Janus Henderson INVESTORS

WHAT GOES UP MUST COME DOWN

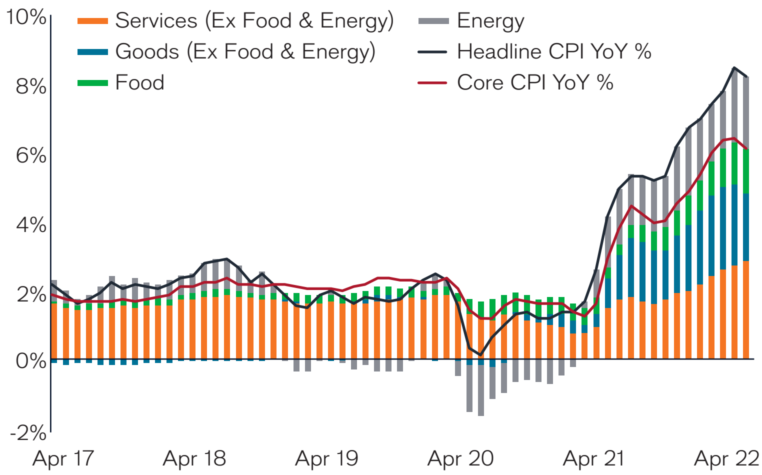
Markets have fastened on to some dramatic headlines in recent months, having to absorb both geopolitical risk from the fallout of the Russia/Ukraine conflict and policy risk as central banks contend with high inflation. It is little wonder that the first quarter of 2022 was the most difficult start for fixed income markets since the 1990s. Yet most headlines are predicated on what happened rather than what will happen. With central bankers looking at lagging indicators, is there a risk of policy error and how might markets respond?

It cannot be comfortable for central banks when inflation is at the higher end of single figures in the US, the UK and the eurozone. Least of all when the ultra-accommodative actions they took to help businesses and households through COVID are being partly blamed for the higher prices. Central banks need to uphold their credibility and that means reminding the public that they have not gone soft on inflation.

The US Federal Reserve (Fed), in particular, has been behind the curve and is now keen to catch-up with an accelerated programme of rate rises (the June and July meetings are pricing in 50 basis points hikes) and quantitative tightening (moving towards shrinking the balance sheet by around US$95 billion a month – almost double the pace of the last round in 2018).

Markets have priced in this rapid tightening but see the Fed having to pause in 2023 and backtrack with cuts. The fact that the widely followed 2s10s curve (which shows the differential between the yield on the US 10-year government bond minus the yield on the 2-year government bond) turned negative temporarily in early April was an ominous sign. It has inverted prior to every one of the last 10 US recessions, typically with a lag of 9-24 months. The surprise, therefore, may not be in the fact that the Fed has to cut at some point but that the market isn't pricing it in earlier. We think something will have to give.

Figure 1: Fed is hiking as US inflation eases



Source: Bloomberg, Burea of Labor Statistics, April 2017 to April 2022. CPI = Consumer Price Index.

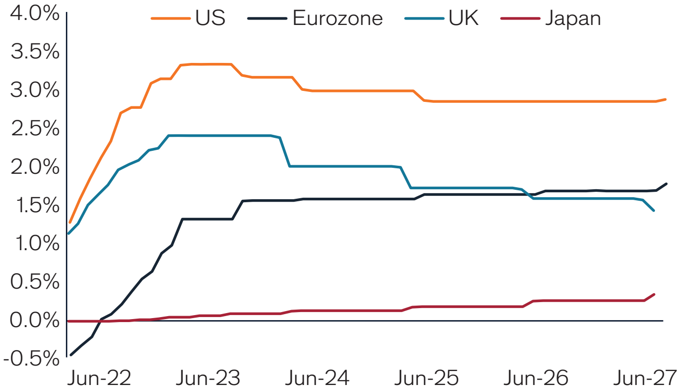
KEY TAKEAWAYS

- Hopes of a gradual glide path after policy tightening are at odds with history where the US Federal Reserve tends to hike and then cut sharply. There is little to suggest this will be an outlier.
- Central bankers will be impervious to pain for most of 2022 as they seek to burnish their inflation fighting credibility. Tighter financial conditions and a real income squeeze, however, mean recession risks are mounting and the global slowdown should ultimately precipitate a shift in policy.
- Central banks are embarking on bringing down the size of their balance sheets through quantitative tightening but are markets ready for this adjustment?
- A dichotomy exists between rates markets and risk assets. Equities and credit are only partially reflecting downturn risks but can this be justified by still-strong fundamentals?

