IMAP Specialist series: Implications of Interest Rate rises

Session 1 : Macroeconomic Considerations

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Moderated by David Cohen, Evergreen Consultants

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Institute of Managed Account Professionals

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How to ask a Question

Morgan Stanley

Interest Rate Outlook

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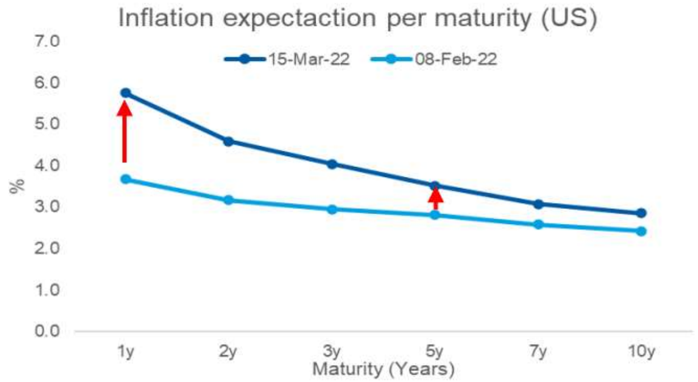
March 2022

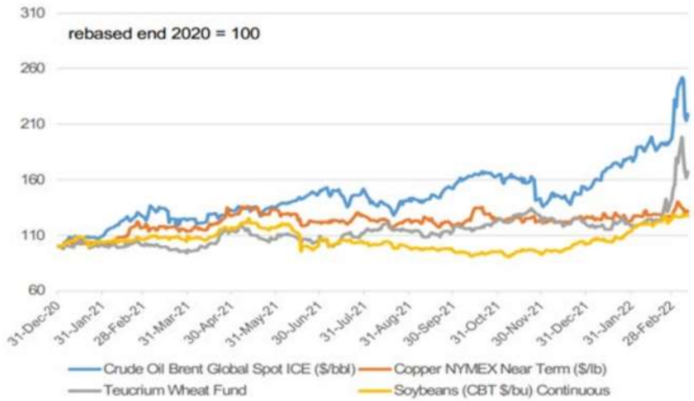
Geopolitical developments in Europe

Uncertainty bodes for prolonged volatility and higher inflation

Markets expect a strong inflationary impact in the short term, but limited in the medium term



Commodity prices were already on the rise prior to the recent events



- While the current geopolitical developments in Europe carry low earnings risk for Australian and US companies, if prolonged could have 3 key implications:
  - Higher energy prices;
  - Heightened volatility/tighter financial conditions;
  - Slower economic growth.

➢ **Morgan Stanley has downgraded 2022 growth forecasts across most regions but still expects above trend growth this year and the next in Australia (4.5% and 3.5%) as well as globally (4.4% and 3.8%).**

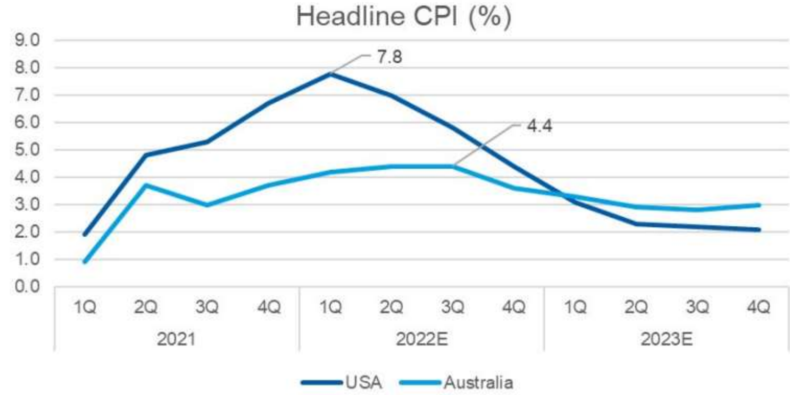
Source: Morgan Stanley Wealth Management Research, Bloomberg, Morgan Stanley Research, Factset. Data as at March 11, 2022.

