Market Insights & Strategy

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Global Rates (May'22 Update / 2H2022 Outlook)

- **Consensus on direction of rates, but challenges to pace and length of normalization**
- **Rate tightening, elevated inflation and geopolitical risk is a Molotov cocktail**
- **Weakening macro growth outlook warrants a dovish revision of rates trajectory**
- **The outlook for U.S. rates just got a little more complicated**
- **ECB hawks are winning for now**
- **As GDP cools, the BoE may have already done enough**

We have long been more dovish in our global rates outlook than current market pricing suggests will be the case. While we do agree on the overall direction of travel for monetary policy, amid normalisation strategies that were really kicked off with the Fed liftoff at the March 16 FOMC, it is our opinion that the implied gradient and length of the rate tightening curve is currently too steep and too long overall.

What is increasingly clear is that price pressures are set to remain sticky to the upside over the remainder of 2022. Moreover, the market is becoming increasingly cognizant that – as we have previously suggested will be the case – the drivers of inflation are relatively interest rate insensitive, suggesting that Fed policy is at risk of appearing increasingly impotent against such a backdrop. This in turn threatens the macro outlook and raises the spectre of stagflation; a market condition that has never been a friend of risk assets.

Markets are left to digest a potential Molotov cocktail of aggressive monetary policy tightening in the face of elevated global inflation pressures, acute geopolitical risk (fuelling the aforementioned price pressures) and ongoing supply chain disruptions as China locks down in pursuit of its current zero Covid-19 policy. All of this is causing a rout in investor sentiment and bolstering concerns about the global growth outlook.

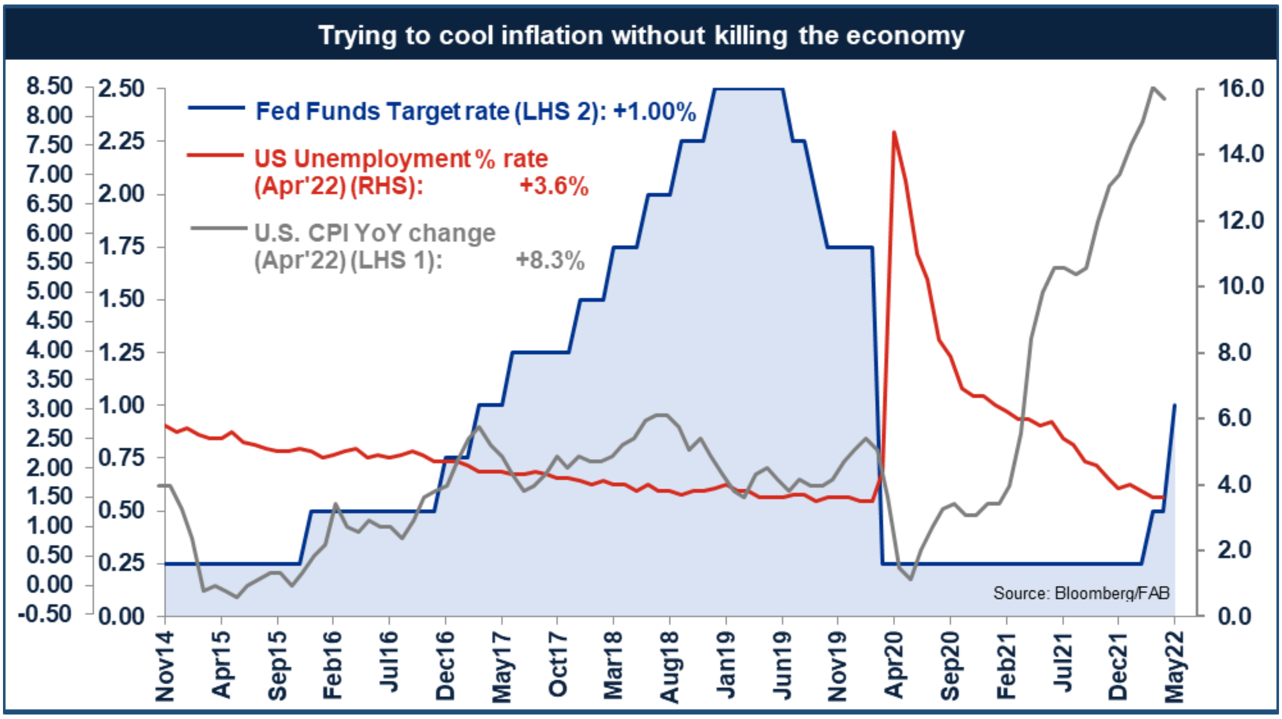
In terms of the latter we note that the IMF in its April iteration of the World Economic Outlook, forecast global growth to slow from an estimated 6.1% in 2021 to 3.6% this year and a similar level of economic expansion in 2023. These projections are 0.8% and 0.2% lower respectively for 2022 and 2023 than the IMF projected in January.

