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AXA Investment Managers

Investment Institute Macroeconomics

Monthly Op-ed

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How far is too far?

Key points

- Policy rates can still be 'around neutral' while overall financial conditions are already restrictive. This raises the risk central banks go 'too far'.
- Markets challenge policy makers as further volatility raises concerns about financial stability in hitherto quaint obscure corners of financial markets.
- For investors, the downside is risk of further portfolio losses in the short-term. The upside is the prospect of conditions for better longer term returns to emerge.
- The additional rate hikes priced in together with the widening in credit spreads means that short-duration assets in fixed income markets look very attractive.

Where are neutral rates?

As long as the US labour market remains resilient, fuelling excessive wage growth, the Fed intends to continue to talk and act tough. As long as the Fed hikes, other central banks – including the ECB – will be forced to follow, irrespective of their own domestic cyclical conditions, to avoid a depreciation in their currency which would trigger another acceleration in imported inflation. This is the unfortunate combination which keeps financial markets under pressure. Risky assets are faced with the cumulative impact of higher rates, higher default probability and lower profits as the recession looms.

The key issue for the Fed is to get the right calibration of the tightening needed to finally force a landing of the US labour market. For an increasingly frustrated central bank, the conclusion to draw from the recent dataflow is that it needs to move its policy rate further into restrictive territory, i.e. significantly above the 'neutral range'. There is a real risk that the monetary tightening goes too far though. Indeed, the state of the labour market is dependent on the policy stance from 6 to 9 months ago. Lags are the bane of the data-dependent policy-maker. It's a fine line between 'restrictive' and 'overly restrictive'.

There are two problems with the notion of neutral rate, which normally allows to gauge the quantum of restriction implemented by the central bank. First, estimating where the neutral rate precisely stands is very difficult in real time. Second, focusing on the policy rate alone can be misleading. What matters is the impact overall financial conditions have on economic activity and hence, down the road, inflation. Unsurprisingly, these limits to the concept make the market quite nervous since they entail significant risks of a policy mistake. In theory, the level of the neutral rate should be driven by potential trend growth together with the preference for savings in the economy. Those two components are not observable with precision in real time. Actually, with the current supply-side constraints weighing on potential growth and with uncertainty rising thus potentially fuelling precautionary behaviour, the neutral

rate may well have fallen recently. This would be consistent with a smaller output gap at the moment – the difference the actual and potential level of GDP. The policy recommendation would then consist in hiking faster – to drive the output gap deeper in order to tame inflation – but also to stop hiking earlier, since the restrictive region would be reached earlier.

But the main issue at this stage may well be the difference between the policy rate itself and overall financial conditions. A simple indicator for the US – the unweighted average of 10-year treasury yields, 10-year BBB-rated corporate bonds and 30-year mortgage rates – has now reached its highest level since the Great Financial Crisis (GFC) of 2008-9. On both sides of the Atlantic, the corporate refinancing gap is also at its highest since the GFC. In the Euro area, given the dominance of intermediated funding, it's the behaviour of banks which matters most. From this point of view, the latest Bank Lending Survey released by the ECB on 25 October sends a concerning message. The net tightening in credit standards on corporate loans reported in Q3 2022 was higher than during the brief but intense financial market turmoil at the beginning of the pandemic, and banks indicated they expect another significant net tightening in Q4. The ECB is widely expected to reach the upper end of the 'neutral range' for its policy rate at the end of 2022, but overall financing conditions may already be in restrictive territory.

Central bankers usually think about the impact of their action in linear terms, with the economy reacting gradually to the change in the monetary policy stance. There is however always a risk that the real economy "snaps" in one go once a certain threshold in financial conditions is met, and this becomes more likely when the monetary tightening is implemented at a fast pace, as it is today. That central banks could be stopped out early in these circumstances would hardly be a consolation to those invested in risky assets, since they would still need to face a deterioration in fundamentals and probably liquidity conditions before being 'rescued' by central banks changing tack.

