ARDEA Investment Management

11 October 2022

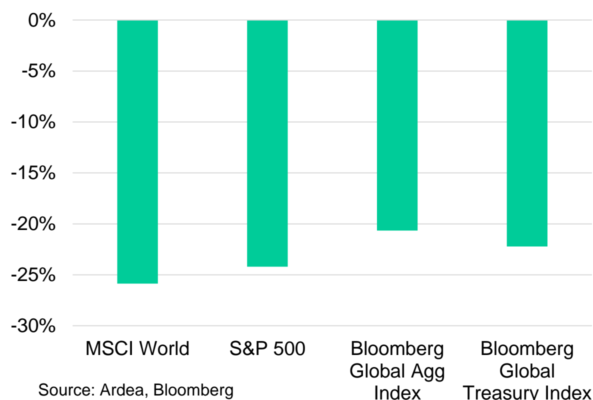
Market Musings: Stretched to Breaking Point

- A historically bad year for markets gets worse.
- The EM-like UK sell-off highlights policy inflexibility and market frailties in a post-QE world.
- Peak inflation in developed markets could be near, but high macro uncertainty and volatility is likely to persist.

From bad to worse

An already tough year for markets has worsened over the last month. The scale of drawdowns and level of volatility hasn't been seen in decades in some asset classes. The Bloomberg Global Government Bond Index fell another 5% in September, taking year-to-date declines to 20% as major market yields hit the highest levels in a decade or longer. Global equity markets have experienced a similar sized correction, after registering 5-10% falls over the month.

Chart 1: Select asset performance 2022 YTD

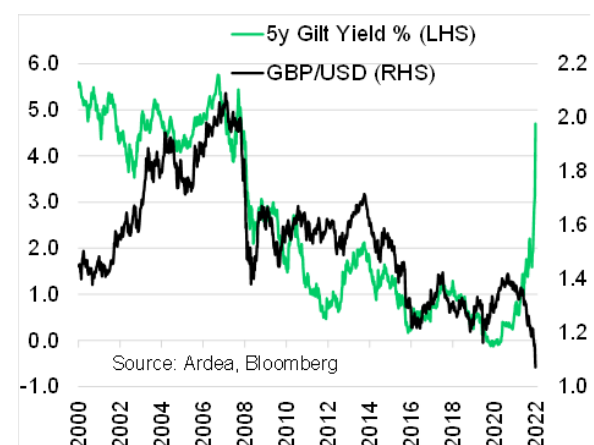


The global macro backdrop remains very challenging, as central banks aggressively tighten policy to fight historically high inflation into a slowing global economy. The Fed, ECB, BoE BoC and other central banks all delivered outsized rate hikes over the last month. The RBA was an exception in surprising markets with only a 25bp hike. Further fueling negative sentiment has been a crisis of market confidence in UK government policy, a continued major disruption to European energy supply and negative geopolitical headlines. Meanwhile, the extraordinary strength of the USD is causing headaches for other global central banks.

UK EM-like sell-off highlights global post-QE risks

In September, Gilts and the GBP were hammered, as markets reacted negatively to the UK government's highly expansionary fiscal policy against the backdrop of surging inflation (headline CPI +9.9% y/y). The GBP fell as much as 9.5% to a new record low of 1.035 vs the USD. Gilt yields experienced the largest weekly move higher in 30 years – the 5y yield lifted 157bp in a week.

