MACQUARIE ASSET MANAGEMENT

The bigger they are, the harder the fall

Macquarie Fixed Income Strategic Forum | September 2022

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Executive summary

Over the past two years, our analysis has determined that the economic environment was largely being defined by first the pandemic shock and then later by the energy price shock resulting from the war in Ukraine. However, at our Macquarie Fixed Income (MFI) September 2022 Strategic Forum, our analysis pointed to the outlook being increasingly defined by the aggressive stance by central banks to tame inflation.

Globally, central banks are currently undertaking the most aggressive tightening cycle in decades coupled with quantitative tightening (QT), driven by a myopic focus to control inflation. In analysing the influences on inflation, we have categorised the pressures into two categories: near term influences, which appear to be peaking, and future influences, which currently do not appear to be genuine drivers, despite the popular narratives. While the focus of market commentators is targeted at how much central banks are hiking and all the reasons why more persistent inflation requires such firm action, it is the trajectory of the global economy that requires as much, if not greater attention.

We are currently operating in a stagflation environment, which based on our research and analysis of similar environments throughout history, is always followed by a period of lower growth, and by association, recession. Despite this lacklustre growth backdrop, coupled with the aggressive tightening of monetary and financial conditions, current financial market pricing generally remains more aligned with the elusive "soft landing" scenario. However, the global economy and particularly financial markets, which have grown accustomed to a markedly low cost of capital, zero-interest rates, and ongoing liquidity provision for more than a decade, face a significant adjustment and the uncomfortable reality of a higher cost of capital, higher volatility, and uncertainty. As these pressures build, the chance of a considerable risk asset decline rises. Put simply, "the bigger they are, the harder the fall," and based on our analysis, ***the more this is going to hurt…***

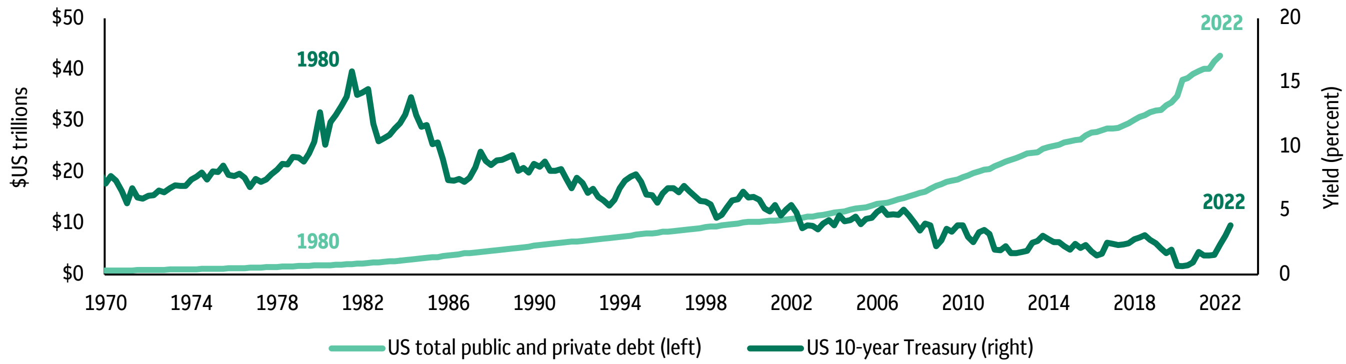
Central banks – The gloves are off

Despite hopes of a slowdown or pause in global central bank hiking cycles over the Northern Hemisphere summer period, the current focus of market commentators remains focussed on asking how much further and what size will they continue to hike rates? The gloves are off, and central banks are out and swinging.

Our MFI May 2022 Strategic Forum CIO note, aptly titled *"Central banks are hiking, quantitative tightening (...very, very frightening?),"* highlighted that the rapid, broad-based across many countries, and significant magnitude of monetary policy hikes was continuing, culminating in what is now the most aggressive US monetary policy tightening cycle seen since US Federal Reserve (Fed) Chair Paul Volcker's 1980 hiking cycle. Central banks, it seems, are not at all interested in waiting to see the impact of, as Milton Friedman infamously termed, the "long and variable" lag effects of monetary policy.

