

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



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Heightened Risks Undermine “Buy the Dip”

- Investor’s Buy-the-dip mentality at risk from the structural shifts in the world.
 - More inflation—key central banks keen to push on with monetary tightening.
 - Measures of financial market risk hit recent highs.
 - China surprises on relaxing the reform agenda, but fresh lockdowns cause some growth angst.
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It would be naïve to think that the recent rally in equities has been caused by “greater clarity” in markets. Despite the rally helping offset some of the losses triggered by the reaction to the Russian invasion of Ukraine, no such clarity exists, and none is likely to emerge soon, either. However, what surprises us is how sanguine many investors continue to remain. The “buy the dip” mentality appears to be ignoring the fundamental changes under way around the world. The present global order – after decades of falling/low inflation – is experiencing an inflation problem of worrying proportions that has only been exacerbated by a fractious world. After years of globalisation, geopolitical interests are forcing countries into different camps, which is undermining the free movement of goods, services, and people. The peace dividend is spent.

The central banks are justified in their worries about inflation. US CPI, for instance, is at 7.9% while PPI was recorded at 10% last week. As we have been pointing out for some time now, US long-term bond yields are too low, and official policy rates are strikingly low. The ECB’s problem is identical: rapidly rising inflation with rates stuck at zero. The war will erase the probability of a drop in inflation any time soon. The apt comparison for today’s stock and bond market performance is the period of the oil crisis of the 1970s and 1980s; later periods don’t count as inflation was in a different ballpark then.

Contrasting messages emerged from central bank meetings last week. While central bankers keep a close watch on the battle with inflation, what also worries them is the risk of a significant drop-in economic activity as the impact of the events in Ukraine flow through to confidence and real activity.

The FOMC meeting last week was a master class in market psychology, with the Fed broadly aligning its view of future interest rate increases to that of the market. The Fed increased the policy rate by 25bps and guided that it could raise rates a further 150bps by the end of the year and by another 50bps in 2023. Its estimate for rates at the end of this year is a whole percentage point above the forecast made at the end of last year. How wrong the central bankers’ predictions could be! The Fed also hinted that it intends to announce a run-off of its balance sheet from the late second quarter. Surprisingly, it rather downplayed the impact of the war in Ukraine and instead concentrated its dialogue on the battle with inflation.

The Fed’s positioning contrasts with the announcements from both the Bank of England and Bank of Japan. Both alluded to the risk of inflation, but both also appeared preoccupied with the threat to growth from the war. The Bank of England was of the view that the scale of the increase in inflation was a material drag on real incomes and hence future growth. The market expects the BoE to increase interest rates to 1.25% by the end of the year.

The fall-out of the Ukraine crisis has likely further changed the world order – at a time when markets are grappling with heightened residual risks anyhow. We wonder whether the market fully appreciates and understands what is coming. The more defined geopolitical groupings only exacerbates the risks of conflict and heightens the friction costs for countries to trade with each other.

The equity market should not be a referendum about peace prospects. Tempting as it may be for investors to vote with buys or sells depending on the reported course of the war, this misses the point. Most of the damage inflicted on the global economy has already been done. Non-transitory inflation is with us, and so are sharply hawkish central bank responses in the

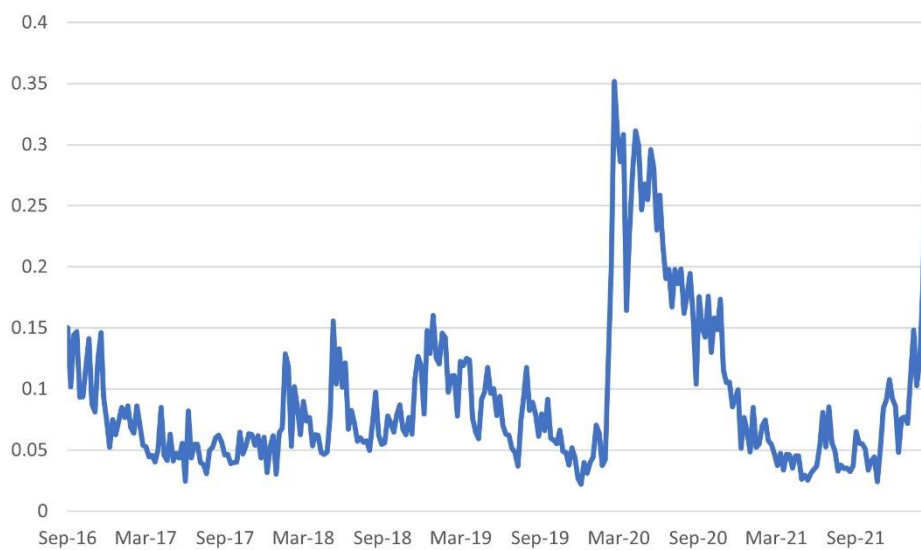
US, Europe and the UK. Not so long ago, the mantra was lower for longer. Cut to present and we have some Fed committee members calling for 50bps increments in the rate hike cycle.

Some market signals are taking note of the heightened risks. We list three of them here:

1. ECB's Systemic Stress Indicator

The indicator is a composite of various financial market variables. Currently, the drivers are primarily in money and bond markets. Equity market levels matter less than volatility; money market conditions and interest rate movements have a more significant effect on the index.

