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Six Minute Strategy

Were central banks asleep at the wheel?

May 2022

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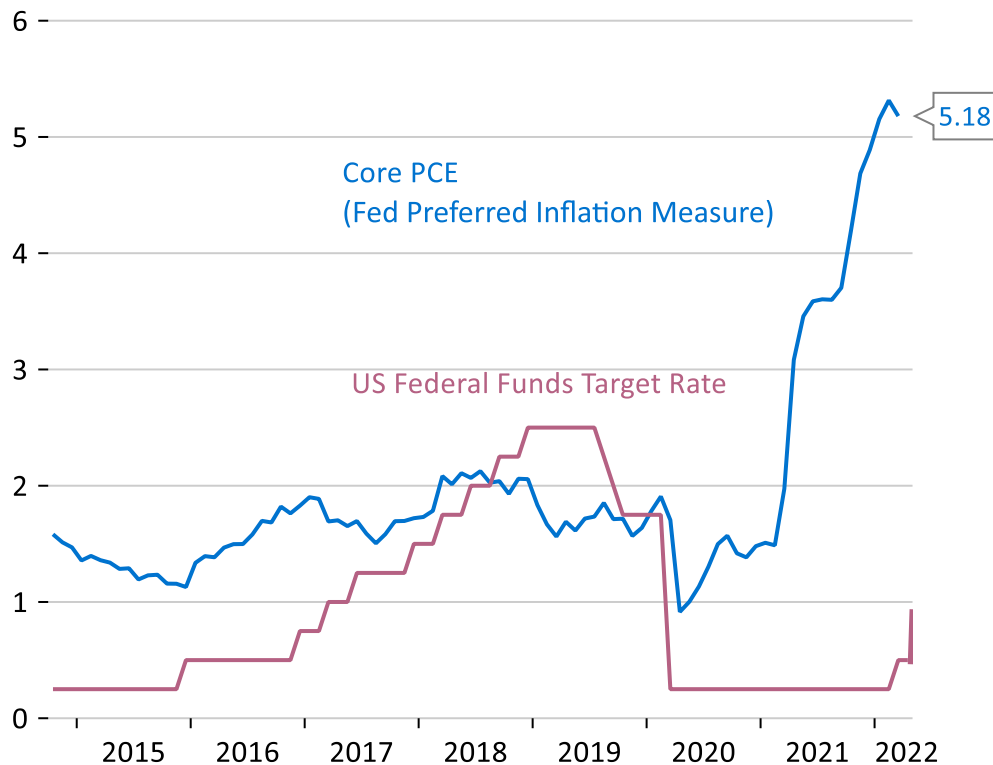


