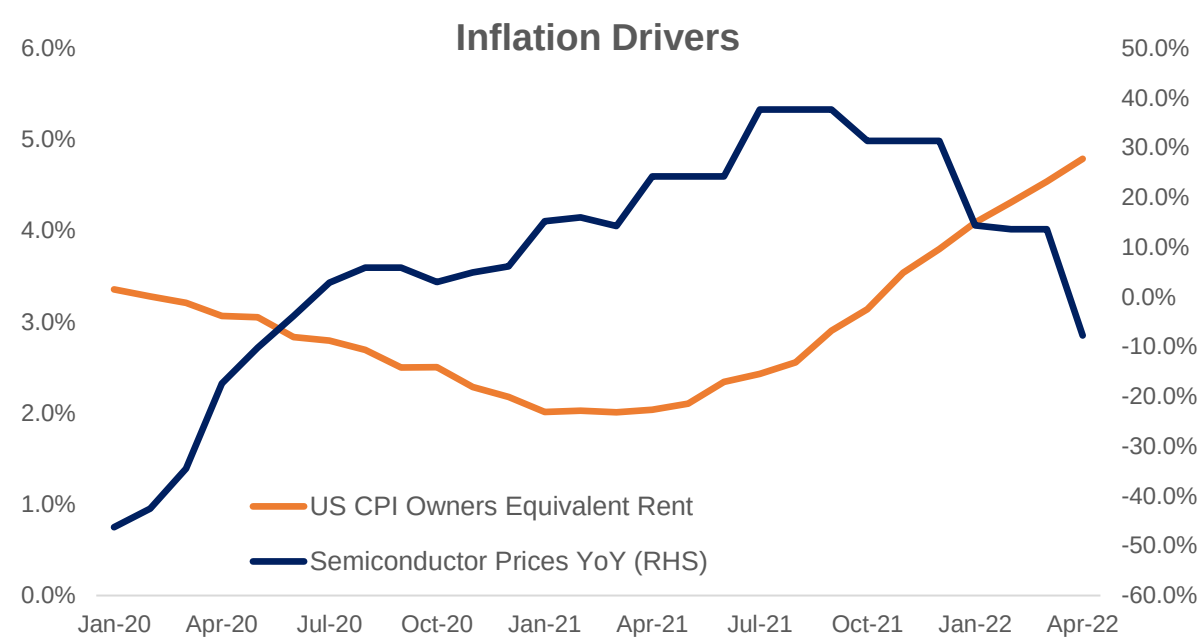
The market reaction to the latest US inflation data speaks to of the realisation that the Fed will need to cause a recession in order to reign in inflation. The ECB's recent about-turn on its willingness to accept and do something about inflation also took the markets by surprise last week. As was the case prior to the collapse of the housing market in 2008, central bankers, and market participants for that matter, allowed group think to get in the way of clear-headed analysis. While it has taken a while, monetary authorities in Europe and the US have finally woken up to reality that inflation is a genuine long-term risk. The challenge now lies in the fact that policy works with a lag, so central banks are going to have to play catch up, and fast.

Background to Inflation Problem

Elements of the initial prognosis were correct as extreme price rises in things like lumber prices were indeed transitory. However what was overlooked was the fact that consumer psychology and expectations adapt to higher prices – temporary or not. The broadening inflation we are witnessing at present has it's roots in the following factors: 1. Fiscal and Monetary-led demand, 2. global supply side constraints (COVID), 3. geopolitical shock (Ukraine), 4. changing structural dynamics in respect of demographics (tighter labour force), globalisation (tariffs) and political discourse (e.g Brexit). Unfortunately central banks failed to take this into account, primarily as their models are based on the past, not the present (let alone the future).

The incorrect assumption that record monetary stimulus would not facilitate inflation was based on the experience of the post GFC deflationary world. The problem is however that while circumstances have changed, their thinking did not. Hubris led them to believe that even if inflation did emerge, it would soon be dealt with. The combination of the aforementioned inflationary forces meant there was only ever going to be one outcome which was never going to be easy to deal with particularly while trying to deal with a juggernaut of an asset and debt bubble.

