14th February 2022

Uncertainty = Volatility

Inflation and the tightening of US interest rates

US consumer price inflation (*CPI)* accelerated to 7%, in December 2021. This is the highest reported level of inflation since June 1982.

It is believed that the COVID-19 pandemic has pushed demand away from services towards goods. Stimulus payments have meant total demand has not fallen, possibly even risen some. As the pandemic subsides, demand will shift back towards services and goods prices will normalise.

However, if strong demand and limited labour supply force wages higher, with wage increases leaking into services a big, sticky wage-price spiral is seen to be possible.

With rising inflation decreasing the purchasing power of consumers, the consequence of a rushed monetary tightening, are likely to result the twin blow of higher prices and lower incomes/discretionary spend. This is due to the Federal Reserve's (*the Fed*) misreading of its transitory narrative and ultra-accommodative monetary policy. A sharp policy pivot, risks considerable damage to livelihoods and market stability.

The Fed's Delayed Response

Martin Wolf, of the Financial Times, believes that the US Federal Reserve's (*the Fed*) policy response to raise rates, won't cool the economy to any significant degree. He says it all comes down to credibility:

> *The actions themselves don't really matter. What matters instead is the confidence that the Fed is serious about its goals. Then, if what it has done is not enough, the Fed will do more — much more. So, the signal is the policy and the signal on its own might be enough…but that only works to the extent that the intentions revealed are believable. The smaller the credibility of its intentions, the more the Fed will need to do to show it's serious…*

> *For 40 years the Fed has lived on [Paul] Volcker's credibility. Maybe it will have to show it means it once again. That would be a nightmare. And that is also why letting inflation rip is dangerous. The more that needs to be done, the less credible the needed actions become. That is why a Volcker became necessary in the 1970s.*

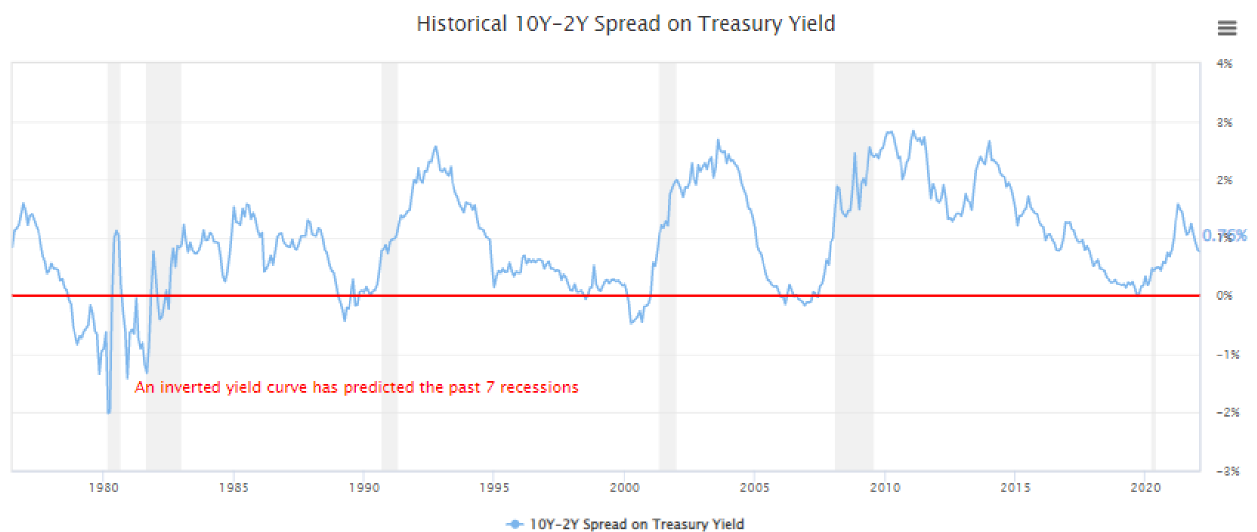
Don Rissmiller, chief economist of the institutional broker and advisory firm, Strategas, believes the endgame of a Fed tightening cycle is an inverted yield curve, which shakes confidence, leading to a tightening in credit conditions:

