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Credit Research
Macro

2022 Credit Outlook: Rates. Turning off the liquidity tap.

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Andrew Mayes

Director, Credit Research
+61 3 8668 8829
andrew.mayes@fiig.com.au

The Federal Reserve turns hawkish as inflation becomes increasingly 'less-transitory', but the central bank from Down Under remains steadfastly dovish…for now

Summary

- 2022 should herald the concluding phases of the end to ultra-loose monetary policies deployed by central banks since the onset of the pandemic. In the near term, the outlook for the end to quantitative easing relative to the policy rate path appears more certain, and the exit path shortening, with many advanced economies approaching full employment and above-target inflation and growth.
- Relative differences in how central banks react to the forementioned data points, as well as market expectations for inflation and rates suggest escape velocity will be uneven and volatile. The United States, in particular, has sharply pivoted to one of fighting inflation with the Federal Reserve expected to conclude its bond purchasing programme in the early part of 2022 before embarking on relative interest rate normalisation. Even before concluding its rate hike cycle, the Federal Reserve is openly contemplating quantitative tightening (reducing the size of its balance sheet).
- Locally, the outlook for short-term rates has also shifted sharply higher as markets started pricing for rate rises earlier than the Reserve Bank of Australia had indicated, with the central bank opting to discontinue its yield curve control program. Much will depend on the path for inflation, and just as importantly, its composition, with the central bank particularly focused on maximising employment and returning wage growth to above three per cent.
- Although the backdrop for Australian households is favourable, we believe there are a number of reasons to suggest the central bank is unlikely to move as aggressively as markets are predicting, who are currently pricing up to three rate hikes in 2022. In particular, the prospect of softer wage and inflation relative to other developed markets should see the RBA proceed more progressively, in our view.
- In theory, less easy money circulating should mean higher interest rates, but in reality, it is unlikely to be as straightforward. Longer-dated yields spiked in the early part of 2021 before subsequently flattening. The pandemic may or may not end in 2022, but unprecedented central bank support should. Yields have already moved higher in anticipation, pricing in the current rate hike cycle. The recent sell-off (higher yields) has been rather aggressive (although the shape of the curve is little changed), so yields are likely to grind higher before the long side appears with conviction.
- With interest rate hikes priced in, greater value may be found in shorter-end, although we wouldn't discount duration (particularly as 10-year yields approach their perceived terminal rate). A laddered portfolio can be useful in mitigating rising yield curves. The idea is to diversify and spread the risk along the interest rate curve to hedge against any idiosyncratic moves in rates, and average into intermediate- and longer-dated bonds as opportunities present themselves.

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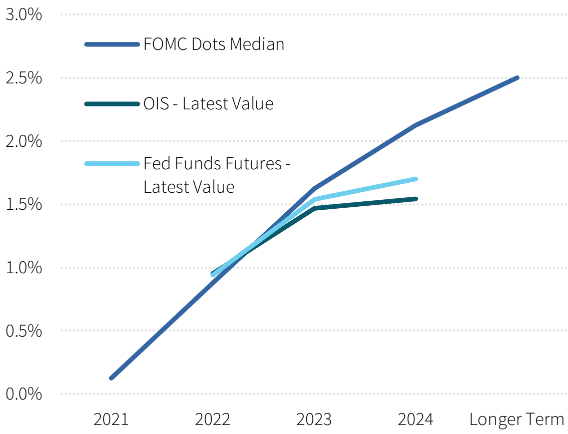
‘Normal’ service resumes as central banks turn off the liquidity tap

The overall theme is one many foresaw coming in 2022, with markets repricing interest rate expectations as inflationary pressures force the hand of central bankers as they bring to a conclusion ultra-loose monetary policies since the onset of the pandemic. Relative differences in central bank reaction functions as well as market expectations for inflation and rates suggest escape velocity will be uneven and volatile. Of the more notable central banks, the US Federal Reserve is leading the way with up to four rate hikes priced in, with the Bank of England also pencilled in for a broadly similar amount. While the European Central Bank has ruled out hiking rates in 2022, it is expected to reduce its purchase of government and other financial assets by around half.

With every communication and decision it appears increasingly clear that central banks’ normalisation schedules are becoming more advanced. In the near term, the outlook for the end to quantitative easing relative to the policy rate path appears more certain, and the exit path shortening, with many advanced economies approaching full employment and above-target inflation and growth; while some of this will be attributable to either temporary or base-effects, it stands to reason that financial conditions shouldn’t need to remain as highly accommodative as they are at present.