1. US rate tightening cycle started late ... but it was by design



US Federal Reserve slow to act as inflation climbed

US Inflation and Interest Rates



Source: Macrobond, 05.05.22

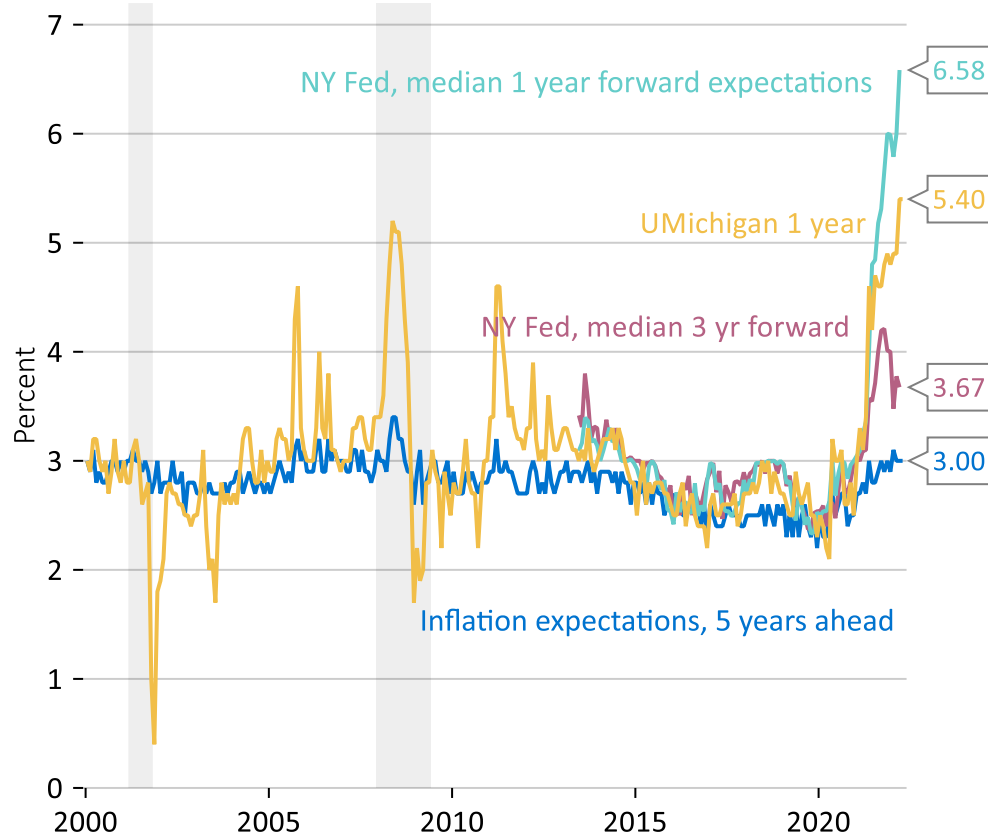
Federal Reserve Policy Error

- Flexible Average Inflation Targeting was introduced in Aug 2020 - this meant that if the economy was coming from a period of weakness when inflation was lower than 2%, then policy makers would seek to achieve inflation moderately above 2% for some time.
- **In other words, the tightening cycle was always going to be late.**
- Timing of the policy shift has been unfortunate: coincided with massive fiscal stimulus and supply shocks.
- Fed's error was two fold: *it failed to recognise that demand and supply elasticities had dramatically reduced and then was slow to adjust policy.*

