

House View

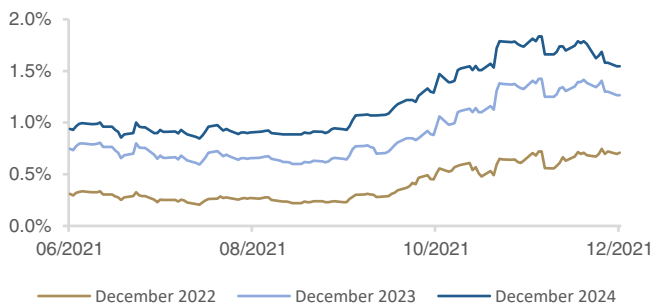
23.12.2021

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Seasonally unusual volatility bout

The festive season towards the end of the year usually casts its holiday mood onto financial markets. Not this time, however, as elevated inflation rates (that appear to be not so “transitory” after all) are raising concerns that the Fed will tighten the monetary screws in a way unseen in a long time. Market expectations regarding future interest rates have started to move. Not in any disorderly way so far: the Federal Funds Rate projected by the Fed Funds futures three years from now is expected to be below 2% - based on the Fed’s own economic forecasts with a core inflation rate of 2.2% still in negative territory on an inflation-adjusted basis.

FED FUNDS FUTURES DEC 22/23/24: PAST 6 MONTHS

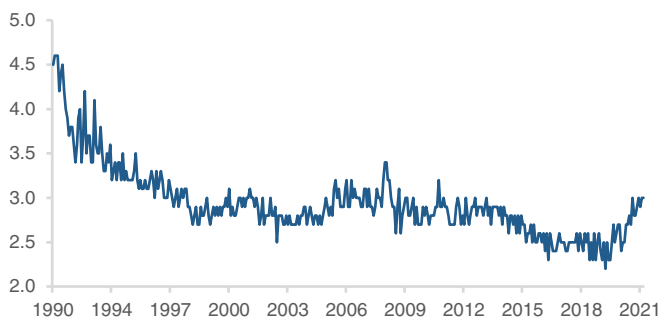


Source: Bloomberg

The question that presents investors currently is whether inflation will calm down after the rise to 40-year highs in the headline CPI rate. We are more persuaded that due to a number of structural factors, price pressures over the coming years will turn out to be significantly higher than that experienced in the past decade (cf. our piece on stagflation: [link](#)).

The final FOMC meeting of the year in mid-December was viewed by many as a bit more hawkish than expected. We would stress the difference between hawkish in an absolute sense, meaning tight monetary reins in the form of high real interest rates, and “a bit more hawkish” in a relative sense as today’s monetary policy stance must still be called highly dovish. With another three years of negative real leading interest rates (based on the Fed’s own projections), we would object to the latest message by Fed chair Powell being viewed as anything close to the absolute meaning of “hawkish”. As the focus of FOMC members is placed on longer-term inflation expectations by households which have only very slowly started to rise upwards, no sense of urgency appears to be felt amongst the monetary policy setters.

SURVEY: MEDIAN INFLATION EXPECTATION FOR NEXT 5-10 YRS



Source: University of Michigan

The next Greek letter

With the latest variant of the coronavirus that’s been gripping the world for almost two years now, uncertainty again has risen, as the transmission of the “omicron” variant is estimated to be far higher than with the “delta” one. Even with the prospect of milder symptoms with omicron, leading to e.g. half the rate of hospitalisations compared to delta, the threat of exceeding the capacity limits in the national health systems unfortunately is very high due to the laws of statistics and compounding growth. Therefore, another season of lockdowns in many countries could come to the fore. The economic effects of renewed partial standstills in some economic sectors will still be felt strongly, however we take the view that by mid- to late Q2 of next year, the pandemic phase will have ended. We draw this conclusion based on various factors, among them rising immunization rates, either thanks to the vaccines or due to recoveries from infections, but also because of the rolling out of covid treatments that reduce the probability of needing to go to hospital by the factor of 3 to 10. The chances therefore are high that the virus will have become endemic by next summer and some form of a return to normalcy can more realistically be hoped for.

Return to normalcy?