The tricky handoff (i)

Highest US inflation in 40 years is likely to remain elevated in 2022

Inflation is still significantly higher in the US than Australia, although we expect the gap to close somewhat through 2022

Morgan Stanley forecasts US inflation to peak in Q1, but only be back at target levels by Dec 23



- Morgan Stanley sees US 12-month core PCE inflation at 3.4% in Q4 2022, meaning even if inflation falls throughout 2022, a **return to 'normal' (i.e. Fed target) is a 2023 story.**
- Australia is also witnessing an acceleration in inflation: December quarter headline inflation (1.3% qoq) was the strongest quarterly print since 2008 – we forecast 3.6% yoy for Q4 2022.
- Similarly, we expect inflation in Australia to normalise into 2023 and towards the top of the RBA target inflation.

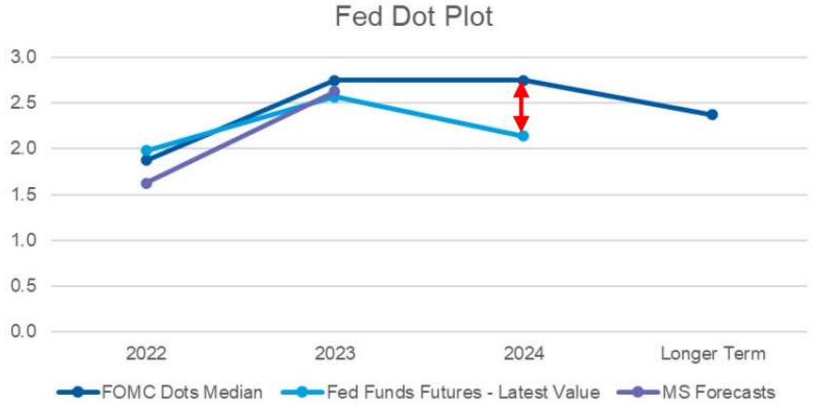
➢ **Inflation is forcing key central banks to abandon their 'lower for longer' stance and move towards hiking rates much quicker and more strongly than previously expected.**

Source: Haver Analytics, Morgan Stanley Research, Bloomberg, Morgan Stanley Wealth Management Research.

The tricky handoff (ii)

Key central banks are now expected to tighten policy materially and sooner than expected

US rates: Consensus aligned on 2022 and 2023, but the market is expecting the Fed to reverse course in 2024



Australian treasury yields continue to trade at a premium to their US peers despite a slower expected hiking path

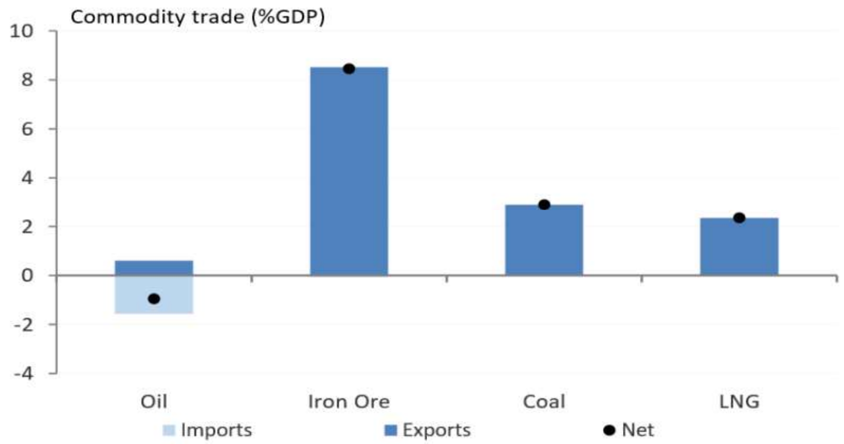
- **Over the next 12 months, key central banks will start reversing their lowest-ever policy rates and their largest-ever balance sheets.**
- Morgan Stanley is now forecasting the US Federal Reserve to deliver a total 150bp of tightening in 2022 and an additional 100bp in 2023.
- Interest rate hikes in the US will be supplemented with Quantitative Tightening likely beginning in May.
- In **Australia**, Morgan Stanley forecasts three RBA rate hikes this year and the cash rate at 1.75% by end 2023.
- The perspective of "higher for longer" rates is expected to be a durable headwind for asset markets, which needs to be repriced accordingly.

Source: Bloomberg, Morgan Stanley Wealth Management Research, Federal Reserve, Morgan Stanley Research.

