

BEYOND AN INFLATION PEAK

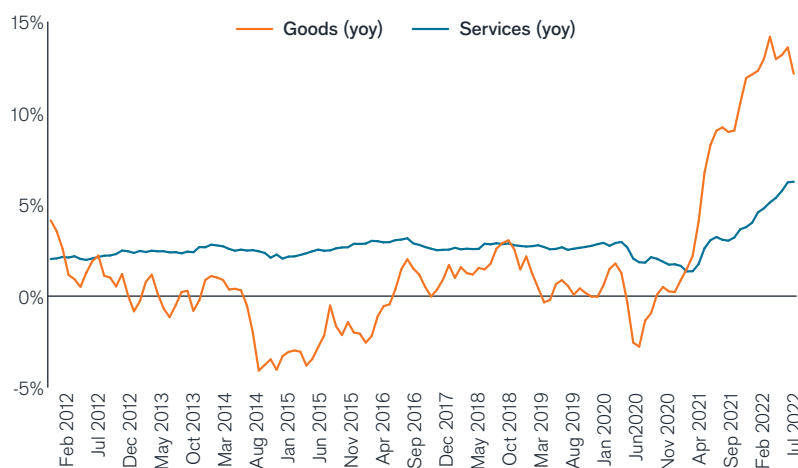
The Investment Strategy Group (ISG) brings together investment professionals from across the global fixed income platform and outside, and it provides a forum for research and debate on the key areas of Fixed Income Asset Allocation and Macro (rates/FX). The two sub-groups are designed to bring together our best ideas globally, aiding decision-making by portfolio managers around portfolio positioning and risk allocation.

In the last asset allocation meeting, portfolio managers debated what happens beyond peak inflation and whether central banks can navigate a soft landing with their inflation 'blinkers' on. Discussions around recession risk and the pricing of risk assets were held in tandem with our Multi-Asset Team to capture both debt and equity perspectives.

What goes up must come down

Markets have been searching for an inflation peak as a signal on the appropriate quantum of concern about central banks tipping economies into recession. A relentless pursuit towards tightening has ignited demand destruction, narrowing supply/demand imbalances and fuelling falling inflation expectations. Freight rates (with new ships and capacity all expected to step up next year) are falling, while commodity prices are showing significant declines in line with demand.

Figure 1: Goods inflation appears to be rolling over



Source: Bloomberg, 11 August 2022.

One measure of inflation, goods inflation in the US appears to be rolling over, which could be followed by services (a stickier key CPI component and therefore key to watch) as squeezed disposable incomes become better reflected in consumer behaviour by further scaling back of spend in this area. One ISG member noted however, that goods inflation can be persistent and is still extremely high while supply disruption continues.

KEY TAKEAWAYS

- ▶ Surpassing an inflation peak could encourage central banks to take their foot off the accelerator in tightening.
- ▶ However, orchestrating a soft landing for economies has been achieved in different circumstances to today.
- ▶ Investors need to establish a peak too. Until rates peak, it's hard to give the all-clear for risk assets.

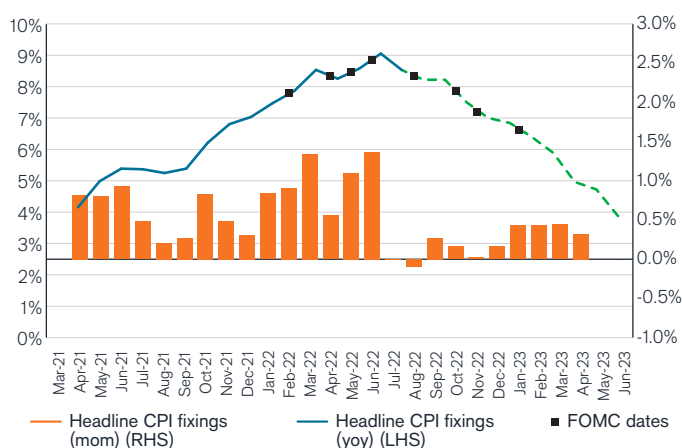
What goes up must come down (Continued)

The increasing glut of retail inventories suggests a moderating impulse to goods inflation later this year, while base effects are washing out, such as weak consumer demand, disrupted vehicle production (used car price strength) and other supply bottlenecks. Some remain however, like food inflation which tends to have a delayed effect in coming through.

