

A Thematic Approach to the Fog of War and Hawkish Central Banks

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Many investors may long for the days when their primary concerns centered on accelerating inflation and central bank hawkishness. Now, they also face a geopolitical shock that could potentially redefine the global world order with profound financial market implications. Given the highly uncertain range of outcomes, we find it instructive to distinguish those economic and market developments that we were confident about before the war from those that now appear highly uncertain. This segmentation not only provides some context to a thorny investment outlook, but it also reveals some emerging investing opportunities.

The Good Old Days of COVID, Recovering Growth, and Rising Inflation

[Our outlook heading into 2022](#) focused on the strength of global growth, especially in the developed world. In the U.S. and Euro area (EA), we projected above-trend growth of 3.6% and 4.3%, respectively. In contrast, after China's strong recovery from COVID lockdowns, we expected the ongoing real-estate crisis to dampen growth in the world's second largest economy to 4.5% in 2022. However, since the conflict started, these estimates are being reconsidered, especially those for the EA as it is a large energy importer with a heavy reliance on Russian gas.

The trend of soaring consumer price inflation has only accelerated this year as the conflict placed further upside pressure on the cost of energy, food, and other commodities. Despite the rapid rise in short-term inflation expectations, markets are keeping the faith in long-term inflation control. For example, even after the compounding effects of the Russia/Ukraine crisis, long-term inflation expectations remain close to their averages since 2005. This suggests that markets remain confident that the Federal Reserve and other central banks can tame inflation by tightening monetary policy.

Three Scenarios and their Investment Implications

Historically elevated inflation, a cohort of hawkish central banks determined to meet their price stability mandates, and a moderating economic growth outlook clouded by the fog of war puts investors in a disorienting environment. Yet, we aim for some clarity by laying out three plausible scenarios for the conflict.

1. A near-term resolution: Persistently strong growth allows central banks to tighten policy in an effort to engineer soft landings. The Fed would be the most hawkish of the major central banks with the ECB set to tighten policy as well.
2. A protracted conflict: No disruption in the flow of energy, especially for Europe. The Fed would likely embark on tighter policy, but the ECB would be less aggressive and non-committal given the higher degree of geopolitical and energy uncertainty.
3. Disrupted energy flows from Russia: Central banks tighten more cautiously as inflation begins to take a toll on growth. The ECB could well be forced to intervene in the bond market to contain the credit spreads on corporate bonds and yield spread on European peripherals, such as Greece and Italy, to German bunds.

These scenarios present very different implications for fixed income markets. For instance, U.S. short-term interest rates could rise further as central banks continue to fight inflation - but the more unfavourable the conflict becomes, the more modest the potential increases. The long end of the curve is likely to remain broadly unchanged with a protracted conflict, but if it is resolved, we would expect modestly higher rates. As for spreads, a rapid resolution to the conflict would lead to tighter spreads as markets price a more benign growth environment. However, we would expect them to remain range bound and potentially widen under the more disruptive scenarios.

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Overall, these scenarios illustrate that investors are facing a highly uncertain macro backdrop with significant two-way risks. Furthermore, our riskier scenario has the potential to be highly damaging for the global economy because it would not only exacerbate fears of recession and inflation (stagflation), but it would also increase the risk of “miscalculations” by Moscow and/or the West.

The Themes of Opportunity

As we write, our view is that we could be shifting towards our “energy disruption” scenario, as the U.S. and the UK have imposed bans on imports of crude oil from Russia. This context warrants a cautious approach to risk markets.

However, some market dislocations are becoming quite interesting. Rather than taking directional views, we prefer to frame these opportunities around the following themes: regional divergences; cross-sector opportunities, and bottom-up opportunities related to supply chains / commodities.