Chart 1: Transitory vs Sticky Inflation Components

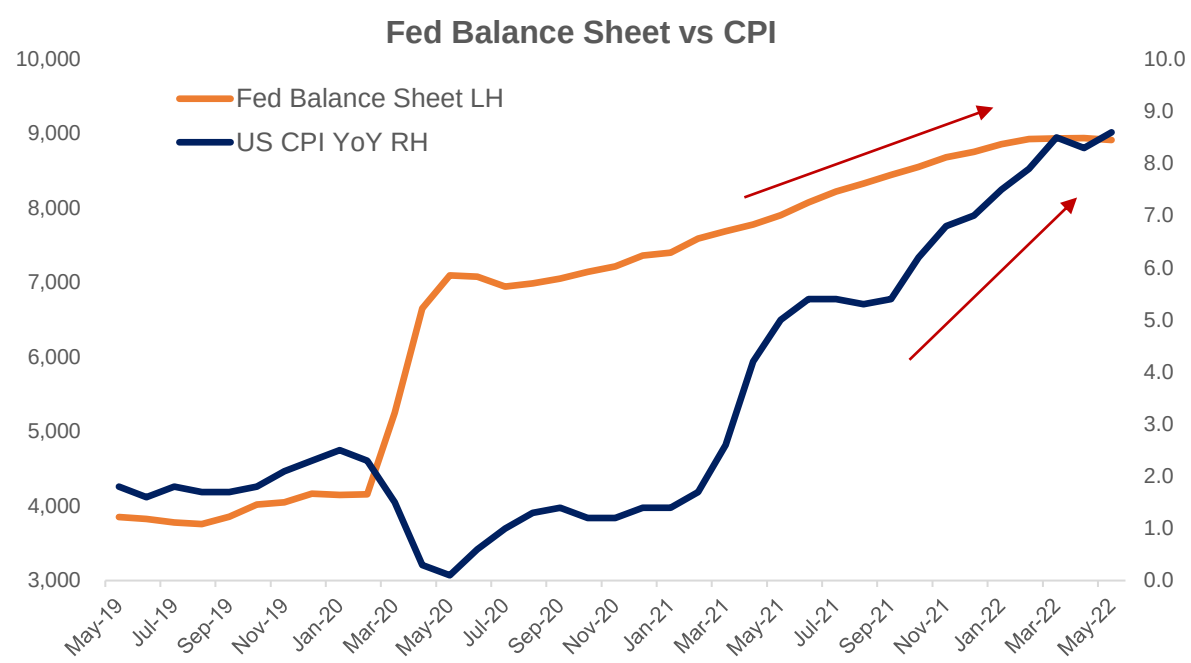


Source: Bloomberg as at 31/05/2022

Today, as in 2008, central banks have read the tea leaves badly. By Q4 2020 the economic recovery was substantial with few signs of credit problems. On the contrary, signs of excessive risk taking were widespread – remember ARKK, SPACS or Bitcoin? Clearly the Fed weren't concerned. The chief contributor to this breakneck recovery from the depths of the pandemic lockdowns was the direct provision of so called 'helicopter money'. However despite the eye watering scale of this fiscal policy - equivalent to six 'New Deals' - the Fed kept its foot firmly on the monetary accelerator – increasing money supply by some 40% in the midst of a recovering economy.

Further still when Biden introduced the Cares Act in January 2021 the Fed refused to let up. Even when it became palpably evident that the inflation problem was not 'transitory' at all, they continued to move at a snail's pace in correcting course. On Friday the 10th of June 2022 however, markets began waking up to a new reality. Not only is the 'transitory' narrative consigned to history, but also the idea of trend inflation at 2%. More on this later.