2. The Fed now needs to get to neutral ‘expeditiously’

Bring demand back in balance with the supply (including war, pandemic disruptions)

US Inflation Expectations



Source: Macrobond, 05.05.22

Federal Reserve Commentary

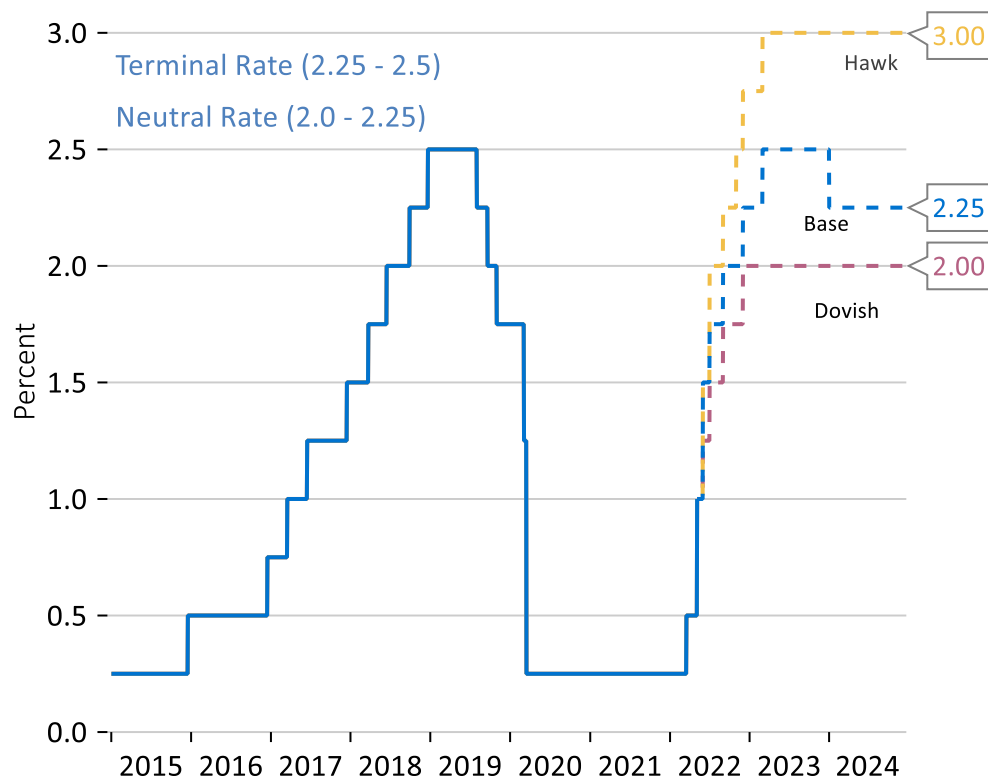
- **Chair Powell:** “Inflation is much too high and we understand the hardship it is causing, and we’re moving expeditiously to bring it back down.” 05/05/2022 Fed Press Conference
- **Lael Brainard:** “By moving expeditiously towards a more neutral posture, it provides the committee with optionality in either direction.” April 2022
- **What is neutral?** The rate at which the economy grows at trend and inflation is at 2%. Fed puts this at 2% -3%.

