What to focus on in Global Macro for the week of January 31st, 2022

Macro Themes on the Radar:

"It's liquidity that moves markets." - Stanley Druckenmiller

Fed

Wednesday's Fed statement was very bland and vanilla, but the press conference was a zinger.

In a word: Hawkish

Let's rehash the main takeaways:

1) Powell went to great pains to stress that the current situation is very different from the last hiking cycle, with much stronger growth, tighter labor markets, and higher inflation, and that this had "important implications" for policy.
2) They did try to dispel the notion that QT would be a hiking tool on par with rate rises, stressing that interest rates would remain the primary tool for executing monetary policy.
3) They want to tighten financial conditions and that means that some pain in asset markets should be expected. Given the strength in the economy and the level of inflation, any "Fed put" is relatively far away, given what markets have come to expect.

Some commentators immediately tried to soften the hawkish stance by pointing out that if they were really serious, they could have ended QE on Wednesday and hiked rates. I think that is silly, and not how the Fed works these days. They go out of their way not to ambush markets and to be incremental. Wednesday's show was about as brash a performance as you can expect.

They are in a tricky spot, and it is not clear if and how the old playbook at the Fed applies. Add to that the fact that a Fed chronically bad at forecasting, now finds itself facing a situation with greatly reduced visibility. Given all that it is going to be very hard for them to execute the soft-landing, they are looking for. Fed policy is geared to the demand side of the economy, but now they also face a supply shock. Their only option is to kill some of the demand, while not rolling over the economy and beating up markets in a way that sets off too big a feedback look. Tricky sledding when visibility is 10 feet.

It is pretty amazing that in 6-months we went from Powell "not even thinking about thinking about rate hikes", to Atlanta Fed Bostic's comments on Friday …

"Every option is on the table for every meeting. If the data say that things have evolved in a way that a 50-basis point move is required or [would] be appropriate, then I'm going to lean into that … If moving in successive meetings makes sense, I'll be comfortable with that."

According to Nick Timiraos at the WSJ here is the rundown of what various banks are now looking for:

• Nomura (Thu): 5 hikes this year, starting with a ½ pt increase in March (¼ pt in May, Jun)

• Goldman (Fri): 5 hikes this year (Mar, May, Jun), 3 next year

• TD (Wed): 4 hikes this year (Mar, Jun)

• UBS (Wed): 3 hikes this year (Mar, Jun, Sept)

• Barclays (Wed): 3 hikes this year (Mar, Jun, Sept)

• Jefferies (Fri): 5 hikes this year

• BNPP (Thurs): Six hikes this year, three next year

• Standard Chartered (Fri): Four this year (at the next four meetings), two next year

• Wells Fargo (Fri): Five this year (Mar, May, Jun), three next year

• JP Morgan (Fri): 5 hikes this year (Mar, May), 3 next year

• BofA (Fri): **7 this year (every meeting)**, 4 next year

• Morgan Stanley (Thurs): 4 this year (Mar, Jun)

• Deutsche Bank (Wed): 5 this year (Mar, May, Jun), 3 next year

With five hikes currently priced by the market for 2022, there is still plenty of time for expectations to shift, maybe a lot.

So far, the terminal rate has barely budged as front-loading of hikes has accelerated. I suspect that this is due to the view that the global economy wouldn't be able to handle rates meaningfully above 2%. In part, because each cycle has brought a lower terminal rate, and, most likely related to that, the level of global debt is now so high that even relatively low rates will start to quickly impact growth.

However, one unforeseen development has been that private sector balance sheets are actually in the best shape they have been in for a while. This is true for both consumers and corporations. To some extent, the pandemic has shifted debt from the private to the public sector.

While private sector balance sheets can quickly become financially constrained, government balance sheets are constrained by resources. This is especially true in a world where the central bank can quickly buy up the debt as it is issued.

Which brings us to QT…

Last week's Fed meeting rejected QT as an outright tightening tool, but it will almost certainly be deployed in the coming months, given the current trajectory. The market is guessing a July kickoff. Some at the Fed have suggested it could be large, even 100bln a month.