Chart 2: Easing in the Face of Growing Inflation

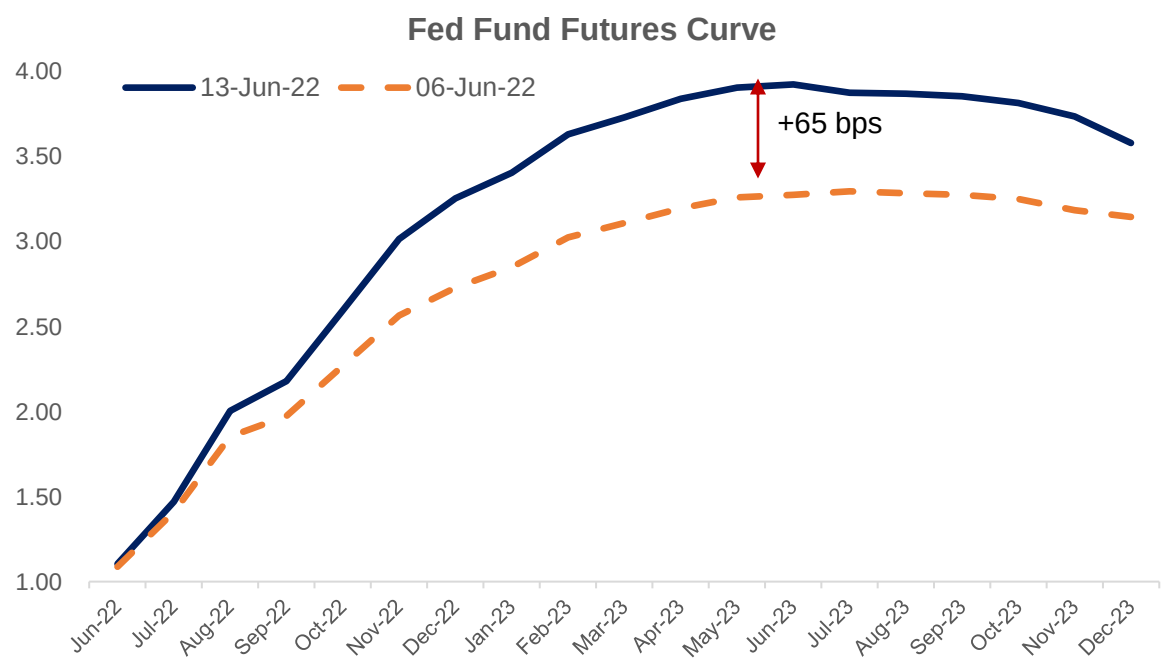


Source: Bloomberg as at 31/05/2022

Policy Challenges – Further Tightening

The current problem for central banks is that the economy is still too strong. A cursory glance at the US jobs market tells you how far the Fed are from slowing the economy. Part of the problem is the delayed impact of monetary policy. Rate hikes take longer than 3 months to work, ending QE and starting QT took much too long to get going. As if confronted by Lord Voldemort himself, central banks simply refused to believe that inflation had returned, no matter what the data was telling them. The market's recent reaction to continued high inflation numbers has been pronounced. The repricing of terminal rates has been as aggressive as we have seen – a whole extra rate hike in one day's trading session is unusual to put it mildly. Such a reaction is not only understandable but now necessary. Central banks in the EU and US must over promise on tightening to get ahead of inflation (more problematic for the EU given the current issues on energy supply), financial conditions must tighten aggressively and quickly. We don't necessarily subscribe to the idea of 75bp rises in the US just yet, but certainly the idea that rate hikes will continue for longer. No more ill-advised comments from Fed members of potential pauses in rate hikes which will only work against them in the long run. We expect three more 50bp hikes and a Fed Funds rate of 3-3.25 percent at the end of the year, with further hikes priced into 2023. The latter, if they happen at all, will likely be in the eye of recessionary storm. Central banks must convince the market they can get ahead of this because their credibility is fading fast. All of that being said, we don't feel we are as far away from this eventuality as the markets currently think.

Chart 3: Aggressive Rate Hike Pricing



Source: Bloomberg as at 31/05/2022

Structural Changes

The nature of todays highly financialised and leveraged economy means that most comparisons to the early 1980s as regards the economic reaction function to higher rates is wide of the mark. We use the example of 2018 to illustrate the point.

