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Investment Strategy Bulletin

Central banks up the stakes – a key risk for the global economy

Investment Solutions

17 June 2022

Key takeaways

- The Fed's goal of bringing down excess demand without causing a recession is becoming increasingly challenging. We expect inflation to trend lower in the second half, avoiding the most extreme economic outcomes
- In Europe, we predict rates peaking around 1.25%, while the ECB may have to do more on fragmentation risks. Swiss rates should turn positive this year
- In Japan, we expect the central bank to adjust its yield curve control in October, and we highlight that the currency has now become an explicit factor for future BoJ decisions
- We are in the middle of an unusually sharp global monetary policy cycle, although we think the cumulative tightening will be lower than markets currently expect.

The Federal Reserve raised interest rates by 75 bps on 15 June, and indicated a rapid pace of monetary tightening ahead, with either a 75 bps or 50 bps hike in July (although Chair Jerome Powell said 75 bps hikes would not be normal). It was the largest rate hike since November 1994. The median member of the FOMC projects the midpoint of the fed funds rate target range to rise to 3.4% by year-end. In light of this shift in the Fed's outlook, we now foresee rate peaking around 3.6% in this cycle, rising 75 bps in July, 50 bps in September, and 25 bps in November and December. Upcoming hikes would take the Fed well beyond its previous estimates of 'neutral' policy that neither stimulates nor curbs growth (in the mid 2% range), and the peak of the last hiking cycle, into restrictive territory.

Inflation continues to force the Fed's hand. May's consumer price inflation will likely be echoed in the month's personal consumption expenditure (PCE) inflation – the Fed's preferred measure – to be released at the end of this month. Easing supply chain bottleneck could lower less noisy "core" inflation, which excludes food and energy prices, in June. Yet headline inflation, which includes these prices, will prove to be uncomfortably high as a result of the elevated core gain and fuel prices. Moreover, inflation expectations, as measured in surveys and priced into bond markets, still point to the risk of above-target inflation persisting in the medium-term. Political pressures are also rising for the Fed to fight inflation actively ahead the mid-term elections. The inflation fight has become the clear priority.

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Data as of 17 June 2022 unless otherwise stated.

Consequently, the Fed is compelled to test the limits of its attempt to achieve an economic 'soft-landing' by frontloading nearly all of its rate hikes to 2022. Previously, we expected the Fed to achieve a kind of soft landing with the fed funds rate peaking around 3%. After the June FOMC, we believe that a mild recession in 2023, with a modest spike in unemployment to 4.5~5.0% and the fed funds rate peaking around 3.6%, is the likelier scenario. We note that this is rather more pessimistic than the market consensus, which currently foresees growth rates around 2% continuing until the end of 2023 and unemployment barely budging from the current 3.6%. Our forecast implies an increase in corporate default rates, but not a large jump associated with more severe recessionary episodes.

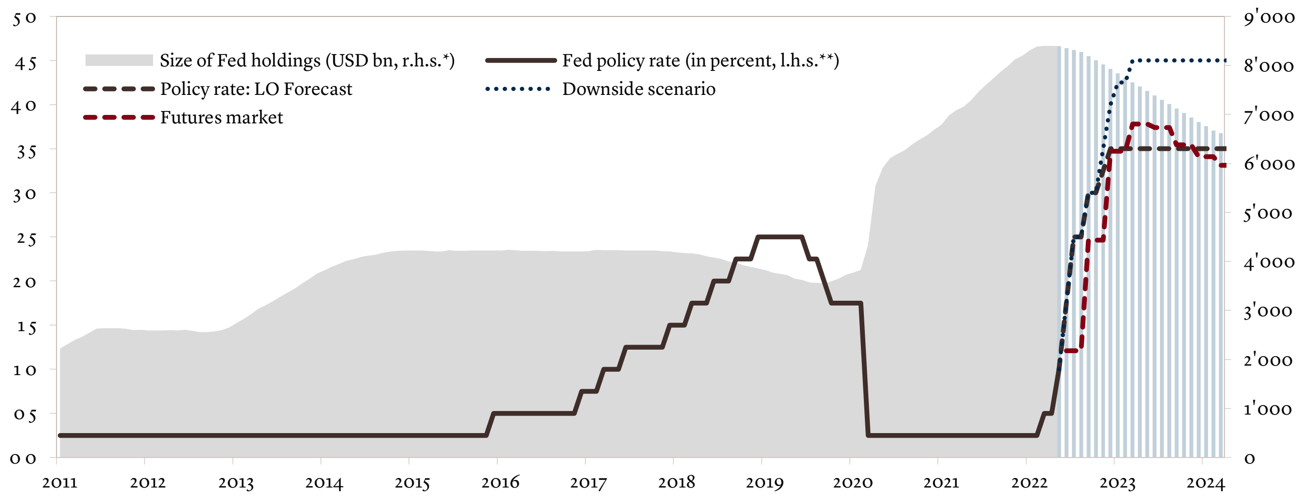
We still think a severe contraction can be avoided, unless a string of uniquely bad inflation data drives the Fed into rate hikes to 4.5% or above (an outcome along the lines of what is illustrated by the "downside scenario" shown in chart 1). We have to acknowledge, however, that the risk of policy overtightening cannot be completely ruled out, as the global economy continues to negotiate a tricky path through prolonged geopolitical and public health shocks. After all, recessionary episodes tend to feature what many call the "fallacy of composition" in which a virtuous behaviour for a single person or company is in fact bad for the overall economy. When companies start reducing hiring en masse, they often trigger a feedback loop between payroll reduction and consumption weakness. This uncertainty is of course why markets suffer high volatility at the start of each recession.

