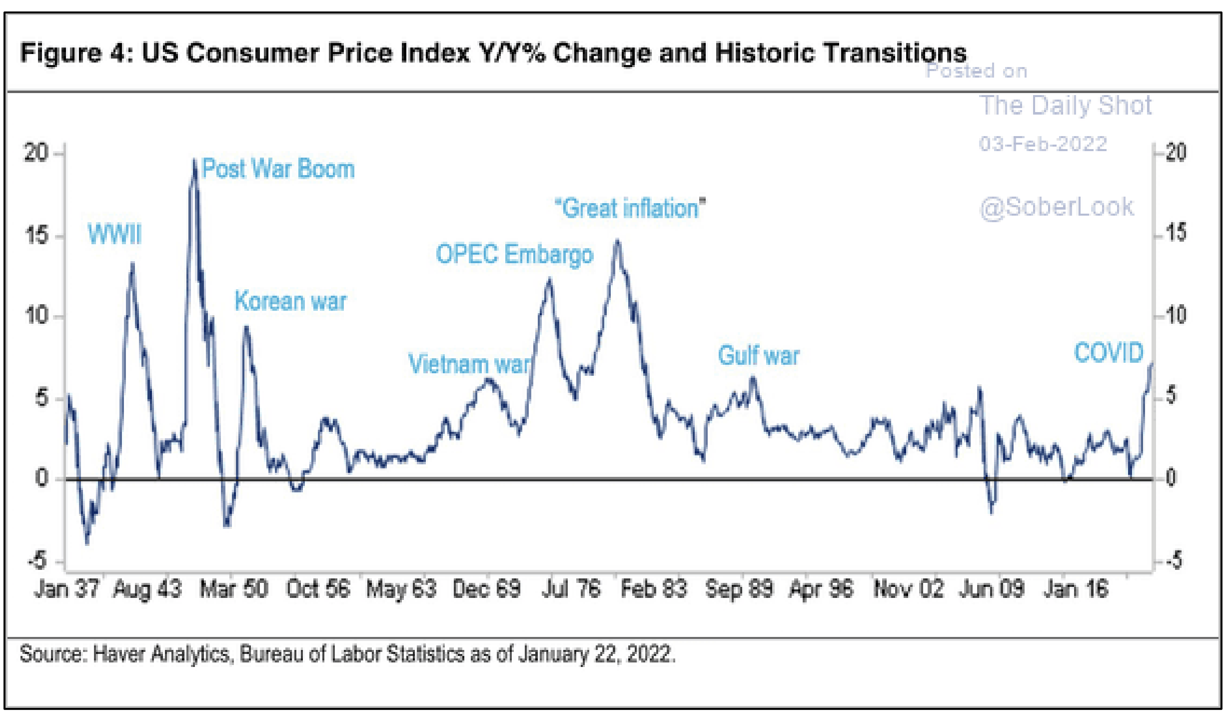
Stargazer
Asset Management

# What to focus on in Global Macro for the week of February 7th, 2022

## Macro Themes on the Radar:

**Inflation** – A global issue

The OECD sees December 30-rich nation inflation at 6.6% y/y - up from 1.2% y/y in 2021 – and the highest since July 1991. It remains broad-based and is over central bank targets in the US, the UK, the Eurozone, and Canada.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Increasingly central banks see no choice but to act as it has gone higher and lasted longer than they expected.

With an already hawkish Fed in play, the Bank of England hiked last week and surprised the market with the revelation that 4 of the 9 committee members voted for a larger than expected 50bps hike.

While the ECB didn't change policy at last week's meeting, Lagarde's comments during the press conference showcased a clear hawkish shift.

"There was unanimous concern around the table of the Governing Council about inflation numbers." – Christine Lagarde, ECB President.

In December Lagarde was adamant that "it is very unlikely we will raise rates in the year 2022". She has changed her tune: "Compared with our expectations in December, risks to the inflation outlook are tilted to the upside, particularly in the near term… If price pressures feed through into higher than anticipated wage rises or the economy returns more quickly to full capacity, inflation could turn out to be higher."

On January 25th, ECB Chief Economist Lane outlined how things could progress…

"So let me, in turn, make clear that what is very important is whether inflation will essentially settle at around our target of 2 per cent, which would be essentially what we want, or whether there might be signs of inflation being above 2% in a significant way for a significant amount of time. And if we saw the data coming in to suggest that inflation would be too high relative to 2%, then of course we would respond. We also have been clear on our sequence. The first decision under that scenario would be to end net purchasing. And only after ending net asset purchases would we look at the criteria for raising the interest rates."

The March meeting will now be important as we will get new inflation and growth projections. Asset purchases will need to end before they hike. As of now, the PEPP is meant to end in March and APP is perhaps in Q4. Will the end of APP be brought forward at the March meeting?

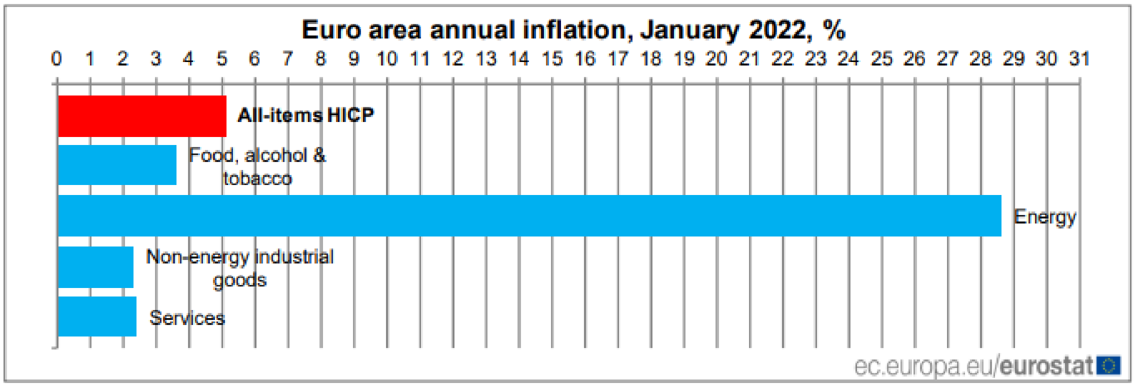
After the meeting, GS now expects asset purchases could end mid-year and that the ECB will end up hiking 25bps in September and December of this year. During an interview on Sunday, ECB's Knot said he thought a rate hike as early as October is now possible.

After the meeting, there were stories circulating, based on anonymous ECB sources, that a sizeable minority wanted to speed up taper already at this week's meeting.

The situation in Europe is a bit more complicated than in the US, for three main reasons.

First, they are experiencing lower wage inflation so far than in the US.

Second, with their sole mandate focused on inflation, the continued rise in energy prices, which accounts for over 50% of the inflation jump they are seeing, puts them in a difficult spot. Rising energy prices are particularly difficult because they also lower net income and consumption.




Inflation driven by energy prices has forced the ECB's hand before. Remember that the ECB actually hiked in July 2008 as the global economy was already rolling and the Fed has already cut 325bps from the cycle high.

The ECB's third problem is potentially a big one, that I think will preclude them from doing any kind of QT, maybe ever.

