Janus Henderson INVESTORS

Inflation dilemma: where now for central banks and fixed income?

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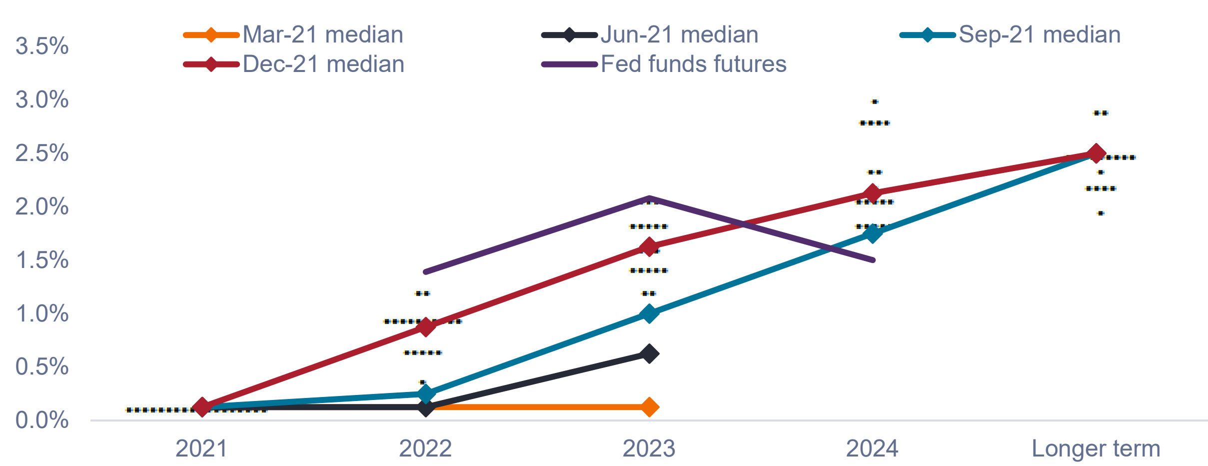
With inflation at decade highs, central banks are caught between responding to current realities and trying to predict where inflation and the economic environment will be in the medium term. In this paper, Jim Cielinski, Global Head of Fixed Income, considers the potential pitfalls and impact on fixed income. Key areas covered include:

- The trajectory of change as central bankers doubt their own “transitory” story, plus the growing divergence at policy level.
- The potential for policy error as economies adjust to the tailwind from reopening but face offsetting headwinds from fiscal drag, a squeeze on real incomes and growing cost pressures on corporates.
- The potential implications for rate sensitive and riskier credit assets.

A change of direction

As the Prussian military strategist Helmuth von Moltke (the elder) noted back in the 19th century, “no plan survives contact with the enemy.” For central banks grappling with high inflation, their expectations and policy actions have had to undergo a sharp revision. Only a year ago at its March 2021 meeting, the US Federal Reserve (Fed) was still predicting no rate rises in 2023, let alone in 2022, according to the median of the dot plot of Fed officials’ projections. In the most recent dot plot (December 2021 shown below) the Fed was suggesting three rate rises in 2022 and we would expect this to adjust higher in the Fed’s March 2022 meeting. The Fed’s volte-face has been exceeded only by that of the market, which on 10 February 2022 – immediately after the 7.5% US consumer price index (CPI) print – was predicting nearly seven hikes of 25 basis points by the Fed this year.[1] Taking the current Fed Funds futures as a proxy for the market, expectations are that the Fed will accelerate tightening this year but will be easing by 2024.

Figure 1: Fed dot plot median projections



Source: Bloomberg, US Federal Reserve, 28 February 2022 [1]Source: Bloomberg, World interest rate probability, 10 February 2022.

FAIT Accompli

It seems bizarre that the Fed should engage in quantitative easing in February, when US CPI inflation is above 7%, yet simultaneously prime the market for an interest rate rise in March to quell the same inflation. The Fed is in a trap of its own making. Its move to Flexible Average Inflation Targeting (FAIT), unveiled back in August 2020, meant the Fed was prepared to tolerate above-average inflation to balance out periods of below-average inflation. Hence much of 2021 was spent discussing ‘transitory’ inflation as the Fed was convinced that the inflation in the system was largely a result of the extraordinary demand and supply disruption brought about by COVID. Low inflation in 2020, together with expectations that inflation would come back down in a couple of years’ time provided room for this measured approach to removing monetary policy accommodation.