Beyond 2023, global growth is forecast to decline to about 3.3% over the medium term. As future economic growth expectations are trimmed, so we would suggest that the rates market should be revising its interest rate forecasts lower accordingly.

U.S. / FOMC rates

Price pressures appear to be suffering from long Covid and the airstrip for a hoped-for soft landing by the U.S. economy just seemed to get a little narrower. In the wake of the recent U.S. April CPI report that showed inflation fading slightly at the headline level (8.5% in March to 8.3% in April, still stronger than the expected decline to 8.1%), but also remaining robust at the MoM core level, the outlook for the Fed just got a little more complicated.

While the CPI data at the headline level implied a potential plateauing of inflation pressures, the month-on-month number came in stronger than anticipated and was more worrisome. Indeed, the latter came in at +0.6% vs expectations of a +0.4% gain, and up from 0.3% in March. The data certainly offered nothing significantly new to the monetary policy debate that might distract the FOMC from raising rates by the telegraphed 50bps at the next (June 15) policy meeting and possibly at least another 50bps at the July meeting after that.



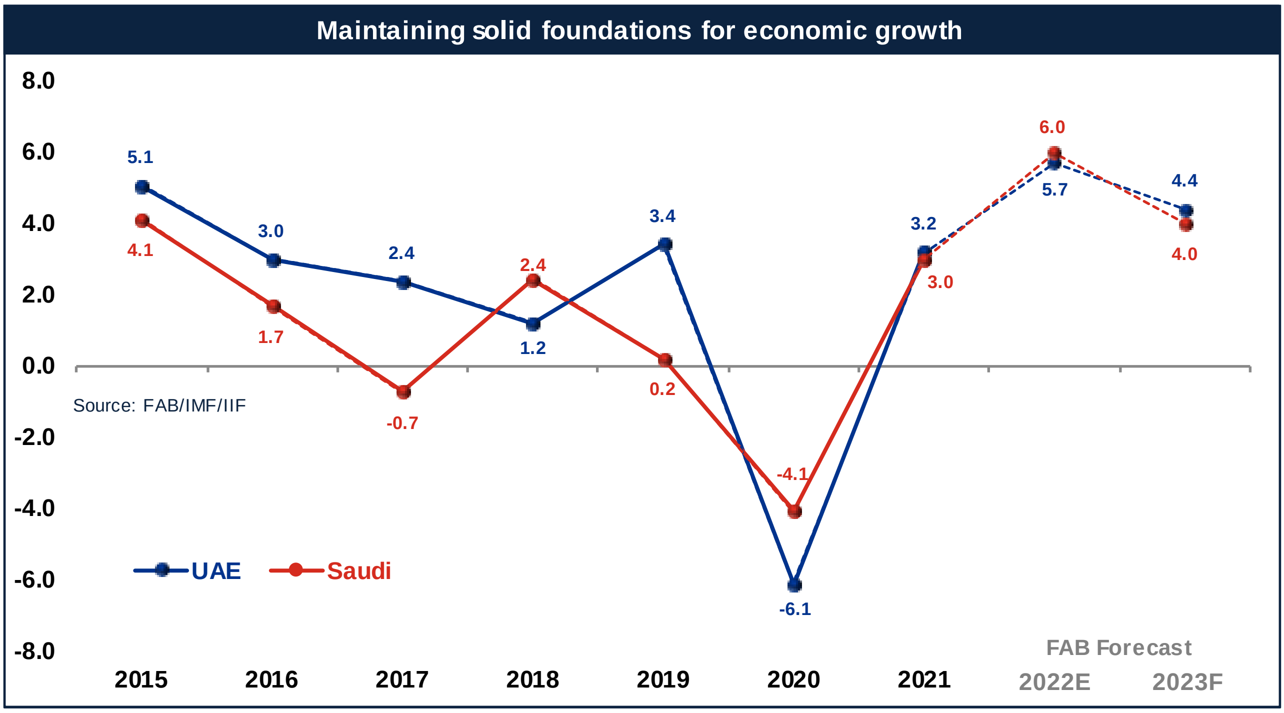
For now therefore, the Fed appears to have committed itself to a reasonably hawkish path of front-loaded rate normalisation in the coming months - suggesting a readiness to raise rates by 50bps at each of the next two FOMC meetings in June and July and after having already tightened by 75bps since March - there appears to be a growing scepticism as to whether the Fed and other central banks will actually be able to deliver on the rates front, while guaranteeing to achieve a soft landing without triggering a recession as they seek to bring down inflation.

