fathom
Independent Thinking

Round-up: Inflation, inflation, inflation

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Kevin Loane
Charts editor

Mind the gap: more hawkish Fed

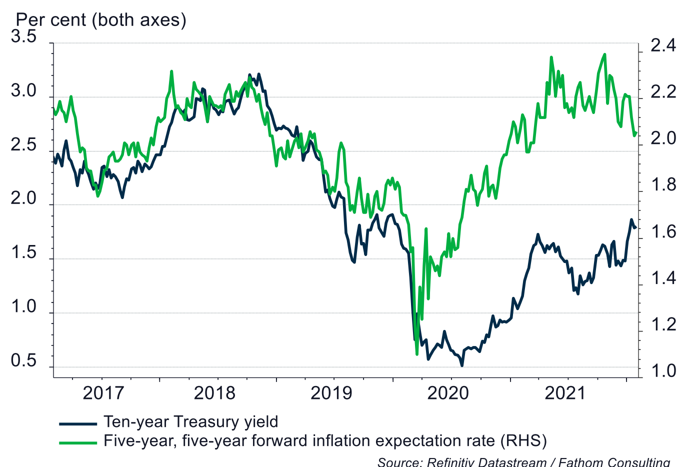
Doubling down on forecast errors

Expected Fed tightening challenging US tech?

Stress in China's corporate debt market

Mind the gap: more hawkish Fed (2 February 2022)

- The close relationship between the ten-year Treasury yield and the five-year, five-year forward inflation expectation rate broke down during the pandemic, as fiscal stimulus pushed up future expected inflation while monetary stimulus kept a lid on bond yields



- This gap has started to close this year as the Fed has adopted a more hawkish tone, and the narrowing could continue as the Fed begins its hiking cycle and winds down new asset purchases
- In theory, these financial instruments should reflect investors' expectations about the medium-term outlook for US inflation and monetary policy; in reality, the short-term outlook for inflation and monetary policy will play a big part

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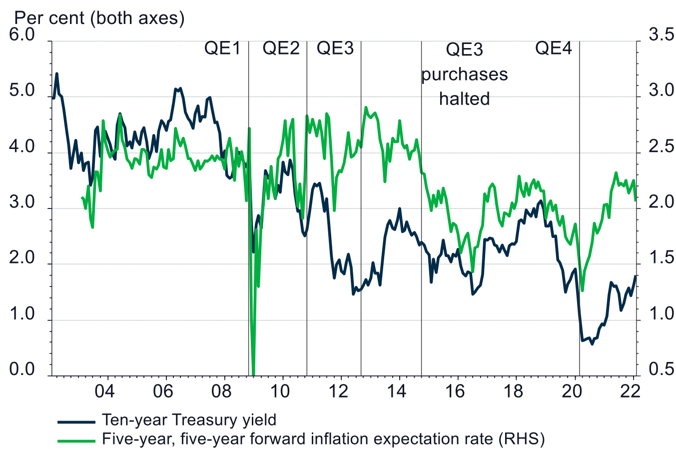
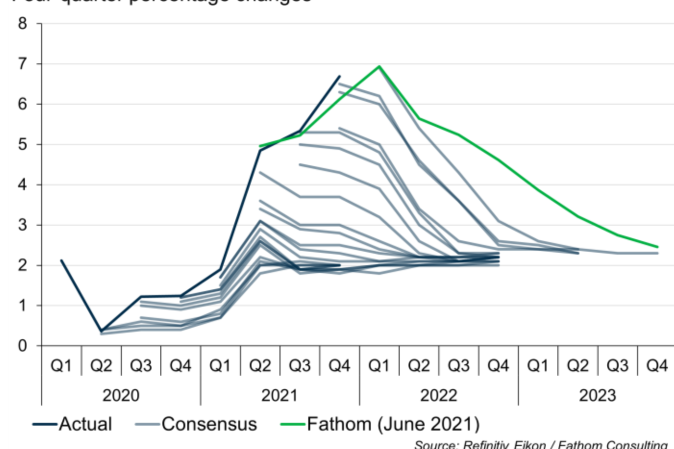
- Scrolling this series back further shows that such a gap is not unprecedented – it was widest under QE2 and QE3, but closed once new asset purchases were halted and the economy was deemed to be on a more sustainable path



- Not only are asset purchases under QE4 set to end soon, but the Fed looks likely to start winding down the size of its balance sheet by the summer; this, coupled with rate increases, raises the possibility of the gap closing quite quickly

Doubling down on forecast errors (9 February 2022)

- As early as March 2020, Fathom was warning that the medium-term impact of the pandemic was at least as likely to be inflationary as deflationary, and probably more so
- By March 2021, we judged there to be a one-in-three chance that US inflation would top 5% by the end of the year, and by June it had become our central case — we recently highlighted this as one of best calls of the past year
- Apparently the rest of our profession was slower to cotton on, doubling down on their forecast errors by repeatedly expecting inflation to fall rapidly back to target (and repeatedly being forced to revise those forecasts up)