3. Policy will move fast - uncertainty still prevails

A highly uncertain phase for policy

Trajectory for US rates

Path of policy normalisation in the US



Source: Macrobond, 05.05.22

Assumptions

- **Neutral rate:** 2.25%
- **Base:** Economy slows to below trend (circa 1.5%) as Fed takes rates above neutral. Similar playbook to 2015 -2019
- **Dove:** Sharp slowdown in economy in 2023 prevents full normalisation. Economy slows to stall speed - below 1%.
- **Hawk:** Economy slows to trend (circa 2%) as Fed takes rates above neutral to bring unemployment back to natural rate.

Unknowns

- *Impact of Balance Sheet unwind (QT)*
- *Monetary policy works with 'long and variable lags' as US is a highly dis-intermediated financial system*

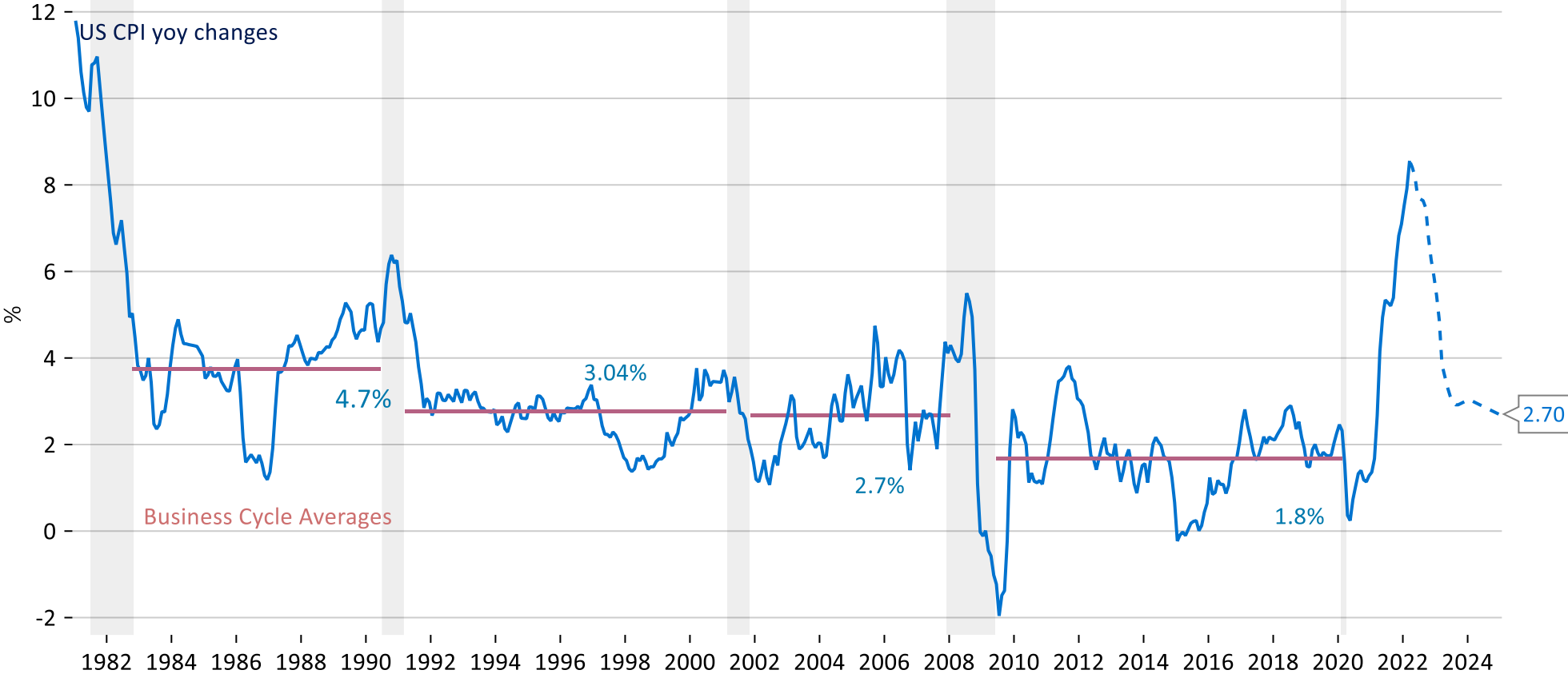
Long term inflation to settle at 1990's levels

