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Inflation, monetary policy, credit crisis: That’s moving the market in early 2022

Guarded optimism on the pandemic front is helping the economy in many countries to recover – but the specter of inflation is what everyone is talking about. What can, what should central banks do in response? In the US, it is particularly uncertain exactly how the central bank will mix rate hikes and a balance sheet drawdown after its March meeting. And then there are the rumblings in the Far East: In China, a huge credit bubble might be about to burst – with global repercussions.

A market commentary by Lucio Soso, Lead Portfolio Manager of the Bellevue Global Macro Fund

2022 began with high inflation numbers and investor attention riveted on central banks. Monetary policy is one of the dominant issues, especially in the US. The Fed has printed USD 4.5 tr to combat the economic fallout of the pandemic – over a trillion dollars more than Ben Bernanke spent on all his QE programs. The Federal Reserve’s balance sheet has swelled tenfold since 2008 to nearly USD 9 tr, and money supply has risen by 41% in the space of just two years. Both are inflationary.

Consumer price inflation was clocked at +7% in December – whether this is a transitory upturn or the start of a prolonged period of high inflation will depend not least on what the Fed does. Consumer price inflation is likely to remain elevated for at least the next six months regardless. This is because the consumer price index at the end of 2021 was sharply higher, so, even if prices don't budge from where they’re at today, the headline inflation rate will probably still be at 5% by the end of June 2022. In fact, June inflation is more likely to be around 6%.

Meanwhile, real interest rates, which reflect the yield on 10-year US Treasury bonds minus inflation, have surpassed the record negative rates seen in the 1970s. A yield of 6% to 8% on 10-year US government bonds is needed to bring real interest rates into positive territory, but that is not in sight at the moment. This situation is not sustainable – in the medium term either bond yields must rise or inflation must fall. Most likely we will see a combination of both.

Our overall expectation is that inflation in the US will remain elevated throughout most of 2022. By March, the Fed will have clearly tapered its QE. What happens after that remains a matter of conjecture. What policymakers would like to see is a steeper yield curve. The market is anticipating four interest rate hikes of a quarter point each in rapid succession for the current year. For most asset classes, any significant increase in interest rates beyond that over the medium term would not be good news.

Less drama in Europe

Inflation is also on the rise in Europe but, at 5%, it is not quite as high as in the US. Money supply growth has been much slower in Europe, too, so the inflation situation there is clearly weaker – but that can also be said of the region's economic growth. It is also important to note that negative interest rates have narrowed the spreads between peripheral bonds in the euro area and German bonds, which is crucial for the survival of the euro. Negative German bond yields have forced yield-hungry investors to buy Italian bonds. If yields in Germany approach positive territory again, Italian bond yields are likely to climb higher as well. We therefore assume the ECB will begin tapering its QE asset purchase as the year progresses but will act very slowly in moving its interest rates higher.

Chinese economy on the verge of a massive contraction?

In China, on the other hand, we have a completely different problem: A credit bubble of epic proportions has been formed there. China's total debt as a percentage of GDP has risen from 160% in 2008 to 320% in 2020 – and corporate debt, which currently accounts for 70% of the total, has increased seven-fold over the same period. Much of this debt has been used to buy property – which is now grossly overpriced. Given that the real estate sector in China has accounted for 27% to 28% of GDP for the past eight years now (similar to Spain's real estate sector during that country's property bubble from 2006 to 2008), the dramatic nature of the situation is clear. Credit crises are usually overcome by a combination of debt repayment, debt relief, and monetization. Outsiders can only guess what action the Chinese government will take to address this issue.

What does this mean for financial markets? A sharp decline in economic activity in China would probably ripple across the globe; the renminbi could decline in value, temporarily or for a prolonged period; and there would probably be a crackdown on outbound investment. At the same time, a downturn in China might cause the Fed to slow the pace of its monetary tightening. That would be good news for US bonds and global equities.

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