Research Institute – Investor Perspectives

12th October 2022

7:11 minute read

#Global / #Insight / #Asset prices

For professional and institutional investors only – not to be further circulated. In Switzerland for qualified investors only.

The fight for fiat: a lonely victory for the Fed

Keeping policy loose for too long put central bank credibility at risk. Central banks are now fighting back, leading the global economy down a recessionary road. This is not in the price of assets. As growth, earnings and inflation all falter, the negative correlation between equity and bond returns is likely to be restored.

Key takeaways

- In the post-pandemic haze, developed market central banks made a judgement call: inflationary pressures would be transitory. It was the wrong one.
- At risk of weakening the credibility upon which fiat currency systems are built, they have had to compensate with hawkish policy of a magnitude few imagined possible.
- Market inflation expectations have been successfully re-anchored. But the repricing of the term structure of interest rates has had profound knock-on effects to all asset classes.
- The fallout will continue. A global recession is not yet in the price of assets. And for spot inflation to return to target, the pain will need to extend beyond financial markets into the economy.
- As economic and earnings growth falter, and disinflationary dynamics set in, the negative correlation between equity and bond returns is likely to be restored.
- The dollar has likely not peaked, though the denouement of the cycle is likely to be associated with the outperformance of the Yen and Swiss Franc.

.

The slide into procyclicality

In their pursuit of price stability and macroeconomic balance, central banks are meant to act countercyclically. That means leaning against cyclical excesses, dampening the effervescence of investors and the magnitude of credit creation in booms, and cushioning the blow in busts.

That is not what happened as the recovery from the pandemic really gathered steam. In the early stages of the pandemic the Fed was convinced that low inflation would be its enemy through the recovery, just as it had been after the financial crisis. They believed that their existing policy framework was biased towards low inflation (and interest rates), while also making it harder to achieve full employment.

To correct this bias, they introduced the concept of Average Inflation Targeting (AIT). This would allow the economy to run hot (cold) and inflation to overshoot (undershoot) its target, helping ensure that inflation averaged 2% over the long-term.

Armed with this new framework, as late as September 2021 the Fed was guiding the market to expect no hikes in 2022 and a tepid pace of hiking thereafter, to a peak of 1.75% in 2024. Yet at that point the economy was already operating above capacity, underscored by core inflation running at a 6% annualised rate.

Dialling up the pressure

These dovish signals extended the economic and asset price boom. By entrenching negative real interest rates the Fed prevented the equity market from derating while earnings were soaring. Even as the rates market tried to price in more hawkish policy, the Fed leant against it. Inadvertently, it was increasing the pressure level in both the economy and markets to unsustainable levels.

With record corporate margins and PE ratios, the equity market was highly vulnerable to a turn in policy. The opportunity to tighten while times were good had been missed. And now the Fed was realising that inflation would not evaporate. Their binary bet had not paid off. Schrodinger's cat's box had been opened, and the animal was alive.

Dollar dominance and asset price de-rating

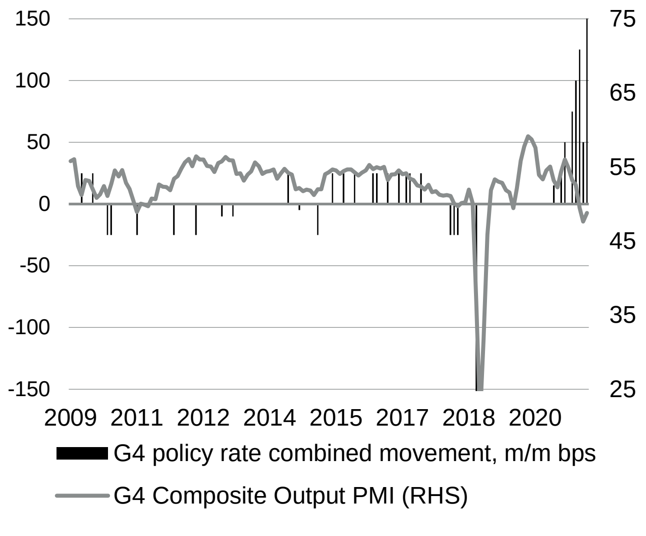
With inflation entrenched and their credibility under threat, the Fed no longer had the luxury of tightening gradually. Starting in March, they have conducted one of the fastest hiking cycles on record, lifting the federal funds rate by 300bps, while guiding the market to expect a terminal rate above 4.5% in 2023.

With inflation so far above their targets, with the exception of the BoJ and PBOC, central banks are now acting in concert to tighten policy even as activity indicators are rolling over, and input prices show signs of having peaked.

The cost of flirting with a loss of credibility is great. They can no longer set policy in forward looking manner because self avowedly their models have not worked. As core inflation has continued to increase this year, they have felt the need to tighten policy at an increasing pace to keep up with it.