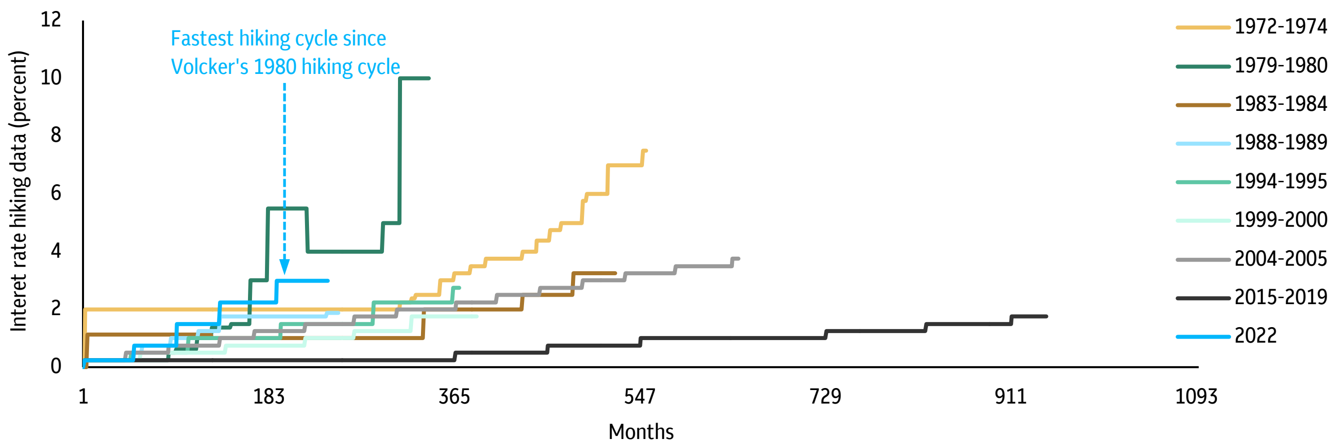
Intriguingly, while the size and pace of tightening in 2022 is as, if not more, extreme than past cycles, the economic and financial market impact may be vastly different. A comparison between the economic environment of the 1980s to that of the 2020s is analogous to operating in two totally different worlds, with the most notable difference being that global indebtedness was a fraction of the massive and ever ballooning debt situation of the modern era.

Chart 1:
Total US public and private debt versus US 10-year Treasury yield



Source: Bloomberg, September 2022.

Chart 2:
Previous versus current Fed hiking cycles



Source: Bloomberg, September 2022.

That one of the fastest, broadest, and most significant hiking cycles in almost 40 years is occurring is eye catching in and of itself. Further still, QT is also underway and only just beginning. While the impacts of QT are not yet visible, liquidity is now being withdrawn from the system and is likely to continue at pace.

With the Fed leading the charge on both pace and magnitude, with 75 basis points per meeting, and some other major economies are "only" hiking 50 basis points, we are also witnessing a considerable strengthening of the US dollar, as is often the case in tightening cycles. This influence is also reducing liquidity, as US dollars return home to relative safety, further decreasing dollar liquidity from the system. In the past, we have referred to this influence as akin to a game of musical chairs. As US dollar liquidity reduces, like a receding tide, it exposes many risk markets to drawdowns as they lose the prior liquidity support they enjoyed. Past cycles indicate that the US dollar continues to strengthen until something breaks – what will break this time?

By leading, the Fed is also essentially exporting inflation to the rest of the world, forcing other central banks to hike in similar magnitudes, otherwise risk a weaker currency and higher import prices. Of note, commodities are priced in US dollars, so while commodities are generally now down in US dollar terms, they are still significantly higher in non-US dollar countries. This is bad news for all importers of food, energy, and commodities.

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This prompts the very simple question – why? Why are central banks hiking so fast, broad, and hard, rather than waiting to see the impacts of the considerable tightening so far. The simple answer to this question - Inflation! Seemingly caught well behind the curve, central banks are now exhibiting an almost myopic focus on inflation and appear very determined to bring it under control.

Lifting the lid on inflation – Blow by blow

Deep research to identify the drivers of the more persistent higher levels of inflation has been a key focus of our recent MFI Strategic Forums. At the start of 2022, our primary finding was that the inflation being experienced was a more persistent by-product of the global pandemic itself, with each and every country (and even city) at differing phases of the pandemic, with differing policies and in differing stages of economic recovery, resulting in severe supply chain distributions. Just as the worst of the pandemic seemed behind us, it was followed by Russia's invasion of Ukraine, which unleashed a second supply shock across a broad commodity spectrum that quickly morphed into an energy supply shock and a genuine shortage of supply of basic needs. The nature of the inflation challenge evolved considerably.

