Kyiv Chicken

US inflation refuses to lie down. In the year to January 2022, it rose 7.5%, the fastest rate since the early 1980s. Markets quickly priced in higher rates as the Federal Reserve dialled up the hawkish rhetoric. QE bond purchases, that peaked at $120bn per month, will end in March whilst the Eurodollar money market now forecasts seven rate rises by the end of 2022. This would lift the current Fed Funds rate from near zero to 1.75%. Bonds, particularly those that mature in less than 5 years, sold off as equity markets tumbled.

Despite the prevailing inflation angst, we continue to believe that the Fed (and other Central Banks) will struggle to deliver meaningfully tighter policy. The last time the Fed tried to temper its monetary support was in 2018; the Fed Funds rate hit 2.5% and the yield on the 10 year Treasury touched 3.25%. With US debt-to-GDP at 106% and global debt of $250trn, dearer dollars undermined growth and triggered a 20% sell off in the S&P500. The Fed Chairman, Jerome Powell, rapidly reversed course cutting rates to 0.1% and recommitting to QE bond purchases. The “Powell Pivot” was born.

Fast forward to today and US debt-to-GDP exceeds 120% and global debt is north of $350trn (source: St Louis Fed). According to “The Longview”, every 1% rise in short term rates costs the US Treasury $150bn per annum; equivalent to 4% of government revenues. With budget deficits forecast at -7% in 2022 and -6% in 2023, the US economy is increasingly rate sensitive. If the Fed meets market rate forecasts and starts to sell bonds to reduce its balance sheet, a nasty recession seems all but nailed on. Further afield, with dollar debt outside the US hitting $13.4trn and the greenback trending higher, the rest of the world is similarly vulnerable (source: BIS, non-bank borrowing, Q3 2021).

Indeed, there is clear evidence that the global economy is slowing even before the monetary “punch bowl” is withdrawn. Whilst US Q4 GDP registered an impressive 6.9% annual expansion, two thirds of the growth came from inventory build. Whilst some of that is a one-off structural shift, as companies ensure ample stocks during ongoing supply disruptions, it will take time for the American economy to digest this surplus. With the benchmark 30 year mortgage rate rising 40% (to 4.2%) over the last 6 months and net fiscal support set to shrink this year by 3% of GDP, the Atlanta Fed currently projects less than 1% growth in the first quarter of this year. IMF projections of 4.0% real GDP growth in 2022 look optimistic.

The Chinese economy is also struggling. An 8.1% expansion during 2021 masks a softer economic tone; Q4 GDP growth was only 4% when compared to the prior year. Domestic consumption shrank 1.7% as property sector travails and weak corporate investment complete the troubled picture. This was despite the highest ever trade surplus of $676bn in 2021, driven by record exports of $3.36trn. As China tries to right-size its property sector and reign in tech monopolies, overseas demand remains a vital prop.

All of which leaves Central Banks navigating a narrow policy channel between the Scylla and Charybdis of inflation and recession. With US CPI at a 40 year high and unemployment at 4%, the monetary authorities have no choice but to talk tough and tighten until something gives. It was easier for Powell to pivot in 2019 when US inflation was less than 2%.

Absent an exogenous shock or significant real wage growth, US inflation should moderate as we move through the summer as year-on–year comparisons become more testing. Slower growth and a gradual improvement in covid supply disruptions could see CPI top out, allowing Central Banks to row back from the more aggressive policy predictions. Even if inflation proves to be stickier than anticipated, we do not see Powell as “Volker incarnate”. If higher rates risk a precipitous recession, we believe that Central Banks will err on the side of caution, loosen policy and risk elevated prices. Of course, we could see a post-Omicron boom as free flowing supply chains meet resurgent consumer and corporate demand; this happy outcome would offer Central Banks a relatively risk-free path to policy normalisation.

We see the latter as unlikely, sharing the bond markets rather gloomy view of economic prospects. Whilst the 3 year Treasury yield has risen from 0.2% to 1.8% over the last year, the 30 year yield is largely unchanged at 2.3%. The lack of movement at the long end, and the shrinking yield differential between short and long-dated bonds, suggest that bond investors see higher short term rates precipitating a disinflationary slowdown and/or the need for further QE bond purchases. Whilst the timing of this more dovish tilt is impossible to know, we would be surprised if bond and bullion markets do not anticipate this outcome well in advance of any policy volte face.

