TRANSCRIPT

Threading the Needle Between Growth and Inflation

Featuring:

Andy Sparks, *Managing Director, MSCI Research*

Oleg Ruban, *Head of Analytics Applied Research for Asia Pacific*

Adam Bass (00:03):

This is MSCI Perspectives, your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass, and today is March 24th, 2022. We're now a month into the war with Ukraine. It is, without doubt, a humanitarian tragedy, and while it hasn't yet turned into an economic tragedy for global markets, it is certainly adding to t he uncertainty as well as the volatility that investors continue to face, things like ...

Oleg Ruban (00:40):

Expected of rising interest rates, rising commodity prices selloff on U.S. treasuries that has sent 10-year government bond yields to the highest level in 33 months. Europe is dealing with large influx of refugees. We see the return of coronavirus to China, which once again threatens global supply chains, which may amplify pressure on prices and apply downward pressure on output.

Adam Bass (01:02):

Not to mention longstanding concerns about inflation and growth. This week on Perspectives, we'll talk about how central banks around the world are attempting to fight inflation without hampering growth. Let's meet our first guest.

Andy Sparks (01:19):

My name is Andy Sparks. I work in MSCI's Solutions Research effort.

Adam Bass (01:24):

And the owner of the voice you heard just a moment ago.

Oleg Ruban (01:28):

My name is Oleg Ruban. I look after solutions research for Asia Pacific.

Adam Bass (01:34):

Last week, the Federal Reserve in the U.S. announced a quarter point rise in the federal funds rate, its first increase in more than three years, its move designed to combat inflation that has ballooned in the United States to levels we have not seen in decades, but according to Andy, MSCI's long-term observer of the Fed, the rate hike was a non-event.

Andy Sparks (01:59):

That's because Chairman Powell had effectively pre-announced this move when he testified to Congress earlier in the month, and I think instead, that the market's primary focus at this meeting was the commentary around the state of the economy and its expectation of future policy moves, and in fact, the Feds signaled a very positive outlook on the economy as well as the Fed's ability to lower inflation. At the press conference, Chairman Powell emphasized the remarkable rebound in the U.S. labor market, which cuts across demographic and socioeconomic groups. He also highlighted the strong growth in wages. He came out clearly on the side of the Fed fighting today's 40-year high in inflation, and he did not think it would lead to a material deterioration in labor market conditions.

Adam Bass (02:53):

So, the decision to raise interest rates was, in part, a reflection of the Fed's belief that the lab or market and job growth in the United States is strong, strong enough to support six more rate increases this year, but is a quarter point rise now enough?

Andy Sparks (03:11):

There was a dissenting voice. It's a very well-known voice. This was the voice of James Bullard, who is the president of this St. Louis Fed. Rather than a quarter of a point increase, he wanted a full half a point on Friday of the same week. He actually released a statement saying that he'd like to see the fed funds rate pushed above 3% by the end of the year. By the way, in contrast, as was announced at this meeting, the median Fed forecast for the fed funds rate by year end is 1.9. So, James Bullard feels the Fed needs to be much, much quicker in raising rates.

Andy Sparks (03:54):

The arguments for raising rates more aggressively earlier on are that if you don't do it aggressively, inflation could get out of control, and so James Bullard, I think his main concern is that the Fed may lose credibility because its current inflation target is 2%. Actual inflation is much above it, so he feels that if inflation continues to be very high and much higher than the target, I think he's just concerned that inflation can become more of a permanent long-term phenomenon rather than making it a short-term phenomenon.

Adam Bass (04:33):

James Bullard. He's basically worried about the Fed losing control of inflation and losing its own credibility if it raises rates too slowly, but honestly, if we're looking at up to six more rate hikes this year anyway, what's the harm in raising them more aggressively now?

Andy Sparks (04:53):

If you go too fast too early, you could, under some views of the economy, you could cut off economic growth. So, we have a lot of momentum in the labor market, but if you're too aggressive at raising rates, you run the risk that recovery in the labor market may be reduced. It may be impeded.