Only time will tell if this was proportionate. With policy acting with long and variable lags, by the time inflation is convincingly falling, the shadow of hikes past will be looming over the global economy, still waiting to exert the lion's share of its impact. A recession is now almost inevitable, and the Fed is acting as an amplifier rather than a dampener of market shocks.

Figure 1: Central banks tightening into falling economic momentum

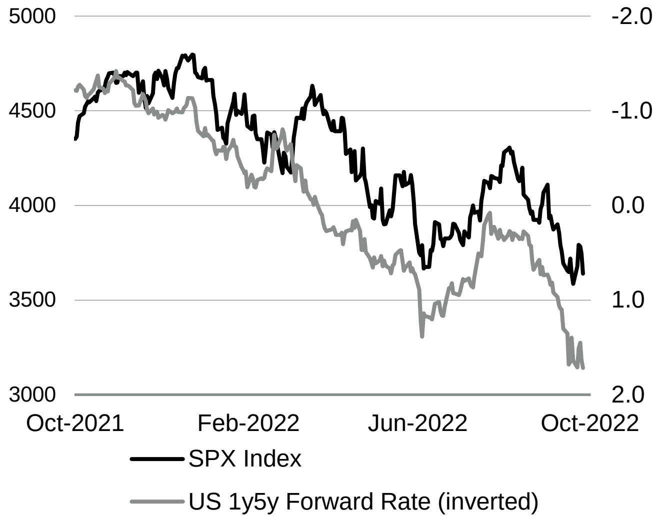


Source: Haver, abrdn, October 2022. Note: PMI above 50 signals expansion.

The Fed's hawkishness has been the largest common driver of market moves this year. 5-year real rates have surged by 350bps, driving a bull market in the dollar. Currencies from the Yen to the Yuan, Sterling and the Euro succumbed to its strength, as the Fed's fight for fiat lifted interest rate payments on dollars, that others either could not keep up with (BoE, ECB) or opposed (BoJ, PBOC).

The performance of equities and credit spreads, meanwhile, has shadowed the fluctuations in real rates as the degree of perceived Fed hawkishness has oscillated. This tendency has increased as the year has progressed, breaking the negative correlation between bonds and corporate risk assets that prevails in more normal times.

Figure 2: Real rates driving performance



Source: Bloomberg, abrdn, October 2022

The fall in the S&P 500 forward PE ratio accounts for more than the totality of the fall in the index YTD. It is discount rates, not yet prospective earnings, that have driven the losses.

This assault has been sufficient to bring inflation expectations down to mandate consistent levels. The one-year inflation swaps staged a dramatic fall from 6% this past summer to 2.5% today, while the market's gauge of the long-term inflation, the 5yr forward 5yr inflation swap, trades today at a benign 2.3%.

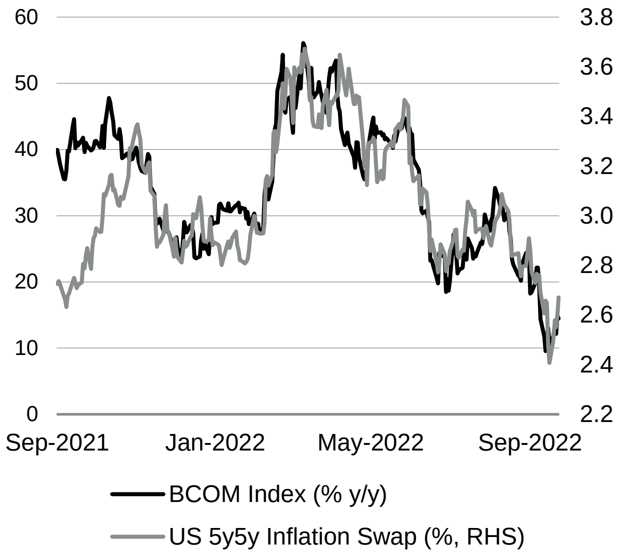
More pain and a different correlation structure await

In its fight for fiat, the Fed is winning. But the job is not done. Inflation in the real economy must be conquered, demand destruction will be necessary to achieve it, and as we enter the recession we think the correlation structure across assets will change. So, what now?

The materialisation of a recession risks taking the Fed's actions further than is necessary and the market to price an undershoot of inflation over the medium and long-term.

Inflation swaps are heavily driven by the year-on-year growth rate of broad commodity prices (BCOM). These are on a steady downward trajectory, with base effects likely to push them from +10% currently to -20% over the next six months unless there is another rally in commodities. This in turn would drive inflation swaps below target consistent levels.

Figure 3: Commodity prices driving inflation expectations



Source: Bloomberg, abrdn, October 2022

The upshot is that the risk to the level of real rates, at 1.5% in the 10yr point of the curve, is looking asymmetrically skewed to the downside.