The key question for markets now is whether investors have sufficiently priced in the growing risk of such an economic downturn. The magnitude of de-rating in key risky assets this year suggests that much of this adjustment might be in the price already. The US yield curve, a rather reliable predictor of US economic cycles has already inverted briefly (2-year US Treasury yields rising above 10-year yields). Key equity indices have seen one of the worst first half performances in history. High yield spreads are steadily getting close to the highs of the 2020 recession. Once the market debate moves from the likelihood of recession to its severity, our mild recession forecast, if proven correct, should suggest narrowing downside risks to stocks and corporate bonds. Markets might not be there yet, but we are probably approaching that crucial phase of the valuation re-assessment.

In the end, all of this depends on the inflation trajectory. One source of hope for more measured inflation is on the supply side, if China's gradual reopening finally sees supply chain disruptions ease. There are also signs of slowing demand. Wage inflation looks to be easing. The housing market is already showing the first signs of demand destruction, and retail sales dipped unexpectedly in May. Financial conditions are also tightening thanks to the end of asset purchases, the withdrawal of emergency fiscal support, and falling equity

1. A sharp and front-loaded Fed tightening cycle

Federal Reserve policy rate and QE holdings



* right hand scale, **left hand scale
Sources: Bloomberg, Federal Reserve, Lombard Odier calculations

and bond prices. We believe supply side improvements and softening demand should see inflation fall back below 4% by mid-2023, with a clear downward path already visible by Q4 of this year.

Repercussions in Europe

In Europe, the situation looks very different from the US (see chart 2). Inflation is driven more by (imported) rising food and energy costs that eat into household incomes than by excessive demand (see chart 3). With GDP still notably below its pre-pandemic trend, wage growth fairly tepid, and the growth outlook more significantly affected by the war in Ukraine, the economy looks much more vulnerable to monetary policy tightening – which is in turn ill-equipped to deal with supply shocks.

What complicates matters further for the European Central Bank (ECB) is the stress in peripheral bond markets, as the prospect of rising rates brings back the question of debt sustainability for certain countries – crucially Italy. The ECB had hoped to put the issue to rest through a vague promise in its 9 June policy meeting to intervene when fragmentation risks arise. Yet it was forced to hold an emergency meeting on 15 June, after markets put this to test through a sharp rise in yields.

The ad-hoc meeting of the ECB's Governing Council resulted in an action plan with two elements. Applying 'flexibility' to the way it invests the proceeds of maturing bonds on its balance sheet via the pandemic emergency purchase programme (PEPP) – implying support for peripheral countries – and the creation of a new tool to prevent fragmentation risks.

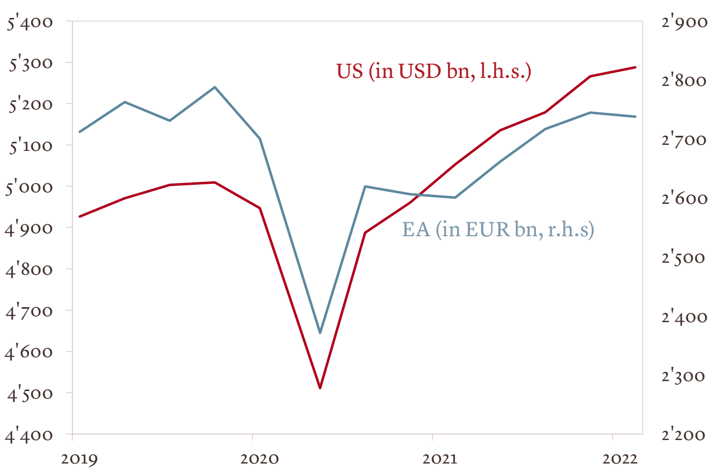
This signals the ECB acknowledges risks in the periphery and the need for firmer commitments than those announced last week. Markets reacted positively, although in practice the plan may prove insufficient and potentially subject to legal challenges. The amount available to reinvest from maturing PEPP bonds, as well as the possibility of buying ahead of redemptions, is not large enough to put the issue to rest. There is only so much front-loading the ECB can do without letting its balance sheet grow to an unwarranted extent, at a time when it is also tightening its monetary policy stance.