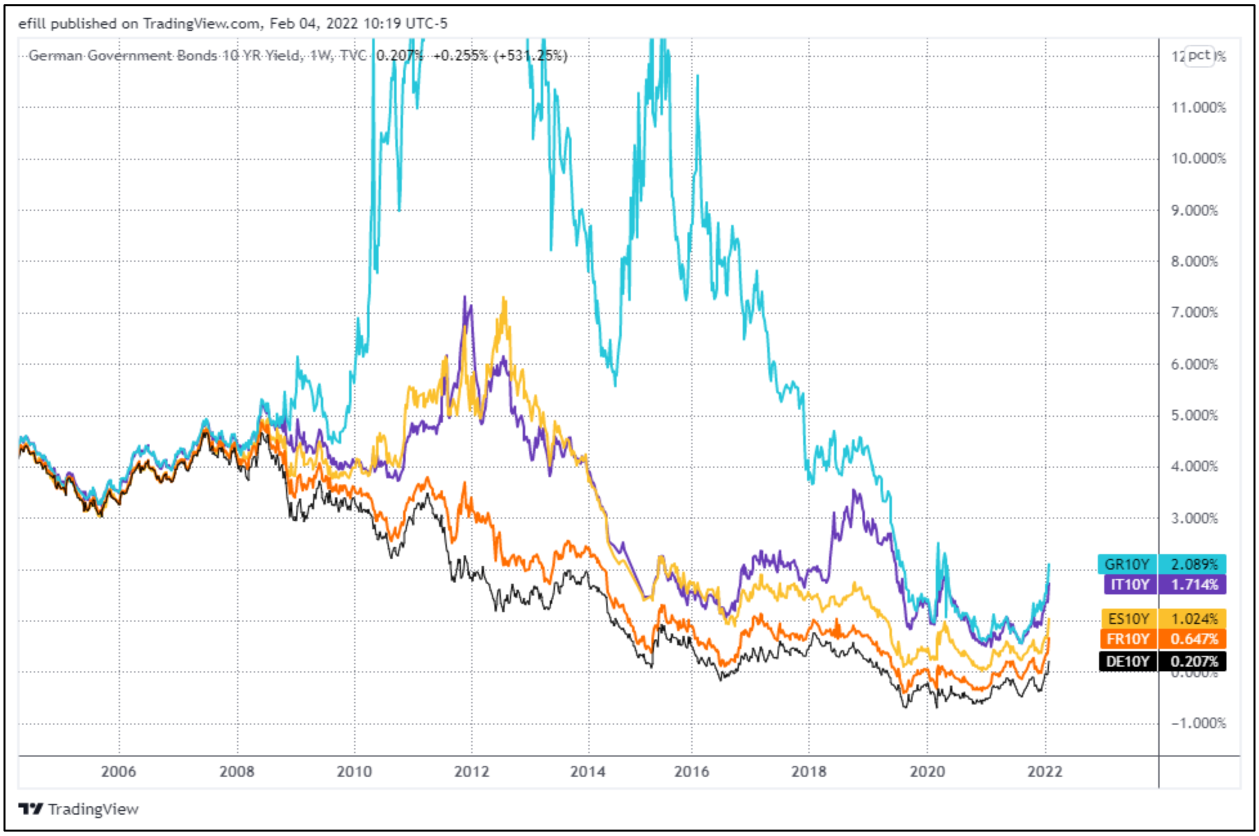
A large part of QE, especially under PEPP has been about spread control vs. the weakest issuers. PEPP was different from APP as it removed the capital key that otherwise controlled how much they could buy from each issuing country. That is about to go away. They touched on how they might try and keep it alive as long as they have some kind of pandemic justification in the post-meeting press release:

*"Within the Governing Council's mandate, under stressed conditions, flexibility will remain an element of monetary policy whenever threats to monetary policy transmission jeopardize the attainment of price stability. In particular, in the event of renewed market fragmentation related to the pandemic, PEPP reinvestments can be adjusted flexibly across time, asset classes and jurisdictions at any time. This could include purchasing bonds issued by the Hellenic Republic over and above rollovers of redemptions in order to avoid an interruption of purchases in that jurisdiction, which could impair the transmission of monetary policy to the Greek economy while it is still recovering from the fallout from the pandemic. Net purchases under the PEPP could also be resumed, if necessary, to counter negative shocks related to the pandemic."*

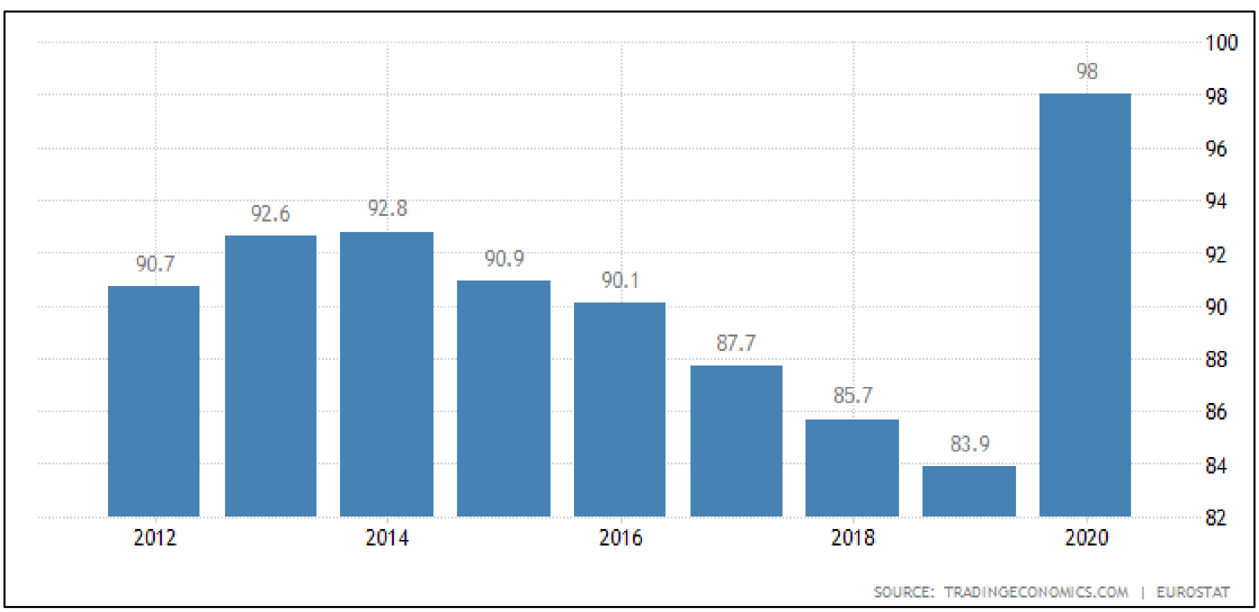
Things could get very choppy very quickly for the ECB if sovereign debt spreads start to blow out in Europe.

If asset purchases end AND rates rise, they could quickly be tested. This is an issue they are going to need to address in March with some sort of plan. We will see how big a stink the more fiscally conservative countries make.

This chart shows 10-year bond yields for Greece, Italy Spain, France, and Germany (in that current yield order). Post 2008, it has taken a concerted effort to keep the band together.

