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Global Macro Insights

Don’t look up

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Key points

- As central banks strive to protect their credibility, we envisage a 'reverse Draghi moment', whereby policymakers refrain from leaning against the current hawkish momentum in expectations for policy withdrawal. Their objective is to let the market do the job for them by tightening financial conditions needed to slow growth and inflation.

- This policy expectations management exercise, if executed correctly, should allow central banks to tighten policy less aggressively in H2 2022 and beyond, compared to current market pricing. But there is a fine balance between doing too much or doing too little. As a result, risks of policy mistakes are particularly high.

- We expect the Fed to hike only three or four times this year combined with some quantitative tightening (QT), a significant difference from the market expectations for nearly six hikes in 2022.[1]

- As the tightening cycle unfolds, the Fed put will likely be more multidimensional - with more focus on real rates, credit spreads and actual inflation data - and will only kick-in when evidence of a business cycle or inflation turn becomes clear.

- With growth likely to pick up from the soft path in Q1, and with inflationary pressures continuing to broaden, the hawkish ECB narrative is likely to dominate markets for the next few weeks or months. This means market pricing for the hiking timeline should become more aggressive and peripheral spreads should continue to widen.

- We believe the market expectation for the ECB's policy rate to get to just below zero by the end of the year is too aggressive. Lift-off in December 2022 or early 2023 is more likely, and we do not expect ECB's policy rates to rise above zero in this cycle.

- Concerns about the peripheral debt burden and thus the need to keep real rates negative, in our view, will act as a speed limit on how much tightening is possible in the Euro area.

- As central banks continue to run with the hawkish narrative for now, we believe there is scope for further spread widening both in IG and HY credit, as risky markets have to play their part tightening financial conditions to bring inflationary pressures down.

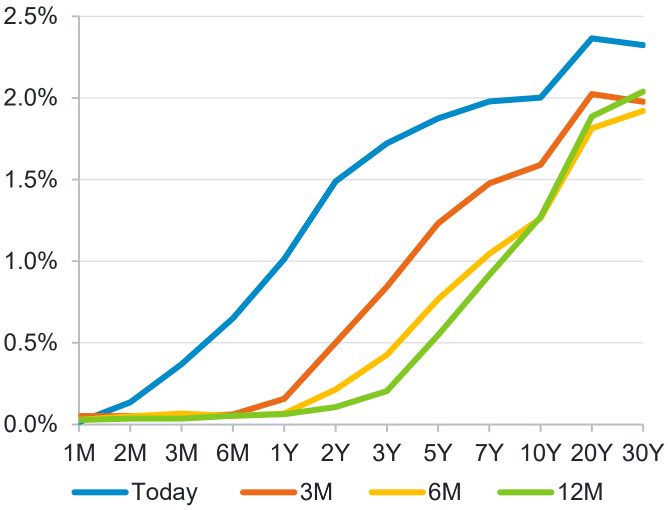
- From an asset allocation perspective, history suggests this kind of macro environment could be challenging for risky assets.

[1] All market pricing in this piece is quoted as of the date of publication.

Don’t look up

As 2022 beds in, economies and markets have been jolted by the sudden hawkish shift in central bank narratives, led by the Federal Reserve in particular. The expected monetary policy path for the next three years is now undergoing a remarkable recalibration (Chart 1). For most of last year, even as inflationary impulses took hold, central banks stuck to the ’transitory’ mantra, which implicitly assumed that monetary policy was not responsible for generating the pricing pressures.

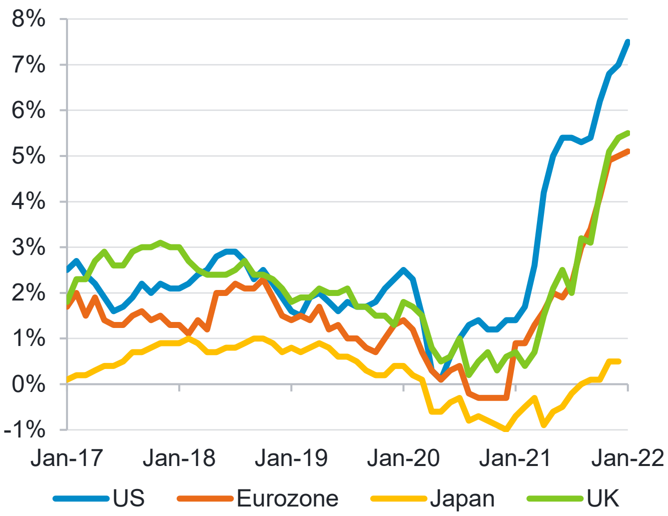
Chart 1: US yield curve has shifted to price in an earlier and steeper rate hiking cycle



Source: Fidelity International, Bloomberg, February 2022.

Chart 2 : Central banks’ ’transitory’ inflation mantra has broken down

Headline CPI, % YoY



Source: Fidelity International, Haver Analytics, February 2022.

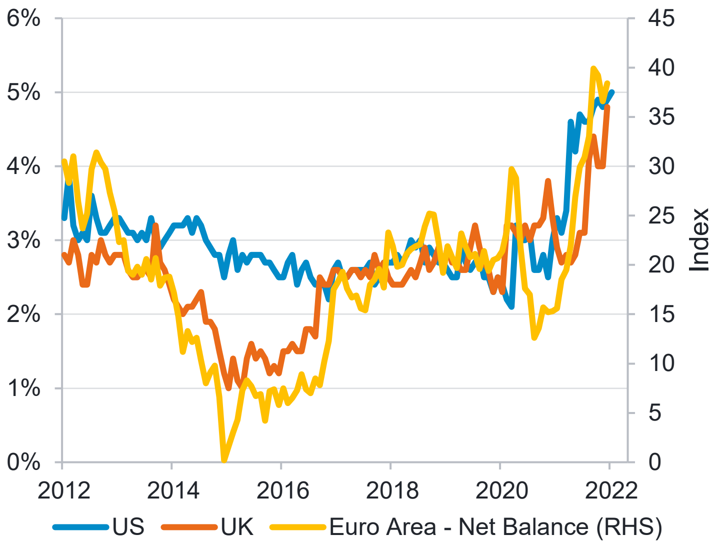
In essence, much like the latest Netflix blockbuster Don’t Look Up, where citizens of the world are told by governments to not look up at the incoming comet, central banks convinced markets and economic agents to ignore the rise in inflation that started in early 2021 (Chart 2). However, as the longevity of the inflation shock has become clearer and political ramifications of the higher cost of living are starting to create public pressure, policy makers have now dramatically changed tack.