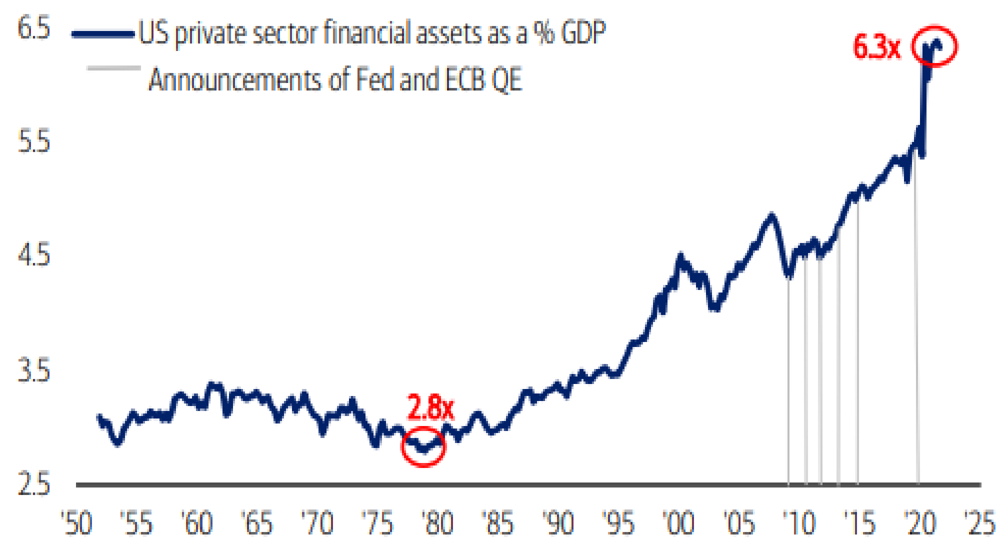
It is important to remember that QT has only been done once before, by any central bank. The BoJ and the ECB stopped buying assets for a period but never actually reduced the balance sheet. There are a lot of unanswered questions about what will happen. It didn't go so well for markets last time, however.

<u>QE doesn't change the quantity of money it changes the composition.</u> As such, QE has tended to bring asset price inflation, via the portfolio rebalancing effect, while fiscal spending tends to price real-world goods and services inflation.

If QE and QT are symmetrical such aggressive QT will almost certainly bring further market volatility.

With the financialization of the economy, we will see how long they can actually keep QT going.

Chart 2: Main St more levered to Wall St than ever before
US private sector financial assets % of GDP



Source: BofA Global Investment Strategy, Haver

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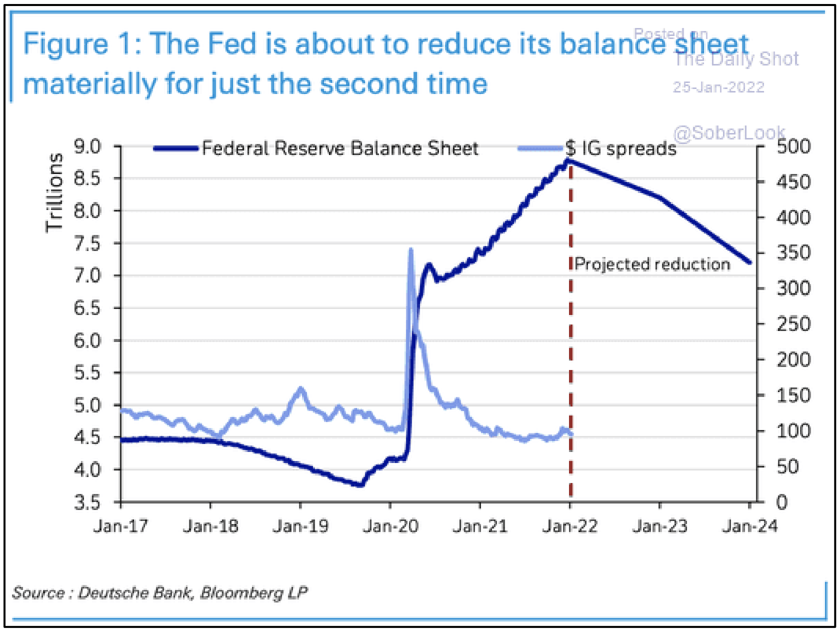
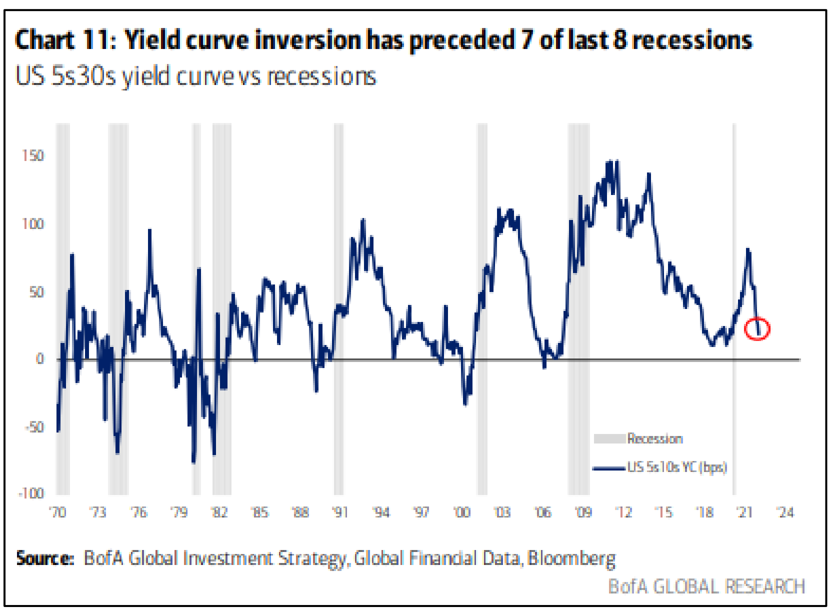
It has been suggested that the goal will be to shrink the $9Trl balance sheet by $2Trl over the next two years. Given the 2018/2019 experience, it is hard to imagine that they can actually pull that off.