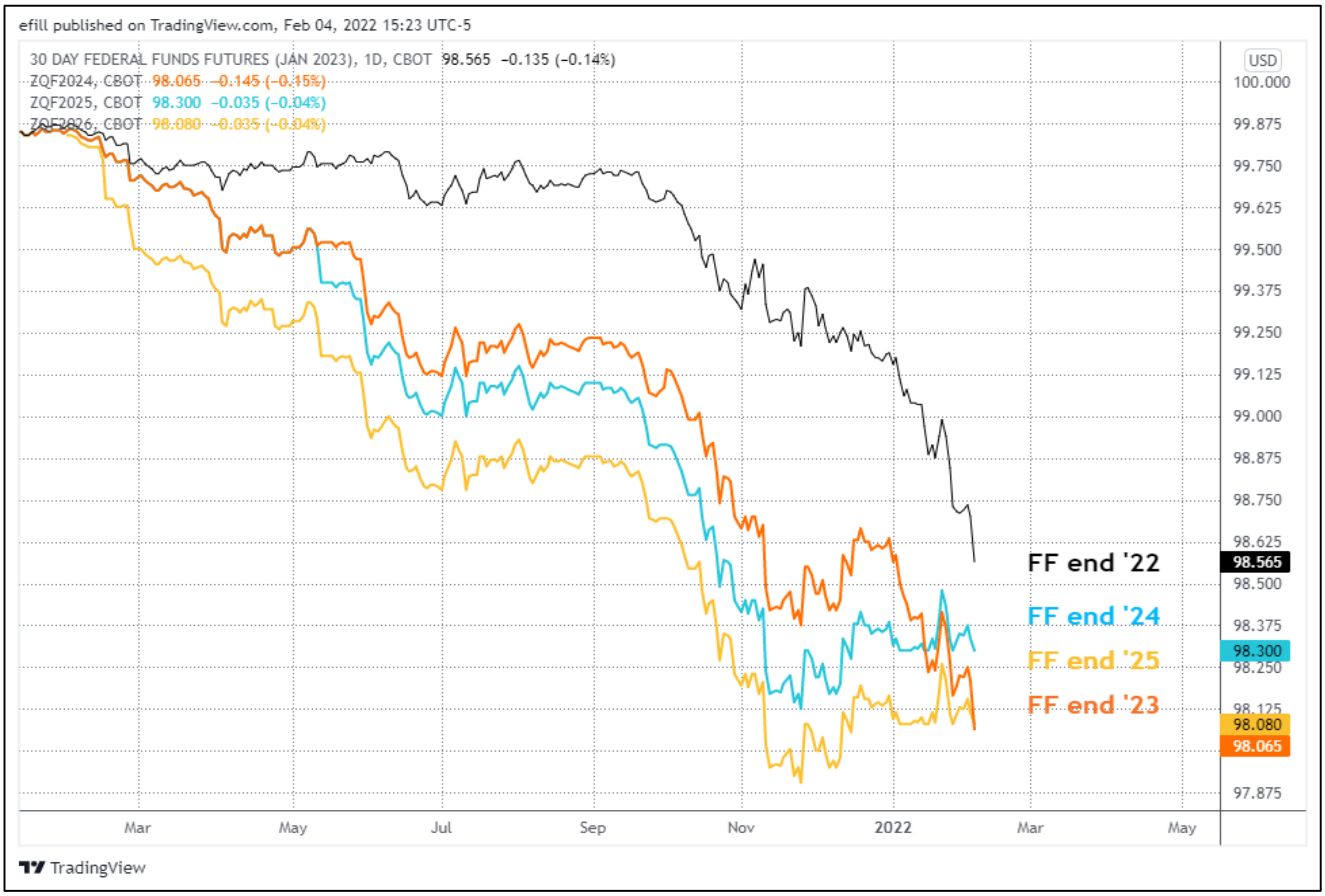



COVID has only upped the stakes with regard to the Eurozone's Debt as a percentage of GDP.



In the meanwhile, the effects of the Fed's very hawkish meeting's effect on rates were amplified by the unexpectedly strong employment data on Friday. A poor ADP report earlier in the week, warnings from the White House regarding omicron's effects on the data, and overall poor economist expectations (range was -400k to +250k) were all proven wrong. At 467K with an additional 709K in benchmark revisions, the data was more than enough to deliver significant repricing of FOMC rate hike expectations.

The front-loading of hikes continued with expectations for '24 and '25 not moving much.




We now have five and a half hikes priced by year-end. Seven hikes would require they hike at every meeting. The market is back to talking about 50bps right out of the gate in March. They haven't done a 50bp hike since May 2000 and I doubt they would do it now, but… unprecedented times. The Fed is in a tough spot now, partially of its own making. As discussed last week, their playbook is all about demand-led inflation. Currently, we have powerful demand and supply forces at work.

Here are a few thoughts from a recent Larry Summers interview with the Harvard Gazette. He has called the inflation pop early and well.

*"I have been critical of the Fed for the better part of a year on its failure to recognize that inflation became, as of last spring, the most serious short-run threat facing the American economy, and I am very glad to see their policy pivot. They used to say that they were not going to raise interest rates until 2024. Now, they're saying that there will be multiple rate increases in 2022. I think that's all to the good. But I am rather skeptical that interest rate increases that will still leave real interest rates negative — that is, interest rates below inflation rates — will be sufficient to contain inflationary pressures. I'm not sure that the policy community has fully faced the likelihood that at least some economic slowdown will be necessary if inflation is going to be contained…*

*The history is that when the unemployment rate in the United States rises by half a percentage point, it ultimately rises by more than 2 percentage points. So, bringing about a gentle tap on the brakes that slows the economy enough to substantially reduce inflation without inducing a real economic downturn and without causing significant financial instability is a quite formidable challenge."*

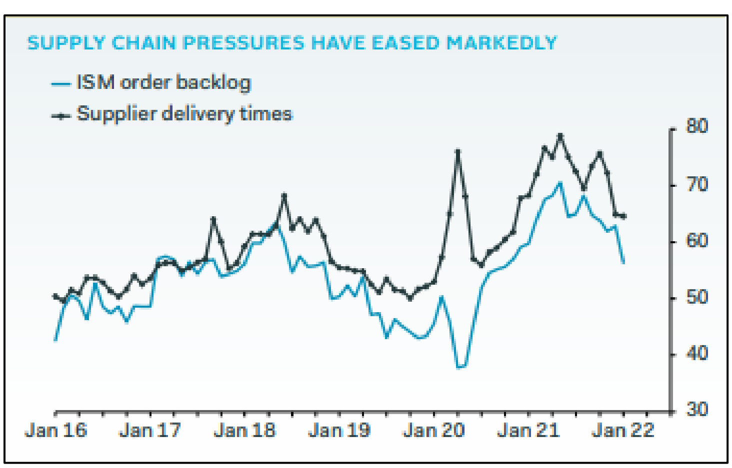
Rate hikes aside, what they do in March regarding the potential start date for QT will be important. They have said that interest rate policy is the main tool. Why?

In a recent column, ex-Fed Vice Chair Bill Dudley illuminated us:

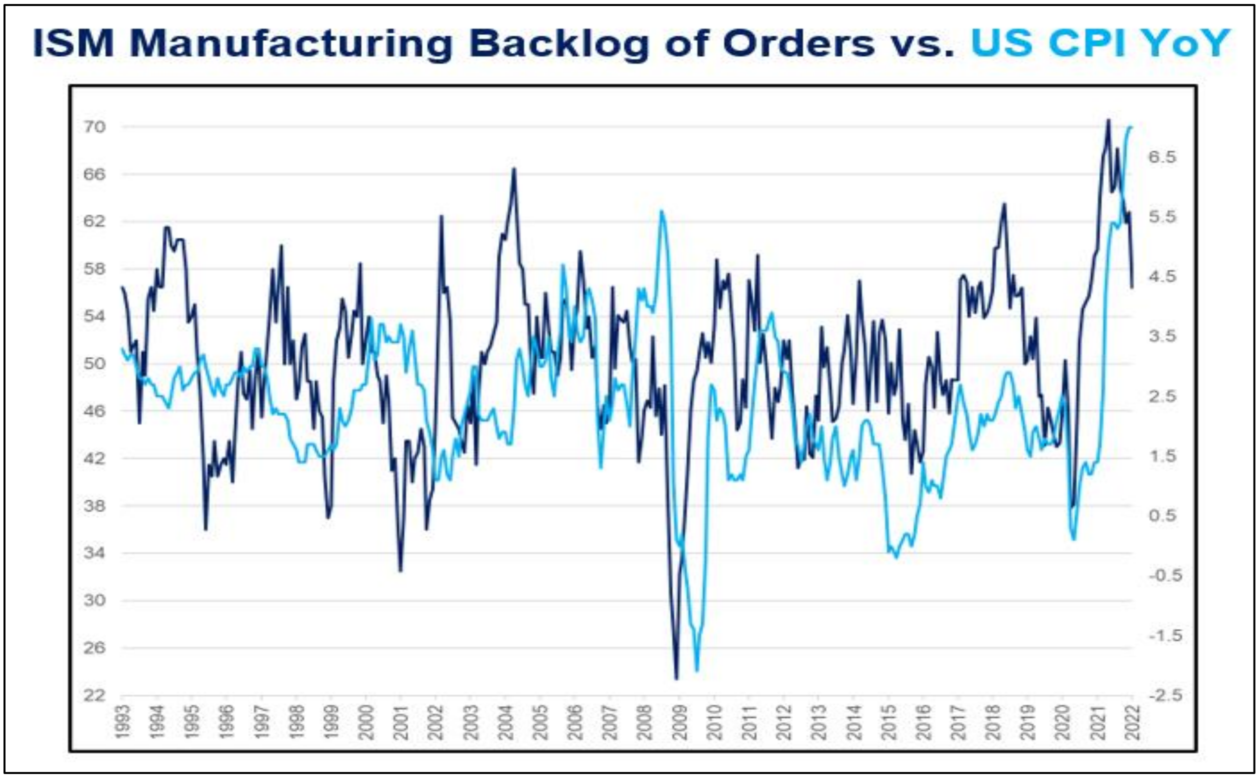
*"Why not use the balance sheet more actively? There are two reasons. First, it creates a communications nightmare. If two tools are both in play, how do you explain why you are using one instead of the other. Second, the FOMC has much more confidence about how changes in the federal funds rate affect financial conditions and the economy than it does about changes to the balance sheet. If you don't have confidence about the magnitude of the impact, then it's best to put it in the background operating at a steady pace."*

On the inflation front, there continues to be hope that there will be a meaningful drop in inflation in the coming months, although the peak may still be a bit off. The recent jump in energy prices won't be helpful but nevertheless, some base effects are due to kick in soon.