Worst still, if inflation proves to be relatively interest rate insensitive, as we expect it will, the result could be one of stagflation. This in itself, we believe, corroborates our preferred more dovish narrative toward the outlook for rate tightening policy in the months ahead. While the market is currently pricing in a further 175bps of aggregate tightening by the Federal Reserve by the end of this year, we believe that as the challenging (stagflationary?) macro backdrop evolves, Mr Powell & Co. will pare back their hawkish rhetoric. An additional 125bps of paced tightening from here by year end would now seem more sensible to us.

GCC Rates

The rebound in GCC regional economic growth has been robust since the nadir of the economic downturn in Q1/Q2 2020. As discussed previously we expect the macro environment to consolidate on firm foundations over the remainder of this year and through 2023. This said, given that there was not the degree of monetary stimulus intervention in this region post the pandemic as seen in the U.S. and Europe, inflation pressures in the GCC in recent months have been more contained than elsewhere.

Compared to U.S. CPI that came in at +8.3% YoY in April, down from 8.5% in March, annual inflation in Saudi Arabia stood at 2% in March, up from 1.6% in February. While this was the highest print since June last year, it conveys a more dovish bias than that in the U.S. Meanwhile, inflation in the United Arab Emirates ended 2021 at 2.50%, down from 2.58% in the prior month. Surging energy prices in recent months will surely push 2022 inflation data to the upside, but in absolute terms price pressures are expected to remain anchored, with UAE CPI seen rising to around just 3% on average this year.