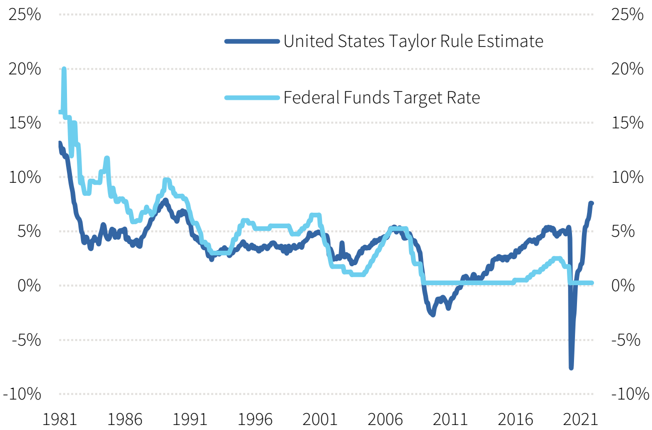
The United States, in particular, appears to have suddenly pivoted to one of fighting inflation with the winding back of bond purchases scheduled to conclude in the early part of 2022, having long contended that current inflationary pressures would subside. Short-term yields have subsequently moved higher in anticipation of tighter monetary policy, with both the Federal Reserve and markets currently pricing up four rate hikes in 2022 and a further two in 2023 and 2024. The upward shift and acceleration in rate hikes over the next three years is very evident (see Figure 1). A logical question to ask is how much higher rates could move.

Figure 1: Implied Fed Funds Target Rate



Source: Bloomberg

Figure 2: Taylor Rule and Fed Funds Target Rate



Source: Bloomberg

The Taylor Rule is one of the best-known formula that prescribes how policymakers should set and adjust the short-term policy rate, suggesting that the Federal Reserve should raise rates when inflation is above target or when gross domestic product (GDP) growth is too high and above potential (the reverse also holds true). Although officials are not bound by its output, they are much influenced by it. For a long time, the rule and overnight rates (Federal Funds Target Rate) have broadly moved in step; more recently, the rule forecast for the fed funds rate now exceeds the actual rate by the most in four decades (see Figure 2). While the increasing divergence can be partly attributed to factors that are widely expected to recede in 2022 (namely inflation), it also shows how far the current approach has moved out of sync with prior policy and quantifies how much potential catch-up tightening might be needed.

For its part, the Federal Reserve has steadily lowered its estimate of the terminal rate (the economy’s long-run potential growth rate) to 2.5% pre-pandemic, where it has remained since. In other words, the Fed presently sees rates as never needing to rise higher than 2.5% in the long run. Markets are pricing in an even lower terminal rate of less than 2.0%, suggesting current pricing of rate hikes through to 2024 would be sufficient to bring inflation under control. An upward shift in the terminal rate would send yields across the curve higher.

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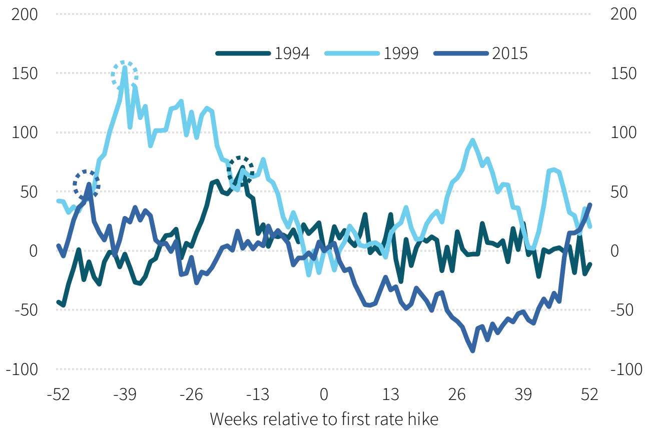
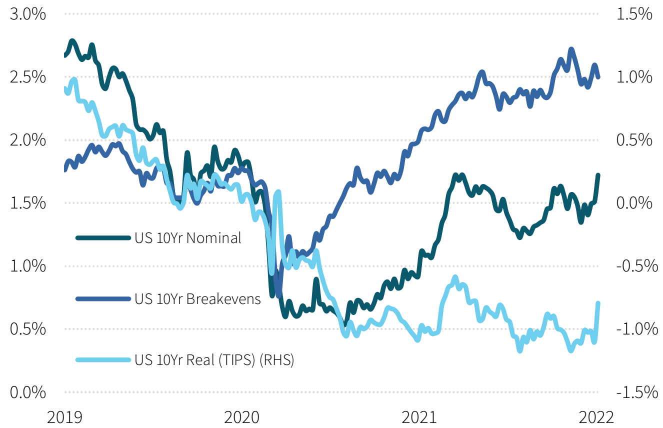
Longer-term yields initially trended lower following a shift in the stance from the Federal Reserve toward tightening, although this is not uncommon (see Figure 3); when central banks tighten policy quickly the yield curve tends to flatten on expectations that a reduction in credit flowing to the economy will slow growth (recall longer-dated yields are a function of inflation and growth expectations).

