

# Central banks are hiking, quantitative tightening (...very, very frightening?)

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## Executive summary

*Inflation was once again a focal point at the Macquarie Fixed Income (MFI) May 2022 Strategic Forum. However, the nature of the inflation challenge has evolved considerably since we last met in January. Supply chain issues arising from COVID-19 were showing signs of easing until we experienced a second supply shock, namely the war between Russia and Ukraine, and the subsequent international backlash. As a result, inflation is no longer a drawn-out by-product of the global pandemic but is a real widespread supply shortage of basic needs, such as energy and food. The outlook is for prolonged supply problems with less certainty of how they can be quickly resolved. Today, inflation appears even more problematic, making policymakers nervous and requiring an urgent response, before it becomes cemented into future inflation expectations.*

*Dealing with a supply shock is very different than dealing with the demand challenges that have been a constant feature of the global economy over the past few decades. All the tools central banks and policymakers have been liberally using to support demand, and financial markets, can no longer be applied. Central banks have started to aggressively tighten monetary policy and meaningfully shrink their balance sheets, in order to reduce demand to alleviate the elevated inflation pressures. However, using these blunt tools to address a slow-moving supply problem is unlikely to prove successful. The more central banks try to lower inflation the greater the risk of negative consequences. Combining expeditious quantitative tightening (QT) with broader, larger, and faster future rate hikes that are currently priced in by markets, there is a lot of monetary policy tightening ahead. Can global economies endure it, and more importantly, how will financial markets, which have become so accustomed to incredible amounts of central bank support, adjust to these much tighter financial conditions ahead?*

*Central banks face an enormous challenge. How do they balance fighting inflation without creating too much financial market distress, that in turn may have a pronounced impact on the broader economy? Tighten too much, too quickly, and the chances of a full deleveraging of financial markets is a genuine risk that would have broad and costly economic and societal impacts (**very, very frightening**).*

## Inflation – now a broad based ‘supply shock’

A key focus of recent MFI Strategic Forums has been conducting thorough research into the drivers causing the persistently higher levels of inflation currently affecting the global economy. At the start of 2022, our primary finding was that inflation was a persistent by-product of the global pandemic itself and the resultant supply chain disruptions including the severe restriction of international mobility. This supply constraining by-product remains ongoing. China, a significant supplier to the global economy, continues to pursue a COVID-19 net zero policy that requires sporadic lockdowns, including those in geographical areas highly important to global supply chains.

In January, our analysis indicated that the inflation being experienced was supply-led. We noted that “*Our analysis suggests that the primarily supply-led inflation we are experiencing could persist through the next few months. However, unless there is another virus escalation or geopolitical event or energy disruption, the current more persistent inflation pulse should decline notably in the second half of the year (as) supply is coming. We acknowledge there is a risk that the coming months will be a period of uncertainty as well as vulnerability.*” Reviewing this again, we note that in the past few months, we have seen both another virus escalation in China and a geopolitical event of significance. It is the latter that is creating considerable challenges for the global economy and financial markets alike.

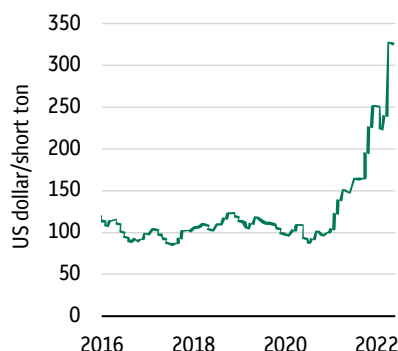
As we all now know, this period of “uncertainty and vulnerability” was exploited, with Russia invading Ukraine. The war in and of itself, as well as the international backlash including wide reaching sanctions, has sparked a genuine broad-based supply shock across almost the entire commodity complex, as highlighted in Chart 1. With both Russia and Ukraine being significant suppliers of key commodities such as oil, natural gas, fertiliser inputs, and grains there is now a widespread supply shortage of basic “needs”. Therefore, the nature of the inflation challenge being faced has evolved considerably. No longer is it a more drawn-out by-product of the disruption caused by the global pandemic, it is a genuine broad-based shortage of supply of key inputs as well as basic needs, with a quick resolution to these shortages appearing unlikely. In short, inflation now appears problematic and sticky at levels that policymakers are being forced to address.

Chart 1

### FAO Food Price Index



### Global Fertilizer



### Wheat



Source: Bloomberg, May 2022.

Definition: The FAO Food Price Index (FFPI) is a measure of the monthly change in international prices of a basket of food commodities. It consists of the average of five commodity group price indices weighted by the average export shares of each of the groups over 2014-2016.

