RUBRICS

When a Pause is not a Pause

Fixed Income Macro View

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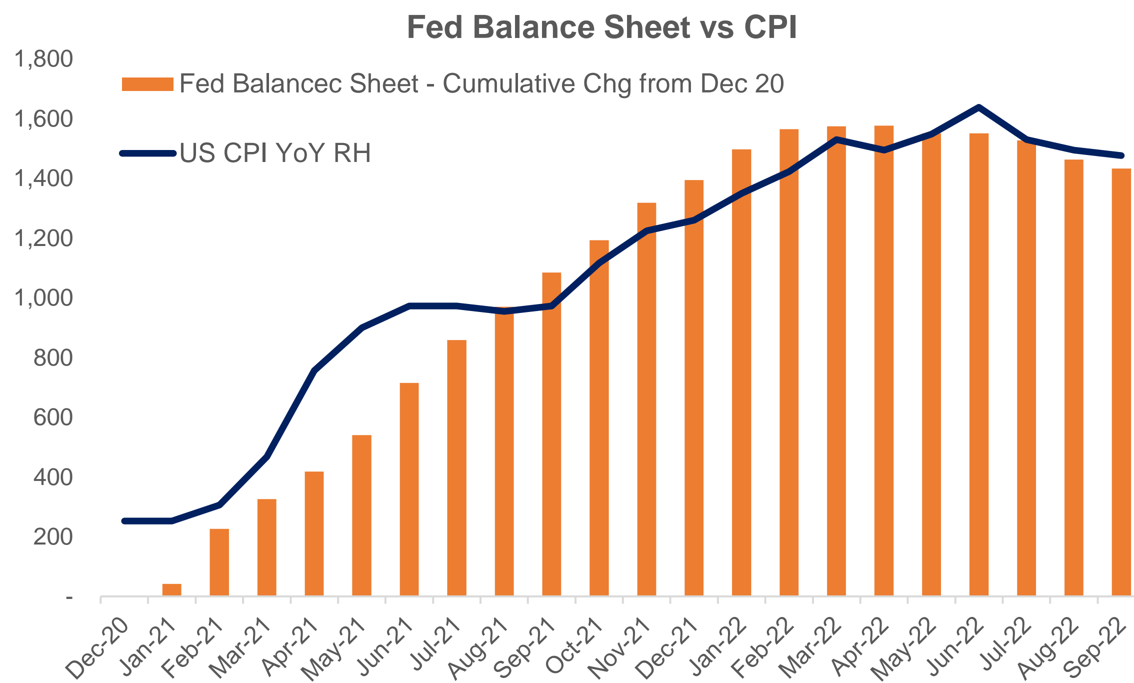
Pause for Concern

Amazingly it wasn't until April 2022 that the Fed actually stopped its QE programme. Despite US CPI reaching 5% in May 2021 the Fed continued to add another $1trln to its balance sheet over the next 10 months, while keeping rates at rock bottom for good measure. Even by the end of 2021, when inflation was clearly broadening, the Fed did not change course. Along with other DM Central Banks, this folly left them well behind the curve and playing the most dangerous monetary game of all – catch up.

