

CIO Viewpoint

Fighting history: monetary policy and the flattening yield curve

Investment Solutions

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Central bankers face their biggest challenge in decades. After nearly 14 years of accommodative monetary policy and asset purchases, can the US Federal Reserve and European Central Bank tighten the costs of borrowing without tripping economies into recession? History is not on their side. We look at the investment risks, opportunities, and how our portfolios are positioned.

Central banks around the world have one mandate in common: price stability. The war in Ukraine has created a commodity shock that has intensified inflationary pressures, accelerating the need for monetary policy to respond. Annual inflation in the US was at 7.9% in February and 7.5% in the eurozone in March. Inflation has stopped being a 'transitory' effect of rebounding demand post lockdowns, and has seeped into every corner of the economy. Commodity price shocks from oil and gas to wheat and nickel, as well as economic sanctions, are exacerbating the fallout from Russia's invasion of Ukraine.

That leaves the Fed and ECB chasing persistently high consumer prices with interest rate hikes. We are at least starting from higher levels of growth, thanks to two years of exceptional fiscal and monetary policy support through the pandemic. In addition, job markets are strong, with latest unemployment rates at [3.6%](#) in the US and [6.8%](#) in the eurozone, while household savings provide some cushion from rising prices. Slowing growth won't therefore result in a recession in 2022, but may test government finances: global public debt rose through the pandemic, and stood at the [equivalent of 351% of gross domestic product in 2021](#), according to the Institute of International Finance.

The key question is whether the Fed can engineer a soft landing in 2023-24. The historical odds are against it. We saw a rare example of a successful soft landing in 1994-95. However, most hiking cycles end in recession (see chart 1). Policymakers lack a model for guiding economies into a 'soft landing' in unprecedented circumstances, as they exit a pandemic and hit a series of external shocks, including the conflict in Ukraine. In addition, monetary policy tightening is starting later in the economic cycle, with employment and inflation higher than previous hiking cycles.



Stéphane Monier
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Key takeaways

- The global economic environment has deteriorated since Russia's invasion of Ukraine, but the post-pandemic boom leaves a growth buffer. Monetary conditions remain far from restrictive
- We do not expect a US recession in 2022. Engineering a soft landing is not impossible for the Fed, but challenging from a historical perspective
- The US yield curve has flattened, suggesting a deteriorating economic outlook for 2023
- While staying broadly underweight in fixed income, we have increased US Treasuries and reduced Chinese sovereign debt in RMB. We remain neutral on equities and use options to shield portfolios.

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

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Lift off

After a slow start, we expect an interest rate hike at each Federal Reserve meeting through the rest of 2022, including one rate change of 50 bps in May, and possibly another of the same magnitude in June. Within 12 months, markets are expecting the Fed funds rate to reach 2.75%. At current inflation levels, that would still leave real rates in negative territory.

On 21 March, Chair Jerome Powell was asked what would stop the Fed raising rates by more than 25 bps in May. “What would prevent us?” joked Mr Powell. [“Nothing: executive summary.”](#)

The dangers of overtightening too quickly cannot be ruled out if the Fed goes ahead with a 1% rise in the cost of borrowing in May and June. Such fast interest rate tightening leaves little time to observe their impact. That risks turning a touch on the brakes into an emergency stop. Traditionally, central banks’ role has been to avoid an economic slowdown by adjusting the cost of capital. Now, for the first time in decades, a conscious policy to counter runaway prices risks driving economies toward recession.

While the Fed has been criticised for being slow to recognise that inflation had turned more persistent, the European Central Bank is further behind still. For now, the ECB is struggling to meet its mandate of “making sure that inflation remains low, stable and predictable.” The ECB is poised to tighten its monetary policy by accelerating the end of its asset purchases through the third quarter of 2022. That would position the central bank to begin raising interest rates no earlier than the last quarter of 2022.

