January Monthly Review

A summary of key events and market trends during the month of January

January Monthly Newsletter

- The month of January feels like it has seen a full quarter worth of events, and asset markets felt the effect of trying to catch up with an incrementally hawkish Federal Reserve

- At its recent meeting the Fed has primed markets for tighter policy and Chair Powell did not provide even a hint of a dovish tilt during the Q&A despite some opportunity to do so

- The US two-year bond now at 1.18 % has almost clawed back to it's pre-Covid levels. The US ten-year at 1.77 % and the thirty-year at 2.11 % are higher than the levels of 21 Feb 2021 when the initial fear gripped asset markets

- Equity markets reacted accordingly: year to date, the S&P is down 5.26 %, Nasdaq down 8.52 % and Eurostoxx down 2.88 %

- Rates markets are now pricing five rate hikes for the year with some participants expecting seven. There also an attempt to form a view and consensus of the pace of Quantitative Tightening expected in the second half of the year

- In an environment of restrictive monetary policy we would expect to see volatility elevated as markets find reason to hedge long exposures. The Volatility Index closed the month at 25

The inscrutable Mr. Powell …

Pushing against prior communications and hence, market positioning, appears to be the Fed's game plan for now

Key markets

Index	Month to Date (%)	Year to Date (%)
Topix	-4.84	-4.84
Hang Seng China Enterprises	1.38	1.38
Dax	-2.60	-2.60
Euro Stoxx 50	-2.88	-2.88
S&P 500	-5.26	-5.26
Dow Jones	-3.32	-3.32
Nasdaq 100	-8.52	-8.52
US 10 Year Treasury	0.27	0.27
Bloomberg Barclays Global Aggregate Index	-10.91	-10.91
EUR USD	-1.19	-1.19
USD JPY	0.03	0.03
Gold	-1.75	-1.75

Recap of the month …

The Federal Reserve is currently still buying assets as part of its quantitative easing program. It intends to stop these purchases in March and an announcement to that effect is expected at the next monetary policy meeting on 17th March along with a rate hike which it has prepped markets for. Then, while continuing to hike it will then likely reduce its accumulated holdings towards the second half of 2022.

As we have noted the tone emanating from Federal Reserve Governors and more importantly from Chair Powell has taken a decidedly hawkish turn over the last couple of months. They have succeeded in getting interest rate markets to price in five 25 basis point hikes this year and potentially some more. Some market participants expect even up to seven such hikes.

This shift in tone is being driven by stubborn inflationary readings which, while moderating over the coming months thanks to higher base effects, will likely still be high enough for some time. Further, and for the moment, the Fed believes employment and growth are holding up well and hence tapping the brakes on the economy is warranted and any ensuing weakness can be absorbed by the system.

The stronger economy and better employment numbers give the Fed a lot more leeway with tighter policy than was allowed at the start of 2021; inflation, then, was brushed aside as it was merely "transitory".

As the market has now fully registered the change in stance, the important areas to focus on in the coming months will likely be the following:

- Fine tuning the expected pace of the Fed with respect to rate hikes as well as quantitative tightening
- The nature of quantitative tightening (which maturities are likely targeted for reduction and at what pace, are bond sales being considered or only maturity proceeds not being reinvested, does the Federal Reserve work in co-ordination with the US Treasury and to what degree)
- What is the incremental pace of fiscal policy support that will likely come through from President Biden's Build Back Better initiative and last but not least …
- <u>Given the recent history of pivots from the Fed, when, and if, the Fed will pivot to dovish policy again and what would be the trigger for the same</u>

One of the more critical segments of the inflation picture is how things evolve for employees. Shrinking purchasing power does not bode well for ruling party politicians seeking re-election in the mid-terms in November. Stimulus checks will soon be a thing of the past and hence bringing down inflation will be a critical element in ensuring employees do not feel constrained by rapid price increases.

It is worth noting that the current inflationary picture has been painted with by combination of:

- highly stimulative fiscal policy both under President Biden as well as earlier, under President Trump
- the US 5 trillion increase in the Federal Reserve balance sheet since the onset of covid and
- the extant additional US 3 trillion at the time covid first hit the headlines
- a supply chain which is proving slower to mend than what was initially thought
- an aging demographic profile (fewer employees available as the Boomer generation heads into retirement) along with restrictive immigration policies which do not allow low-cost labor to pick up the slack pushing cost of hiring up considerably

Hence, for investors attempting to understand the Fed's reaction function to data it will be important to understand how much of the previous monetary support they would likely withdraw and at what pace, as well as trying to gauge the pace of fiscal support and the pace of repair of global supply chains. Given the contentious nature of immigration policy we expect it to remain relatively static in the short term.

Following the lead of the Federal Reserve it is likely other central banks also turn more hawkish and the upcoming policy meetings will be closely monitored. In, unarguably, the most dovish country of them all, Japan's ten-year bond now trades close to 20 basis points; while still low at an absolute level is the highest since January 2016. A globally coordinated tightening of policy will likely prove to create a challenging environment for risk assets.

We have maintained a relatively sanguine view of volatility over the last 18 months. However, as tighter policy pressures assets, both real and financial, and restricts the quantum of leverage the system is allowed as well as the cost of that borrowing we would expect markets to get incrementally more volatile. The Volatility Index (VIX) close at 25 from a more muted reading of 17 at the end of December.