While monetary policy operates with a lag – the full force of a rate hike won't typically be felt until 12-18 months later – central banks are making decisions based on the latest inflation data, which means a risk of overtightening. US CPI

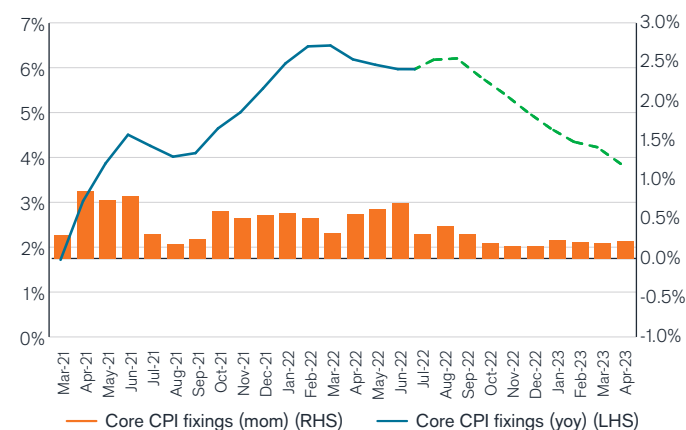
fixings¹ can give a better indication than economic models that tend to lag inflation. Post the June 2022 CPI release, markets believed headline inflation had peaked that month² and the July release confirmed this expectation. However, markets expect core inflation to rise for one more print. So while headline CPI has likely peaked, the inflation narrative will likely switch to core, which will still look too high. Rising core inflation will be very concerning for the Fed. This infers to us that the inflation narrative probably won't shift until September, as inflation pressures won't look like they're falling significantly until then as energy base effects wash out.

Figure 2: Headline inflation appears to have peaked



Source: Citi, 11 August 2022. FOMC= Federal Open Market Committee. **There is no guarantee that past trends will continue, or forecasts will be realised.**

Figure 3: Core expected to rise for one more print



Source: UBS, 15 August 2022. **There is no guarantee that past trends will continue, or forecasts will be realised.**

+ Demand indicators are on a downward trajectory, but forward-looking indicators need to also come down to pacify central banks. There is little to suggest that we won't see this, as we are likely to get a double whammy from both monetary and fiscal policies dragging on growth in 2023.

- Should services supplant goods inflation, shelter inflation persist and wages spiral, the seeds for stagflation will likely be sown.



¹ Monthly market pricing of CPI.

