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Macro Overview

Mission Accomplished?

Fixed Income Macro View

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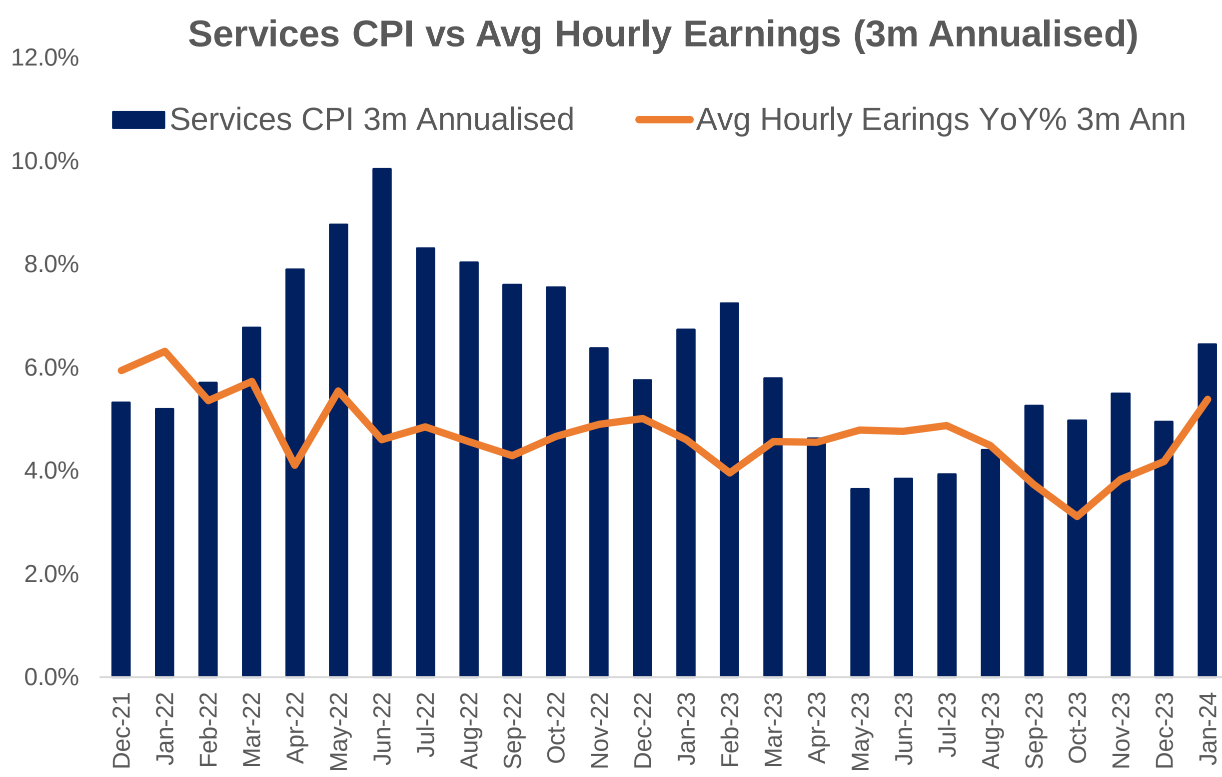
Mission Accomplished?