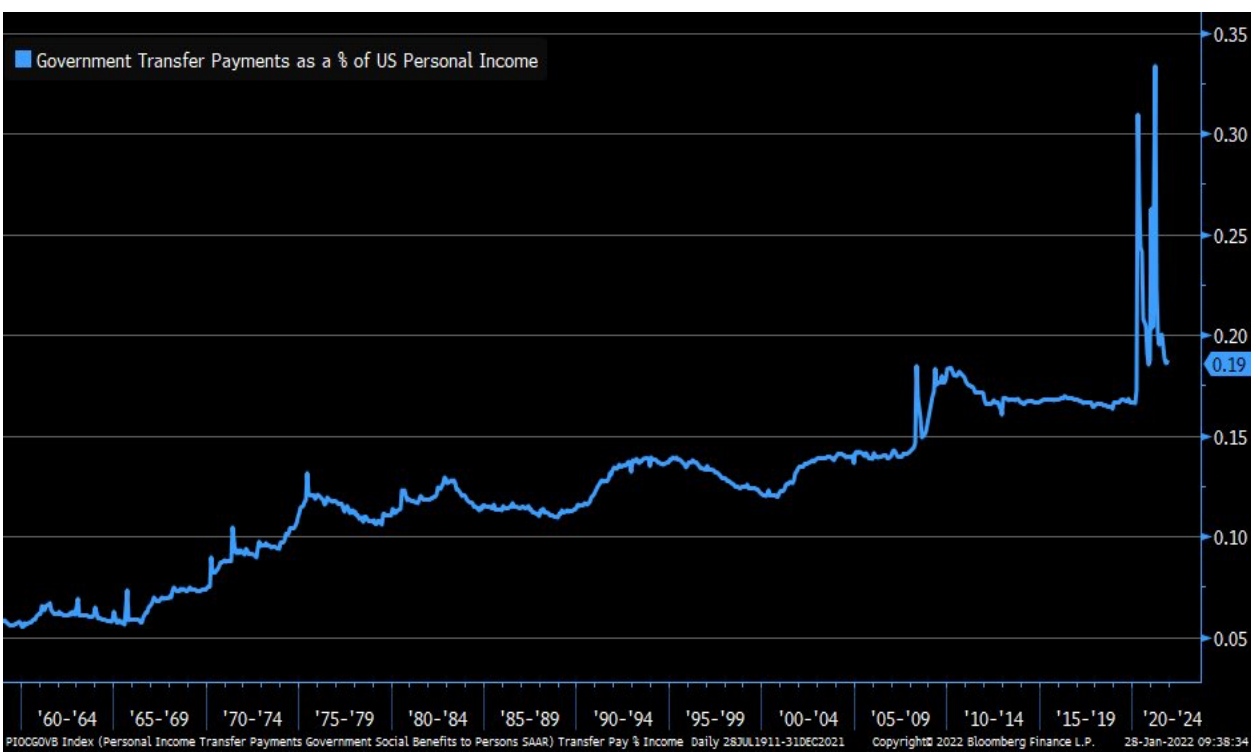
There continue to be signs that at least some of the bottlenecks are easing.



At least historically that should start to feed through as well.




The fiscal tailwind has also been moderating.

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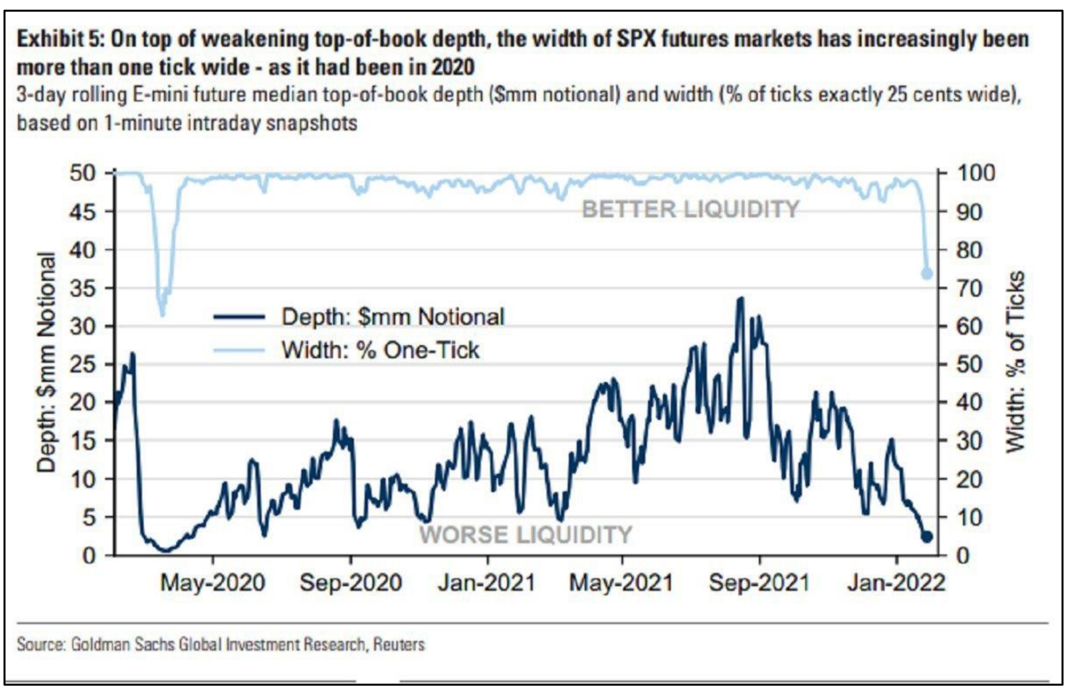
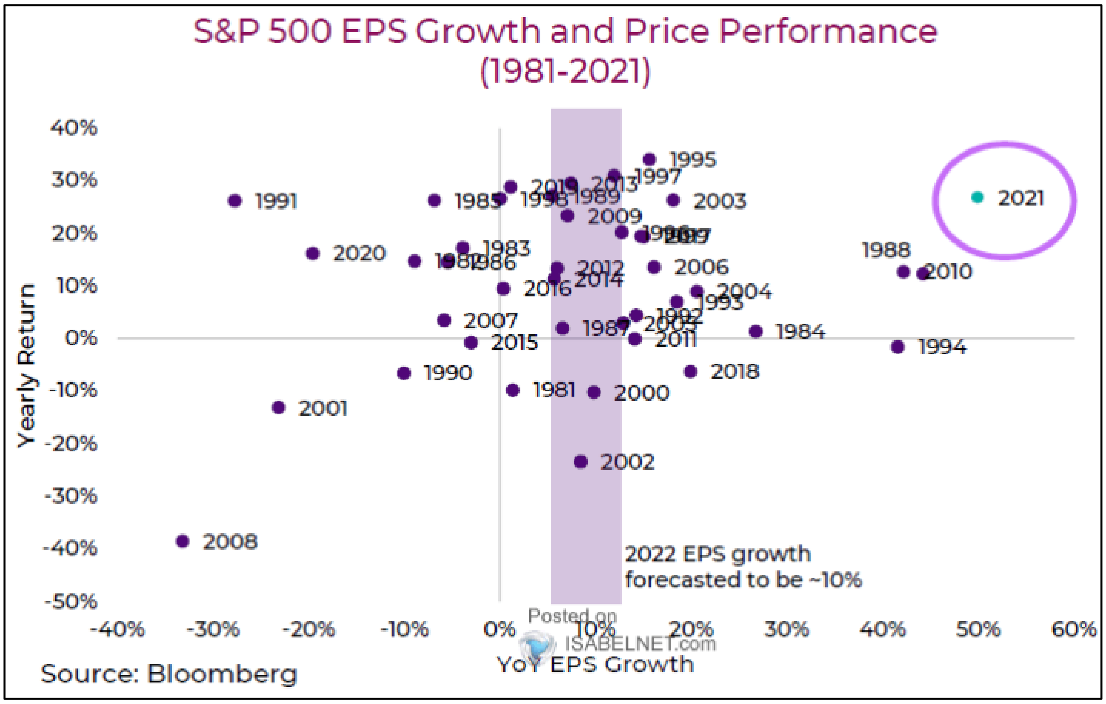
What to Focus on Now:

**Equities** - Watching the moves in some of the biggest tech companies in recent weeks increasingly makes you wonder about liquidity. Many had big down moves but obviously, GOOG and AMZN saw huge jumps.

