

Some 'silver linings' I see in markets today

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Last week, I was lucky enough to present to several different clients and to also address a group of business school students. Questions and conversations with them this week have helped to shape what's been on my mind, especially regarding the "silver linings" I'm seeing in some concerning issues. Below, I discuss a few of them.

A "melt up" in global yields

The issue: Developed market government bond yields are on the rise, especially on the long end. Hawkish central bank speak in recent days is having an impact — especially comments from Fed Governor Lael Brainard as well as the Federal Open Market Committee (FOMC) minutes released last week. Brainard has traditionally been perceived as a "dove," but she appears to have turned into a "hawk" because of inflation, and her comments about balance sheet reduction "at a rapid pace" were noticed.

The FOMC minutes provided more details on the Federal Reserve's (Fed) plans to reduce the size of its balance sheet, indicating that the monthly cap on the passive roll-off of the balance sheet (allowing securities to mature and not be replaced) would probably be \$95 billion. In addition, they talked about the potential for the Fed to start actively selling some of the mortgage-backed securities (MBS) on its balance sheet once runoff is "well underway." And it's not just the Fed — the Bank of Canada is widely expected to begin quantitative tightening (QT) soon and it is already underway for the Bank of England. However, the bold move forward with QT for the Fed seems to be having a particularly significant impact, especially coupled with growing market expectations of several 50 basis point rate hikes in the offing, starting at the May meeting.

Where do I see a silver lining? The fact that central bank speak is already causing a tightening of financial conditions has a silver lining, in my view: The Fed (and perhaps other central banks) may not need to tighten as much as many expect. As I have said before, I believe they would prefer to speak loudly but use a smaller stick. In the meantime, the Fed has helped reverse the temporary inversions seen in parts of the Treasury yield curve, which might cause some jittery investors to breathe easier given all the attention that has been given to the recent inversion of the 2-year/10-year Treasury yield curve (which as of this writing has reversed and is actually at 25 basis points).¹

The future of Europe

The issue: Last week, European Union leader Ursula von der Leyen toured some of the destruction caused by Russia's invasion of Ukraine. Reflecting horror and outrage, she denounced the actions of the Russian army and pledged to expedite Ukraine's application for membership to the European Union. She shared her vision for the future with Ukrainian President Zelensky, "Russia will descend into economic, financial and technological decay, while Ukraine is marching towards the European future, this is what I see."² But what is the European future? Some of that will be decided by the French presidential elections underway, given Emmanuel Macron's emergence as something of a "de facto" leader of Europe now that Angela Merkel is no longer Germany's chancellor.

Market fears had risen in recent days as challenger Marine Le Pen gained in the polls. Spreads widened last week between French and German government bond yields³ — the increase in borrowing costs for the French government indicated the market's concerns about a potential change in leadership. The first round of the election was held April 10 and, as expected, Macron and Le Pen garnered the most votes and are advancing to the second and final round later this month, just as they did in 2017.

Le Pen's rise in the polls is a result of the drop in popularity of a candidate farther to the right, whose pro-Putin stance has negatively impacted his popularity in the face of Russia's invasion of Ukraine. At the same time, Le Pen was able to focus on domestic issues including inflation, which is top of mind for many disgruntled French voters (and a cautionary tale for US mid-term elections). Conventional wisdom suggests that Macron should eke out a narrow victory, but I would expect spreads to widen and volatility to increase between now and then.

Where do I see a silver lining? As my colleague Paul Jackson pointed out, "a Marine Le Pen presidency would initially take France down a very different path (more isolationist, more assertive, anti-EU/US and fiscally expansive). Though we think the reality of office could soften the approach, we fear that financial markets would react negatively in the first instance, with French and other peripheral Eurozone assets suffering." But it is that visceral market reaction that could force a Le Pen presidency to soften more radical elements of its platform, just as it did with the François Mitterand presidency in the early 1980s.

COVID in China

The issue: There are waves of COVID emerging around the world right now, but investor concerns appear centered on China given that the policy response has been a significant level of lockdowns. Looking at the issue from an economic perspective, this could obviously contribute to short-term supply chain disruptions and create headwinds for the economy in the short run. However, as I have said before, I believe fiscal and monetary stimulus should help spark a re-acceleration in Chinese growth in the second half of the year.

Where do I see a silver lining? The lockdowns are causing a short-term reduction in demand for oil, helping to exert downward pressure on energy prices at a time when the world can use all the help it can get in terms of lowering oil prices.

Demand delay and demand deterrence, not demand destruction

This week, some key data points will be the US Consumer Price Index (CPI) — consensus expectations are for 8.4% year over year,⁴ and I wouldn't be surprised to see it at that level — as well as CPI readings for France and Italy. But I believe there is even a silver lining in high inflation. Higher prices have a way of solving for higher prices since they can cause a reduction in demand. In addition, the Fed and other central banks are also helping to reduce demand through monetary tightening. For example, mortgage rates in the US have risen very substantially in just a few weeks, which should help to cool the red hot housing market.

The fear is that this so-called “demand destruction” will send developed economies into recession. Demand destruction is a dramatic term; I would describe what I am seeing thus far in the US not as demand destruction but a combination of “demand deterrence” and “demand delay.” For example, we are seeing demand deterrence in that some consumers are reducing driving when possible and are switching to generic brands for some staples to reduce costs. And we are seeing demand delay in that consumers seem to be foregoing “big ticket” purchases that they don’t need immediately, such as delaying an auto purchase until next year — although I suspect that any material drop in prices in the near term would bring them back into purchasing mode rather quickly. Demand is not being fully destroyed, as it is being supported to a substantial extent by the tight labor market and more sound household balance sheets. In my opinion, the ability to engineer a “soft landing” will depend in large part on achieving demand deterrence as opposed to demand destruction.

Looking ahead

Looking ahead, I will be following ZEW Economic Sentiment for Germany. Germany is under enormous pressure to sanction Russian energy, which would be an enormous burden given Germany’s great reliance on those imports. I suspect significant pessimism about the near term will be reflected in the sentiment reading, which could signal more disappointing economic activity in the near term (especially reduced capex spending). Finally, I will be looking at preliminary consumer sentiment data from the University of Michigan to get a sense of where the US consumer is — and what their current expectations are for longer-term inflation.

Notes

¹Bloomberg, L.P.

²Reuters, “EU chief promises speeded up process for Ukraine to seek membership,” April 8, 2022

³Reuters, “French government bond yields extend rise, peripheral spreads widen,” April 6, 2022

⁴Source: Bloomberg, L.P.

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.

Quantitative tightening (QT) is a monetary policy used by central banks to normalize balance sheets.

A basis point is one hundredth of a percentage point.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another.

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. An inverted yield curve is one in which shorter-term bonds have a higher yield than longer-term bonds of the same credit quality. In a normal yield curve, longer-term bonds have a higher yield.

Capital spending (or capital expenditures, or capex) is the use of company funds to acquire or upgrade physical assets such as property, industrial buildings, or equipment.

The Consumer Price Index (CPI) measures change in consumer prices.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan designed to assess US consumer expectations for the economy and their personal spending.

The ZEW Economic Sentiment survey is a monthly survey of about 350 analysts that measures economic sentiment in Germany for the next six months.

The opinions referenced above are those of the author as of April 11, 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.