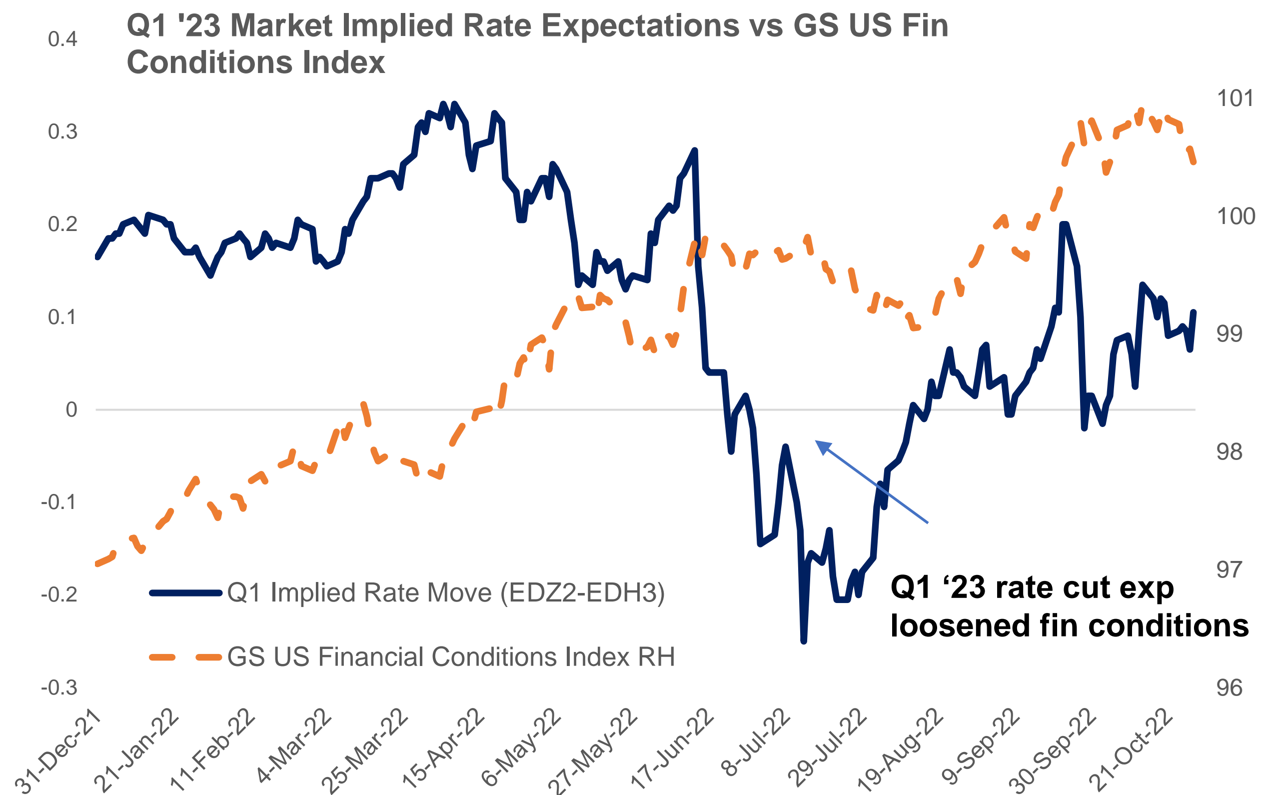
Chart 1: Inflation and Fed Balance Sheet



Source: Bloomberg as at 31/10/2022

Since those early days of inflation denial, the Fed has undergone a dramatic shift and drastically picked up the pace on tightening. This has not come without its challenges. Encouraged by a decade plus of unfettered monetary support, financial markets refused to believe there was a genuine hawk at the Fed. After all this was 'Pivot Powell' we were talking about. Despite messaging to the contrary, markets continued to discount early rate cuts throughout the summer boosting risk assets in the process. Powell was forced into action, and at the Jackson Hole meeting he was unequivocal in telling the markets to tighten their expectations. It wasn't until September that this really began in earnest.

