

A broadening of inflation forces a Fed pivot

Monthly Commentary

For wholesale or professional investors only

Global equity markets started the year with a sharp selloff led by US tech stocks. The Nasdaq 100 closed down 9.7% almost beating the worst January on record, the 9.9% fall in January 2008. The correction was likely driven by a surge in real yields as investors recalibrated expectations on the pace of monetary tightening from the Federal Reserve. Looking at the prospects ahead for 2022, we know economic growth will decelerate as fiscal and monetary support is withdrawn. The extent and pace of the drop however is highly uncertain and dependent upon several factors. The IMF highlights at least three risks in their updated World Economic Outlook (WEO), including the persistence of supply chain disruptions, higher than expected inflation and the emergence of new variants prolonging the pandemic. We can also add a spike in geopolitical risk to that list as tensions build up between Russia and Ukraine.

Fed tightening into slowing economic growth?

Starting with interest rates, US 10-year real yields derived from inflation protected securities (TIPS) increased by 50 basis points over the month, the largest one month gain since the taper tantrum of 2013. Fed minutes of their December meeting revealed a sharp pivot in policy. Then in the January FOMC, Chair Powell all but confirmed a first rate hike and an end to quantitative easing in March. The abrupt pivot has been driven by a reassessment of the potential for inflation to become entrenched in the US. In particular, the tightness of the labour market suggests that inflationary pressures are broadening beyond the 'transitory' effects from energy prices and supply chain bottlenecks. The IMF highlighted that unit labour costs in the US are significantly above pre-pandemic levels, a phenomenon not witnessed in other advanced economies. The Employment Cost Index which tracks the increase in wages and benefits showed a 4% rise for 2021 the strongest growth in 20 years. Additionally, average hourly earnings have been growing close to 5% since the second half of 2021, versus historical trend growth of 2.7%.

Real GDP numbers released this month revealed the strongest annual rate of growth for the US since 1984. Real GDP grew by 1.7% in Q4, resulting in full year growth of 5.7% for 2021. Looking beyond the headline numbers paints a less optimistic picture and sets us up for a sharp contraction in Q1 of this year. The bulk of the growth in Q4 was a result of a surge in private inventory investment as companies restocked following months of strong consumer demand. The strength in consumption is fading however as consumers draw down their savings, fiscal policies unwind, and inflation begins to bite into real earnings. The overall savings rate in the US is now back down to its pre-pandemic level of 7%. Retail sales contracted by 1.9% in December and the Michigan Consumer Sentiment Index dropped below the level seen at the height of the pandemic in April 2020. Importantly, the Build Back Better plan failed to pass last year and has since prompted the IMF to downgrade growth forecasts for the US by 1.2% percentage points this year. They now expect the US to grow by 4% in 2022 meaning the Fed is now tightening policy into an already slowing economy. The ultimate effect on growth will depend on how many rate hikes occur over the year, which in turn will be driven by the path of inflation.

China easing in a world of tightening

The second largest downgrade in the IMF's latest economic outlook was a 0.8% cut to growth for China's economy. China has been going through a slow-motion crisis triggered by weakness in its property sector. Investment in real estate fell by 13.9% over the last 12 months. An uptick in Covid cases also weakened consumer spending as China's zero tolerance policy resulted in lockdowns across several regions. Retail sales growth slowed, growing by only 1.7% in December, the lowest rate since August 2020. Likewise, real GDP growth weakened to 4% in Q4 versus 4.9% in Q3 and 7.9% in Q2. In response to this sharp slowdown and in contrast to most other economies around the world, China is now easing policy. The PBOC this month cut the required

reserve ratio for commercial banks as well as the one year prime loan rate for the second consecutive month. More easing is expected as China seeks to engineer a soft landing and avoid financial contagion spreading from the property sector to the rest of the economy.

Finally, Q4 GDP in the Euro Area was a mixed bag. France led the way with growth of 0.7% in Q4 resulting in annual growth of 7%, the fastest rate in 52 years. Similarly, Spain posted above consensus growth of 2% for Q4. Germany, on the other hand, contracted in the fourth quarter by -0.7%. This was expected as the German economy has been most exposed to supply chain disruptions and materials shortages. Manufacturing makes up 20% of total value added in the German economy versus around half of that in France. A European Commission survey released at the end of the month showed more than half of European manufacturers have been affected by materials shortages and a quarter of them were also dealing with labour shortages.

A volatile start to 2022

Markets were volatile against this shifting backdrop with the VIX index climbing from 17 to 27 over the month. The tried and tested approach of buy the dips in large U.S. equity markets has fallen by the wayside with value and dividends being favoured over growth and momentum. The sharp increase in U.S. Treasury yields was to blame as the market acknowledged the Fed is serious about raising rates and that it would also soon start reducing the size of its \$8.9 trillion balance sheet. The US yield curve flattened over the month with the yield at the short end moving up more than the long end.

The comfort and safety of the “Fed put” is being called into question now that inflation in the US, and many other economies, is running at worryingly high levels. The “put” was possible because inflation was benign, providing scope for the Fed to support growth. The weakening of this safety net has seen the most speculative risky assets led the way down with investors reassessing the valuations they have been paying and the durability of the business models they have been invested in.

Looking ahead, there is broad acceptance that the Omicron variant is less severe and will not derail economic reopenings. Risks do remain in the form of various China risks, energy risks, slowing earnings growth as well as the delicate balance act central banks are trying to perform in controlling inflation.

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