## Monetary policy, from 'just doing more and more' - to tackling a genuine 'supply shock'

Dealing with a supply shock is very different than dealing with the demand challenges that have been a constant feature of the global economy over the past few decades. The global financial crisis in 2008 and the episodes since then have generally been a demand challenge or a series of shocks to demand. Policymakers could respond to these demand shocks by reducing interest rates all the way to zero and by expanding liquidity through quantitative easing (QE) programmes well into the trillions of dollars. In efforts to boost demand they could “just do more and more and more” to support economies and financial markets and they did.

We have written about this at length: The structural challenges weighing on the global economy created the lower-for-longer environment. Today's situation is not a challenge with growth or demand; it is a shortage from the supply side that is creating considerable inflationary pressure. The tools that central banks and policymakers have been liberally utilising to support demand, and upon reflection most notably supporting financial markets and asset valuations, can no longer be used. Continuing with these policies would exacerbate the inflation problem. Indeed, to fight inflation – one of central banks' primary objectives – they are required to about face, go the other way, and at pace. They have to tighten monetary policy, perhaps aggressively and meaningfully, to reduce demand so that it is more aligned with the constricted supply available, in order to alleviate the inflation pressure.

To be clear, policymakers are using a demand tool, tighter monetary policy, to tackle a supply problem, a shortage of needs. It is not perfect. Tightening monetary policy will not end wars, produce oil, create fertiliser, or grow food. The more central banks try to lower inflation, the greater the risk of negative consequences. All they can do is squelch demand and yet they have spent the last 12 years going to once unthinkable extremes to support demand. Indeed, they were still applying considerable support via QE as the supply shock occurred.

This is a significant adjustment for the global economy and in particular for financial markets, which have grown very accustomed to very low cost of capital, near-net-zero interest rates, and ongoing liquidity provision that has been occurring ever since the financial crisis.

## Broad, fast and with magnitude – the tightening path ahead

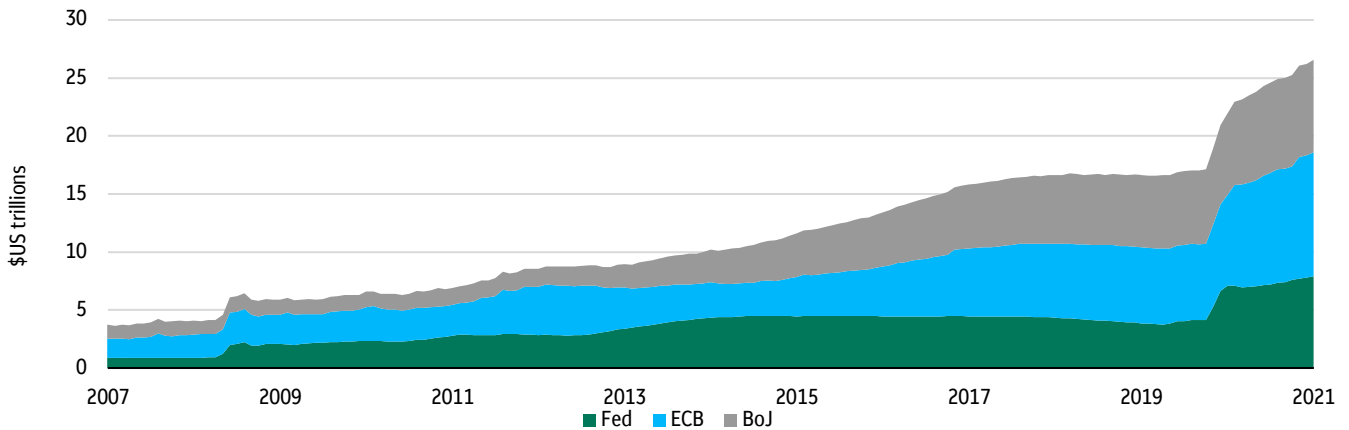
During the May Strategic Forum, our interest rate and bond yield presentation included a thorough description of what has been priced into financial markets, with comparisons to the tightening cycles of the past few decades.

