



**Kristina Hooper**  
Chief Global Market Strategist



I entered this industry back in 1995, and I've seen a lot over the last 27 or so years — but the last few years have seemed particularly wild. I'm reminded of a line from one of my favorite Grateful Dead songs, "What a long strange trip it's been." The last year hasn't really been that long — but it's certainly been strange. Below I tackle a few questions I'm hearing from clients who are trying to put today's events into perspective.

# Market FAQ: Inflation, monetary policy, earnings and more

**Weekly Market Compass | April 18, 2022**

## **Q. Has inflation in the US peaked?**

In my opinion, probably not yet (although some great minds that I respect think it peaked in March). I do think that it's likely to peak soon — probably around the middle of 2022. The most recent Producer Price Index print was very high, suggesting the Consumer Price Index (CPI) could go higher before it starts to moderate.

But I also believe that when inflation peaks isn't as important as how quickly inflation will moderate once it peaks. Unfortunately, I expect inflation to remain at an elevated level for some time — I would anticipate headline US CPI to still be modestly above 5% by year end given continued pressures. That's because the war in Ukraine has seriously impacted prices and supply chains; adding to pressure are COVID lockdowns in countries such as China. And don't forget the still-tight labor market. It will take time to get back to the Fed's inflation target.

## **Q. How many rate hikes will we see from the Federal Reserve?**

According to the March "dot plot" released by the Federal Open Market Committee, members anticipate the terminal rate to be 2.8% — which it expects to reach in 2023. However, many are starting to question whether the terminal rate could be so low given such high inflation. There is a school of thought that interest rates have to exceed the inflation rate in order to "break the back" of inflation. I don't believe that's the case; however, that doesn't mean the Fed won't be on an aggressive track in the shorter term.

Last week, Fed Governor Lael Brainard proclaimed that moving inflation back to the Fed's 2% target is the central bank's "most important task."<sup>1</sup> This was the latest in a series of comments that indicate she is focused on aggressively fighting inflation. As a Fed official historically perceived to be "dovish," Brainard's comments have reinforced market views that the Fed has made a very hawkish pivot and will likely be aggressive in the coming months. I anticipate a 50 basis point rate hike in May and see a very good chance of a 50 basis point rate hike in June. I do believe the Fed will be data-dependent, but I expect the data to continue to show elevated inflation and a strong labor market, so in the near term nothing is likely to deter the Fed from a hawkish path.

In other words, I believe there will be two phases to Fed rate hikes: aggressive and then "aggressive lite." In the next four to six months, I believe the Fed will be desperate to play catch up because it perceives itself to be well behind the curve. After that initial burst of tightening, I expect the Fed to become more moderate in its rate hikes — if the data offers the opportunity to do that.

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**Q. How much will the ECB tighten this year?**

The European Central Bank (ECB) met last week and recognized that upside risks to inflation have increased. In addition, ECB President Christine Lagarde recognized that longer-term inflation expectations are rising, raising the specter that they are becoming unanchored. As Lagarde explained, "The last thing we want to see is inflation expectations at the risk of de-anchoring."<sup>2</sup> However, the ECB was more dovish than expected, deciding to keep rates at current levels, and to continue bond purchases through the third quarter

But that hasn't changed rate hike expectations, which are surprisingly hawkish. Market expectations of rate hikes for the ECB indicate a high probability of multiple rate hikes this year. However, I expect the ECB to be more dovish; just one hike -- and not until the fourth quarter -- seems far more likely given economic growth coming under greater pressure. For example, the ECB Survey of Professional Forecasters, released last week, indicated downward revisions to real gross domestic product growth expectations, largely due to consequences of Russia's invasion of Ukraine. The eurozone economy is in a more difficult position, with a greater risk of recession than other major economies, and that should have an impact on monetary policy.

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**Q. What is happening with the Japanese yen?**

The Japanese yen has become one of the weakest currencies globally in recent weeks. The primary factor for yen weakness is a much wider bond yield differential between the US and Japan. This reflects continued monetary policy accommodation by the Bank of Japan (BOJ) while the Fed is expected to tighten considerably in the near term. As long as Japan's headline CPI remains at a manageable level, the BOJ appears committed to maintain its ultra-easy policy. Since the market seems to believe that intervention by the Japanese government is unlikely, and I would agree, the yen may stay quite weak in the short term — possibly even reaching a 130 JPY/USD level, in my view.

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**Q. How synchronized will major central banks be?**

In the short term, there will be significant differences among major central banks, given that, as I mentioned above, their respective economies are in different places with varying levels of recession risk. However, that is likely to lessen over time.

Last week, the Bank of Canada decided to hike rates by 50 basis points, which I believe will be followed by a 50 basis point rate hike from the Fed in May. However, the ECB has chosen not to raise rates yet, the Bank of Japan remains very accommodative, and the People's Bank of China decided last week to loosen monetary policy further. Our eyes will be on the Bank of England to see if it might be less hawkish than expected, following in the footsteps of the ECB.

