GLOBAL RATES OUTLOOK 2022

FROM FAMINE TO FEAST?

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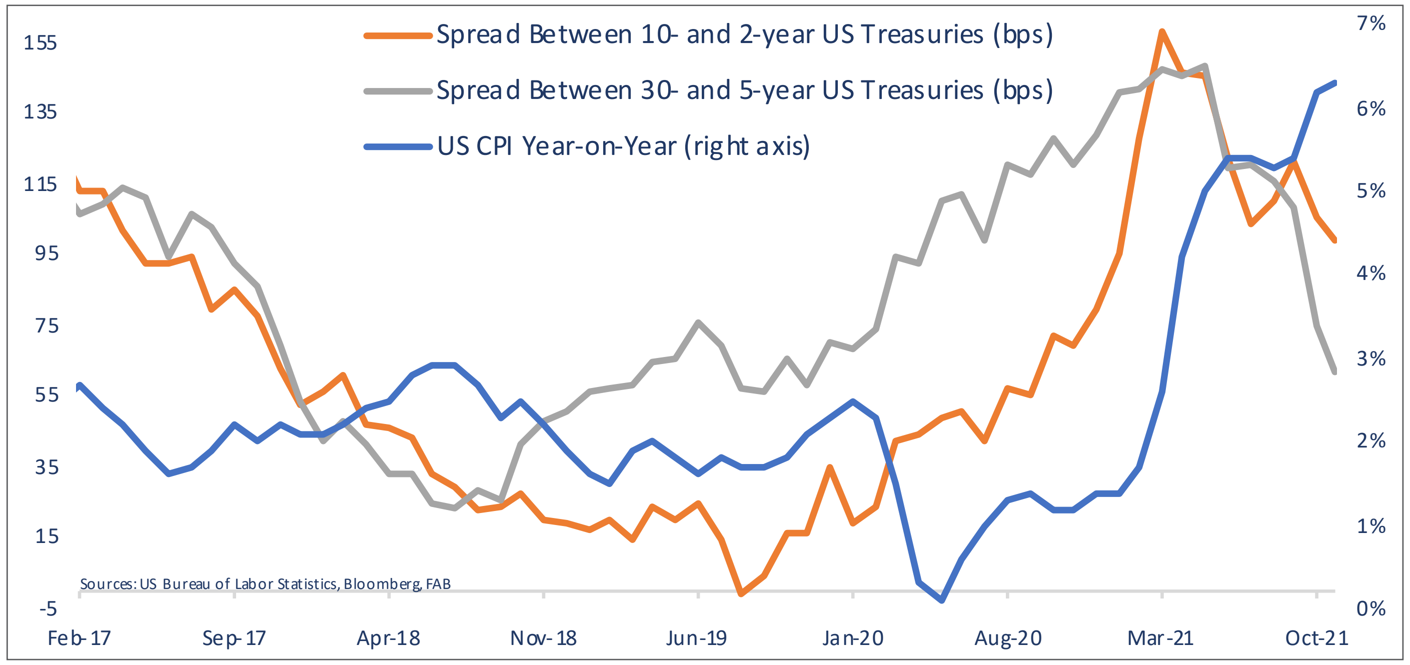
- Rates are poised to bounce off the zero bound even as the pace of reflation eases.
- Generic yields should rise, curves modestly bear-steepen over the course of 2022.
- 'Cautious optimism' should be the buzz phrase of macro conditions.
- When it comes to inflation, 'temporary' is a matter of perception.
- Fed hawks may be cohabitating with ECB doves throughout the coming 12 months.

As we traverse what we hope will continue to prove to be the post-pandemic terrain, global financial markets will position themselves with respect to prospective economic growth and inflation conditions over the coming year. We have long argued that the strongest V-shaped element of the recovery may lie behind us in 2021 and that the trajectory of recovery in the coming quarters may be more shallow U-shaped in nature. We expect this moderating recovery projection to hold true for growth as well as inflation over the coming year.

This said, even assuming that initial rebound momentum fuelled by loose monetary and fiscal stimulus begins to wane in the months ahead, we do expect robust reflationary growth levels to be maintained overall through 2022, subject to the well-documented caveats. The net result of this is that nominal policy rates across most developed economies now appear poised to bounce off the zero bound that is still largely priced into the rates market. This will lead to a gradual rise in generic yields and a modest bear-steepening of yield curves over the course of 2022.