Chart 2: Q1 '23 Rate Expectations vs Financial Conditions

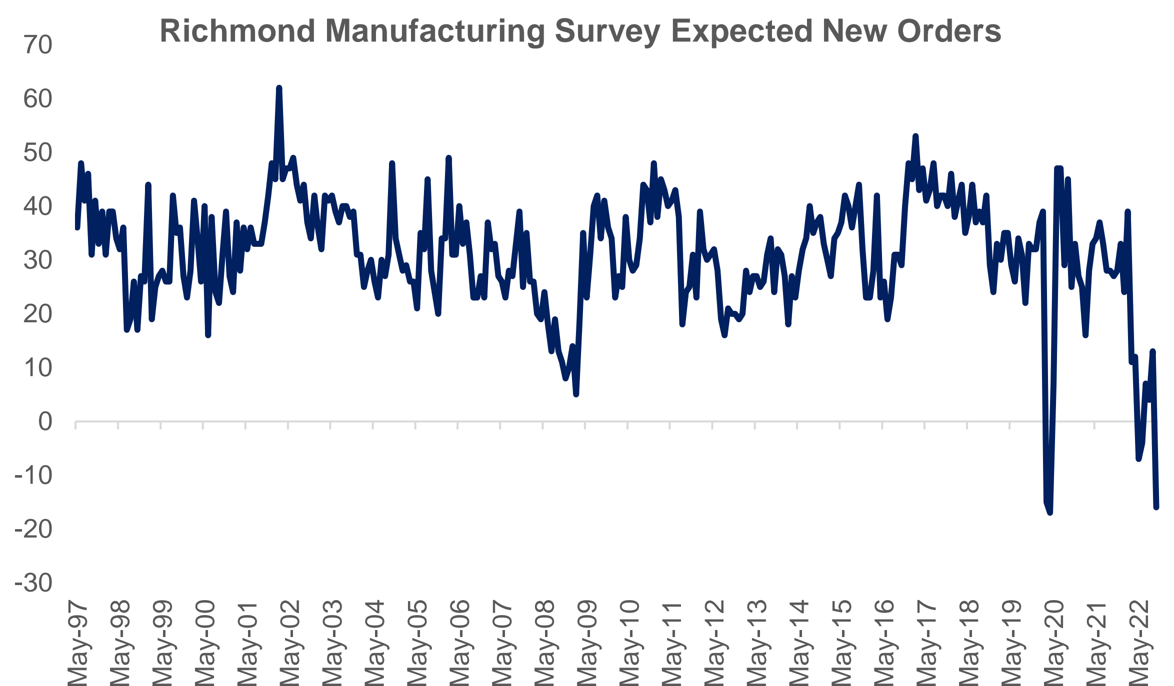


Source: Bloomberg as at 31/10/2022

Clear Weakness in Economic Data

Recent forward looking data from China, Europe and US is clear in pointing to a significant deterioration of economic conditions. Various measures have shown weakness with new orders in particular pointing to a sharp slowdown in manufacturing and services. Hard data which is backward looking by nature has yet to factor this in.

Chart 3: Expected New Orders Plummeting

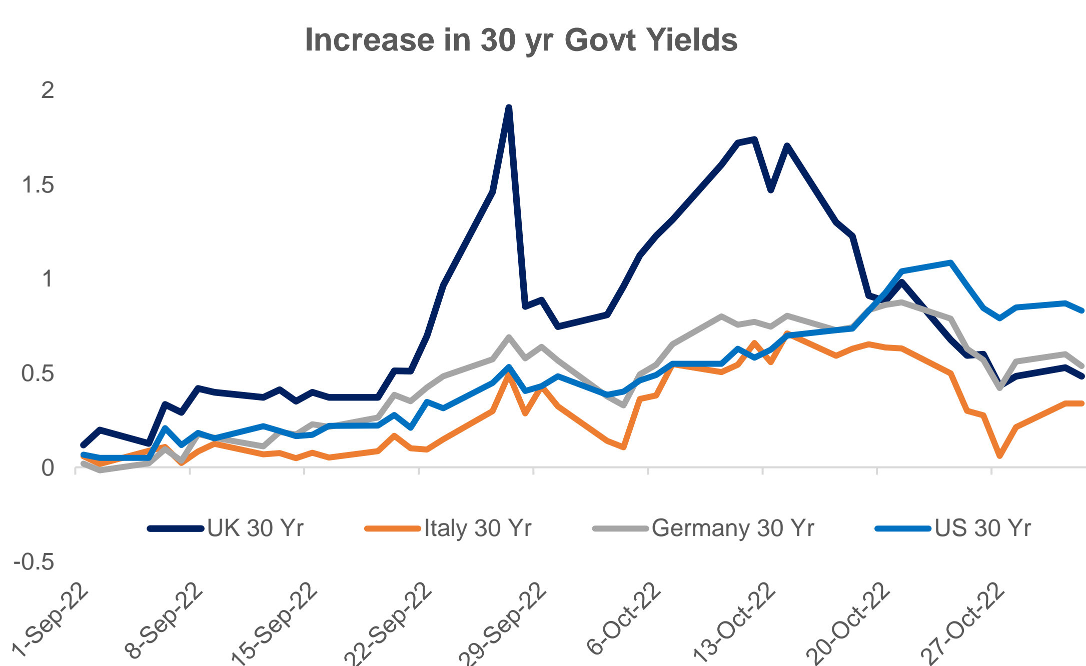


Source: Bloomberg as at 31/10/2022

On the markets side of the equation further tightening has been priced in, with the US now showing a terminal base rate of 5%. Housing markets have unsurprisingly struggled on the back of this as

mortgage rates globally have undergone a precipitous increase – in the US 30 year fixed rates are now in excess of 7% with 2-5 year fixed rates in the UK now 6%. While this correction has already resulted in a sizeable wealth effect, the closest we have come to a 'system break' has been the extreme volatility in the UK Gilt market following recent short-lived mini-budget. While the BoE have averted a crisis for now, regulators are clearly concerned about a repeat elsewhere.

