April 20, 2022

Taylor Rules!

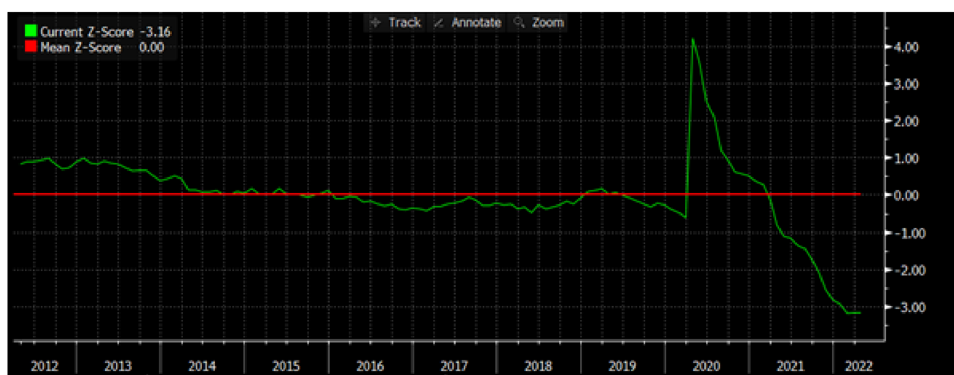
- **The Taylor Rule implies that Fed funds rate could hit 7-10%**
- **We fear that higher rates may do little to curtail demand growth and help ease inflation**
- **The Fed can try to control excess demand but have little impact on supply disruptions**
- **Markets remain at risk; bond yields to go higher, gold to rise above $2000/oz**
- **Equity market investing needs to remain defensive**

You might also like our The bond reset is here. Now what? and An inverted world? Click here to read them for free.

If famed American economist John B. Taylor is correct, the financial markets are in trouble. The Taylor rule – a treatise on how central banks should change interest rates – suggests that the Fed funds rate should be somewhere between 7% and 10%. Broadly, the rule is an econometric model that describes the relationship between the Federal Reserve policy rates and how far the actual levels of inflation and growth deviate from the desired levels. While the concept indeed has some flaws, it is always a helpful starting point to determine where interest rates might be headed.

What we see today is one of the most significant gaps between the interest rate forecast based on the Taylor rule and the actual Fed policy rate. The Taylor rule calculator available on Bloomberg indicates an appropriate Fed funds rate of 10%. The current Fed funds rate is deviating unprecedently from where interest rates should ideally be headed (Chart 1). Hence, the current market angst about the Fed funds rate going up in increments of 50bps towards 2.5% to 3.3% over the coming 12 months seems a moot point when prevailing economic conditions may force the Fed to significantly boost its forecast for the Fed funds rate well above what it expects currently.

Chart 1: Deviation of current interest rate from the Taylor rule



Source: Bloomberg

According to the median estimate, the Fed currently indicates that it could raise interest rates to 1.9% by the end of 2022 and to 2.8% by the end of 2023, while the neutral rate is seen at around 2.4%. However, since the last Fed meeting, there appears to be a greater sense of urgency on part of the policymakers to push up rates. The Fed governors seem to be falling over each other to be more hawkish. A building consensus is for 50bps hikes in interest rates, a pretty extraordinary rise given that a 50bps policy rate increase has not happened since 1995, when Alan Greenspan was the chairman.

Policymakers continue to expect that the current global events will ultimately bring about a soft landing in the global economy. Some economists expect the headwinds of the Ukraine war, the gradual decline in fiscal support for economies, and weakness in the Chinese economy to bring growth down potentially. But will these events bring inflation down, too? Stagflation remains a distinct possibility that causes a headache for central bankers.

Just a quick economic history lesson here – US inflation peaked at 14.8% in March 1980 before falling sharply to 3.0% in 1983. However, it necessitated an unprecedented measure – the Fed had to raise interest rates to a peak of 20% in June 1981 before the inflation pressures abated. History also tells us that it's not just about indulging in some demand destruction with higher interest rates; you need policies that break the back of inflation psychology. Companies

and individuals get used to higher inflation, with companies annually increasing prices, and households bringing consumption forward on fears that prices will rise.

Remember also that inflation is not just a demand phenomenon. The current elevated levels of inflation have been caused by supply-led problems, too. Broken supply lines and genuine shortages of goods such as fertilizers and energy sources are not corrected through higher interest rates.

On this occasion, interest rate hikes may be less effective in curtailing demand growth. After more than two years of lockdowns, consumers may be on a spending binge as they seek to catch up on missed holidays and general spending. Hence, spending becomes less price sensitive, a phenomenon that has already been seen in the airline industry. The average domestic airfares in the US, for instance, are up 38% year-on-year, and air travel is still vibrant there.

It is also worth remembering that the Fed's inflation target is more critical than its employment target. When the-then Fed chair Paul Volker was increasing policy rates to double-digit levels to combat inflation, unemployment rose to 10.8% because of the recession that occurred due to the hawkish Fed policy. Investors have got used to the idea that the Fed will always be sensitive to market levels – market collapse and the Fed will relent on raising interest rates is a commonly held view. However, most market collapses of recent times have brought the risk of deflation. We believe this time will be different. Hence, there is a much lower chance of the Fed relenting early in its fight against inflation.

