Global macroeconomic update

Key themes

- The subtle yet profound shift in central bank narratives last fall has continued to underpin our consistently more-hawkish-than-the-market view, eschewing growth concerns, for now
- Short, short-end expressions have, not surprisingly, done well; we continue to like the space, particularly the German curve, as the ECB makes up for lost time
- We believe the Fed is genuine when it suggests it wants to get to neutral this year or early next; if true that probably means further curve inversion

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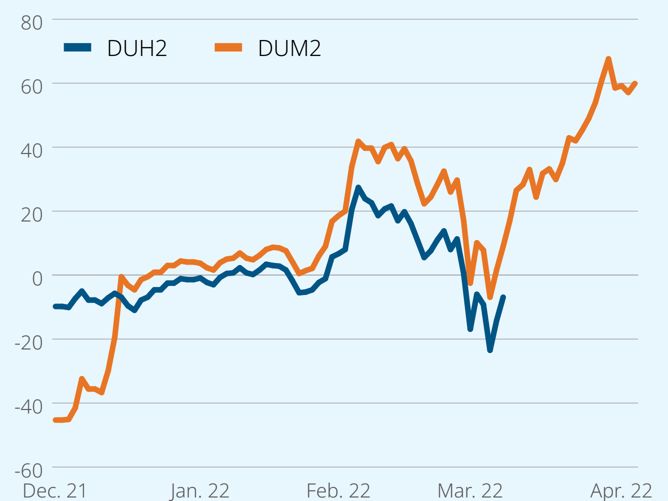
Fixed income market volatility during Q1 was ferocious with curves recalibrating across the globe. Frequent readers will know we have generally been on the hawkish side of the narrative, particularly with respect to the Federal Reserve (Fed) and the European Central Bank (ECB) policy with the Fed expected to lead global sentiment and the ECB with work to do. Part of our hawkish rationale was picking up on what at the time was a subtle, yet profound shift in many G10 central banks thinking last fall; namely, due to the already elevated levels of inflation present and with the beginnings of a natural gas squeeze happening in Europe, central banks were more likely to not look through the impact of higher energy prices due to supply constraints on already high inflation levels this time around – despite risks to growth.

In addition to the incalculable human toll and suffering, the incursion by Russia into Ukraine has effectively supercharged inflation via less commodities / energy on offer and interrupting traditional goods supply lines through the Black Sea in what was already a challenging global supply chain dynamic and ongoing Covid disruptions in China. And given central banks change in M.O. from the fall of 2021, it looked to us like central banks would be forced to hike sooner and more aggressively as opposed to the other path of simply "looking through it." This is one of the reasons we particularly liked being short the 2- and 5-year sectors of the curve, as well as general directionality of curve flattening (Read My Lips – 28 January, 2022), and the question to us now as we set off in Q2 is how much more needs to reprice given the ferocious moves year-to-date.

Chart 1 | March & June 2022 Schatz Futures
(Daily, bps, Dec 1/21 - Present)



Sources: Bloomberg; Mackenzie Investments

In recent weeks we have been particularly focused on the European (German) curve and the ongoing ECB pivot which has taken time, but we now think is about to hit full stride; after the EU's March flash inflation print clocking in at 7.5% annually, we continue to see more upside risks to prices from here as energy and food supplies are likely remain constrained. In particular, ECB Executive Board member and Chief Economist Lane has

recently opened the door to acknowledging rate hikes are possible this year, something that four weeks ago seemed to be a near impossibility given his staff projections. The reality is the ECB is still well behind where the Fed and Bank of Canada (BoC) have recalibrated in terms of forward guidance and actual policy; with the ECB having a lot more to do, the market opportunities are there. Not surprisingly given our views, we liked being short March German Schatz futures (ticker DUH) during Q1 and continue to like the June futures (DUM) as this scenario unfolds – please see chart 1.

The Fed, meanwhile, has issued its own mea culpa of sorts, effectively admitting that in hindsight it would have been appropriate to raise rates earlier and that the labour market might be the tightest in multiple generations. Two days before the March FOMC meeting we moved to a "50-50 probability of 50 & 50" (i.e. 50bp each in May and June FOMCs) and the new "dots" at the March FOMC solidified this as a base case going forward. Although not quite there at time of writing, we are toying with an additional 50bp at the July FOMC which might sound exceptionally aggressive – except at 125bp through July the market is already well on its way there. We think there is a strong probability the Fed wants to get to so-called neutral before year end – even traditional dovish members like Governor Brainard think it's necessary - and depending on where you believe neutral is, that would require at least another 200bp before January which would put the targeted Fed Funds range between 2.25-2.50%.

But in reality the neutral rate – the rate where the Fed is neither providing accommodation nor hindering economic growth – is probably higher than 2.25-2.50%, particularly with recent massive nominal GDP prints seen in the last few years coupled with the beginnings of an underlying wage-price spiral that is occurring in the labour market. We think that level is probably somewhere between 2.50% and 3.00%. If true – and if the inflation problem is as sticky and ingrained in the economy as we believed last year and continue to believe – then the Fed and other central banks will need to go beyond neutral for a period to break the ingrained inflationary impulse. Accordingly, we continue to believe the curve remains inappropriately priced and is in the process of transitioning from a period of pronounced flattening to a period of prolonged inversion as 2023 stagflationary concerns mount.

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