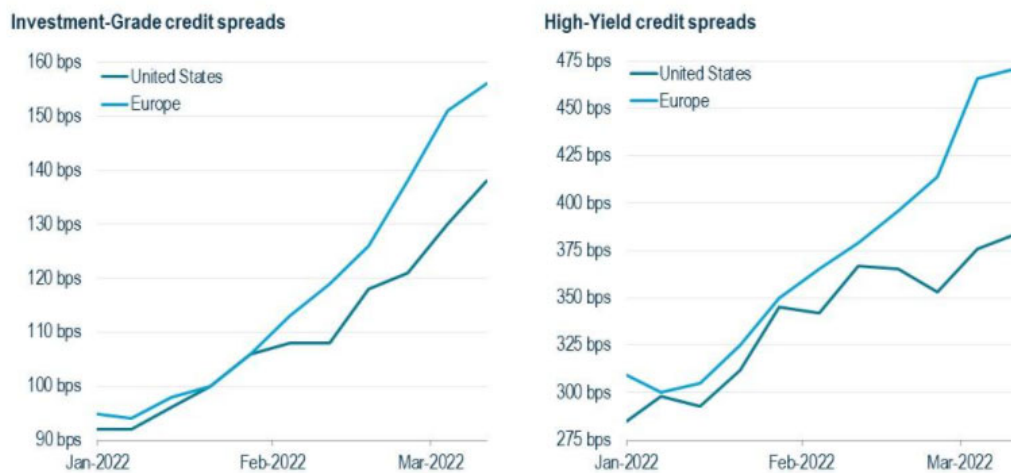
Regional divergences: In the rates space, for example, the front end of the German curve has been extremely volatile as markets are unsure about the likely path of the ECB in the face of the ensuing stagflation shock. That hasn't been the case in the U.S., where the economy is on much stronger footing and inflation is much higher. But if the conflict continues to escalate or lingers on, we see the prospects for U.S. yields as asymmetric to the downside. In such an environment, we would also expect the ECB to be more dovish and to avoid fragmentation risk. Italian 10-year yields recently traded near 1.9%, not far from U.S. 10-year yields (Figure 1), but we see a more attractive risk/reward dynamic for long positioning in Europe.

FIGURE 1: Italy and U.S. 10-year Yields Align Despite the Likelihood for More Support from the ECB



Source: Bloomberg.

In the credit space, euro area corporate IG and HY spreads have widened significantly versus those in the U.S. (Figure 2), mirroring the worsening growth prospects in Europe relative to the U.S. and the ECB's most recent hawkish tilt. Admittedly, that repricing could continue. If it does, we are confident of a bold fiscal policy response, and monetary easing will ultimately be needed to ensure cohesion and limited interest-rate costs on the high debt stock. European IG credit is starting to look particularly interesting as it should be part of the ECB's first line of defense in a downturn and spreads are not far from their pre-pandemic wides.

FIGURE 2: European Credit Spreads Pull Away from those in the U.S.

Source: Bloomberg.

Cross-Sector: Another area of opportunity may be selling top tranches of CMBS or CLOs, both of which have outperformed and remained much more liquid than other spread sectors, and moving into attractive corporate or sovereign sectors that have underperformed on a relative basis in the recent flight-to-quality trade (Figure 3). Another relative value dislocation in the markets has arisen from investors fear of higher rates. This has pushed investors into floating-rate securities, such as bank loans, stretching their valuations relative to comparably rated high yield bonds. In recent weeks, high yield mutual fund outflows pressured bond prices, further exacerbating the valuation dislocation and creating opportunities to pick up incremental spread by switching from loans to bonds.

FIGURE 3: The Resilience in AAA CLOs may Point to Opportunities in Recent Underperformers

Source: Bloomberg.

Bottom-Up Opportunities: Ample opportunities exist with the ongoing “commodity/supply chain shock.” Russia and Ukraine combined account for more than 5% of global exports for a large number of commodities that directly affect energy (oil and gas), food (wheat and corn), and manufacturing industries (base metals and bulk commodities). Global supply chains were already impaired in the aftermath of the COVID crisis. This conflict is likely to make that problem even more severe.

Conclusion

Market participants are facing a very unusual and challenging environment. On the one hand, the Russia/Ukraine conflict has resulted in a global supply shock that casts the shadow of stagflation as commodity prices and inflation reach levels not seen in decades. On the other hand, central banks are being forced to combat high inflation. The Federal Reserve is on a clear tightening path, and even the ECB is keeping its options open despite the imminent downside risks to the growth outlook in the eurozone.

The uncertainty facing investors is huge, leaving the macroeconomic and market environment wide open with significant downside risks. Such uncertainty makes it difficult to make big macro bets in portfolios. While the lack of clarity can be unnerving for investors, it's clear that inflation poses tangible risks to their real returns if they gravitate, or remain, on the sidelines. Rather, they can assume a thematic approach to the environment by identifying the compelling relative-value opportunities that exist across regions, asset classes, and industries.

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