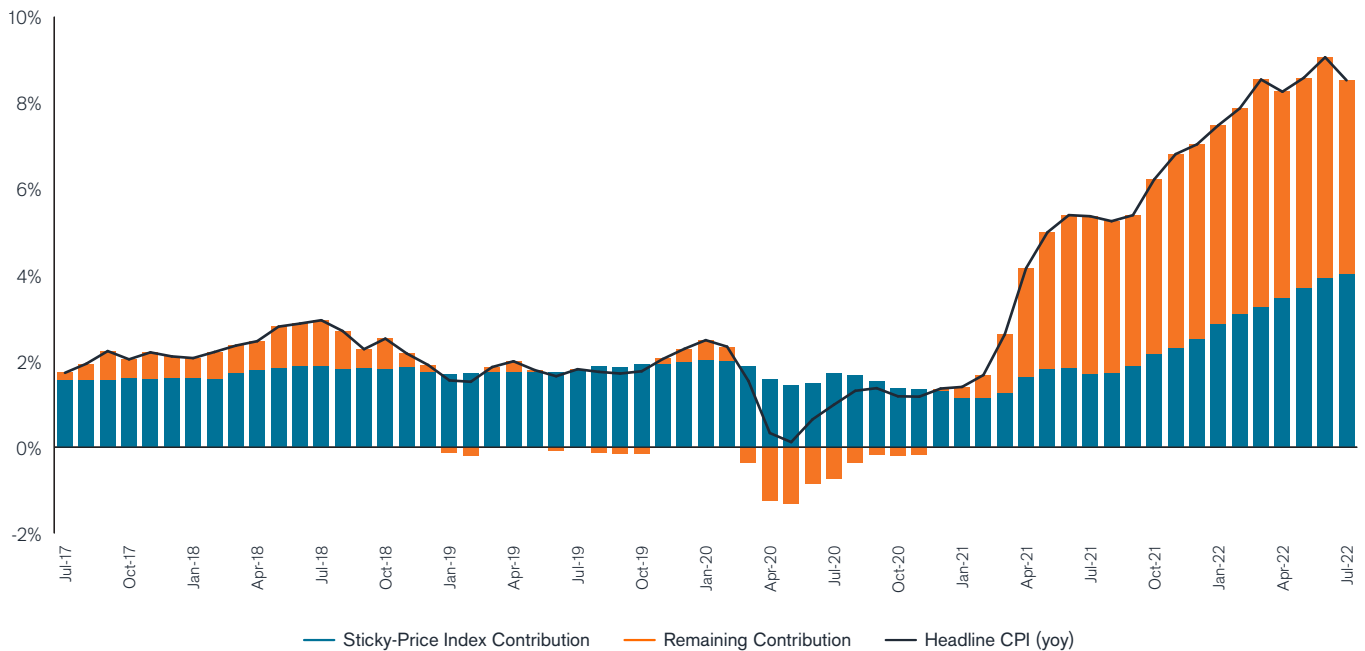
² Source: Citi, as at 18 July 2022.

The consumer is king

The rotation from goods to stickier services inflation means the consumer is king in defining whether inflation more broadly rolls over (or just plateaus). Post the anomaly of a reopening bounce back, nominal retail sales growth is masking the slump in real consumption. The June 2022 Personal Consumption Expenditures (PCE) data (the Fed's preferred inflation gauge) reveals consumer spending rose even faster than prices, albeit this cannot last, particularly given a drawdown in savings.

Housing is one element of sticky inflation, which is creeping up in its contribution to headline inflation. A sizeable chunk of headline CPI is shelter inflation³ where such pressures could persist until the end of the year. While there are no clear signs of shelter peaking, housing data is lagging and even shelter could cool along with the market (home prices are moderating).

Figure 4: Sticky inflation climbs as a proportion of US headline CPI



Source: Bloomberg, 11 August 2022. Sticky-Price Index consists of: Food Away from Home; Household Furnishings and Supplies; Infants and Toddlers Apparel; Medical Care Commodities; Alcoholic Beverages; Personal Care Products; Miscellaneous Personal Goods; Rent of Primary Residence; Owners' Equivalent Rent of Primary Residence; Tenants and Household Insurance; Water, Sewer and Trash Collection Services; Medical Care Services; Motor Vehicle Maintenance and Repair; Motor Vehicle Insurance; Public Transportation; Recreation Services; Education and Communication Services; Personal Care Services; Miscellaneous Personal Services.

By some measures, wage inflation appears to have peaked, but labour market dynamics are a recipe for consumers to demand higher wages. Less supply and strong demand equates to nearly 11 million job openings⁴ in the US. For the first time in four decades though, the poorest cohort are relatively more optimistic about their real income rising in the next year or two than the wealthiest⁵. Higher vacancies along with such optimism and lower post-pandemic real earnings (and less excess savings) implies workers are going to push for higher wages and have a better chance of succeeding.

Positively, the strength of the labour market is the saving grace for rescuing the US economy from being officially declared as in recession by the National Bureau of Economic Research (NBER).

However, historically every time the US had two consecutive quarters of negative growth (like it just has) it ultimately declared a recession.

+ US consumer confidence has weakened and services PMI is in contractionary territory; services inflation could roll over.

- Rental inflation moderates but doesn't fall, as people opt to rent rather than own as they are priced out of the housing market. Little slack in the labour market creates a wage price spiral.



