Market Review & Outlook

01 March 2022

At the January 26th FOMC meeting Chairman Powell reaffirmed his December hawkish message saying there was "quite a bit of room" to raise rates without affecting the labour market. The FOMC Committee noted with concern that "prices could continue to run higher as inflation risks are to the upside". In his clearest signal to date, Chairman Powell declared "part of this will be the Fed moving away from very high accommodative policy to substantially less accommodative policy and over time to a policy that's not accommodative". The Fed also indicated that their monthly bond buying programme would reduce to $30B in February and stop in March - which seems long overdue. The market has translated all this into pricing up four 25bps rate hikes through 2022.

US 4Q21 GDP came in strong with a 6.9% rise versus an expected 5.5%. That's a rate of 5.7% for 2021. GDP has not been this high since 1984 when it was 7.2%. Back then inflation was 4.3%. Today its 7.0%. But the shocking difference is that Fed Funds rate was between 12% and 10% then… today its 0.25%.

UK inflation remained high at 5.5% in January as energy prices, increasing demand and ongoing supply chain issues continued to drive up consumer prices. The BoE sees a continued tight labour market and forecasts wage inflation at 4.75% into 2023. Governor Bailey noted that the main driver of inflation is "imported" which seems more a statement to transfer blame than one which lends real insight and that it "could become entrained within the domestic economy" if nothing is done. The Bank hiked rates on February 3rd by 25bps to 0.5% but what was really notable was that 4 of the 9 voting members voted for a 50bps hike. That should leave no one in any doubt regarding their high level of concern that wage inflation is weaving itself into the fabric of the economy. Further hikes in March and May seem near certain.

The last 20 years of major central bank monetary policy has been built on a culture of published minutes, forward looking statements, and small incremental rate moves to effect change gently, but all in an environment of benign inflation, globalisation and a focus on growth. Today's environment couldn't be more different and one has to wonder whether such different circumstances do not demand a different approach.

In the near term the Russian invasion of Ukraine is dominating everyone's lives as well as markets. Witnessing a superpower like Russia invading a passive neighbour who made no threat and then listening to Putin peddling utter nonsense and mis-representation about history and facts is truly horrifying. Clearly Russia's role and place in the global economic system has now changed fundamentally and indefinitely as democracies around the world seem at least set to shun Russian business and at best to sanction and ban any interaction. While making and implementing the rules to isolate Russia long term will be extremely complex it is clear that this further accelerates the wider de-globalisation process which began six years ago. This lends further momentum to ongoing medium term inflationary pressures. Russian exports of energy and wheat have been covered by the media but they are also an important producer of aluminium (Rusal), nickel, fertilisers and even coal. The biggest exporter to Russia is Germany who will be hard hit in their automobile sector and the Italians in fashion. Germany exports to Russia totalled $30B in 2021.

Gauging the impact on inflation of Covid and isolating Russia is beyond the scope of any economic models so central bankers have a particularly tough job ahead. They will have to use experience, judgement and intuition more than ever before in guiding monetary policy over the next 12-24 months. As investors we must all heed Powell's words, try and gauge the degree of current Fed accommodation, define where we think monetary policy neutrality lies and then calculate the scale and timeline of the policy changes that lie ahead. Like the central bankers we will need to estimate and judge the real economic impact of each step in monetary tightening as central banks try to damp down inflationary pressures. To build a numerical picture of what the Fed will need to do we have synthesised various research pieces into the following overview. The Fed has to move on two fronts to reduce monetary accommodation. First is to increase the Fed Funds (FF) rate and the second is to reverse QE with Quantitative Tightening. The Fed balance sheet is currently $9T and neutrality is estimated at $6T. No one knows whether this estimate is correct but we are using it as an informed consensus value. As an aside, to understand the scale of these numbers it's worth noting that the Fed balance sheet was $1T before the GFC in 2008! US GDP was $21T in 2021 for comparison. Academic research on the effects of QE suggests a rule of thumb that $100B of QE equates to 5bps of monetary easing. There are many competing ratios but this one is conservative and middle of the pack. Assuming QT to be the mirror opposite of QE and that its linear (two very risky assumptions) a $3T B/S reduction would equate to 150bps of monetary tightening to reach neutrality. The two assumptions used require a considerable leap of faith. Recent historical evidence does not support the notion of symmetry given what happened in the 'taper tantrum' but there's no other data or model to work with so we go with this assumption. Multiplying this out, to judge where we are today, $3T of QE accommodation equates to a FF easing of 30x5bps=150bps. Given FFs are at 0.25% this implies a shadow FF rate which is 150bps lower than today's headline rate of 0.25%, i.e. -1.25% which is deeply negative and incredibly accommodative. The current reported US inflation rate is 7%. To tackle those pressures it's clear that central bankers have a tremendous amount to do on the twin fronts of QT and rate hikes just to take away the stimulus and reach neutrality let alone begin tightening. A simple monthly balance sheet reduction of $100B will take 2.5Yrs to reach $6T! That dose of $3T of QT will equate to 150bps of monetary tightening. And in the same vein FFs need to rise at least 5 times in 25bps steps to achieve a rate of 1.50%-2.00% which is the rough level most economists judge to be near neutral. Inflation is normally fought with policy tightening, not just moving from accommodation to neutrality. This puts into perspective just how far out of line most central bank policy is with the current inflation epidemic and explains the acute anxiety in bond investors minds when they say the central bank is 'behind the curve'. The broad story is no different in the UK and perhaps this will be the first central bank that goes for a 50bps hike as their next move. Without the Russian military invasion this was a plausible event given 4 of the 9 members voted that way in February. Now it cannot be gauged without a better of sense of how and when the Russia-Ukraine conflict will de-escalate and end. What does seem certain is that, assuming that conflict does not end in global disaster, then the world will return to addressing three big questions of de-globalisation, inflation and monetary policy. Whether central banks will then be able to get back in control quickly enough and get onto the front foot without triggering either a financial market meltdown or a recession is far from certain.