Macro Outlook Summary

12 April 2022

Government bond markets have provided no sanctuary so far this year, with global yields rising strongly. Using US 10Yr yields as a global barometer for the price of liquidity the yield has increased from a low of 0.7% at the onset of the Covid pandemic in April'20 to 1.7% at the start of this year and 2.7% now. While spreads have widened, the sell-off in credit has been modest and orderly, suggesting that for the time being credit markets see government bonds yields as an adjustment which will not trigger either a meaningful economic slowdown or recession. Should that change then public credit markets can be expected to react more forcefully and be less calm.

In the real economy US data has remained strong, particularly in the labour market where non-farm payroll data has persistently exceeded market estimates and the unemployment rate has hit a remarkable low of 3.8%. Fed Chair Powell has repeatedly referred to the strong labour market over recent months as being a primary source of policy concern and his worries are a clear indicator of what they and therefore we should be watching. Not just in the US but in Europe and Asia for nearly six months there have been repeated and systematic labour supply issues as the workforce tries to adapt to Covid related shortages and the changed labour demands of the re-opening economy.

One might have thought that such shortages would quickly translate into higher wages and worker satisfaction. The Michigan Consumer Sentiment gauge however tells us something interesting and slightly different. While US income growth has grown at 5%, inflation has risen faster at 8%+ leaving consumers with negative real income growth. The negative effects of shrinking consumer purchasing power are captured by the low Michigan index which speaks of worker discontent even while headline macro data shows the economy is booming. The UK's OBR tells us something similar when they project UK real wages to be -2.2% this year – the most negative since records began in 1956. We believe this is an important issue to keep in mind while central banks remove liquidity and support. Persistently wide income disparity and the extremely unfair social impact of high energy and food prices on lower incomes will only add to this discontent and at a minimum leaves every central bank with no option but to act quickly with strong affirmative action against inflation.

Exclusion of large parts of the Russian economy from the global economic system is another step in the de-globalisation trend and is adding to already rising inflationary pressures. Across the spectrum from agricultural produce through base metals to energy commodities, prices are substantially higher either in anticipation of global supply disruptions or because of real shortages. As we have said before, this is widespread evidence of cost push inflation which was always going to be the consequence of de-globalisation as it plays out in so many different ways. Inflation data has continued its upward trend with the US just reporting +8.5%, the UK +6.2% and Europe HCIP +6%, with seemingly even higher readings still to come. Even Switzerland inflation is now reported above 2% at 2.4%. And before this is dismissed as being due to the ever-volatile effects of food and energy, US core inflation is running at 6.5%.

Substantially higher energy prices are a huge contributor to these high inflation readings but looking forward it remains hard to see how supply will be increased sufficiently to cause a substantial price reduction in the next twelve months even if demand pulls back. The thawing of relationships with Iran is a pretty obvious precursor to increased oil supplies and bizarre thought it may seem, heavily sanctioned states like Venezuela may be next. US onshore rig count is already indicating increased activity but these transitions all take time to come on stream. Governments' renewed focus on greater energy independence should be good in the long term for the nuclear power industry and help its chances of being more widely regarded as clean fuel even if only from short term necessity. The UK government have clearly come out as backers of this view even though their national record for long term strategic planning and execution is not particularly good.

The supply chain issues in the auto industry have been well covered in the media. Less noticed is the construction industry where some interesting points of tension are emerging. Successful property development requires execution of a plan which must be on budget and on time. Financiers require this discipline and hold developers to account. While rising financing costs are known, today's combination of products not being available or delayed with unknown final pricing makes execution of any development project truly risky. Lenders have already begun to react by tightening up their lending book which in due course will weaken demand and the price for refurbishment projects. End demand is still there but the terms of business for supply have changed dramatically.

What has changed most significantly from last month however is that central banks have radically shifted their messaging to an agenda of overt inflation fighting. Fed Chair Powell's recent statements are crystal clear. The Fed mandate is for full employment and price stability. They have undoubtedly achieved the first and are now focusing on the second. The March FOMC meeting confirmed their first 0.25% Fed Funds rate hike and projected similar hikes at each of the remaining seven meetings this year. A 0.50% hike at some point soon is now within the bounds of expectation when only a year ago such a move would have been dismissed as absurd.

Recent Chair Powell comments are instructive. The following are a series of quotes from March testimonies and speeches: "we expect inflation to take longer than previously expected to return to price stability". "We expect Fed Funds to be 1.9% at YE22 and 2.8% at YE23. Balance sheet reduction is also imminent. The US economy is very strong and well able to withstand the impact of Fed policy actions". "The labour mkt has continued to strengthen and is extremely tight. Labour supply is subdued and job openings are proving hard to fill. Wages are rising very fast and inflation is well above target levels. Supply disruptions have been larger than expected and have lasted longer than expected".

From such messaging it should be clear to anyone that we are in a new regime where the central bank recognises there is an inflation issue and that they have a long way to go to get it under control. As we have previously described, US monetary neutrality seems likely only to be achieved late this year, which is a long wait for something required right now. At the least we think this will continue to keep markets volatile and should lead to a downward reassessment of equity valuations given the certainty of higher rates and slower growth. The divergence in thinking between bond market investors and equity investors has been widening all year and we believe in this instance that the bond market is right.