May 9th, 2022

They Don't Know What They are Doing

- **Central Bank meetings show a wide diversity of views within each individual bank**
- **Relative to expected levels of inflation monetary policy remains behind the curve**
- **Rising recession risks has credit wobbling**
- **A further stage of equity market sell off may follow the credit markets**
- **In China it doesn't get any better but the markets have discounted a lot of bad news**

Last week's central bank meetings have only boosted evidence of the growing concern about the scale of the problem posed by the runaway inflation. We understand that central bankers can only move in a measured way but what leaves us surprised is the UK Monetary Policy Committee's admission that inflation will, by its own estimate, peak at 10% at the end of the year, and yet increasing interest rates to just 1%. What's even more intriguing is the fact that two members of the committee voted to leave the policy rates unchanged, while three other members were in favour of raising the rates more substantially. That makes us wonder if they really know what they are doing? Or putting it another way, central bankers are patently just best guessing their policy, which only increases the risks of a policy mistake.

Despite inflation proving to be sticky and the increases in interest rates, almost all central bankers continue to run seriously loose monetary policy, hoping that they will be able to rein in inflation at some point to manageable levels.

However, the signals on inflation are still running at extremes and do not indicate an immediate respite. The Netherlands is a case in point; the latest inflation reading there was 11.2%, with the unemployment rate at 3.3% - that is broadly full employment and yet the ECB is slated to increase interest rates no earlier than in July. In Germany, the producer price inflation was above 30%, and the IG Metall Union has opened its bid at an 8.8% increase in wages for its 85,000 metalworkers.

Back in the US, the Fed dutifully increased the policy rate by 50bps, with Chairman Powell giving an impression that there was a reasonable consensus on the decisions taken.

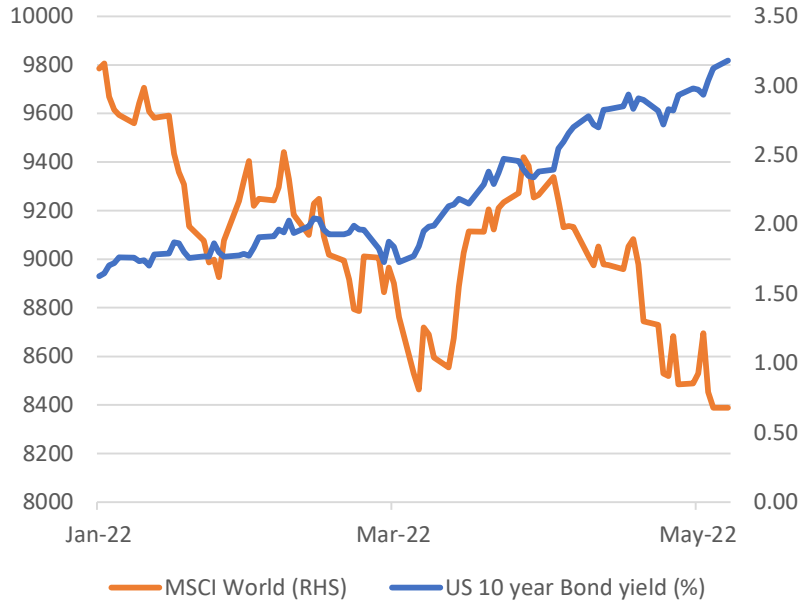
However, that just doesn't ring true. We know that some FOMC members would like to move in a more forthright way to head off some of the inflation pressures by increasing rates more aggressively upfront.

Too much of current central bank policymaking is built on the hopes that inflation will in some way be spirited away. However, investors should remember that it is not where the level of inflation goes to; what is crucial **is at what level inflation expectations get embedded into the economy.**

Current inflation has a fair degree of momentum to it. Wage negotiations, for instance, are starting at levels that are often close to double digits. Labour shortages abound, particularly in the service sector. In the past week, I've walked into restaurants in Europe with signs on the door looking for staff, "have you come about the job, or do you want to eat?"

The lack of market trust in what the central bankers are doing (or not doing) is amply evident in the way the market have behaved of late. It was another week of record sell-offs in both equities and bonds. Both the asset classes were down 2% on Thursday, the first time in 20 years. The yield on the US 10 year, meanwhile, breached the 3% barrier, surging to 3.13%. Selling pressure has been immense, and on top of the higher inflation risk comes the Fed tapering of quantitative easing. For now, the Fed will just allow the simple run-off of bonds from its balance sheet as they mature. Later, it might choose to sell bonds. Either way, the days of easy money are well behind us.

Chart 1: US 10-year bond yield up and Global Equities down



Source: Bloomberg

Investors are starting to realise that 'the Fed put' that had propped up the equity markets has probably gone, or at the very least lost steam.

Credit markets are in the midst of reflecting the broader issue of a risk of recession. Credit spreads have been under pressure to rise, potentially adding to fixed-income investors' woes. For now, the higher-grade parts of the credit markets are holding up better, but the global aggregate index is still down 13.4% year-to-date. The high yield index is down around 10%, but it benefits from lower duration risk. With government yields still vulnerable to markets pricing in the risk of recession fully, bonds are still a way off from regaining their safe-haven status.

In China, political dogma (over) rules

Rigid political dogma is not helping the Chinese asset markets. Like many, we have held out hopes of better times ahead, but the rigid lockdowns imposed in Shanghai and Beijing continue to detract from growth and only spring further negative surprises that have not been offset by a material increase in support for the economy. Recent missives from the government appear to be defensive and an attempt to potentially ward off any internal criticism. Premier Li Keqiang has in the recent past seemed to offer an olive branch of an easing up in the rigidity of the dogma of government policy. However, that seemed to fall by the wayside as the authorities doubled down on their policy stance when they announced the Politburo Standing Committee stands behind no "slackening in the control effects" around the latest COVID policy.

The equity market has traded sideways after recovering from the precipitous fall in mid-March. It may not be the worst asset out there but it completely lacks transparency for investors.

Hong Kong's equity market performance suffered from the election as chief executive of a person seen as a hardliner. The market has suffered a harsh de-rating since the start of the year as earnings forecasts have fallen away.

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)