

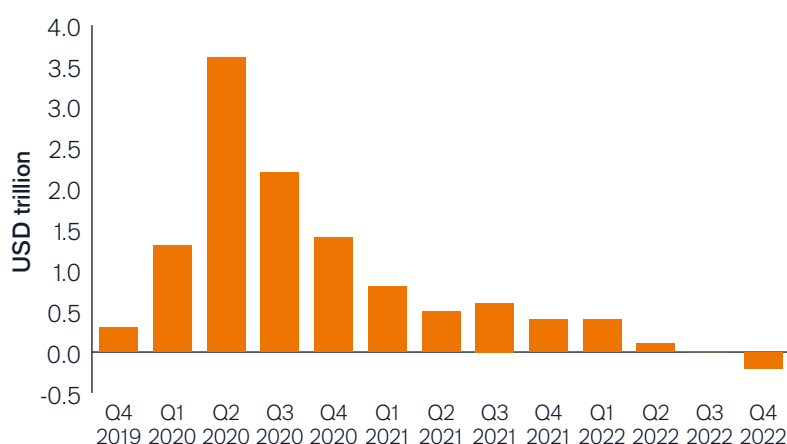
MARKETS VERSUS POLICYMAKERS: WHO'S IN CHARGE?

Economic data and market expectations have shifted dramatically in the past few months. Gross domestic product growth figures have disappointed while inflation has surged, causing some commentators to blow the dust off a long-neglected word stagflation. Markets brought forward tightening expectations, but central banks are sticking to the 'transitory inflation' line – for now. So who has the better handle on the economic outlook?

In June, financial commentators, including several investment banks, were calling for US GDP growth in percentage terms to hit high single-digits in the third quarter. As Q3 progressed, these forecasts were revised down – the actual outturn was 2%.¹ Meanwhile, fiscal stimulus has begun to roll off and the US Federal Reserve (Fed) has said it will begin tapering its quantitative easing by moderating the pace at which it injects liquidity into the bond markets.

Figure 1: Central banks set to reduce quantitative easing

Net asset purchases per quarter



Source: Janus Henderson Investors, Bank of America, data based on aggregate of actual and estimated purchases of US Federal Reserve, European Central Bank, Bank of Japan and Bank of England, June 2021. Forward-looking data are estimates and are not guaranteed.

At the same time, inflation – which was expected to be high because it was so low last year – has surged. US CPI reached 6.2%² and a backlog of containers at the country's ports suggests the meaning of 'transitory' (no pun intended) may be longer than we all thought.

This has led central banks to turn more hawkish and expectations for rate hikes brought forward, but are risk assets too complacent? Credit spreads (with the exception of China) have been relatively docile, and implied volatility muted. Here we examine some of the risk scenarios: the persistence of higher inflation and China growth.

KEY TAKEAWAYS

- ▶ Central banks are reticent to tighten for fear of choking off the recovery when data is still affected by pandemic distortions, yet markets may test policymakers' resolve
- ▶ A wild card and potentially on the minds of central bankers is China, where a slowdown in credit growth could have global implications
- ▶ While borrowing costs and real rates stay low, capital markets are likely to continue to offer a home for money but low spreads and volatility near record lows means there is little cushion to buffer against surprise

¹ Source: Bureau of Economic Analysis, Q3 2021 advance estimate of US GDP growth (annual rate).

² Source: Refinitiv Datastream, BLS, US Consumer Price Index – All Urban Sample: All Items. October year-on-year inflation rate was 6.2%.

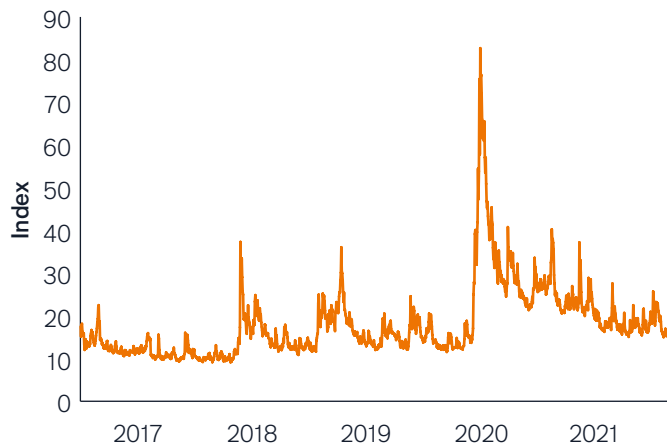
Are central banks leading the market into passivity ...?