A mixed glide path

Projections are for interest rates to remain in the ascendant. Figure 2 provides a snapshot of market expectations in early May. Rates are expected to rise across most developed market central banks, although Japan appears to be the holdout in terms of retaining policy close to the zero bound for longer. They are then expected to hold at more elevated levels before, in the case of the US and UK being gradually reduced.

Figure 2: Market interest rate projections differ globally

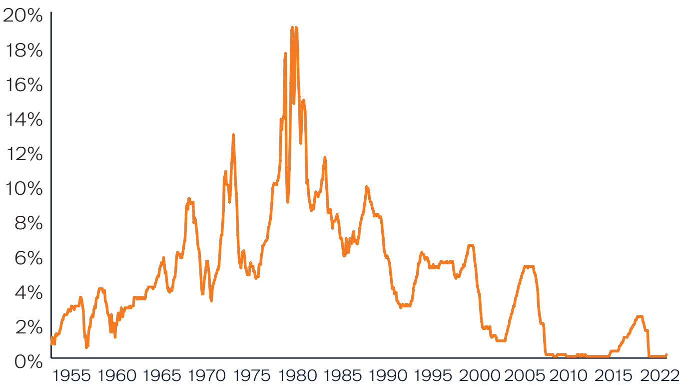


Source: Janus Henderson Investors, Bloomberg, as at 9 May 2022. Forecasts based on overnight indexed swaps (OIS) pricing of 1-month forward rates. Estimates may vary and are not guaranteed.

It is actually rare for the Fed to stand pat after hiking rates. More commonly, the central bank keeps tightening the screw until economic participants begin to squeal. No pain, no gain, so to speak. At which point, the bank begins to bring rates down again. This was especially true during the more inflationary periods in the decades leading up to the 1990s.

Figure 3: Rates rarely plateau for long at the top

Federal funds effective rate



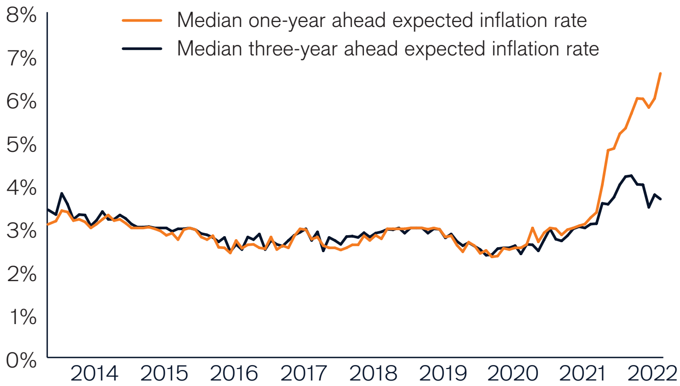
Source: Federal Reserve Bank of St Louis, FRED, federal funds effective rate, January 1955 to March 2022.

We do not dispute that the Fed is laser-focused on fighting inflation. There is an ardent desire to prevent inflation expectations from becoming entrenched. It is also a convenient foil for retooling the monetary armoury. When people see prices rising around them, they are more likely to be persuaded that something must be done and less likely to criticise the rate hikes. Better to go into the next slowdown with something to cut.

Where we struggle more, is whether the current trajectory of rate hikes can be met. While current headline inflation numbers are not pretty, inflation expectations themselves looking three-years out remain reasonably contained according to the Fed's own survey.

Figure 4: Concerns today, calm tomorrow?

Expected inflation rate



Source: Survey of Consumer Expectations © 2013-2022 Federal Reserve Bank of New York (FRBNY).

The survey is based on a rotating panel of 1,300 households so arguably offers as good a snapshot as any of consumer opinion. Yet it is possible that consumers are exhibiting 'recency bias', so their near-term experiences of higher inflation lead them to expect more of the same but they are still reluctant to accept a longer-term uplift in inflation, i.e. they may be slow to adapt.