Figure 3: Prior Rate Hike Cycles and 10-Year Yields*



*Source: Bloomberg *As measured by change in 10-year yield (basis points) relative to first rate hike.*

Figure 4: United States 10Yr Yield Breakdown



Source: Bloomberg

2021 was a particularly volatile year for longer-dated yields, and it's reasonable to expect a similar story in 2022. The yield curve is likely to go through bouts of steepening and flattening throughout the year as central banks navigate a number of strong economic variables amongst an unavoidable period of unknown as the pandemic (and the authorities' response) evolves. The subsequent tilt more recently toward higher longer-dated yields stems from higher real yields (see Figure 4), which could reflect one of two developments (or a combination of the two): that markets are comfortable assuming the current rate hike path won't derail the economy (real yields are a proxy for growth expectations), or that markets are assuming reduced buying activity from the Federal Reserve (who owns 25% of all TIPS, from less than 10% pre-pandemic), and are being repriced accordingly (if one product of quantitative easing is to drive down yields, then logically, higher yields should be a product of quantitative tightening [reducing the size of the central bank balance sheet by letting purchases of treasuries and other financial assets roll-off]).

With the Federal Reserve still in the process of extricating itself from quantitative easing, it seems premature to consider the opposite in 2022. But the prospect of shrinking the central bank balance sheet has emerged as a real option to reduce central bank support and re-introduce a degree of price discovery back into markets, which is likely to further complicate the outlook--and keep bondholders on their toes. For their part, inflation expectations spent much of the latter part of 2021 range-bound and have yet to reveal their hand in terms of breaking higher (which is likely to engineer an even stronger response from the central bank) or lower.

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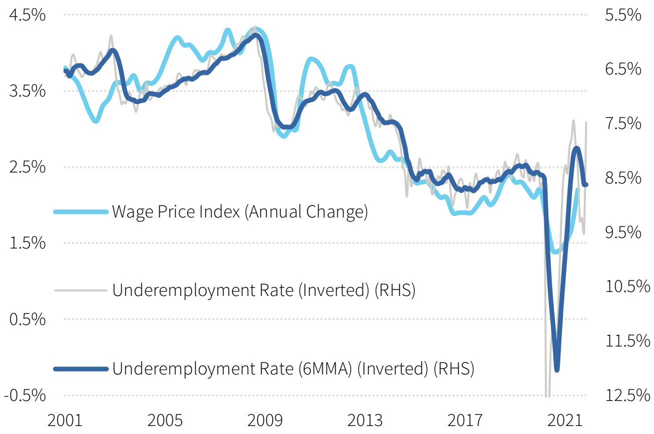
RBA: No rate hikes before stronger wage growth – unless they change their mind…

Locally, the outlook for short-term rates has also shifted sharply as markets started pricing for rate rises earlier than the Reserve Bank of Australia (RBA) had indicated, with the central bank opting to (rather abruptly) discontinue its three-year government bond yield curve control target of 0.10% following stronger than expected developments in economic data. Given not only economic momentum locally but also the momentum in other advanced countries in withdrawing quantitative easing, it appears reasonable that the RBA will conclude its program in the first half of 2022 (subject to any further adverse pandemic developments). In terms of further progress toward a more neutral setting for interest rates, much will depend on the path for inflation, and just as importantly, its composition, with the central bank particularly focused on maximising employment and returning wage growth to above three per cent.

