A Tug of War - Round 2

March 2023

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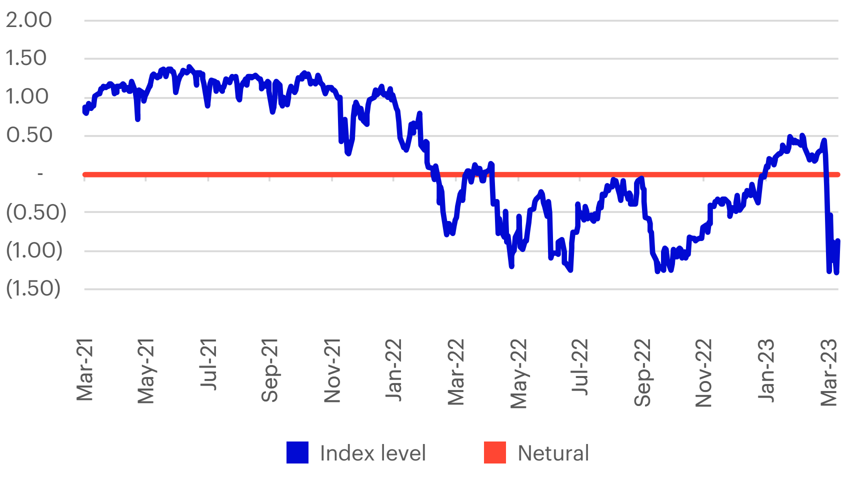
Our previous thoughts on global macro highlighted the tug of war between market expectations and the central bank's policy stance on interest rates. Market expectations of a lower peak of rates and a faster rate cut cycle was based upon the sharp economic slowdown/ recession, whereas the central bank continued to maintain a hawkish eye on inflation as well as jobs market. With this on-going Tug of War, the first three months of 2023 have been volatile with a see-saw. The yields declined sharply at the beginning of the year (US 2-year down 35 bps) to later give up the gains and end up going higher than the start of the year (up 100 bps from Jan 2023 lows) as FED hawkishness was accepted by the markets. Even as that tussle continues, a new tug of war readies itself, where the central banks have to decide between maintaining financial stability or continue with their fight against inflation.

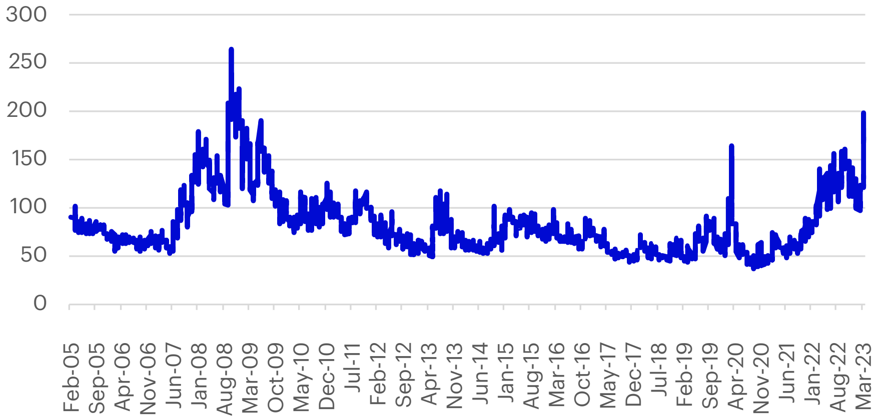
Recent events surrounding US regional banks and Credit Suisse highlight the fragility of financial systems and the interconnectedness of risk. The catalysts can be any/many but when global central banks tighten monetary policy at this unprecedented fast pace, accidents are bound to happen albeit with a lag. Whilst policy makers have done an admirable job at containing the fallout from US regional banks' issues and fall of the Credit Suisse, the second order effects will start to play out, namely tighter financial conditions and risk averseness. This is already getting reflected in the Bloomberg financial conditions index which is at the tightest level for the last 24 months, as well as the MOVE Index (indicative of volatility in US Fixed Income markets) which is also at the highest level for the last 12 months. Credit spreads have widened, and risk assets in general have wobbled. Bank lending standards which were already tight will likely become even tighter with greater scrutiny on their risk management practices.

Bloomberg US Financial Conditions Index



Source: Bloomberg, as on March 21, 2023

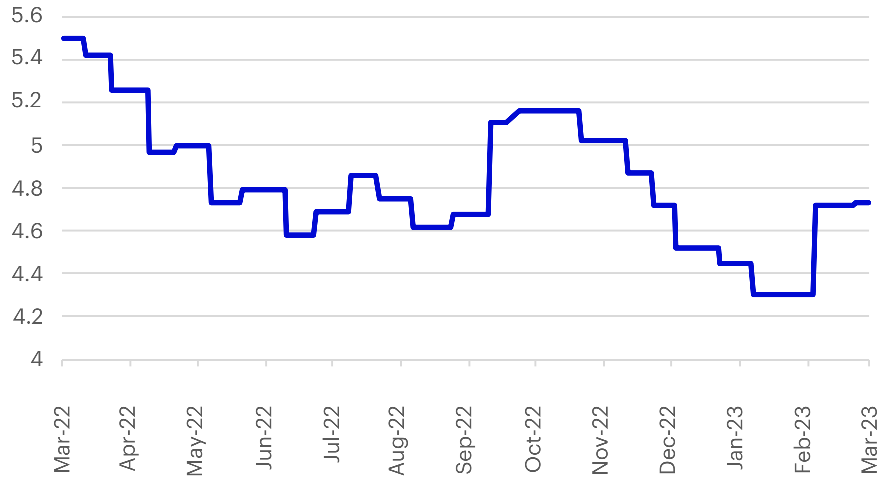
US Move Index (measure of interest rate volatility)