We were warned that the Fed would tolerate higher inflation and there are some useful trade-offs. After the period of COVID-related disruption, a bout of inflation allows companies some cover in pushing through price rises to help offset losses in recent years. Second, higher prices encourage supply and curtail demand, helping to speed up a return to equilibrium in markets that have become out of balance. Third, it reduces the real value of fixed-rate debt – convenient given that corporate and government borrowing soared during the pandemic.

Countering this is the rising cost of living, which tends to have an outsize impact on lower earners given the current propensity for inflation to occur in non-discretionary items such as food, energy and rent. Second, it pushes up costs for businesses, which if they are unable to pass these on fully to end customers will ultimately hurt earnings and may necessitate higher levels of working capital. Third, floating rate debt will become more expensive for households, corporates and governments. Countries such as the UK, with a high proportion of index-linked government debt (21% at end Dec 2020)[2] are more vulnerable to this latter point.

Everything in moderation. For economies, a little inflation is arguably more attractive than a little deflation since gently rising prices encourage consumption. Too much inflation, however, and the costs outweigh the benefits, which is why central banks have convened around a rule of thumb of an acceptable level of 2% year-on-year inflation. As inflation continued to pick up, markets became convinced that the Fed was behind the curve and would ultimately have to shift position.

Who’s behind the curve?

Markets do not wait. They have essentially front run the Fed, pricing in tighter financial conditions before the central bank has undertaken an actual hike. This is evident across rates markets where yields on short-dated debt have climbed rapidly in recent months, mortgage rates have gone up sharply and credit spreads have widened on concerns around potentially weaker growth and lower liquidity.

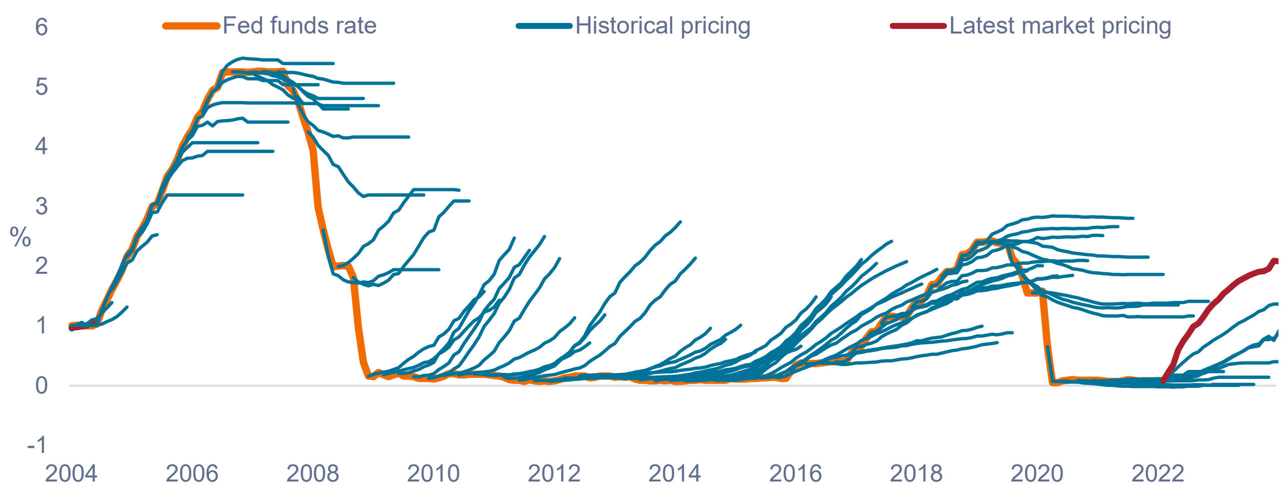
Figure 2: Market moves table

Index	30 Jun 2021	31 Dec 2021	Current (28 Feb 2022)
2-year US Treasury yield %	0.24	0.66	1.42
10-year US Treasury yield %	1.44	1.50	1.85
30-year US mortgage interest rate %	3.02	3.11	3.89
Credit spread BBB rated US Corp (bps)	107	121	160
Credit spread B rated US Corp (bps)	349	351	411

