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Bond Bites

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The Beautiful and the Damned

Who would be a central banker today? Between war in Ukraine and high levels of inflation, engineering a soft landing poses a challenge.

Are you familiar with the Roche Limit? Probably not, unless you have studied celestial mechanics – in which case I hope you had the good sense to divert your career energies into discovering the origins of the universe, rather than the far harder question of where inflation is headed next. I could show you some tricky looking maths but you would probably still be in the dark.

So how about a technical description instead? The Roche Limit: the point at which a celestial body, held together by its own gravity will disintegrate when the tidal gravitational force of a second body exceeds the first body's gravitational self-attraction. Trust me, you know it when you see it. If you have ever marvelled at the austere and lonely beauty of rings of Saturn you see the maths in action. Our best theory is that these rings are the fragments of a former moon that drew too close to the planet and was destroyed by the powerful tidal effect as it entered the Roche Limit.

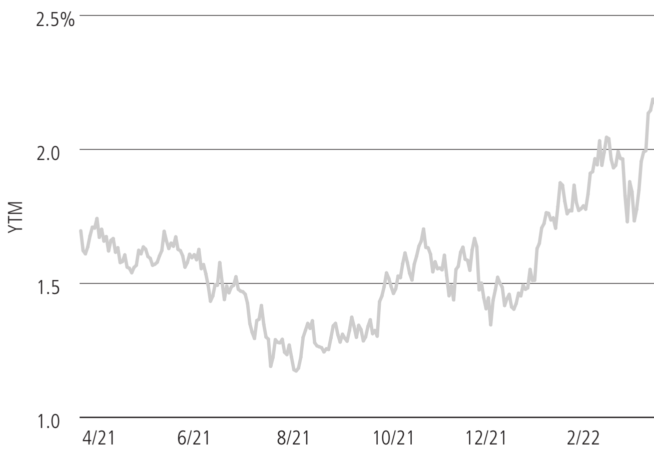
While, on a cosmic scale, the tidal force of gravity can obliterate worlds and reduce moons to mere space debris, in earthly matters it is the force of inflation that can devastate economies and crush savings into rubble. In physics and in finance there are limits beyond which nothing may be saved.

Something of the push-and-pull of powerful forces in bond markets was on full display in recent weeks. The safe haven status usually given to government bonds in moments of crisis was not much evident in the opening days of the war in the Ukraine, however shocking the events and uncertain the outcome.

No safe haven

Exhibit 1 shows that the yield on 10 year US Treasuries fell (i.e. prices rose) at first but quickly sold-off again and are now higher than at the start of the war. Safe havens are not so safe when investors are doubly unnerved by high inflation and monetary policy tightening to come.

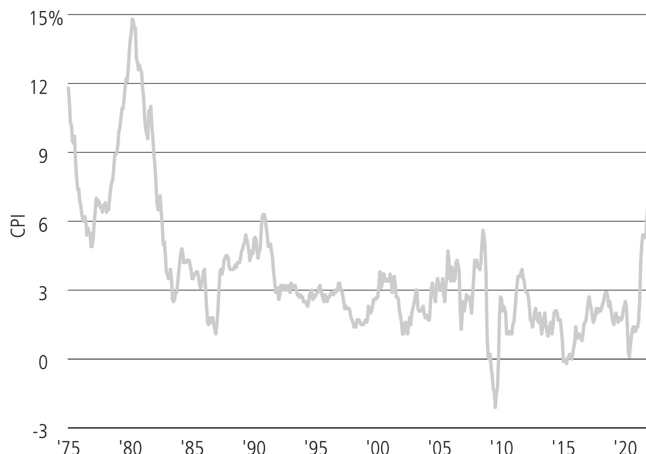
Exhibit 1: US 10-year treasury yield



Source: Bloomberg, as at 21 March 2022

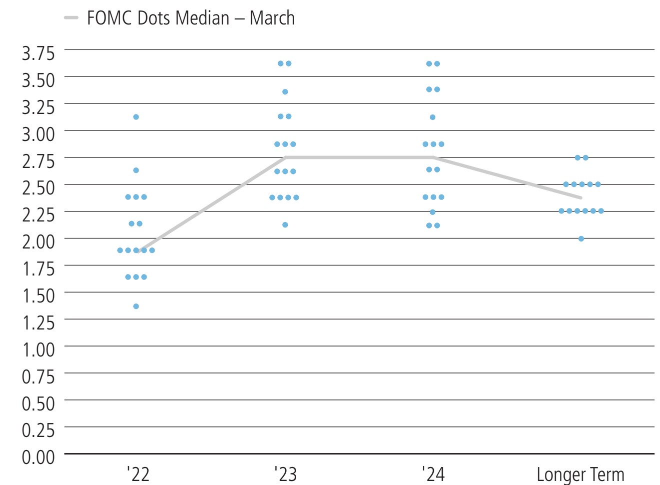
Certainly the Fed was not swayed by events, sticking resolutely to script and making the first of what is likely to be a series of hikes at their March meeting. And they need to act. Exhibit 2 shows the long run history of headline inflation in the US which hit nearly 8% at the last count. After the relentless focus on crushing unemployment back to pre-pandemic trends, the Fed made it clear that bringing inflation back under control is the priority now. Fed members also laid out their expectations

Exhibit 2: US CPI (YoY)



Source: Bloomberg, as at 31 January 2022

Exhibit 3: Distribution of FOMC members' projections for the US Fed Funds rate (March Meeting)