US 2s/10s, 5s/30s yield curve vs. US CPI 'Rethinking reflation'



The foundations for reflation are well known – strong and successful COVID-19 vaccination programmes, a reopening of economic activity and consumption and solid inventory building across most sectors, but so are the risks (virus variants, economic uncertainties, fragile labour market conditions). As such, the inference in this is that the path of least resistance for global rates over the coming quarters should be tentatively higher. 'Cautious optimism' should remain the buzz phrase of the macro rates outlook in 2022.

During the second half of 2021, it seemed that global investor sentiment was steadily being conditioned by central banks for an impending turn in the monetary policy screws. Elevated inflation rates around the globe, while perceived as 'transitory' by several major central banks including the Federal Reserve and ECB, continued to fuel bond market fears that monetary authorities' hands would be forced earlier and more acutely than previously anticipated. At the same time, such anxieties have pushed many market participants to the sidelines, thereby draining the market of liquidity and fuelling outsized volatility across risk assets.

Meanwhile, though, fiscal policy seemed and still seems set to remain ultra-loose during 2022, albeit with governments becoming increasingly cognisant of the structural debt pile that is being accumulated as a result of their emergency pandemic rescue packages. Indeed, it was the recognition of this debt position coupled with current high inflation that led the Federal Reserve to announce the tapering of its asset purchase program at the conclusion of its November 3rd, 2021 FOMC meeting, though it left underlying interest rates unchanged. The Fed aims to have concluded the tapering by early 2022.

At the same time though, the Fed was keen to reassure markets that tapering does not predetermine the start of rate tightening, even though it has stressed its readiness to act if appropriate faced with the current backdrop of macroeconomic risks and conditions. As reflation gathers momentum, the spectre of possible monetary and fiscal policy 'normalisation' during the course of 2022 will now surely cast an increasingly opaque veil of uncertainty across global markets over the coming months.

With markets having learned to live with and depend on not only a near-zero interest rate environment for much of the past two years but also deep structural stimulus in the form of quantitative easing, fears over how global markets might survive once tighter conditions prevail have begun to grow. With inflationary pressures seemingly building by the day, albeit what is still expected to be largely transient inflation in our view, it is perhaps a natural question to ask. However, the key error that markets have made in recent months has been the blunt assumption that QE tapering and rate tightening are one and the same. They are not.

While the Federal Reserve has begun the process of tapering its asset purchase program, it has stressed that it does not anticipate an increase in actual interest rates until late 2022 at the earliest. The anchored nature of the underlying US Treasury yield curve suggests that the market concurs. In the context of fragile reflation and the prospect of easing price pressures over the coming months, we would conjecture that the timeline for Fed tightening may edge back toward early 2023.

US money market futures in November 2021 saw some 15 basis points of tightening priced into the US curve by the end of 2022. Indeed, in recent months, futures have fluctuated between implying a Q4 2022 or Q1 2023 start date for Fed funds tightening. The FAB house view favours the latter.