Chart 4: Bond Market Carnage



Source: Bloomberg as at 31/10/2022

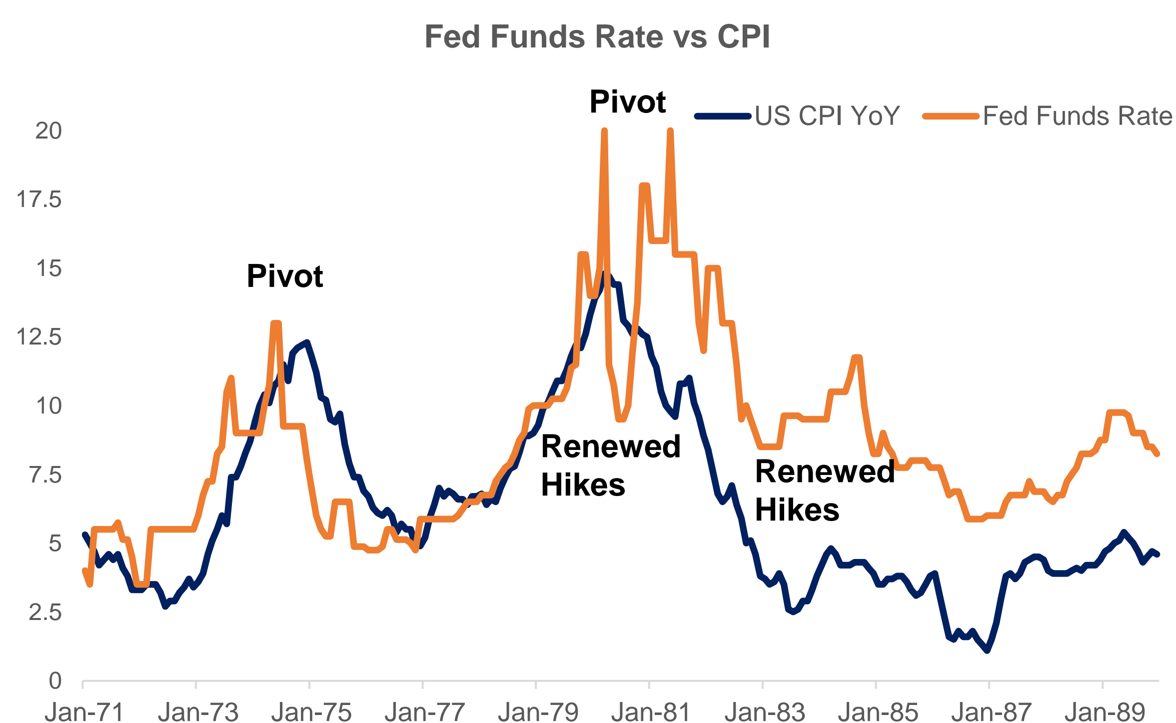
Is a Pause Coming?

We have recently seen both Australia and Canada hike less than expected while several US Fed members have advocated a 'wait and see approach' to the impact of recent aggressive hiking activity. They have also acknowledged the strong dollar is adding significant discomfort to the global financial system (US exporting inflation and importing deflation). Circumstances however are continuing to work against them. The dynamic changes to the labour markets since Covid have ensured that it is no longer easy to undermine domestic demand. The tightening of the labour market means there is still a plentiful supply of jobs. On the inflation front while many early scares have subsided, stickier components continue to keep inflation elevated (in the US) - rent being a significant component of this. Despite being in decline, the OER component of CPI won't reflect falling rents until some time in the middle of 2023. Don't expect a dramatic decline in CPI anytime soon. The upshot of all of this is that we find ourselves in the unusual situation of aggressive rate rises into a contracting economy – there will surely be fallout from this.

Where does all of this leave us?

Central bankers are well aware of the issues we had in 1970's – every time they loosened (pivoted) monetary policy too early inflation came roaring back. Even Paul Volker went too soon in 1981 and was forced to inflict an even deeper economic contraction in 1983 to compensate.