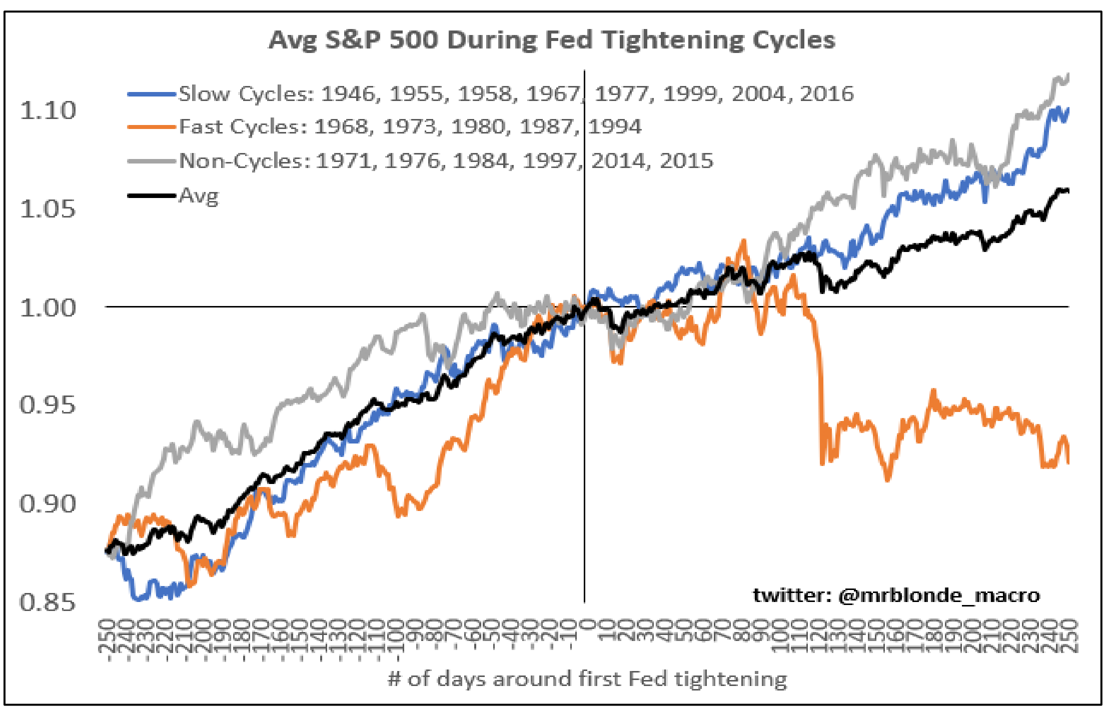

GS data says it's feeding into the indices. Will it make its way into other asset classes?



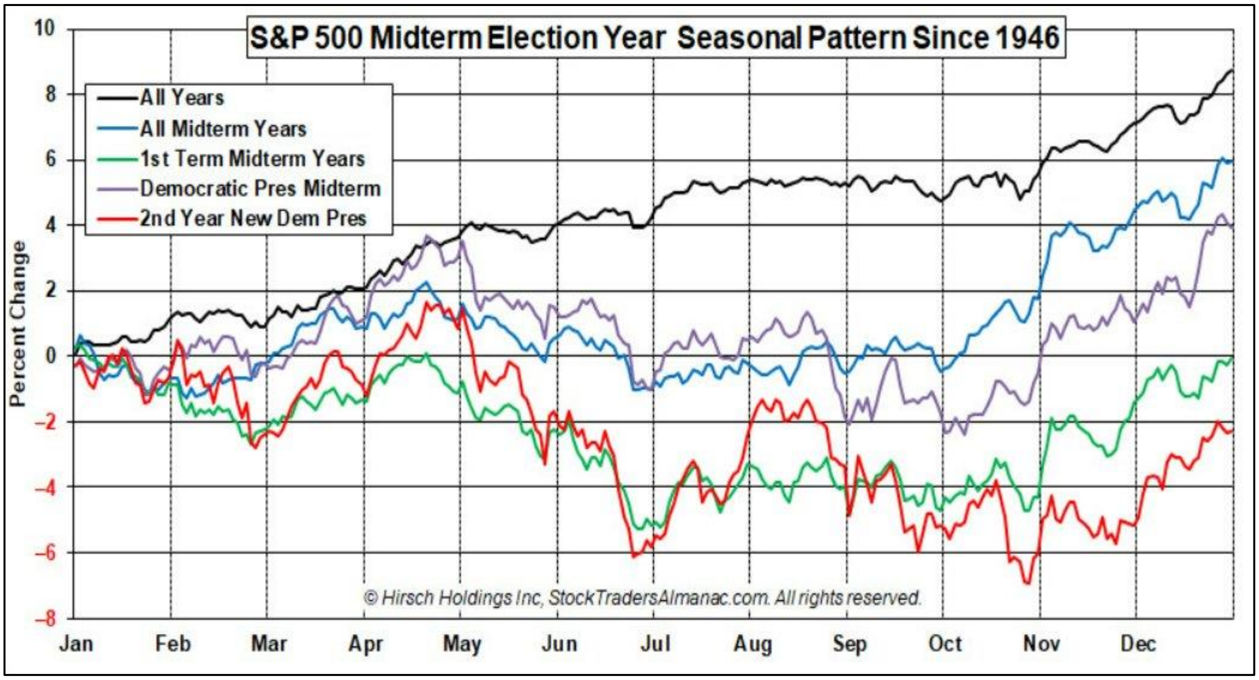
Last year was a spectacular year in terms of returns and EPS growth. Given that the government liquidity tsunami is now likely to recede I think continued volatility is a given.



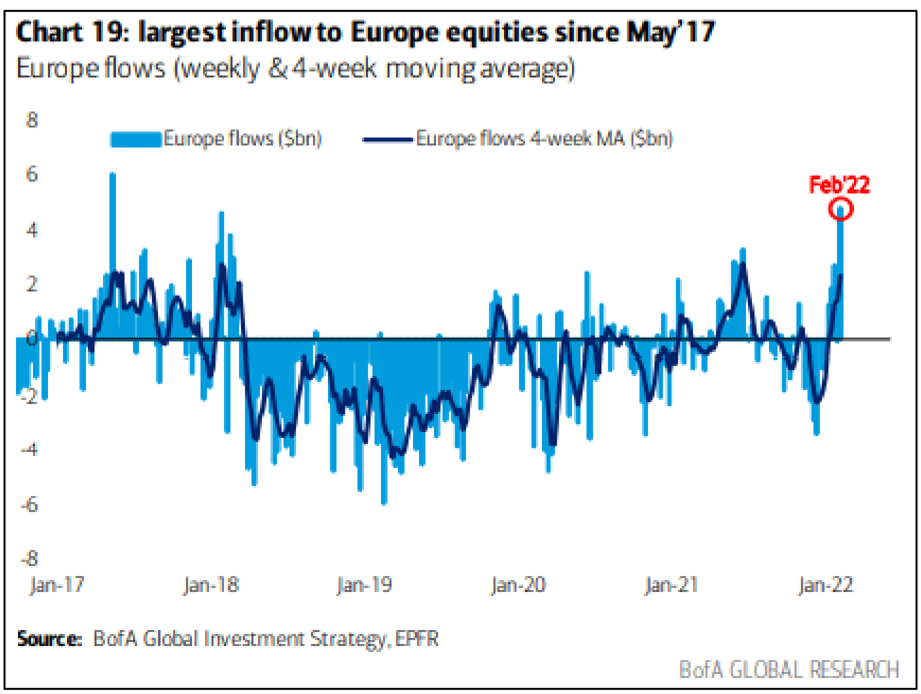

Historically, fast tightening cycles have also contributed to volatility. Does it matter now?