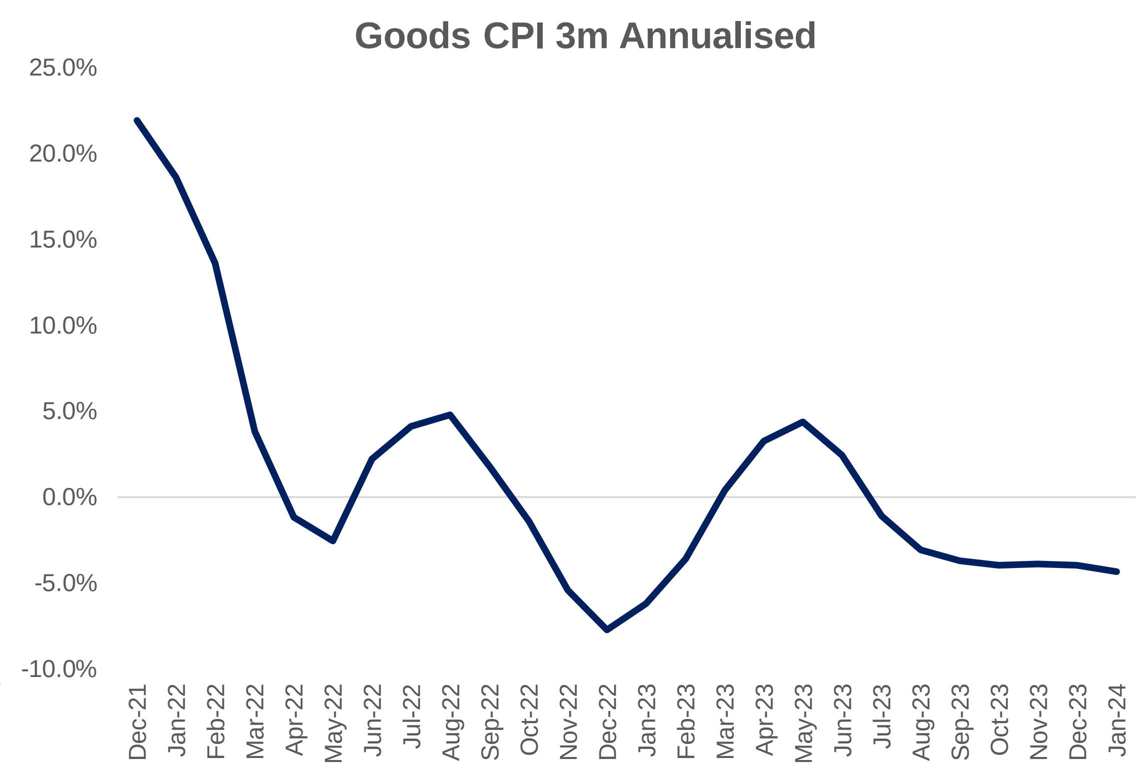
Hotter than expected CPI and PPI prints last week indicated that the path to 'target' inflation will be a little less smooth than expected. This is due in no small part to the Fed's actions in December when claiming mission accomplished on inflation long before a sustainable 2% had been achieved. The early pivot can now be added to the factors slowing the disinflation the market and the Fed had taken for granted.

Short-Term Pick Up in Services Inflation



Source: Bloomberg as at 31/01/24

Goods Deflation Continues



Source: Bloomberg as at 31/01/24

Over the past year inflation had been coming down mostly on the back of goods deflation – a dynamic which could not last indefinitely. Service based inflation, although slowing, was still coming in at 5% plus not helped by the fact that wage growth remains stubbornly high. The Fed pivot was the final push to take inflation off target for now. The shift from "higher for longer" to "lower even quicker" gave such a significant boost to financial conditions in the 4th quarter that the rally in financial markets helped reignite services inflation. The Fed clearly got its timing wrong in jumping the gun a few months too early.

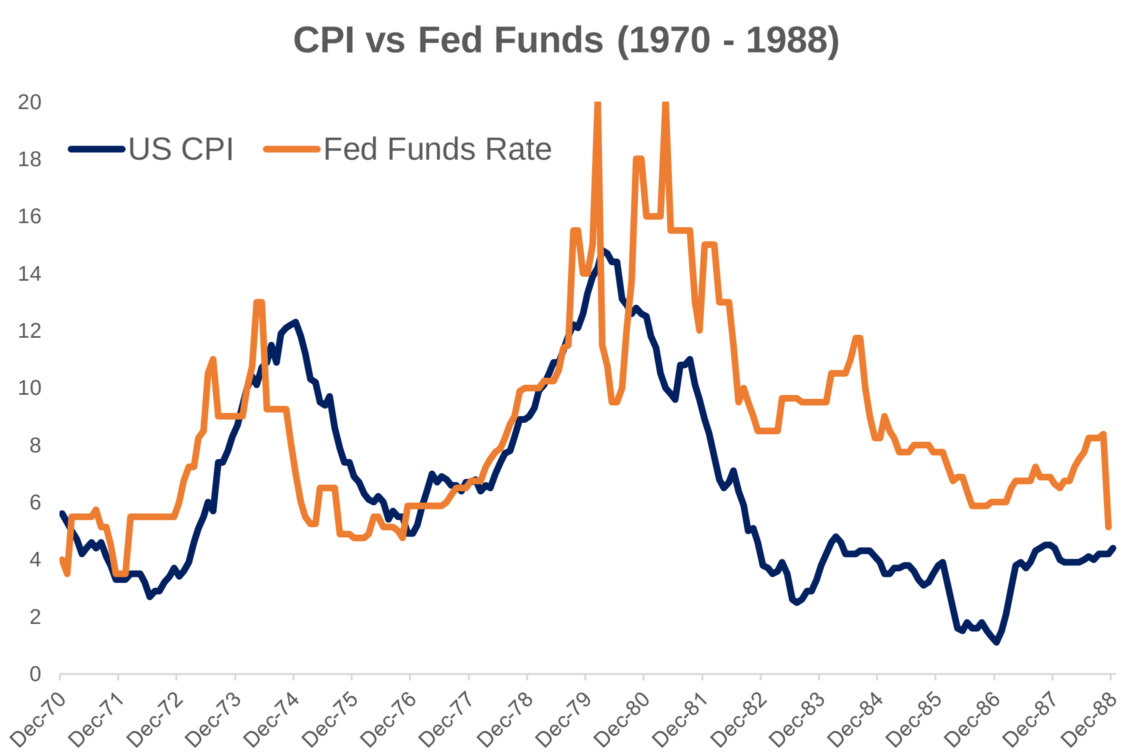
Not all of the factors feeding into the higher inflation numbers are sustainable. For example, the jump in the Owner Equivalent Rents (OERs) will, given other data indicators, reverse course again pretty quickly. Any tightening of financial conditions will also be a headwind to the financial services impact on inflation in the near term. Per the chart above, the key factor driving services inflation is wage growth. Current yoy average hourly earnings are at 4.5% - which ceteris parabus takes inflation to region of 3% not 2%. However anecdotal evidence from earnings season is showing an increased number of companies cutting headcount to ensure continued earnings growth. Is the hoarding period finally behind us as the public transfer of profits to the private sector is coming to an end?

