Australian Standfirst

Understanding The Financial Markets Tumult of 2022:

Maintaining Portfolio Quality In The Era Of Quantitative Cheating

Portfolio Attribution

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Stirling Larkin, **CIO**

It has been difficult for many to reconcile that after thirty-five years, government backstops are no more, leaving many exposed to natural market dynamics which had been significantly repressed since the era of Reagan, Thatcher and Hawke – sober solace can be found in Swami Vivekananda's truism, "*Be free; hope for nothing from anyone. I am sure if you look back upon your lives you will find that you were always vainly trying to get help from others which never came.*"

Cite:- End The Fed, 24 September 2019

Cite:- Central Banks Are Now Market Makers: Reshaping The Global Economy From A Torus Revolution Towards A Torus Knot, 22 July 2020

What began in early 2022 as a *Taper Tantrum* devolved throughout the subsequent months into a far more corrosive trifecta of compounding cost-push inflation, destabilising geopolitical fracases and mushrooming recessionary concerns, with the bellwether US S&P500 index having its worst start to the year since the *Kennedy Slide of 1962* – all of which worsening without the spectre of government rescue programmes, intervention or even *prima facie* succour.

Cite:- Rates Riot Behind The Market Correction, 29 August 2015

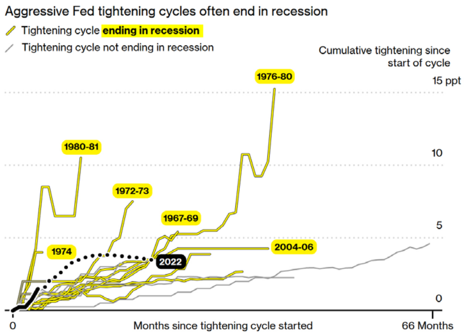
Cite:- Taper Tantrum 2.0: Quantitative Tightening (QT), China's Nocebo Effect & Why To Avoid Emerging Markets (EM), 7 February 2022

Cite:- Understanding Reflation & Central Bank Liquidity During A Taper Tantrum: 'Treasury Switches', FIMA Repo Facility & Other Market Microstructural Reforms Are Bullish For Eurozone, Japanese & US Blocs, 14 April 2022

The 2022 nadir was seen during the second Friday of May, which crossed the ominous threshold of being the longest drawdown (continuous downswing) on the US Dow Jones index since October 1929, the first year of the Great Depression.

Unsurprisingly, the *Battle Royale* between state actors and market pundits is being contended at the intersection of US monetary policy and North American *Risk Assets*, namely equities.

Following this week's 75-basis-point increase by the US Federal Reserve's Open Market Committee, or FOMC — the largest increase since late 1994 when the FOMC raised the target rate from 4.75 to 5.5 percent — what has become evident this week is that the protagonists behind this year's ***Taper Tantrum 2.0*** (1.0 being 2013) are clearly motivated in pressuring the US Central Bank to lift interest rates by an entire one percent, or 100 basis points at July's upcoming FOMC caucus – Central Banks around the world are scrambling to keep pace, one day after the FOMC announcement the Swiss National Bank raised its policy rate for



Source: Bloomberg Economics

the first time in fifteen years by half a percent to negative 0.25 percent plus the Bank of England also hiked, with the only disagreement being how fast to continue ratcheting higher from here.

The FOMC seems clear: control inflation at the expense of growth and ensure the cessation of the central bank backstop is overt to everyone.

Many pundits are now forcing a recession as a necessary cure to the inflation dilemma and unsurprisingly global Risk Assets have sold off aggressively again since last Friday as a result.

Cite:- The Monetary Interventionist Wildcard & Start Of A Deeper Corrective Process, 3 May 2020

This is also reflected in the underlying narrative of the US interest rates market, which has shifted with remarkable speed in recent weeks.

As recently as late May, escalating growth concerns and diminished focus on inflation risks had taken yields lower across the curve, with volatility declining as the market coalesced around a central path for the US Central Bank.

While the initial phase of the June retracement was relatively subdued, with curves fairly stable and volatility still contained, last Friday's inflation news and the ensuing shift in FOMC expectations, coupled with some impact from the significant repricing in Europe following the hawkish European Central Bank, sharply accelerated the move.

Since the FOMC hiked in early May, there have been significant shifts in the composition of yields, how the rates market is pricing the distribution of risks and the problem with being in a '*data dependent*' mode, is that the data is not particularly predictable in this unprecedented post-pandemic epoch.

Cite:- Quantitative Easing & Why Financial Markets Appear Complex: Corroboration 'QE' Is The Only Game In Town, 29 October 2020

One material concern with tightening at such a firmly restrictive pace is that it may boost the likelihood that the FOMC would have to cut rates back towards zero nearer to 2024 and despite the correction in equity markets, the yield gap between equities and bonds – a proxy for the Equity Risk Premium or ERP – has narrowed to one of the lowest levels of the post-Great Recession cycle, suggesting that equities will need to deliver strong earnings growth to outperform bonds and compensate for the extra risk.

Without stronger growth, rising bond yields are likely to remain a headwind for equity's absolute valuations: while slowing growth could drive yields lower in the near term, any such decline is likely to be risk-premia led and temporary; a true apex in yields for this cycle is likely to occur only when it is clearer that a pause or end to the hiking cycle is nearing.

Cite:- German-American Interest Rate Differentials: The Bundesbank's, ESG & A Federalised Europe, 8 August 2020

How high US interest rates will ultimately go against this backdrop depends mainly on the path of inflation and as FOMC Chairman Powell continued to make the point, many drivers of inflation are beyond the US Central Bank's control; the price of oil and other commodities depends on the vagaries of the war in Ukraine and the Chinese response to Covid-19.

Notwithstanding, now that the US and other Developed Market, or DM central banks are withdrawing their explicit and tacit backstops, it's difficult to refute the ***monetarists*** position, led by Milton Friedman, which held that inflation was always and everywhere a monetary phenomenon, which following the ***Reflation Supercycle***, refers to unconventional liquidity and outright money printing.

Cite:- Bidenomics, Slavery Reparations & The Global Reflation Supercycle: Atoning For America's Original Sin Recompensed Via Even More Money Printing (US$7-9 trillion), 23 March 2021

Cite:- The Unprecedented Reflation Supercycle: Big, Bold, Strategic Moves, Surreptitious Inflation & The Incandescence of "Swarm Trading", 22 February 2021

There is far more money around than there used to be thanks to Reflation and whilst *main street* has more money on deposit at the bank, it's natural to assume that they'll spend it and thereby drive inflation higher.

As elucidated in ***Seismic Shifts of 2019***, knowing that the economic infrastructure determines the political superstructure, the new industrial revolution creating the knowledge-based economy is replacing the needs of the (human) worker with those of citizens.

The greatest weight on global financial stability is therefore the transition from the old economy to the new and whether looking at North America, Europe, Japan or Australia, financing the overgrown and increasingly ossified state pyramid, built to represent the needs of workers, has become much more difficult.

As a result, there is a complete incongruity between the economic infrastructure and the political superstructure and, as usual, it will be the political superstructure that crumbles – today in 2022 that is being distinctly seen by the withdrawals of government backstops across financial and investment markets. ■