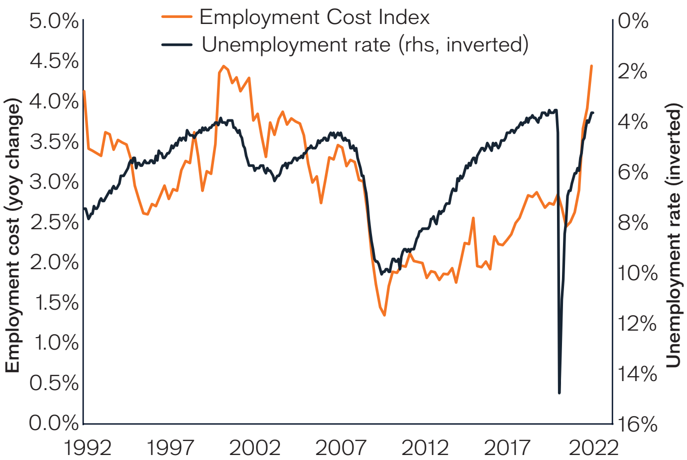
And who can blame them when there are so many unpredictable factors causing pressure on prices and supply chains, including the Russia/Ukraine conflict and zero-COVID policies in China. While a resolution in both could rapidly ease costs, these recent disruptions underscore broader concerns precipitated by the COVID pandemic and increased geopolitical tensions. Both countries (for national security reasons) and companies (adopting additional just-in-case inventory as opposed to minimal just-in-time inventory and more localisation of manufacturing) are contributing to a reconfiguration of supply chains. This builds additional cost into the system.

Base effects, however, mean inflation should begin to turn down sharply as the year progresses. For example, used car prices in the US are already showing signs of peaking and the oil price while higher than last year is down on the pace of change the previous year. The deceleration in the rate of change of several key inputs should see inflation turn down this year but the overall level may remain above the Fed's target of 2%.

A key factor here is labour costs and the dynamic between inflation and employment levels. The challenge here is that employment statistics are typically lagging indicators so basing decisions off these figures can be akin to driving by looking in the rear-view mirror.

There is an assumption that inflation has become less sensitive to changes in unemployment, supported by the experience of the past decade which was one of declining unemployment but fairly contained wage growth. In the parlance of economists, the Phillips curve – which plots wage inflation on the vertical axis against unemployment on the horizontal axis – appeared to have flattened. Since COVID, however, there has been a rapid fall in unemployment but a sharp increase in wages.

Figure 5: Low unemployment in the US is feeding into wage growth



Source: Refinitiv Datastream, US unemployment rate, Employment Cost Index, Bureau of Labor Statistics, April 1992 to April 2022.

Partly, this was due to some workers voluntarily leaving the workforce, shrinking the available pool of labour, but also the disruption to service sectors meant many people found jobs in alternative sectors. Employers in key industries such as travel and hospitality are finding it tough to recruit as economies reopen fully from lockdowns – witness the 'staff wanted' signs on local high streets.

This is a concern for central bankers as wage growth is the principal mechanism through which higher inflation becomes embedded. The tough policy tightening talk from central banks is, therefore, deliberately designed to engineer a slowdown but will this be a soft(ish) landing or a recession?

Figure 6 shows the Fed has a mixed record in engineering a soft landing but scepticism towards them being able to achieve this may be unfounded as it has been possible in the past. Somewhat ominously, the 1973-4 and 2008 recessions (incidentally both known as the 'Great Recession' to contemporaries) have some echoes with today. The early 1972-4 rate rises attempted to correct for the big fiscal stimulus ahead of Nixon's re-election and shocks from higher food and oil prices, while the mid-2000s tightening sought to cool a hot housing market. Where we see clear differences with the 1970s, however, is that broad money growth grew strongly for sustained periods in the 1960s and 1970s as opposed to a temporary spike in 2020-21 that is fast coming down, which should help to temper inflation over the coming year.