What does that mean for the economy? Much depends on the government sector: will we see tax hikes in order to close the deficits that had jumped to above 10% of GDP in the previous two years? Will there be spending cuts? The latest news on the Build Back Better legislation definitely speaks in favor of a sizable reduction in government spending. However, still much is unknown when it comes to both levers, as the wings of the Democratic party are in a bitter infight and the other side of the aisle, the Republicans, are happy to drag their feet and sit out the current two-year term in Congress, obstructing at maximum effort so as to increase their chances of winning the House in November 2022. We would therefore not be overly surprised to see the talks on further stimulus be reopened in January, reflecting at least some will to survive politically amongst many Democratic members of Congress.

US NOMINAL GDP GROWTH RATE MINUS FED FUNDS RATE



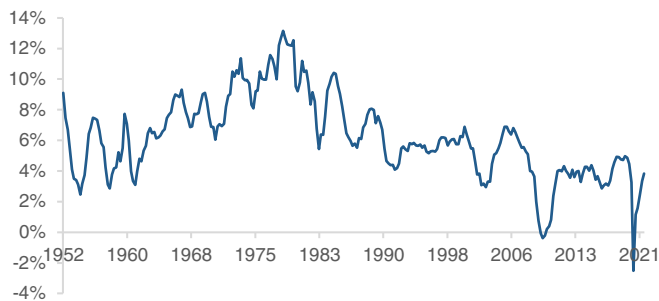
Source: Bloomberg

The current record divergence between nominal growth and official rates of course is also a function of the deep, but very short recession in the context of the first wave of the covid pandemic that has lowered the base. Given stubbornly persistent inflation, the outlook for nominal growth remains strong for the coming quarters. Therefore, the divergence stays and the parallels to the 1970s era are rising.

Old normal vs new normal

For the coming months, however, central banker complacency may continue. The new normal, with strongly negative real rates acting as a tailwind for risky assets, appears set to continue. The old normal, where too much monetary largesse directly led to stronger inflation rates, we suspect is only suspended. Only as macro-economic data confirms that the rosy picture of comfortably retreating inflation rates towards two percent will be missed over a much longer period, will the market awake to the trouble that looms. The same is true if the Fed during 2022 (likely somewhere after Q2 as by then the thought of the base effect taking care of itself will sufficiently have been put into question) scares the market with much more tightening to quell inflation. In the coming weeks, we may even hear more praise about the virtues of a flexible monetary approach by central bankers, signaling an alert willingness to adjust the pace of taking away the proverbial punch bowl.

2-YEAR GROWTH RATE OF US NOMINAL GDP (ANNUALIZED)



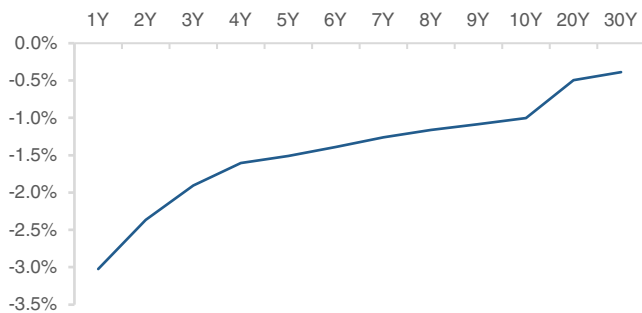
Source: Bloomberg

Galloping nominal growth

Nominal growth rates are the strongest in decades. Should the economic consensus of some 9% annualized growth in the coming 3 quarters prove correct, the two-year growth rate in nominal GDP will eclipse the previous record since WW2 of 28% (translating into 13% p.a.), set in Q4 of 1978. What a striking difference to today's federal funds rate: the lead interest rate back then stood at 10%, some 1000 basis points higher than currently.

So while there are numerous explanations (or rather claims) as to why rates need to be kept lower for longer, the growing disconnect between growth and rates will need to be tackled one day – and this day may come earlier than many would hope.

TIPS REAL RATES CURVE



Source: Bloomberg

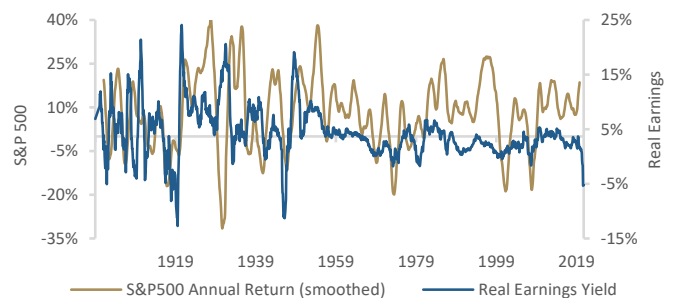
Based on our expectations, the Fed may become even more hawkish as 2022 passes. It has indicated three hikes next year (the market currently expects two and a half, according to fed funds futures) at the latest FOMC meeting. For the time being, however, markets are taking comfort at the fact that renewed lockdowns are dampening demand and hence limiting price pressures. When exactly the markets will take longer-term inflation risks more seriously, we do not know. But at one point, maybe already quite early in the year, some re-pricing should occur.