The world's central banks, and the Fed in particular, have been actively suppressing market volatility. We wouldn't call this an explicit objective, but it looks to us like a significant implicit one. And central banks have done a masterful job at it. In a

little over a year since the biggest shock to the world's economy since the Great Depression, volatility in equities, currencies and even oil are near their pre-pandemic levels, though rates volatility is more elevated.

Figure 2: Still betting on a low volatility world

VIX (equity volatility)



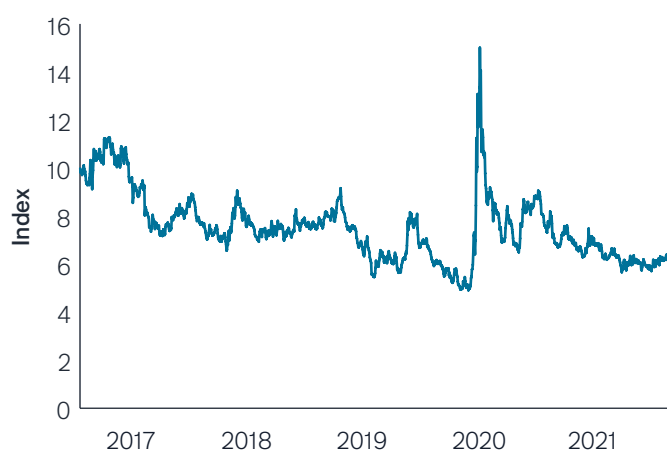
Source: Bloomberg, CBOE VIX Index (Futures implied equity volatility), September 2016 to November 2021.

MOVE (Treasury volatility)



Source: Bloomberg, MOVE Index (Treasury futures volatility), September 2016 to November 2021.

JPMorgan G7 FX volatility



Source: Bloomberg, JPMorgan G7 FX Volatility Index (VXY), September 2016 to November 2021.

CBOE crude oil volatility



Source: Bloomberg, CBOE Crude Oil Volatility Index, September 2016 to November 2021.

In the past few quarters, the Fed has shown just enough concern about the strength of the economy to allow bond markets not to worry too much about overheating. And, it has made enough of an argument that inflation will prove transitory that the market is not yet panicking about that either. But few believe the Fed is any more confident in its

views than commentators are in their own. The Fed has been, and still is, buying time. It is, understandably, reluctant to tighten too soon (we all remember 2018 when the Fed conducted a series of hikes even as the economy was slowing).

But the Fed is changing its policy. At its November Federal Open Market Committee (FOMC) meeting, it explicitly set out its near-term tapering plan, committing to reduce purchases by a combined US\$15 bn per month spread across Treasuries and mortgage-backed securities (MBS) for each of the next 2 months. Assuming a steady taper trajectory this would see net purchases end in June 2022, although asset purchases could be adjusted to allow for smooth functioning of markets in these securities. The Fed has been less explicit about dates for interest rate hikes, with press conferences keeping the market guessing as to when lift-off could occur. At the November meeting Fed Chair Powell stated in the accompanying press conference that (rates) lift-off was not discussed because the employment threshold had not yet been met.

...or are markets guiding central banks?

Should volatilities in global markets be as low as they are when we are transitioning from a loose monetary policy to a tighter one? Is the market saying there is only a negligible chance of a policy 'mistake'?

Yet the chance of a mistake is greater than negligible. Not through any fault of the Fed, but because data has a tendency to, and a recent history of, surprising the most astute economists. Modelling the unique nature of the recovery from the pandemic is even more difficult, so confidence in such models should be lower. More specifically, the Fed has been very clear that it is watching the data to gauge the pace of any tightening – the same data the market is looking at. Put another way, the Fed has indicated that policy will follow the data, not anticipate it. For over a year the Fed has stated its intent to see an 'average' inflation target, which is, by definition, backward-looking.

We are taught that central bank policy drives markets, but it increasingly seems it is the other way round as the rates market has begun to challenge the ultra-accommodative stance of central banks. Take the Reserve Bank of Australia's yield curve control policy, which was effectively abandoned before it was officially announced at the policy meeting as 3-year yields repriced well above the target. Could a glass-half-empty read on Fed policy be that rates are 'on hold' until the market forces its hand? Since the Fed is targeting a long-term average for inflation, will it tighten policy if short-term data surprises spook the market and price it in? *You go first. No, you – please, I insist.*