Chart 1: ECB Systemic Stress Indicator



Source: Bloomberg

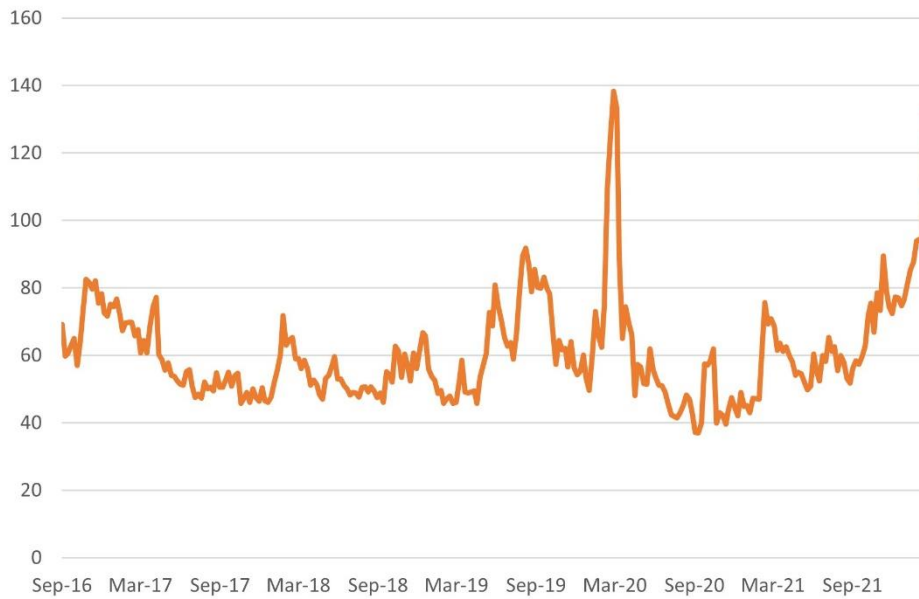
The same pattern is observable in the US, where the interest rate environment is starting to affect rate volatility and the normal functioning of the money market.

2. MOVE Index of Interest Rate Volatility

The MOVE index plots the implied volatility used to price long bond options and swaps. The most recent spike in volatility nearly mirrored the distress levels generated by the COVID-19 meltdown seen in Q1 2020. At that point, the Fed was forced to intervene in the market to provide liquidity. The current situation is perhaps more manageable – the next few weeks will be interesting to watch – but there is one significant difference: The Fed at the moment has no appetite at all to increase QE.

On the contrary, the debate is on to put the brakes on even faster. Technically, the Fed can step in and provide purely short-term funding relief. There is precedent for this as well.

Chart 2: MOVE Index

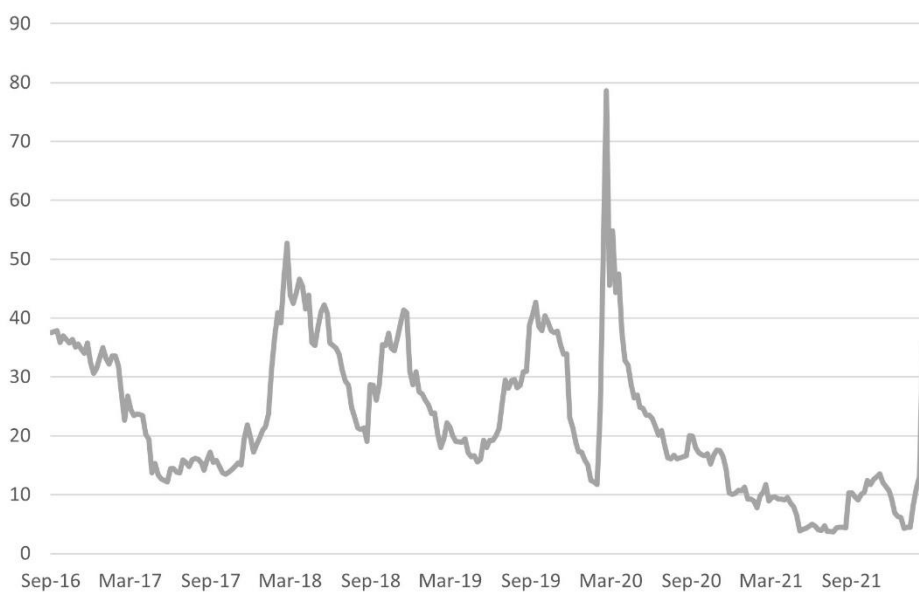


Source: Bloomberg

3. FRA-OIS Spread

We plot the situation at the short end of the bond maturity spectrum in the chart below; it is the FRA-OIS spread. This spread should be in the 10-20bps range in more sedate times. It jumped recently and perhaps will settle down now. But the risk is for renewed volatility if the market starts to fully appreciate the scope of the policy response required to rein in inflation. Also, the market is at risk from the absence of the Fed as the buyer of most US treasuries when rates are already on the rise.

Chart 3: FRA-OIS Spread



Source: Bloomberg

China – better structural news, worrying lockdown news

At the start of last week, we remarked that we felt that Xi Jinping’s assault on some sectors of the Chinese economy could be moderated. By the middle of last week, a short statement from the authorities held out the prospect for at least a moderation in the bull dozing policies of recent quarters. While the move caused some jubilation in parts of the markets, helping erase the precipitous fall of the previous days, it could provide a much-needed breather for tech and stocks with overseas listings. Nevertheless, the key challenge to a more profound rally is the large spike in COVID cases in parts of China. The authorities maintain a zero tolerance to COVID and hence the lockdowns are severe and can derail growth. Recent economic data releases have beaten expectations, however the renewed lockdowns risk downgrades to Q2 GDP growth.

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