Reviewing these influences on inflation again now in September 2022, we have classified the pressures into two categories, near-term influences and future influences. Based on our analysis, most near-term influences are generally in the process of peaking or have already peaked. Such influences include:

- supply chain disruptions and shortages, which like chain reactions, continue to reverberate throughout the global economy. Signals from a broad range of measures are now indicating that the supply chain is improving, albeit slowly.
- Labour shortages and tight labour markets - with influencing factors ranging from the lack of immigration and global mobility, early retirement of "over 55s,", ongoing elevated sick leave and long COVID-19-related illnesses, to the "Monday/Friday" effect (lower productivity) and fear of losing talent dynamic that currently features in many industries

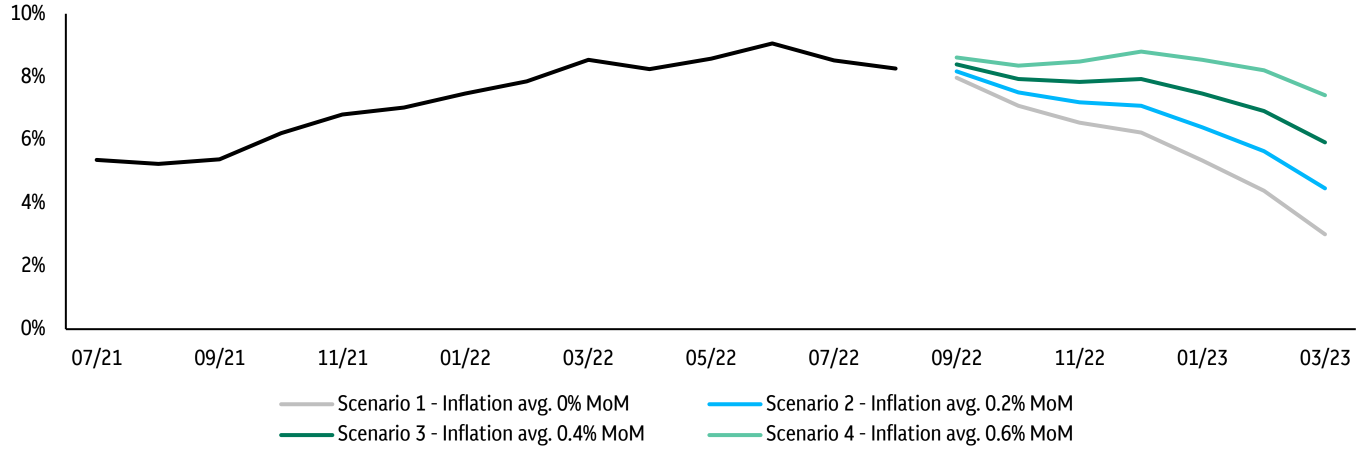
Future influences, most of which are market narratives broadly encapsulated as "the end of the great moderation" theme, are catching the eager ears of audiences keen to understand the risks of potentially more persistent inflation. While these real and valid themes may play a role in the future of inflation, there is little evidence at this time to suggest they are influencing the current inflation dynamic... at least, not yet. Such influences include:

- the desires to embrace "green" clean energy sooner, before adequate investment has taken place, coupled with a lack of investment in older "brown"' energy due to heightened environmental, social, and governance (ESG) considerations
- the belief that the pandemic upended globalisation, resulting in an increasing adjustment from offshoring to onshoring, creating higher input costs
- the genuine risk that the heralded '"cost of living crisis" engulfing societies may see governments respond with additional fiscal handouts that could further fan inflation. The UK is currently demonstrating this risk in real time.

Additionally, we appreciate that the probability of a further supply shock cannot be discounted. Indeed, the geopolitical situation in Europe has the potential to create a third inflationary wave as the Northern Hemisphere winter progresses. Other geopolitical pressures, including Taiwan tensions and China's zero-COVID policy, also remain elevated and cannot be discounted as a zero risk.