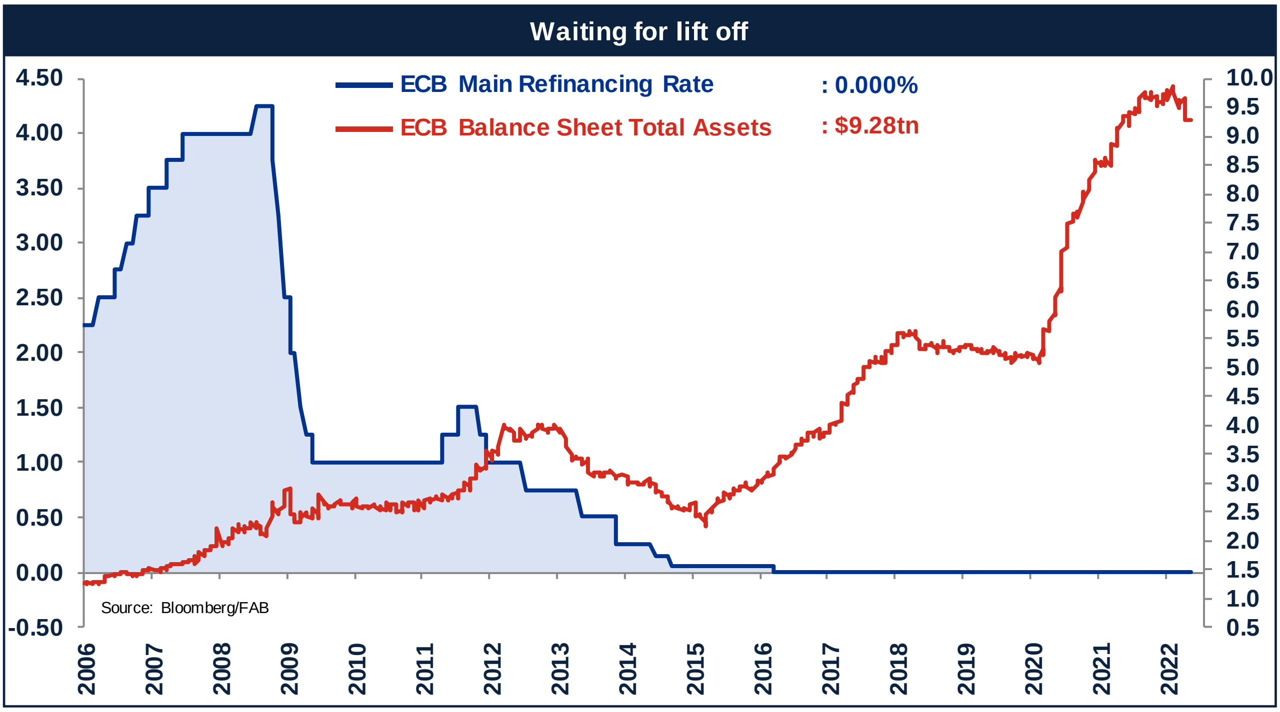


In this context, GCC central banks will be expected to mirror rate moves from the Federal Reserve, in respect for their dollar-pegged (or, in the case of Kuwait, dollar-linked) currencies. This has been the case with the two initial rate moves by the FOMC this year as GCC central banks matched the rate moves in the hours following the U.S. announcement.

EUROZONE / ECB Rates

With ECB President Christine Lagarde having this week flagged a July rate increase from the ECB, it seems that the hawks are winning the inflation vs growth debate in the Euro area. Certainly, recent ECB communication suggests that the Bank is currently far more concerned about upside inflation risk than it is about imminent downside risks to economic growth. This said, myriad questions remain and the path to rate tightening is surely not without obstacles. The impact of the Russia/Ukraine conflict, especially if the war were to escalate, should not be underestimated.

Previously we had thought that the fragile nature of the Euro area economy would constrain the ECB from lifting rates at least until the end of this year and any renewed disruption in energy supplies and pricing in Europe could quickly reignite such concerns. Moreover, we are cognizant that energy market disruptions and geopolitical risk could quickly tip the Euro area back into recession. Therefore, whether Lagarde's shift to a more hawkish perspective is founded on improving macro credentials, conviction in a Russia/Ukraine resolution or simply her being bullied into this position by Fed rhetoric across the pond remains to be seen. We believe it is more of the latter.