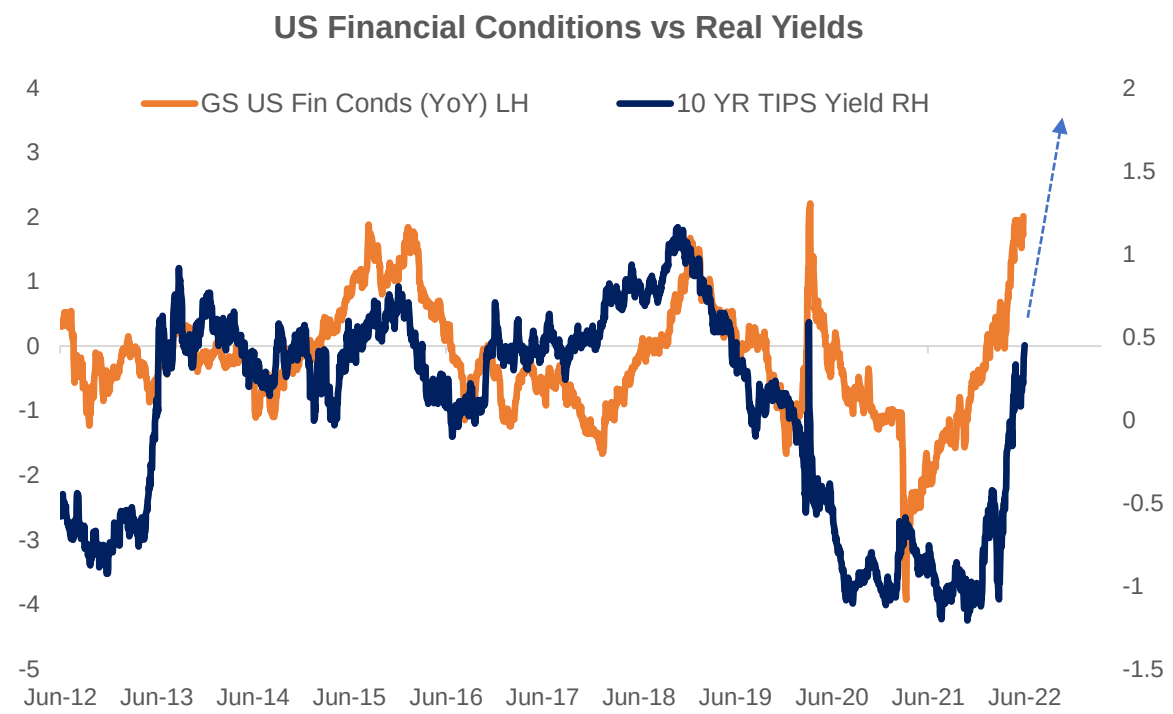
At the start of the year, every commentator was extremely bullish about the growth and market prospects – essentially because monetary and fiscal policy has been extremely loose coming out of Q4 2017. By Q4 2018 the economy was collapsing into recession. Why the sudden turnaround? Tight financial conditions hit the economy hard. This should be no surprise given the Fed has spent 12 years and nearly 10 trillion dollars to support the economy, not on the back of investment and productivity, but rather financial engineering and asset price appreciation. Remove this critical foundation and the excess demand for discretionary goods will collapse. Add to this the impact of higher commodity prices on the consumer, current inventory levels and tightening fiscal conditions, and the prospect of slowing headline inflation on the back of a weaker economic picture may happen sooner than the market thinks.

Necessary Evil

While recessionary conditions are required to stop inflation, these might not be as effective as the Fed believes in getting inflation back to target. There are two critical reasons why the much heralded 2 percent target will not be hit quickly. Firstly, not all of the inflation we are seeing today is cyclical (demand led). As Rubrics have spoken about over the past year structural inflation is fundamentally higher today than at any point since the boom in globalisation in the early 2000's. The world has changed significantly in a very short period of time as globalisation and geopolitics have been turned on their heads and the significant costs of climate change continue to grow.

The zero goods inflation we have seen since the early 2000's looks increasingly unlikely moving forward. Some of these inflationary tailwinds cannot be offset by higher interests rates no matter how high you take them, structural changes are needed. Herein lies the second problem - economic pain. There is only so much the Fed can inflict politically before they need to back off. We would expect that once the economy gets into trouble and inflation falls a few percentage points with projections indicating a 3% handle, the Fed will pause. Rates may potentially remain static for a while running alongside a targeted QT program. The recessionary pressure and potentially stronger dollar should keep the CPI trending lower not higher.