However, in terms of US inflation, we know that the base effects on the US Consumer Price Index (CPI) will begin to shift notably from October. Specifically, the monthly change rolling off from last year's prints will be 0.9%, 0.7%, and 0.6% into year-end, and then 0.6%, 0.8%, and 1.2% through the first quarter of 2023. With this in mind, and in consideration of the above evidence of peaking near term, influences, and relative absence of future influences (at least for the moment) – it appears more likely, for all intents and purposes, that inflation will begin to moderate into year end. Scenarios based on moderated month-over-month (MoM) US CPI prints are illustrated in Chart 3.

Chart 3:
Inflation scenarios based on a range of average MoM prints



Sources: Bloomberg and Macquarie, September 2022.

If inflation is in the process of peaking, then central banks should be able to begin to slow the pace of rate hikes or perhaps even pause, as they otherwise normally would have done in similarly as aggressive hiking cycles. It is well acknowledged that monetary policy is a blunt instrument that works with long and variable lags. Clearly, if inflation were to remain persistently higher, as is the current underlying concern and narrative, then central banks appear likely to remain hiking at pace and with magnitude. The more persistent the inflation, the more tightening required… and the **harder the fall.**

Stepping aside from the crowd psychology for a moment: What normally happens to inflation when central banks hike this aggressively? Inflation decelerates, and rapidly. While this time might be different, the past remains an instructive input.

While all the focus of market commentators is targeted at how much central banks are hiking and all the reasons why more persistent inflation requires such firm action – it is the trajectory of the global economy that requires as much, if not greater attention.

Economic growth – On the ropes?

During the September 2022 Strategic Forum, we conducted a thorough review of global economic indicators, which ultimately suggested that the current environment is best characterised as a low-, or no-growth, and high-inflation world – in other words, stagflation. A key takeaway from our research and analysis of similar environments throughout history is that periods of stagflation are always followed by lower growth, and by association, recessions.

While some, mostly lagging indicators still show signs of resilience, it is becoming more apparent that global growth is slowing meaningfully – Europe with its acute energy crisis is highly challenged, China is dealing with a multitude of challenges (zero-COVID and property sector weakness), the “cost of living crisis” is impacting numerous other economies, and many leading economic indicators are also losing altitude at pace. Little discussed, although just as important, fiscal contraction is also occurring in many economies at the same time. All told, there are many headwinds challenging the economic growth outlook. FedEx as a credible bellwether, recently captured it well, indicating that what it is experiencing does not portend well and that we could likely be facing worldwide recession.

In May’s *“Central banks are hiking, quantitative tightening… (very, very frightening?)”* note, we highlighted that central banks normally hike when economic growth (demand) is hot, and this time, it is not. Currently, we observe that not only was global growth not particularly “hot” to begin with, but we would also note that central banks do not normally hike when growth is slowing either. Both observations capture our attention as we consider the likely growth trajectory looking into 2023. In addition, central banks are also hiking into an acute European energy crunch that is likely to further drag on growth. This is all occurring while financial markets are also abruptly adjusting from the zero-interest rate policy (ZIRP) and quantitative easing (QE) world of addiction to cheap money, with the widespread imbedded by-products being massive indebtedness and heightened asset prices. It’s not difficult to imagine how this is going to play out.

In the event of any lingering doubts, we point out that before the current inflation episode, even when the economic landscape was challenged (as it so often was, and to a large degree still is), there was comfort in financial markets that central banks were on the scene to assist, either with monetary policy easing or utilising QE – “just do more, and more, and more” liquidity. Essentially, central banks were openly supporting financial markets. Today, despite growing evidence of numerous economic growth challenges, central banks are clear in their communications of an unwavering focus on inflation and desire to make the macro environment more challenging to ensure inflation is adequately resolved. They want slower growth and higher unemployment, and they are outright clear about this. This is in stark contrast to the preceding decade. It is no longer “just do more, and more, and more” – it is the complete opposite. Financial markets appear somewhat reluctant to appropriately acknowledge this.

Soft or hard landing – Points decision or going down for the count?

Financial markets, during the Northern Hemisphere summer, exhibited hopeful leanings toward a soft-landing outcome. We acknowledge that the word “pivot” is increasingly used in considering the central bank reaction function although a soft landing for financial markets could easily come in the form of central banks simply pausing or even just slowing the pace of hiking. Benefit of the doubt in financial markets can be very powerful and often does build paper bridges to the other side of economic slowdowns.