Source: Refinitiv Datastream, Benchmark US 2-year and 10-year Treasury yield, redemption yield; Freddie Mac 30-year mortgage rate; ICE BofA US BBB Corporate Index and ICE BofA US B High Yield Index, credit spread = option adjusted spread over government (Govt OAS) in basis points. Basis point (bp) equals 1/100 of a percentage point. 1 bp = 0.01%, 100 bps = 1%, at 28 February 2022.
[2]Source: HM Treasury Debt Management report 2021-22, March 2021

A meatier question now is whether the market is correctly gauging the level of tightening. Historically, markets were too eager to price in rate hikes in the period after the financial crisis, which helps explain why they initially supported the transitory story. Yet in both of the last two tightening cycles the market underpriced the extent of rate rises once the Fed got into its tightening stride. Having arguably been behind the curve, the Fed may seek to make up time. The market already views the December dot plot as out of date and sees the Fed taking the Fed funds rate close to 1.5% at end 2022 and above 2% by end 2023 but predicts that by late 2024 the Fed will be reversing course and cutting rates again.

Figure 3: Fed funds rate and historical forward pricing



Source: BofA Global Research, Janus Henderson Investors, Bloomberg. Historical pricing lines indicate market expectations for Fed funds rate over next 24 months. Latest market pricing at 28 February 2022 showing Fed futures pricing to 31 December 2023. Market pricing may vary and forecasts are not guaranteed.

So where do we stand?

We were in the transitory camp, albeit expecting inflation to rise more sharply than the Fed's projections and be stickier. We adjusted our thinking in light of a number of factors. It was clear that rising rent costs were likely to see US CPI remain elevated. Commodity prices remain stubbornly high and the conflict in Ukraine is likely to exacerbate high energy prices, which, as a key input cost, affects costs elsewhere in the economy.

Although the conflict is likely to depress risk assets the concern surrounding high inflation is likely to dominate, even though we expect inflation to peak in the next few months. In the very near term, central banks will be keen to be seen to be doing something, hence their hawkish pivot. With inflation high and unemployment low, for the Fed to pivot again and not raise rates in March would, in our view, be too damaging to its credibility to be countenanced. If not now, when? The Bank of England and Reserve Bank of New Zealand are already ahead of the Fed among developed markets in raising interest rates. Emerging markets are even further down the tightening path as highlighted in our research piece "*Divergent Emerging Market outcomes in an uneven recovery*", which is on the *Insights* section of our website. China is the major exception here, which appears to be seeking to relax credit restrictions, having induced a sharp slowdown in property markets last year. The European Central Bank (ECB) continues to have to balance the needs of economies in different stages of growth. While inflation is a concern across the Eurozone, the developments in Ukraine and the high energy costs across Europe mean the ECB may be reluctant to penalise the economy with higher financing costs, so rate rises may remain off the agenda for 2022.

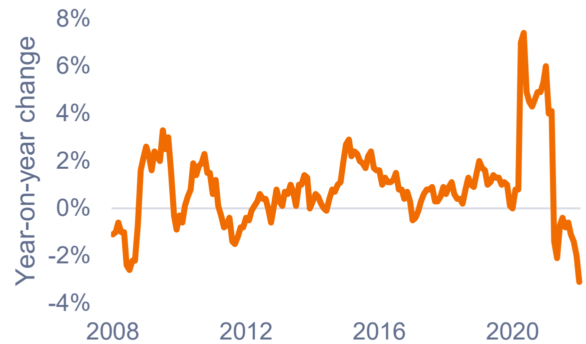
Inflation remains a tax on the economy, however, so we have some misgivings about the future strength of the global economy. We think declining inflation later in 2022, as base effects work through, together with evidence of growth slowing, may encourage the Fed and others to row back on their hawkish rhetoric. We would not be surprised to see medium-term government bond yields falling back later in the year. In fact, it is typically in advance of or around shifts in central bank rhetoric, however slight, that active investors can look to exploit mispricing.