US inflation to average 7.5 % in 2022



US CPI settles at 2.7-3% in the medium term

Long-term behaviour of US inflation



Source: Macrobond, 05.05.22

Will elevated debt levels tie central banker hands

Past cycles needed sharply positive real rates to cap inflation but debt is already at record levels

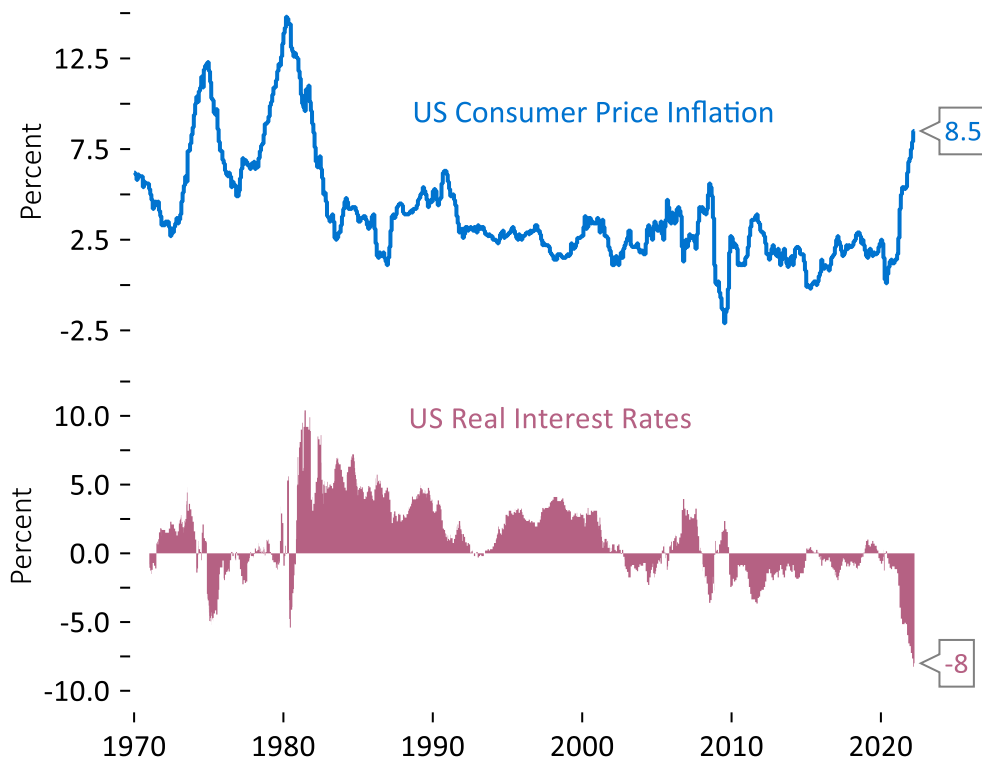


Strongly positive real rates needed to curb inflation in 1980's



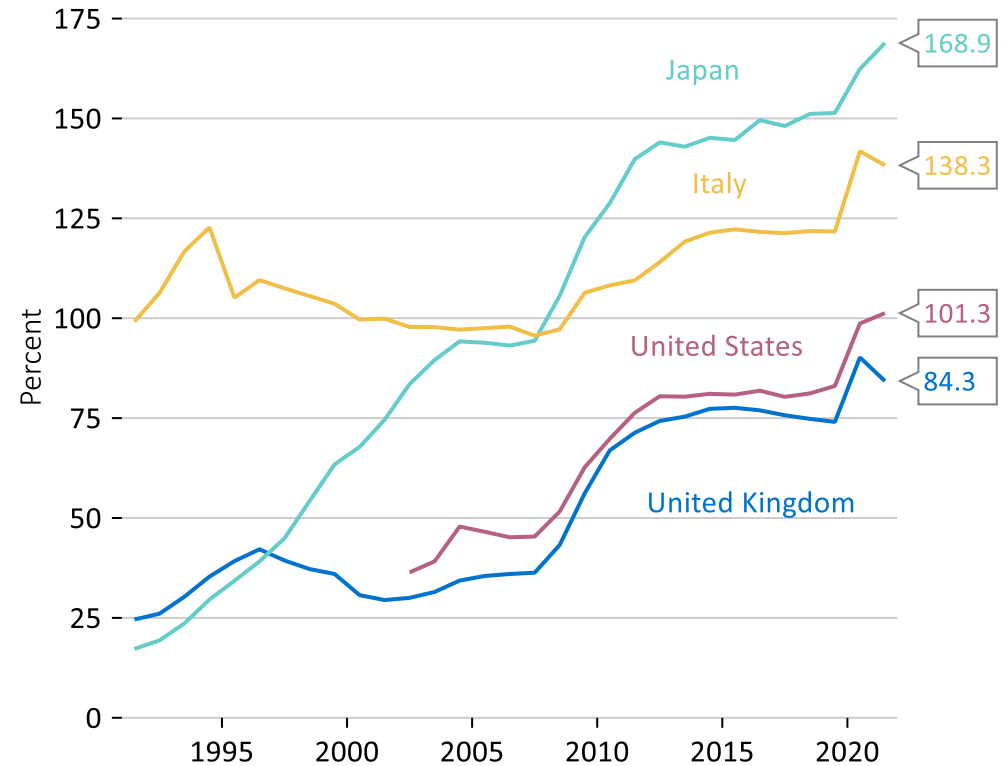
But government debt levels are very elevated

US inflation & real interest rates



Source: Macrobond, 05.05.22

Net Debt, IMF Fiscal Monitor, Estimate, Percent of GDP



Source: Macrobond, 05.05.22

Financial markets probably behaving as the Fed hoped

Financial conditions tightening – lower equities, higher bond yields, stronger Dollar

