ARDEA Investment Management

5 Key Themes for 2022

As each year draws to a close, it's common for investment managers and banks to publish predictions for the year-ahead. In fixed income, these notes tend to be heavily focused on the macroeconomic and central bank policy forecasts that drive yield predictions. Forecasting is a tough gig. Even seasoned market professionals have a patchy record in accurately predicting key variables like growth, inflation, and the level of bond yields.

At Ardea Investment Management, macro forecasting is not part of our investment process because we adopt a pure relative value investment approach that aims to be independent of the level of bond yields, the direction of interest rates and the macroeconomic factors that dominate the performance of conventional investments. Therefore, instead of the traditional year-ahead forecasts, in this note we highlight 5 key themes that will impact the risk/reward balance for fixed income in 2022: 1) high expectations and risks to global growth; 2) peak inflation; 3) peak QE and bond supply/demand dynamics; 4) rate hikes to further un-anchor yield curves; 5) cross-market rates divergence and volatility.

A common link among these broader market themes is the rising level of macro uncertainty (as also outlined in a recent note on central bank policy tightening). For relative value, this uncertainty is likely to manifest in further distortions in yield curve shapes, interest rate volatility and changes in the relationship between bond and interest rate derivative curves.

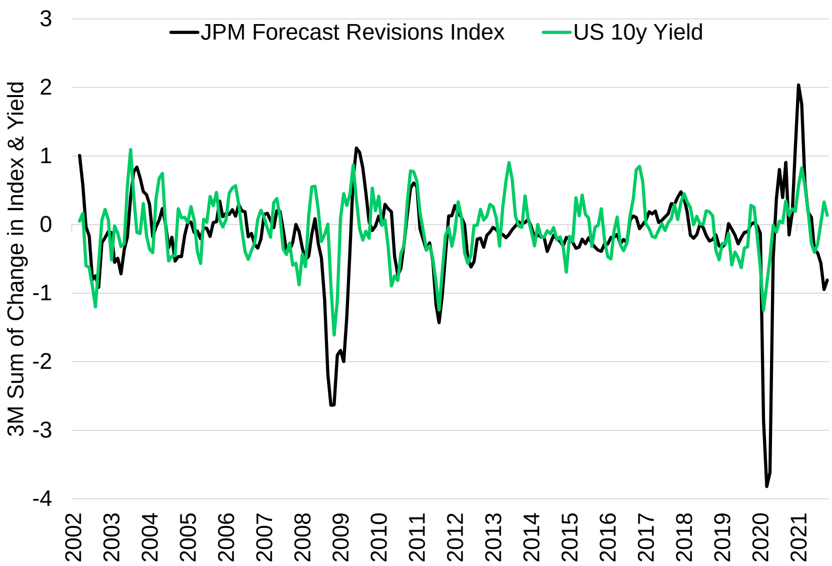
1. High expectations and risks to global growth

Since mid-year, global growth momentum has been slowing. This slow-down helped suppress bond yields and dampen risk sentiment through Q3, particularly as the US confronted the delta COVID wave. But that was quickly forgotten by markets in October amid optimism about future growth prospects and as the ongoing surge in inflation led to central banks signaling tighter policy. As we write, markets are still coming to grips with the wide range of paths for economies in 2022 amid historically high levels of forecast uncertainty that are likely to persist into next year. The base case for many investors looks something like the IMF's latest outlook which has global growth slowing from a peak of 5.9% in 2021 to a still solid 4.9% in 2022. For the advanced economies that bond markets track more closely, growth is expected to ease from 5.2% in 2021 to 4.5% in 2022, which returns these economies to pre-pandemic trend paths. Therefore, an incremental slowing in global growth is still viewed as positive for markets since it is forecast to be strong enough to eat into the elevated slack that persists from the 2020 recession.

However, these optimistic base case forecasts are subject to substantial risks that are likely to periodically drive volatility in bond markets and challenge risk assets valuations. As Chart 1 shows, large forecast revisions are consistent with big swings in bond yields and the pattern of forecast volatility in 2021 will likely continue next year.

One of the biggest assumptions behind relatively optimistic economic forecasts is that the pandemic will gradually fade. The emergence of yet another new variant of COVID in recent weeks is challenging the consensus view. At the time of writing, health experts suggest there are still many more questions than answers. Much will hinge on the effectiveness of vaccines, emergence of new treatments and government policy responses to any rise in cases. Even ahead of market concerns over this variant, some European economies recently re-introduced social distancing measures. Meanwhile China has shown zero tolerance to any rise in COVID cases. Optimistic forecasts and many asset valuations depend on the world overcoming COVID and there remains risks of further setbacks on this front in 2022.