Volatility challenges the monetary stance

The risk of increased levels of market volatility as financial conditions tighten by more than that simply implied by policy rates is a key challenge to policy makers. For investors, the challenge is to understand where and how market developments pose such a challenge to policy that both the policy itself and the subsequent market pricing is not sustainable. We are at a stage of the cycle where the potential for extreme market pricing and policy reversals is greater than normal. The downside of this is further volatility and portfolio losses in the short-term. The upside is that conditions for better longer-term returns should emerge.

At the core of market tensions is the fact that the monetary policy regime is being challenged by the highest inflation rates for 40 years. Central bankers have continued to be hawkish, fighting against expectations of a pivot in the summer and pushing markets to price in higher and higher levels of where rates will get to. Market pricing of the peak in rates on both sides of the Atlantic have risen by over 120 basis points since the summer rally. The belief underpinning the monetary stance is that independent, inflation targeting central banks delivered the great moderation of inflation from the 1990s and they will break the back of this inflation cycle as well.

Meanwhile, growth is slowing and the risks of financial instability are rising. Some combination of evidence of a peak in inflation, weaker economic data and financial instability will eventually bring the rate hiking cycle to an end. Until central bankers blink, however, markets are likely to remain extremely nervous. In Europe, there is increasing evidence that the Euro Area economy is moving into contractionary territory. The Eurozone composite purchasing managers index has been below 50 for the last four months and we expect negative GDP growth in Q4. Yet the European Central Bank is poised to raise rates by another 75 basis points at its October 27th meeting. It is only logical that markets price in higher risk premiums on corporate debt and equity as a result. Investment grade credit spreads are moving back to their June highs while all-in borrowing costs in the Euro Area are heading to levels not seen since the global financial crisis. Markets are not giving the policy stance a vote of confidence.

Moving away from quantitative easing and zero (or lower) interest rates was never going to be straightforward. There is little clarity on when this policy reset will come to an end. The odds are in favour of the peak in rates, not being because central bankers have concluded that they have reached some optimal level of monetary restrictiveness, but because they will realise, they have gone too far. That realisation will come from markets pricing in that enough pain is being generated to bring inflation down. Wider credit spreads, inverted yields curves and multiple compression in equity markets are consistent with this scenario. Of course, a lot of this has already happened and it may be financial instability that eventually triggers the 'pivot'.

Markets have power

Markets can force policy changes. The UK has recently provided a clear and extreme example of this. The ill-fated attempt to introduce a package of unfunded tax cuts was met by a currency crisis and a bond market meltdown. These market moves became

disorderly as they triggered distressed selling of assets by leveraged investors in, of all places, the normally staid-world of pension funds. The result was a massive U-turn on the fiscal policies, the creation of an emergency bond buying facility at the Bank of England and another change in political leadership. It was also a very clear reminder financial instability can erupt anywhere in markets.

The market message to UK policy makers was "don't risk debt sustainability". The foreign exchange markets are currently sending a message to the Japanese authorities to not risk credibility by ignoring the long-awaited increase in inflation. The inevitable outcome will be an adjustment to the "yield curve control" policy that has kept government (10-year) bond yields in Japan below 0.5% since 2015. If not, the yen will likely continue to weaken as yields rise in the rest of the world. Japan's foreign currency reserves will be depleted, tightening domestic liquidity conditions in more extreme way than if there was a more controlled adjustment of monetary policy settings. Either way, conditions don't favour investing in Japanese assets.

