LA FRANÇAISE

INVESTING TOGETHER

# Macro flash

# OCT.2022

**By François RIMEU**

*La Française Asset Management's Strategist*

## Fighting inflation, no matter what it takes?

# The Federal Reserve determined to reverse the trend

September is for the moment the high point of an already historic year 2022. Although the fall in the equity markets was significant, it was small compared to the movements seen in the bond markets.

Some examples of these movements:

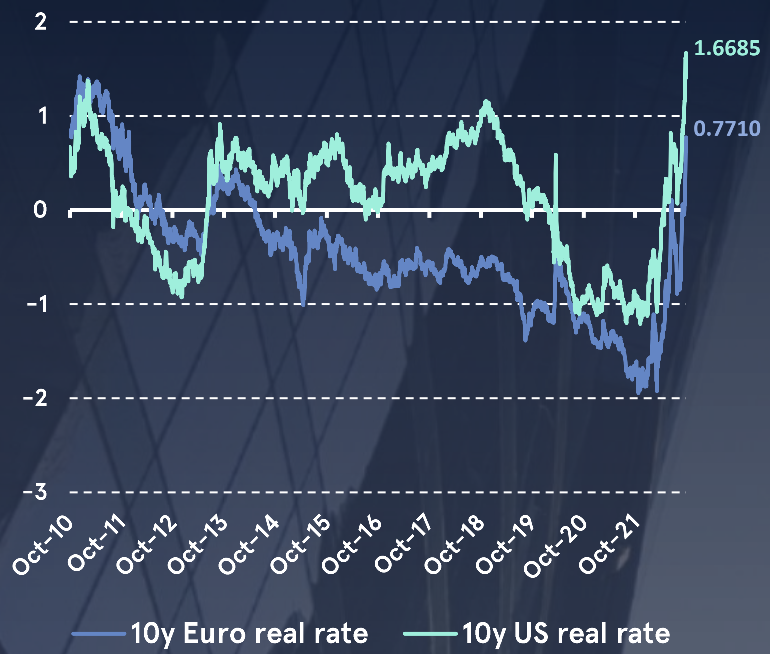
- UK 10-year rates jump **121bps**
- Real US 10-year rates rise by **87bps**
- European real rates close **90bps** higher

To find movements of similar magnitude, we need to refer to the most volatile periods of the last decades, such as October 2008. While there are many explanatory factors, three events seem to have had a greater impact than others.

Chronologically the first**, the US inflation figure** released on September 13 **dashed the financial markets' hopes** that the risk of inflation would recede. The New York Fed's surveys had given hope for a lull in inflation expectations, which had been corroborated by the University of Michigan's surveys. Similarly, the price sub-components of the ISM and PMI indicators showed less upward pressure. The release of the inflation figure at 8.3% versus 8.1% (and an equivalent surprise on core inflation, source Bloomberg) thus came against the market's expectations: **goods inflation is certainly decreasing, but services inflation continues to accelerate**, with an inflationary risk still present.

The Federal Reserve then renewed its Jackson Hole speech: **the institution will continue to tighten its financial conditions** to avoid the formation of a price-wage loop that would lead to disanchoring inflation expectations. In order to do so, the Fed will continue to pursue a policy aimed, ultimately, at lowering asset prices (especially real estate) and raising the unemployment rate. The publication of the "dots" above market expectations, with a rate at the end of 2023 expected by the members of the Fed at 4.625%, also surprised the market and participated in the decline of the bond markets. Combined with the inflation figure released earlier in the month, **the impact on real rates was very violent.**

## 10-year US vs. Euro real rates




**Key points:** ***Sharp rise in the 10-year Euro rates and the 10-year US rates.***

Sources: Bloomberg, data as of 30/09/2022

**The ECB considers that it is still difficult to estimate whether the inflation peak has passed, even though consumer prices continue to rise fuelled by soaring energy costs.**

