Macro Outlook Summary

June 2022

Primary economic data continues to make grim reading. US April CPI came in at +8.3% versus an expected +8.1%. In the UK the reading went from +7% in March to +9% in April. As we have pointed out before, employment remains strong and wages are rising but not at the inflation rate. Producer price indices have printed some startling numbers and indicate just how much pressure is being loaded onto corporate margins. If products have pricing these higher costs are getting passed on but with many basic consumer products, where competition is fierce, retailers margins are being squeezed hard.

Looking behind the market volatility year to date, several trends have become crystal clear. Inflation data has crossed the line and central banks now have no choice but to take steps to cease bond purchases, reduce their balance sheets and tighten rates. Even with the Fed in a relative hurry this process has taken far too long, putting all central banks far behind the curve.

The root of the problem goes back to 3Q21 when inflation was already in lift off and action was needed but poor judgement and complacency prevailed. It's convenient to blame the Russian invasion of Ukraine but UK inflation was already +6.2% in Feb'22 and the US was +7.9%, so all that did was accelerate a process which was already under way. Moving from the front foot to indecisively chasing from the back foot never works and rightly the UK Bank governor Bailey is being put under pressure. Admitting to a House of Commons select committee that 'he felt helpless in the face of soaring inflation' isn't quite what the public needed to hear and inspired no confidence from the very person who is supposed to be 'anchoring inflationary expectations'. ECB Chair Lagarde has begun to pivot towards tightening, at least in recent public speeches, but there's a distinct air of reluctance or indecisiveness behind the messaging. The central bankers manual on communicating with markets was written in the era of deflation and hasn't been revised. Whether it's the right way to continue in this inflationary environment remains to be seen.

We noted last month a growing market concern that there may already be a stubbornness in underlying inflationary forces which will not go away quickly or quietly. That means this fight against inflation will be more protracted than previously thought and the risks of recession become greater. The simple concern is that requisite central bank measures to kill inflation may now be so severe that they kill the economy. Almost always the economy responds faster than inflation so the risk is that the economy slides into recession well before inflation data turns convincingly downwards. But this risk is not equal across the major economies. The US economy looks most resilient and able to withstand the Fed's measures while the UK and Europe not so.

Understanding consumer sensitivity to interest rate increases will become increasingly important in this balancing act and hopefully central banks have updated their models. Pre-GFC consumer debt was heavily tilted to housing and autos. Today consumers can finance everything, and they do. House, car, kitchen, furniture, furnishings, white goods, mobiles, second homes and investments. Lives are now driven by income statements deployed to the max with everything on finance. When rates were near zero a remarkably high living standard was apparently possible but little cushion was left for the unthinkable. It seems likely that these consumers will be the first to succumb to higher rates long before inflation eases which in the end of course does bring inflation down but only because the recession kills demand.

So far this year, in a sea of rising yields Government bonds and credit markets have failed to protect capital and indeed have contributed significant losses. Further rate rises are inescapable meaning further losses are very likely to continue. Losses on the 10Yr Bund, long thought of as a safe haven and low risk asset, stand at -12% so far this year.

Credit is in a dangerous place. The gross mispricing of public credit achieved by central bank bond buying programmes is coming to an end. Spreads will widen as pricing normalises back to un-manipulated levels. But on top of that government yields continue to rise, corporate liquidity is tightening and underlying business profits are being squeezed hard. Recession makes this worse. A hard shakeout in credit looks like the next domino to fall.