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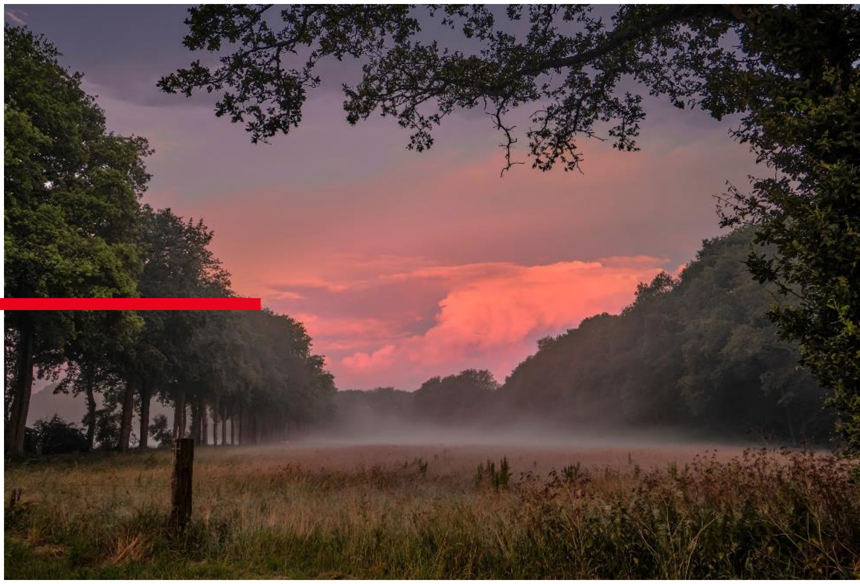

CIO VIEWS

It is before dawn that the night is darkest

After a period of unbridled rate hikes, the credibility of the US Federal Reserve in its desire to fight inflation has now been reinforced. However, the success of the reduction of the Central Bank's balance sheet is not a foregone conclusion, as previous attempts have not been successful. Turmoil is to be expected, as has already been observed over the past month. As global growth slows, cracks are appearing in the financial strength of governments. Foreign exchange crisis, balance of payments crisis, energy crisis, ecological crisis: there are many issues at stake in the coming months. Asset allocation choices will be more decisive than ever, opportunities are emerging in certain asset classes despite the many risks.

Unbridled pace of monetary tightening

« An unprecedented monetary tightening »

The Fed has applied an unprecedented pace of monetary tightening in 2022. Fed funds rates are now at 3% and are expected to exceed 4% by the end of the year, whereas they were still at zero last February. After long debates and procrastination about the transitory nature of inflation, the Central Bank has finally started an unprecedented monetary tightening. The objective of slowing growth to reduce imbalances between supply and demand is being achieved. In fact, there has been a clear decline in leading indicators, both in the United States and in the rest of the world.

If the Fed has taken control back, inflation will only fall slowly and gradually

« Fed has taken back control over its interest rate policy »

The decline in inflation expectations shows that the Fed has taken back control. Breakeven inflation rates have fallen significantly and are now in line with the central bank's objectives. With real interest rates now in positive territory and the first signs of a decline in inflation, the Fed is on track to meet its objectives. The gap between key rates and market expectations is now much smaller than at the beginning of the year, confirming that the Fed has taken back control over its interest rate policy.

« there are signs of a second round of inflation »

But while inflation seems to have passed its peak in the U.S., it may take longer to come down. Indeed, there are signs of a second round of inflation with rising unit labor costs and more sectors that are raising prices. Wage pressures are accompanied by falling labor productivity. Services, which account for a large share of GDP, will therefore naturally continue to experience price increases. Margins of companies that had previously resisted the surge in material costs should mechanically decline.

The reduction of the balance sheet may cause disruptions

« Balance sheet reduction will become a major issue »

While interest rate policy is now under control, balance sheet reduction will become a major issue. After a period of unbridled growth of its balance sheet, the Fed must complete the normalization of its quantitative easing policy. The injections of liquidity during the Covid health crisis are not unrelated to the inflationary surge observed in recent months. Indeed, the money supply grew by more than 30% between March 2020 and December 2021, i.e., twice the nominal GDP growth observed during this period. The independence of central banks from governments requires that they complete this phase of balance sheet consolidation, otherwise the market's trust in the currency will be undermined.

« This is an illustration of a foreclosure effect »

In September, the Fed started to reduce its balance sheet at a rate of USD 95 billion per month. This phase of quantitative tightening comes on top of the interest rate policy and makes monetary policy even more restrictive. This is an illustration of a foreclosure effect, with commercial banks and economic agents preferring to finance the US Treasury to the detriment of other market segments. The tightening of financial conditions is therefore much more significant than key rates would suggest. The residential real estate sector is a good illustration of this, with interest rates on 30-year mortgages now easily exceeding 6%. Similarly, corporate credit rates are approaching 10% for speculative grade ratings.

US: 30y Mortgage rates

Source: Societe Generale Private Wealth Management, Bloomberg, October 2022
Past performances are not a reliable indication of future performances.

Rising dollar and vulnerabilities in the foreign exchange market

« The United Kingdom is a good example »

Given the importance of the United States in the global economy and the dollar's status as a reserve currency, the pace of tightening by the Fed and the resulting rise in the dollar is putting pressure on other central banks at a time when global growth is showing signs of weakness. This environment is propitious to tensions in the foreign exchange market. Countries with twin deficits (trade and government budget deficits) are the most at risk. The United Kingdom is a good example. The announcement of a large budget deficit by the Chancellor of the Exchequer Kwasi Kwarteng was met with a harsh reception by the markets. The misnamed "Mini Budget" is in fact a largely unbalanced budget which, coupled with an abysmal trade deficit, is weighing on the British pound, and increasing the cost of British public debt. Fiscal policy is now largely constrained by the external balance in the United Kingdom.

« The euro zone's trade balance remains in surplus »

Other countries will be faced with this dilemma, especially the emerging countries, which are historically sensitive to this type of exchange rate crisis. However, they now seem better prepared: within the BRICS, only India has twin deficits, but the country still attracts a lot of foreign direct investment. The euro zone's trade balance remains in surplus, which is a guarantee of stability, despite the rise in imported energy prices. Nevertheless, coordinated action by the Central Banks may be necessary to halt the dollar's appreciation cycle.

It is before dawn that the night is darkest.

The phases of monetary tightening are clearly not favorable to the markets and strong tensions are appearing in foreign exchange and residential real estate. Activity indicators are stalling, and a recession cannot be ruled out in mid-2023. A cautious asset allocation is certainly still in order, but new opportunities are already beginning to emerge.

The equity markets have already strongly corrected. On average since 1960, the duration of bear markets is around 15 months for the US market, compared to 11 months for the current phase of decline since the highs in November 2021. The historical price drawdowns average 35%, and even 40% in the event of a recession. To date, the US equity market has fallen by 25%. We are therefore two thirds of the way through a typical average correction. If history does not repeat itself, these data nevertheless plead for a cautious approach on the equity markets. European and emerging markets are clearly cheap with valuation multiples at 15-year lows, but uncertainties are high and tensions in the currency markets may lead to bouts of volatility.

Bond markets, which had lost all appeal during the Covid period, are now offering much higher yields and should be reconsidered. Keeping margins of safety, knowing one's risk tolerance and adopting a balanced and diversified approach are the key words in these difficult market phases.

Written in October 2022 by
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