³ By some estimates, shelter costs make up about a third of headline CPI. Shelter inflation comprises rents paid by tenants and owners' equivalent rent, a measure of what homeowners believe their properties would rent for.

⁴ Source: Bureau of Labor Statistics, 2 August 2022.

⁵ Source, Bloomberg, University of Michigan top 33% real household income expectations during next 1-2 years, 29 July 2022.

Removing the inflation ‘blinkers’ in landing?

To successfully combat inflation, however, the Fed has to cool the labour market more, risking a deeper recession (lasting longer than a year). In the past, soft landings are better engineered when the economy (and ergo inflation) isn't too hot with wage inflation and unfilled job vacancies not too high. The balancing act of forcing unemployment rates higher from these levels without causing recession has never been pulled off.

Figure 5: US economic conditions prevailing during soft landings

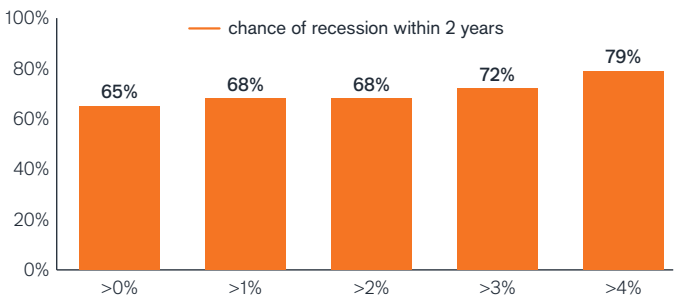
	1965	1984	1994	Today
Unemployment rate	4.9	7.8	6.6	3.6
Vacancy-to-unemployment rate	0.7	0.5	0.5	1.9
Wage inflation	3.6	3.8	2.5	6.1
Interest rate > inflation rate?	Yes	Yes	Yes	No

Source: Bloomberg, as at 12 July 2022.

Around two thirds of hiking cycles in G10 countries have seen recession in the two years following the last rate hike when core inflation overshoots by under 2%, but this probability jumps to nearly 8 in 10 at a 4% overshoot. The US is currently in the 3% area and so it seems the runway

for a soft landing is not only long, but narrow. Some unlikely armistices may alleviate some headline inflation pressures, such as the partial restoration of gas supply through Russia's Nordstream 1, the Ukraine-Russia agreement on grain exports and diplomatic progress on other elements of the Russia sanctions.

Figure 6: Higher inflation means higher recession risk
Probability for different starting levels of core inflation overshoot



Overshoot defined as difference in maximum annual core inflation rate and previous 2-year average.

Source: Janus Henderson Investors. Goldman Sachs, 17 April 2022. Note: Data based on all recessions since 1945.

Another difference to other soft landings is that the US interest rate is currently below inflation. But is it important to get this rate above inflation if some elements are transitory like food and energy?

+ Armistices help engineer soft landings, which become more plausible when inflation falls. The worst-case scenarios with the biggest tail risk for growth are avoided and we see a bigger reversion in commodity prices.

- Toxic combination of falling growth and too sticky inflation. Deeper recession from policy overtightening and/or Russia switching off gas supply to Europe. Even if inflation rolls over, this doesn't necessarily mean negative prices and demand destruction in areas that are necessities could see only some discounting from high levels. Consumers don't have the financial power to rescue the economy as they fight to afford necessities.



Peak hawk, peak rates

Figure 7: Fed Funds rate always peaked above CPI inflation

Tightening cycle	Fed Funds peak (upper bound)	Date	Headline CPI	Real Fed Funds rate
1973	11.00%	30/08/1973	7.4%	3.60%
1976-1980	20.00%	03/03/1980	14.8%	5.20%
1980	20.00%	05/12/1980	12.5%	7.50%
1983-1984	11.75%	24/08/1984	4.3%	7.45%
1986-1989	9.75%	24/02/1989	4.8%	4.95%
1994-1995	6.00%	01/02/1995	2.9%	3.10%
1999-2000	6.50%	16/05/2000	3.2%	3.30%
2004-2006	5.25%	29/06/2006	4.3%	0.95%
2015-2018	2.50%	19/12/2018	1.9%	0.60%
2022	2.50%	11/08/2022	8.5%	-6.00%

Source: Jim Bianco. 2022 data updated by Janus Henderson Investors, 11 August 2022.