Jobs-a-plenty but real wages are going nowhere

The Fed and other central banks are keen to prevent a wage price spiral in which inflation becomes engrained into price setting and wage demands. The jobs market is strong and wage growth has risen but it is failing to keep pace with inflation more broadly. If workers are not feeling better off – and declining wealth effects from falls in asset markets may aggravate this – it is difficult to envisage economic growth motoring, especially with the fiscal impulse from government spending moving to a fiscal drag.

Figure 4: US job openings rate and Employment Cost Index

Figure 5: US real average weekly earnings



Source for Figure 4: Bloomberg, Bureau of Labor Statistics, US Job Openings Rate and Employment Cost Index, 31 December 2006 to 31 December 2021. Note, the job openings rate is computed by dividing the number of job openings by the sum of employment and job openings and multiplying that quotient by 100 to reach a percentage figure. The employment cost index measures changes in employee compensation costs (wages, bonuses, and benefits in kind) as well as indirect cost such as social security contributions, medical benefits, taxes etc.
Source for Figure 5: Bloomberg, Bureau of Labor Statistics, US real average weekly earnings, % change year-on-year, seasonally adjusted, January 2008 to January 2022.

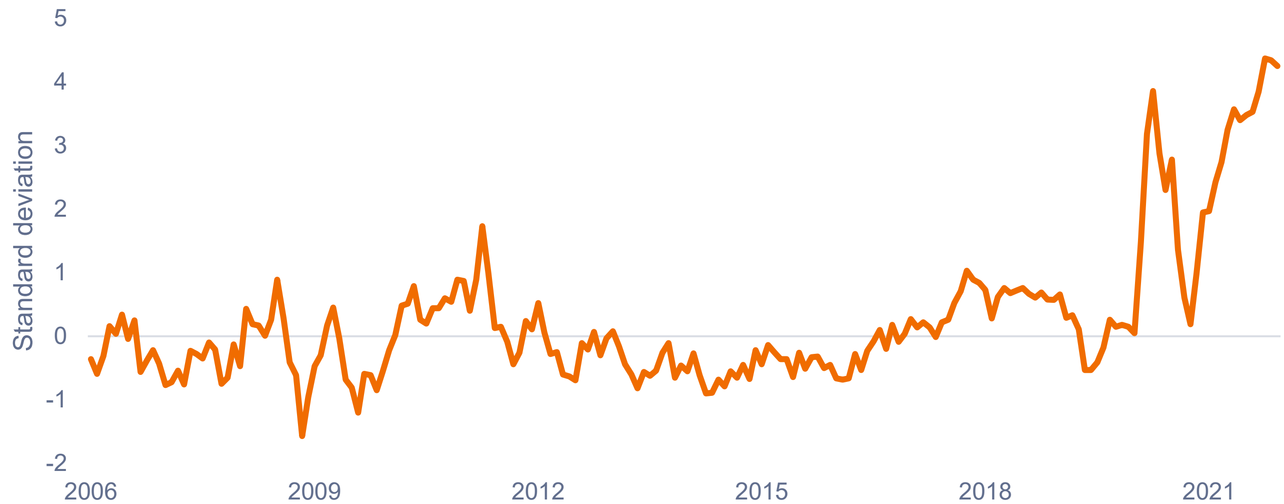
Consumer sentiment in the US, the UK, the Eurozone and China has been weakening. While some of this can be linked back to COVID restrictions there are other factors at work, not least the rising cost of living. Last year, US households were still receiving stimulus checks. Most of these have been spent. Government spending as a proportion of GDP is set to fall as countries seek to rein in borrowing. It is still not clear that US President Biden's Build Back Better Act will pass Senate approval and, even if it does, it is set to be at a much lower level than was first envisaged. Inventory build was a key driver of growth in the final quarter of 2021 and could prove to be a drag in the first quarter of 2022. In the UK, personal taxes are rising. Taken together, these factors, alongside the Russia-Ukraine conflict, may counter some of the positivity expected from economies emerging from COVID restrictions.

Supply chain pressures

Supply chain problems were alleviating, but only slowly. As shown by the new New York Fed Global Supply Chain Pressure Index, there was hope that issues peaked out late last year. The Baltic Dry Index that measures cost shipments of raw materials has been falling but Harpex indices on cost of freight containers remain elevated. With COVID fading as a threat in the West but still a concern within Asia, supply chain problems are expected to persist. Added to the uncertainty is the Russia-Ukraine conflict. These two countries are key players in energy, metals, grain and fertiliser markets. Beyond the immediate disruption caused by the conflict, should sanctions tighten further or Russia elects to restrict exports this could create fresh challenges.