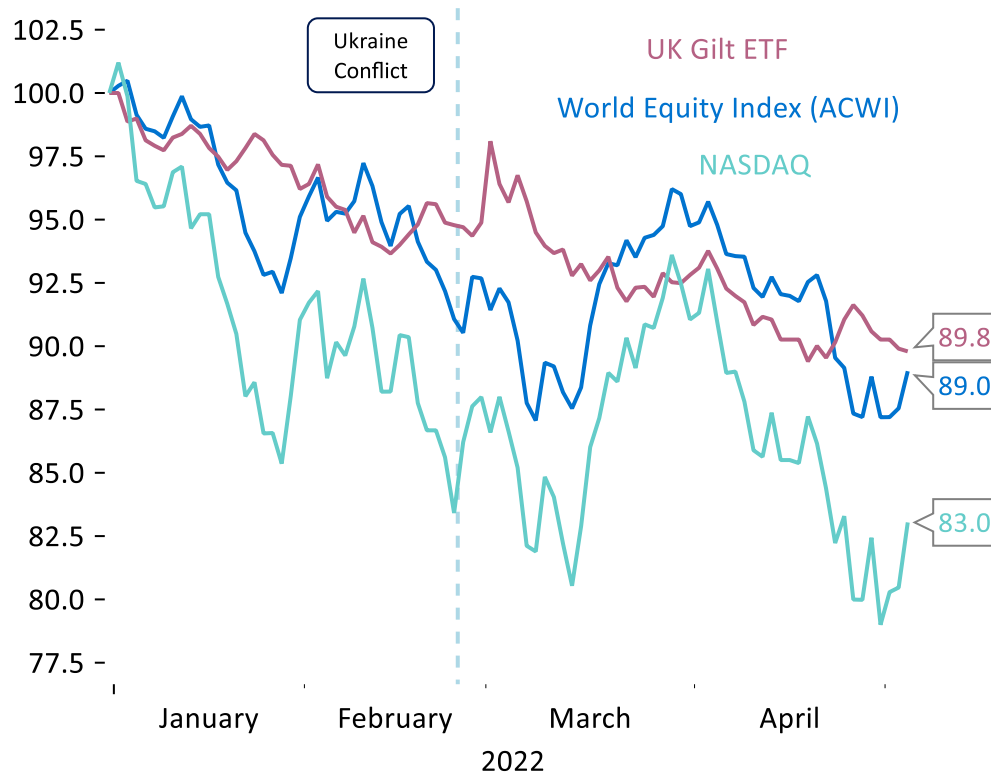


Simultaneous fall in bonds and equities



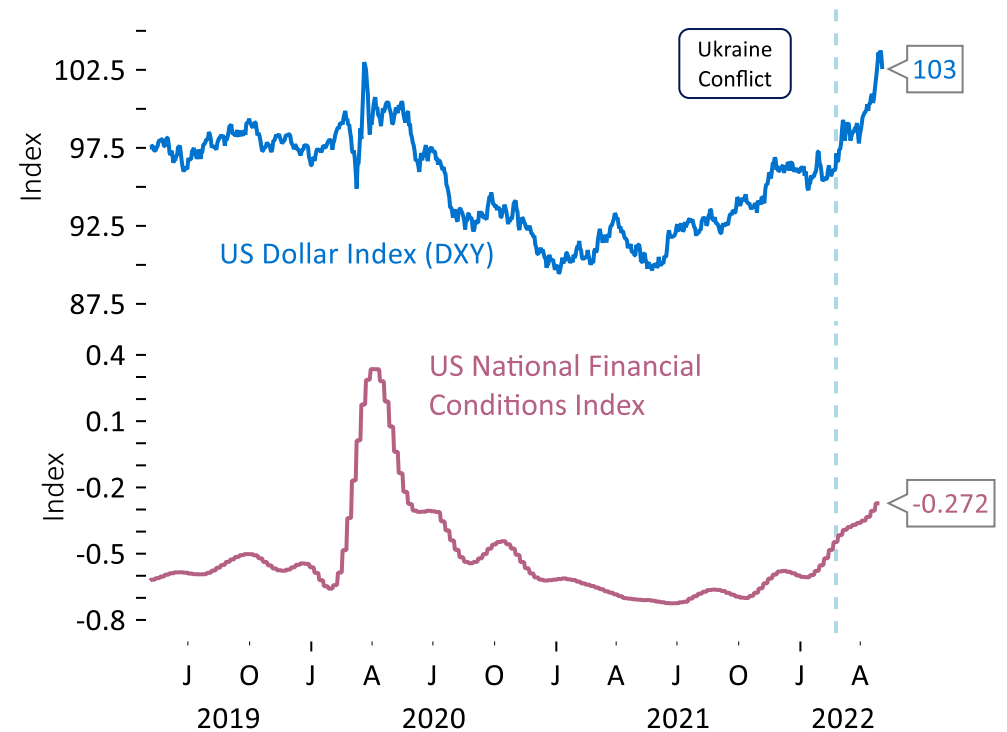
Dollar rally continues – Financial conditions tighten

Global Asset Returns 2022



Source: Macrobond, 05.05.22

US Dollar Index and Financial Conditions Index



Source: Macrobond, 05.05.22

Important information

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