The central bank has been both characteristically vague but within the same breadth relatively definitive in its view that a precursor to higher rates will be inflation that is *sustainably* within the 2 to 3 per cent target range, which *will require* the labour market to be tight enough to generate wages growth that is materially higher than it is currently. In other words, unemployment close to or below 4 per cent and wage growth returning to above 3 per cent. With core inflation already inside the target range on the preferred trimmed mean measure and forecast to remain there throughout 2022, the trigger for higher rates will largely centre on further improvements in both employment creation and wage growth.

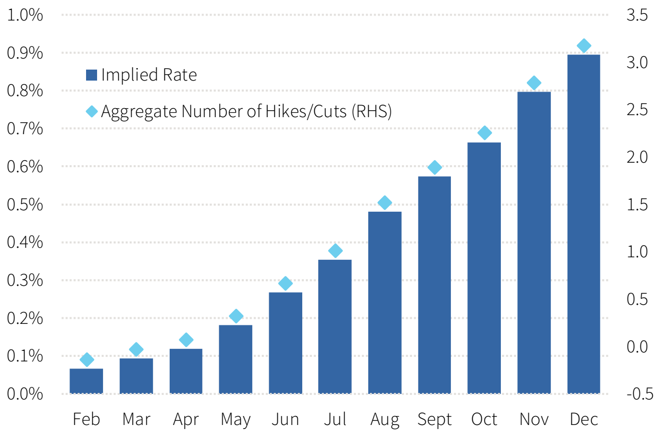
Unemployment has already fallen sharply to levels not witnessed since 2007-2008, while the more important indicator for wage growth, underemployment, is pointing toward stronger wage growth in 2022 (see Figure 5). Further progress will depend on the supply of labour, which has been constrained by limited inward migration over the past two years. While international border restrictions have eased, persistent disruptions caused by the current pandemic will likely present a headwind to a quicker supply response in 2022.

Figure 5: Wage Growth and Underemployment Rate



Sources: ABS, FIIG Securities

Figure 6: Implied Rates in 2022



Source: Bloomberg

It is therefore feasible unemployment approaches the 4 per cent target earlier than central bank guidance (end of 2023), although the market seems a little too optimistic in our view, currently pricing in a substantially earlier achievement and for the central bank to hike rates three times in 2022 (see Figure 6). Although we acknowledge the current momentum in both employment and wage growth, as well as the favourable backdrop for households in 2022, both they and inflation more broadly are relatively subdued compared with other advanced economies--particular the United States, with both the US Federal Reserve and markets forecasting up to four rate hikes in 2022, but amongst a backdrop of superior growth at present. We favour somewhere in the middle; rates could be raised in the latter half of 2022, earlier than the RBA envisages, although less than the market is currently pricing.

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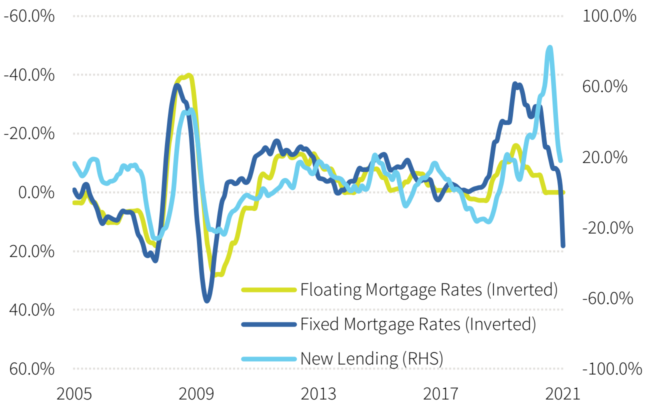
Tightening in financial conditions is already underway, which may also alleviate the need for the RBA to hike rates too sharply. The central bank is unlikely to feel obligated to respond directly to movements in house prices (the RBA has repeatedly said it does not target house prices, but rather is focused on [un] sustainability in household borrowings), and may be comforted with the knowledge that momentum is waning as the cost of credit starts to (relatively) normalise.