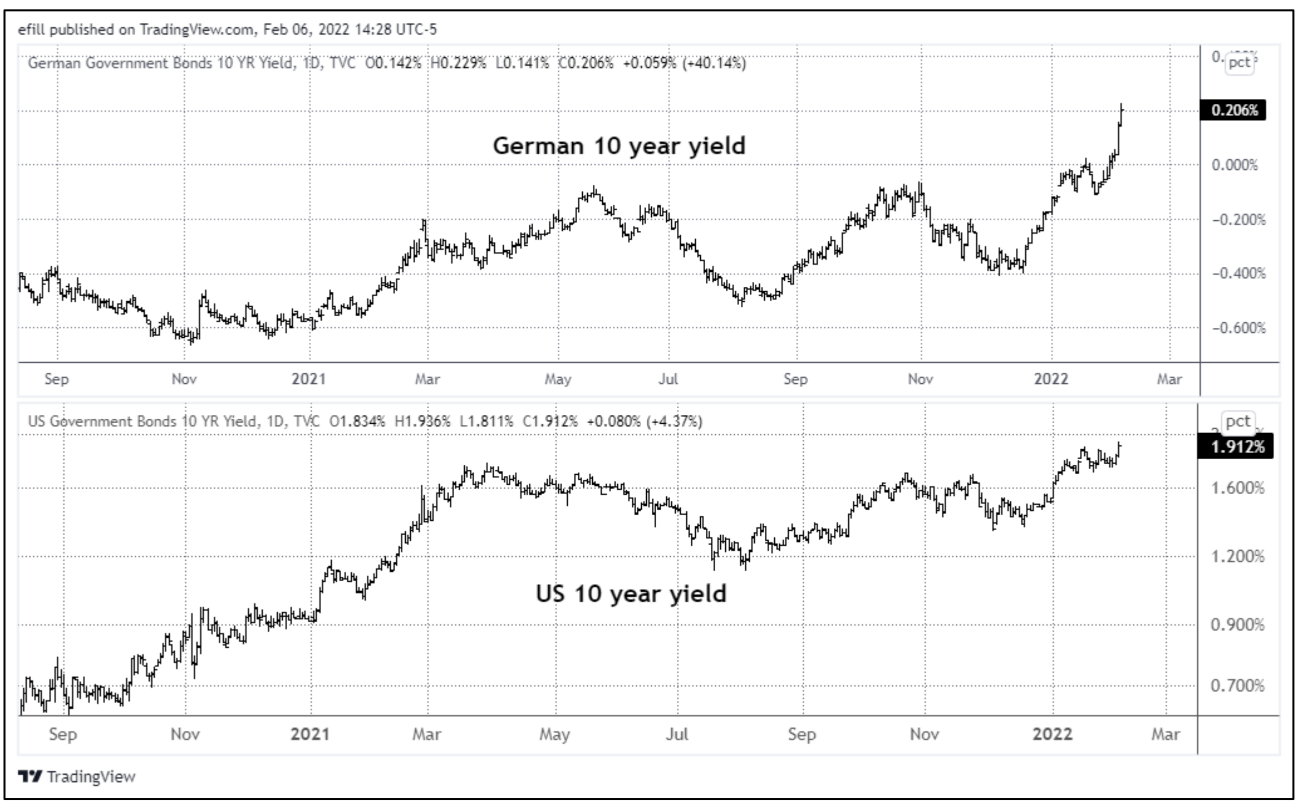

Later in the year, the midterm election cycle has historically also been a source of volatility.




With US big tech under pressure, capital continues to look for "cheap" alternatives. As noted previously, people have probably also noticed that Europe tends to outperform the US during tightening cycles. Although again, I would say that all these historical comparisons are very questionable given the current backdrop.

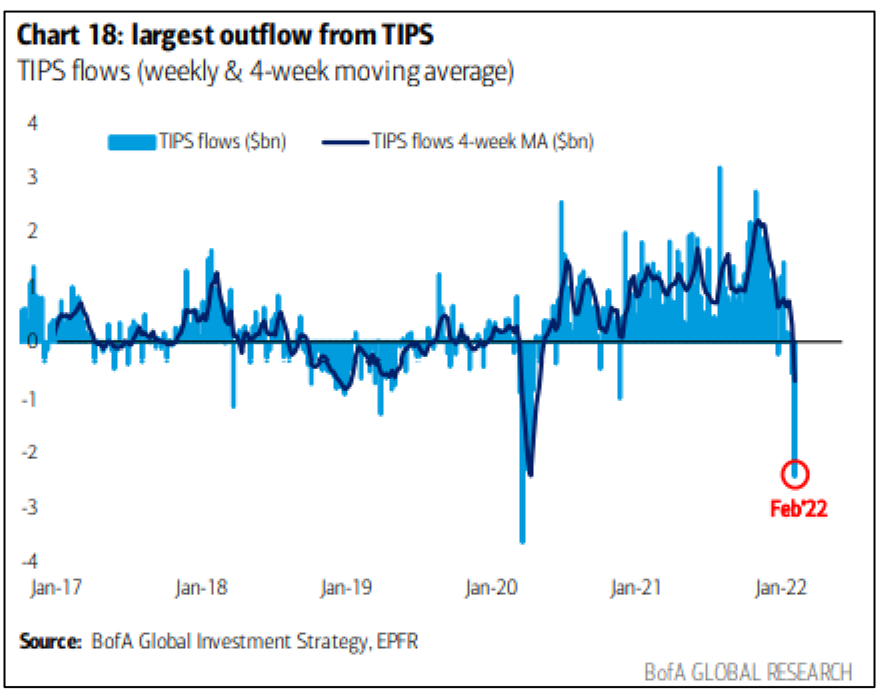


**Fixed Income** - The recent moves in the front-end, both in the US and now in Europe, have been impressive. However, longer-end yields are now pushing higher as well.