Figure 6: Soft landings are possible just not probable

Tightening period	Δ RFF (bps)	NBER first recession month	Real GDP drop	Comment
Sep 1965 – Nov 1966	175	---	None	slowdown in 1966
July 1967 – Aug 1969	540	Jan 1970	-0.6%	3 of 5 negative Qs
Feb 1972 – Jul 1974	960	Dec 1973	-2.7%	5 of 7 negative Qs
Jan 1977 – Apr 1980	1300	Feb 1980	-2.2%	2 of 2 negative Qs
Jul 1980 – Jan 1981	1000	Aug 1981	-2.1%	4 of 6 negative Qs
Feb 1983 – Aug 1984	315	---	None	strong growth
Mar 1988 – Apr 1989	325	Aug 1990	-1.4%	2 of 2 negative Qs
Dec 1993 – Apr 1995	310	---	None	perfect soft landing
Jan 1999 – Jul 2000	190	Apr 2001	-0.1%	2 of 3 negative Qs
Jun 2004 – Jun 2006	425	Jan 2008	-3.8%	5 of 6 negative Qs
Oct 2015 – Jan 2019	225	March 2020	-10.1%	2 of 2 negative Qs

Source: 'Alan Blinder on Landings Hard and Soft: The Fed, 1965-2020', Princeton University, Bendheim Center for Finance, NBER, 11 February 2022.
ΔRFF= change in the federal funds rate. --- means no recession.

Is the UK the canary in the coal mine?

The UK started on its rate tightening journey earlier than the Fed but is expected to tighten more moderately. This appears to reflect growing concerns about the strength of the economy and greater acknowledgement by members of the Bank of England rate setting committee that economic data will disappoint. Trade challenges from Brexit and a domestic energy market that is heavily reliant on fluctuating gas prices have fostered unique challenges for the UK but the issue of squeezed real incomes is common to all countries.

This makes the strong consumption numbers in the US first quarter GDP something of a surprise. While overall GDP contracted due to a fall in stock building (something we warned about last year) and a big drag from net trade as exports fell and imports swelled, consumer spending remained buoyant as did business investment.

Given many consumers are still making the most of new-found freedoms post Covid and benefited more in the US from stimulus cheques, it is possible that the high inflation has not yet altered consumer behaviour, although this does seem to be at odds with the apprehension exhibited in the weak University of Michigan Consumer Sentiment Index.

Trying to disentangle this is a complication for the Fed. Given monetary policy tends to act with a lag, the relative strength of consumption may simply reinforce the desire to front-load tightening to dampen aggregate demand.

Markets are beginning to reappraise the growth outlook in light of the central bank tightening, the collapse in household real incomes and the potential cost pressures on companies. In our view, the forecasts still look optimistic.

Figure 7: Real GDP growth by region could be revised down further

	Economic growth %			90-day revisions (%)	
Region	2021	2022F	2023F	2022	2023
World	5.8	4.0	3.5	-0.4	-0.1
Developed	5.2	3.3	2.4	-0.6	-0.1
Emerging	6.5	4.2	4.6	-0.7	-0.2
US	5.7	3.4	2.3	-0.5	-0.2
UK	7.2	3.9	1.8	-0.9	-0.4
Eurozone	5.2	3.1	2.5	-1.1	0.0
Japan	1.7	1.7	1.7	-0.6	0.3
China	8.1	5.0	5.2	-0.2	-0.1

Source: Janus Henderson Investors, Bloomberg consensus forecasts, as at 5 April 2022. F indicates forecast. Forecasts are estimates, may vary over time and are not guaranteed.

Bringing balance sheets down

A more marked economic slowdown and inflation peaking could make policymakers pause, but otherwise they will press on with tightening. The growth numbers after all remain positive so it makes sense for central banks to remove emergency policy accommodation. Exiting ultra-low interest rates is one method, the other is to stop expanding their balance sheets through net asset purchases (quantitative easing) and shift to shrinking them (quantitative tightening). Buying securities outside their normal repo and currency supply operations is not their natural remit and central bankers are keen to bring their balance sheets to a more natural size.

Everybody's doing it.

The past year has seen a sea-change in policy, with many of the major central banks moving from quantitative easing (QE) to quantitative tightening (QT), although how they go about it differs. One way is to approach this passively by allowing maturing bonds to roll off the balance sheet (and mortgage-backed securities where applicable to be paid down) without being reinvested. The other is to actively sell securities to accelerate the pace of the run-off. The following provides a snapshot of what has been announced, with some taking conditional approaches, others phased and others more accelerated. The direction of travel, however, is clear.

Figure 8: Key central banks on the move

- **Australia** – Reserve Bank of Australia (RBA) aggressively expanded its QE programme in 2020/2021, tripling the balance sheet to A$620 billion, 28% of GDP.
  - RBA ceased these purchases on 10 February 2022 and in May announced the end to reinvestments, which should result in a slow decline of the balance sheet of around A$14.5bn and A$37.5bn in 2023 and 2024 respectively.