History shows it is, as the Fed has never stopped hiking with a negative real Fed Funds rate, meaning that the Fed Funds rate always peaked above CPI inflation in past hiking cycles.

The lowest real Fed Funds rate in a hiking cycle was in 2018 at +0.6%; we are currently at -6%. So even if inflation came down from July's 8.5% to 5% and the Fed hikes 100bps by February 2023⁶, we would still end up with a negative (-1.5%) Real Fed Funds rate. Getting to 5% by February assumes month-on-month inflation to be basically net zero until the end of the year with a slight pick up in January and February⁷. This seems unlikely; so we may not have seen yet the peak in rates in fixed income markets.

Nevertheless, the magnitude in hikes going forward could be smaller (as the Fed hinted in its July meeting). Monthly inflation prints have been rising more than 1% in three of the last five months; these huge monthly prints should fall to below 1% on a monthly basis and hence 0.75% hikes will be less necessary, even in a strong economy.

Outside of Japan, inflation breakeven rates have broadly been on a downward trajectory. As lower policy rates have been priced in, bond yields have rolled over globally and yield curves have flattened, as they reconnected to the slow growth story. As a barometer of near-term inflation prints, the five-year point on the curve has been affected by the rollover in commodity prices and the yield has richened since finding a peak.

+ Five-year rates indicate a turn in the cycle

and that a peak in rates has been reached. A sooner peak in terminal funds rate and a lower level priced now⁶.

Low yields may eventually lead to lower rates volatility.

- The Fed has a data-dependent mantra

and rate hike decisions will be made on a meeting-to-meeting basis. The Fed is still prepared to break the economy to tame inflation and is not thinking about its policy response in a recession.



⁶ According to Overnight Indexed Swaps (OIS), as at 1 August 2022.

⁷ Source: US Bureau of Labor Statistics, 11 August 2022.

Stepping back from the brink

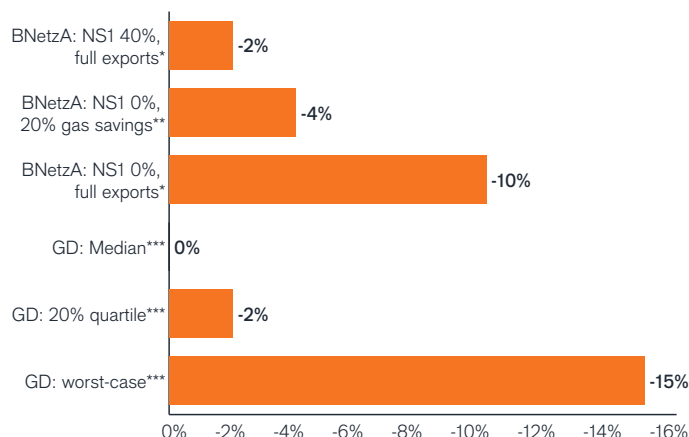
This begs the question does a peak in rates mean a peak in the cycle that paves the way for a central bank pivot towards loosening? We believe a number of conditions are necessary, such as stability in rates, a fairly sharp rollover in goods inflation, services inflation to stop climbing, a peak in core inflation and more broad-based earnings downgrades alongside slower economic momentum for an extended period.

Would reversing rates be a silver bullet though? Or would it be back to the policy tool of last resort – aka restarting quantitative easing (QE)? One ISG member noted that we seem to be moving into a regime where monetary tools are exhausted and the taboo on fiscal ones has dissipated. This could be used more in future and be more targeted to specific areas of the economy that need it.