In our paper titled ‘The Great Inflation Debate: More persistent than transitory’ published in October 2021, with the help of our bottom-up Global Investment Research analysts, we identified four key sources of inflation that we believed would be persistent contributors to inflationary pressures over the following few months. These included wage growth, housing costs, decarbonisation and self-fulfilling inflation expectations.

Our empirical analysis shows that the inflation formation process has changed meaningfully since the 1990s. The influence of inflation expectations has risen, while past inflation as a determinant of future inflation has become insignificant. We noted that even factors that are transitory by construction but last longer than initially anticipated - such as COVID-related supply chain disruptions - can indeed have persistent effect on actual inflation via inflation expectations.

Chart 3: Survey-based measures of consumer inflation expectations have risen across the board

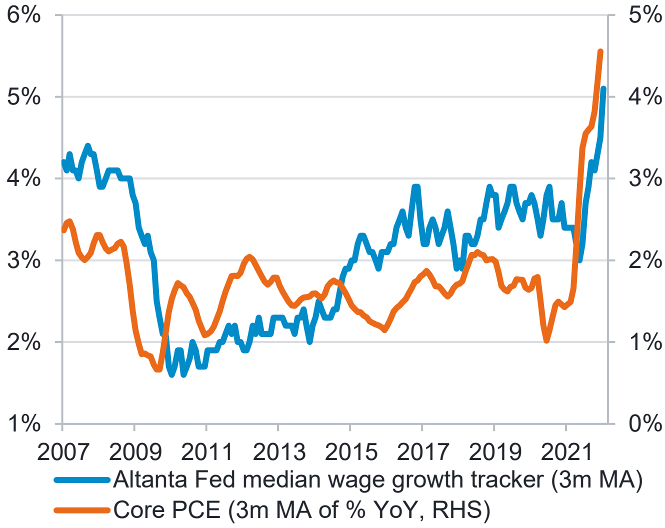
12-month ahead consumer inflation expectations



Note: For the US and the UK, the surveys measure actual inflation expectations. For the Euro Area, the survey measures consumers’ expectations of general “price trends”. Source: Fidelity International, Refinitiv Datastream, University of Michigan, YouGov/Citi Group, European Commission, February 2022.

Chart 4: Accelerating wage pressures in the US are starting to feed through to consumer prices

Wage Growth vs Core PCE Inflation



Source: Fidelity International, Refinitiv Datastream, February 2022.

Over the past few weeks, major central banks, notably the Fed and the Bank of England, have acknowledged the changing nature of inflation given the breadth of price rises, the shifting inflation expectations, and the emerging evidence of wage-inflation spirals (Charts 3 and 4). Even the ECB is now concerned by the latest upside surprises in euro area inflation. The 'transitory' inflation mantra has broken down.

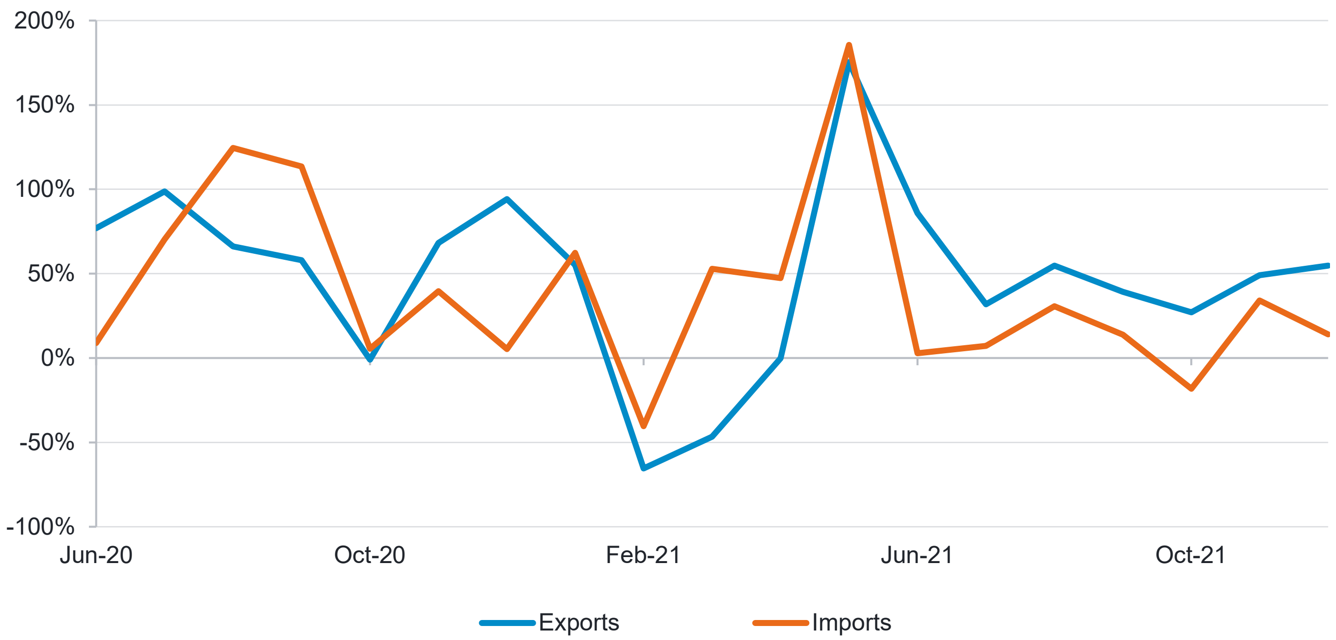
License to hike

The extent of the demand surge that was fuelled by extremely accommodative monetary policy and aggressive fiscal easing in developed markets (DM), especially in the US, is still visible. One of the strongest signals of this can be found in China's exports data, which is a key barometer of global goods demand. Indeed, the difference between China's exports and imports growth momentum, shown in Chart 5, which developed over the course of 2021, reveals the decoupling between DM and China macro fundamentals. While DM demand has boomed, China's profound regulatory policy shift created a negative growth shock for the Chinese economy, putting pressure on imports.

The latest DM business surveys are weakening from their recent peaks but remain high, while underlying components, like delivery times and inventories, continue to show the impact of supply side constraints. As fiscal stimulus (amounting to 12% of GDP in the US) passes through the system, goods spending growth has remained strong in the face of supply chain disruptions and, until recently, rising inflation (Chart 6).