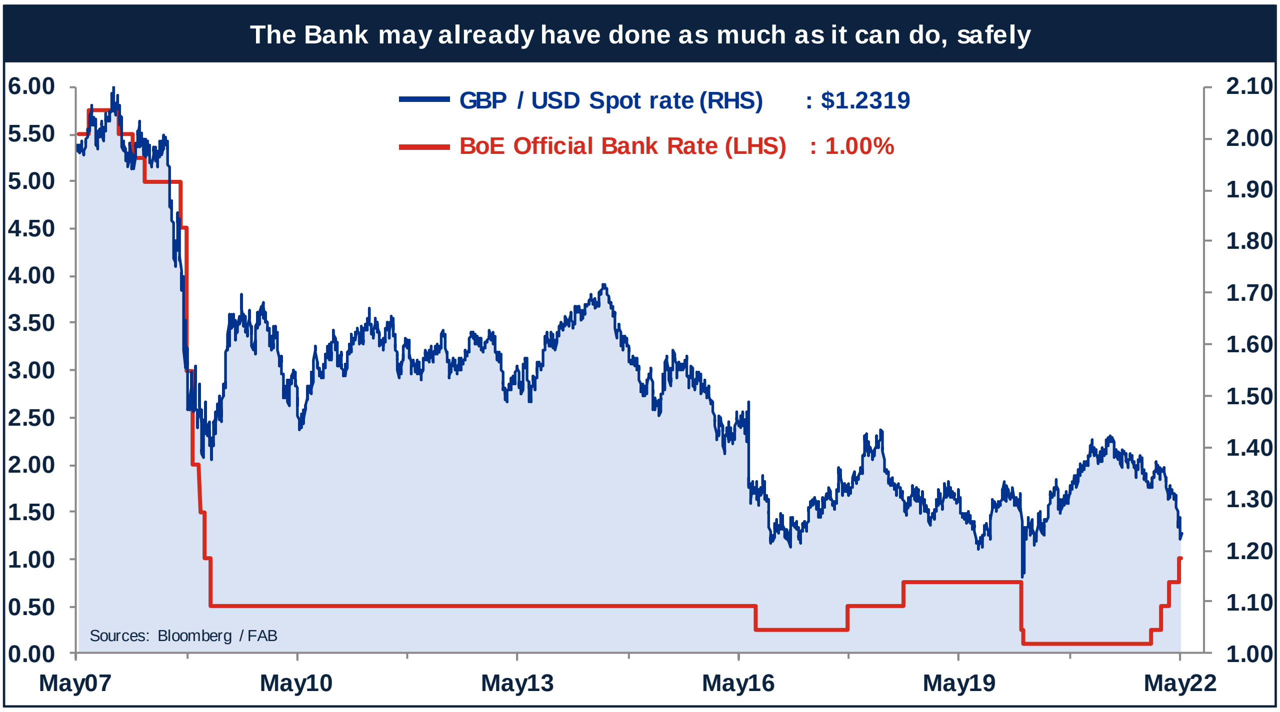


So now, regardless of whether ECB liftoff begins in July or September – we believe the June 9 meeting is too soon – the bigger question will be how fast and how far the ECB is able to go in terms of absolute tightening. Against the backdrop of a hawkish Fed we would suggest that the ECB will now be biased to raise rates twice or three times by year end (July and/or September and December), subject to no adverse geopolitical newsflow. So, our base case is for 2 or 3 hikes by the ECB by year-end and then a cautious pace of additional tightening in 2023. Such a strategy should lead us toward a terminal (neutral) rate of around 1.50%, although we would again stress that, currently, there is probably more downside than upside risk in our forecast. .

UK / Bank of England Rates

While the UK economy registered a (surprisingly) strong start to the year, economic activity has subsequently lost momentum as inflation has edged higher, triggering an increasingly worrying cost-of-living crisis across the country and amid the ongoing pressures originating from the harrowing situation in Ukraine. As a result UK GDP contracted -0.1% MoM in March, weaker than expected (0.00%) and down from the already frail 0.1% expansion seen in February. This now leaves preliminary Q1 GDP at just +0.8%, shy of the Bank of England's +0.9% forecast and leaves the economy facing the possibility of slipping into a technical recession, although we believe it will avoid 2 consecutive months of negative GDP. Nonetheless, the risk is clearly to the downside.

More likely though is that this delicate balance between recession risks and high inflation will persuade the BoE to now forensically parse all data in front of it and perhaps to pursue a more cautious outlook in terms of monetary policy setting. With the Bank having increased the official Bank Rate by 90bps over the course of the past four MPC meetings (Dec 16 2021, Feb 3, Mar 17 and May 5) as well as begun the unwinding of its balance sheet, one could argue that it will soon be time to pause.



For now, the market is pricing in 4 further (25bps) rate increases by year-end, an outlook that has been encouraged by tight labour market conditions, even amid a notable slowdown in demand. But in the context of the weaker March GDP data print, we believe that the balance of (macro) risks will lie firmly to the downside for the UK in the coming months, all of which should support the case for the BoE to sit tight in the coming months.

The Bank itself will want to be seen as being proactive toward the red hot labour market, but we would suggest there is now a strong case for taking at least two of the expected upcoming rate hikes back off the table as the growth outlook cools. Caveat emptor, the latter half of this year could turn out to have a more cautious/dovish tone to it than is currently expected.

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