Adam Bass (05:16):

But what if James Bullard is right?

Andy Sparks (05:20):

So, that is a real concern that many market participants have. That's a very important question. The Fed's median inflation forecast for 2022 is noticeably more optimistic than the market's implied inflation forecast. Those implied inflation forecasts are taken from prices of traded U.S. Treasury securities. So, if the market proves to be correct and inflation is higher than the Fed, then the Feds will likely need to tighten monetary policy more than previously thought. This could include more aggressive increases in the fed funds rate as well as accelerated tapering of the Fed's balance sheet,

Adam Bass (06:04):

Which is bad because?

Andy Sparks (06:06):

The markets do not like abrupt changes in monetary policy, so in this case, equity markets could sell off. Short maturity treasury yields could come under significant pressure resulting in a flatter yield curve, and in addition to increased market volatility, I mean, very importantly, the Fed's credibility in the market would likely suffer. So, therein lies the problem. How do you cool inflation without cooling the labor market? So, you have different scenarios that are possible. There could be the too little, too late.

There could be too much, too early, and then you have, let's call it a soft landing or threading the eye of the needle, something where you just get it right. So, skeptics of the Fed might argue the Fed is way overly optimistic about being able to control inflation while having minimal effects on the labor market.

Adam Bass (07:04):

There you have it, the title of our episode. Oleg, continue the thread.

Oleg Ruban (07:10):

Chair Jay Powell saying that he was acutely aware of the need to return the economy to price stability and was determined to use the toolkit to do exactly that, and those recent statements from him indicate that the Fed may well be prepared to move more aggressively to quell inflation. I think he said in the last few days that there was nothing to prevent the bank moving forward with a half point rate increase in May but of course added that the committee has not made a decision yet on the next policy move.

Oleg Ruban (07:41):

Most central banks, they try to create that balance between inflation and growth. Now, some have been more pro-growth in nature. ECB, for example, due to the historical influence of kind of the Bundesbank philosophy, has been very much an inflation-fighting central bank in nature, but there's always this idea of, okay, if you raise rates too far, too fast, then you are essentially quelling growth, which is not something that ... is something you may be more cautious about doing, given that there are significant risks to growth as we mentioned earlier. So, basically, it's a very delicate balance that some developed market central banks need to tread right now.

Adam Bass (08:24):

Another thing investors pay close attention to is the composition of the Fed's portfolio. Andy brought up the fact that the Fed may begin tapering as early as May, and this is significant.

Andy Sparks (08:37):

Just take into account that the Fed currently owns about 25% of the U.S. Treasury market. They also own about 25% of the agency MBS market. So, they are huge, huge market players, and the significant selloff in the treasury market we've seen over the past six months, some of that selloff probably can be attributed to anticipated reductions in the size of the Fed's balance sheet.

Andy Sparks (09:06):

The real questions a lot of investors are asking is the speed at which the Fed may reduce its portfolio and how might the composition change, and so specific to the composition change, for example, if they let the mortgage portfolio shrink faster than the treasury portfolio, that could put upward pressure on mortgage spreads, and in terms of selling treasuries, the Fed owns treasuries along the yield curve. They also own a lot of Treasury Inflation-Protected Securities also known as TIPS, and the TIPS market generally is less liquid than other parts of the treasury market. So, if, for example, the Fed sold a lot of tips. That could put pressure on the prices of TIPS and the inverse of the price on the TIP or the yields, and those are real yields. So, the market pays a lot of attention to real yields, and those real yields are generally being drawn from the TIPS market. So, that's another important parameter to be focused on.

Adam Bass (10:07):

How is the rest of the world handling all of this?

Andy Sparks (10:10):

The ECB is grappling with the same basic issues as the Fed. Inflation was rising in the Euro zone even before the invasion, and now, it is likely to be even higher along with weaker growth in the wake of the invasion. The inflation rate in the Euro zone is still quite a bit lower than in the U.S., and Europe is being more affected by the war than is the U.S. So, the ECB is in the process of tightening monetary policy like the Fed is, but given that the Euro zone economy faces greater risk from the war and given a lower underlying rate of inflation, its tightening of monetary policy will likely be significantly less aggressive than what we will see in the U.S.