- **Canada** – The Bank of Canada QE programme ended on 27 October 2021, reinvestment of maturities ceased on 25 April 2022; holdings of government bonds and mortgage bonds amount to 18% of GDP, 50% of which should roll off in the next three years.

- **US** – The Fed's balance sheet reduction is primarily via adjusting the amounts reinvested of principal payments, initially with a cap of $30bn Treasury/$17.5bn mortgage-backed securities (MBS) for June, July and August, moving to a cap of $60bn Treasury/$35bn MBS thereafter. Balance sheet size is 38% of GDP. $1 trillion should roll off each year, around 11% of total.

- **UK** – The Bank of England has total bond holdings of £867bn, 40% of GDP.
  - BoE will actively sell its holdings of £20bn of corporate bonds, commencing September 2022 and to complete by early 2024.
  - BoE ended reinvestment of gilt proceeds when bank rate hit 0.5%; August meeting is expected to include an update on pace of active sales now that bank rate has hit 1%. Gilt maturities alone would lead to £125bn maturing over the next three years.

- **New Zealand** – The Reserve Bank of New Zealand will actively sell bond holdings via the New Zealand Debt Management Office to the tune of N$5bn per year from July onwards.

- **Eurozone** – The European Central Bank (ECB) is currently engaging in tapering of QE rather than QT. Its balance sheet amounts to 70% of eurozone GDP.
  - Pandemic Emergency Purchase Programme (PEPP) ended in March 2022, reinvestments will continue until at least the end of 2024.
  - Asset Purchase Facility (APP) is still purchasing bonds but recently accelerated the pace of tapering to €40bn in April, €30bn in May and €20bn in June 2022. Net purchases are expected to end in Q3 but will be data-dependent.

- **Japan** – The Bank of Japan is committed at the moment to keep Yield Curve Control, which it has used since September 2016. While it has faced pressure to widen this band, the central bank has over time slowed its purchases as the amount of bonds required to keep rates low has declined, but its balance sheet still amounts to 134% of GDP.

Source: Central bank websites, Janus Henderson Investors, Bloomberg, Bank of America, as at 9 May 2022. Balance sheets as a % of GDP at 30 April 2022, Policy decisions above may be subject to change.

> "Ceasing purchases under the bond purchase program does not imply a near-term increase in interest rates."
>
> **Philip Lowe, Governor, Reserve Bank of Australia**

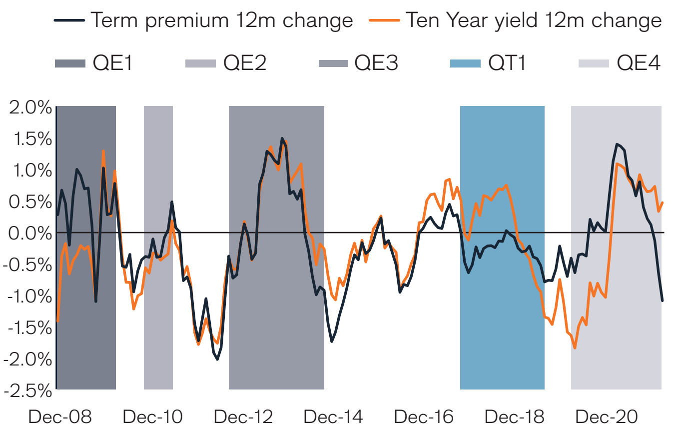
In the rhetoric around quantitative tightening, central bank governors were keen to make a distinction between hiking rates and quantitative tightening, as different tools in the armoury. Both are directed at a similar outcome in seeking to tighten financial conditions so one might assume that the impact of QT on the economy would be the opposite of QE. Yet there is asymmetry in signalling: QE meant rates would be lower for longer but QT does not mean more hikes for longer. In fact, if QT tightens financial conditions it can potentially negate the need to hike as much.

Contradictory signals

But does QE and QT work in the way we intuitively think it would? Data suggests the contrary. Intuitively, one might expect QT to lead to a steepening of the yield curve given that QE artificially keeps the term premium flat by depressing long-term rates. In the very short term, this may ring true. When the ECB announced a tapering of QE on 16 December 2021 there was a subsequent steepening of the curve, as the gap between the German 2-year and 10-year bond yield widened, but the impact was much more muted around March 2022 when accelerated tapering was announced. In contrast, the Fed's announcement of tapering in November 2021 had the opposite effect, with the 2s10s narrowing, although trying to extract this narrowing from a general expectation that rates were heading up is difficult.

