Investment Management

Monthly Market Musings: Hawks Take Flight

- Global rates surge higher following hawkish signals from central banks.
- The sell-off in bonds could continue until the inflation pulse turns lower. The current level of monetary stimulus remains extraordinarily accommodative.
- Developed rates markets are pricing front-loaded policy tightening, leading to flatter curves with the peak in rates below previous cycles.
- Risk assets have been rattled and elevated volatility could continue, even as the level of real yields and recession probabilities implied by yield curve models are benign by longer run standards.

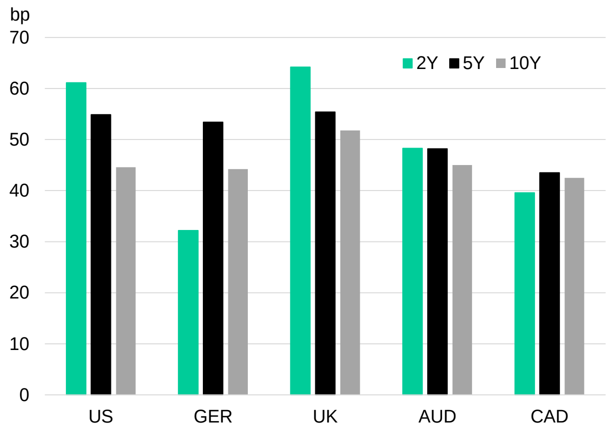
Well, that escalated quickly

A rapid repricing of central bank policy tightening expectations has made for a messy start to 2022 for markets. The policy pivot from the Fed has had the most profound impact. The Fed signalled in both the minutes to the December meeting (released January 6) and later at the January FOMC meeting that policy rate lift-off is imminent. A much stronger set of jobs figures (despite Omicron) added to the sell-off in bonds. Markets are now pricing over five 25bp Fed hikes for 2022, from less than three at the end of December and some forecasters are calling for 25bp hikes at every 2022 meeting (seven rate rises).

Other central banks followed the Fed with more hawkish intent. The ECB press conference underpinned speculation rate hikes could come this year instead of 2023 or beyond and bond purchases could end as soon as Q2. Meanwhile, the Bank of England delivered its second rate rise of the cycle and the RBA formally ended its QE program.

The rise in front-loaded policy tightening expectations is driving global yields higher, most notably in shorter maturities. Year-to-date, the US 2y yield is up 61bp to 1.34% and the 10y yield lifted 45bp to 1.96% - both are at pre-COVID highs. The 5y Bund yield is up 53bp year-to-date to 0.08% - in positive territory for the first time since early 2018.

Chart 1: Year-to-date change in yields



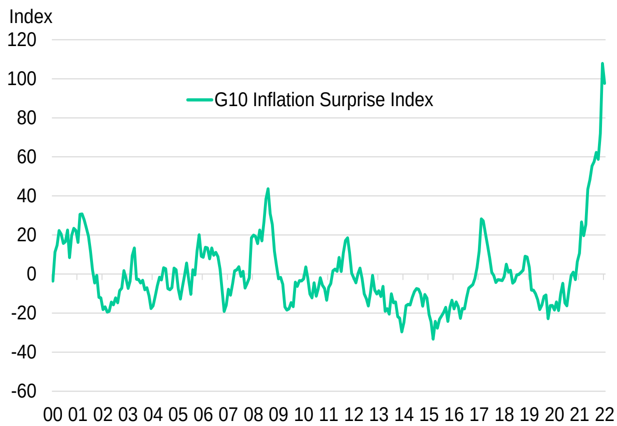
Source: Ardea, Bloomberg

A reminder of the macro picture confronting central banks and investors in early 2022:

- Inflation measures are at or above central bank targets across major developed markets (ex-Japan) and upside surprises relative to forecasts are at a record high (Chart 2). US headline CPI is running at 7% and the Fed's favoured core PCE measure is running at 4.9%, compared with a 2% target. Eurozone inflation is similarly well above the ECB's comfort zone, with the annual headline and core measures running at 5.1% and 2.3%, respectively.

- Unemployment rates in most major economies are at or below pre-pandemic trends, with wages pressure emerging.
- The level of monetary policy stimulus remains extraordinarily easy – the four largest central bank balance sheets have grown by US$12tn since the onset of COVID and policy rates are still close to or below zero.

Chart 2: G10 inflation surprise index



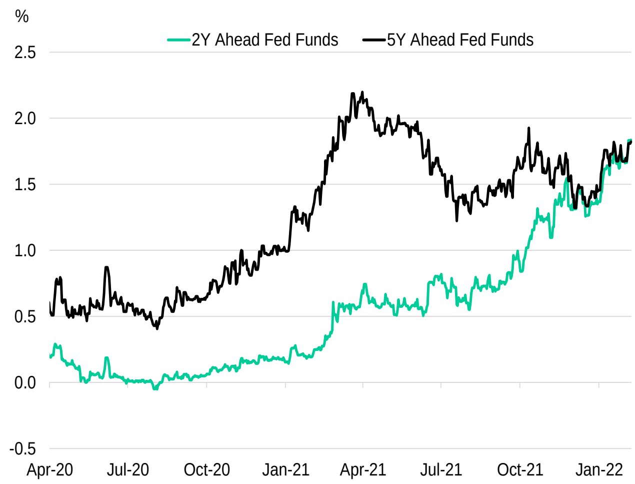
Source: Ardea, Bloomberg
*Index below zero is inflation below expectations

Faster tightening cycles and flatter yield curves

The implications of tighter monetary policy featured heavily in our early December note on 5 Key Themes for 2022 (and in the latest Ardea podcast last week). The speed of the adjustment in markets has surprised, but the themes all remain relevant, especially the dynamics of inflation, QE and the un-anchoring of short-dated yields. As we discussed in that note, historically high macro uncertainty will keep rates volatility elevated. Given the heightened sensitivity of markets and central banks to ongoing high inflation, yields may not peak until the inflation pulse turns lower, even with substantial tightening now priced in. As the Fed Chair pointed out in January, this is a very different economy to the 2015 tightening cycle.