Chart 2: GBP and 5y gilt yield



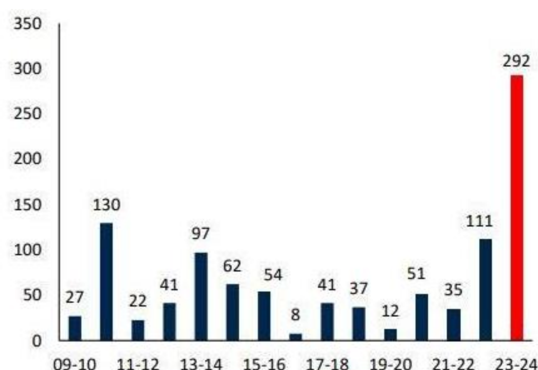
Forced selling by UK Liability Driven Investors (LDIs) such as pension funds, exacerbated the turmoil in Gilts. While funding ratios have

benefited from a lower present value of liabilities amid higher rates, LDIs lever into long duration positions with derivatives. The large move higher in rates has forced LDIs to sell bonds to meet collateral calls on derivative positions.

The big expansion of UK fiscal policy is staggering at a time of high inflation. A few of the key fiscal metrics:

- An energy bill support package (8% of GDP) and tax cuts (2% of GDP).
- A projected UK fiscal deficit of 9% of GDP in FY22 and FY23, while public debt is expected to rise from 95% to 105% of GDP by FY24.
- Total Gilt and bill issuance for 2022-23 is projected to rise to £234bn – a £72bn increase since the prior estimate in April. Issuance is then expected to jump sharply again in 2023-24 (Chart 3).
- Auction sizes will rise to the highest levels since 2008-09.

Chart 3: Gilt after QE net issuance projections (£bn)

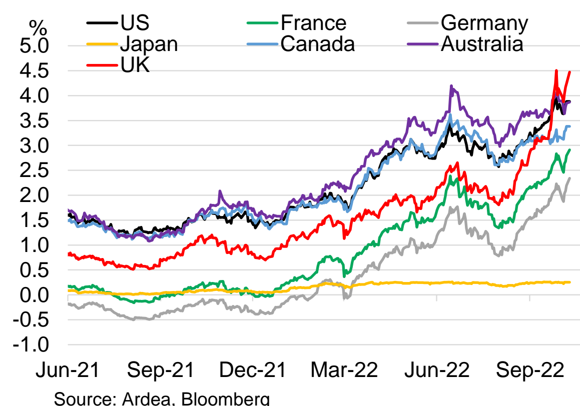


Source: DMO, BoE, Bloomberg, RBC Capital Markets

Unlike previous fiscal expansions, these announcements came at a time of no QE backstop. The BoE intends to actively shrink its balance sheet by £80bn over the next year.

However, in response to the chaos in markets, the BoE subsequently announced it would delay the start of QT by a month and actively buy gilts up to £5bn per day until 14 October (later upgraded to £10bn) with a promise to buy more if necessary. So far, actual BoE purchases haven't been anywhere near those limits, underscoring the policy goal of financial stability rather than lower yields (a key difference with QE-focused programs). A temporary repo facility has also been implemented to ease liquidity pressures on LDIs. These measures have so far had only limited success in calming markets. UK yields fell initially but at the time of writing are rebounding sharply again.

Chart 4: Global 10y yields - extreme UK volatility spilling over into other markets



Source: Ardea, Bloomberg

The key issue for markets is fiscal sustainability. The government has walked away from tax cuts (only a symbolic, small fiscal impact) and made other assurances on the longer-term fiscal outlook. Markets will be scrutinizing fiscal plans in a more detailed update due to be released on 31 October, which will also inform the BoE ahead of their early November meeting.

It has been 30 years almost to the week of "Black Wednesday", when the UK abandoned its attempts to keep the GBP in the European Monetary System, amid sustained selling pressure from hedge funds (after the BoE had run through £10bn of reserves). The current economic backdrop is different. The similarity, however, is in markets pushing policy makers to a breaking point. Outside of emerging markets, governments and central banks have become