Pressures on supply chains can moderate quickly, as they did between August and October 2020 after the first COVID lockdowns were eased (see Figure 6), but extended disruption means reductions in supply pressures may be less rapid in future. Supply chain pressures are contributing to inflation, but central banks should recognise that interest rates are a blunt instrument to deal with supply costs, since they can only affect the demand side of the equation.

Figure 6: New York Fed Global Supply Chain Pressure Index



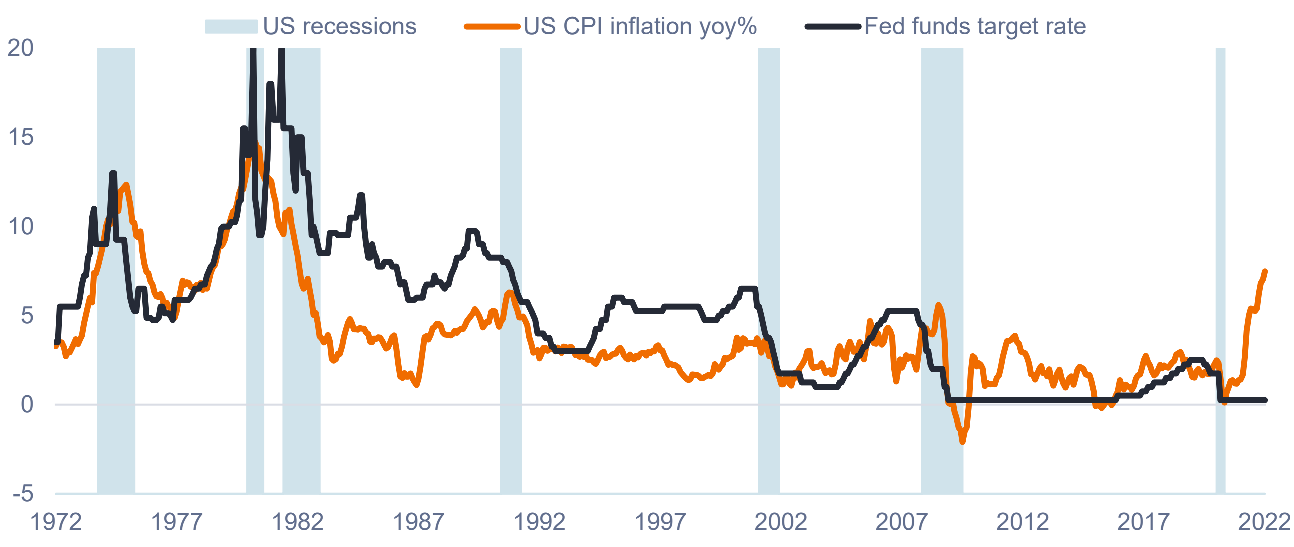
Source: New York Federal Reserve, Bloomberg, January 2006 to December 2021.

The overall outlook for the global economy in 2022 is therefore looking more clouded and that is before the lagged impact of higher financing costs. So are we at risk of a policy error?

Triggering a recession?

Central banks were keen to let the recovery from COVID become embedded, even if that meant accepting higher inflation. The concern now is that central banks, having been behind the curve and potentially over eased, risk whipsawing the economy by tightening too aggressively and tipping the economy into recession. It is a careful balancing act made trickier by the uncertainty surrounding the Russia-Ukraine conflict. As things stand, with inflation concerns still dominant, outside of a major escalation it is hard to see the conflict deflecting developed market central banks away from tightening. As the following chart shows, past combinations of inflation and higher interest rates have typically not ended well, although the economy can grow for extended periods under these conditions. It would be unusual to enter a recession so soon after a previous one, although the early 1980s proved the exception to the rule.