> *[An] inverted curve is hard to deal with, if you assume the future is more uncertain the present. It hurts confidence, and the financial sectors' ability to make profits…you at least get a situation where, with an inverted curve people will become concerned and take less risk…and then if the tide goes out a bit, someone [a big creditor] has a problem, and then credit spreads widen, and it all becomes self-reinforcing.*

Ultimately, inflation is also a large motivation to invest. To preserve and grow your purchasing power, you need a return on investment (ROI) that's above the current rate of inflation. Investors are unlikely to see returns high enough to fend off inflation whilst holding cash in a bank account. However, as policy uncertainty persists, the continued market rotation from highly valued ICT and growth stocks to consumer durables and defensive shares, is likely to persist, as prolonged market volatility endures.

Market Outlook

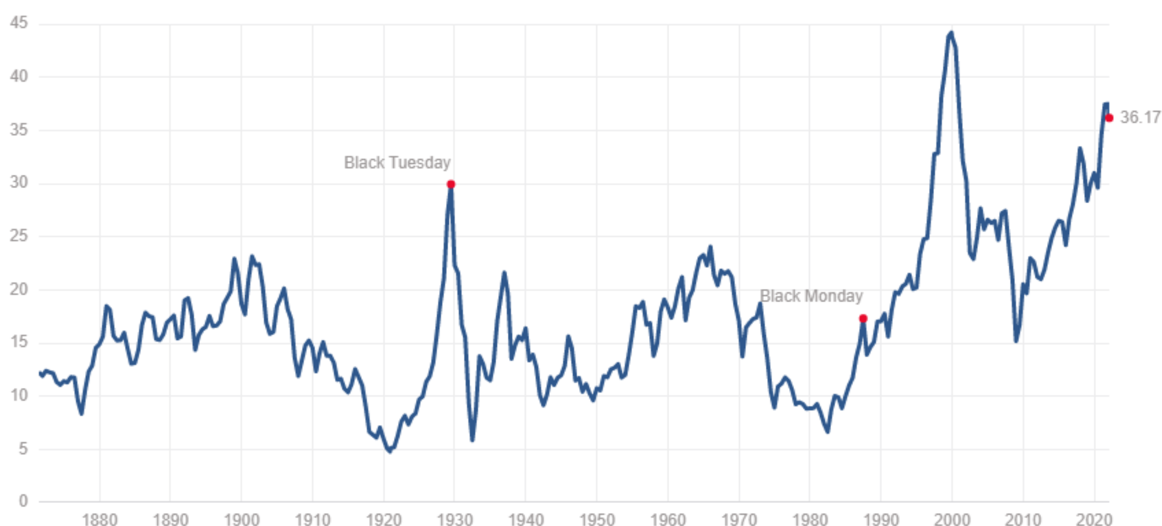
10Y-2Y Treasury Spread 1970 – 2021.



We have spoken at length over the past 12 months about the Treasury Yield Curve and its importance in determining the current market conditions. We are currently witnessing a sharp flattening of the 10Y vs the 2Y Yield Curve as the shorter duration bond yields rise faster than the longer duration yields. The spread between these two yields is decreasing, currently sitting at 0,42%. Significantly, per the below chart, every time the yield spread has turned negative, the market has witnessed a recession.

On the back of the yield compression between the 10 and 2-year treasury spreads, we have witnessed the market correct with major declines since the start of 2022. Drops in major indices, include the S&P 500 declining 9,80%, the Nasdaq 100 declining 15,14%, and the Euro Stoxx 50 declining -4,46% as of 31st January 2022. The US Cape Shiller Index, another leading indicator which we watch closely, has also declined. However, relative to its long-term mean, valuations remain above their long-term averages.

US Cape Shiller Index:



By defensively positioning our client portfolios, ahead of the change in Fed's policy (we rotated client ICT exposures into Consumer Staples, Cyclicals, Healthcare and Financials), we were successful in limiting negative real return. One Such example was going overweight British American Tobacco PLC (*BATS)* in November 2021: Following a positive 3rd quarter update, a sustainable 7% dividend yield and relative valuation of 9.59 we upweighted BATS. This position correlated positively to the market rotation out of sectors like ICT, into more defensive staples, in the search for yield. As a house, we continue to be positioned defensively, whilst increasing cash holdings during this time of market volatility.