

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



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The Fed's Dots Go for Lift-off

- The Fed's policy stance has undergone a subtle but significant hawkish shift
 - Bond markets noticed, and yields rose
 - The start of higher rates may now be in 2022, and not 2023
 - US government shutdown talks gain momentum
 - Evergrande, no news is not good news
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Last Wednesday's Fed meeting brought a subtle but significant shift in the language that accompanied the decision to hold off on any action. We think two meaningful inferences could be made from the statement.

First, the Fed all but acknowledged that the current economic conditions warrant a start to the tapering process sooner. That means we could see the beginning of the process by November this year, as the monthly purchasing of \$120 billion of assets per month starts to be unwound towards zero. The statement's wording does leave some room to walk back the intention to start at that point, given the possibility that conditions might change between now and then. Still, a move from December to November is noteworthy.

Second, and perhaps even more significantly, the Fed has opened the door to a lift-off in interest rates by end-2022, from early 2023 before. This can be inferred from the fact that nine of the famous plot dots have moved to call for the first increase to happen in 2022 and not 2023. Previously, that number was seven.

It is absolutely not cast in stone that the Fed is bound to move by then, but it is clear that more members are taking note of the inflation numbers. Inflation was described as "is elevated" from "has risen". It is not yet the case that the Fed has given up on the "transitory" belief. However, it is noteworthy that some analyst houses in the market are upgrading their inflation forecasts as new data becomes available. For example, Moody's has upped its forecast for the US PCE deflator to 3.9% for Q4 2021, compared with 3.5% last month.

The bond market appears to be of a similar mind, looking at the price action of the long end of the curve. After the meeting and the statement that followed, the 10Y yield hopped to 1.4% from 1.3% and ended the week at 1.45%. The 30Y Treasury yield jumped to just below 2%, leaving investors at the very long end of the curve down all of 3% in total return terms for the week.

Are we finally seeing the adjustment that looks to be so necessary for the bond market? With inflation likely to run at least in line with the TIPS market (2.5% or thereabouts) in 2022 and onwards, how long can negative real rates last after all? It is important to be aware that the Fed views its "neutral" funds rate at 2.5%. That is a lot higher than 0% today. Assuming a lift-off of interest rates at the end of 2022, the rate hike cycle could be interesting: the Fed would have to hike ten times to reach the neutral point. This is not being priced into the market yet.

Government shutdown: any market impact? By the end of this week, the US Congress has the massive task of dealing with the debt ceiling issue or facing the prospect of a US government shutdown. There are precedents for this eventuality, and in the past, the market has reacted in different ways. In 2011, high yield bond spread widened by 200 basis points, and the VIX index spiked to 50 from 20. In 2013, when the drama was played out again, markets were aloof by comparison. On its own, we look for the shutdown to come and go without too much incident. However, caution is warranted with US yields rising for other reasons and Evergrande's dark shadow looming.

Evergrande: no news is not good news.

Last week saw the non-payment of a coupon on an Evergrande USD bond. However, a default has not been triggered. There is a grace period of a month before it is counted as a default. The Chinese government has not yet delivered the crisis-ending intervention that would bring the speculation about "Lehman moments" or not to an end. For now, the base case appears that the worst will be avoided. However, some damage is highly likely, as priced in by both the bonds and equity of the stricken firm.

Speed is of the essence: We still think there is some considerable systemic risk, even if the overseas investors (banks and asset managers) look to be able to stomach a default on the more than \$300 billion of outstanding debt. In any case, the authorities are likely to be more focused on the impact on the domestic property market, where 70% of Chinese household wealth is tied up.

A loss of confidence could be a huge blow: If property investors (retail buyers) respond to a sudden failure by Evergrande and go on a buying strike, the sector as a whole could struggle. Many of the other firms in the sector rely on pre-sales to finance activity. Authorities, therefore, face the mammoth task of ensuring a fine balance between continuing to engineer a deleveraging of the property market without triggering a broad wealth dilution. Local governments often use the land as collateral for bank loans. The impact on asset quality and solvency for domestic banks is obvious. This is one of the echoes of the Lehman crisis: matters came to a head once it became clear that the market price of a lot of the sub-prime assets held by financial firms (banks, monoline insurers, and similar) was close to worthless. Herein lies the policy challenge.

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