Powell went out of his way during the press conference to dismiss any concerns regarding the current flattening of the yield curve. We will see if it keeps going and if it matters.



A big outstanding question regarding QT is how much can the Fed reduce bank reserves without something breaking loose as it did in 2019 in the repo market. Once people, and markets, get used to something it can be hard to take it away.

I recently read a piece from a former trader on the Fed's open market desk, Joseph Wang. He was there during the last round of QT and had an interesting take on how it may play out this time.

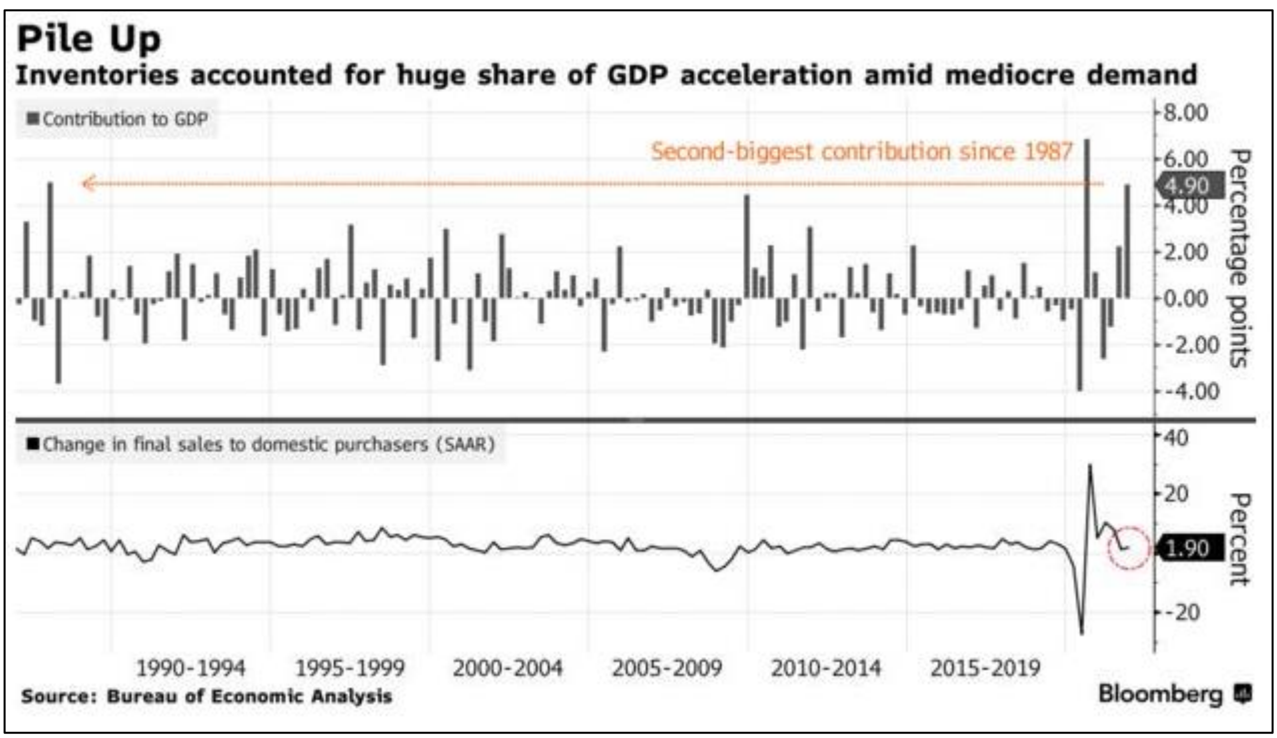
If he is right, the curve could eventually see a big re-steepening.