The first key outcome was the appreciation that this cycle would include QT. It may surprise many readers just how significant this is. On a global developed market basis, financial markets have not experienced any environment other than one of net positive quantitative easing for every rolling quarterly period since the global financial crisis of 2008. That's right – central banks have been providing liquidity to financial markets throughout that entire period, even more so during the COVID-19 years, as shown in Chart 2. We observed that QE did little to pump up demand but was successful at inflating asset prices, so it is logical for financial markets to fear QT as the reverse impact is likely to unfold. To emphasise this point, every time central banks got close to ending QE, financial markets convulsed, volatility rose, growth slumped and central banks pivoted to once again keep doing more. Secondly on QT, the only central bank to have successfully reduced its balance sheet (quantitatively tighten) was the US Federal Reserve (Fed) in 2018. The rate of tightening in that period, of more robust economic growth, was gradual. At the same time, the Bank of Japan and the European Central Bank went the other way with increases in QE that more than offset the Fed's QT. Ultimately this gradual rate of QT, combined with gradual and well-telegraphed interest rate hikes, ended with the famous 'Powell pivot'. Equity markets fell and credit markets seized up over the new year holiday period leading into 2019, forcing Fed Chairman Jerome Powell to change the course monetary policy. Here in 2022, the guidance on QT is for a much faster rate of balance sheet reduction, and this time there will likely not be an offsetting QE from other central banks; indeed they will broadly be seeking to implement QT as well. Given that financial markets have not enjoyed periods where QE is contracting, let alone actually experiencing QT. An outlook that includes genuine and broad based QT is a significant development. How will financial markets react this time?



The clear risk, in our view, is that markets will face an environment where central banks hike more and at a faster pace, resulting in a period of substantive volatility. This still may not resolve the inflationary pressure.”

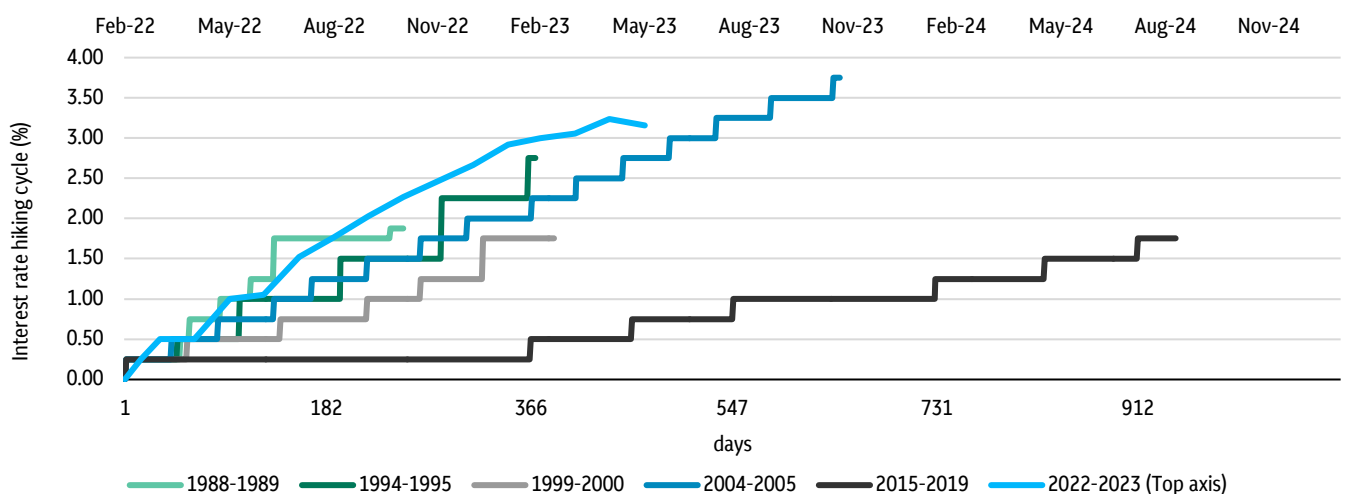
**Chart 2**  
**Major central bank QE**



Source: Citi Research, 2021.

The second key outcome was the collection of evidence outlining how much traditional monetary policy (rate hikes) has been priced into financial markets and comparing this to past tightening cycles, as shown in Chart 3. This analysis revealed an aggressive, fast, broad-based hiking cycle, (across most major economies notably excluding Japan and China), of magnitude (many hikes priced), culminating in a collective tightening size and pace not seen in recent prior tightening cycles. In previous tightening cycles economic growth was broadly more robust. The observation here leaps off the page – with QT (at pace) and broader, larger, faster rate hikes priced – that is a lot of monetary policy tightening. Can economic growth endure it, and more importantly, in our view, how will financial markets, that have become so accustomed to all the “just do more” quantitative easing, adjust to this much tighter monetary policy environment?

**Chart 3**  
**Previous versus current US Federal Reserve hiking cycle**



Source: Bloomberg, May 2022.