It is too early for the Fed to allow financial conditions to ease. The core PCE deflator must sequentially and persistently print at or close to target consistent levels first. That likely requires a significantly higher unemployment rate.

The consequence is that we are at an unstable inflection point, temporarily locked in a circular pattern.

Bear market rallies are driven by the market's hope that inflation can recede *absent* a recession. As real rates rally on the idea of a policy pivot, the dollar weakens, PE ratios increase and financial conditions ease. This pushes inflation breakevens back up, something the Fed cannot allow.

Hawkish commentary, backed by hikes, ensues, and real rates are driven back up, supporting the dollar and weakening corporate risk. Financial conditions tighten and breakevens fall back down, threatening to move too far. The market then hopes for a policy pivot, and we experience a renewed bear market rally.

This holding pattern will only be sustained while we wait for the effect of this year's tightening to exert its impact on economic activity. With so much pent-up tightening in the system, the mere passage of time is likely to be sufficient to see growth roll over.

What should we expect from markets in 2023?

Beware of the notion that a recession is already in the price. While it is tempting to chart asset prices against growth, it is a low-resolution caricature of macro analysis to reduce asset price performance to one factor alone.

Although the real rate curve has inverted, the Fed has successfully guided the market to price a terminal rate above 4.5% and, what is remarkable, a stabilisation around 4% for the long run. No recession priced here.

Meanwhile, the expectations of earnings growth for the S&P 500 next year remains 8%, a little lower than it was only recently, but still consistent with a robust level of economic growth and a preservation of high corporate profit margins.

As the economic downturn accelerates we expect the pattern of market moves to become characteristic of a disinflationary bust. Corporate risk should sell off amidst a duration rally, reigniting the negative correlation between bond and equity returns.

Pre-empting the Fed, the market will price a cutting cycle, one that will see the dollar sell off against safe heaven currencies that have held rates low during this cycle (most notably the Yen).

Equities and credit risk at this point will reach new lows, even as government bonds, currently considered by many to be lumps of radioactive uranium, deliver strong returns.

We expect this to occur within a 12-month timeframe.

Epilogue

The shape of the world on the other side of the recession will depend on the choices of policy makers. Governments and central bankers have an opportunity to let the system readjust, avoiding a repeat of the 1970s. But the temptation to step in and alleviate the pain will be great, as will be the political pressure to do so. Should they succumb we might move towards a world of more structurally entrenched inflation. For now though, it is disinflationary dynamics and falling growth that will dominate the market regime.

Authors

Maximilian MacMillan

Important Information

For professional and Institutional Investors only – not to be further circulated. In Switzerland for qualified investors only.

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by abrdn**. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, abrdn** or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes any fund or product to which Third Party Data relates. **abrdn means the relevant member of abrdn group, being abrdn plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

The information contained herein is intended to be of general interest only and does not constitute legal or tax advice. abrdn does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. abrdn reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

Some of the information in this document may contain projections or other forward-looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document, and make such independent investigations as he/she may consider necessary or appropriate for the purpose of such assessment.

Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither abrdn nor any of its agents have given any consideration to nor have they made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document.

This communication constitutes marketing, and is available in the following countries/regions and issued by the respective abrdn group members detailed below. abrdn group comprises abrdn plc and its subsidiaries:

(entities as at 3 October 2022)

United Kingdom (UK)

abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated in the UK by the Financial Conduct Authority.

Europe[1] , Middle East and Africa

[1] In EU/EEA for Professional Investors, in Switzerland for Qualified Investors - not authorised for distribution to retail investors in these regions

Belgium, Cyprus, Denmark, Finland, France, Gibraltar, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, and Sweden: Produced by abrdn Investment Management Limited which is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL and authorised and regulated by the Financial Conduct Authority in the UK. Unless otherwise indicated, this content refers only to the market views, analysis and investment capabilities of the foregoing entity as at the date of publication. Issued by abrdn Investments Ireland Limited. Registered in Republic of Ireland (Company No.621721) at 2 -4 Merrion Row, Dublin D02 WP23. Regulated by the Central Bank of Ireland. **Austria, Germany:** abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. Switzerland: abrdn Investments Switzerland AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market ("ADGM"):** Aberdeen Asset Middle East Limited, 6th floor, Al Khatem Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 764605, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only. **South Africa:** Aberdeen Asset Managers Limited ("AAML"). Registered in Scotland (SC108419) at 10 Queen's Terrace, Aberdeen, AB10 1XL AAML is not a registered Financial Service Provider and is exempt from the Financial Advisory And Intermediary Services Act, 2002. AAML operates in South Africa under an exemption granted by the Financial Sector Conduct Authority (FSCA FAIS Notice 3 of 2022) and can render financial services to the classes of clients specified therein.

GB-111022-181972-1