The QT Timebomb - Fed Guy

"The mechanics behind the 2019 repo spike suggest that another spike in rates will eventually occur. Last time banks deployed their enormous QE cash balances into repo, but this time around they are pouring it into Treasury and Agency MBS securities to the tune of $1.5t. An aggressive QT will ***both rapidly increase the supply of duration to the market while at the same time rapidly reduce the cash balances of banks, a key marginal buyer****. The combination of a positive supply shock and negative demand shock can eventually again lead to violent dislocations."*

Eco data may get very complicated shortly … as if things were not already hard enough for the Fed.

Last week's GDP numbers were very good, however, with inventories a big driver, it very likely won't be sustainable.



Unless post omicron spending kicks in, that could lead to disappointment.

Credit

Credit spreads have held in very well so far. It will be interesting to see if that can continue as liquidity is drained going forward.

The end of QE and its likely reversal via QT, may not mix well with high positioning and likely outflow in an illiquid market.

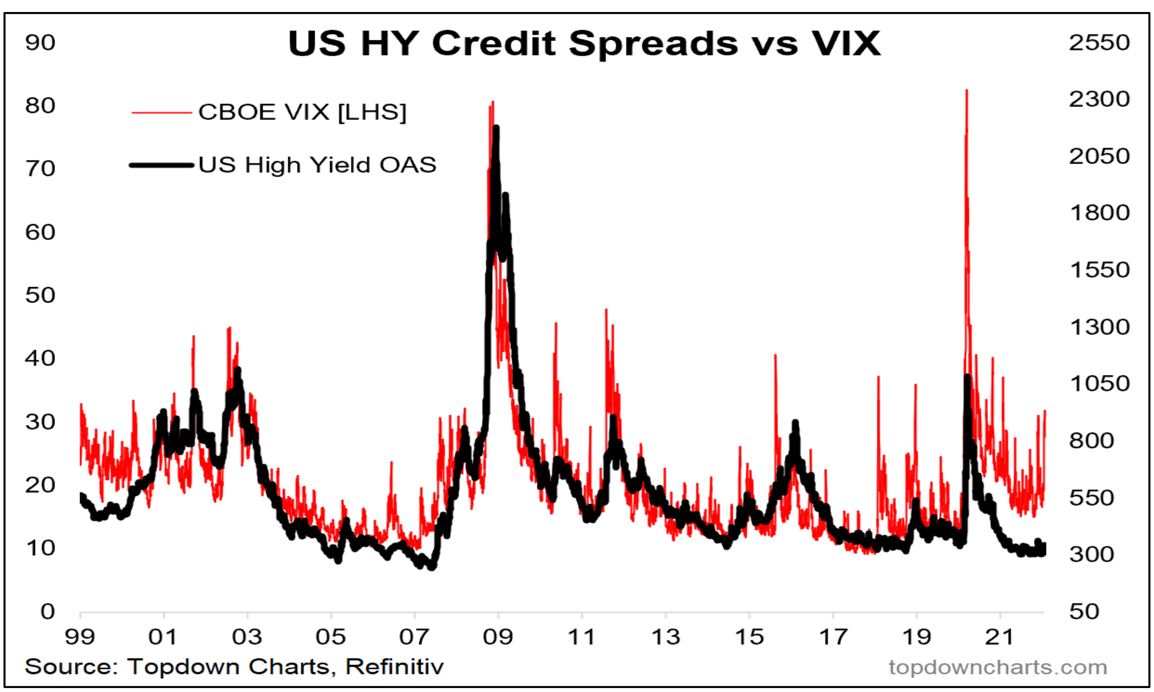
GS put out a not last week discussing just that. Here are the highlights.

