CULROSS GLOBAL

Macro Outlook Summary

May 2022

What has started to emerge this year is a significant divergence in monetary policy ranging from the super hawkish Fed, closely followed by the UK with Europe some way behind and Japan at the other extreme, unmoved. Currency markets have reacted logically and meaningfully with the USD strengthening +9.5% against the EUR, +10.8% against GBP and a whopping +12.6% against the JPY since the beginning of the year. Of course, a strong dollar has always been part of the risk-off playbook and maybe against the EUR it makes even more sense as investors move cash away from the war risk of Europe and away from the zero-interest rate outlook of Japan.

The Fed hiked 0.25% in March, 0.25% in April and 0.50% in May bringing Fed Funds to 1%. The Bank of England hiked 0.25% in March and 0.25% in May bringing base rates to 1%. Government bond markets sold off in the US and UK, particularly across short maturities as 2-5Yr bond yields were re-set sharply up from the 1-1.5% zone they had been languishing in for years. None of this is a surprise given the soaring inflation data which looks less transitory with the passing of every week. There is now clear evidence that inflation goes well beyond food and energy. The 'Median' inflation measure which measures underlying core inflation remains remarkably strong in the US and across Europe. For example, in Europe this measure lifted off from 1% at the beginning of 2021 in a steady trajectory to over 4% currently. The trajectory is exactly the same for the UK and US with their rates at 5% and 6% respectively. This data evidences that inflation has been in a clear trend upwards for years not months.

In Japan the picture remains somewhat different. Core inflation is +0.8%, albeit rising as elsewhere, and the BoJ remains firmly committed to yield curve control (YCC) and easy money. With 10Yr JGBs yields locked at 0.25% by the BoJ's unlimited bond buying programme, yield opportunities are non-existent and the currency is left with little attraction.

Inflation data and ongoing pressures are dominating market thinking. The latest Covid related lockdown in China has re-ignited global supply chain and logistics issues. The Antwerp Port Authority CEO recently commented that they are now preparing for greater disruption to operations than 2021. To illustrate, building materials shortages are becoming noticeable and when deliveries have an unknown date and unknown price then budgeting and project planning becomes impossible. Financial risks rise and project financing dries up with an obvious knock on into construction activity and employment.

Central banks have come to life with recent hikes and more hawkish language. To be clear, they are not tightening but finally proceeding with urgently needed steps to reduce accommodation. That will re-set the bearish tone for government bonds and reinforce the increasingly audible central bank message that short term rates are headed much higher just to achieve neutrality.

Meanwhile equity indices have sold off, but still not by much. Market commentators in early May have finally raised the possibility that the rate hiking programmes being followed by central banks in fighting inflation may lead to a slowdown which could overshoot into recession. While avoiding recession is part of every central bank's agenda, their fight is prioritised to contain inflation, but where recession may end up being an unintended consequence. If the drivers of inflation go into reverse and the reported data peaks and turns down convincingly then central banks will quickly call a halt to their hiking programme and recession may be avoided. Our concern is that there is already a stubbornness in underlying inflationary forces which will not go away quickly and quietly. That means this fight against inflation will be more protracted than markets currently envisage and the risks of recession become greater.

Central to any plan for investment is an estimation of the path and future level of interest rates. So, we must judge how far central banks will have to go in hiking rates and an important question to contemplate is where 10Yr and 30Yr bond yields will settle because that informs discount rates and equity valuations. As central banks end their QE programmes so those bond markets will lose their largest buyer and the floor under yields which that programme provided. But they will also be freed of manipulation and be able once more to seek their natural market equilibrium. This yield level has historically been close to the long-term trend rate of nominal GDP. So, for example in the US the 10Yr moving-average nominal GDP rate is 4%. A rise in 10Yr yields currently at 2.9% to that equilibrium rate of 4% translates into a capital loss of about 10%. Having been priced on a yield of 1.7% on 1st March 2022 the rise to 2.9% has already equated to a capital loss of 11%. In summary, US 10Yr bonds moving from 1.7% to 4.0% will represent a capital loss of over 20% for those holders. This bond bear market is creating large losses in an asset which is supposed to be low risk and capital defensive. For years we and others have been making the point that traditionally in decades gone by bonds were low risk assets generating attractive yields. Then QE entered the picture and manipulated bond yields downwards so transforming them into high-risk assets with no yields. But as long as yields did not rise the true riskiness embedded in government bonds was not visible to the believing eye. If at any point however interest rates were to rise, then government bonds would become one of the worst possible assets to own. And here we are.

Two questions follow. How will the credit market fare if public corporate bond yields have to rise? And secondly can equity valuations really hold up at their current levels?

We will discuss these two points in months to come but in short our current view is that publicly traded corporate credit is poised on the brink of disaster. How big we don't know but the gross mispricing of public credit achieved by the central bank bond buying programmes is coming to a rapid end. Yields on corporate credit must rise at least as fast as government bonds to maintain their spread. Spreads cannot tighten. Indeed, spreads must widen, first to normalise back to un-manipulated spreads but secondly in addition because the possibility of economic slowdown or recession is increasing. So corporate bond performance will be even worse than governments. Pension funds and insurance companies are huge backstop buyers of government bonds. So are those looking for safe havens. Buyers of A or BBB corporate debt don't buy for the same reason.

Given this outlook for yields and as recession becomes more likely then we think a substantial repricing of equities seems guaranteed.