Figure 7: US inflation, rates and recessions



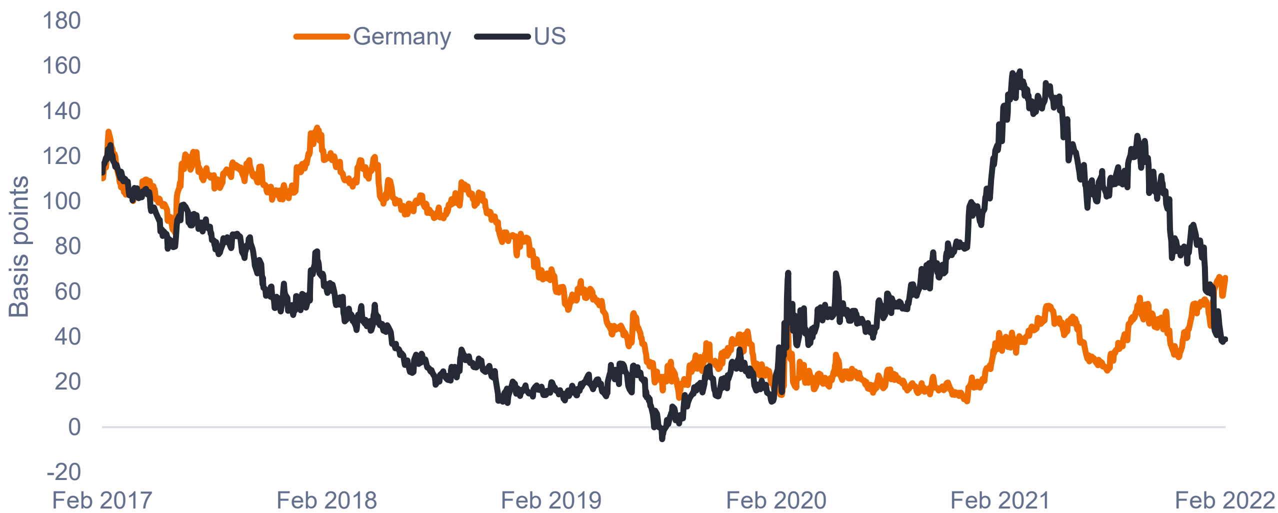
Source: Janus Henderson Investors, Bloomberg, 31 January 1972 to 31 January 2022. Shaded areas reflect US recession periods as depicted by the National Bureau of Economic Research.

Markets are nervous that the Fed will overtighten. The flattening of the yield curve in the US as short-term rates rise yet medium to long-term rates remain relatively unmoved or fall suggests bond markets lack conviction that the Fed will be able to hike towards its long-run equilibrium rate of 2.5%. We suspect the neutral rate – that is the rate consistent with full employment, trend growth and stable prices ie, neither accommodative nor restrictive - is lower than 2.5%, not least because of the higher weight of debt in the system.

Yield curve flattening – not everywhere

It is easy to take a US-centric view of the world. While the US yield curve has flattened markedly, the yield curve in Germany is the steepest it has been in three years. This reflects the view that the ECB will hold off raising rates in 2022. Tightening – or less easing – within the eurozone is to be pursued first though the winding down of asset purchase programmes, although weakness in money supply growth might lead the ECB to postpone the scaling back of quantitative easing.

Figure 8: Yield curves are steepening in Germany, while falling in US
Difference between spread on 2-year and 10-year government bond



Source: Bloomberg, Spread differential between 2-year and 10-year government bonds, 28 February 2017 to 28 February 2022.