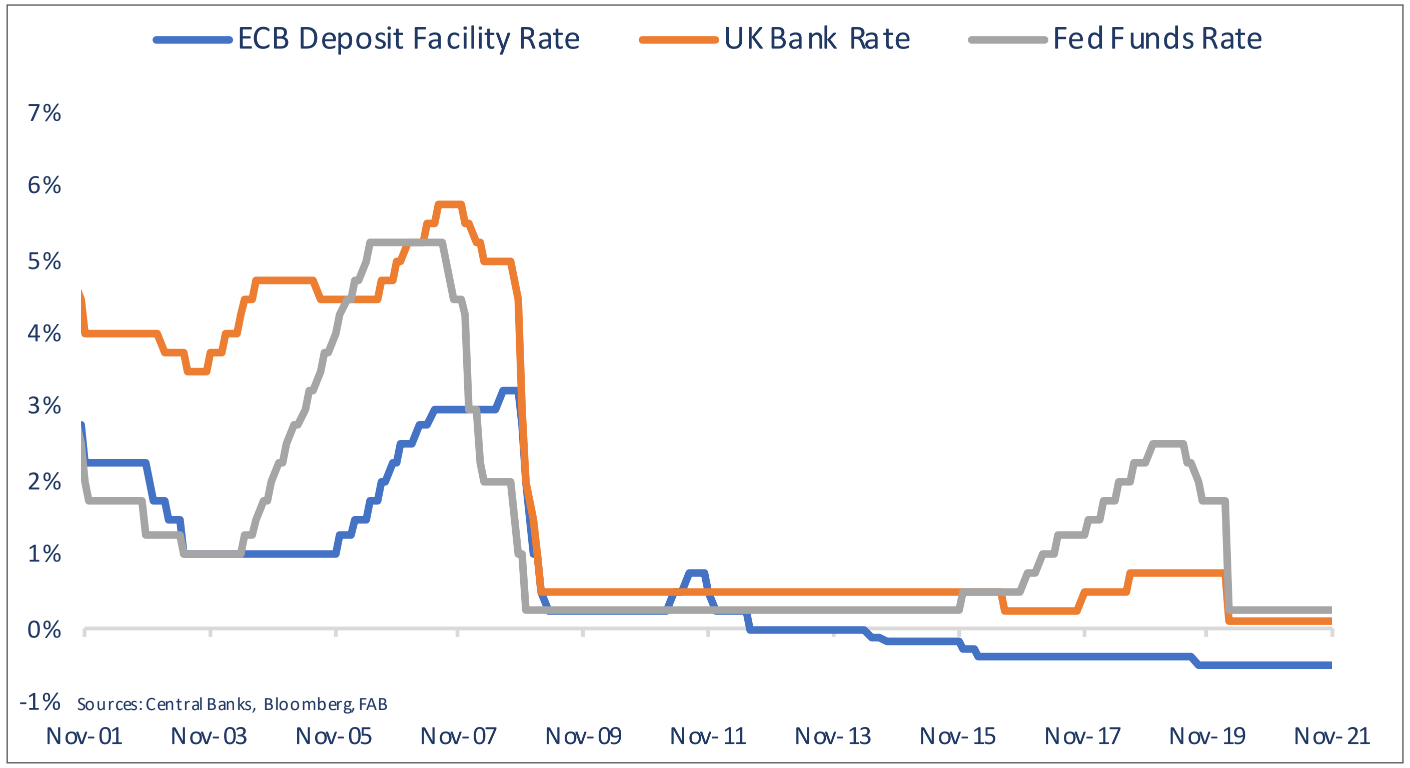
While current inflationary pressures are unarguably elevated, we still subscribe to the view that they will prove to be transient in 2022. Nonetheless, in order to avoid a more disruptive, hawkish outcome, we believe that it may be appropriate for the FOMC to ratchet up the pace of its taper process in the early months of 2022 in order to send the correct 'we've got this' message to the markets. Failing to act swiftly enough after having acted so swiftly in response to the pandemic could lead to future claims that Mr Powell has overseen the greatest policy mistake of modern times. Risk markets would not be sympathetic to such a view.

In broader terms though, as we move further away from the nadir of the economic downturn in Q2 2020 and the low point in terms of price compression, we also expect headline year-on-year inflation rates to recede. Admittedly, the terminal rate of inflation may remain structurally higher than it was pre-pandemic, but we anticipate a gradually less hawkish rhetoric to prevail over the coming quarters nonetheless.

In such a scenario, we currently believe that US rates will remain anchored and that the first actual tightening of the Fed funds rate will materialise at the February 2023 FOMC meeting at the earliest. As generic economic conditions make tentative gains though, the underlying yield curve should edge higher/steeper during the course of 2022 such that the yield on the 10-year Treasury may only just break above the 2% level by the end of the year.

In this context, UAE and broader GCC interest rates also seem set to remain steady during 2022. Expect rates and yields across the region to largely continue tracking their US counterparts, albeit with some modest variation to be expected over time due to oil price fluctuations and regional geopolitics.

Fed funds, ECB refi, BoE Bank Rate 'Anchored well into, if not through, 2022'



In the Euro area, we expect the overarching tone of monetary conditions to remain far more dovish. The ECB has stated quite categorically that it does not expect macro conditions to be strong enough to support tighter monetary policy any time before 2023. We agree and do not expect the ECB to be in a position to pull the rate tightening trigger until Q4 2023 at the earliest. But this dovish spin is not reflected in market pricing, which we feel has recently overshot with expectations of a more hawkish bias from the ECB. Markets should correct over the coming months to withdraw such hawkish assumptions.

Meanwhile, the lack of a coherent communications policy at the Bank of England put investors on alert for a UK rate hike at the November 4^{th}, 2021 meeting, only for the Bank's MPC Committee to vote with a solid 7-2 majority to leave its benchmark bank rate unchanged at 0.1% . UK interest rates will rise in time and government bond yields will react accordingly but, we believe, not as quickly or as hawkishly as many currently anticipate.

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