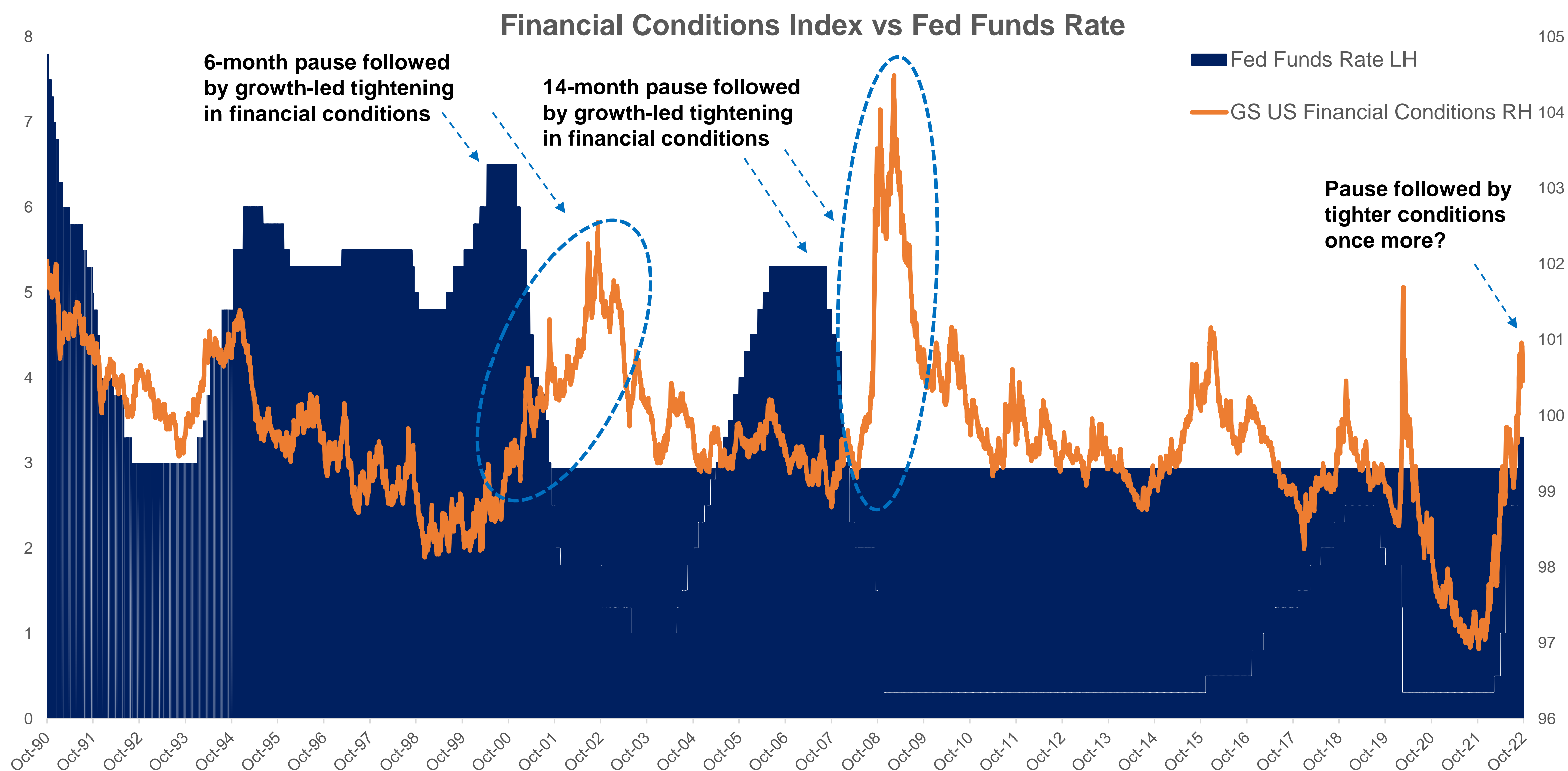
Chart 5: 1970s and 80s – Pivot vs Hike



Source: Bloomberg as at 31/10/2022

This is exactly why Powell has been at pains to stress that what is coming, eventually, is a pause not a pivot. Given the delayed impact of monetary policy, the rate hikes already witnessed should be more then enough to slow the economy sufficiently, particularly when considering the debt levels of today's economy vs the 70s and 80s. Global central banks are only a few

Chart 6: Fed Funds Rate and Financial Conditions



Source: Bloomberg as at 31/10/2022

rate hikes away from a pause knowing full well the damage that they have likely already inflicted on a weakening economy – we just haven't seen it yet.