The new tool, which should be announced by its July meeting, is likely to be a new emergency purchase programme for markets where stress emerges (e.g. Italian bonds). It would aim to achieve the 'magic' of former ECB President Mario Draghi's announcement in 2012 to do "whatever it takes" to preserve the euro's unity. But the fact that the ECB is only designing this now, that no details have been shared, and most crucially that it may need to be put into use at a time of high inflation, show the challenges ahead.

Our forecast is for gradual and shallower rate hikes in Europe than the market expects. Futures markets predict the ECB's

2. The recovery of domestic demand in the US and Europe: a very different story

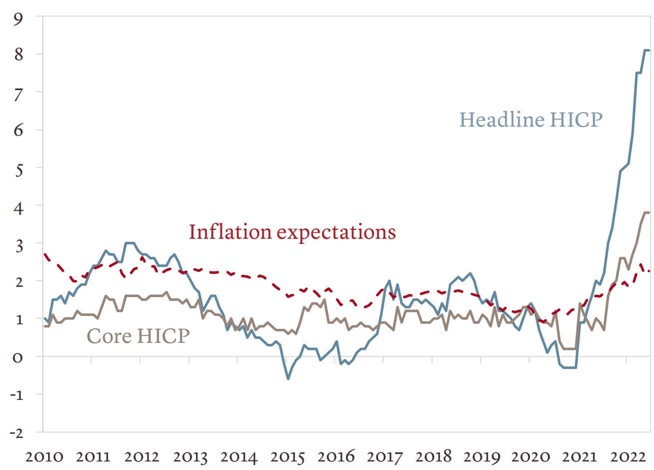
Real domestic demand (in bn)



Sources: Oxford Economics, Lombard Odier calculations

3. Euro area inflation looks more like a supply shock than a demand boom

Euro area HICP inflation



Sources:Bloomberg, Eurostat, Lombard Odier calculationsss policy rate peaking around 2.5%. We think the euro area is unlikely to sustain such a sharp monetary tightening and expect a terminal rate around 1.25% in early 2023 (25 bps in July as telegraphed, 50 bps hikes in September and October and 25 bps in December and February). Still, if the ECB manages to deal effectively with fragmentation risks this would allow it some additional leeway in its hiking cycle.

Swiss surprise

In Switzerland, a combination of factors conspired to push the Swiss National Bank (SNB) towards taking faster action than expected – a 50 bp increase in its policy rate – at its June monetary policy meeting.

Even in Switzerland's low-and-stable inflation economy, there has been a notable shift in recent months: new SNB projections show rates of inflation above 3% for the second half of 2022, even after accounting for the effects of tighter policy. Upcoming rate increases by the ECB also mean the spread between European and Swiss rates would widen unless the SNB was prepared to roughly match these moves. Because it holds scheduled monetary policy meetings less frequently (only four times a year), this means the SNB will sometimes make larger moves to keep the differential in check (see chart 4).

The fact that the starting point in Switzerland was one of deeply negative interest rates increases the willingness to hike when the opportunity to exit the "negative rates trap" arises. Meanwhile, the strength of the US dollar has also resulted in a lower overall value for the trade-weighted Swiss franc (given the dollar's large size in Switzerland's trade basket). The SNB therefore no longer sees its currency as highly valued, in what is a substantial shift to its past assessment.