"THE FED WANTS TIGHTER FINANCIAL CONDITIONS [...] the Fed now needs to hike more than the forwards in order to generate any tightening in FCI via purely the rate channel. Alternatively, the Fed needs to engineer higher 10y (real) rates, a stronger dollar, wider credit spreads ... or lower equity valuations.

Credit spreads have a 40% weight in the Financial Conditions Index from GS Research, only comparable to the 45% weight of long-term rates (FX, equity prices and nominal policy rates are all below 6%). ***In other words, 85% of the Financial Conditions Index is driven by credit yields (rates + spreads).***

CREDIT HAS REMAINED VERY WELL SUPPORTED...and our GIR team note the volatile price action in global sovereign bond markets has been a stronger headwind for equities relative to credit spreads. The resilience of credit vs. equities reflects the lack of direct spillover from higher rates to spread valuations that is analogous to the growth vs. value rotation in the equity market...sentiment in credit markets is much more driven by rising downside risk to growth, as opposed to declining upside risk. However, as QT starts later this year, I do expect to see a material *repricing of downside risk in credit stemming from the risk of a sharp and persistent rates selloff that is largely driven by real yields. This should widen credit spreads and may trigger asset allocation shifts away from credit…whilst these flows have thus far been absent and are hard to time, they have large pricing implications when they do appear so it's worth keeping firmly on the radar. It feels to me that credit is likely to do some of the legwork in FCI tightening this year…"*

The higher volatility environment won't matter, until it does.