## Can demand withstand?

Our deep dive into current economic growth performance revealed that the recovery from pandemic impacts is continuing, although we found it difficult to find much evidence that growth was running above trend, or “hot”, rather returning to its pre-pandemic trend – sufficient more than exciting. Our research recognises the important role that fiscal policy played in “restoring” demand through 2020-21 and the pandemic shock, but this support has already faded with demand only just returning to, a relatively uninspiring, trend. While many, often lagging, economic indicators continue to show encouraging signs of economic resilience, there were notable signs of softening in the more forward-looking data, suggesting that economic growth may be beginning to slow already.

In considering the outlook for economic growth we noted numerous headwinds:

- the likelihood of monetary policy hikes that are currently priced to be broader, faster and of magnitude
- an abrupt shift from considerable QE to QT at a relatively faster rate – this is likely to pose a headwind to financial markets, which in turn will likely then impact the global economy
- a further tightening of financial conditions via the widening of credit spreads and the reduction of asset values, equities in particular
- higher energy, raw materials, and broader input costs as a result of the war induced supply shock, but also the lingering supply chain disruptions relating to COVID-19 mobility restrictions, primarily in China
- higher food costs, along with higher energy costs that are likely to affect discretionary spending
- fiscal drag, as all the pandemic programs roll off.

If global economic growth were overheating, perhaps there would be a decent argument that demand could weather these headwinds. Unfortunately, that is not the picture that the swath of evidence we reviewed suggests. If anything, a truer story is that this is all occurring following two years of pandemic induced turmoil and the environment is yet to find its new equilibrium. So, our assessment is one that the chance of recession is not insignificant, indeed it may be unavoidable.

## Central banks are hiking, quantitative tightening (...very, very frightening?)

The current market commentary and narrative appears more focussed on how the global economy is holding up to this adjustment with many, mostly lagged, indicators exhibiting a level of resilience. Our sense is that this focus while sensible, may not appreciate that it is financial markets that warrant much greater focus.

Ever since the global financial crisis, the macro cycle appears to have disconnected from financial markets, principally as market participants learned time and time again that the real influence on financial market direction was increasingly from central banks and their incredible liquidity programs. Indeed, it could be argued that the economy hasn't really mattered, or has mattered a lot less, to financial markets for a long time. To be focusing on the economy and macro cycle now appears to be missing an important point: If it were financial markets that thrived during the period of once unthinkable amounts of liquidity injections, into the trillions and trillions of dollars, benefiting from the next to net zero cost of borrowing, much more so than the economy, aren't financial markets of greatest vulnerability to this significant change in the investing environment?

If the monetary policy tightening, including expeditious QT, that is currently forecast and largely reflected in the pricing of bond markets is delivered, it is increasingly apparent to us that the very favourable conditions that have supported financial markets and elevated asset prices will no longer be in place. Consequently, volatility has risen and will likely stay elevated. Our sense is that market participants are underestimating the numerous dependencies on very low interest rates and abundant liquidity that have grown over the past decade or so, with far reaching tentacles. The “financial” economy is now many times larger than the real economy, and it is the financial economy that is highly sensitive to the change in monetary conditions. In turn, it is likely to have an amplified impact on the economy, much more so than the other way around.



High debt levels and high bond yields are not natural dance partners – they do not and cannot co-exist.”

The structural forces that we have continually highlighted in previous notes (indebtedness, ageing demographics, digitalisation, deglobalisation, and dependency on central banks) continue to exert their influence. It is important to repeat that these influences are real and large, and no magical fairy has flown in to cure them.

To be direct, and to use one of our favourite tag lines – “High debt levels and high bond yields are not natural dance partners – they do not and cannot co-exist”. The supply shock is colliding with an indebted global economy that monetary policy encouraged as the primary policymaker tool of the last few decades. There is a limit to how much financial conditions can tighten. Central banks are hiking, quantitative tightening, very, very frightening.

## Are central banks inflation fighters or will financial markets force them to blink?

Central banks face a challenging dilemma – how do they balance fighting inflation without creating too much financial market distress that in turn may have a pronounced impact on the broader economy? This is the very delicate bind in which central banks now find themselves. Changes in inflation are likely to be slow moving, whereas the tightening of financial conditions is likely to have an almost instant reaction in very sensitive financial markets, and then a lagged impact on the broader economy. Central banks are using a blunt tool with heightened sensitivity to deal with a slow-moving supply shortage problem – how will they know when enough is enough?

A way to think about this dilemma is through the lens that widespread inflation essentially places a higher cost of living across society as a whole. As that unfolds, people become discontent with a reduction in their standard of living, which is clearly evidenced in negative real wage growth across countries. This rising discontentment risks instability and can influence a considerable change in the social fabric, often via political change or at extremes, widespread protests, and demand for change. Central banks are charged with ensuring this societal pressure is handled via the appropriate management of inflation. The tools they have to do this are primarily demand tools – monetary policy, the use of interest rates, and QE/QT. Monetary policy works with long and variable lags to the economy, and any impact on inflation will take time to become apparent. Watching lagging indicators is like driving using the rear vision mirror. Central banks will need to use leading indicators to know when to stop.