Longer Term Inflation Outlook

While we believe the structural backdrop to the de-globalising world economy is inflationary, in the near term the lagged effect of higher rates will play a significant role in the dampening the outlook for inflation. The US has successfully outrun the rate hikes so far, but the economic momentum is starting to slow.

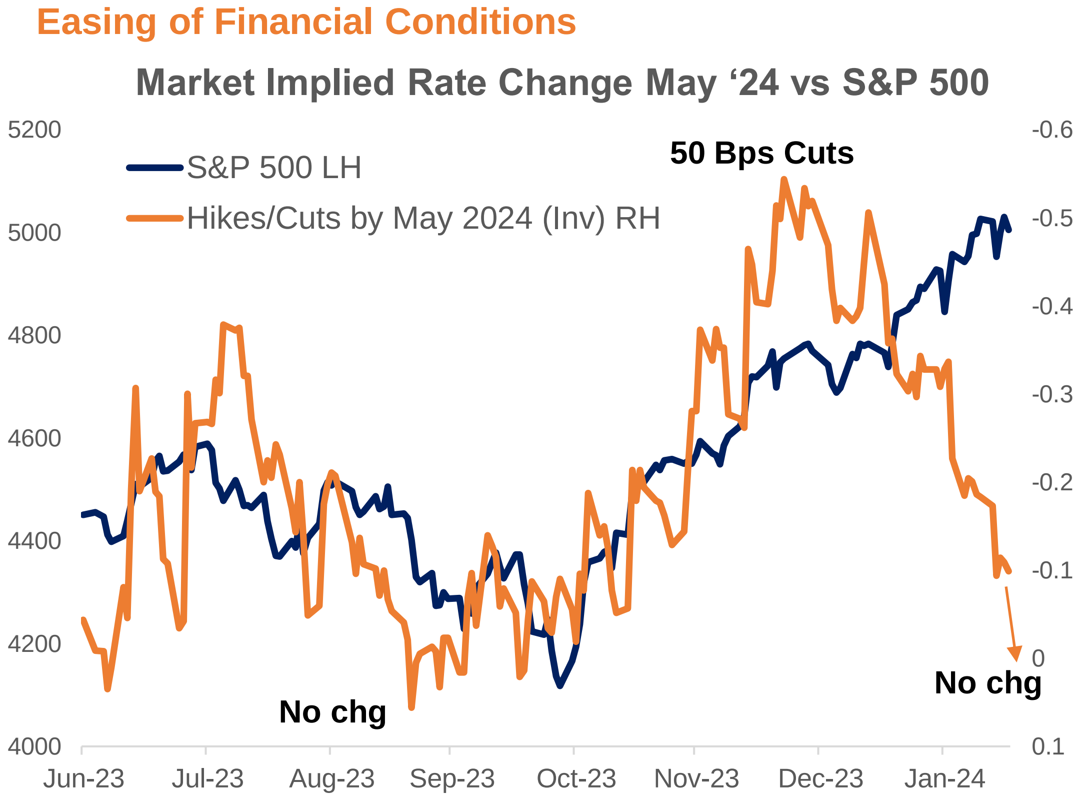
The early pivot was there for a strategic reason. Many of the factors behind the booming US economy in 2023 will start to roll off in 2024. Credit and fiscal impulses will be more subdued, savings are nearly depleted and the liquidity backing all of this (sitting in the Fed's RRP) is running out. The Fed clearly felt it needed an early pivot to keep the gravy train going. Longer term this will probably be a good outcome for inflation because the Fed now knows any early pivot will mean a resurgence in price pressures. They would do well to remember the lesson of Arthur Burns - in a world of structural inflation early pivots are a mistake. Even Volker made this error. This Fed needs to learn its own hard lessons of easy financial conditions in a structurally inflationary economy. Other central banks will have taken notice of the Fed's mistaken belief that the inflation rate will fall to 2% with a highly stimulated economy. Everyone is on notice. What this means for now is that more damage to the economy is required to achieve a sustainable "on-target" inflation rate.