Chart 4: More Tightening Needed



Source: Bloomberg as at 13/06/2022

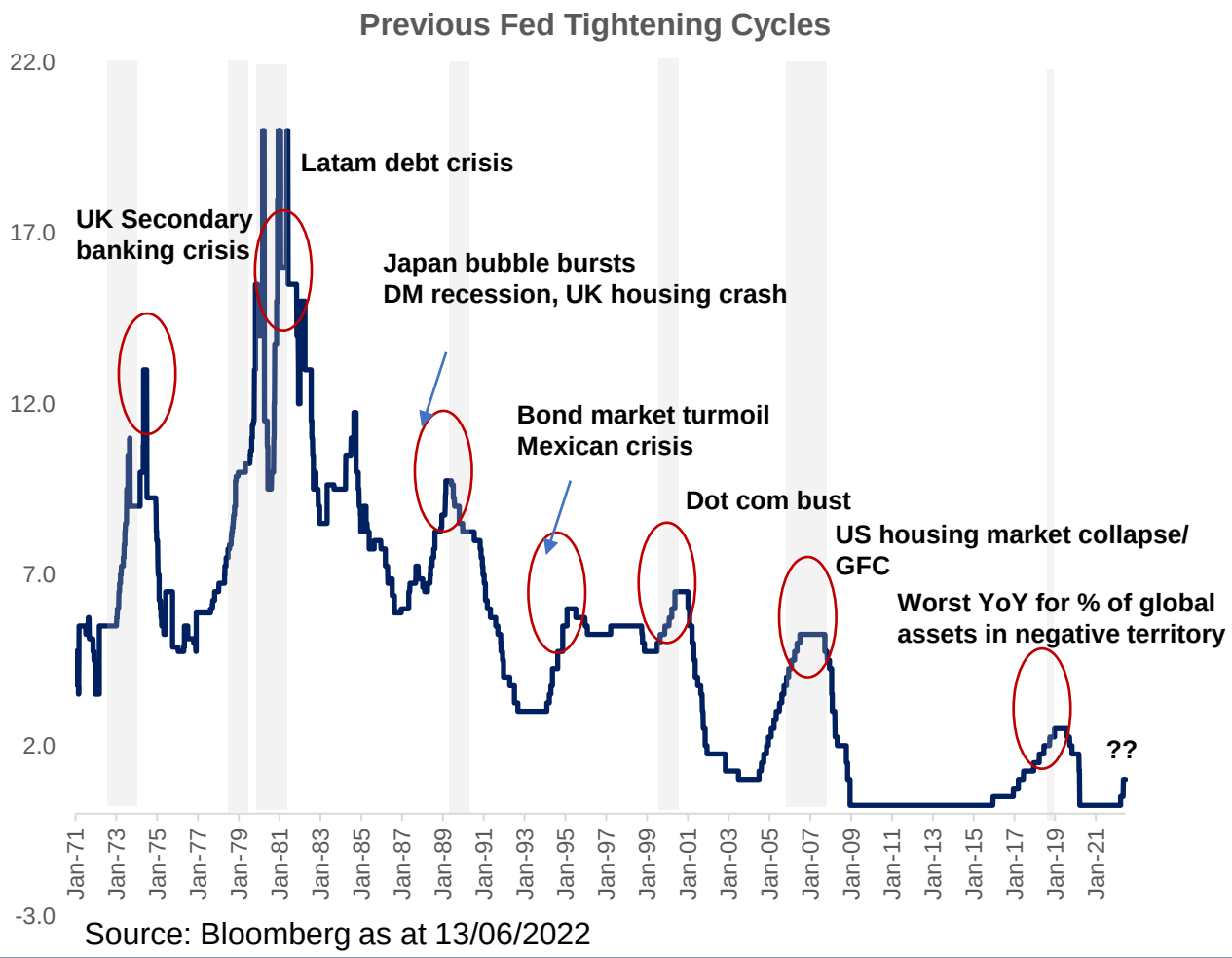
In reality interest rates wouldn't have much impact after that point anyway, the Fed understand this. It is critical that financial conditions stay tight, hence any stock market rescue missions are highly unlikely anytime soon. Credit market stresses will be the only thing to make the Fed come back to the table. Twelve years of monetary policy incentivising unproductive economic activity on the back of exponentially growing debt levels leaves a very bad legacy for central bankers and economists.

Market Projections

Our recent projections of terminal rates of 3-3.5% are currently behind more recent market expectations. However, we feel as with the deflation scare of Q1 2016 (the story was already over by the time the markets woke up to it and we had positive inflation again by Q3 2016) the current inflation scare will be quickly usurped by recessionary concerns by 2023. While there are a number of strategists predicting 4% Fed funds rates next year, history suggests this would be high relative to current sustainable levels of debt in the economy.