Taking the US 10-year Treasury as the key example, it would appear that far from lowering term premia and rates, QE corresponded with them rising.

Figure 9: QE appeared to push rates and premia up



Source: Janus Henderson Investors. Federal Reserve Bank (FRB) of New York, December 2008 to March 2022. The Treasury term premia are estimates derived by New York Fed economists Tobias Adrian, Richard Crump and Emanuel Moench (or "ACM") and are not official estimates of the FRB of New York.

It is difficult to make a clear judgement call on what the impact of QT is likely to be given that we have so few historical examples against which to compare it. Intuitively, removing a large price insensitive buyer from the market and replacing it with many smaller more price sensitive buyers does not sound like a recipe for low volatility. Moreover, the move to QT and associated liquidity withdrawal is coming at a time of fiscal retrenchment and tighter financial conditions: a full reversal of the fiscal and monetary tailwinds during the pandemic.

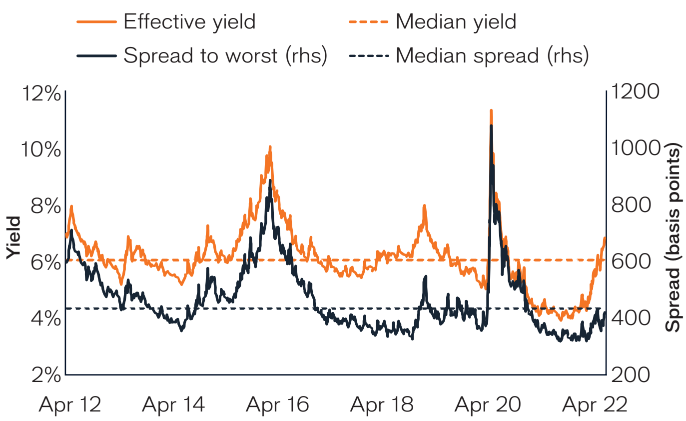
Perhaps the biggest concern around QT is that markets typically respond to change. So while the stock of assets on the balance sheet of central banks may remain large, it is the directional flow of purchases that counts for more in terms of sentiment impact.

Ultimately, this could manifest itself less in the government bond markets and more in credit and peripherals. A key area to watch is Europe where the ECB has bought more than €330 billion of corporate bonds and whose purchases have essentially neutralised Euro investment grade net issuance recently, and the UK where the Bank of England's intention to sell £20 billion of corporate bonds is equivalent to about one year's additional supply. Markets may face some indigestion.

Dichotomy between risk assets and rates

While yield curves may have given a brief recession signal, risk assets are still not pricing in recession risk. Equity markets have corrected but are far from exhibiting extreme panic, having only partially retraced the exuberance of 2021, although the round-trip has been particularly painful for recent investors in tech and pandemic-beneficiary sectors. The ghost of TINA (there is no alternative) has been present among investors, who have struggled to consider allocating to cash and government bonds from a returns perspective when rates were so low. That paradigm is shifting as the yield on 'lower risk' assets climbs. Rising rates have pushed up yields on credit yet spreads have not widened aggressively, despite rising concerns about an economic slowdown.

Figure 10: Credit reflects higher rates but spreads still below average (US high yield)



Source: Bloomberg, ICE BofA US High Yield Index, 30 April 2012 to 30 April 2022. Basis point (bp) equals 1/100 of a percentage point, 1bp = 0.01%, 100bps = 1%.

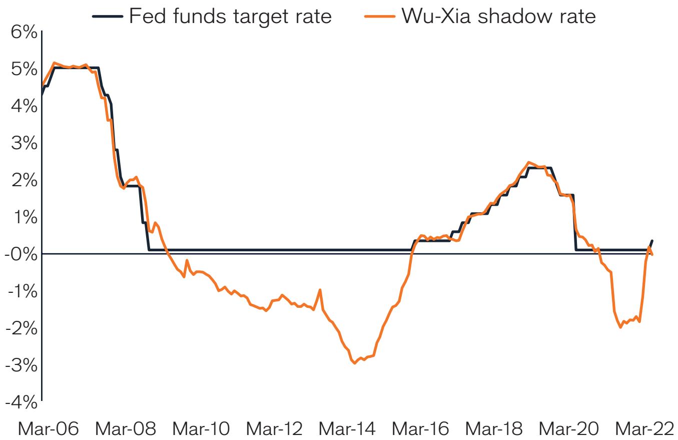
We would argue this reflects the reasonably strong fundamentals of corporate borrowers, with leverage at low levels and interest cover near historical highs. Default rate expectations remain anchored at low levels with forecast global speculative-grade defaults estimated to be around 3%[1] over the coming year. Ultimately, however, the growth outlook will shape corporate health and signs of difficulties or deeper weakness in equities could spill over into further spread widening.

