January 10th, 2022

Risk Markets on Alert as Rates Spike

- **2022 has started with markets on the backfoot**
- **Technology stocks have retreated as bond yields have crossed last year's highs**
- **The Fed has signalled that it will take inflation threats seriously**
- **Labour market conditions are getting tighter**

The year just gone by will be remembered not just for the ravages of COVID but also as the year when buy-the-dip sentiment ruled. The initial days of 2022 already appear to be testing the resolve of the risk bulls. Alarm bells are ringing in the bond market as the Fed's pivot away from the transitory narrative begins to sink in, and investors assess the implications of possible Fed actions to stem inflationary over-heating on portfolios.

Bond yields have spiked: The rise in the US 10Y Treasury yield to 1.76% at Friday's close takes the market to a level last seen in March 2021. At the start of 2021, the 10Y yield was hovering near 1.5%. On two previous occasions in 2021, the market had a brush with 1.75%, but on both occasions yields receded. The absence of a breakout to higher levels on those occasions was partly a result of the market's comfort that the Fed had a patient view on inflationary pressures building in the system.

Tech stocks have had a difficult start to the year: Except for the one-day rally to start the year, technology stocks have been on a downtrend, reflecting their distaste for the notion of higher rates and tighter policy. By Friday, the Nasdaq Composite Index was down 5.7% for the year. Over and above the dislike for higher rates, it has been the case of stretched multiples – for more than a year now global technology stocks are trading at high earnings multiples. The MSCI World Information Technology Index is trading at a trailing PE ratio of 36x even now, down from 38x in December. However, that still constitutes a huge expansion in the earnings multiple, which was at 21x immediately after the first COVID-induced dip in March 2020. Technology pricing has run ahead of earnings and will remain vulnerable into a Fed tightening cycle and as yields spike.

Not all markets had such a tough start to the year: US high yield bonds had a very solid December, with spreads reaching multi-year lows. Although the start of the year has seen

some consolidation, there has been no serious sell-off. The HY spread to government bonds is at 383 basis points in the broad market, compared with 429 basis points at the beginning of December (based on JP Morgan indices). Some tech names have faced selling at a more granular level, offset by gains elsewhere, including the volatile energy sector. A particular standout in the sub-investment grade market has been leveraged loans, where the appeal of low-duration credit exposure has been a trigger for greater investment demand. While the outlook for good total returns for high yield could be challenged by the Fed's stance and policy course, loans could prove to be a more resilient performer this year in relative terms.

This time might very well be different: No longer can the market view the Fed as on the sidelines. The minutes of the latest FOMC meeting make it amply clear that the Fed means business. We know that the tapering process will end by March, implying there will be no further purchases after that. We also know that the lift-off in rates could easily begin at much the same time, with market commentators touting several hikes (three or maybe even more) during the year. Another policy action that will have a tightening effect will be a balance sheet run-off, estimated by JP Morgan to be around $100 billion per month phased in from July onwards.

Don't be fooled if inflation cools off: After the serious lift-off in inflation in H2 2021, it would be wrong to assume that the level of 6% and higher in US CPI will be maintained. Statistical base effects make that very unlikely, as does the moderation in input costs that will slowly permeate through the price surveys from now onwards. However, despite the headline payrolls number disappointing somewhat on Friday (199K versus 450K expected), a theme for 2022 will be the tight labour market. The unemployment rate fell from 4.2% to 3.9%, a new post-pandemic low. Nevertheless, there is little evidence to suggest that labour market shortages are about to ease. While much of the chatter about the great resignation is still just that, at the margin, evidence is emerging that wages globally are starting to edge up in favour of workers.

Inflation pricing still hinting at a higher post-COVID level: With actual CPI running at 6%, it is worth noting that long-term breakeven rates appear to have stabilised in the 2.5% to 2.6% range. Such a level is high by historical standards but much lower than the prevailing level. That chimes well with the view that while inflation should moderate from here, nominal yields are at risk of further increases, possibly beyond 2% fairly soon, to adjust to the reality of tighter policy.

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)