Trimming assets, anchoring expectations

Another unknown factor comes from the Fed’s plan to reduce its balance sheet. The US central bank held [assets worth USD 8.96 trillion](#) on 21 March, more than double the total at the start of the pandemic two years earlier (see chart 2). Next month the

Fed is also expected to detail how it will let these bond assets’ maturities run down, or sell them off over the next three or four years.

We do not yet know what impact that would have on the fixed income market. It is possible that increasing the availability of Treasury bonds would lead to higher long-term yields, in turn making risk assets relatively less attractive to investors.

The risk for central bankers is that their inflation outlook loses credibility, or in monetary policy jargon, becomes ‘de-anchored.’ This undermines some of the economic effectiveness of guiding corporate decisions by managing borrowing costs higher.

Central bankers in Washington and Frankfurt only have to look to London for recent experience of mismanaging expectations. The Bank of England led investors to expect a rate hike in November 2021, then didn’t raise rates. Markets were surprised when the BoE did increase rates by 15 bps on 16 December, becoming the first G7 central bank to do so since the Covid pandemic.

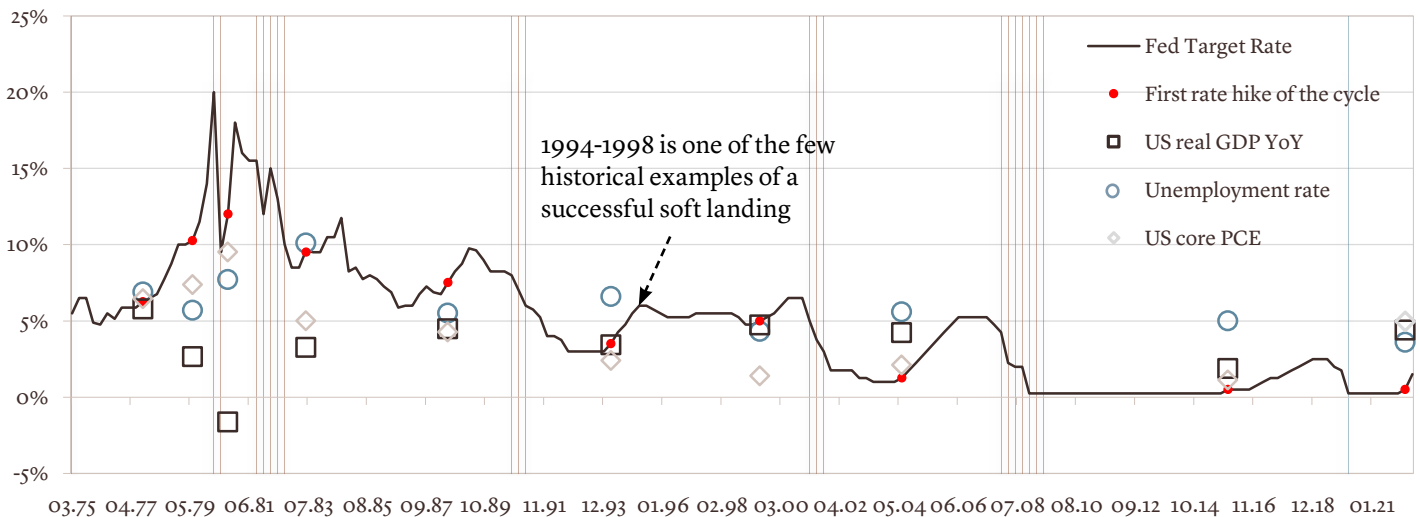
Yielding forecasts

Markets fear a monetary policy mistake. The difference in yield between different US Treasury bond maturities is closely watched. Investors expect a higher yield for holding debt for longer. The yield on the US Treasury’s two-year and ten-year notes has inverted before every US recession since 1955, [and did so again last week.](#)

Still, an inverted yield curve does not indicate an imminent recession. Historically it takes an average of 12 months to translate the inverted yield curve into a downturn.