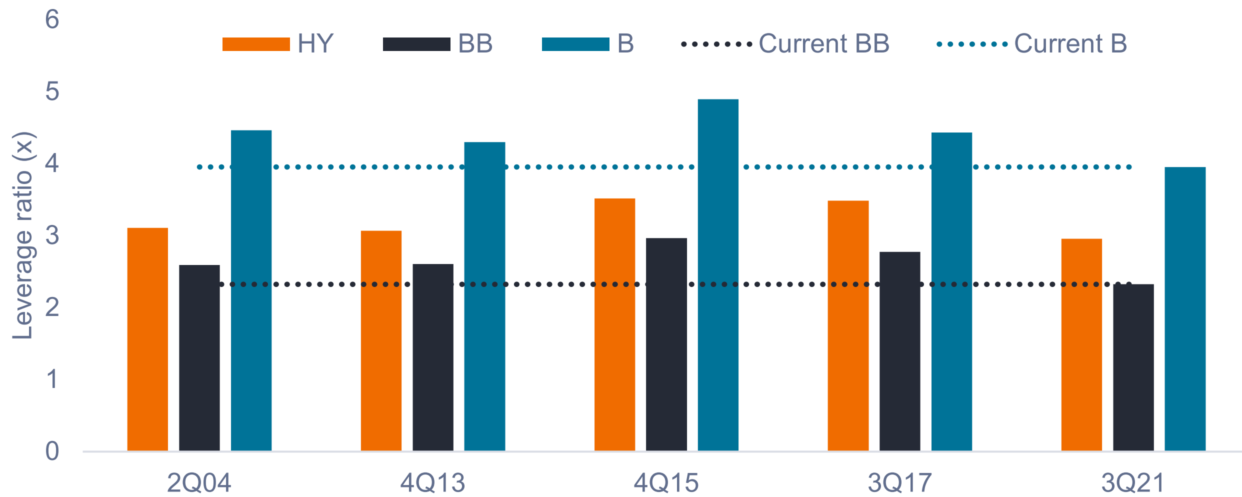
The front end of the yield curve in the US is therefore beginning to look compelling, particularly if our view that weaker growth and inflation falling from its peak prompts a reassessment of the pace of central bank tightening. The minutes of the December 2021 Fed policy meeting also alluded to how reductions in the Fed's balance sheet (quantitative tightening) could potentially be used in parallel with changes in interest rates to limit yield curve flattening during policy normalisation. We expect to get more information at the March policy meeting on if and when balance sheet reductions might commence but, for now at least, we think decisions on US quantitative tightening remain relatively insulated from the Russia-Ukraine conflict.

Credit perspective

Credit fundamentals remain robust. Earnings for the most part have been strong and the outlook for defaults remains low. Yet credit spreads have widened. This potentially reflects less confidence in growth in the future. Earnings may not be at a peak but earnings growth is clearly slowing. Guidance from companies has been less bullish in the most recent round of quarterly reporting as cost pressures build. Geopolitics will have played a role but so too might nervousness around central banks potentially choking off growth.

European credit spreads have widened more than US spreads.[3] This arguably reflects more uncertainty around the implications of the Russia-Ukraine conflict given the greater economic links between Russia and Europe and the commensurate pain that sanctions levied on Russia will impose on European companies. Interestingly, from recent lows, as a proportion of starting spread, the widening in credit spreads has been relatively more significant in investment grade than in high yield.[3] This can partly be explained by investment grade's initial tightness but also the composition of markets, with high yield's higher weighting to energy helping to dilute the pain. High yield enters the current tightening cycle with historically low net leverage (debt as a multiple of earnings before interest, tax, depreciation and amortization). But we need to be mindful that if costs cannot be passed on then net leverage could begin to rise again if earnings fall.

Figure 9: US high yield net leverage never been lower entering a recent tightening cycle



Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ, 2004 = rate rise, 4Q13 = taper, 4Q15 = rate rise, 3Q17 = quantitative tightening, at 21 January 2022.
[3]Source: Bloomberg, ICE BofA US Corporate Index, ICE BofA Euro Corporate Index, ICE BofA US High Yield Index, ICE BofA Euro High Yield Index, Govt OAS, spread movements during six months to 28 February 2022.

In the near term, floating rate securities may offer a more attractive investment, but investors should be mindful that over the longer term, higher rates bring greater credit risk to companies with high levels of floating rate debt.

SUMMARY

The tragic Russia-Ukraine conflict should not greatly alter the policy path of central banks. Inflation concerns will continue to dominate, ensuring that the tightening actions that have been clearly signalled in recent months are delivered. Yet we believe that softer growth as the year progresses will lead to a climbdown in some of the hawkish rhetoric.

- Central banks have been behind the curve but risk trouble ahead for the economy if they overtighten in the face of weaker growth.
- Geopolitical risk tends to stabilise quickly and outside of directly involved countries and companies should not leave a lasting risk premium on assets.
- We believe value is starting to emerge in rates, particularly at the front end of the US yield curve if we are correct in our assessment of the economy.
- Wider credit spreads are creating pockets of value, but growing indications that central banks are shifting rhetoric again should offer a stronger buy signal.

IMPORTANT INFORMATION

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