Chart 5: The spread between export and import growth momentum points to China's decoupling from DM

3-month annualised rates of growth for Chinese exports/imports

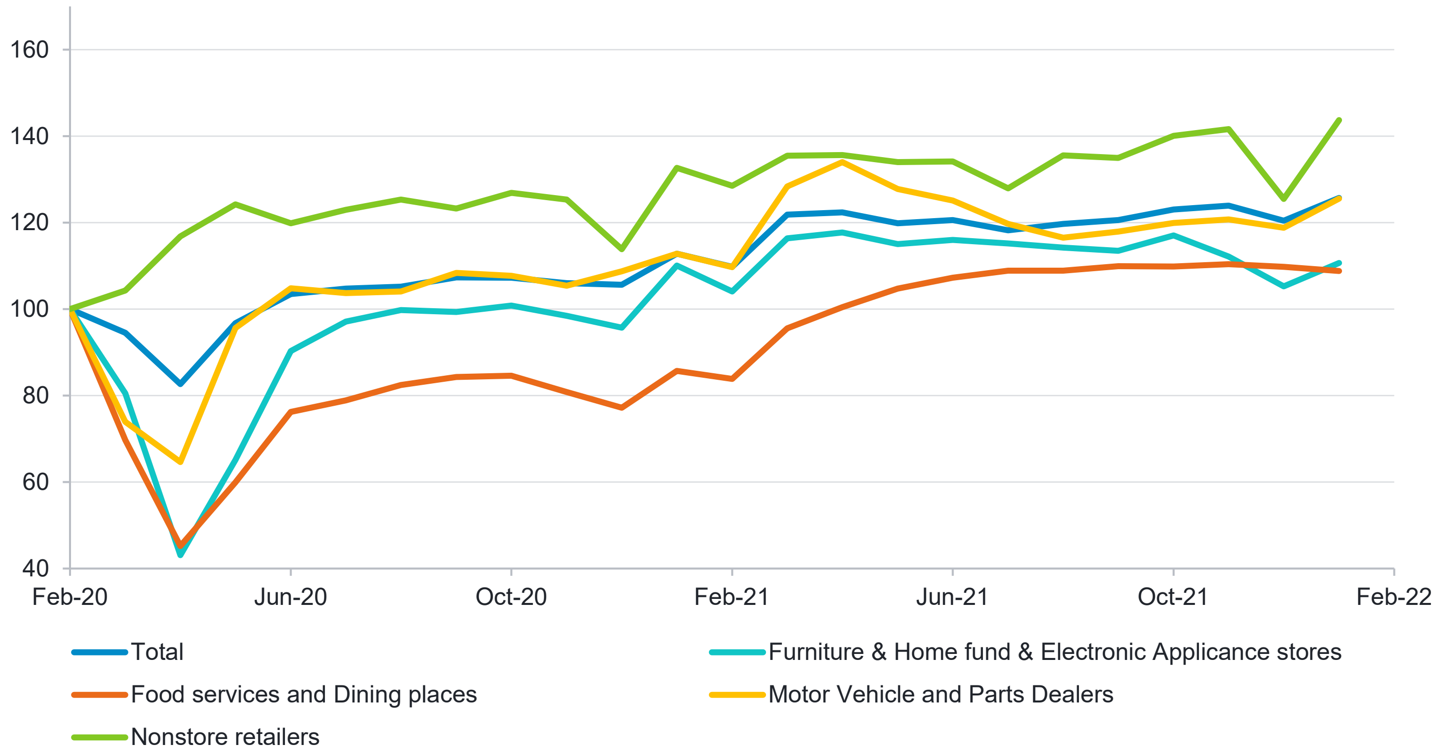


Source: Fidelity International, Refinitiv Datastream, February 2022.

It is these demand side pressures that led the Fed to accept that its monetary policy setting was inconsistent with medium-term inflation stability around the target of 2%, even within its more flexible average inflation targeting framework. With the unemployment rate now very close to pre-pandemic levels and labour force participation regaining some momentum (now at 62.2%, though still well below the pre-COVID rate of 63.4%), the Fed's labour market mandate has been largely met. The central bank's focus is now squarely on inflation.

Chart 6: US retail sales point to softening demand after a strong bounce in goods categories

Selected retail sales categories; February 2020 = 100

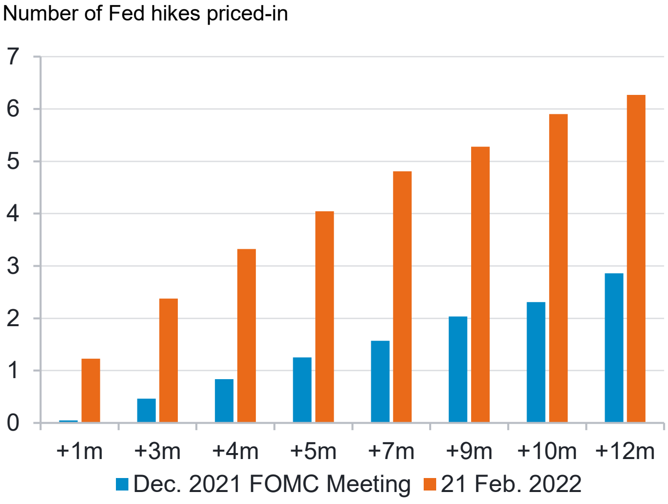


Source: Fidelity International, Haver Analytics, February 2022.

The Fed: Fast & Furious

Having underestimated the breadth and persistency of inflationary pressures and having fallen significantly behind the curve as a result, the Fed is now eager to tighten policy. As it has changed its guidance, the market pricing of the path of monetary policy has shifted rapidly (Chart 7). As recently as 6 months ago, no hikes were priced in for 2022. Now markets are expecting around six hikes for this year and around two more hikes in 2023, with the implied policy rate settling just below 2.0%. This stands in sharp contrast to the FOMC members' own median expectations of 3 hikes reflected in the December dot plot. All eyes are now on the updated dot plot in the March meeting which will likely signal a steeper policy path.

Chart 7: Markets have rapidly shifted from pricing less than 3 hikes for 2022 only 2 months ago to nearly 6 hikes now



Source: Fidelity International, Bloomberg, February 2022.

Expectations of the policy tightening path are complicated by the possible unwinding of the Fed's balance sheet, which Chairman Powell firmly put on the table at the latest meeting. In this cycle, the sharp explosion of the Fed's balance sheet has been an important policy easing tool, both through the provision of actual liquidity in the system and through signalling as part of the forward guidance package. Judging from the previous quantitative tightening (QT) episode, unwinding this process is likely to be wrought with risks - unlike "watching paint dry".