A second, closely followed recession indicator is the Sahn Rule. This says that an economy is either in, or about to enter recession if the three-month average unemployment rate is

1. Can the Fed engineer a soft landing?



Sources: Bloomberg, Lombard Odier

more than half a percentage point above its previous 12-month low. For now, the US labour market remains strong with jobless levels close to five-decade lows and a workforce still confident in its ability to switch employers quickly.

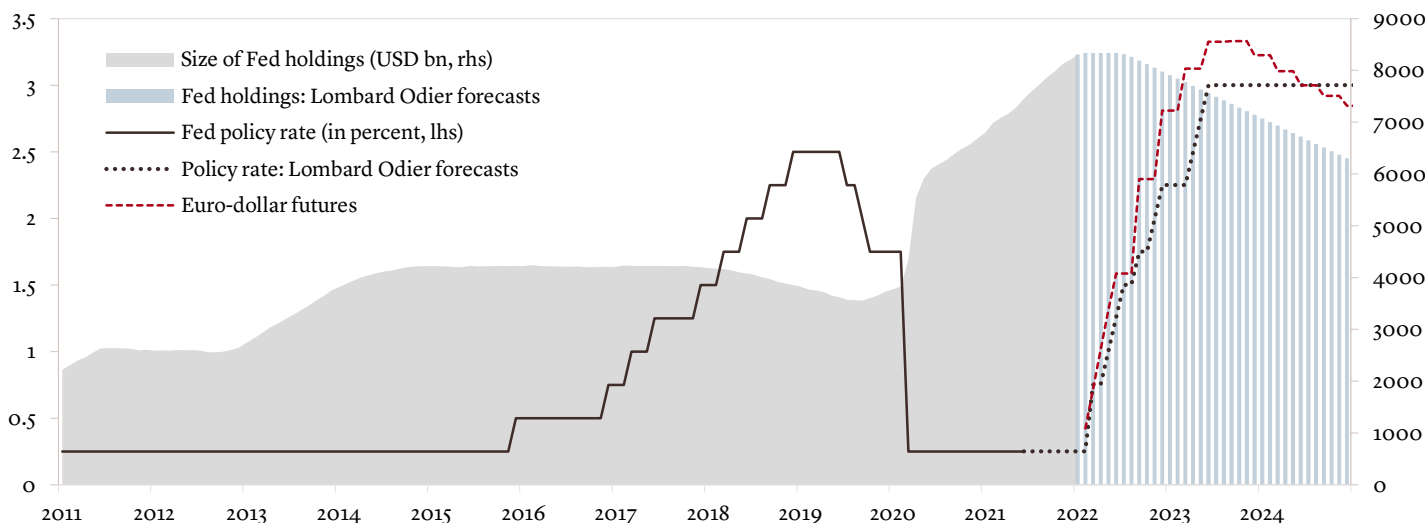
Positioning portfolios

While the direction of interest rate policy is clear, its scale and impact is less so. The longer the Ukraine conflict goes on, the greater the impact on the global economy's energy markets, trade flows and consumer confidence and the higher the risk of recession in Europe, with potential spillover effects on monetary policy decisions.

Both US and European equity indices are now above levels last seen before the war. Although markets historically perform well in the early stages of a hiking cycle, this time it may be different. Corporate valuations remain elevated though have improved, and share buybacks are at record levels, although expectations for first-quarter earnings are lower and depend on the evolution of rates and economic growth. That makes the longer-term environment for continued equity gains less favourable. While we are still neutral on equity markets overall, we have implemented put option strategies on US and European equity indices to cushion potential stock market falls while partially capping the upside.

We have added to our US Treasury positions as yields are more attractive, while more broadly remaining underweight government bonds and corporate debt. We have also reduced our overweight positions in renminbi-denominated Chinese sovereign debt. This is because the yield differential with US Treasuries has narrowed and the risk of a weakening renminbi has risen, as China faces potentially slowing economic growth. We are overweight in commodities and cash, to which we have added in recent months, allowing us more flexibility to deploy as market opportunities present themselves.

2. Fed policy rate and size of QE holdings vs expectations



Sources: Bloomberg, Federal Reserve, Lombard Odier

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