History of Pivots



Source: Bloomberg as at 31/01/24

Easing of Financial Conditions



Source: Bloomberg as at 20/02/24

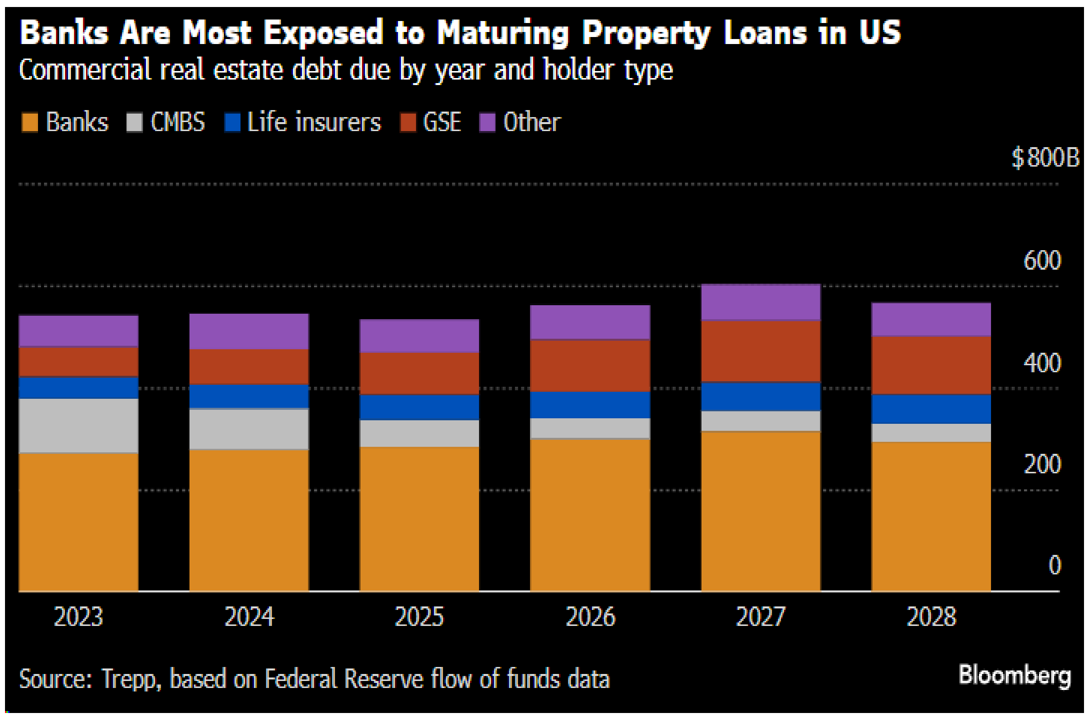
Bond Market

For the bond market, surprisingly, we feel this is a positive in the medium term. While we have had significant volatility, the peak in rates has likely already been seen. Rate cuts have been postponed for now but the long-term outcome in terms of inflation has improved due to "higher for longer" being reinstated. The credit side of the equation is a different matter. The Commercial Real Estate (CRE) market is already showing real signs of stress as loans come due. We have also seen strains in the Private Credit/Private Equity world although at this stage not as pronounced. Poor liquidity is beginning to impact large institutions like CalPERS who had borrow $40billion to meet liquidity requirements. The risks of a further credit event like SVB in 2023 are growing as the Fed is hamstrung due to the re-emergence of inflation however ephemeral it might prove to be.