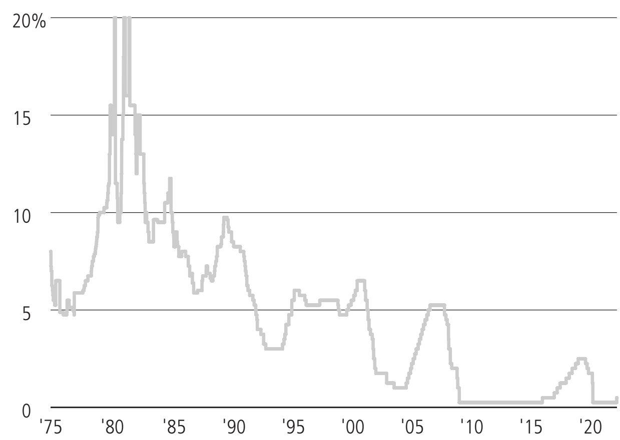


Source: Federal Reserve, as of March 17, 2022

for the trajectory of rate hikes expected to choke off inflation – their best guess being about 1.75% by the end of this year and to 2.75% by the end of 2023, as evidenced by the so called 'dot plot' in Exhibit 3.

I wonder. It's just that with inflation at these levels today's investors and policy-makers are in uncharted territory. Look closely again at Exhibit 2; the last time annual headline inflation in the US reached anything close to these levels was 1981. Jay Powell, Chairman of the Fed, was 28 and this writer was still in high-school. The 1980s feel further away than the Oort Cloud. Who really knows how high rates might have to go to get inflation back to target in the complex world of 2022? (in 1981 the answer was 18% - see Exhibit 4 - not that I expect anything close to that today).

Exhibit 4: Fed Funds Rate, Upper Bound



Source: Bloomberg, as at 21 March 2022

It is clear the Fed has been much slower than in previous cycles to try and tame inflation today. Historically rate hikes have been pre-emptive and based on forecast inflation – today they are lagging. And the broader economy seems in very good shape. The Institute of International Finance[1] pointed out in a recent report that both household consumption and business investment in the US have exceeded pre-pandemic trends. Wage growth stands at a 30-year high according to one of the Fed's own measures[2] and the US stands out as one of the best performing global economies. My point is simply that engineering a soft-landing[3] with inflation at these levels and a buoyant economy might be very tricky indeed and require higher rates than are expected today.

But there are opposing forces at work too. It is clear that rising food and energy prices will place enormous strains on household budgets. As economists would put it; the relative price shock in food and energy could easily spill over into much lower discretionary spending later this year. This in turn would lead to lower business revenues and investment. In any case, by the end of the third quarter of 2021, US real GDP growth had already fallen back to the pre-pandemic trend of about 2%[4]. So the US economy, while relatively strong globally, was already cooling down after the recovery from the pandemic. Finally, government spending, that had supported households all during the pandemic as the budget deficit peaked at about 17% of GDP during 2021, will tail-off from here. Taken together these factors might mean that the Fed is, in fact, starting to tighten policy just as the economy runs into headwinds. So with tighter policy today the Fed might be risking a deflationary crash later.

We considered all these factors at our March Investment Forum. On balance we think that the risk to the bond market is tilted towards higher yields, and have therefore remained underweight bonds. We are just at the start of a number of rate hikes in the US, with probably sticky inflation and the prospect of the Fed selling assets as well (so called quantitative tightening) so our base case is that yields move higher still (prices fall) into the summer. The case for bonds will be more compelling if some of those deflationary forces come to the fore later in the year.

In Europe the situation is even more complex and the war in the Ukraine has profound long-term implications for the Eurozone economy too complex to cover in full here. Despite the challenges, and somewhat counterintuitively, the ECB laid out a fairly resilient baseline scenario out to 2024 at its recent meeting, with growth of 3.7% this year and inflation falling to 2.1% (i.e. almost exactly at target) next year[5]. The ECB also outlined the end of the Asset Purchase Program (quantitative easing) and the suggestion remains that rates could also be increased before 2023. At face value this rather hawkish tilt follows the Fed's playbook, but this all seems far too optimistic. Tighter monetary policy feels awkward at such a time and, as the IIF pointed out in the report mentioned earlier, the post-pandemic recovery in Europe still lags the US by some way. All that said, the ECB has not actually tightened yet (unlike the Fed and Bank of England) and probably has plenty of time to change its mind.

Our global strategies have relatively little exposure to European bonds. The challenges to the growth outlook this year are obvious, allied with upside risks to inflation, an even greater relative price shock for households and the prospect of a much bigger fiscal expansion than had been expected a few months ago. Typically combinations such as these have been very challenging for investors to navigate and often led to poor real returns in the short term – hence our cautious stance today. However, unity across the EU has been rock solid and this bodes well for the future. Pro-growth monetary and fiscal policy, an expansive future investment program to drive changes in energy supply and greater economic unity could all transform the outlook. So we pay very close attention to developments in Europe and will look for opportunities to add to high-yield, credit and government bonds as the story evolves.

Across the world the uneven recovery from the pandemic and stubbornly high inflation already challenged policy-makers and investors alike. Now has been added the appalling war in the Ukraine and possibly dire consequences. Who would be a central-banker? Somewhere between the damnations of spiralling inflation or a deflationary crash lies the beauty of a soft-landing. Getting there has rarely seemed harder.

To find out more about UBS AM's fixed income offering, click here.

[1] https://www.iif.com/Publications/ID/4718/Global-Macro-Views-The-Global-COVID-Recovery
[2] The Atlanta Fed Wage Growth Tracker
[3] "soft landing" here meaning low unemployment and inflation back at the central bank target
[4] True, there was a jump to about 7% in Q4 but this seems most likely due to greater spending by business to build up inventories ahead of expected shortages cause by the omicron COVID variant
[5] https://www.ecb.europa.eu/pub/projections/html/ecb.projections202203_ecbstaff~44f998dfd7.en.html. Surprisingly even the more severe scenarios seem overly optimistic given what is at stake.

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