TWIN PEAKS?

Equity markets ended 2021 on a strong note, following typical seasonal patterns. However, volatility in both interest rates and equities has picked up as of late. Real-time economic data is showing the negative effect of the Omicron variant, while persistently high inflation has pushed the Federal Reserve into a distinctly more hawkish stance. Market expectations of interest rate hikes have edged up in the last month, while volatility in interest rate markets has increased noticeably due to investor uncertainty. Financial market history can provide some comfort to investors, as the exhibit below shows. Equities, along with bonds, can perform well during interest rate hike cycles — especially when they are well-telegraphed. In the last seven rate hike cycles, stocks only generated a negative return during the 6-month period before and after the initial hike once — and that was accompanied by a whopping 3.25% increase in the Fed funds rate.

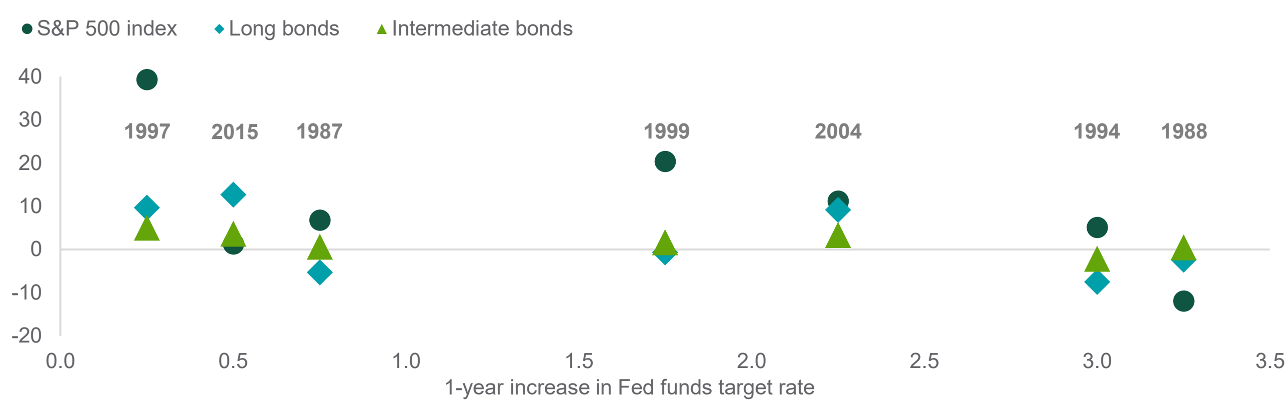
While we made no changes in our global policy model this month, our risk case around inflation did change significantly. Previously, we were concerned about Fed overreaction to inflation, while now we are concerned that persistent inflation could justify a more hawkish Fed. The first quarter of this year could see “twin peaks” in COVID and inflation, especially in the developed world. While the recent surge in the Omicron variant has dented current activity, that will likely subside faster than the risk of disruption in supply chains. COVID case counts in Asia haven’t yet come close to the surge seen in the West — which represents a production risk in countries like China with a zero-COVID public health policy.

We continue to focus more on the implications of inflation than just on the level of overall prices. Corporate pricing power remains strong, offsetting increased costs and buttressing profit margins, earnings and stock prices. Bond markets have had a difficult month since the Fed pivot, but the 10-year Treasury yield of ~1.8% remains well-behaved and within our expected range of 1.5—2.0%. We think the Fed’s accelerated timetable around tapering its asset purchases, and then the potential for shrinking its balance sheet (see our discussion in the interest rate section) will be executed with a close eye on the impact on fixed income markets. With nominal rates still low overall, we continue to underweight fixed income and favor risk assets in our global policy model. We expect developed markets to outperform emerging markets again in 2022, and we continue to favor high yield bonds over investment grade bonds due to their lesser interest rate sensitivity. Finally, global natural resources remains a favored asset class as a play on economic growth and constrained supply, and as a hedge against continued high inflation.

RATE HIKE RESILIENCY

Stocks can handle initial rate hikes well, while substantial rate hikes tend to have a more limiting impact.

RETURNS 6-MONTHS BEFORE THROUGH 6-MONTHS AFTER INITIAL RATE HIKES



Source: Northern Trust Asset Management, Bloomberg. Total returns for long bonds: Bloomberg U.S. Long Government/Credit Index; intermediate bonds: Bloomberg Intermediate U.S. Government/Credit Index. Data as of 1/14/2022.

BASE CASE

Slowing but Sustainable Growth

Growth is moderating from the past year's strong pace but we are only mid-cycle in the expansion. Meanwhile, steady (albeit slightly more restrictive) major central bank policy provides support to financial asset valuations. All of this allows risk assets to continue to perform, despite recent impressive returns.

Resilient Corporate Profits

Pockets of elevated inflation, supply/demand mismatches and slowing economic growth have not impacted business profitability — notably in tactically overweight developed markets. Earnings growth has materially outstripped already-impressive revenue growth, leaving a solid fundamental backdrop.

RISK CASES

Persistent High Inflation

Underlying inflationary pressures continue over the next year, forcing the Fed into a materially more aggressive policy response – resulting in a challenging environment for both stocks and bonds.

China Growth Disruption

A China policy miscalculation harms global economic functioning as it deals with a number of issues from the pandemic to energy shortages to financial stability and the property sector.

Prepared by Northern Trust Asset Management for Iron Mountain.

ViewPoints reflects data as of 1/18/22.

Powered by

NORTHERN TRUST