Commercial Real Estate (CRE) Impacting European Bank Bonds

Source: Bloomberg as at 19//02/24

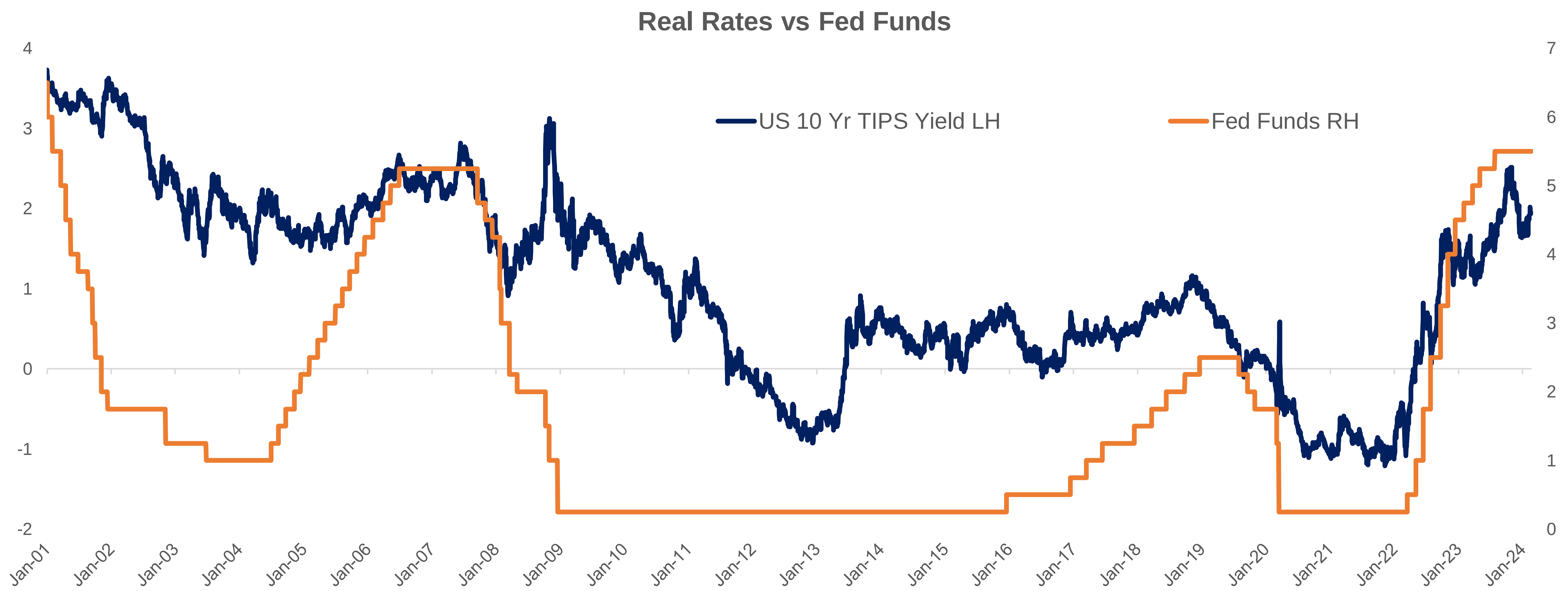
Commercial Real Estate (CRE) Exposure in US



Source: Bloomberg as at 19//02/24

Current real rates are by any historical levels pretty high, and once you factor in the debt overhang in the economy real rates are likely excessive. The economy however has been able to stave off an interest rate induced slowdown due primarily to huge fiscal stimulus, $ trillions in liquidity injections and Fed induced easing of financial conditions. Other structural factors such as changes in the labour market have played their part in keeping the employment market tighter than might otherwise have been expected. The outperformance of the long end of the bond market over the last week may be an indication that any unwinding of rate cuts will hit future growth and benefit longer term rates.