Ultimately real yields matter most. The Fed must get real yields up to or greater than +2%. That can happen by higher nominal rates and/or slowing inflation expectations. We would expect a combination of both – first higher nominal rates then feeding into slowing inflation expectations. If necessary, they need to get the markets to price in a hard landing, difficult to be avoided now anyway. Once real yields reach these levels, one can be confident the Fed is starting to get ahead of the curve.

Chart 5: Fed Tightening – Something usually breaks



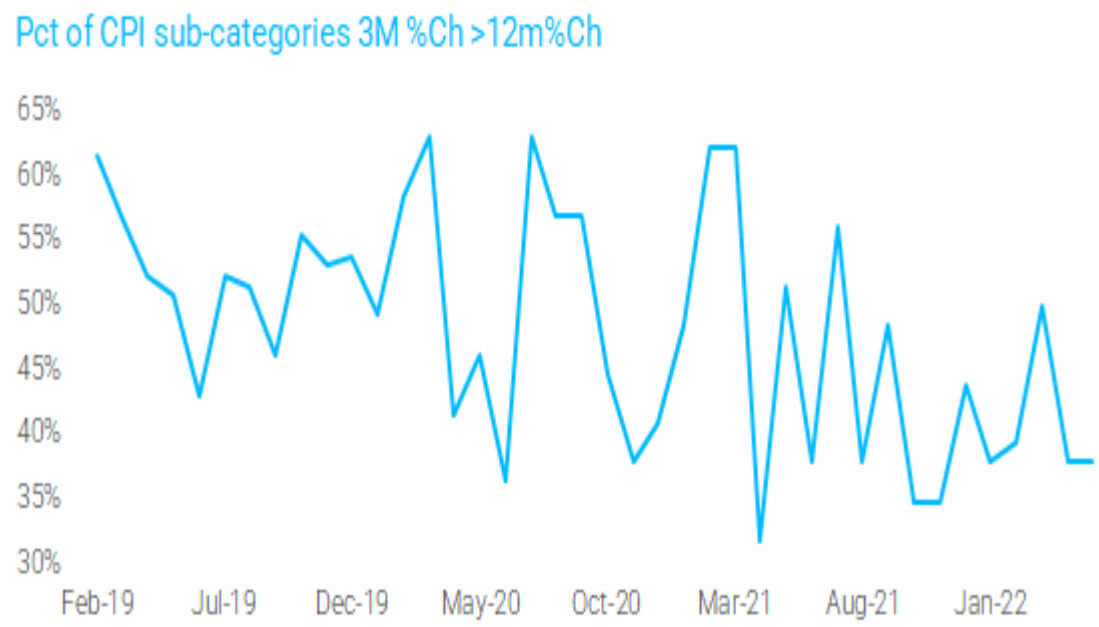
Source: Bloomberg as at 13/06/2022

Another important argument by many is the importance of getting nominal yields higher than inflation to slow it down, like what was required in the early 1980's. It wasn't until 1980 when inflation was 14% and the Fed Funds rate 15.6% that the tide turned. While this was a very valid argument at that time, we feel the structure of the economy also matters and therefore today's financialised economic system will be a lot more responsive to tightening financial conditions then we saw in the industrialised, highly unionised, low debt economy of the late 1970's and early 80's. If wage growth can be managed, today's inflationary outcomes can be considerably better than the 70's and early 80's for sure. Evidence of Germany's inflation experience of the 1970's clearly demonstrates wage constraint is one of the most critical elements of inflation management and ultimately even more important than monetary policy itself.

Signs of Hope

It is likely there may be some difficult months ahead as service side inflation in particular is unlikely to dissipate over the summer months. Anyone trying to rent a car in Europe, book a hotel room in Dublin or get a flight to Spain can certainly testify to that effect. However such extremes are unsustainable and by the autumn a steadier outlook may be forthcoming. Core US CPI has fallen from a 6.5% high to 6% over the last few months. Wage growth has also started to moderate. Another encouraging fact is that the percentage of CPI constituents whose 3 month moving average is greater than the 12 month continues to decline meaning the acceleration in changes to