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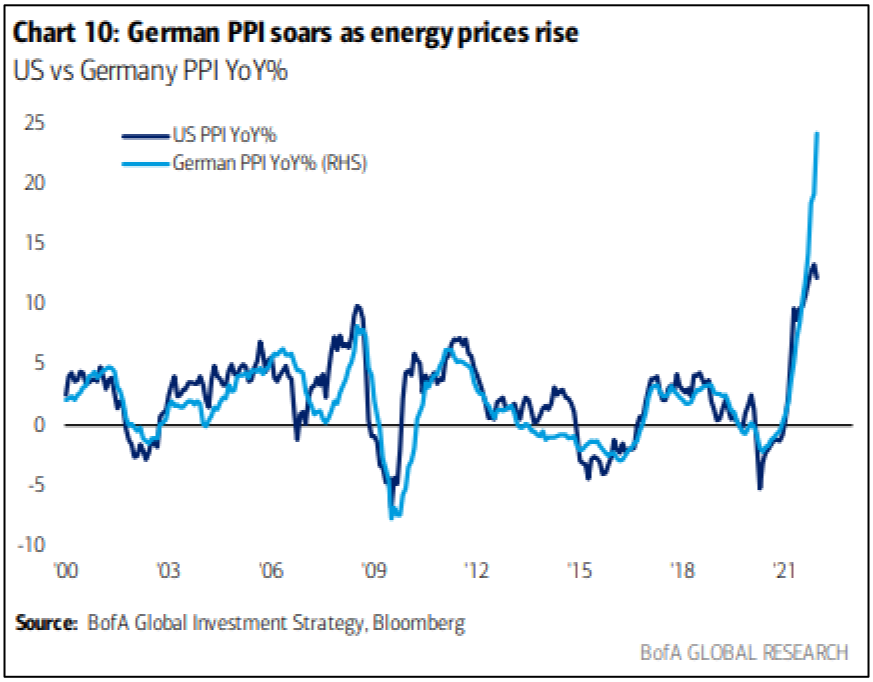
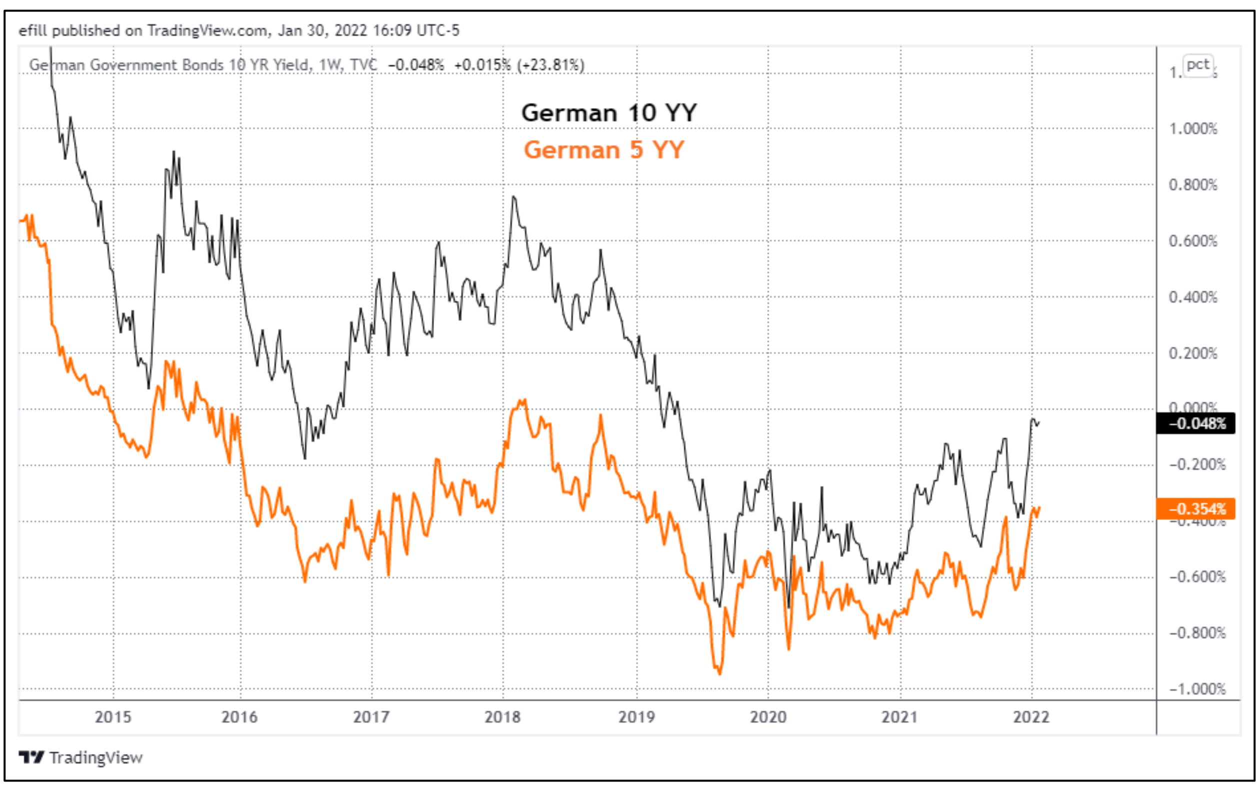
ECB

Markets will be watching next week's meeting for any change in the ECB's inflation call. Will it follow the Fed in ditching "transitory" in regard to inflation? It may well depend on next week's inflation data and internal ECB member dynamics. The pressure is building…

