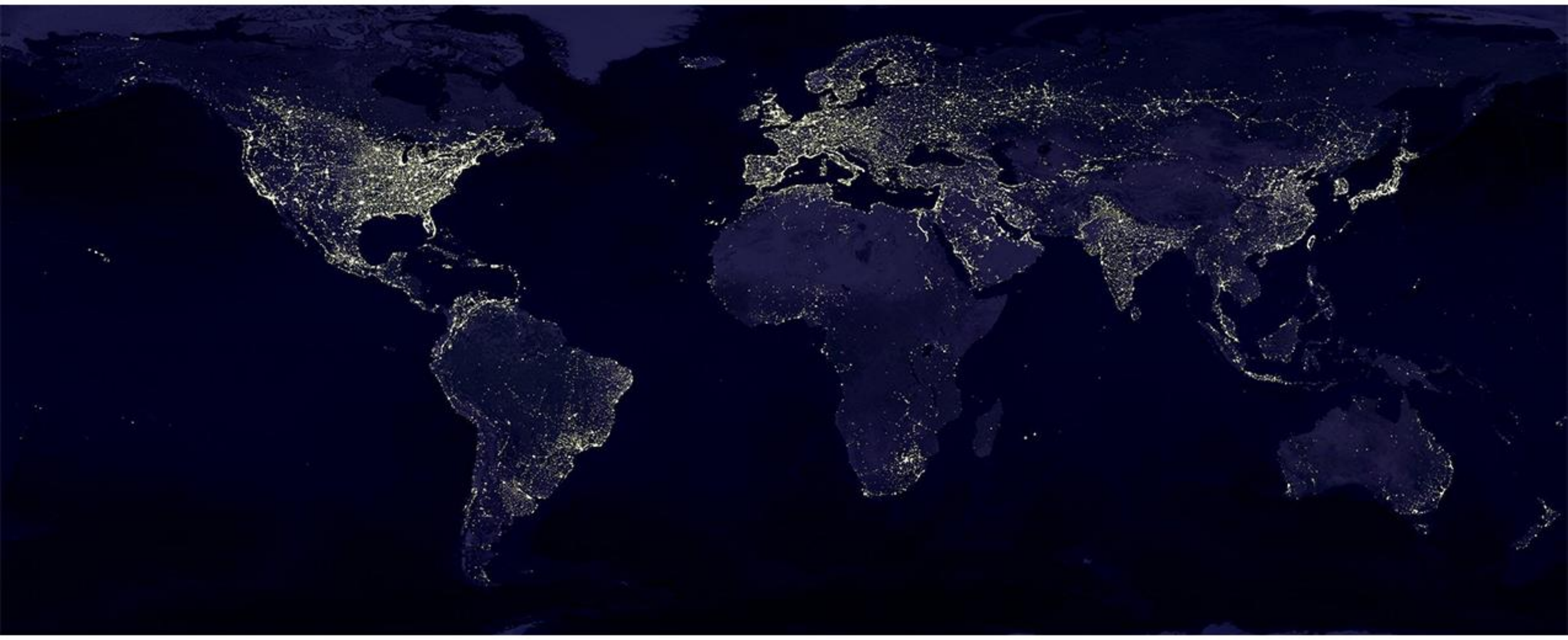
THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY **BY GARY DUGAN**



Sanctum View

April 05, 2022

An Inverted World?

- **The inversion of the yield curve has fuelled talks of an impending recession.**
- **Depends on your definition of yield curve, 2y-10y inverted, but 3mth-10Y not so.**
- **The minutes of the Fed's last meeting likely to set out pace of quantitative tightening.**
- **Food inflation-some worrying trends.**
- **Political challenges in Sri Lanka warn of the effects of food and energy shortages**
- **Equity markets, meanwhile, continue to defy logic. We remain steadfast in our belief that equities are wrongly priced.**

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Last week the inversion of the US yield curve attracted much attention. The two-year US government bond yield surged 10bps on Friday to climb above the 10-year yield, fuelling worries of an impending recession. Bill Dudley, the former Fed governor, was more forthcoming in his assessment of the situation as he remarked, “the Fed has made a recession inevitable”. The two-year yield has now increased 100bps in just one month, a massive move relative to history. The rise in yields also underlines the Ukraine crisis as the principal source of the market’s inflation angst.

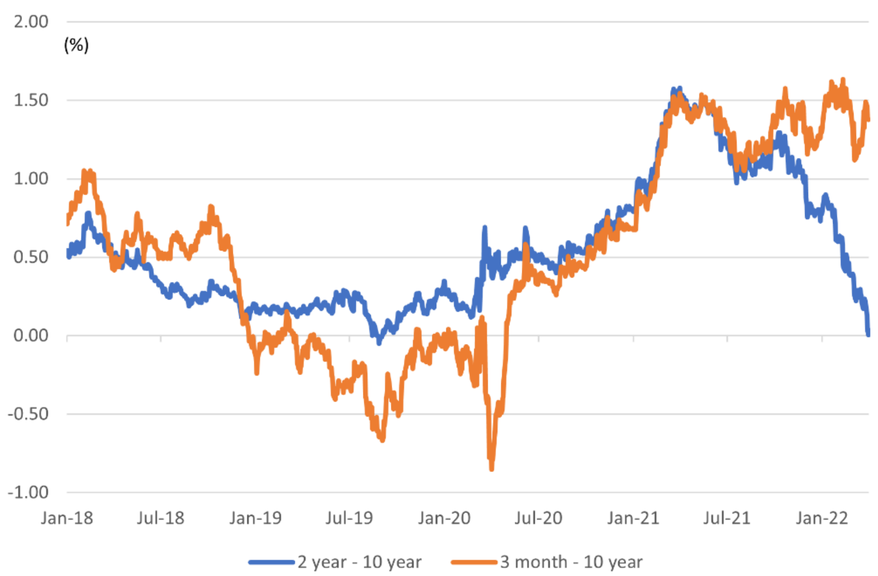
This week’s publication of the minutes of the Fed’s last meeting assumes critical importance as the central bank is expected to set out the pace at which it will move on its quantitative tightening. Any suggestion that the Fed could reduce the size of its balance sheet faster than the market previously expected may undo the inversion to some extent through a higher 10-year bond yield. Still, it would do nothing to unwind the volatility in the US government bond market.