[1] Source: Moody's, April 2022 Default Report, 16 May 2022, 12-month trailing global speculative-grade corporate default rate, baseline forecast for April 2023. Forecasts are estimates, may be revised and are not guaranteed.

Further along the tightening curve than rates suggest

Monetary trends are considered to be a leading indicator of the cycle and are currently giving a negative signal for the global economy and risk assets. As our Economic Adviser, Simon Ward, notes in his Money Moves Markets blog, the latest data shows that broad money growth has normalised[2] in the major economies, suggesting that core inflation rates will return to target in the second half of 2023. The monetary slowdown shows that policy tightening had already begun via the withdrawal of "unconventional" support measures, such as quantitative easing and dovish forward guidance. This is reflected in the Wu-Xia shadow fed funds rate[3], which indicates that March's rate rise was the ninth such move (not the first) in the Fed's tightening cycle (Figure 11). The current situation has similarities to early 2016 after the Fed first raised rates in the last cycle, but core inflation was below target then (it is above now) and the global stockbuilding cycle was bottoming (it currently appears to be peaking). This poses a higher risk of a recessionary outcome than in 2016.

Figure 11: Wu-Xia shadow federal funds rate



Source: Federal Reserve Bank of Atlanta, March 2005 to March 2022, Board of Governors of the Federal Reserve System and Wu and Xia (2016). The Wu and Xia model uses one-month forward rates beginning n years hence, with n=1/4, 1/2, 1, 2, 5, 7, and 10 years. Full details of the Wu and Xia model are available on the website of the Federal Reserve Bank of Atlanta.

Beyond the peaks

With the squeeze on real incomes likely to cause households to tighten their belts and rising costs for businesses set to spur them to seek efficiencies, it is not difficult to envisage a global economy slowing markedly. It may be premature to talk of a "Global Inflation Spring" and widespread civil unrest but struggling households wondering why governments cannot ride to their rescue as they did in the pandemic may prove a heady cocktail.

It is early days in the tightening cycle so central banks still have the stomach to take the fight to inflation. Our expectation, however, is that inflation will start to retreat, first in the US and subsequently in Europe, and with profit margins and economic growth heading south central banks may have to row back on their hawkish rhetoric. A dovish pivot from the combination of rates and QT should not be discounted by markets.

As shown earlier in Figure 6, eight of the 11 last Fed hiking cycles have ended in a recession. Hard landings are typically the rule rather than the exception but each incremental rise in rates brings us closer to a neutral rate, while the rise in yields across much of fixed income should invite growing interest in the asset class and in extending duration.

For those venturing back into riskier assets, heightened volatility will provide some opportunities. The cycle has turned, however, and the playbook from past tightening cycles suggests that patience is warranted. Wait for policymakers to begin panicking that they have gone too far. Their retreat should serve as the all-clear signal.

[2] As measured by "M2+", which adds large time deposits at commercial banks and money fund balances to the official M2 measure.

[3] This uses the term structure of interest rates to quantify the impact of such measures when the policy rate is at the lower bound.

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 key drivers of the market. The ISG Insight seeks to provide a summary of recent debate within the group.

FOR MORE INFORMATION, PLEASE VISIT **JANUSHENDERSON.COM**

Janus Henderson INVESTORS

Important information

Consumer price index (CPI) is an unmanaged index representing the rate of inflation of the US consumer prices as determined by the U.S. Department of Labor Statistics.

Credit spread is the difference in yield between securities with similar maturity but different credit quality. Widening spreads generally indicate deteriorating creditworthiness of corporate borrowers, and narrowing indicate improving.

GC-0522-118985 07-31-23 TL

200-99-118985 05-22