Oleg Ruban (11:00):

There were hopes that Europe's economy might grow faster than U.S. in 2022. If you look at the recent months, most central banks would have tapered the seized asset purchases, and many began increasing policy rates, but what we're seeing now is that many policymakers are also kind of looking towards a gloomier outlook than what they have been earlier. In fact, some are talking about how the current military conflict in Europe could be much worse for the European economy than the coronavirus pandemic due to a number of things, supply chain disruptions, energy scarcity, inflation, but there's also a confidence effect. So, put all of those together. This then sets up many central banks to think about a gloomier outlook especially in developed markets.

Adam Bass (11:48):

When monetary policy tightens in developed markets, it's tended to stem flows of capital into emerging ones, which makes sense. I mean, if yields are higher in markets that have tended to be more stable, why take greater risk in markets that have historically been more volatile? I asked Oleg what he thought about this, and here's what he said.

Oleg Ruban (12:10):

In general, a lot of emerging market countries are in better shape today than they would during other periods of Fed tightening. What does that mean? Basically, bigger foreign currency reserves, better budgetary and external balances have helped insulate them to some extent from the risk of capital outflows, but that doesn't mean that a large enough shock still could not penetrate that buffer. There is a possibility that capital flows may revert abruptly, and that could leave both asset markets, both in equity markets as well as currency markets in emerging markets in turmoil. So, while vulnerabilities in countries have decreased to some extent relative to what we saw a number of years ago, let's say during the taper tantrum in 2013, that still doesn't mean that emerging markets are completely insulated from what is happening with respect to Fed rate rises.

Adam Bass (13:07):

In our prep meeting for the interview, Oleg mentioned something interesting. Well, I mean he mentioned a lot of some things interest, but he said that inflation, while it was a huge concern for developed markets in the West, it's not as much of a concern in Asia, for example, at least not in the same way. I asked him why that is and what it means for the global economy.

Oleg Ruban (13:34):

Many countries in Asia have been insulated to a large extent from the surge of inflation, so at least so far. The way we can see that is if we compare core inflation at the end of last year with average inflation over the past 10 years or so. Then, the underlying inflation in most Asian countries remains below its pre-pandemic levels. This is especially so in the middle income Asian economies where outputs remain somewhat depressed, but even in kind of a higher income economy such as Japan, this is also the case.

Oleg Ruban (14:08):

Now, there's some dispersion there as well. So, there have been some countries where the economy has rebounded more strongly after the coronavirus pandemic. So, countries like Taiwan and Korea come to mind, as does Singapore, and here, inflation did rise to above historical average rates more recently. In particular, we've had service prices have a bit of an effect on inflation in these countries, but I think in contrast to what we're seeing in the U.S., in Japan, most market participants still expect the BOJ to leave its policy rate unchanged probably until about 2025 or so.

Adam Bass (14:46):

Can you give any idea about why is the ... Why would the Japanese Central Bank make that decision in the face of higher inflation, as opposed to the Fed, for example? What factors are in play there?

Oleg Ruban (15:02):

Well, I think first of all, there is, in Japan itself, the inflation still remains somewhat subdued, and this has been the case for a while. So, in fact, if we look some years ago, with Abenomics, one kind of aspect of this was how to restart inflation and the idea that restarting inflation might have a positive impact on growth in Japan. So, again, it's that same kind of growth versus inflation trade-off. In Japan, frankly, growth is somewhat of a high priority from probably relative to inflationary pressures that remain rather subdued.

Adam Bass (15:41):

Let's stick with this part of the world but switch over to commodities. Let's talk about Australia. Head south a bit. How have they been affected during this time especially as inflation goes up, generally, commodities do pretty well, right?

