

CIO Viewpoint

As inflation rises, will central banks blink?

Investment Solutions

8 November 2021

Markets believe inflation will be higher for longer. Faced with this new reality, investors have driven up short-term bond yields and priced in earlier interest rate rises. Yet in the US and Europe, central bankers have pushed back on these rate expectations – for now. The months ahead will prove a test of nerves for markets and central banks, and the risk of a misstep has risen.

Rate expectations have moved sharply higher in recent weeks (see chart 1 on page 2). Rising short-term bond yields imply markets now expect interest rate rises to happen sooner in many developed economies. For months, central banks have played down price spikes as ‘transitory’: a situation where roaring demand has hit supply bottlenecks and depleted inventories, which will ease in time. Monetary policy cannot easily curb supply-led inflation: higher rates cannot solve queues at ports or build new gas pipelines. Meanwhile, headline inflation has climbed to 5.4% in the US and 3.4% in Europe, versus 2% targets.

Temporary insanity

Yet the narrative of temporary inflation is now being challenged. Talk of cost inflation and future price rises was a staple of third quarter earnings calls. US employment costs rose at a record pace in Q3, as firms facing labour shortages hiked wages. Bank of America’s October survey showed 38% of fund managers now think inflation is permanent, up from 28% a month earlier. Consumers in the developed world are beginning to expect higher inflation, and to worry about the impact on their finances.

Many central banks would appear to agree. Banks across the emerging world have been hiking rates this year. Among developed countries too, Canada ended its quantitative easing programme in a surprise move in late October. New projections at the Reserve Bank of Australia’s November meeting now imply a 2023, not 2024, rate rise. In October, Bank of England (BoE) governor Andrew Bailey said the bank would “have to act” in the face of rising inflation, though kept rates on hold at its November meeting.



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Key takeaways

- Markets are challenging the narrative of temporary inflation, and pricing in 2022 US and European rate hikes
- We see some measures of inflation peaking, and believe hiking cycles will start later than market estimates, with more cumulative US rate rises than consensus forecasts
- Central banks face a difficult balancing act and the risk of a policy misstep has risen
- We favour a defensive duration stance in fixed income, remain overweight equities – preferring cyclical and value-exposed assets, take a more constructive US dollar stance, and see more catalysts ahead in currency markets

Important information: Please read the important information at the end of the document.

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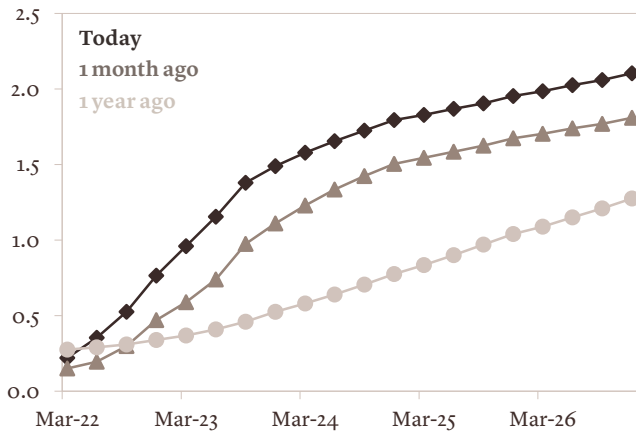
Data as of 8 November 2021 unless otherwise stated.

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Chart 1:

Fed lift-off – markets pricing in Q3 2022

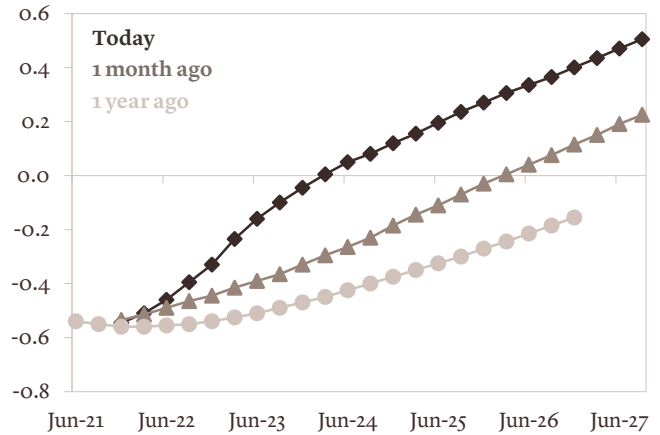
USD money market rates from 3-month Eurodollar futures, %