Chart 1: Global growth revisions index vs US 10y yield

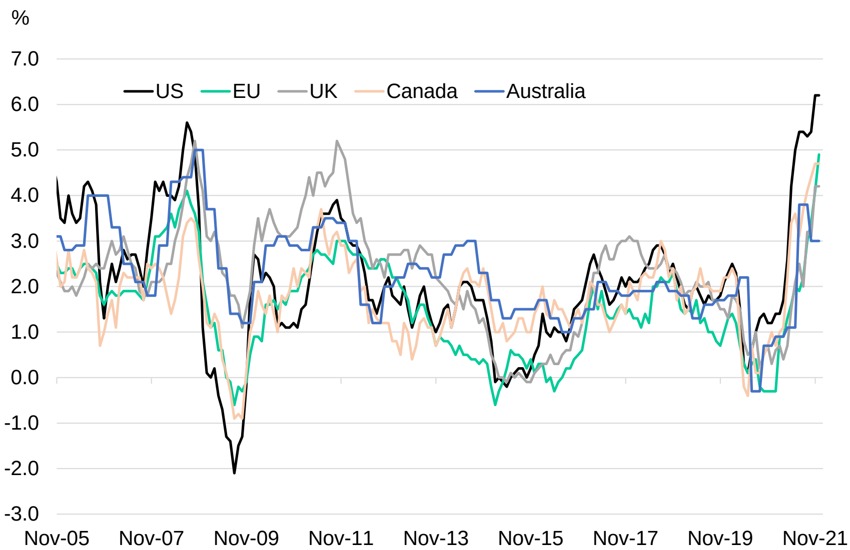


Source: Ardea, JP Morgan, Bloomberg

2. Peak inflation

Inflation surged in 2021, as demand recovered strongly from the depths of the pandemic in 2020, while the supply side of economies has struggled to keep pace. Headline CPI in advanced economies is running at the highest levels in a decade or longer.

Chart 2: Headline CPI (Y/Y)

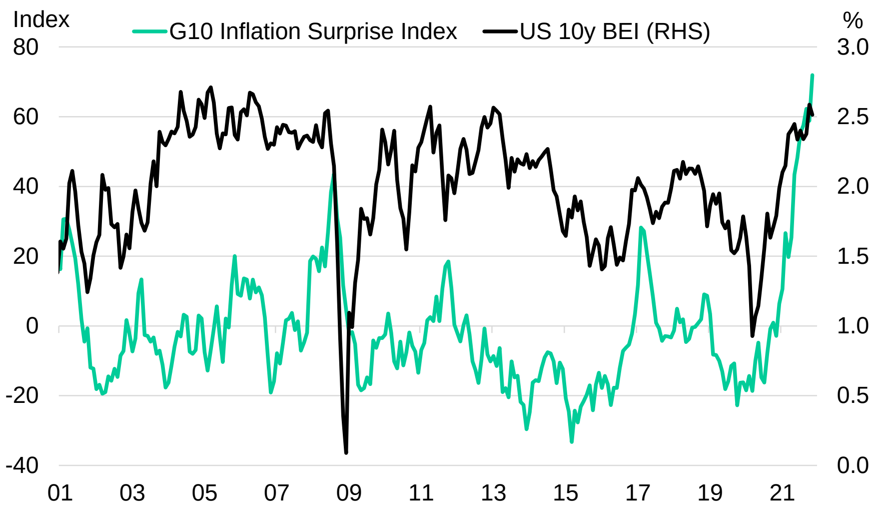


Source: Ardea, Bloomberg

The consensus among private sector economists and central bankers is that inflation pressures will ease substantially in 2022 – as early as Q1 – as the supply side of economies catches up. A closer examination of CPI prints reveals some highly concentrated and temporary drivers such as rising energy costs. Supply-chain bottlenecks and pent-up demand for goods are expected to ease and contribute to a significant deceleration in CPI.

Market participants, however, are less confident. The experience at the coal face through 2021 for fixed income investors has been one of persistent over-shooting of inflation outcomes relative to forecasts, as supply shocks persisted. Chart 3 shows that the G10 inflation data surprise index reached decade highs alongside rising market implied inflation expectations.