Already better prospects for defensive strategies

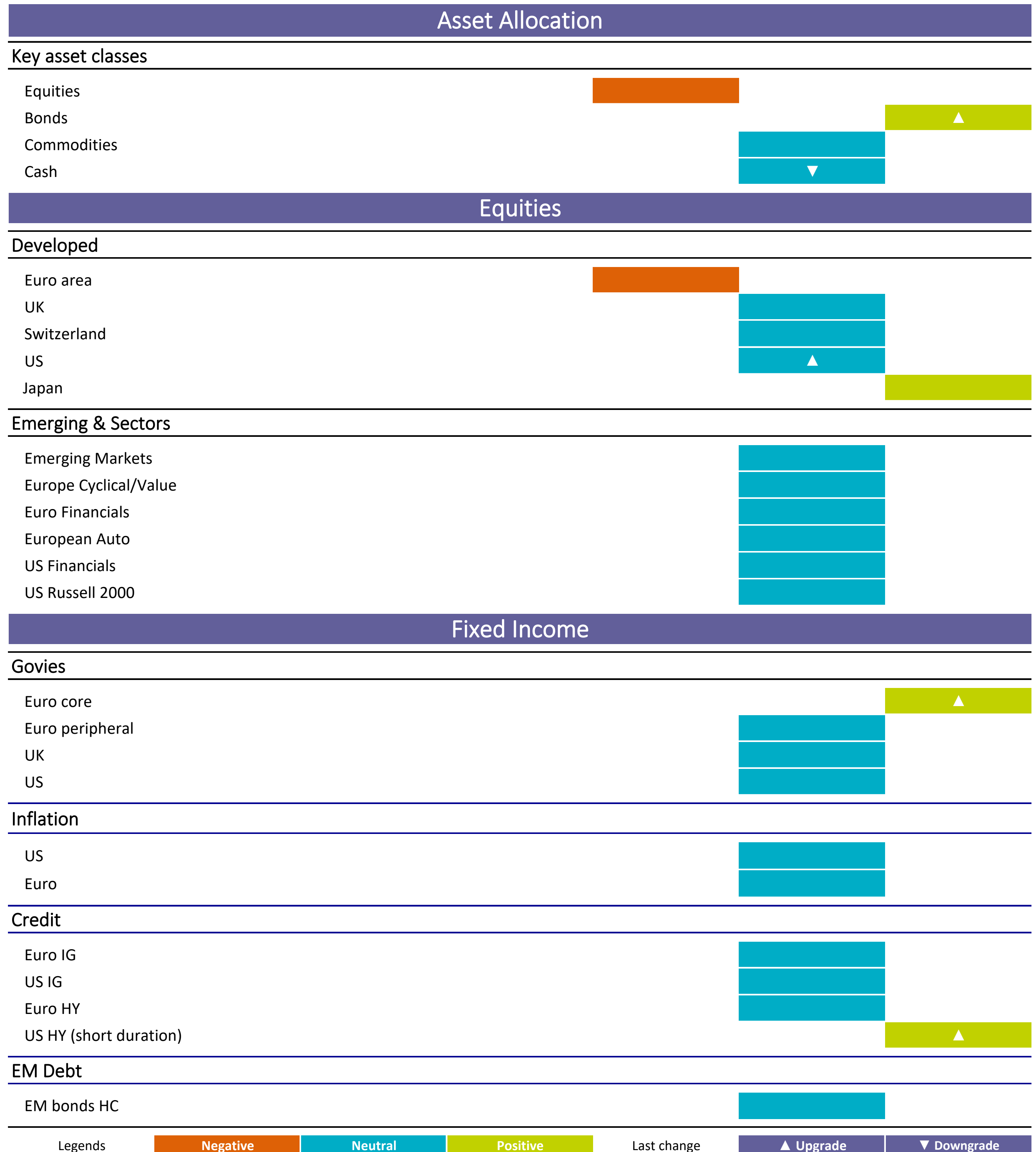
As market volatility increasingly challenges prevailing policy, the environment for investors will remain difficult. Yet there are signs of potential better returns in 2023. The extent to which markets have priced additional rate hikes together with the widening of credit spreads mean that short-duration assets in fixed income markets look very attractive. With limited interest rate and credit risk, investors can earn yields that are well above implied peak interest rate levels in both US dollars and euros. These are yield levels that create a high probability of positive returns over the next year, compared to the negative performance of the last several quarters.

For riskier assets – high yield bonds and equities – more pain might be required before a central bank pivot provides relief. Yet valuations are to the very cheap end of historical ranges. Equity earnings might not yet have fallen in line with GDP forecasts for 2023-2024, but equity prices have fallen a lot. This means multiples, especially outside of the US, are low even with a recession imminent. Some market analysts argue that there needs to be a final capitulation, perhaps triggered by weaker earnings being reported, before the market bottoms. It may be that the equity market won't find low until rates and bond yields have peaked and a recession is clear across economic data. But all those things might not be too far away.