Chart 6: CPI Sub Categories Trending Down



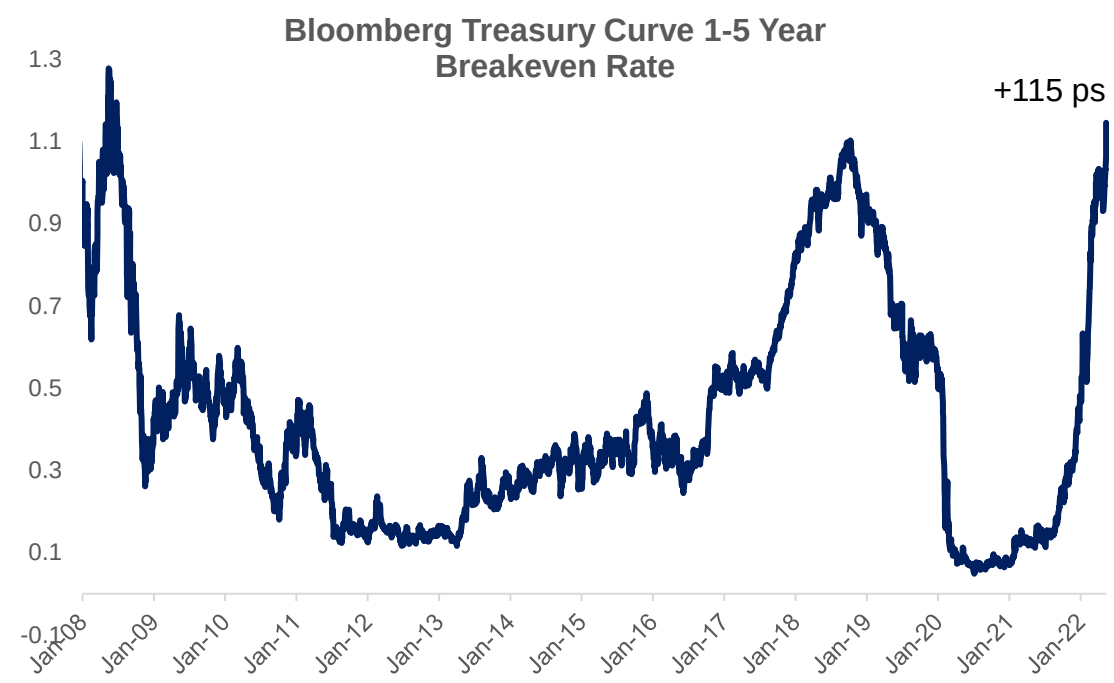
Source: TS Lombard as at 09/06/22

inflation are stabilising even if month on month figures haven't yet. It is extremely important to note that these figures do not and should not give any comfort to central bankers. What should give investors some hope is that global central bankers as far afield as Australia, Brazil, UK, Europe, Canada and the US are all now taking serious action to combat growing inflation threats even if some are doing it belatedly, whilst kicking and screaming. On a global scale this is a statistically significant number of central banks tightening concurrently while China's outlook doesn't look like its going to be a driver of global growth anytime soon – prepare to trim your growth expectations and your inflation expectations thereafter.

Portfolio Positioning

If that is the case the asset class best positioned for that reality is currently short term high quality assets like short TSY and selected IG as well as some high quality cash generative equities which in many cases have already priced in considerable economic tightening. While our initial entry point of 3% for US 3 year has overshot somewhat we don't see dramatic downside over the medium terms given the global conditions we have outlined. While rates won't return to zero or even one percent any time soon, the current and ongoing carry on these investments will importantly cover the cost of market volatility and ultimately over the medium-term return capital plus carry plus. The additional benefit is the flexibility this provides in respect of liquidity – i.e. when valuations improve elsewhere the cost of re-allocation should be low.

Chart 7: Breakeven Yield at Short End of US Yield Curve



Source: Bloomberg as at 13/06/2022

Postscript

The current market malaise is happening due to a combination of factors that have been building for some time. While central bankers have been caught out by unforeseen events (e.g. pandemic, Russia/Ukraine), predictable or not, these 'black swans' have laid bare the real problems of policy making over the last 14 years. Europe is once again potentially staring down the barrel of another crisis of 'fragmentation' while the fundamental weakness of the United States economy and its overreliance on the financial sector' leaves them both exposed. While in some ways it was inevitable that some sort of reckoning would come, we are certainly hopeful that in attempting to deal with the fallout the authorities make better choices next time around.

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