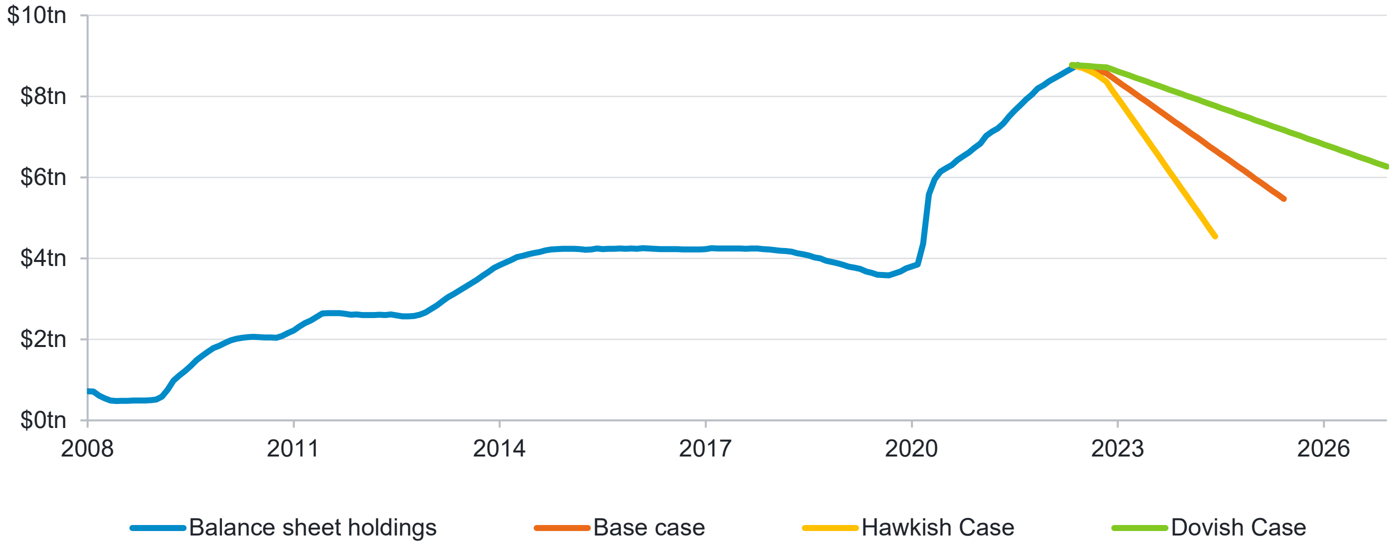
Compared to the 2018-2019 QT experience, we expect the balance sheet runoff to start earlier - after one or two hikes - and to be steeper, at least initially. Assuming the ratio of quantitative easing (QE) to QT pace is held the same as before, the maximum runoff cap is likely to be about $90-100bn per month for both Treasuries and mortgage-backed securities (MBS), which is double the maximum cap seen in the last cycle. Powell's latest press conference comments give us confidence on this estimate, which is likely to be predominantly done through halting re-investments, with a bias towards MBS to begin with.

If the Fed's goal is to return the balance sheet to its pre pandemic size of 20% of GDP, QT at this pace could last until 2025 if begun in the second half of 2022. Risks are skewed towards a faster runoff if upside inflation surprises continue and financial conditions remain easy despite rate hikes. In this instance, the Fed might need to be more decisive to protect its credibility. Chart 8 shows three potential scenarios - central, dovish and hawkish. Once the parameters are announced, possibly at the March meeting, we will be able to assess not only how much and how quickly liquidity will be withdrawn from the system, but also what lies ahead in terms of the hiking cycle in 2023 and 2024 and ultimately the terminal rate in this cycle.

How fast and how far this tightening cycle can go depends on a number of factors along the way, not least on the inflation dynamics, overall financial conditions and the terminal level of real rates the economy and markets can digest. For now, exceptionally easy financial conditions and negative real rates (Charts 9 and 10) give the Fed a green light for a hawkish stance. But while we believe 3-4 rate hikes and some balance sheet runoff is achievable in 2022 (though of course the balance sheet devil is in the detail), we are more sceptical on the tightening pace in 2023-24 especially if Fed manages to hike as much in 2022 as is currently priced in by the markets.

Chart 8: Fed’s balance sheet calibrations based on previous episodes suggest the possibility of a steep runoff

Fed balance sheet scenarios*



Note: * Targeting balance sheet size of 20% GDP. Base Case: Holdings under QT forecast using max cap of $100bn per month and pre-pandemic BS target. Hawkish Case: Holdings under QT forecast using max cap of $200bn per month and pre pandemic BS target. Dovish Case: Holdings under QT forecast using max cap of $50bn per month and pre pandemic BS target. Source: Fidelity International, Bloomberg, Haver Analytics, February 2022.

With the debt burden so much higher after the pandemic, real rates have to remain in negative territory for an extended time for the debt trajectory to stabilise at sustainable levels. Indeed, we believe maintaining negative real rates is currently the implicit policy objective of all major central banks. In this respect, the Fed's policy action over the next few months is likely to be guided by real rates - any major shock resulting in positive real rates would likely lead to a more dovish stance.

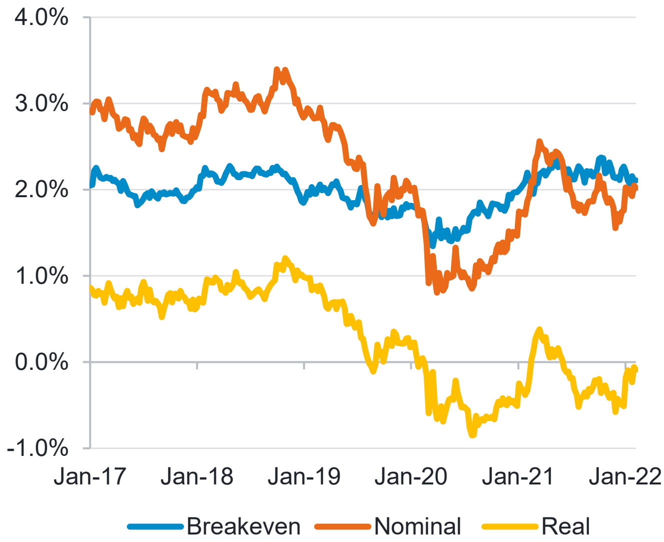
Chart 9: Financial conditions are exceptionally easy

Goldman Sachs US Financial Conditions Index

Source: Fidelity International, Bloomberg, Goldman Sachs, February 2022.