Peak in sight

Central banks are creating condition themselves for a pivot. Aggressive tightening in 2022 against a backdrop of rapidly slowing economic growth and rising financial stability risks will result in markets forcing a change in stance. The message will be "don't risk a massive recession" when inflation is very likely to moderate in 2023. The level of interest rates and bond yields will be higher going forward than in the QE era, but as long as central banks first stop raising rates and then moderate their monetary stance over the next two years, investors can look towards starting to build wealth again rather than protecting against the ongoing losses that have plagued this year.

Download the full slide deck of our October Investment Strategy



Macro forecast summary

Real GDP growth (%)	2021	2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	6.1	3.1		2.4	
Advanced economies	5.2	2.5		0.1	
US	5.7	1.8	1.7	-0.2	0.5
Euro area	5.4	3.0	2.9	-0.5	0.2
Germany	2.8	1.3	1.4	-1.5	-0.7
France	7.0	2.4	2.5	0.0	0.6
Italy	6.6	3.3	3.3	-0.6	0.3
Spain	5.1	4.7	4.3	0.6	1.6
Japan	1.6	1.5	1.5	1.7	1.5
UK	7.4	4.2	3.4	-0.7	-0.3
Switzerland	3.7	2.3	2.3	0.6	0.8
Canada	4.6	3.3	3.3	0.7	1.2
Emerging economies	6.7	3.6		3.9	
Asia	7.1	4.4		5.1	
China	8.1	3.6	3.3	5.2	5.0
South Korea	4.0	2.3	2.6	2.0	1.7
Rest of EM Asia	6.2	5.6		5.2	
LatAm	6.8	2.8		2.0	
Brazil	4.6	1.5	2.4	1.0	0.9
Mexico	4.8	1.7	2.0	1.3	1.3
EM Europe	6.5	-0.7		-0.2	
Russia	4.7	-6.0		-3.5	
Poland	5.7	4.8	4.1	0.9	1.4
Turkey	11.0	5.6	4.8	1.5	2.2
Other EMs	5.4	4.2		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 25 October 2022

CPI Inflation (%)	2021	2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	3.2	7.2		4.7	
US	4.7	8.2	8.0	5.2	3.8
Euro area	2.6	8.1	8.2	5.5	5.4
China	0.9	2.1	2.3	2.3	2.3
Japan	-0.2	2.3	2.2	1.3	1.4
UK	2.6	9.0	9.2	5.6	7.0
Switzerland	0.6	2.8	2.9	2.0	2.0
Canada	3.4	6.9	6.9	4.3	3.6

Source: Datastream, IMF and AXA IM Macro Research – As of 25 October 2022

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy						
		Meeting dates and expected changes (Rates in bp / QE in bn)				
		Current	Q3-22	Q4-22	Q1-23	Q2-23
United States - Fed	Dates	1.50-1.75	26-27 July 20-21 Sep	1-2 Nov 13-14 Dec	31-1 Jan/Feb 21-22 Mar	2-3 May 13-14 Jun
	Rates		+1.5 (3.00-3.25)	+1.25 (4.25-4.50)	+0.25 (4.50-4.75)	unch (4.50-4.75)
Euro area - ECB	Dates	-0.50	21 July 8 Sep	27 Oct 15 Dec	2 Feb 16 Mar	4 May 15 Jun
	Rates		+1.5 (0.75)	+1.0 (1.75)	0.25 (2.00)	unch (2.00)
Japan - BoJ	Dates	-0.10	20-21 July 21-22 Sep	27-28 Oct 19-20 Dec	Jan Mar	May Jun
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	1.00	4 Aug 15 Sep	3 Nov 15 Dec	3 Feb 17 Mar	5 May 16 Jun
	Rates		+1.00 (2.25)	+1.25 (3.50)	+0.75 (4.25)	unch (4.25)

Source: AXA IM Macro Research - As of 25 October 2022

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Our Research is available on line: www.axa-im.com/investment-institute

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