Notwithstanding this, a review of past cycles indicates that soft landings are rare and are rarer still when structural factors, such as a supply shock, are taking place. The reality is that while central banks’ slowing or pausing or even eventually pivoting is entirely possible, what has occurred to date in terms of aggressive policy tightening indicates that a hard landing is all but inevitable – and risk assets do not appear priced for this scenario.

Current pricing in financial markets appears more aligned to a soft landing (slow/pause/pivot) scenario and prompts concern about an additional notable risk to the outlook – should markets adjust to the reality of a hard landing, as appears increasingly likely, the amplified impact of a contraction in the financial economy would have a pronounced, amplified impact on the real economy. In other words, should financial markets adjust to a hard landing scenario, the slowdown will be accelerated as the unravelling agitates for a broader reaction in the real economy.

As our earlier outlined evidence from the September 2022 Strategic Forum culminates, our attraction to safe havens is increasingly heightened. Yet, the bulk of our commentary has so far concentrated on the here and now – central banks hiking due to inflation, despite lacklustre growth and highly dependent financial markets. A proper assessment must also include the structural environment and the starting point – where we have come from. This is a significant adjustment for the global economy, and particularly financial markets, which have grown accustomed to a very low cost of capital, zero-interest rates, and ongoing liquidity provision that had been continuously occurring ever since the global financial crisis in 2007 and 08.

Going the distance. Knowing where we are going begins with remembering where we’ve been

As we have previously written “In the context of financial markets and asset prices, this (change) has profound ramifications. Over the past decade, the ongoing presence of extremely accommodative monetary policy has created a sense of what we call “the central bank contained environment.” Meaning the containment of risk(s) and indirect suppression of volatility, via once unthinkable amounts of quantitative easing and liquidity provision by central banks, being used time and time again.

This influence has become embedded as a central pillar in financial markets’ psyche. The awareness and pattern that central banks can “just do more” (a lot more!) has reassured markets by providing a backstop or safety net, and in all episodes over recent years, including now a global pandemic, central banks have successfully prevented a prolonged period of increased volatility from occurring in financial markets. These patterns and beliefs over many years have bred widespread complacency and at times a genuine sense and behaviour reflecting of fear of “missing out.”

We remind readers, if it was financial markets, ever more so than the economy, that thrived during the prior decade of financialisaton, trillions and trillions of dollars of liquidity injections, and next-to-zero cost of borrowing, isn’t it financial markets that are of greatest vulnerability to this significant change in rhetoric, messaging, and actions that are markedly affecting the investing environment?

The by-products of ZIRP and endless QE environment were more and more debt and credit expansion, low volatility, higher and higher asset prices, and imbalances such as rising inequality. Given that we are now in a world of much higher interest rates and ongoing QT driven liquidity reduction, these prior by-products, and the wealth and benefits afforded by them, have promptly lost their support. It no longer makes sense to borrow and buy assets, and indeed those who stretched the furthest now face the uncomfortable reality of higher cost of capital, higher volatility, higher uncertainty, and a likely unwinding of elevated asset prices.

As these pressures build, the chance of a considerable risk asset decline rises. Safe havens of cash and bonds are looking increasingly attractive. Yes, central banks may keep hiking – although reviewing all the evidence laid out above and summarising - we know monetary policy is a blunt instrument and we know the effects of aggressive tightening. It is not often that there are so many uncertainties, and the traditional safe havens like bonds react by cheapening. Given the dependencies of the post-global-financial-crisis world, they are a standout opportunity at some stage. 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." If one believes in sustained higher yields, then one anticipates a reduction in indebtedness. If one believes that the global economy cannot tolerate a reduction of indebtedness (as the past decade or so has repeatedly shown), then ultimately yields will need to fall. In summary – despite all the excitable market narratives – take note, there is a limit to how much financial conditions can tighten.