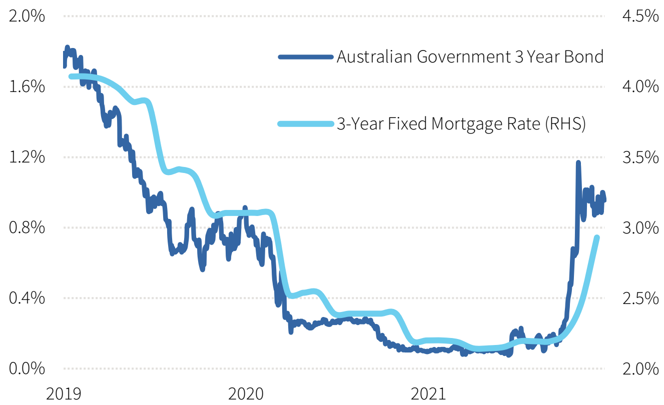
Readers will recall the strong relationship between the change in mortgage rates and the pace of new credit (see Figure 7), with the latter a key determinant in the movement in house prices. While financing conditions remain incredibly accommodative by historical standards, fixed rate mortgages, which accounted for close to half of all new loans over the past bank financial year (from around a fifth a year earlier), have started to rise following the central bank's decision to discontinue its three-year government bond yield curve control target of 0.10% (see Figure 8). Three-year fixed rate mortgages, which have marched higher in unison with government yields in recent months, were particularly effective in driving up the demand for new household credit, aided by the RBA's AUD200bn in low-cost three year fixed-rate funding to Australia's commercial banks.

Figure 7: Annual Change in Mortgage Rates and New Lending



Sources: ABS, FIIG Securities

Figure 8: 3-Year Bond Yields and Mortgage Rates



Sources: RBA, FIIG Securities

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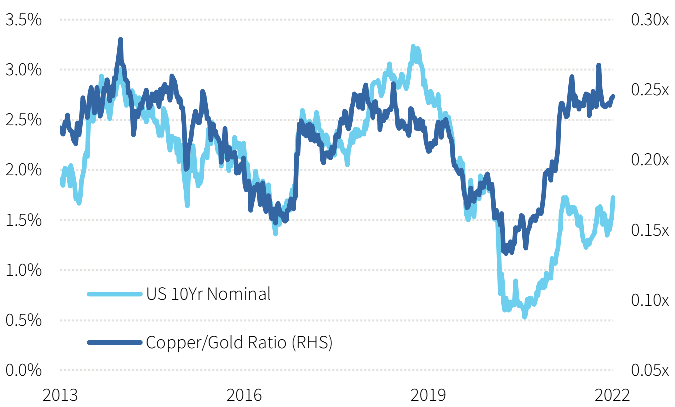
History doesn't repeat itself, but it often rhymes

For bondholders, there are no shortage of variables to consider at present, many of which bear some resemblance to the prior year. If the start of 2021 was all about vaccine optimism, 2022 appears all about optimism that the pandemic will take the next step in its natural evolution and transition to an endemic (i.e., one that we live with…). Longer-dated yields spiked in the early part of 2021 before subsequently flattening. The pandemic may or may not end in 2022, but unprecedented central bank support should. Yields have already moved higher in anticipation (in other words, the expected rate hikes are already priced in), and sharply--many parts of the Treasury curve had their worst performance in decades in the first two weeks of the new calendar year. If history is any guide, yields appear set to move higher (there is certainly scope in the near-term for yields to push higher on a cyclical growth upgrade post the Omicron scare, see Figure 9), but should peak before we see higher rates. The caveat to this of course is whether rates need to move even higher than what is currently priced in--forecasting the path of interest rates in this cycle is likely to be more challenging than usual.

While there may be periods when the yield curve steepens, our base case expectation is for higher yields but narrower spreads (in other words, a flattening curve where the difference between short- and long-term yields narrows). Demand for longer-dated lower-risk bonds should remain strong amongst institutional investors with long-term mandates to meet their liabilities. Consistent with 2021, there is a lot of talk of US 10-year yields approaching 2 per cent, where increased buyer interest for longer-dated bonds may re-emerge. The recent sell-off (higher yields) has been rather aggressive (although the shape of the curve is little changed, see Figures 4 and 10), so yields are likely to grind higher before the long side appears with any conviction.

With interest rate hikes priced in, greater value may be found in shorter-end, although we wouldn't discount duration (particularly as 10-year yields approach their perceived terminal rate). A laddered portfolio can be useful in mitigating rising yield curves. The idea is to diversify and spread the risk along the interest rate curve to hedge against any idiosyncratic moves in rates, and average into intermediate- and longer-dated bonds as opportunities present themselves.

Figure 9: Gold/Copper Ratio to US 10-Year Yield



Sources: Bloomberg, FIIG Securities

Figure 10: United States 10Yr-2Yr Spread (bps)

Sources: Bloomberg

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