Chart 3: G10 inflation surprises and breakeven inflation rates



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

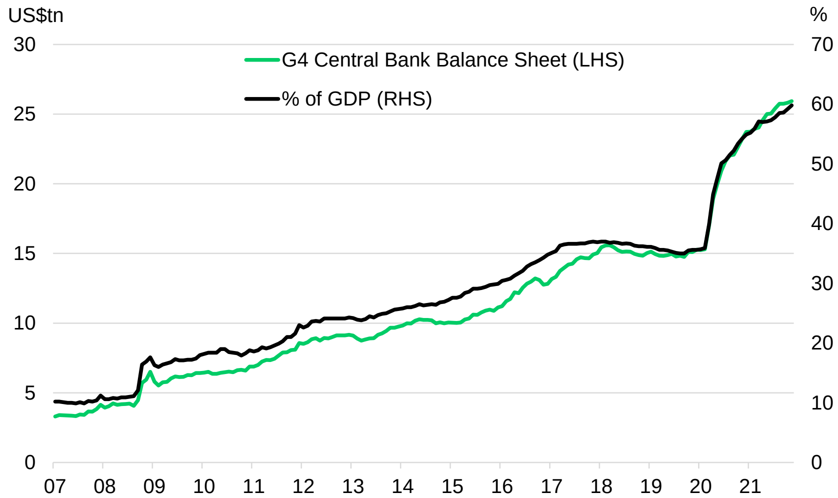
The Fed recently dropped its key "transitory" message, acknowledging that inflation is more persistent and could see them speed up the pace of QE tapering. A key risk scenario for 2022 is if markets question the credibility of central bankers in containing inflation, resulting in even higher long-term inflation expectations or aggressive repricing for higher policy rates. This outcome would likely see more significant adverse spillovers into risk assets which have mostly weathered bouts of interest rate volatility in 2021. Conversely, a sharper pull-back in inflation pressures early in the year could see fixed income markets remove some of the rate hike pricing factored into the front end of yield curves over the last few months. In either case, we see potential for higher rates market volatility while high inflation uncertainty persists (as we highlighted in previous notes, here and here).

3. Peak QE and bond supply/demand dynamics

Central bank balance sheets will likely peak early in 2022, removing a major tailwind behind all assets since March 2020. The pace of QE purchases is set to imminently slow in the US and Australia, while central banks have stopped buying bonds altogether in Canada and NZ. In Europe, the Pandemic Emergency Purchase Program (PEPP) is due to expire in March 2022 (although other smaller purchase programs could continue for a bit longer).

The impact on bond markets - and by extension other asset classes - can be thought of as comprising both stock and flow effects. That is, both the size of the central bank balance sheets and flow of after-QE net supply work to lower yields (although in practice disentangling the influence of each effect is difficult). The overall size of balance sheets will remain massive, with central banks not outright selling bond holdings.

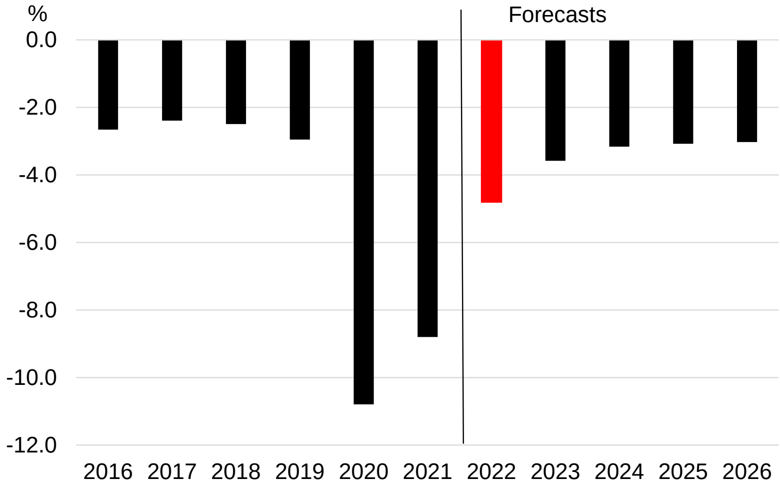
Chart 4: G4 central bank balance sheets



Source: Ardea, Bloomberg

There is still pressure towards rising long-term yields as QE fades. From a flow perspective, in an environment where large price insensitive buyers have stepped away, bond markets will be even more sensitive to periodic swings in fixed income fund flows and changes in bond supply. Fortunately for policymakers, the pull-back in QE coincides with a projected improvement in fiscal balances, leading to lower gross bond supply in 2022 across advanced economies.

Chart 5: Advanced economy fiscal balance (% of GDP)