Oleg Ruban (16:02):

I think it's kind of the ... It's almost the other way around. Rising commodity prices tend to be reflected in higher inflation rates overall. Until recently, I would say that inflationary pressures in Australia have been somewhat less pronounced compared to other major developed economies. However, what we saw in recent months, the last few months of 2021 and early 2022, is that it looks like headline inflation as well as underlying inflation were higher than expected by the Reserve Bank of Australia. So, there is evidence of inflationary pressures there broadening beyond goods prices and the services prices, and there are also upstream cost pressures in housing constructions and durable goods, which may push underlying inflation higher in the near term.

Oleg Ruban (16:47):

Now, high commodity prices, of course, would increase the cost of producing goods and further fuel the inflationary pressures. There is also a possibility that rising oil prices and rising food prices, which we are seeing and may see more of in the coming months, may dampen the demand for other goods in Australia. So, this then leads to some economists downgrading their expectations for growth in Australia while increasing their expectations for inflation. Yet at the same time, of course, Australia is a commodity exporter, and there are indications that coal exports in particular could increase very significantly in the current month, in the next few months so March through May, for instance, with export earnings correspondingly jumping upwards. That benefits the trade surplus that benefits certain sectors of the Australian economy as well as, of course, the country's budget.

Adam Bass (17:44):

I wondered about China. It's had its own difficulties over the past year. In fact, Evergrande was in the news again just this week with a $2.1 billion asset seizure, but China is far removed, at least geographically, from both the war in Europe and inflation in the states.

Oleg Ruban (18:03):

At the moment, it seems like the Chinese economy may still be expanding relatively healthily so around its pre-pandemic trend perhaps this year, but there has been a gradual slowing of potential growth, and that's likely to continue in the coming years. Unlike what we saw in the U.S., I would say financial conditions in China are also easing a bit. So, you've had the central bank lowering several of its policy interest rates not so long ago. It also lowered the reserve requirements for banks, but on the other hand, we had some Chinese officials sufficiently worried about the situation to say in recent days that the government would act to boost the economy in the first quarter and introduce policies that are favorable to the market. So, while there is a reasonably benign economic picture in China, there are still some worries about how the current situation might affect what is, as you say, now a very large emerging economy.

Adam Bass (19:04):

It's a truism that we live in uncertain times, but it can also seem that investors are especially attuned to that uncertainty. I wanted to find out from Oleg what indicators investors may be looking for as they plan their next steps and the kinds of questions they might be asking.

Oleg Ruban (19:22):

From a kind of more, let's say, medium to long-term perspective, I think over the recent years, what we have seen is a steady decline in the trend of globalization. That's been a big driver of economic growth for quite a number of decades. Globalization was positive for growth, and it helps suppress inflation. We've seen that take a hit both from the pandemic of the last two years, as well as the current geopolitical crisis that has accelerated this decline in globalization. So, what we are seeing now is that some institutional investors are worried that stagflation, instead of being a risk scenario which it has been for a while, can become the baseline scenario. So, that's the first worry. So, how do you position the portfolio in that kind of environment?

Oleg Ruban (20:12):

The other thing is that given the kind of the decline from globalization, one aspect of this is that there's also likely to be significant dispersion between individual country, economic outcomes be it with respect to growth or with respect to inflation. We've already mentioned some of this, right, with respect to how the Asian economies haven't really had the same inflationary pressures as some others. Also, it's true to say that the track of growth has been quite different between the emerging markets in Asia versus countries like China versus developed markets. So, there has been this decoupling of economic prospects. The right level of granularity is something that probably a lot of allocators are still struggling with. So, they see that there is dispersion, but at what level do you capture that dispersion is an important question that market participants are facing.

Adam Bass (21:11):

That's all for this week. Joe and I would like to thank Oleg and Andy for offering their insights and thank all of you for listening. Next up, it's time for our quarterly check-in with Hitendra Varsani, and a look at the markets over the first quarter of the year. We'll also be joined by MSCI's Mark Carver and our old friend, Anthony Kruger of BlackRock. Until then, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process. To learn more, please visit **www.msci.com**.