What does this mean for financial markets? On forex markets, the erosion of purchasing power of the greenback relative to other currency areas should have a weakening influence on the USD, unless a credible policy of reining in the threat of substantial losses of buying power is implemented. Unfortunately, such a turn in direction cannot be made out at this point. Less so, one must add, over the pond in Europe, where rate hikes for next year (except in the UK) were all but ruled out. In many countries considered emerging markets, the rate hiking cycle has already taken several steps, with close to zero and even positive real rates in many currencies.

The outlook for the fixed income markets remains very bleak, as only minimal yield and spread compression may further be expected, meanwhile the risks of significant capital losses in the event of yield or spread expansion are the highest in decades. Real yields of government debt are in negative territory up to thirty years' time to maturity – the market has all but admitted that some form of loss of purchasing power is inevitable, it appears.

While, from a relative perspective vis-à-vis the latter asset class they may appear good value, equities in a scenario of elevated inflation rates for multiple years should be considered unattractive. Their real asset character would however protect at least partially against losses in purchasing power. Ultimately, in inflation-adjusted terms, returns on stocks after all were deeply negative throughout the 1970s, the last period of persistently high inflation, so there is no obvious escaping from the threat of losing wealth in real terms over the coming decade, apart from an active approach reducing the downside risks at times of heightened volatility.

REAL EARNINGS YIELD AND S&P 500 ANNUAL RETURN



Source: Robert Shiller/Yale

Equities remain the preferred choice of many investors, but we would point at below-average returns to come, potentially even a sharp downturn. Stock valuations that take into account inflation do not paint a rosy picture for the asset class: the real earnings yield, that is earnings relative to price (the inverse P/E), adjusted for consumer price inflation, is at 70-odd years low.

Based on the calculations of Noble laureate Robert Shiller, such a low level with the exception of the post-WW2 era was only reached in the post-WW1 era, and in both instances, movements of the real earnings yield into deep negative territory were the precursors of significant stock market drawdowns (in real terms) of more than 30% peak-to-trough. While the inflation rate can easily retreat in 2022 by several percentage points from the current rate of almost 7%, it is hard to imagine the real earnings yields swiftly moving back into positive territory over the next couple of years – the warning signal therefore will not disappear anytime soon.

The mid-December woes appear likely to drag into the new year, as the outlook for 2022 remains clouded by the threat of the pandemic keeping its lid on the economy, while monetary policy becomes a tad less easy (but remains very accommodative). With the fallen support from key Senate members for the planned “social infrastructure package” in Congress, amounting to almost USD 2tn, a gloomier view is now being held by many economists. Whether this will mean a cooling of the labor market, is another open question. As things stand today, the undersupply of workers in many sectors definitely drags on. That leads to expect a continued upwards pressure on wages, which in turn could support healthy consumer demand making up for the drag from the government sector. Therefore, nominal growth could well remain close to 10% going forward. In such an outcome, the table pondering question is: how will bond markets and how will central banks (primarily the Fed) react? Heightened volatility and the risk of sharp drawdowns may as a result be braced for throughout 2022.

CONCLUSION

- ▶ The surge in volatility during the past weeks marks an unusual seasonal pattern which by itself gives a dire warning signal of heightened fluctuations ahead.
- ▶ There are numerous potential triggers that could continue to exert turbulences, among them geopolitical trouble in Eastern Europe, renewed severe restrictions on a broad scale related to the covid-19 pandemic, and a change in the markets’ rather relaxed attitude towards longer-term inflation threats.
- ▶ 2022 will mark the stress-testing of globally important central banks’ credibility and reputation, as the base effects from the pandemic cannot anymore be made responsible for still elevated inflation rates that undermine their goals of achieving price stability.
- ▶ Compared to the developed world’s deeply negative real rates, their counterparts in emerging markets are substantially higher, while in nominal terms they in many cases reach high single-digit levels, offering at least some form of protection against adverse yield movements.

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