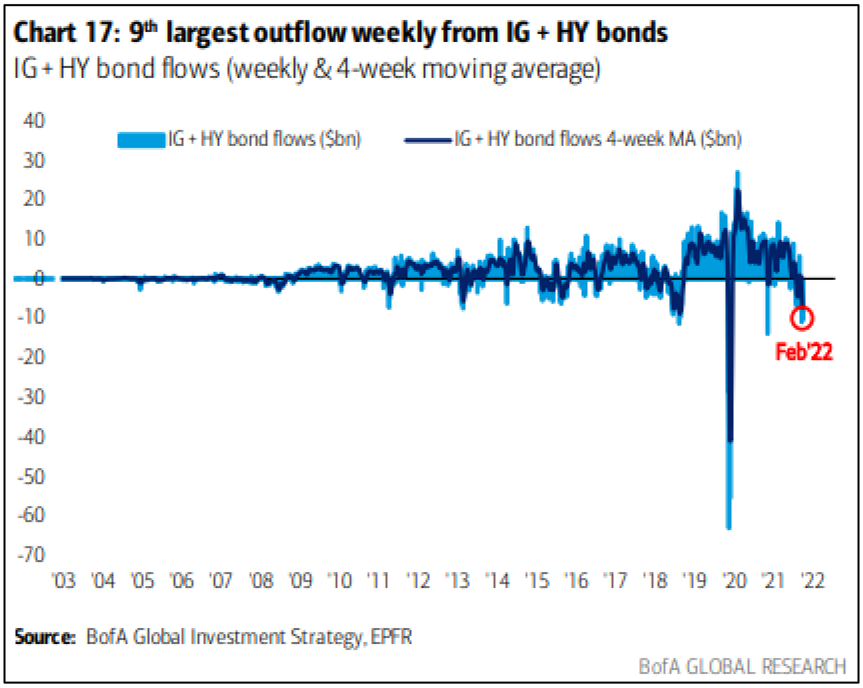



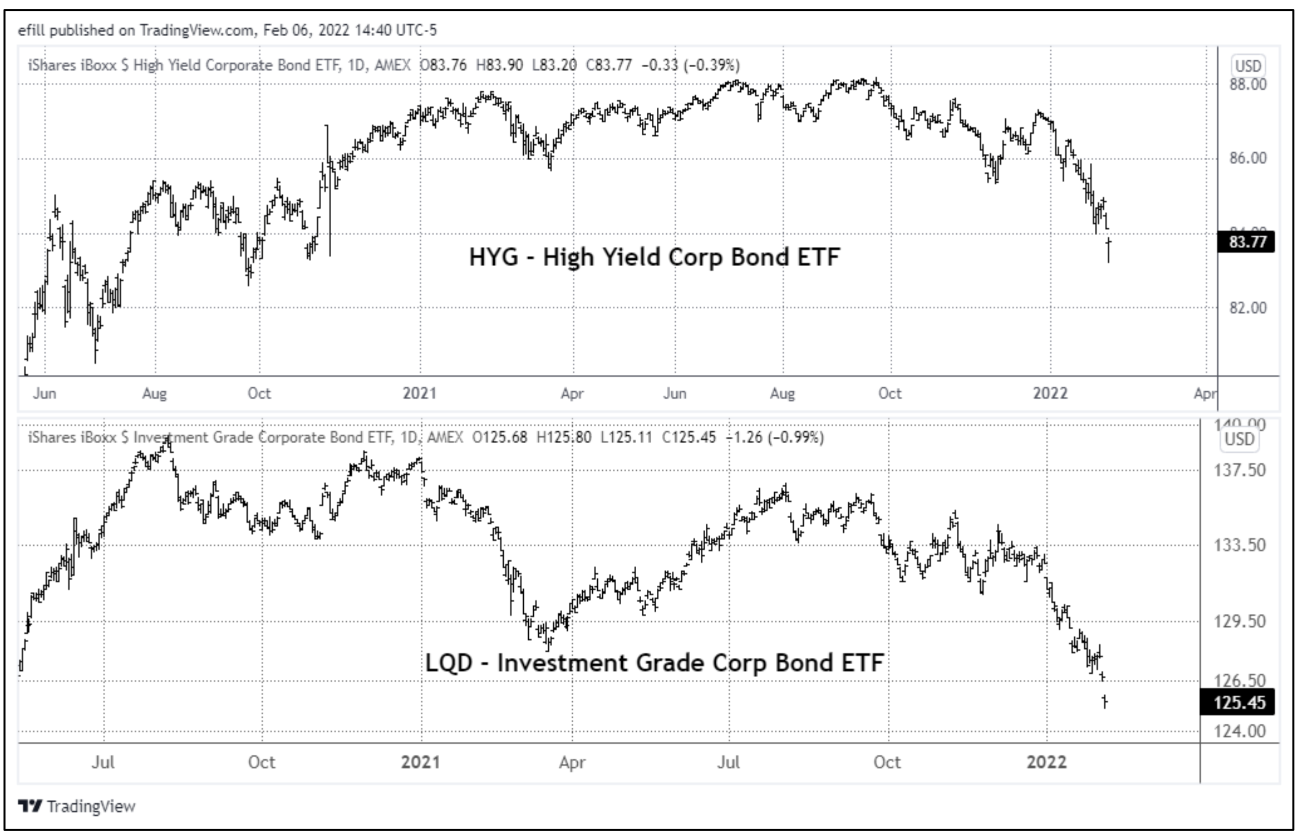
TIPS have been hammered as investors discover they also have imbedded duration.

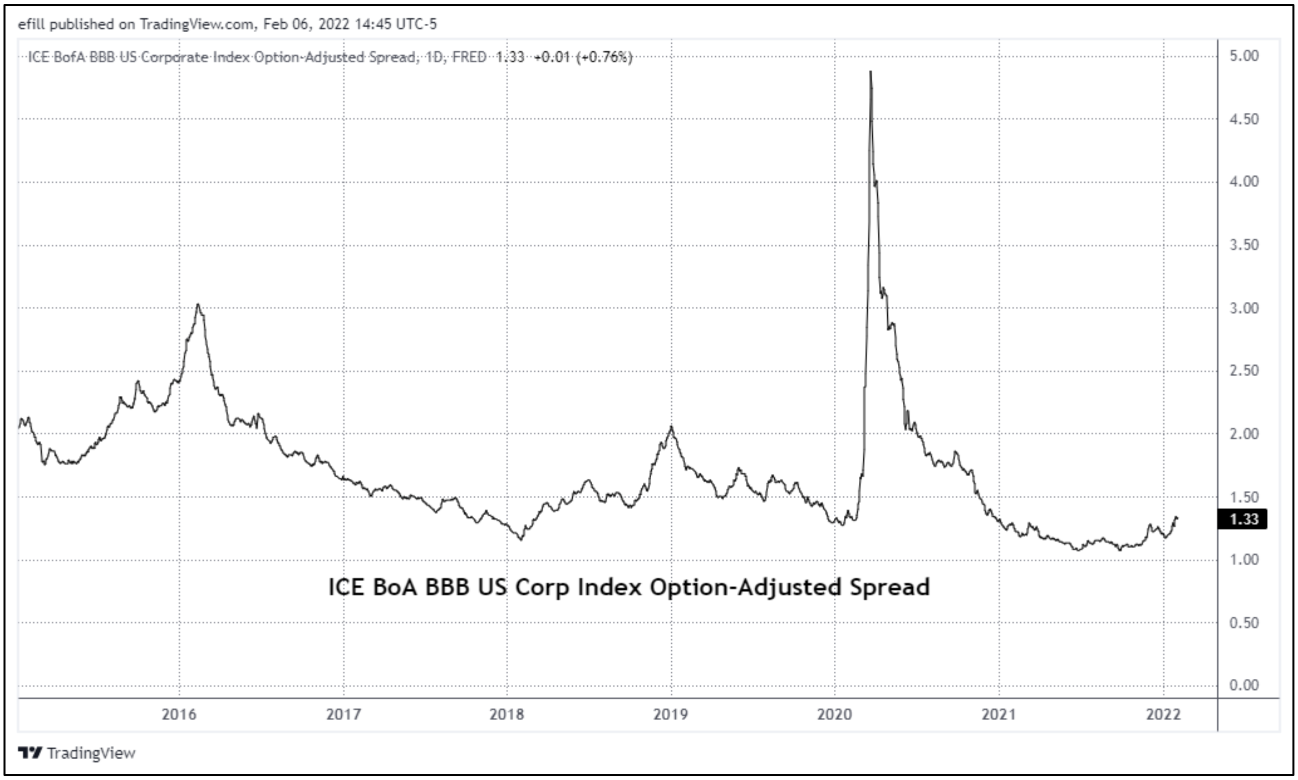

The Fed has also been a big buyer in what is a relatively small market. Investors have been heading for the exit.



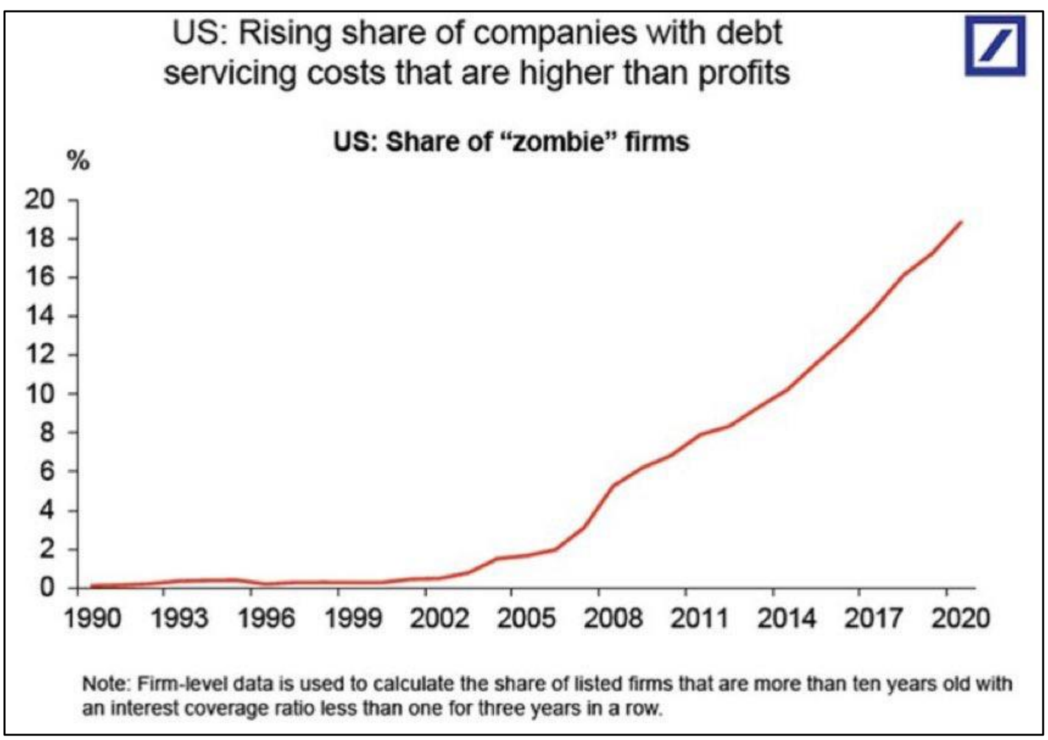
Corporate Bonds have been hit as well. Largely because of duration so far, as spreads have continued to be relatively well behaved.