Chart 10: Tighter policy can lead to positive real terminal rates which could be a challenge for the economy and markets

5Y5Y fwd. US Treasury yields

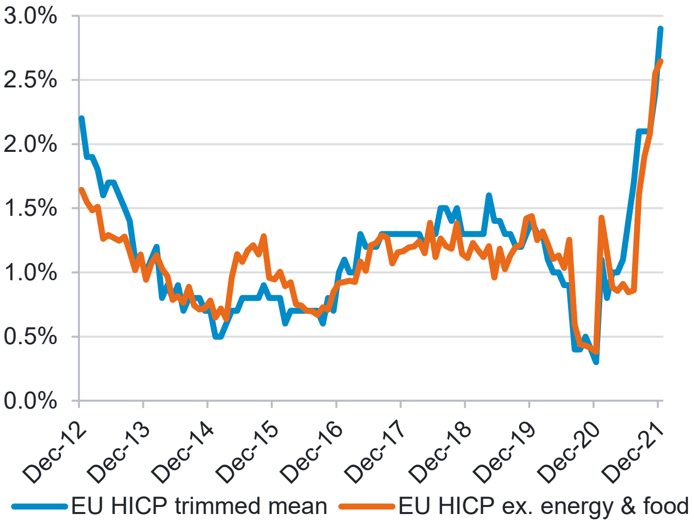


Source: Fidelity International, Bloomberg, February 2022.

The ECB: Stand By Me

We had expected the ECB to turn its attention to policy normalisation later in the year but the change in narrative materialised much earlier. The ECB is concerned by the latest inflation developments that indicate growing breadth and potential persistence (Chart 11) and, just like other DM central banks, it is looking to protect its credibility as an inflation-targeting central bank.

Chart 11: Euro area inflationary pressures are broadening, with signs of persistence



Source: Fidelity International, Haver Analytics, February 2022.

With two rate hikes from the Bank of England already done, and the Federal Reserve poised to kick off its tightening cycle as soon as March, the ECB is feeling the pressure to communicate its exit plan. The hawkish pivot at its February meeting was designed to leave options open for policy action at any time, depending on growth, inflation and market developments over the next few months. It seems unlikely that the Governing Council has a clear policy path in mind yet. However, they have now given themselves flexibility to act within the constraints of the existing framework, should the need arise.

How high are the hurdles for a rate hike?

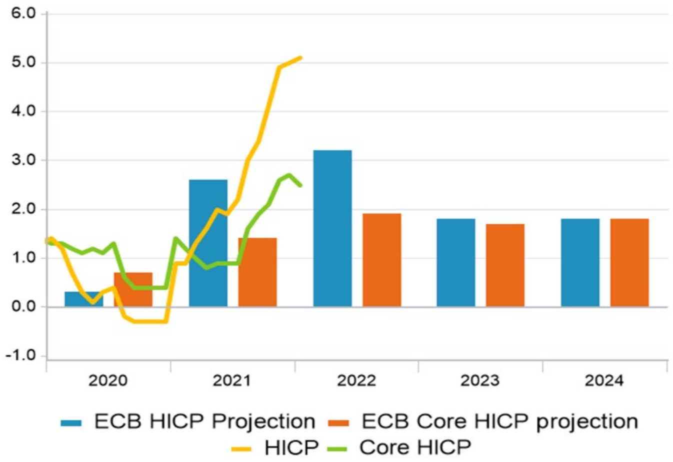
The ECB has set out two hurdles for a rate hike. The first is the new strengthened guidance on conditions for a rate hike introduced at the strategic framework review last year. Second is the sequencing with respect to asset purchases and rates. The former describes three conditions that need to be fulfilled for rate hikes to be considered:

- "Inflation reaching two per cent well ahead of the end of the projection horizon”.
- The 2 per cent inflation projection needs to be “durable” for the rest of the forecast horizon, likely meaning that the inflation projection needs to stay at least at 2 per cent for the remaining forecast period.
- Evidence on progress in underlying inflation towards the new target to be "sufficiently advanced".

For these to be met, it is likely that both 2023 and 2024 inflation projections need to be at or above target for both headline and core. As Chart 12 shows, the latest ECB forecasts from December 2021 have headline and core inflation just below target for both years. So, for rate hikes to become a possibility, these forecasts would need to be upgraded to 2 per cent or above in upcoming meetings. At this point we are not convinced the staff projections will be revised up to fully meet the three criteria in the March meeting. It is possible the 2024 forecasts will remain unchanged for the time being. If underlying inflation remains strong, June or one of the subsequent meetings, might be used for further inflation revisions to meet the three criteria for a rate hike.

Chart 12: ECB still expects inflation below target in 2023 and 2024 but could revise forecasts up in one of the upcoming meetings, laying the ground for a rate hike

ECB inflation projections vs actual (Y/Y % change)



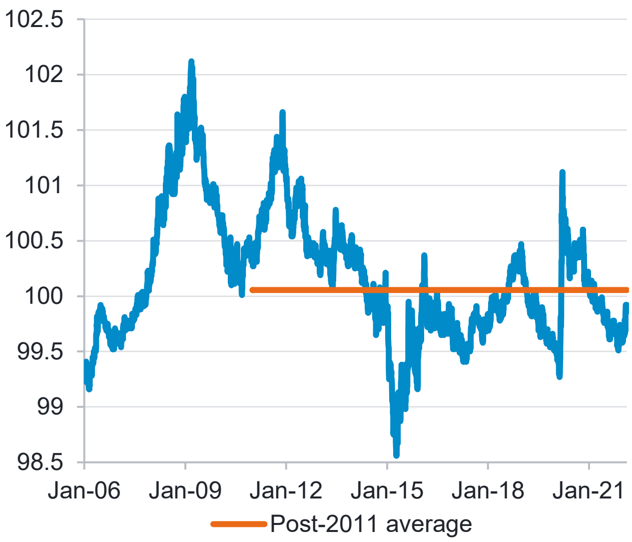
Source: Fidelity International, ECB, Haver Analytics, February 2022.

