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There was a gasp heard around the world last week, prompted by the words of Christine Lagarde, president of the European Central Bank. At the ECB's press conference last week, Lagarde turned decidedly hawkish, admitting that inflation is higher and more persistent than expected, with risks now leaning to the upside. While Lagarde insisted that rate hike liftoff was still unlikely to occur in 2022, it appears markets are expecting it to begin in mid-2022.

The ECB is clearly getting concerned about inflation, just as the Federal Reserve has been. And with some good reason: A flash estimate for January euro area inflation clocked in at a 5.1% annualized rate.¹ What a difference a year – and a pandemic re-opening – makes: As of a year ago, in January 2021, euro area inflation was rising at a 0.9% annualized rate.¹

Last week also saw the Bank of England raise rates by 25 basis points again, following a 25 basis point rate hike in December. Also gasp-worthy was the revelation that four of the nine members of the BOE's Monetary Policy Committee actually wanted to raise rates by 50 basis points. Worries about inflation are spreading among central bankers like a bad case of poison ivy at summer camp.

Meanwhile, the double-gasp-worthy January US jobs report, released on Friday, helped support the view that the Fed will likely act quickly to tighten monetary policy. Not only was nonfarm payroll growth strong (for January as well as in terms of revisions to December) but wage growth was high – and, more importantly, higher than expected. This report bolstered the perception that the Fed will hike rates in March – and even increased the possibility of a 50 basis point hike for liftoff.

How did markets react?

The global bond market reacted emphatically to last week's events. The yield on the 10-year German bund rose to 0.20% – its highest level in years.² The yield on the 10-year Italian bond also rose significantly during the week. And so did the 10-year US Treasury yield, which rose above 1.9% last week.² In response to the rise in US and European bond yields, the 10-year Japanese government bond yield rose to nearly 0.2% – for the first time since January 2016 – although the Bank of Japan is clearly nowhere near tightening mode.²

What may happen next?

The BOE, the Fed, the ECB, and the Bank of Canada are all in different places on the path to normalizing monetary policy, but the commonality they share is that they have all turned more hawkish in the last several months. So where do we go from here?

First of all, I expect to hear more hawkish talk from them. Central bankers rely on their words to do some of the heavy lifting, and to a certain extent it has worked thus far. In terms of actual tightening, the pace for these four central banks will largely be dictated by the data – inflation and inflation expectations, that is. For some central banks, there remain concerns about the vulnerability of their respective economies, so I anticipate the ECB and the Bank of Canada will be more sensitive to that.

It is important to recognize that, while the balance of the data has been stronger than expected (pointing to higher inflation) and central

bank policy signals in the West are more hawkish than expected (pointing to tighter monetary policy), the situation is more nuanced and country-specific.

For example, the US jobs report showed that workers may be starting to come off the sidelines to take part in the strong economic recovery, enticed by lots of job openings and higher wages and salaries on offer – reflected in average hourly earnings, the labor participation ratio, and the employment-to-population ratio. If workers continue coming back into the labor force, that could give the economic recovery longer legs, and help take some pressure off wage growth.

Europe – both the eurozone (EZ) and UK – also is experiencing a bit of a renaissance in its jobs market. Unemployment tends to be much stickier in the EZ than the UK, and even more so than in the US, because it's harder to add or reduce workers for most firms. The consensus has been that the ECB won't be able to do, or need to do, as much tightening as the Fed – mainly for this reason. But if the EZ labor market continues to tighten with falling unemployment, markets may reassess how much more ECB hawkishness to price in.

The BOE, on the other hand, sent mixed messages on future policy. BOE Governor Andrew Bailey called for wage restraint to avoid further inflation pressures, noting that real disposable incomes – the “take home pay” after inflation – will suffer. He was at pains to argue that the market shouldn't extrapolate from this more BOE rate hikes – even though the 5-to-4 vote for a 25 basis point rate hike instead of a 50 basis point hike was much more hawkish than expected.

While the Fed, BOE and ECB have taken most of the limelight, the Bank of Canada shouldn't be left outside investors' radar. BOC Governor Tiff Macklem has indicated that inflation will remain uncomfortably high in the first half of the year, but it's expected to fall significantly in the back half of the year. Acknowledging the uncertainties created by the pandemic, by supply-chain and labor market issues, he still signaled a series of rate hikes ahead.

Whatever one's view of the causes of this inflation – excessively loose monetary policy, outsized fiscal support, or pandemic-driven change in the economy – it's clear that inflation is a bigger, longer-lasting concern than most central banks had hoped. And they're reacting by pivoting to a more hawkish stance, although that means different things to different central banks.

I expect more volatility as market participants assess what various data releases mean for central bank actions, as well as “central bank speak” (which admittedly can be at times more difficult to decipher than ancient Greek). And I would expect a tailwind for equities in countries where monetary policy is getting closer to the end of tightening or, even better, becoming more accommodative. I think it's no coincidence that Chinese equities showed strength in recent days, as the People's Bank of China has been getting more dovish this year.³

What to watch this week

Looking ahead, the week will be rather US-centric and inflation-centric. I expect central bank whisperers to be particularly interested in the US Consumer Price Index (CPI), Michigan Inflation Expectations, the Fed's Monetary Policy Report (submitted in advance of Chair Jay Powell's semi-annual testimony to Congress), and various speeches from ECB officials.

I can only hope for a “no gasp” week in terms of the data. US CPI is expected to be significantly hotter than the previous month, so I don’t expect any real rattling of markets unless it comes in above expectations. Regular readers of this blog may recall that we don’t anticipate inflation will peak until the middle of 2022, so we would not get flustered by a 7.3% year-over-year rise in inflation — which is the consensus expectation for the CPI. What could be more important are the preliminary Michigan Inflation Expectations for February. The New York Fed’s inflation expectations for the next one and three years remained high in December, but appear to have peaked; we would want to see the same from the Michigan data (we will have to wait until next Monday for January inflation expectations from the NY Fed.) And there are always interesting insights to be found in the Fed’s Monetary Policy Report.

Of course, equity and bond prices have been gyrating as policy expectations are recalibrated for the hawkish turns of central bankers. Our attention remains on just how far the Fed and other central banks feel they must adjust to match the new realities of inflation—and therefore how much longer we expect policy to dominate the market narrative. Until we see inflation abate, or at least inflation expectations indicating they are better anchored, we’re likely not through the woods yet.

With contributions from Arnab Das and Ashley Oerth

Notes

¹Eurostat, the statistical office of the European Union, Feb. 2, 2022

²Bloomberg, L.P. Rates reached these levels during the week ending Feb. 4, 2022.

³Based on the China Shanghai Composite Stock Market Index and the Hang Seng Index. The China Shanghai Composite Stock Market Index is a major stock market index which tracks the performance of all A-shares and B-shares listed on China’s Shanghai Stock Exchange. The Hang Seng Index is an unmanaged index considered representative of the Hong Kong stock market and includes the largest companies traded on the Hong Kong Exchange. Past performance is not a guarantee of future results. An investment cannot be made directly in an index.

Important information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

The consumer price index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics. Core CPI excludes food and energy prices.

Personal consumption expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services. Expenditures included in the index are actual US household expenditures.

The University of Michigan’s inflation expectations are published monthly, based on a telephone survey (the Surveys of Consumers) designed to assess US consumer expectations for the economy and their personal spending.

A basis point is one hundredth of a percentage point.

The opinions referenced above are those of the author as of Feb. 7, 2022. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.