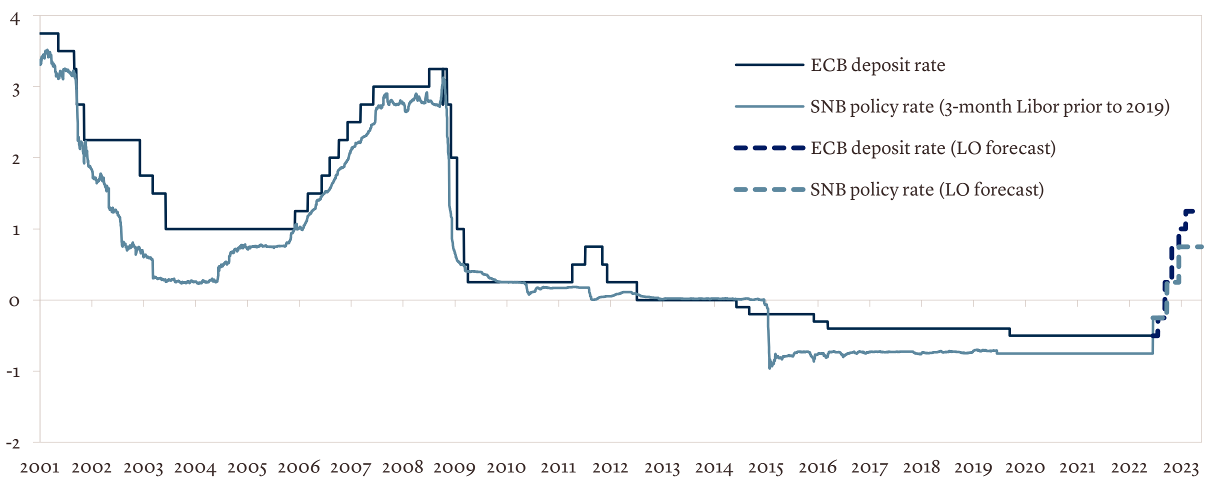
From here, we expect continued Swiss rate hikes at a pace of roughly 50 bps per quarter and look for the hiking cycle to peak at around 0.75% in early 2023. While we see the need for the policy stance to shift from easing to neutral given the aforementioned developments, we do not think there is a need for policy to turn actively restrictive.

Yen now linked to the BoJ's policy

In a twist ending to a week of historic hawkish adjustments by key global central banks, the Bank of Japan (BoJ) maintained all three key dimensions of its accommodative policy unchanged in its June meeting. In a 8-1 decision, the BoJ's board kept the rate on "policy rate balance" at -0.1%, the 10 year Japanese government bond (JGB) yield target at "about 0%", and retained its pledge to conduct unlimited purchases of 10 year JGBs at 0.25% yield. While this was not a surprise for economists, it proved a slight setback for investors, who had been testing the BoJ's yield curve control pledge in recent weeks.

4. The end of negative rates: we expect similar normalisation paths for ECB and SNB, getting policy to neutral but not into restrictive territory

Policy rates in euro area and Switzerland, historical data since 2001 and Lombard Odier forecasts from mid-2022 onwards



Sources: Bloomberg, SNB, ECB, Lombard Odier calculations

We think an important clue was provided in the bank's official statement. The BoJ noted that "it is necessary to pay due attention to the developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices." This atypical reference to currency movements effectively links the BoJ's future policy adjustments – which are highly likely to be tightening moves – to the value of the Japanese yen. As a result, any movement of the yen past comfort zones for both the BoJ and the Japanese cabinet would open discussions for possible tweaks to current policy. This is an interesting change to the BoJ's forward guidance, which could potentially cap yen weakness in the medium-term.

This raises our conviction that the BoJ will adjust its yield curve control in the second half. The falling cost of living is becoming a political issue in Japan, amidst the first genuine above-target inflation (i.e. excluding previous hikes in consumption tax) during Governor Haruhiko Kuroda's term. Increasing online searches for expressions like "bad yen depreciation" indicate that the public holds the BoJ responsible for the ongoing shift in their inflation outlook. The government is also paying attention to this ahead of July's upper House elections. In this environment, there is a clear incentive to reduce at least the pro-cyclicality of the BoJ's yield curve control. For this reason, we see the BoJ prepping the ground in coming months for the widening of the 10-year JGB yield tolerance band from the current plus/minus 0.25% to 0.50% in October. From our perspective, this would matter more for the markets than the Ministry of Finance's direct interventions in the currency market, which we see as unlikely.

For sure, the markets will continue to test the BoJ on its willingness to defend its current 0.25% ceiling for 10-year JGBs in the near-term while the US Fed keeps its steep rate hike trajectory. This, in turn, creates modest upside for USDJPY, especially since we expect another 75 bp hike in the July FOMC. Beyond summer, however, we will likely see USDJPY settling in a range around 135 instead of rocketing past rarely-seen levels, as the BoJ's policy tweaks become more likely.

A cautious outlook

We retain a cautious outlook ahead, as central banks around the world sacrifice growth opportunities to control inflation. However, we expect a downtrend in inflation in the second half, thanks to tighter policy and improvements in ongoing supply-demand imbalances. Even if inflation is likely to stay above central bank targets for a while, this deceleration should allow them to shift to a less aggressive tone, making the most extreme economic outcomes less likely.

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