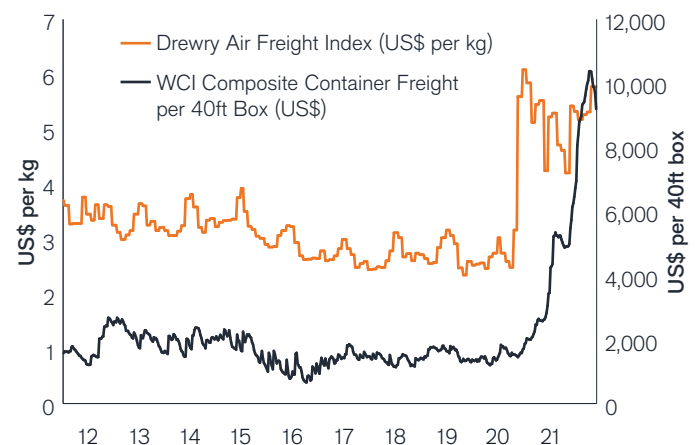
Inflation is rising, but is 'impermanent' more precise than 'transitory'

Speaking of surprises, the extent to which bottlenecks in the global supply chain have caused significant disruption, and inflation, has been a surprise. But, so far, the market is still looking through this particularly unique bout of cyclical inflation and assumes the Fed is correct in surmising that it will ultimately fade. But it may take longer than the market, and the Fed, would like.

Meanwhile, supply chain bottlenecks are real, raising transportation costs and thus end prices. Surging energy prices aren't helping. However, as the year-on-year changes in these measures are relatively dramatic, we would expect a dampening effect of similar magnitude on inflation as the supply chain normalises.

Figure 3: Commoditised prices rocket

Air freight and container rates for major East-West routes



Source: Bloomberg, Drewry Air Freight Index, World Container Index Composite Container Freight Index per 40ft Box, 23 June 2011 to 4 November 2021.

Natural gas price in Europe



Source: Bloomberg, World Bank Commodity Price – Natural Gas Europe, US\$ per million British thermal units, 31 October 2011 to 31 October 2021.

Our view on energy prices largely mirrors our view on transportation costs. The sharp rise in the price of energy is largely a reaction to past events. Just because prices reset to a higher level does not mean they will continue to rise at the

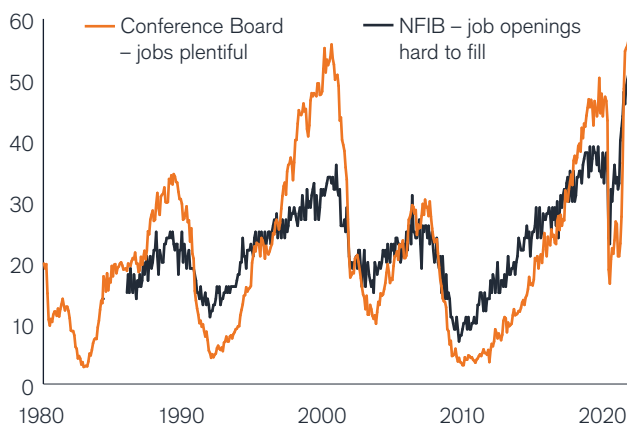
same year-on-year pace. However, like transportation costs, the price of energy can weigh on sentiment. Employers and employees see the prices and feel the impact daily.

Nevertheless, we are optimistic that rising prices begets rising supply. The US rig count has doubled in the past year.³ The futures curve in most energy markets is currently in backwardation (ie, the current price of oil and gas are higher than prices trading in the futures market), suggesting that there will be a more than commensurate supply response to rising prices. This does not mean that short-term volatility couldn't push WTI oil to US\$100/barrel, but even if oil did reach that level by June of next year, the year-on-year percentage changes would be sharply lower.

For example, the WTI oil price rose from US\$35.6/barrel in October 2020 to \$83.6/barrel at end October 2021 – a rise of 135%. An increase to US\$100/barrel by end October 2022 would be a 19% year-on-year rise. Prices have risen so far and so fast that anything other than sustaining that pace leads to a dampening of year-on-year inflation.

There is a risk that inflation keeps rolling through different sectors of the economy, incrementally adding a layer of higher prices, until the notion that it is 'transitory' begins to look optimistic. The output gap is closing in the US, and wages are rising. There are shortages of workers in a variety of sectors, and wage pressure is building because employees' confidence that they can find a job has surged (see Figure 4) The participation rate tells a similar story: we are just a few months on from the unemployment benefits dropping back to pre-pandemic levels and there is little evidence that people are clamouring to return to work. If statistics like these persist, it is difficult to imagine wages won't continue to edge higher, helping inflation remain elevated.