As for the sequencing hurdle, for now the ECB has outlined its plan to continue with net asset purchases to the end of the year, meaning the first rate hike is only possible in early 2023, in line with the sequencing constraint. However, the ECB might well accelerate the tapering timeline in order to cease net asset purchases before the end of 2022 and meet the conditions for a rate hike earlier if required. While it is possible the APP will now end in June, we are more inclined to think the quantitative easing exit will be pushed to Q3 or Q4, to allow for a more gradual tapering and for more evidence to emerge on the nature of inflation, especially as far as wage negotiations are concerned.

We believe the current market expectation for the ECB's policy rate to get to just below zero by the end of this year, implying rates rising by around 40bps, is too aggressive. In our view, an early 2023 rate hike is more likely, although a December 2022 hike seems equally possible. For now, financial conditions are easy, though notably not as easy relative to their own history as in the US (Chart 13). But with growth likely to pick up from the soft path in Q1, and with inflationary pressures continuing to broaden, the hawkish ECB narrative is likely to dominate markets for the next few weeks or months. This means market pricing for the hiking timeline should become more aggressive and peripheral spreads should continue to widen.

Chart 13: Euro area financial conditions have eased but remain modestly above pre-pandemic levels

Goldman Sachs Euro Area Financial Conditions Index



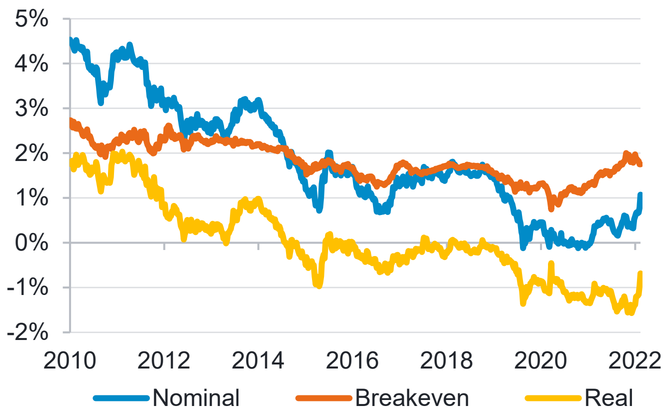
Source: Fidelity International, Bloomberg, Goldman Sachs, February 2022.

Final Destination

The key focus for the ECB - and investors - from here should be discerning the level of terminal real rates (just like in the Fed's case) and peripheral spreads that both the economy and markets can digest. As Chart 14 shows, terminal real rates in Europe have been negative since 2015 and have dipped lower since the end of 2018 - since the episode when the system buckled once US real rates rose past 1%. With an even larger post-pandemic debt burden weighing on the economy, the ECB will need to prevent large and rapid increases in real rates. Any large shocks - especially into positive territory - would be a trigger for the ECB to become a dove once again. Assuming the terminal real rate in the euro area is negative, potentially in the range of -50 to -25bp, any overshoot this would be challenging for markets and the economy.

Chart 14: Euro area terminal real rates have to remain negative to prevent solvency issues

5Y5Y fwd. OIS rates



Source: Fidelity International, Bloomberg, February 2022.

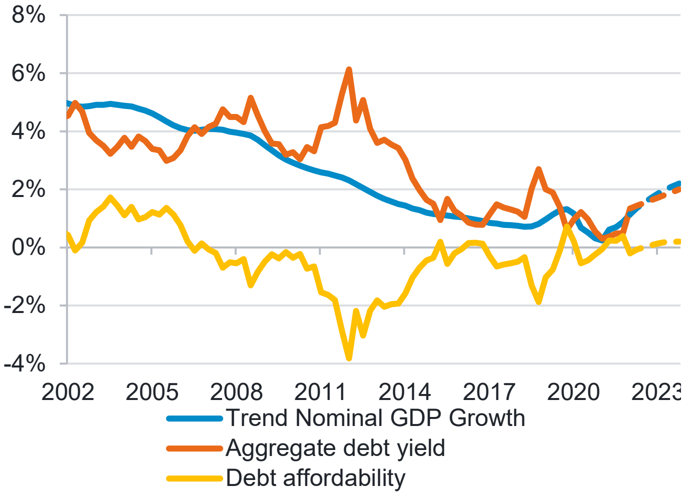
The Italian Job

As the global bond rout unfolds following the central banks' hawkish pivot, focus has unsurprisingly shifted to the European periphery and Italy in particular. The potential for Italy's nominal growth trend to rise, largely on the back of significant Recovery and Resilience Facility (RRF) investments over the next few years, introduces even higher uncertainty around the level of interest rates that the economy can withstand.

A moderate increase in the nominal growth trend to pre-sovereign debt crisis levels means that a repricing of yields across the curve to well over 2% would be required before debt affordability started coming into question. We model this dynamic, where the aggregate yield on Italy's debt stock rises to 2% by the end of 2023, from 1.34% today, in Chart 15.

Chart 15: Italy's debt sustainability back in focus as yields rise

Modelling debt affordability

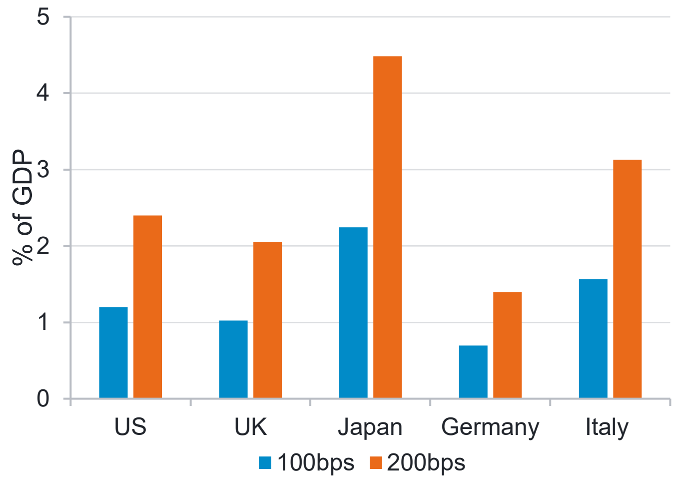


Note: Trend nominal GDP growth calculated as the 10-year moving average of YoY nominal GDP growth. Affordability calculated as trend nominal GDP growth minus 10-year BTP yield. Dashed lines represent OECD forecasts or FIL projections. Source: Fidelity International, Bloomberg, Refinitiv Datastream, OECD, February 2022.

Assuming Italy's growth trend goes back to pre-pandemic levels, the debt sustainability threshold would be notably lower. A simple calculation of debt servicing cost sensitivity shows that, all other things being equal, a 100bp interest rate shock for Italy would translate into higher costs amounting to 1.5% of GDP, and a 200bp shock would equal just over 3% of GDP (Chart 16).