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Postscript: *The very day after this note was penned, the Bank of England (BoE) dramatically intervened in the UK gilt market, pledging unlimited purchases of long-dated bonds to ease to heightened dysfunction and threat of financial market instability. Notably, the BoE was forced to postpone the commencement of its QT program before it had even commenced it and return to QE in an unlimited emergency (temporary?) action. In terms of a limit to how much financial conditions can tighten, we simply say, case in point.*

Fixed income asset class implications

2022 has presented a challenging year for investors across asset classes. Significant repricing in both government bonds and credit markets has contributed, as markets have struggled with the implications of global inflation, war, and slowing growth. The backdrop is certainly challenging: Central banks will likely be attempting to achieve an immaculate (and historically elusive) soft landing, taming inflation while skirting the many clear risks. We believe the current fixed income environment offers an array of opportunities, although it requires flexibility and agility to navigate. Our approach during this uncertain market regime highlights the need to be dynamic and flexible in actively taking advantage of opportunities as they arise.

- **Rates:** Based on our analysis that the macroeconomic environment is slowing, coupled with our outlook for a tempering of inflation, barring any exogenous shocks, the considerable rise in bond yields offers an attractive entry point and strong protection levels. While a period of heightened volatility is likely to continue in the immediate term, duration is offering an increasingly attractive opportunity for long-term investors, and we will be seeking to add.
- **Credit:** Fundamentals remain strong in both investment grade and high yield markets, and given the recent repricing, valuations are relatively attractive. However, we are entering an uncertain macro environment with the impact from inflationary cost pressures and potential recessionary risk likely to lead to weakening fundamentals, particularly if a hard landing scenario manifests. Industry and issuer impacts will likely be varied with most acute risks to industries in those most exposed to consumer demand and interest rates. Against this backdrop, we believe defensive positioning within credit is appropriate with a preference for highly-rated investment grade credit in favourable sectors.
- **Emerging markets debt (EMD):** We retain a cautious outlook for EMD, with a mixed picture for underlying fundamentals alongside varied region-specific impacts from the global macro environment. We maintain the risk-controlled approach within our EM strategies with highly selective exposures: for example, favouring energy exporters, avoiding food importers, and high-dollar-price high yield
- **Structured:** In the structured security market overall, fundamentals are stable but facing slower growth. Across most sectors, we are poised to maintain current positioning.
- **Currency:** The US dollar has continued to appreciate off the back of higher US federal funds rate and pricing for further rate hikes. While this appears overvalued, we believe further upside remains likely over the short term. Key indications for a change, in our view, would largely be around a change in Fed activity, as the underlying weakness in global growth would also likely be positive for the US dollar.

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Fixed income securities and bond funds can lose value, and investors can lose principal, as interest rates rise. They also may be affected by economic conditions that hinder an issuer's ability to make interest and principal payments on its debt. This includes prepayment risk, the risk that the principal of a bond that is held by a portfolio will be prepaid prior to maturity at the time when interest rates are lower than what the bond was paying. A portfolio may then have to reinvest that money at a lower interest rate.

Market risk is the risk that all or a majority of the securities in a certain market – like the stock market or bond market – will decline in value because of factors such as adverse political or economic conditions, future expectations, investor confidence, or heavy institutional selling.

Natural or environmental disasters, such as earthquakes, fires, floods, hurricanes, tsunamis, and other severe weather-related phenomena generally, and widespread disease, including pandemics and epidemics, have been and can be highly disruptive to economies and markets, adversely impacting individual companies, sectors, industries, markets, currencies, interest and inflation rates, credit ratings, investor sentiment, and other factors affecting the value of the Strategy's investments. Given the increasing interdependence among global economies and markets, conditions in one country, market, or region are increasingly likely to adversely affect markets, issuers, and/or foreign exchange rates in other countries. These disruptions could prevent the Strategy from executing advantageous investment decisions in a timely manner and could negatively impact the Strategy's ability to achieve its investment objective. Any such event(s) could have a significant adverse impact on the value and risk profile of the Strategy.

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Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower expects to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Inflation is the rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Central banks attempt to stop severe inflation, along with severe deflation, in an attempt to keep the excessive growth of prices to a minimum.

Quantitative easing is a government monetary policy used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increased the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

A zero-interest rate policy (ZIRP) is when a central bank sets its target short-term interest rate at or close to 0%.

Economic trend information is sourced from Bloomberg unless otherwise noted.

The US Consumer Price Index (CPI) is a measure of inflation representing changes in prices of goods and services purchased for consumption by households.

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