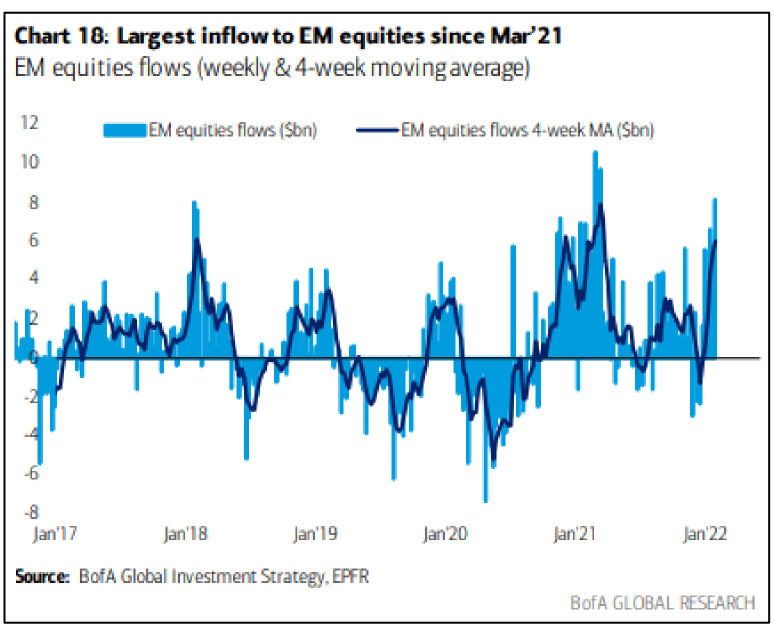




What to Focus on Now:

Equities - Last week's wild gyrations got the VIX into the high 30's (38.93) and delivered five days that saw an average daily range in the S&P north of 3%.

There was plenty of dispersion inside the US in terms of relative index and sector performance. In global markets, Europe and EM held up relatively well. EM inflows have continued.



Asian EM didn't fare all that well as Korea and China came under renewed pressure, but there were some relative winners such as Brazil that has remained stubbornly bid.

Fixed Income – US 10 year yields ended the week unchanged…

While the front end adjusted to the very hawkish Fed on Wednesday.

Leaving the curve substantially flatter.

Breakevens remain caught between new highs in oil and a flattening US curve.

TIPS have remained under pressure.