- Economists and investors continue to underestimate inflation risks — if inflation proves to be sustained, the Fed may need to hike by several hundred basis points more than is currently being priced in by futures markets, risking a big equity market correction

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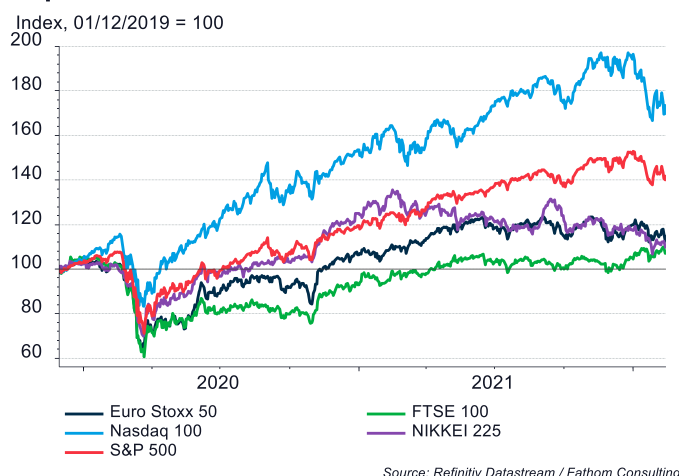
Expected Fed tightening challenging US tech? (16 February 2022)

- Expectations that the Fed would raise interest rates to tackle inflation hit the post-COVID recovery of the S&P 500 in January



- The Nasdaq 100 fared worse as the future earnings of tech stocks look less attractive in a world of higher discount rates, with a sell-off last month pushing the index into correction territory
- Since then, however, the Nasdaq 100 has gained 4.4% even though inflation continued to surprise on the upside while more than 50bps in additional Fed tightening this year has become priced in
- This resilience may be explained by the smaller increase in long-term interest rates (which arguably matter more for growth-heavy technology companies), which are still anchored at historically low levels due to secular forces such as debt and demographics

Continued

Stress in China's corporate debt market (23 February 2022)

- With the precedents of the Japanese and US real estate bubbles in mind, Fathom flagged early in the Evergrande saga the challenges and contagion risks associated with China's efforts to tackle its overleveraged real estate sector
- The short-term challenges of doing so remain significant. Of all fixed-coupon corporate bonds maturing in 2022, 9.3% show signs of stress — defined as a trading price below 60
- Almost 70% of the bonds showing signs of stress are directly classified as belonging to the construction sector. A further 16% belong to companies with a reference to real estate investment or infrastructure in their name
- So far, the corporate bond market problems remain largely limited to the real estate sector, consistent with our central scenario of a protracted but controlled approach to reforming China's housing market
- Investors will however continue to scrutinise the 'common prosperity' policy for further signs of a weakening in China's long-standing and broad-based implicit guarantee. Further weakening could lead to stress in the corporate debt market broadening out to other sectors, increasing the risk of a far messier and more dangerous deleveraging outcome

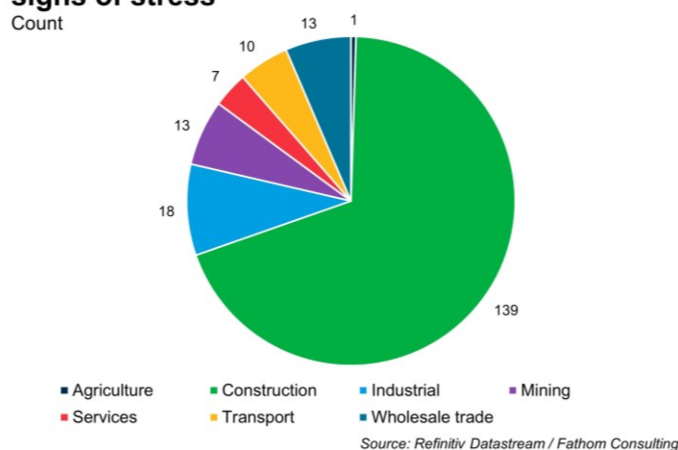


Chart authors: Brian Davidson, Andrew Harris, Ellie Hassell, Andrea Zazzarelli

More of Fathom's views on the economic outlook*:*

GEMO 2022 Q1: Credibility stretched

Hits and misses in 2021

In case you missed it, here's last month's round-up:

Can science alone save us from climate change?

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Fathom Consulting
47 Bevenden Street
London
N1 6BH
Tel: +44 (0)20 7796 9561

Contact information
kevin.loane@fathom-consulting.com
www.fathom-consulting.com

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