Source: Bloomberg, as on March 20, 2023

Central Banks, however have a current inflation battle to also fight for which they look at more co-incident / lagging indicators. With current inflation still running significantly higher than the long term target of 2%, it will be difficult to dismiss the high inflation altogether since a bad attempt to fight the current war against inflation can cause even higher collateral damage later (as is being felt now with most central banks now having to play aggressive catch-up in fight versus inflation). Cleveland FED's nowcasting on core PCE (FED's favoured inflation measure) has started to inch up again since stabilizing in January 2023. The inflationary rebound of the 1980s will be in the US FED's mind as they want to avoid inflation coming back sharply.

Cleveland FED Core PCE Nowcast - YoY %

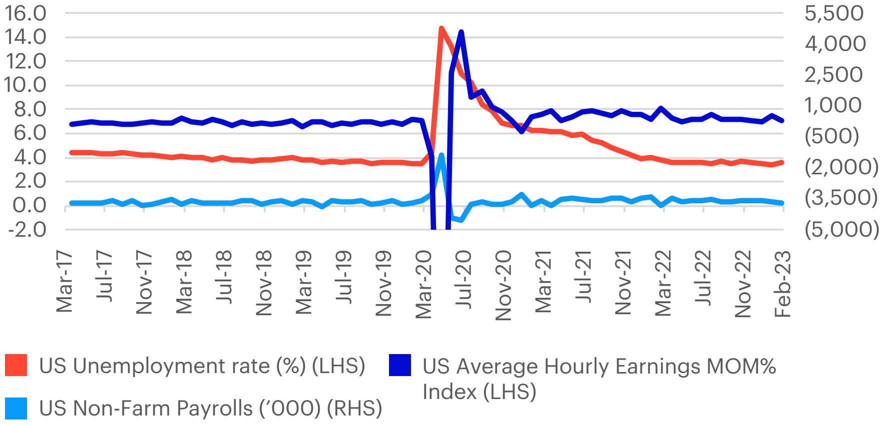


PCE: Personal Consumption Expenditure

Source: Bloomberg, as on March 20, 2023

Additionally, US job markets continue to still remain tight only despite some recent relief seen in unemployment rate and hourly wage rates.

US Employment data



Source: Bloomberg, as on February 28, 2023

Growth indicators were already slowing down in the US as well as globally and the impact of the recent events will only further impact negatively. While there was euphoria at the beginning of the year for China's economy re-opening & China also cut Bank reserve requirements by 25 bps over the weekend to spur liquidity and growth, recent global events have impacted the growth potential as also reflected in correction in commodity prices. Bank lending standards have been tightening and will likely tighten more as Banks focus on risk management. US consumer strength has been touted as an area of optimism, but employment data is a co-incident to lagging indicator and in all slow-downs employment data and thus consumer is the last shoe to drop.

So whilst the financial stability concerns and forward looking growth outlook may warrant pause / end to the rate hike cycle, the tight employment market, high and sticky nature of current inflation, as well as the risk of inflation expectations getting entrenched and resulting in a second wave like the 1980s pose a very difficult question for FED.

Our Thoughts:

- The FED will acknowledge recent events in the banking sector but rightfully highlight the strength of the financial sector.
- There is a reasonable likelihood that the FED raises rates by 25 bps to show that the fight against inflation matters. At the same time, it may highlight that lagged effects of monetary policy are being felt and hence they will have an eye on that.
- If the FED tones down its previous hawkish rhetoric, rates markets will take it as dovish and may rally a little. A lot of the dovishness is already priced in.
- If the FED changes its stance to be more balanced, markets may reprice the short end upwards as it has come down a lot and needs to price in possible further rate hike.

- If the FED remains hawkish to highlight no issues in financial stability and that fighting inflation remains a priority, interest rates in the short end will go up sharply. The long end of rates curve may start pricing in risk averseness especially if risk assets don't like FED hawkishness.
- Critical to watch out the inflation projections and interest rate dot plot whether the FED factors in recent financial stress.
- On RBI policy actions, the MPC's last hawkish commentary and subsequent elevated inflation print has raised the probability of one more rate hike in the next meeting in April 2023 (from almost nil earlier). While the debate on peak policy rate is still on, we believe MPC's next policy action would be largely driven by the monetary policy action of other Global Central Banks especially US FOMC. A dovish US FOMC will lead RBI also turning neutral on future rate hikes and become more data dependent.
- INR will be driven by global risk assets although our external position looks much better given improving current account deficit from lower oil prices, declining imports as well as strong services exports.