LA FRANÇAISE
INVESTING TOGETHER

# Warning for the Bank of England, are the british markets on borrowed time?

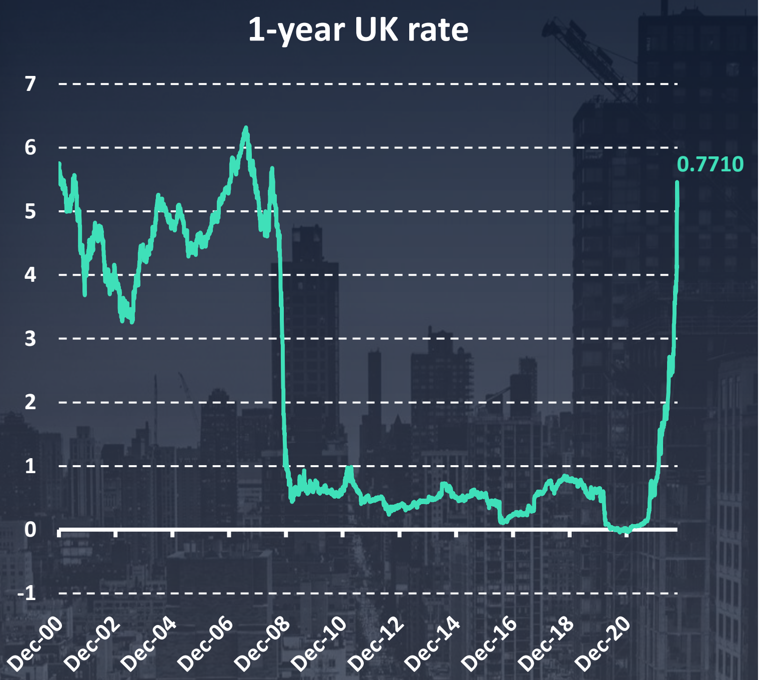
Finally, **the release of the UK budget caused a panic in the bond market** in a degree rarely seen before. While the market was expecting a large budget deficit based on Liz Truss' statements in the previous weeks, it was not expecting that UK bond issuance would increase from £60 billion to £190 billion for the year 2023, nor was it expecting that the government would make the largest tax cuts since 1971. **Bond markets fell** so much in the sessions following the announcements that the **British central bank had to intervene** to stabilize the market. It should be noted that this same central bank was supposed to start its asset sale program at the beginning of October and **that it is now forced to do exactly the opposite, at least until October 14*.**

Even if nuclear attack threats by Mr. Putin, earnings bearish revisions, the probable production cuts by Opec or the beginning of the Chinese Communist Party's Quinquennial Congress would deserve our attention, the last point concerning the British situation seems to us to be probably the most notable.

For several decades now, monetary and fiscal authorities **have navigated in a world in which the risk of inflation had virtually disappeared.** The Covid crisis did not change this state of affairs and even amplified it with an unprecedented fiscal windfall. **The current British situation seems to put an end to what can be done in terms of budget deficits**, unless we accept an extremely restrictive monetary stance.

How will our governments proceed in the months and quarters to come, faced with the energy crisis we are going through? What balance can be brought between fiscal policy and monetary policy? Unless the inflationary risk recedes sharply and quickly, **our governments will have difficult choices to make.**

*Sources: Bank of England



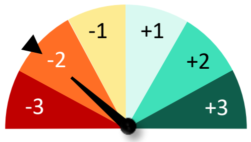
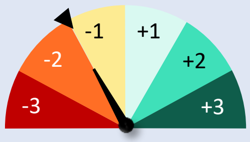
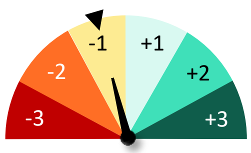

**Key points:** ***Abrupt rise in the 1-year British rates. Levels are similar to pre-2008 levels***

Sources: Bloomberg, data as of 30/09/2022

**UK 2-year mortgage rates are back above 6%, levels not seen since 2008.**

LA FRANÇAISE
INVESTING TOGETHER

LA FRANÇAISE
INVESTING TOGETHER

| Assets | Allocation level | Strategic View |
|---|---|---|
| **Equity** |   | We remain very cautious on equities due to the tightening of financial conditions, the sharp drop in growth forecasts and a Fed "pivot" that we do not believe will happen in the short term. Not to mention the likely decline in earnings forecasts. |
| **Credit** |   | Again, we are cautious, for reasons similar to the equity markets. Investment Grade seems to incorporate a bit more risk than the High Yield market, hence our preference for this market segment. |
| **Rates** |   | Inflationary uncertainties are still very high vs. risks to growth that are also very high. The UK market example and the uncertainty surrounding the budgetary responses to the current situation lead us to remain cautious, even if some segments are beginning to be attractive, such as US short interest. |

## October Outlook

Overall, we remain cautious in our asset allocations with a preference for the dollar. Weak market positioning and expectations that central banks will halt their monetary tightening may lead to sharp rebounds in the short term. However, in our view, it is too early to expect inflationary risks to dissipate, which is essential for a sustainable improvement in financial conditions.



## AGENDA

**5 October**
OPEP Meeting

**13 October**
US Inflation

**16 October**
CPC meeting

**27 October**
ECB meeting

**31 October**
Euro Inflation