When a Pause is not a Pause

What is clearly overlooked by many market participants is that a pause is not in fact a pause without a pivot. What we mean by this is that once a central bank pauses due to growth concerns, financial conditions will continue to tighten. This is because they are determined by both the prevailing interest rates and growth trajectory of the economy. Financial conditions can tighten due to rising interest rates **or** falling growth. If the latter is not offset by a lowering of interest rates financial conditions will continue to tighten. Historically, the period of tightening associated with raising interest rates, while uncomfortable, is rarely unbearable as positive growth typically keeps financial conditions loose. However once economic conditions start to slow periods of more intense pain tend to follow. With rates often at or close to their highs, this is when conditions are typically tightest and historically when most of the damage is inflicted on financial markets.

Bear Trap for Risk Assets

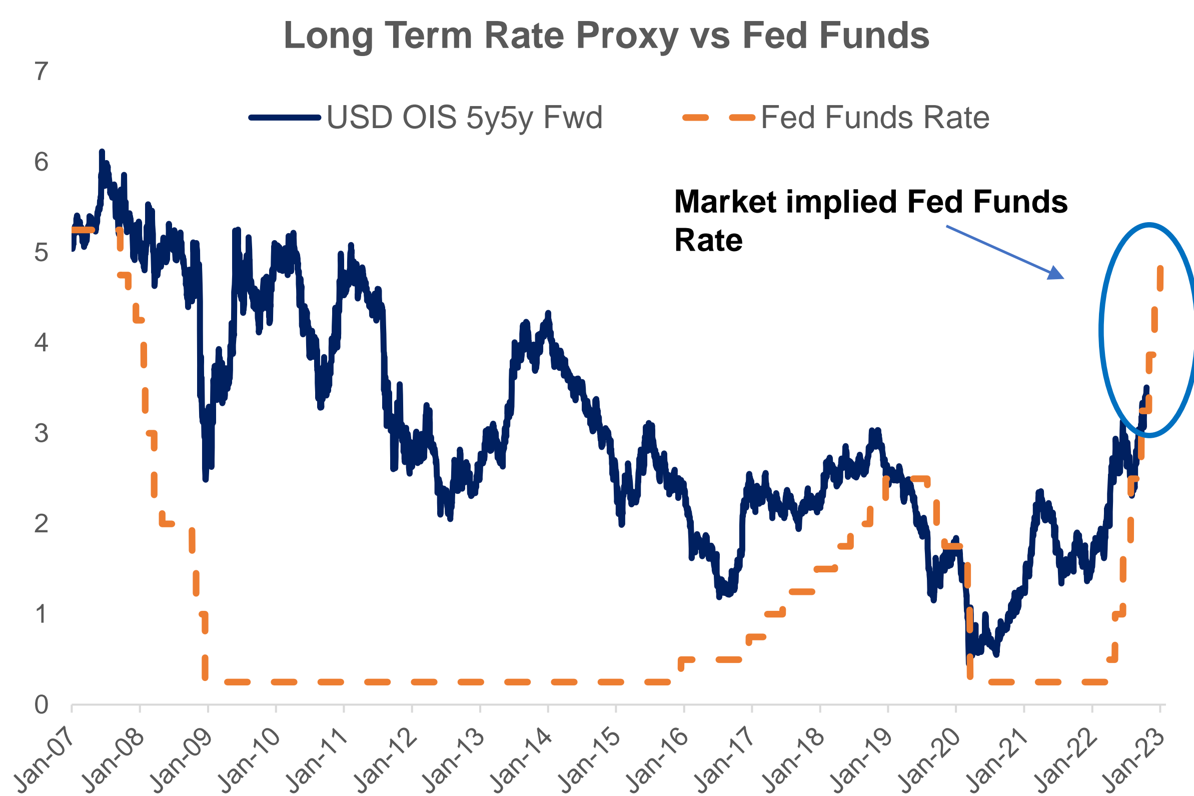
The upcoming Fed pause (at the already priced in terminal rate of 4.75/5%) has all of the hallmarks of a bear trap. Why – because risk assets will rally in expectation of looser financial conditions, not recognising that the coming recession will see tighter conditions – particularly in the absence of rate cuts and QE.

Green Shoots for Rates

While the Fed will be unwilling to pivot quickly due to historical precedent, the rates market will ultimately price this in to the longer term neutral rate. Given the still robust jobs market and persistent inflation, we have a historically high gap between current and long-term sustainable rates. This represents an attractive

opportunity in a number of rates curves at current yields. While there is still volatility ahead, the main leading economic indicators clearly point to a shift from inflation concerns to recessionary ones.

