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Monetary tightening shifts up a gear

« 2022 got off to a turbulent start with anxiety about inflation taking centre stage. Inflation is now above central bank targets in all but a few major regions, and a global tightening cycle is kicking into gear as they try to bring it back down into their comfort zones. As such, rates are beginning to resist gravity, and while their direction is important for almost every asset class, what is even more crucial is the speed of their ascent. »

Fredrik Skoglund *Chief Investment Officer, BIL*

Inflation is proving to be much less fickle than central bankers had hoped. In December, headline CPIs came in at 7.0% in the US, 5.0% in the Eurozone and 5.4% in the UK; each figure representing a multi-decade high. Various factors are keeping prices elevated. Firstly, there is the lingering public health crisis – the highly contagious Omicron variant means that the original inflation catalysts (supply chain disruptions and shortages owing to factory closures, clogged ports and absenteeism), have persisted into this year. On top of that, geopolitical tensions along the Ukraine-Russia border are keeping energy prices elevated, with Brent crude futures topping USD 90 a barrel for the first time since 2014.

Central banks were tolerant of "temporary" inflation. However, in some regions, notably the US, price pressures have permeated into stickier categories such as wages and shelter costs. Failure to remedy this sooner rather than later presents a risky scenario for society, as it could result in an even larger bunching of contractionary policies further down the line. As such, the Fed, the most influential central bank, has dispelled any dovishness from its communique and is set to join the Bank of England and various emerging market central banks in what is fast becoming a global tightening cycle. Fed Chair Jerome Powell has suggested that officials are willing to move faster than they did the last time the Fed was raising rates in 2015, noting that the economy is "much stronger" than it was then – as is inflation. The Fed is set to cease its asset purchase programme in March, with a rate hike expected in the same month. Thereafter, it is considering a winding down of its USD 8.8 trillion balance sheet by letting existing holdings mature without reinvesting.

However, the policy action priced in by markets (potentially a 50 basis point rate hike in March and five in total through 2022) points to a very fast and furious Fed. The market is now even pricing in a 10 basis point ECB rate hike as soon as July, when Christine Lagarde has firmly pushed back on any hikes in 2022. Our view is that the market may have gotten slightly ahead of itself in terms of pricing in central bank action. Moving forward, we expect to see some further flattening of the US curve as Fed rate hikes push up the short-end more than the long-end increases due to policy and growth normalisation. We do not expect serious growth or recession concerns that would push down long-term rates.

Investment Strategy

2022 will be more challenging for risk assets as central banks slowly reduce excess liquidity. However, if they do so in a gentle, gradual manner, and if underlying economic growth persists at current above-trend levels, we still believe that risk assets can hold up.

As such, we remain overweight on equities, noting that earnings are still adequate (even if surprises are much more muted in previous quarters) and that, despite a recent lurch, real yields still have quite a bit to go before they pose a real threat to the relative attractiveness of this asset class.

In terms of regions, we like the US given its high concentration of quality stocks and its safe haven characteristics, which are beneficial during bouts

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of volatility. We also like Europe at this time for three key reasons: economic surprises (as measured by the Citi Surprise Index) are trending upwards; the ECB is decidedly more dovish; and the continent typically performs well in an environment of rising rates and inflation due to its Value characteristics.

However, the most crucial decision inside of the equity space during the ongoing tightening cycle is probably related to sectors – this year we have seen a strong divergence between the best performing and the worst. We like Energy (which has strong revisions), Materials (which still stands to benefit from higher commodity prices) and Financials (which benefit from higher interest rates and inflation). We added some hypothetical airbags in case the road gets bumpy, with an overweight on Healthcare – a more defensive play that also has some degree of immunity to the current context of supply chain issues and higher input costs. Additionally, we have brought the Technology sector to overweight, believing that market sentiment may have been too bearish on this sector in the early innings of 2022. After all, companies within this sector are directly linked to the fast-moving structural trend of digitalisation, while also exhibiting resilient earnings growth, healthy balance sheets and strong cash flows.

With tighter policies pressuring yields upwards at a global level (note the German 10-year Bund's recent venture into positive territory), we are broadly reluctant on Fixed Income, particularly Sovereigns. Where we do hold this asset class, we give preference to Investment Grade corporates (primarily financials) and high yield (focusing on short duration).

Looking at commodities, at our latest Asset Allocation Committee, we decided to move from positive to neutral on oil. The oil price has reached highs unseen since 2014, as buyers are eyeing patchy production and an unstable geopolitical landscape. Moving forward, despite healthy oil demand growth, supply increases by OPEC and non-OPEC members might start to put pressure on prices in Q2 2022. We remain neutral on gold, believing that a stronger dollar and a hawkish Fed dim its shine in portfolios, but nonetheless, the downside will probably be limited due to stronger retail demand from Asia.

The bottom line is that market volatility is likely to persist, with investors fully focused on the trajectory of inflation and the subsequent reaction of the yield curve and central banks. If the latter comes at inflation in a way that is too fast and too furious, risk assets could hit the chicane. However, for the meantime, majors such as the Fed appear to be applying pragmatism, remaining data-driven and transparent.

Investment Strategy

27/01/2022

Global Allocation	+	N	-	
Equities	●			
Bonds			●	
Gold			●	
Oil		●		▼
USD	●			

Equities	+	N	-
US	●		
Eurozone	●		
China		●	
Japan		●	
Emerging Markets Ex-China			●

Fixed income	+	N	-
Government Bonds - Developed			●
Emerging Market Debt			●
Corporate - Investment Grade	●		
Corporate - High Yield	●		

Stance: Indicates whether we are positive (+), neutral (N) or reluctant (-) on the asset class.
Change: Indicates the change in our exposure since the previous month's asset allocation committee: increase, decrease or no change.

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