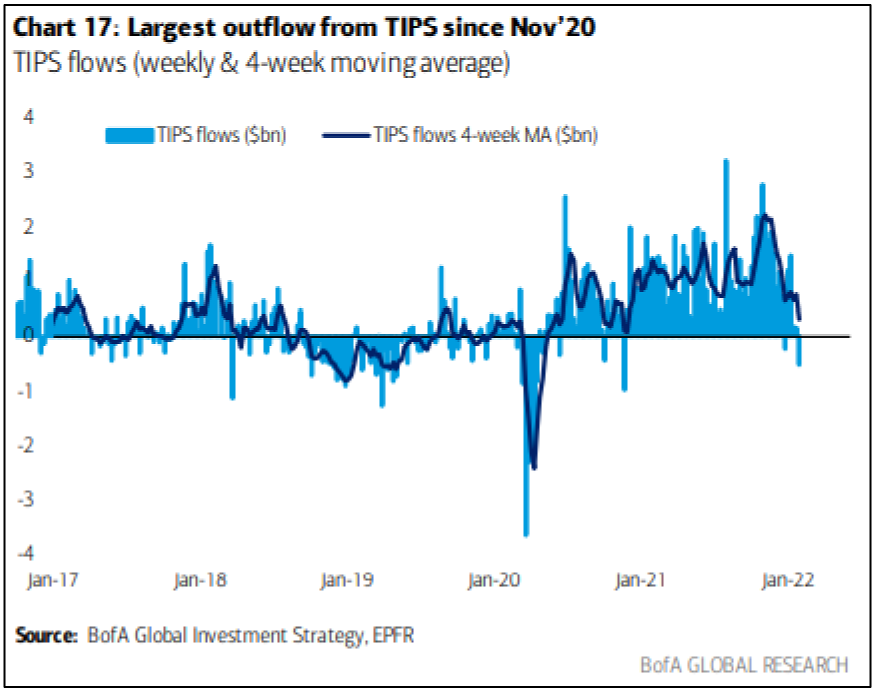


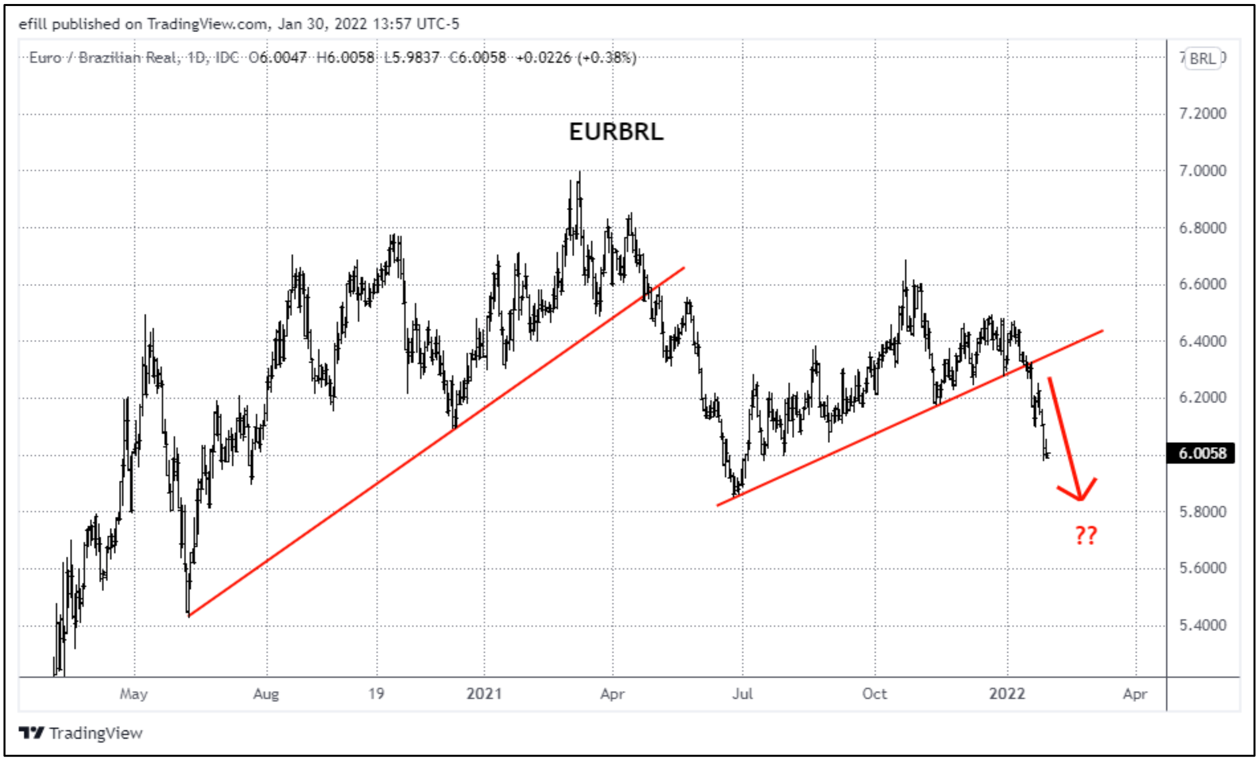
Chart 17: Largest outflow from TIPS since Nov'20
TIPS flows (weekly & 4-week moving average)

Source: BofA Global Investment Strategy, EPFR

Sell TIPS if you think inflation will be lower than breakevens.

FX - Meaningful up-move in the dollar last week as US front end rates priced a faster Fed. However, all said and done and we are not far from the middle of the 2015-current range.

I have been watching EURBRL, which pushed on last week as EUR fell and BRL held firm.



Commodities – EM and Commodities divergence continues as a strong USD, weakening China growth, and rallying energy make for an unusual combination.

Zooming oil and hard-hit tech stocks has made for some impressive relative performance extremes.

This week ECB and BoE. Payrolls expected to be volatile again …

Important Macro Data Releases and Events for the Week

Monday
1/31/2022

- GDP (Q4)
- Harmonized Index of Consumer Prices (Jan)
- Chicago PMI

Tuesday
2/1/2022

- Retail Sales (Dec)
- Final Markit Manufacturing PMIs across Europe (Jan)
- Final Markit PMIs (Jan)
- ISM Manufacturing (Jan)

Wednesday
2/2/2022

- OPEC Meeting
- CPI (Jan)
- ADP Employment Change (Jan)

Thursday
2/3/2022

- Final Markit Service and Composite PMIs across Europe (Jan)
- **BoE Interest Rate Decision and Policy Statement**
- **ECB Interest Rate Decision and Policy Statement**
- Initial Jobless Claims
- Initial Jobless Claims 4-week average
- Continuing Jobless Claims
- ISM Services PMI (Jan)

Friday
2/4/2022

- Retail Sales (Dec)
- **Nonfarm Payrolls, Unemployment Rate, Ave. Hourly Earnings, Participation Rate**

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