Inversion? What inversion?

Recent moves in the bond market have ignited the debate about the next recession. On Friday, a strong labour market report prompted some more selling of the US Treasuries, with the front end of the curve bearing the brunt. Once the dust settled, the short-dated yields were appreciably higher than the longer ones: the 3Y US Treasury bond yields are at 2.63%, compared with 2.38% on the 10Y and 2.43% on the 30Y. However, some purists have pointed out that this is not a “true” inversion, as money market rates are still at a low 90bps or thereabouts. The signaling, in one case or another, is vastly different.

With the two different “curves” in different territories, as shown in the chart above, which is the one to accept as correct? At stake is the “prediction” that the curve is supposed to be carrying: an inversion signals a recession in the offing. Usually, the timing when the recession sets in is somewhere between six and 12 months after the inversion.

Chart 1: More than one inversion…



Source: Bloomberg

By that measure, the 3M-10Y differential signaled falsely in 2020 that a recession was brewing. It has since steepened sharply as inflation fears have pushed the 10Y yield higher. On the other hand, the recent inversion of the 2Y-10Y yield differential has been driven by the short end reacting more violently to the threat of inflation than the longer end. Most recently, Fed Chair Powell's comments that 50bps hikes were on the table appeared to increase the volume of the alarm bells already ringing in the bond market.

We would note that every inversion is different from the previous one in at least some respects. In the current market environment, there are at least two clear differences from the previous inversions – assuming we accept that there is an inversion in the first place. Market watchers quickly look at the nominal term structure of interest rates and infer that a recession is on the way. However, the real structure (adjusted for inflation) is still highly stimulatory. With US inflation running at 7.5%, and long-term rates at 2.5% (on average), inflation-adjusted rates are a negative 5%. It is difficult to imagine this to be a recession signal. Nonetheless, we concur that the Fed is probably behind the curve, and in its zeal to catch up, it may cause a hard landing.

The second significant difference this time around compared with previous inversions is that we now face a period of quantitative tightening. That process will involve the Fed actively reducing the size of its balance sheet. Nobody can fully claim to have a handle on this situation. We can guess that treasury yields might have a difficult time maintaining their current levels if the Fed is a persistent seller of notes and bonds.

The equity markets continue to shrug off the trouble and have stabilised with modest losses since the start of the year. We continue to believe that equities are wrongly priced. The truth of the challenges from COVID lockdowns and the burst of inflation related to the situation in Ukraine will only become more evident with time.

Fish and Chips…luxury!

One issue that still does not seem to get enough attention is that inflation is not just about energy prices. Pipeline inflation pressures are quite evident and are likely to put significant pressure on corporate margins as the year progresses. On a swift trip back to the UK last week, I was struck by how prices have surged rather precipitously. The media was filled with stories about the challenges of the eclectically British fish and chip shop. Summarising the complete tale of inflation woes, each element of a standard fish and chips dish is seeing double-digit inflation and input prices have risen manifold.

Potatoes, with Russia being a major supplier, have seen a significant cost increase not only because of the recent events but also partly due to the higher prices of fertilisers (+300% over two years). Embargoed supply from Russia and limited likely supplies from Ukraine also cause substantial problems; there is a fear that potato prices could double when the next crop comes in. **Whitefish** – Russia accounts for 45% of the global supplies. Haddock prices are already up 81%. **Mushy peas** – prices are up 120%.

Compound the inflation problems in the UK with the increase in energy prices, cooking oil prices, minimum wages and VAT, and you can see that the price of a standard fish and chips is likely to rise substantially to sustain the fish and chips outlets.

The UK is also struggling to take advantage of the recovery from COVID. My trip took me to probably the worst airport in the country (Manchester), but the labour challenges prevalent at these places do tell a story. After the layoff of a substantial percentage of the workforce at airports and airlines, even if there is demand, there are insufficient resources to meet the demand. Manchester airport has insufficient check-in and security staff. Queues are horrific and staff inexperienced…"What's that in your back pocket, sir?" "A piece of paper!" So, they are not manned for recovery even in industries primed to recover.

Food shortages and price increases start to hurt the emerging markets

Meanwhile, events in Sri Lanka amplify the concerns about the impact of inflation on some emerging countries. Sri Lanka faces food and energy shortages due to a lack of foreign reserves to meet the higher prices. But more importantly, inflation tends to highlight the structural problems within a country.

A report by Qadijah Irshad published in the Khaleej Times sums up the sad state of affairs in the island nation: "Imported medicines are unavailable, including for hypertension. Two weeks ago, surgeries were suspended in hospitals due to a shortage of drugs used for anesthesia, and dental clinics do not have basic equipment for simple procedures. On Saturday, the ministry of education announced that school principals "have been allowed to decide to bring in students for only term examinations" due to unavailability of diesel, while the end of term examinations have been cancelled in most schools as cash-strapped Sri Lanka could not print paper."

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