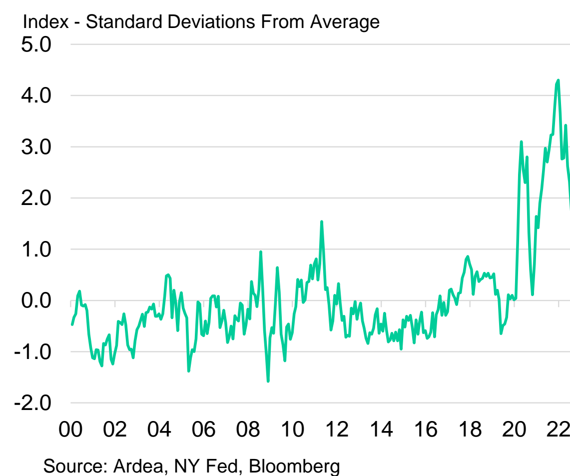
accustomed to investors being compliant with expansionary fiscal policy in the years since the European sovereign crisis (we raised the risk of bond vigilantes re-emerging in this note at the peak of fiscal stimulus spending in 2020).

Where to from here?

Now inflation and debt levels are high, policy flexibility to deal with a slowing economy is diminished. The UK experience highlights the risk of policy missteps by other governments in an environment of slowing global growth, which is set to worsen in 2023. This backdrop suggests that even with yields higher and further rate hikes priced in, bond yields may not yet offer sufficient risk premia in a world without QE (as discussed in this note).

The bullish case for most assets requires a central bank policy pivot (as discussed in prior notes). A general easing in the pace of aggressive tightening – already started by the RBA but not yet other central banks – could come by early 2023. This outlook depends on inflation rates stabilizing and then easing. There are some positive indications on this front – supply chain price pressures have moved from a peak of 4 to 1 standard deviation above normal levels (Chart 5). Energy prices remain volatile and elevated but are off the peaks seen a few months ago. However, labour markets remain tight and so eventual relief from energy and supply side pressures may not bring inflation down fast enough for central bank comfort.

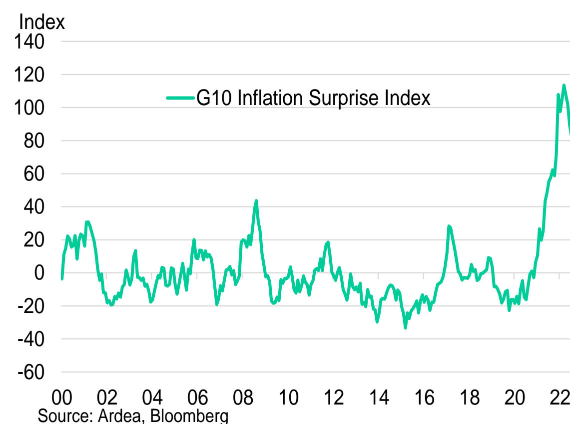
Chart 5: Global supply chain price pressure easing



Source: Ardea, NY Fed, Bloomberg

After staying behind the curve on inflation for the last year, central banks will be biased to tightening more rather than less in the near term. High macro uncertainty is here to stay, which could leave volatility elevated over the coming months.

Chart 6: Inflation surprise index still historically high (above zero = inflation exceeding forecasts)



Source: Ardea, Bloomberg

This material has been prepared by Ardea Investment Management Pty Limited (Ardea) (ABN 50 132 902 722). Ardea is the holder of an Australian financial services licence AFSL 329 828 and is regulated under the laws of Australia.

This document does not relate to any financial or investment product or service and does not constitute or form part of any offer to sell, or any solicitation of any offer to subscribe or interests and the information provided is intended to be general in nature only. This should not form the basis of, or be relied upon for the purpose of, any investment decision. This document is not available to retail investors as defined under local laws.

This document has been prepared without taking into account any person's objectives, financial situation or needs. Any person receiving the information in this document should consider the appropriateness of the information, in light of their own objectives, financial situation or needs before acting.

This document is provided to you on the basis that it should not be relied upon for any purpose other than information and discussion. The document has not been independently verified. No reliance may be placed for any purpose on the document or its accuracy, fairness, correctness or completeness. Neither Ardea nor any of its related bodies corporates, associates and employees shall have any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of the document or otherwise in connection with the presentation.