Real rates at elevated levels by historical standards



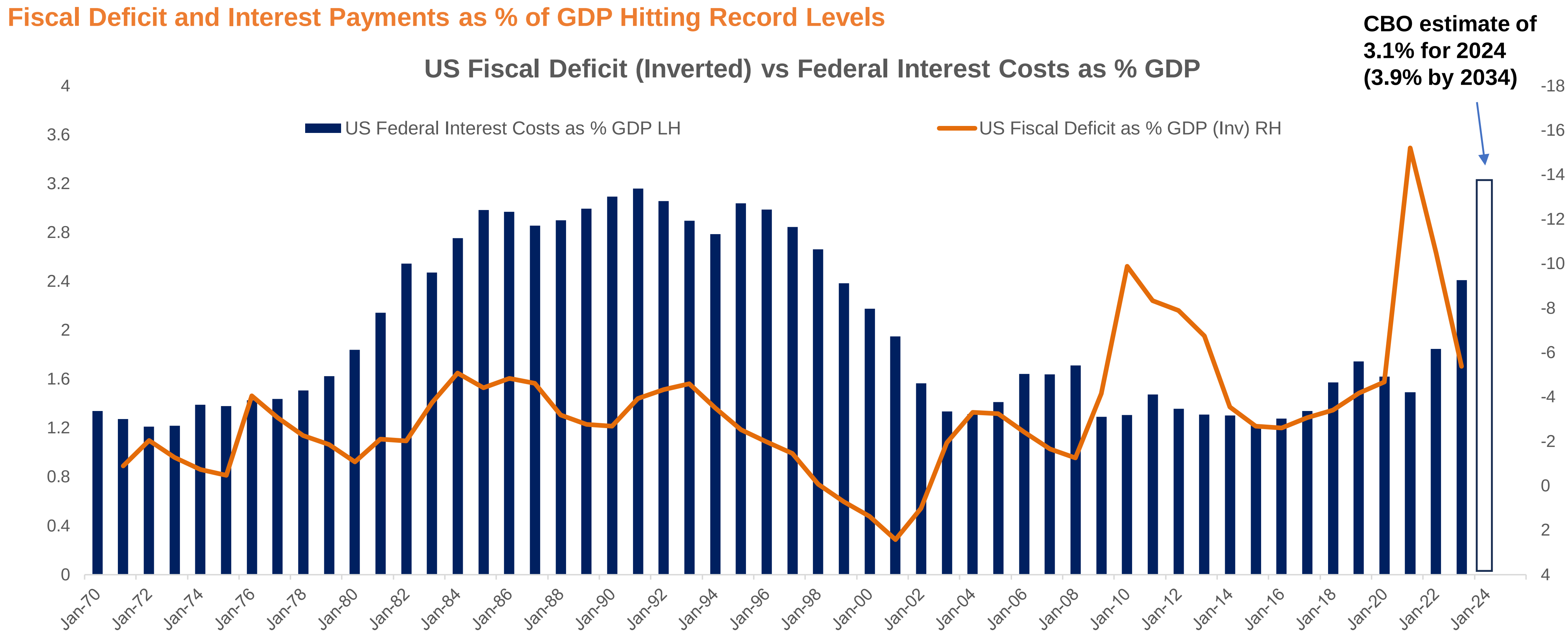
Source: Bloomberg as at 19//02/24

Beating inflation must be the first challenge for the Central Bankers. Trying to engineer a soft landing may create worse outcomes in the longer run for the average person. All indicators show that the spike in inflation over the last few years has really hurt many people outside of the top income brackets. We were surprised the Biden administration forgot the importance of subduing inflation first - Jimmy Carter proved inflation is kryptonite to presidential re-election hopes.

Global Backdrop

The global backdrop is precarious at best. Structural headwinds have beset most of the world's leading economies as all but the US have succumbed to economic stagnation. The UK story is bleak – had it stayed on trend growth since 2007 it would be now 25% larger than it is today. At the same time debt to GDP is 3 times bigger. China's sizeable property bubble has burst leaving a massive bad debt overhang. Germany's industrial might peaked in 2017 and has been headed in one direction since then. Global growth impacts everybody – politics and demographics will make tackling these structural challenges very difficult. The easy way out of pilling on more debt is nearly exhausted – the shift in the structural inflation backdrop will see to that

Fiscal Deficit and Interest Payments as % of GDP Hitting Record Levels



Source: Bloomberg as at 19//02/24

The US can keep the game going for a little while longer through its fiscal and liquidity support but they too have painful structural changes ahead. By dropping the cost of capital to zero and providing unlimited liquidity, productivity collapsed, along with the living standards of everyone outside the top 1%. The US is an economy driven by financialisaton of everything from education and health care to housing - held hostage by low interest rates and constant liquidity. Fiscal policy can take up the mantle for a while but debt levels are such that continuing to push the deficit envelope must be done with caution. As Janet Yellen said while Chair of the Federal Reserve in 2017 a $20 trillion national debt "should keep people awake at night". Well today its $34 trillion.

IMPORTANT INFORMATION

20th February 2024

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