Sources: Bloomberg, Lombard Odier calculations

ECB lift-off – markets pricing in late 2022

EUR money market rates from 3-month Euribor futures, %



Sources: Bloomberg, Lombard Odier calculations

A complex picture

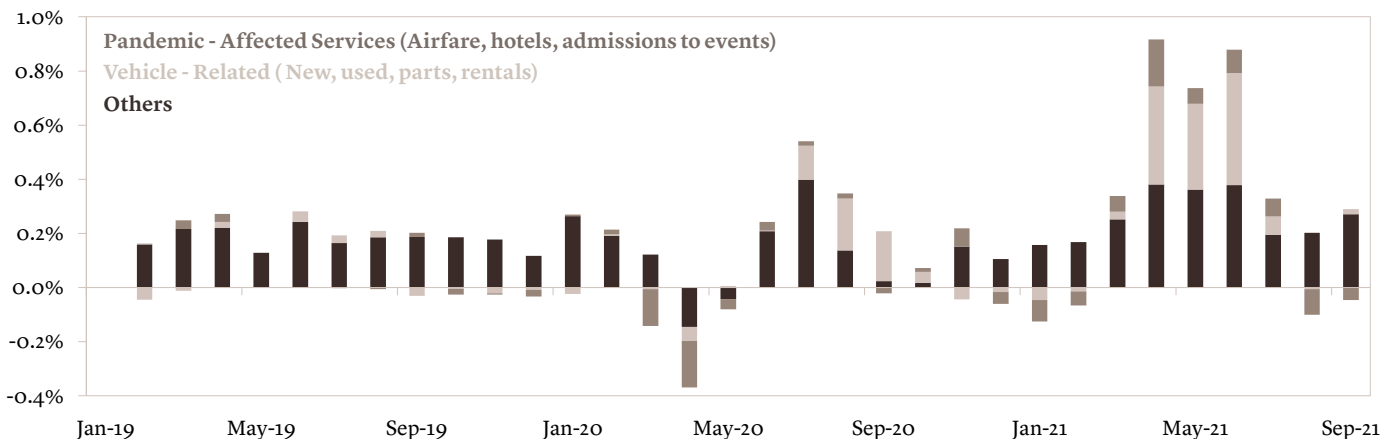
Yet the BoE’s November decision wrong-footed markets, and shows the inflation picture is more complex than it appears. While investors fret about inflation becoming entrenched, some statistics point the other way. European gas and Chinese coal futures are falling. Core US consumer price inflation – appears to be peaking (see chart 2 below). Despite solid US jobs growth in October, employment remains way below pre-pandemic levels, implying slack in labour markets. As winter looms in the developed world, the risk of Covid disruptions – and hence weaker demand – has not gone away. Added to this, emergency fiscal stimulus, including support for ‘furloughed’ workers and boosts to benefits, is gradually being withdrawn. We think inflation should start to ease in 2022, taking some of the heat off central banks.

Meanwhile, expectations of 2022 rate hikes in the US and Europe look premature to us. While both the Fed and the European Central Bank (ECB) acknowledge that inflation could be higher for longer, the ECB has pushed back on markets’ rate rise timeline. The Fed has repeatedly stressed that the bar for raising rates is much higher than that for tapering asset purchases. Reaching maximum employment still looks some way off. Raising rates to stave off higher inflation expectations looks more an emerging market imperative than one for countries with a history of price stability (and in Europe, of persistent inflation undershoots). We believe the first Fed and ECB rate hikes will come in 2023.

Chart 2:

Has core US inflation peaked?

Core consumer price inflation, month-on-month, %



Sources: BLS, CEA, Lombard Odier

In many ways, the balance of risk could even be skewed the other way: that the Fed and the ECB delay hiking for longer than is prudent. In the last 18 months, both have made changes to their inflation-targeting regime that can imply leaving inflation below – or above – target for longer. Both have been criticised in the recent past for prematurely hiking rates (the ECB in 2008 and 2011, the Fed in 2015). We project a later rate “lift-off” for the Fed, but more hikes cumulatively over time than consensus estimates currently forecast, with the US rate cycle peaking at 2.75% in the latter half of the decade.

A test of nerves

The coming months will be a difficult balancing act for central banks, as they wait to see how prices – and employment – evolve. There is no playbook for a post-pandemic recovery. Policymakers will be painfully aware of high asset prices, and the need to wean economies off free money. As the recovery continues, emergency monetary support in the form of asset purchases will be slowly withdrawn, with fiscal policy delivering more targeted help to those in need. In China, fiscal, not monetary, policy should be the economy’s main support next year, [a former monetary policy advisor notes](#). We will return to the topic of fiscal policy in a future CIO Viewpoint.

Meanwhile, the stakes for central banks are high – hints that Australia was about to scrap its yield curve control led to a 50bps move in three-year rates over two days. Sharp repricing of market expectations can cause big damage, as the 2013 ‘taper tantrum’ demonstrated. Central bankers must pay more attention than ever to clearer guidance and messaging, to avoid the criticism of “unreliable boyfriend” that was once levelled at the Bank of England. It is a difficult balancing act to pull off, but the Fed’s launch of its tapering programme in November – with barely a murmur from markets – is an encouraging sign.

How should we be investing?

With this in mind, we favour remaining fully invested, and take a constructive view on risk assets. With volatility potentially rising, hedging strategies could become more relevant. In fixed income, a backdrop of persistent inflationary pressures and rising rate expectations favours our current defensive duration stance. We prefer to take credit risk in emerging market hard currency debt and high yield.

Equity markets remain untroubled by the rise in short-term bond yields; US markets hit fresh highs after the Fed’s November meeting. Rising inflation is historically better for investment portfolios than stagflation, which was markets’ concern after the summer. Nor does an analysis of S&P500 total returns suggest that a rising rate environment is necessarily bad for stocks: from 1961-1966, rates rose 325bps and the index returned 37%; from 2003-2006 they rose 500bps, with a total return of 39%. As long as rates rise for the “right” reasons, i.e. reflecting economic improvements, equities can continue to do well. We remain overweight equities, favouring sectors and regions with more cyclical and value-exposed assets with catch-up potential, e.g. UK and small caps.

Perhaps the biggest impact of recent developments could be on currencies, where volatility remains below historical averages, partly because of the impact of coordinated central bank intervention. As global growth gradually slows and high monthly inflation data could see markets continuing to price in a 2022 Fed rate hike, we have turned more constructive on the US dollar. Going forward, more divergence in global monetary policy – among developed markets, and between the developed and emerging world – could bring clearer catalysts for a range of currency pairs. And as the tide of central bank liquidity gradually ebbs and growth slows, active management of portfolios’ risk exposures becomes even more important.

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