The more central banks tighten, the more financial markets will convulse and the likelihood of a recession increases. Our warning indicators suggest that we are in an environment of fragility such that the prevailing state of the economy is highly susceptible to recession. The three fundamental causes of recession include supply shock, financial crisis or policy tightening. Tighten too much, and the risk of a full deleveraging of financial markets is a genuine risk that would have broad and costly economic and societal impacts. The good news is that the healthy position of household and corporate balance sheets suggest a level of resilience in the face of tighter policy, but still achieving a soft landing will prove difficult with sticky inflation.

The delicate path ahead is likely to be a rough one where central banks continue tightening monetary policy via rate hikes and QT, aiming to deal with inflation, as their rhetoric suggests. Although, like so many times before, they may not get too far before the withdrawal of stimulus impacts financial markets. Indeed, if volatility were to continue and become more violent, central banks may be forced to blink and may not be able to tighten very much at all. Which do we think they will choose? Ultimately, we think they will be forced to blink: They cannot let the house that monetary policy built fall. Timing of that hesitation is the hard part. Our sense is it will be delayed, but ultimately it will come. And when the dust has settled – the question will be, will inflation still be there?



## Fixed income asset class implications

A period of instability is likely to underscore the current investing environment, as markets seek to navigate a potentially significant tightening of financial conditions. To date, financial markets, and asset valuations in particular, have been considerable beneficiaries of the net zero cost of capital and ongoing suppression of volatility. As our research has indicated, it is financial markets and the financial economy that will likely be most susceptible to a change in monetary conditions, given their dependence and borderline addiction to the ultra-easy, liquidity-induced environment. How will financial markets respond to a broader, larger and faster path of monetary policy tightening? In anticipation of the answer to this question playing out in markets, our portfolio positioning is defensive, reflecting our expectation for future volatility and poised to take advantage of opportunities as they emerge at more attractive valuations.

- **Rates** | With central banks becoming myopic on fighting inflation, by raising rates “expeditiously” to neutral levels, the commencement of QT, and ongoing hawkish rhetoric regarding future rate moves, yields may continue to drift higher. However, given our beliefs around the amount of tightening already priced in by markets and our expectation for more volatility ahead if they do deliver what is priced, this will ultimately cap how far yields can rise. As such, a further drift higher in yields would present a buying or accumulating opportunity.
- **Credit** | Credit spreads have widened in response to tightness in financial conditions, with valuations starting to improve. However, we anticipate heightened volatility in credit markets to remain, as markets grapple with the withdrawal of central bank support and an aggressive tightening cycle, with the potential for credit spreads to trend wider. While current fundamentals remain solid, we see vulnerabilities in the form of headwinds to growth and higher inflation. Against this backdrop, we believe it is prudent to take a defensive stance within credit with a preference for high quality investment grade credit. We continue to seek opportunities to deploy our cash buffer, now at more attractive valuations. Within high yield and bank loans, we feel that a disciplined and cautious approach is warranted with a higher quality bias within portfolios.
- **Structured products** | Market volatility is improving valuations, to a degree, with curves steepening from historically compressed levels. Across most sectors, we are poised to maintain current positioning, with the potential to opportunistically and selectively add exposure at more attractive levels.
- **Emerging markets** | Economic growth within the region has moderated after a strong COVID-19 rebound, with the commodity shock having a varying impact across countries. We expect greater variance within both emerging market (EM) corporates and EM sovereigns, with corporate fundamentals having likely peaked and the expectation for rising political and social tensions as inflation rises. As a result, the team is focussed on security selection in this environment, monitoring opportunities arising from asymmetric market moves.
- **Currency** | The US dollar has rallied considerably over the past year, and we expect it is approaching a peak. However, we do not anticipate a sharp reversal given the volatility facing financial markets as liquidity is removed and growth slows. Elsewhere we view the outlook for the euro and Australian dollar as challenged, given the energy crisis in Europe and looming growth slowdown. Alternatively, we expect the Japanese yen is primed for a comeback later in the year, with policy divergence likely to peak over the coming months, with the potential to provide a compelling recession hedge. Overall, we see currency positions as a potentially attractive approach to managing volatility ahead.

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The FAO Food Price Index (FFPI) is a measure of the monthly change in international prices of a basket of food commodities. It consists of the average of five commodity group price indices weighted by the average export shares of each of the groups over 2014-2016.

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