There is still a significant source of uncertainty that muddies the inflation and economic outlook, namely gas supply from Russia. Scenario analysis from Gemeinschaftsdiagnose (GD) Thinktank research states that Germany (which passes gas to its neighbours) could avoid a gas deficit in winter 2023 even with Russia's Nordstream 1 running at zero capacity⁸, but could face a deficit later. The real energy crisis could therefore arrive in 2024. Eurozone co-operation in a cold winter with no gas supply would be fractious (and in a worst-case scenario of Russia cutting off gas could cause a 2.2% eurozone GDP contraction in 2023⁹). Gas prices are pivotal to inflation, as shown by the 7.7% fall in gasoline in the US July CPI print, contributing to a likely peak passing in headline inflation.

Figure 8: Germany could circumvent gas problems

Gas deficit as a % of annual consumption



Source: BNetzA, Gemeinschaftsdiagnose, Bernstein Autonomus, 1 July 2022.* exports in line with historic trends (January 2018- June 2022); ** 20% domestic reduction in gas consumption from 1 July and liquefied natural gas (LNG) terminal at 90% capacity from January 23; *** assumes zero flows through Nordstream 1 from July. NS1= Nordstream 1.



Central bank credibility wouldn't necessarily be tested by a pivot. A plausible narrative would be by aggressive front-loading hikes, they can afford to pause or take a step back now in tightening.



Company fundamentals are not solely protected by looser policy, but while producer prices are rolling over helping companies, some higher input prices are going to squeeze margins. The energy crisis isn't going away anytime soon!



⁸ Source: Alliance Bernstein, Autonomus, 1 July 2022.

⁹ Source: UBS, 11 July 2022.

Bear market bounce or a sustained rally?

A central bank pivot could be enough to morph recent relief rallies into a sustained turnaround in risk assets. Even the absence of bad news could initiate a bounce, as investors are skittish with sentiment indicators in the panic zone. However, perhaps markets need to become less worried about recession to see a trend shift towards tighter spreads.

Figure 9: Credit spreads (bps) not at recession wides

	Investment grade		High yield	
	US	EU	US	EU
Current	138	183	442	553
Recession	250	250	1000	1000
Non-recession	100	75	350	350
% recession priced in	25	55	14	31
Yield (%)	4.4	2.4	7.4	6.2

Source: Bloomberg, JP Morgan as at 16 August 2022.. Uses data from last six months and compares to historical drawdowns. Index tickers used: SPX, SX5E, LUACTRUU, IO2002EU, LF98TRUU, IO2501EU, USGGT05Y, GEIL5Y.

Credit spreads are pricing in some (but arguably not enough) recession risk, albeit recessions are normally not priced in until they happen. Equities aren't fully reflecting recession risk either, as price multiple compression reflects higher discount rates (rather than earnings-per-share declines). The S&P 500 has climbed with the pricing in of a lower peak in the Fed Funds rate, which reached a high in June and has fallen since¹⁰.

A more dovish sentiment supports the stock market bulls. While the central bank narrative influences sentiment, fundamental and liquidity factors normally matter more to investment decisions.

Earnings downgrades are seeping through and so further spread widening could emerge as analysts recalibrate forecasts.

So who is more out of touch – the market or the Fed? Inflation (that is sticky) needs to fall far and fast towards the Fed's 2% target if rates are to be cut from early next year. Flatter yield curves thus make sense even if the Fed is more aggressive than expected. This argues for being short duration to not unduly expose portfolios to interest rate risk.

One could also argue rates have repriced significantly higher and markets often price the end of the hiking cycle before the Fed gets there. More upside than downside then appears likely for owning long duration, particularly given the available value. Holding duration especially at the longer end of the yield curve during a deep recession (where rates will be cut) could help with risk management and diversify portfolios.



No broad-based earnings weakness yet, but consumption trends indicate this is coming. Spread volatility could continue until we know how long or deep a recession will be.



Returns are highly dependent on starting points and spreads are at or surpassed the wides seen in 2018¹¹ (the end of the last Fed hiking cycle). Market volatility opens up compelling entry points to capture better yields, not seen in years.



¹⁰ Source: Bloomberg, OIS, as at 1 August 2022.

¹¹ Source: Spread-to-worst data, Bloomberg, ICE BofA indices, 31 July 2022.

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