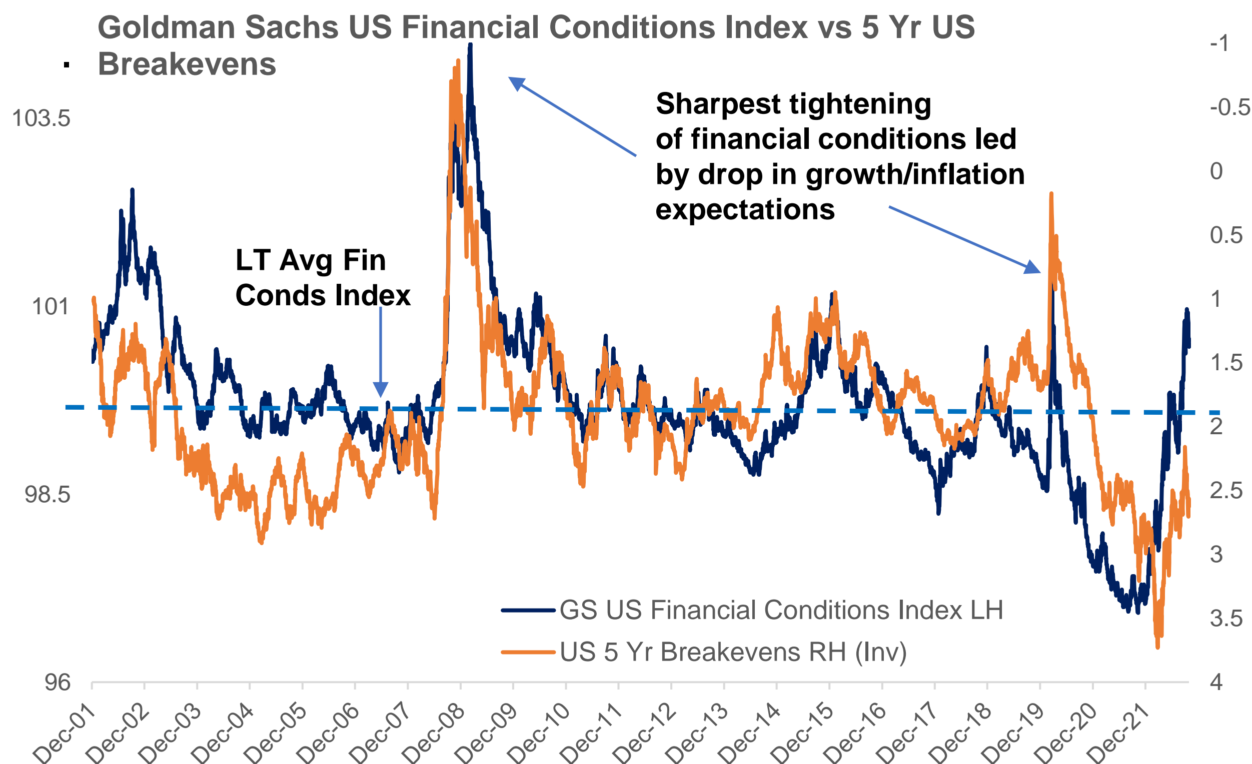
Chart 7: Terminal Rate Proxy vs Fed Funds



Source: Bloomberg as at 31/10/2022

Outside of the US, which is currently exporting inflation through its strong dollar, the picture is still mixed. The European economy remains mired in difficulty from Russian gas embargos to structural weakness and its peripheral bond markets. The Japanese are closer to the end game of yield curve control which has the potential to disrupt many markets including its own as the BOJ attempts to tighten financial conditions from a structurally weak position.

Chart 8: Financial Conditions Index vs Breakevens



Source: Bloomberg as at 31/10/2022

The lessons from history are clear, asset bubbles created by excessively loose financial conditions are difficult to unwind. We saw periods from the 18th century to the 21st century when central banks with much political support underwrote various speculative bubbles only to find themselves unable to exit without significant wealth destruction. Any holder of a traditional 60/40 portfolio can testify to that today. Fixed income assets have in 2022 suffered its largest drawdown in history. While we don't believe we are quite finished yet in terms of recession induced volatility the rate component of bond pricing is about to turn positive at extremely attractive carry levels.

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