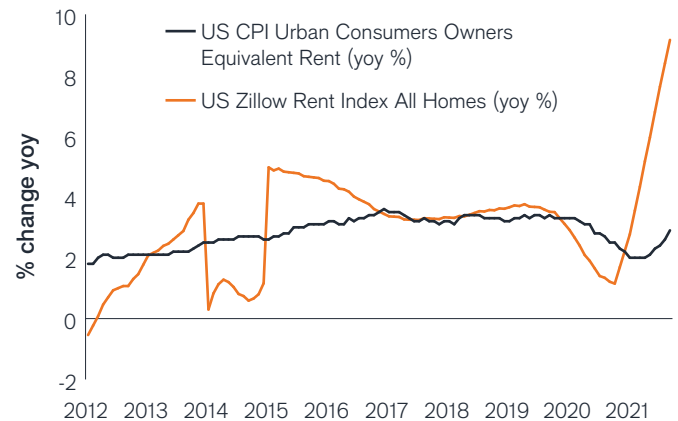
Figure 4: Survey balances of households (jobs plentiful) and companies (jobs hard to fill)



Source: Bloomberg, Conference Board jobs plentiful, NFIB – job openings hard to fill, December 1980 to October 2021.

Similar concerns could be raised about the rise of home prices in the US. Whether it is increased urgency among employees to demand higher wages to afford the same housing, or the fact that rents and owners' equivalent rents make up a substantial portion (around 40%) of the US core CPI index, consensus is currently for home prices to rise further in 2022, so we could see greater-than-expected pressures on inflation from housing.

Figure 5: Rising housing costs could lift inflation further



Source: Bloomberg, US CPI Urban Consumers Owners Equivalent Rent of Residences, US Zillow Rent Index, All Homes, year-on-year change, January 2012 to September 2021.

The current consensus forecasts for US inflation (CPI) are 3.6% in 2022 and 2.3% in 2023, while world inflation is a bit higher next year at 3.5% and more persistent at 2.9% in 2023.⁴ We, roughly, agree with these numbers. But that it is rough is precisely the point. How many basis points higher than expectations must be realised before the market starts to doubt the Fed?

There is talk of stagflation but that seems somewhat misplaced as growth is slowing from high levels not contracting. It is worth being cognisant of downside risks, however, which leads us on to China.

³ Source: Baker Hughes, US rotary rig count has risen to 544 on 29 October 2021, up 248 from a year earlier.

⁴ Source: Bloomberg, Consensus Economic Forecasts, Consumer Price Index, 15 November 2021.

The outlook for China

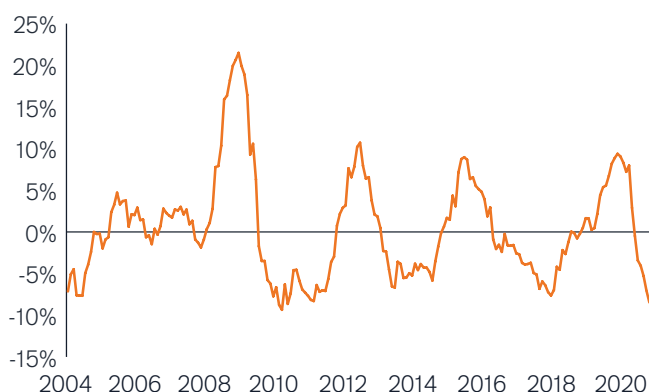
The country that is credited with inventing playing cards has increasingly become an economic wild card. China has led global growth in recent memory, both contributing towards, and benefiting from, globalisation. But as the country changes its approach to support the distribution of wealth, what is best for China may not be as helpful to the global economy as in the past. Could China's policies spoil the low volatility party?

China's economic decisions could influence market movements insofar as, in the short-term, China is integral to the supply chain bottlenecks affecting growth and pushing inflation higher while, in the long term, a China that is not growing rapidly is itself a disruption. For decades, China's export model simultaneously fueled consumption while keeping inflation in check. Likewise, demand from China for US and European goods became an increasingly important part of the business model of these regions' companies.

While China is not at risk of slipping into recession, the difference between steady growth in the high single-digits and the mid single-digits should not be underestimated. For now, the change in outlook for Chinese growth has mostly impacted domestic markets, and high yield issuers (especially in the real estate sector) that borrowed in US dollars. The broader market has assumed that financial contagion beyond the borders will be limited, not least because the Chinese authorities will pursue their goals but not at a pace that creates systemic risk to the financial markets or economy.

Yet slowing momentum in China is concerning. The China credit impulse, which measures the growth in new financing as a share of gross domestic product is firmly in negative territory – it is a key indicator of the business cycle in China. If growth remains subdued, the Chinese authorities may respond with some form of policy measures to stimulate credit growth.