Of course, this analysis could be upended by the unfolding drama in Ukraine. We are painfully aware that geopolitical prognostications can have the half-life of a fruit fly, especially when the chief protagonist is Vladimir Putin. With that said, we find it hard to believe that Russia will mount a full scale invasion. More likely, the troop deployments are a hard ball negotiating tactic aimed at destabilising the Ukrainian government and removing objections to the Nordstream 2 gas pipeline. If we are wrong and Putin does march on Kyiv, he would unite NATO members, triggering sanctions that would exact a brutal economic price from the President, his cronies and the economy. Putin’s hold on power would be threatened by an impoverished domestic populace and an internationally ostracised oligarchy.

To us, the worst case scenario is a limited incursion, on a par with the 2014 annexation of Crimea. By focusing his ambitions on Ukraine’s periphery, Putin would undermine NATO solidarity as the resolve of member states wavered in the face of higher oil and gas prices. The spectre of stagflation could temper sanctions as politicians excuse "modest" empire building as a price for economic calm. Furthermore, higher hydrocarbon prices would bolster Russian reserves, reinforcing a buffer against economic penalties; the Bank of Russia declares current reserves of $630bn, up from $371bn five years ago. Finally, aid agencies estimate up to five million refugees would be displaced by a conflict, challenging EU members to accept vast immigration at a time when such flows are politically divisive.

So a limited incursion could deliver strategic territory without triggering an extreme, united reaction from NATO; it almost seems a logical step until you consider the "Xi factor".

As China grapples with a debt-laden slowdown, exports have taken on an outsized importance; the 2021 trade surplus ably illustrates. Any meaningful Ukraine conflict would likely trigger a global recession as oil and gas prices spike higher. Not only would this choke off external demand, it would exact a destabilising economic price on the world's largest oil and gas importer. Put simply, whilst Russia could potentially weather the economic fallout of a limited Ukrainian incursion better than most NATO members, China would be a key casualty. Would Xi welcome this as he majors on stability and prosperity in a bid to be re-elected for an unprecedented 3rd term?

Whilst China will be assessing the West's reaction to Russian adventurism through the optic of its Taiwan ambitions, we doubt that they support Putin's more extravagant aims. The increasingly isolated President could ignore this 'Sino-subtlety' but it is a far more meaningful hurdle to action than the vapid diplomatic posturing from Western leaders of late.

Policy Matrix Summary

The matrix below is a summary of our current 12-24 month outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high level guide on where we stand at this time.

12-24 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives	Gold Miners China A Shares UK Small Companies Japan ESG & Impact funds FinTech & Blockchain	Inflation-linked, China	Gold, Volatility Strategies
−	Bonds	European US	UK European Japanese High Yield	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	31 Jan 22	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.3447	-0.6%	-1.7%	-1.9%
CHF	1.0788	-1.6%	-1.2%	-3.9%
AUD	0.7067	-2.7%	-6.0%	-7.5%
JPY	115.1100	0.0%	-1.0%	-9.0%
EUR	1.1235	-1.2%	-2.8%	-7.4%
BOND YIELDS (10 yr)				
UK	1.30	0.33	0.27	0.98
US	1.78	0.27	0.22	0.71
Germany	0.01	0.19	0.12	0.53
Australia	1.90	0.23	-0.19	0.76
Japan	0.17	0.11	0.08	0.13
EQUITIES				
US. S&P 500 (USD)	4,515.55	-5.3%	-2.0%	21.6%
UK. FTSE 100 (GBP)	7,464.37	1.1%	3.1%	16.5%
FTSE Europe Ex UK (local)	1,660.42	-4.6%	-2.2%	17.2%
Japan. Topix (JPY)	1,895.93	-4.8%	-5.3%	4.8%
China. Shanghai Comp (RMB)	3,361.44	-7.6%	-5.2%	-3.5%
HK. Hang Seng (HKD)	23,802.26	1.7%	-6.2%	-15.8%
Australia. All Ords (AUD)	7,268.29	-6.6%	-4.9%	5.8%
FTSE Asia Pac ex Japan	1,371.56	-5.6%	-9.1%	-5.2%
FTSE World (USD)	3,059.05	-5.3%	-3.6%	14.9%
FTSE World (GBP)	2,276.58	-4.7%	-2.0%	17.2%
COMMODITIES				
Oil (WTI)	88.15	17.7%	12.4%	80.0%
Gold	1797.17	-1.8%	0.8%	-2.7%

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