Chart 16: Italy stands out on its vulnerability to higher interest rates, alongside Japan

Debt cost analysis per interest rate shock

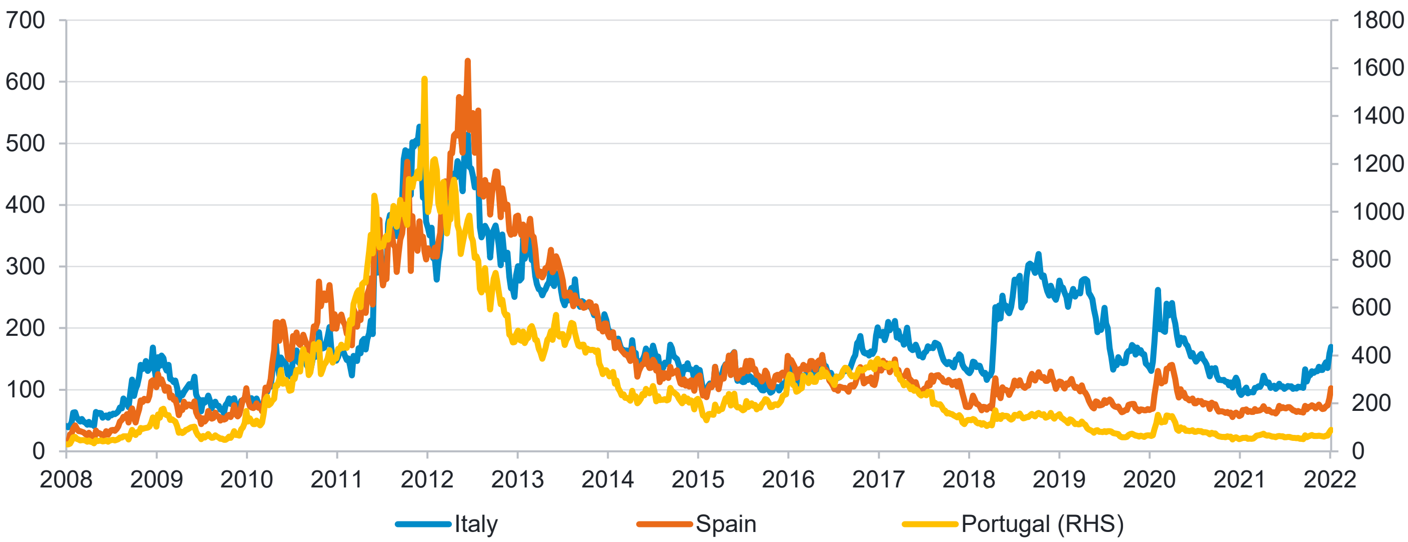


Source: Fidelity International, Haver Analytics, Bloomberg, February 2022.

Peripheral spreads have been gradually widening since October last year and more dramatically since the ECB's February meeting (Chart 17). Currently at around 160 basis points, the spread of Italy's BTPs over German bunds remains well below the 250-290 bps that was prevalent during the 2018-2019 Five Star-Lega Coalition, when markets were pricing in political risks including redenomination. It is notable, however, that Italian spreads, now above the 60th percentile, have widened the most relative to other main peripheral countries, which are still around their respective 25th-40th percentiles (Chart 18).

Chart 17: Peripheral yields have widened over the past few weeks but remain well below levels previously associated with heightened risks of fragmentation

Peripheral countries' yield spreads over German bunds (bps)



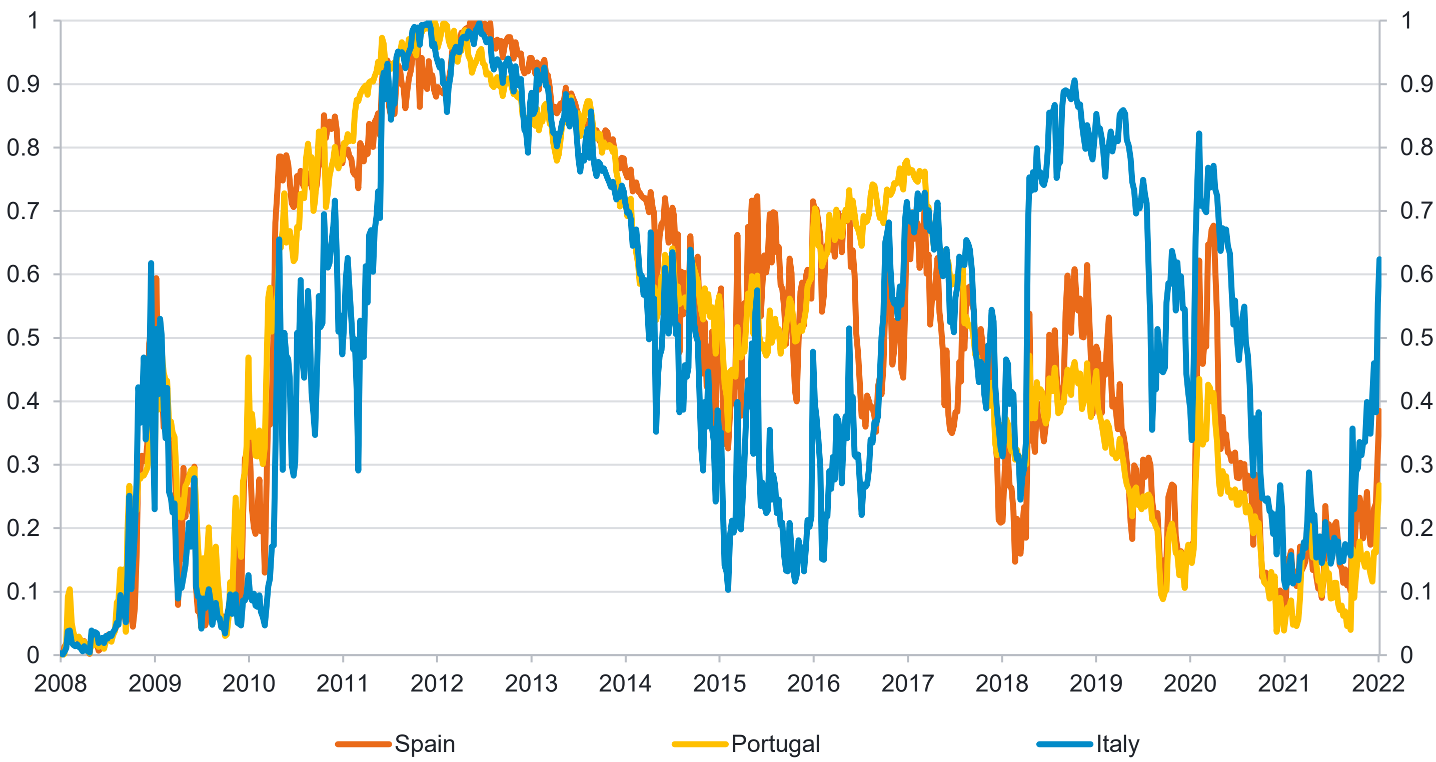
Source: Fidelity International, Refinitiv Datastream, February 2022.