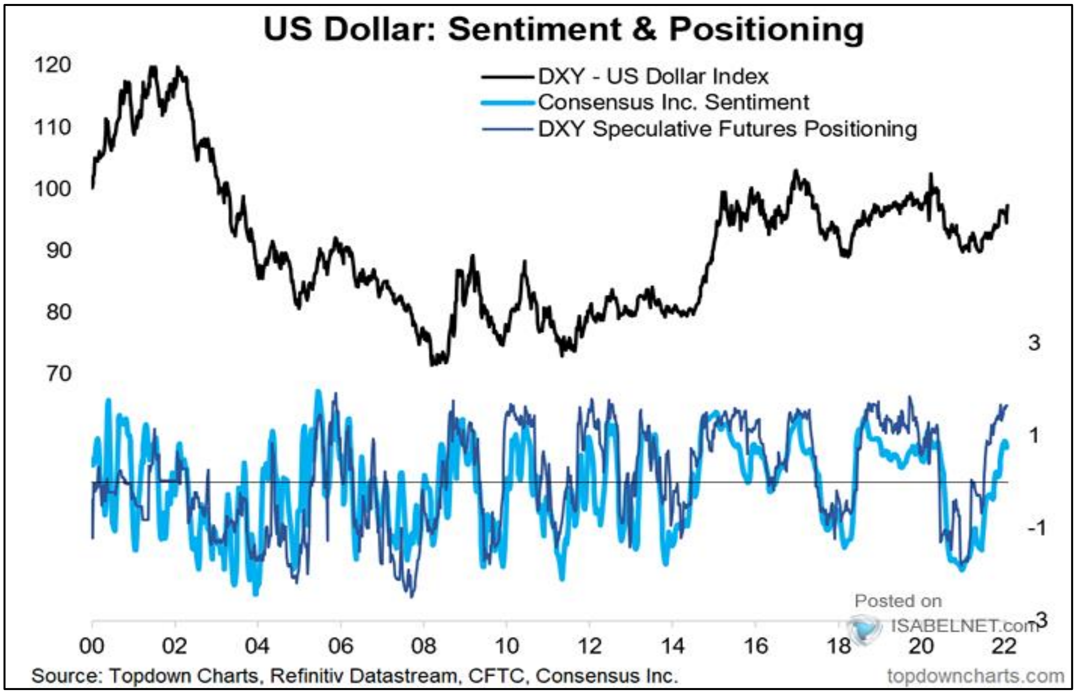






While the better borrowers seem to be in generally good shape, higher rates by themselves can start to have an effect on already stressed companies.

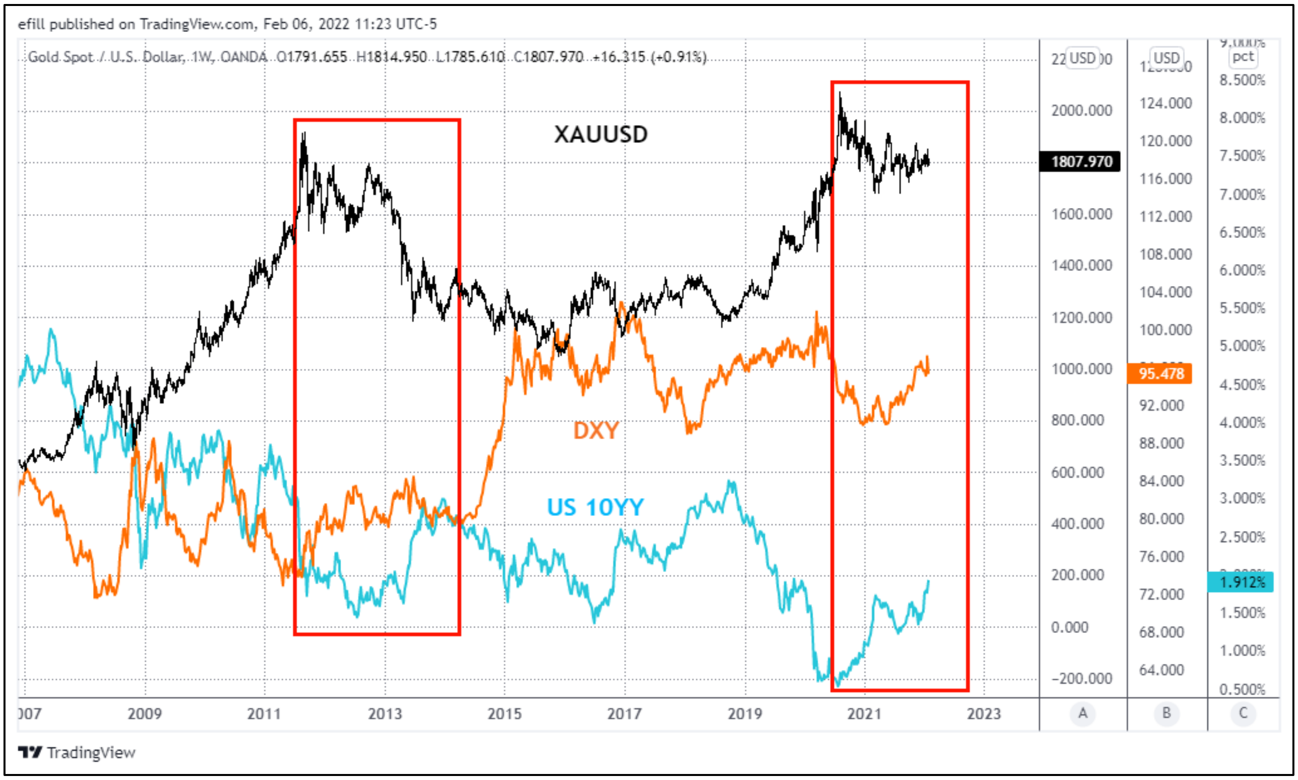


**FX** – The dollar has remained relatively firm. Investors remain long, but volatility is picking up. The USD has been torn between higher US front-end rates and capital flows searching for greener (cheaper) pastures. The sudden jump in European hike expectations has put some downward pressure on the USD. We will see if it lasts or further develops.




**Gold** – Despite an increasingly challenging backdrop, it remains range-bound.

There are similar headwinds as in 2013, given rising yields and a persistently firm USD.




The rising real yields (10yy adjusted for breakeven inflation) potentially pose the biggest challenge.

We will see… of course, we could get a correlation break given the wild backdrop so just have to keep our eyes open. One way or the other it feels like we are coiled for a move.

**All eyes on CPI this week!**

## Important Macro Data Releases and Events for the Week

| | |
|---|---|
| Monday 2/7/2022 | Caixin Service PMI (Jan) Sunday night ET |
| Tuesday 2/8/2022 | Trade Data (Dec) |
| Wednesday 2/9/2022 | BoC's Governor Macklem speech |
| Thursday 2/10/2022 | European Commission Economic Growth Forecasts |
| | **CPI (Jan) Both headline and core are expected rise further** |
| | Initial Jobless Claims |
| | Initial Jobless Claims 4-week average |
| | Continuing Jobless Claims |
| Friday 2/11/2022 | Harmonized Index of Consumer Prices (Jan) |
| | Michigan Consumer Sentiment Index (Feb) |
| | **Fed Monetary Policy Report to Congress from Chair Powell** |

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