So far this year, markets are continuing to front-load rate hike pricing, such that the peak in rates across many markets is expected to be reached within around 2 years (sooner for GBP as rate hikes have already started and later for EUR). This makes for a very different sell-off to the one witnessed this time last year, which was led by longer maturities (Chart 3).

Chart 3: Fed Funds pricing - 2y and 5y ahead



Source: Ardea, Bloomberg

Curve flattening is to be expected in a tightening cycle and history suggests these moves can ultimately go a lot further. However, it likely won't be one-way traffic, especially this early in the cycle. Periodic bouts of steepening are still possible as the market also grapples with the end of QE and uncertainty over whether central banks are behind the curve on inflation or not.

Spillovers from higher rates into risk assets

Rising bond yields have contributed to the shaky start to 2022 for risk assets, along with slowing in growth and earnings momentum. The S&P 500 has lost over 5% year-to-date, after being down as much as 9% in late January (and larger impacts seen in some sectors). In credit, major investment grade CDS spreads are at the widest levels since 2020 and high yield spreads have widened more substantially.

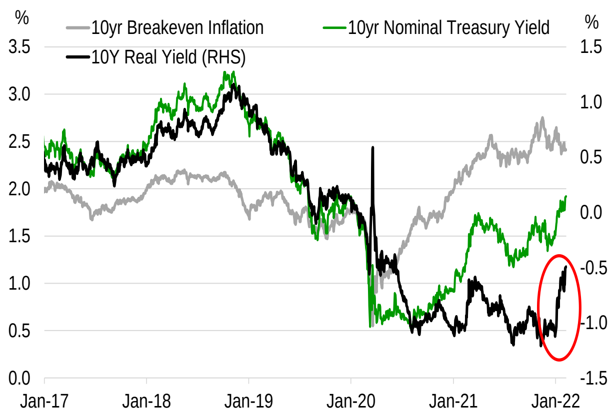
Investors are wary of higher rates driving a more substantial correction in risk assets. 2018 was the last time policy tightening was the driver of a substantial correction in equities. At that time, Fed rate hikes and quantitative tightening (balance sheet reduction) contributed to a peak-to-trough drawdown in the S&P 500 of just under 20%.

Looking ahead, whether we see a repeat or worse outcome comes down to whether inflationary pressures start to ease (as central banks are expecting). Current market pricing with the peak in rates below prior peaks suggests reasonable market confidence that inflation pressures can ultimately be contained. Or perhaps that future central bank balance sheet reductions could substitute for rate hikes later in the cycle. (We discussed in more depth the risk of "bad inflation" undermining multi-asset portfolios in a note last year – see Are interest rate markets pricing an inflation problem?).

We note two bond market signposts with historical relevance for equities:

1) **Rising real yields** (nominal yields adjusted for inflation expectations). The US 10y real yield is up a staggering 60bp year-to-date, but at -0.5% is still low by historical experience. This benchmark rate traded over +1% during the 2018 rout in stocks.

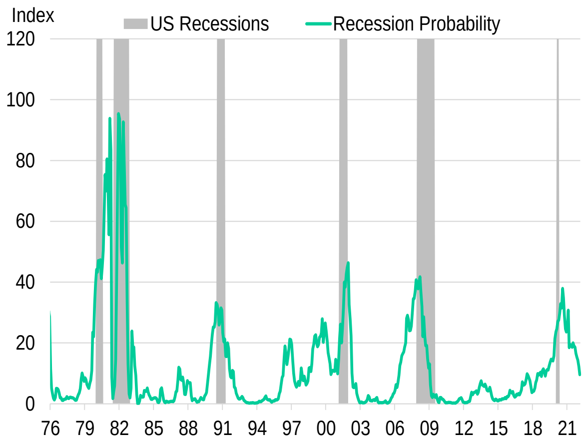
Chart 4: UST 10y yield breakdown



Source: Ardea, Bloomberg

2) **Recession indicators from yield curves**. Historically, the largest corrections in equities tend to come about when the business cycle rolls over. A flat yield curve is one indication of rising recession probabilities, but even after recent moves curves are a long way off signaling a major concern. While 2-5y ahead forward curves are now flat or inverted, research shows broader curves like the spot 3m vs 10y tend to be a better predictor of recessions. The NY Fed recession probability model is based on this 3m vs 10y curve and with hikes yet to commence, suggests recession probabilities are still at benign levels. Expect curve shape to get more focus among multi-asset investors over the coming months and year as central banks start to deliver on the tightening that is now being priced in.

Chart 5: Recession probability model



Source: Ardea, NY Fed, NBER, Bloomberg