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**Q. What will happen in the French presidential election?**

This is a nail biter. In the first round of the election, incumbent Emmanuel Macron garnered the largest share of votes but was far from a majority at 27.8%.<sup>3</sup> Marine Le Pen received 23.2% of the vote, with far-left candidate Jean-Luc Melenchon securing 22.0% of the vote and other candidates receiving smaller percentages.<sup>3</sup>

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Melenchon has requested that his supporters not vote for Le Pen, but as of yet has chosen not to endorse Macron. This could result in a significant portion of voters choosing not to vote in the final round on April 24. Given voter concerns about high inflation, it seems likely that Le Pen could gain a far higher vote share than in the '17 election (when she garnered 34% vs. Macron's 66%). However, much is likely to hinge on Wednesday night's debate. In the 2017 election, Le Pen's debate performance was disappointing and is widely believed to have hurt her popularity. It seems that this election is Macron's to lose. I certainly recognize Macron's potential to snatch defeat from the jaws of victory, and the stakes are much higher this time around, given Russia's invasion of Ukraine and the need for a strong EU and NATO front — so markets are likely to be on edge this week.

If Macron is able to secure another term, attention will turn to the June legislative elections. Macron's party is expected to do well in those elections, but Le Pen's popularity may yet limit Macron's reform agenda — which so far has been relatively successful — and his efforts to integrate European Union economic and security policies.

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#### **Q. What is happening with Chinese monetary policy?**

The People's Bank of China recently cut its reserve requirement ratio by 25 basis points in order to stimulate an economy that's been weighed down by COVID-related challenges. This is a more conservative cut than anticipated, though policymakers have left the door open for further monetary easing.

A supportive monetary backdrop alone isn't enough to give the economy and Chinese stocks the boost they need, however — I believe businesses will need to respond with an increased credit appetite to fund real commercial activities. The good news is that we are starting to see this happen. China recently reported its March's total social financing (TSF) — a broad measure of liquidity in the system. The TSF grew 10.6% year-over-year, up from 10.2% in the prior month.<sup>5</sup>

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#### **Q. What should we be watching for in earnings season?**

I always find the most valuable part of earnings season is the additional color and forward guidance provided on earnings calls. I love to pore over earnings call transcripts, which can give me a sense of key factors such as the strength of the consumer. For example, in the past week, some financial services companies have indicated household finances are strong (Synchrony Financial cited the "strength of the consumer" while Ally shared that delinquency increases off the 2021 lows "remain gradual and overall levels remain well below 2019.") In light of the negativity we are seeing in consumer sentiment readings, it suggests consumers are troubled by inflation but financially sound and capable of spending.

I'm particularly keen to get greater visibility on supply chain disruptions and difficulty sourcing labor, as those are two significant issues facing companies and their profit margins. For retailers, I want to hear about foot traffic. According to Google mobility data, in the US, foot traffic at retailers and restaurants is down only 5% from pre-pandemic levels, as of April 14. However, there are winners and there are losers in the retail space, and earnings calls can shine a light on that.

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## Q. Is the 60/40 portfolio allocation dead?

I have gotten this question a lot recently. I believe the genesis of this question has been concerns about fixed income. Despite current pressures, I believe it's important to maintain a long-term exposure to a diversified sleeve of fixed income asset classes including investment grade, floating rate and municipal bonds. However, I don't believe a 60/40 approach makes sense for most portfolios. At Invesco, we have long advocated a more inclusive approach to asset allocation, one that includes alternatives. Alternatives can offer investors exposure to asset classes with lower correlations to more traditional equities and fixed income, adding to diversification potential. A 50/30/20 or 55/30/15 portfolio may make more sense for investment portfolios — investors should talk to a financial professional about the allocation that's right for them.

*with contributions from David Chao, Emma McHugh, Tomo Kinoshita and Arnab Das*

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### Notes

<sup>1</sup>The Wall Street Journal, "Fed's Brainard Expresses Confidence in Ability to Reduce High Inflation," April 12, 2022

<sup>2</sup>Reuters, "ECB on track to unwind stimulus after inflation warning," April 13, 2022

<sup>3</sup>Bloomberg, "French election live results"

<sup>4</sup>The New York Times, "How France voted," May 7, 2017

<sup>5</sup>The People's Bank of China, April 11, 2022

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### 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.

Diversification/asset allocation does not guarantee a profit or eliminate the risk of loss.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

There is a risk that the value of the collateral required on investments in senior secured floating rate loans and debt securities may not be sufficient to cover the amount owed, may be found invalid, may be used to pay other outstanding obligations of the borrower or may be difficult to liquidate.

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/or interest.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

The Producer Price Index (PPI) is compiled by the US Bureau of Labor Statistics and measures the average change over time in the selling prices received by domestic producers for their output.

The Consumer Price Index (CPI) measures change in consumer prices. Core CPI excludes food and energy prices while headline CPI includes them.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

The Federal Open Market Committee (FOMC) is a committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The terminal rate is the anticipated level that the federal funds rate will reach before the Federal Reserve stops its tightening policy.

A basis point is one hundredth of a percentage point.

The ECB Survey of Professional Forecasters collects information on the expected rates of inflation, real GDP growth and unemployment in the euro area at several horizons, ranging from the current year to the longer term.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The reserve requirement ratio is the percentage of depositors' balances banks must have on hand as cash.

The opinions referenced above are those of the author as of April 18, 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.