Figure 6: Bloomberg Economics China Credit Impulse

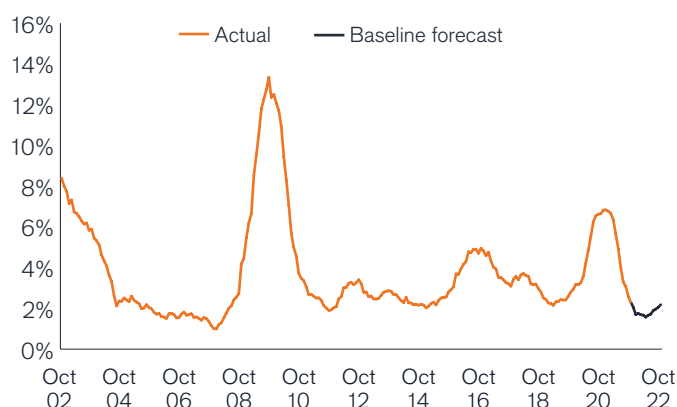


Source: Bloomberg, Bloomberg China Credit Impulse, December 2004 to October 2021.

We still think (less) liquidity will be manageable for bond markets

With central bank balance sheets, such as those of the European Central Bank (ECB) and the Fed respectively around 60% and 40% of GDP⁵, access to capital plentiful and interest rates low (negative on a real basis), you have to think that the central banks at least have the ability, the capacity, to drive markets. At times, such periods of central bank easing and liquidity provision have driven the market more than fundamentals (such as the 2020 pandemic period where the unprecedented intervention helped restore market confidence well ahead of the economic rebound). We wrote last quarter about our outlook for high yield corporate bonds, emphasising the low forecast default rates. When default rates are forecast, as they are now, to be around or below the 'frictional' level – the level which should be expected irrespective of economic conditions – it is hard to argue that liquidity broadly does not play an important role in bond markets.

Figure 7: Global speculative grade default rate remains subdued



Source: Moody's, global speculative grade trailing 12-month default rate (actual and forecast), October 2002 to October 2022. Forecast is baseline forecast at 9 November 2021. Forecasts are estimates and are not guaranteed.

What matters most for markets now is the rate of change and how gradual the process of policy normalisation can be. We think the Fed learned its lesson from the 2013 'Taper Tantrum', and efforts to better communicate its intentions have so far paid off. But its new average inflation targeting framework is somewhat vague, so persistent inflation above target does complicate communication. Moreover, other central banks such as the Bank of England have struggled in recent months to guide market expectations. So while central banks' desire is to be patient, the market may force their hand and the narrative change in response to persistent inflation overshoots. So far, the market's verdict is this requires an earlier start to rate hiking cycles but still ending up at roughly the same destination which is why long-term rates have not moved much higher. We see the risk of a policy mistake or forced tightening as most detrimental to risk assets, but not a central case.

⁵ Source: Yardeni Research, Central Banks: Monthly Balance Sheets, 2 November 2021

It is all TINA's fault (there is no alternative)

While we agree that markets are right on the central case scenario, there is some complacency around the risks, which appear underappreciated. Abundant liquidity, stimulative fiscal policy, strong corporate earnings, the steady demand for yield across the globe – these are all factors that would suggest investors stay long, receive the carry and rolldown, and let profits run. Money does have to go somewhere, and as long as borrowing costs remain low, the capital markets remain a relatively attractive home.

But with real yields significantly negative (the US 10-year real yield represented by US inflation indexed government bonds reached an all-time low of -1.2% in mid-November 2021⁶),

spreads in investment grade corporates near the lows, and volatility having little room to go lower, the impact of a shock – a surprise – could be significant, at least in the short term. While we believe that building diverse portfolios can help insulate a portfolio from surprises, and active management is designed to respond to change quickly, we are and will continue to monitor the dynamics of growth and inflation in the US, the developed world, and in China particularly.

Our base case is that the Fed is right to buy time, as inflation is likely to prove 'impermanent', but the market has done no harm in nudging central bankers away from their ultra-accommodative positions.

The Fixed Income Investment Strategy Group (ISG) brings together investment professionals from across the global fixed income platform and other Janus Henderson teams, providing a forum for debate around the fixed income asset class and the key drivers of the markets. The ISG Insight seeks to provide a summary of recent debate within the group.

⁶ Source: Bloomberg, generic inflation indexed US 10-year government bond yield, at 9 November 2021.

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