President Lagarde has noted that the ECB has the tools to manage the spreads in the event of renewed market fragmentation, including the flexibility of PEPP reinvestments as well as special tools such as the SMP and the OMT programme. In the environment of above-trend growth and above-target inflation, we believe the ECB will be more tolerant to the repricing of peripheral risk premia. At the same time, markets will test where the new pain threshold for fragmentation lies. As PEPP reinvestments are unlikely to be sufficient to contain significant spread widening, similar to the SMP in 2011, there is a risk the never-tested OMT programme might have to be brought back, an undesirable option for Italy given the conditions attached. This is another reason why we expect the ECB to make a dovish turn yet again, with peripheral spreads acting as a speed limit on how much tightening is possible.

Looking beyond the first hike - if and when the ECB gets there - we believe the policy rate trajectory will most certainly be shallow due to the aforementioned constraints. In addition to the structural issues, political risks are hard to dismiss this year, including the French elections and the risk of Russia invading Ukraine, which could have significant implications for markets and the euro area economies in the form of confidences shock and sanctions. It therefore seems highly unlikely at this point that the ECB will manage to push policy rates into positive territory in this cycle, with zero presenting the upper bound in our view.

Chart 18: Italian spreads have widened the most relative to other peripheral countries

Peripheral countries' yield spreads over German bunds - percentiles



Source: Fidelity International, Refinitiv Datastream, February 2022.

A 'Reverse Draghi moment' and the multi-dimensional put: Implications for asset allocation

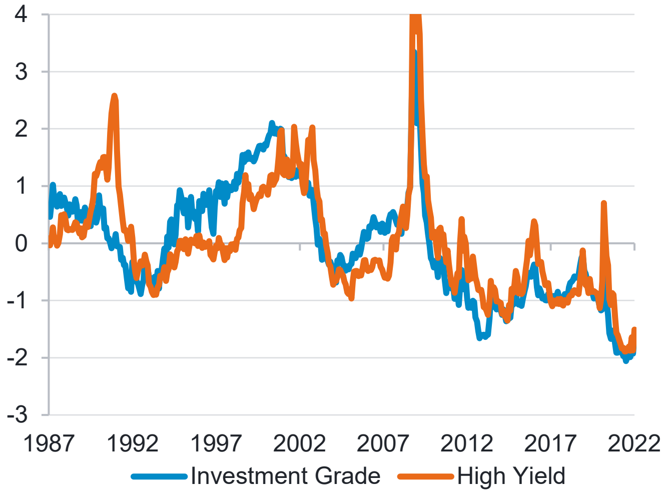
The monetary policy landscape since the global financial crisis has been one of a consistent fight against deflationary fears. Regulatory changes focussed on the banking sector and austerity contributed to a significant change in the inflationary process. The abrupt shift in monetary policy as the first lockdowns hit in 2020 was a direct result of that prior experience, which showed that delaying policy support only makes the fight harder. However, the unprecedented fiscal policy support that came alongside the monetary support, especially in the US, and the extreme supply side disruptions unleashed by the Covid shock has brought about inflationary forces that have similarities with those of the 1970-80s. As the sharp pivot towards tightening monetary policy takes hold across major DM economies, the high debt burdens that are perhaps the most important macro legacy of the Covid crisis cannot be ignored.

Here, we think that the "whatever it takes" message from Mr Draghi holds true as long as markets take the cue from key central banks and price in a rapid and significant amount of tightening in the coming months. In essence, we envisage a 'reverse Draghi moment', whereby central banks refrain from leaning against the current hawkish momentum in expectations for policy withdrawal, letting the market do the job for them by tightening financial conditions to slow growth and reverse inflation momentum.

The risks here are clear. If the current tightening (ex-post) goes too far, the chances of a recession become unnervingly high (the current flattening of the curve is an important signal here) and raises the possibility of financial stability issues given the heavy debt burden. The often-reliable Fed put has not been forthcoming this year, despite the wobble in equity markets, due to inflation being so high. All in all, we think this time the Fed put will be more multidimensional - with more focus on real rates, credit spreads and actual inflation data - and will only kick-in when evidence of a business cycle and/or inflation turn becomes clear.

Chart 19: The all-in real yields for US Credit markets have only recently come off all-time lows

US credit real yield Z-scores



Note: Investment Grade real yield calculated using 10-year breakeven and High Yield real yield calculated using 5-year breakeven in order to capture the duration differences between the two asset classes. Breakeven rates prior to 1998 (10-year) and 2002 (5-year) use GS backcasted rates. Z-scores are calculated using the whole sample. Source: Fidelity International, Bloomberg, Goldman Sachs, February 2022.

Given this context and taking into account the current extreme compression in credit spreads in real terms versus long-term history (Chart 19), there is scope for further spread widening both in IG and HY credit, as risky markets play their part in tightening financial conditions to bring inflationary pressures down. Ultimately, this should allow the Fed and central banks such as the ECB, which must also consider periphery spreads, to ultimately tighten policy less than current expectations.

For now though, we believe a 'reverse Draghi moment' will remain the crucial dynamic, as key central banks allow the aggressive tightening of expectations in order to bring inflation down. It remains to be seen if we will see a *Total Recall* of central banks deploying markets to achieve their goals or we will have a "fracture" along the way. From an asset allocation perspective, history suggests this kind of macro environment could be challenging for risky assets.

Fidelity Global Macro & Strategic Asset Allocation Team

This paper is written by the Global Macro & Strategic Asset Allocation team, which forms a key input into Fidelity Solutions & Multi Asset's investment process. This team conducts rigorous macroeconomic and investment analysis, studying the drivers of markets across time horizons. The team works with Portfolio Managers across tactical and strategic asset allocation, supporting decision-making across the investment process.

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