GAM Investments' Fixed Income & Currencies Specialist Rahul Mathur on the Bumpy Road to Rate Normalisation

Rahul Mathur, Investment Manager, for the Global Rates Strategy at GAM Investments, joined our handful of experts for our Hubbis Digital Dialogue of April 21 to offer his views on how private clients should be adapting their portfolios in anticipation of what now appears to be a more sustained bout of inflation. Rahul told delegates how as inflation might now become deeply embedded and sustained, investors need to be much more selective in sovereign fixed income, especially at the shorter end of the maturity spectrum. He said that the recent surge in commodity prices, driven by geopolitical tensions, had reinforced the existing inflationary dynamic and underscored the extent of mispricing at the front-end of fixed income markets. And he warned that the risk that core inflation remains elevated and that inflation expectations become entrenched suggests that policymakers may ultimately have to be far more aggressive in normalising monetary policy.

GET IN TOUCH

View Rahul Mathur's LinkedIn Profile

Find out more about GAM Investments

Rahul opened his commentary by noting that when he and colleagues consider the outlook for inflation, they first look at producer prices, which give a good indication of the likely direction of headline inflation, certainly over the ensuing six to 12 months. He said that the most recent headline producer prices in the US jumped 1.4% in March alone, well above the consensus of 1.1%, and that the core rate rose 1.0%, double the consensus for that month. He explained that the headline measure was unsurprisingly boosted by energy and food prices.

He remarked that the war in Ukraine had added to inflation momentum, and that margins were a key driver of producer prices, again, accounting for some 30% of core producer price inflation in the US. In addition, he said that the sustained surge in prices in some sectors, notably auto dealers as well as furniture, hardware, apparel, were to blame.

Rising inflationary tensions

"Whilst we are likely to see variations in headline inflation, our primary concern is that inflation expectations remain elevated, which we think will be reflected in sustained, higher core CPI," he reported. "Ultimately, that's what central banks focus on. The near real time economic indicators continue to rebound following the plunge in Omicron COVID cases, signalling that spending on discretionary services is rebounding. Sentiment data indicates that consumers are unhappy about the continued increase in food and gas prices, which disproportionately raises inflation expectations and depresses confidence. But in the US alone, households are sitting on around USD4.25 trillion in extra cash than they were before COVID, so we expect them to spend a good chunk of that to catch up on missed experiences during the pandemic."

And what does that all add up to? "All in all, while headline inflation in the US may moderate in the coming months, we think that core inflation is likely to remain elevated and we anticipate more entrenched inflation expectations and rising nominal wages," he surmised.

"Whilst we are likely to see variations in headline inflation, our primary concern is that inflation expectations remain elevated, which we think will be reflected in sustained, higher core CPI," he reported. "Ultimately, that's what central banks focus on."

The ECB points to higher prices

He noted that the ECB briefing a week earlier had focused on the upside risks to inflation having intensified, a view with which Rahul and his team concur. He said that the ECB had also remarked on the war in Ukraine having increased the downside risk to growth, as well, and that this was weighing materially on sentiment throughout the Eurozone.

Turning his attention to Asia, he said the Russian invasion had resulted in energy prices surging and pushed other commodities and food prices had also risen. However, in China and Japan, CPI inflation did not look likely to sustainably breach their central bank targets, and policy tightening by either central bank seemed highly unlikely in the near term.

"If anything," he said, "the cost shock is likely to deliver more easing at the margin, with the growth recovery still fairly fragile, particularly in China. The oil shock coupled with ongoing supply chain problems, may have actually tipped global trade over the edge. In short, it is a mixed picture across global markets but certainly when we look at the US and the Eurozone, those price pressures remain persistent."

Inflation's impact on growth

Rahul said that the recent surge in commodity prices, driven by geopolitical tensions, has reinforced the existing inflationary dynamic and underscored the extent of mispricing at the front-end of fixed income markets "Given the starting point of historically low real and nominal interest rates, fairly limited spare capacity, healthy private sector balance sheets, elevated core inflation, rising inflation expectations, and, specifically for the US economy, the likely minimal impact of the commodity price shock on the growth outlook," he told delegates. "And all of that, taken together, means that central banks, especially in the US, remain materially behind the curve as they continue to pursue a fairly gradual approach to policy normalisation."

He said that an environment of higher inflation, policy normalisation and liquidity

withdrawal present significant risks to traditional asset classes. But for Global Macro strategies, such as Global Rates, this type of environment provides a number of attractive opportunities.

Spotting the opportunities

"Central banks in play and divergent business cycles can have a material impact on sovereign fixed income and currency markets and allow us to take advantage of a number of high conviction, non-consensus relative value trades, which are uncorrelated to traditional asset classes and generate alpha in both bull and bear markets."

He explained that, for example, the Global Rates strategy is well positioned to benefit from this environment with its continued focus on higher, short-term developed market interest rates, inflation protection, fixed income relative value trades, tactical currency exposures and selective EM fixed income themes.

To give some examples, but without delving into too much detail, he said that the US, the UK and Canadian markets are pricing in the expectation that the central banks will have to start cutting rates after a couple of years. However, the risk that core inflation remains elevated and that inflation expectations become persistently entrenched suggests that policymakers may ultimately have to be far more aggressive in policy normalisation.

"So, if we look at the very front end of the UK, we feel there is a mismatch, in other words that very little has been priced in taking into account actually some of the initial conditions which are unique to the UK, such as Brexit, which is having a material impact on labour supply and further adding to the inflationary woes there." For example, in the last month the Global Rates team added to their short position in UK interest rate futures (June 24 Sonia) and initiated a short-sterling mid-curve put spread, to take advantage of the possibility that the Bank of England may ultimately have to raise rates more than is currently anticipated.

"Central banks in play and divergent business cycles can have a material impact on sovereign fixed income and currency markets and allow us to take advantage of a number of high conviction, non-consensus relative value trades, which are uncorrelated to traditional asset classes and generate alpha in both bull and bear markets."

Real rates and FX dynamics

Turning his attention to currencies, he said relative rates are really reasserting themselves as drivers of currency performance. "If we look at, for example, the Scandinavian currencies and the Swedish Krona in particular, versus the Euro, we've seen quite a marked shift in rhetoric from the Riksbank over the last 6 to 12 months," he observed. He

explained that there is evidence to show that negative rates in Sweden contributed to a weaker krona by dampening capital inflows after the Riksbank cut rates to negative in Q1 2015. The Riksbank abandoning negative rates should see some normalisation of capital inflows, in turn supporting the Swedish krona over time.

In a similar vein, the currencies of Mexico and Brazil have been well supported this year as their central banks moved to raise rates ahead of the Fed.

A global juggling act

He said a particular challenge for many market watchers right now is in trying to understand the intersection between policy normalisation and growth risks, which vary across different economies combined with the likely vulnerability of traditional asset classes to liquidity withdrawal.

"Watching and monitoring central bank reaction functions is becoming increasingly critical to working out the likely path of currencies and interest rates," he said. "Last week, we saw the Reserve Bank of New Zealand hike rates by much more than the market had anticipated, however the suggestion that they are considering frontloading rate hikes and the implication of a lower terminal rate, resulted in currency weakness. These types of nuances with respect to growth and inflation need watching carefully, and the opportunity set for discretionary, uncorrelated, liquid global macro remains highly attractive." ■