Source: Ardea, IMF

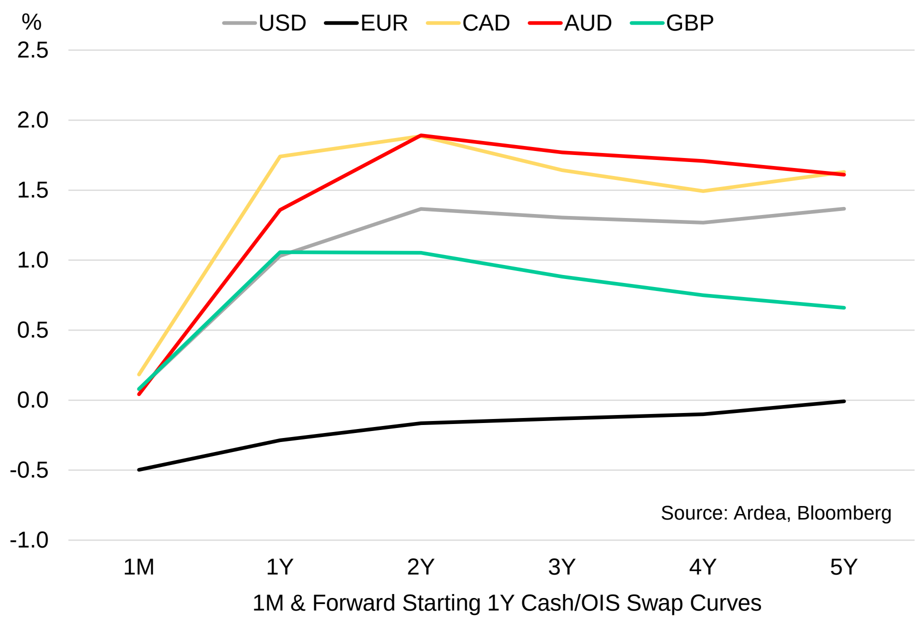
Estimates of the supply of bonds net of QE which private investors need to absorb varies (depending on issuance and QE assumptions, timing etc). Overall, investors across major bond markets are likely to be facing the same or more net supply in 2022 than in 2021 (depending on the market), but with potential differences in duration. In the US market for example, most estimates are for around $1.4-1.6tn of issuance net of redemptions and Fed purchases, which is only slightly under 2021 and after accounting for duration might not actually represent much of a decline in risk absorbed by the market (although this remains a point of uncertainty). Periodic cheapening of sectors of yield curves in reaction to changes in supply/demand dynamics is likely to create relative value opportunities in 2022.

4. Rate hikes to further un-anchor yield curves

In October 2021, interest rate markets priced a significant increase in policy rate expectations over the next 2-3 years in the wake of stronger inflation data, hawkish central bank comments and a positioning washout among highly levered investors. While positioning shifts tend to fade quickly, the sheer amount of stimulus still yet to be unwound means that volatility in the front end of interest rate curves has structurally reset higher. This shift has significant implications for fixed income portfolio construction and yield curve strategies (see our primer for details on how macro regimes impact the shape of yield curves).

Another key theme is the amount of overall tightening factored into interest rate curves. The market has recently moved to front-load the entire policy tightening cycle into the next few years without materially lifting the expected end point in the cycle. In some markets, 2y and 3y ahead forward rates are trading higher than 4y and 5y ahead forward rates (Chart 6). One interpretation of this pricing structure is that a type of policy mistake is being priced. That is, rate hikes may go too far and will have to be quickly stabilised or reversed. More generally, markets doubt economies can handle a much higher peak in rates in the cycle because of debt levels and/or long-term inflation and growth dynamics. Or put another way, the market expectation for the neutral policy rate (the rate at which monetary policy is neither expansionary nor contractionary) will be materially lower than in previous cycles.

Chart 6: 1M and Forward Starting 1Y Cash/OIS Swap Curves



These assumptions can change quickly. As we noted in previous notes (see here and here), medium to long term rate expectations have previously tracked wider trading ranges with policy normalisation cycles in the early stages. In the US we note the Fed and some private sector economists see neutral policy rates closer to 2.5% than the 1.4% currently priced into long-dated forwards. If inflation is higher for longer or potential growth rates get revised up, markets may view central banks as behind the curve, which could reset longer term rates higher. Therefore, given the current pricing structure curves may periodically steepen in 2022 even if the market is embarking on a longer term trend towards curve flattening in a tightening cycle (as is typical when policy rates are hiked, such as the US experience in 2015-2018).

5. Cross market rates divergence and volatility

In 2022, bond markets are likely to show greater divergence, as progress towards central bank goals varies by region. This cross-market difference could be exacerbated further by any new COVID variants, as governments take different approaches to social distancing and fiscal support. Under the more optimistic base case growth outlook where the pandemic recedes, there are still likely to be big differences between economies in terms of vaccination rates and the capacity of services sectors to recover towards pre-pandemic norms.

In terms of central banks, clear differences are already emerging. At one extreme, the RBNZ has hiked twice already and is widely expected to remain aggressive in tightening policy through 2022. At the other end of the spectrum, the ECB is expected to keep rates on-hold, but instead adjust QE in 2022, while the ice age in JPY rates is set to continue. Most economists and investors expect the BoE to hike sooner than the RBA or Fed, but that the latter two central banks will ultimately take rates higher in the cycle. The central banks themselves are providing mixed messages on how much and when highly accommodative policy will be unwound. For example, the BoE recently wrong-footed markets on the timing of a hike, while the RBA continues to talk down the likelihood of a hike before 2023.

Overall, bond market performance and the volatility of returns will likely vary throughout 2022. For investors, this will likely create additional uncertainty over duration allocations, but also cross-market yield spread opportunities.