Also, many investors are of the view that the Fed is only there to support the US equity market, the so-called Fed put. However, **the 'Fed put' never really existed, despite looking like it did.** On several occasions, the Fed appeared to be pulling the levers at its disposal to save the equity market because the fall in the equity market was coincident with either a threat of deflation or rising unemployment. Hence, Fed actions effectively meant investors were saved from losses in the equity market. However, in reality, the Fed was still working within its mandate to conduct monetary policy "to effectively promote the goals of maximum employment, stable prices, and moderate long-term interest rates."

The goals of the Federal Reserve are no longer consistent with an ever-rising equity market. In fact, in reality, it’s quite the opposite. The US government and the Federal Reserve have made a policy error in overstimulating their economy in the wake of the COVID crisis. They instituted measures that focussed on stimulating demand without understanding the consequences of the pandemic on supply. Consequently, heavily supported demand recovery met significantly impaired supply lines. The result is more inflation that they (might not have) bargained for. Now throw into the mix the impact of the Ukraine War, and you have a magnified threat of persistently higher inflation.

It should be evident to anyone with peripheral vision in the market that interest rates are about to go to levels we would not have dreamt of in our worst nightmare. Clearly, the pressure is on. Sri Lanka, an early victim of higher inflation, had to double interest rates last week to provide support for its currency and attempt to take some pressure off the economy. South Korea's central bank unexpectedly raised rates to 1.5%. New Zealand raised rates by 50bps to 1.5%, the most significant increase in 20 years. Singapore tightened monetary policy for the third time in as many meetings.

By contrast, Turkey held interest rates despite inflation hovering at a staggering 61%!

A strategy for much higher interest rates

Short bond duration risk. Analysts talk idly about a pause in the rise of the US 10-year bond yield at 3%. However, this remains a hope rather than a level justified by a robust well researched argument.

Energy sector

The oil price was up 8% last week as both short term technical factors and increasing concern that Europe may move to a full embargo on Russian energy. Disruption to Libyan oil supply due to domestic political challenges only added to the upward pressure on prices.

Healthcare

The healthcare sector fits into that bracket of sectors that should be relatively immune from the volatility of global geopolitical events and the spike in inflation. As brand and IP leaders many of the companies can maintain pricing power. The sector has largely performed in line with the trend in corporate profits. For the moment, corporate earnings have stalled hence the sector may give the investors relative but not absolute gains.

Utilities/Infrastructure

While the defensive characteristics of these sector should protect investors, they can be prone to problems of profitability where governments intervene to cap price increases. Active management is needed to pick the winners and avoid the losers.

Precious metals

Gold and silver have started to push higher as the ability of asset classes such as bonds and equities to protects investors capital is increasingly called into question. If the gold price were to push through US$2000 it could help breach much of the technical resistance holding the price back from a making substantial move.

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)

Disclaimer & Important Notice

FOR THE INTENDED RECIPIENT'S USE ONLY

The Global CIO Office operates under Purple Asset Management. This document has been prepared by Purple Asset Management Limited ("PAM" or the "Company").

The document has been prepared on the basis of accounting and non-accounting grade information extracted from within the Company and its affiliates; and of publicly available economic and market data sources. This information has not been verified by an independent third party and should be treated accordingly. It is furnished to you solely for your information, should not be treated as giving investment advice and is to be kept confidential and may not be copied, reproduced, distributed, published, in whole or in part, or otherwise made available to any other person by any recipient.

The facts and information contained herein are as up to date as is reasonably possible and are subject to revision in the future. Neither PAM nor any of its directors, officers, employees or advisors nor any other person makes any representation or warranty, express or implied, as to the accuracy or completeness of the information contained in this document or undertakes any obligation to provide recipients with any additional information. Neither PAM nor any of its directors, officers, employees and advisors nor any other person shall have any liability whatsoever for losses howsoever arising, directly or indirectly, from any use of this document.

Whilst all reasonable care has been taken to ensure that the facts stated herein are accurate and that the opinions contained herein are fair and reasonable, this document is selective in nature and is intended to provide an introduction to, and overview of, the business of PAM. Any opinions expressed in this document are subject to change without notice and neither PAM nor any other person is under any obligation to update or keep current the information contained herein.

Such information contains "forward-looking statements" which are not historical facts and include expressions about management's confidence and strategies and management's expectations about future revenues, new and existing clients, business opportunities, economic and market conditions. These statements are made on the basis of current knowledge and assumptions. Various factors could cause actual future results, performance or events to differ materially from those described in these statements. These statements may not be regarded as a representation that anticipated events will occur or that expected objectives will be achieved. The forward-looking statements in this document are only valid until the date of this

document and ISI does not undertake to update any forward-looking statement to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. This document is not an offer to sell securities or the solicitation of an offer to buy securities, nor shall there be any offer or sale of securities in any jurisdiction in which such offer or sale would be unlawful prior to registration or qualification under the securities laws of such jurisdiction.