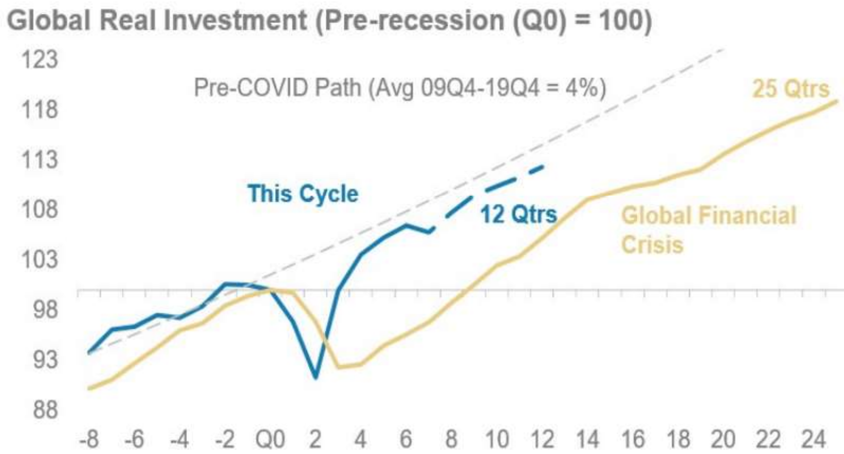
Morgan Stanley continues to see 2022 as a year of solid growth

Economic growth is slowing, but from high levels

Australia is a net exporter of commodities



A strong global investment cycle will support global growth



- The geopolitical developments in Europe are impacting inflation pressures as well as sentiment and Morgan Stanley has downgraded our GDP outlook in most regions. We now see global growth at 4.4% in 2022 and 3.8% in 2023.
- Morgan Stanley sees headwinds to growth in the first quarter of 2022, but we continue to expect solid growth in the US and globally based on a resilient consumer, a strong investment cycle, as well as fading but still stimulatory monetary and fiscal policies.
- Australia is well placed to outperform most Developed Markets this year and the next given strong economic momentum, the nation's position as a commodity exporter, lower inflation pressures, as well as a more accommodative RBA. Morgan Stanley currently forecasts GDP growth of 4.5% for this calendar year and 3.5% for next year.

Source: ABS, Bloomberg, Haver Analytics, Morgan Stanley Research. Note: Trade shares are for 2021. The global aggregate is a weighted average using PPP weights.

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Craig Vardy
Head of Australian Fixed Income
March 2022

BlackRock®

Macro Economics – Implications of Interest Rate Rises

2022 investment themes

Living with inflation – We expect inflation to be persistent and settle above pre-Covid levels. Central banks should kick off policy rate hikes but remain more tolerant of price pressures, keeping real interest rates historically low and supportive of risk assets.

Implication: We prefer equities over fixed income and remain overweight inflation-linked bonds.

Cutting through confusion – A unique mix of events – the restart, new virus strains, supply-driven inflation and new central bank frameworks – could cause markets and policymakers to misread inflation. We keep the big picture in mind but acknowledge risks – to the upside and downside - around our core view.

Implication: We trim some risk amid an usually wide range of economic outcomes.

Navigating net zero – Climate change is part of the inflation story. We believe a smooth transition is the least inflationary outcome, yet even this still amounts to a supply shock playing out over decades.

Implication: We favour developed market (DM) equities over emerging markets (EM).

The opinions expressed are as of December 2021 and are subject to change at any time due to changes in market or economic conditions. Strategic implications refer to long-term views, tactical implications refer to asset views on a 6-12 month horizon.

War complicates the base case in that is adding to the supply shock that was already in train.

The new regime – and alternatives

Global equities

Base case: new nominal
Mildly higher inflation meets with a muted central bank response, keeping real rates historically low. Stocks can thrive, but bonds still suffer as the yield curve modestly steepens.

Safety premium questioned
The perceived safety of government bonds is questioned amid rising debt levels. Investors demand larger compensation for the risk of holding long-term bonds. The yield curve steepens sharply. Yet this is a relative asset shift: equities can still do well.

Productivity boom
Sustained capital investment boosts potential growth, keeping the macro environment disinflationary. The Fed is patient and keeps policy loose, with rates below neutral. The yield curve steepens, real yields stay low, and risk assets do well.

Slamming the brakes
Delays to the restart, perhaps due to a new vaccine-resistant virus strain, result in weaker growth but persistently higher inflation. Central banks aggressively push against inflation, initially sparking a surge in yields. Result: recession with high inflation. The yield move hits stocks hard.

Stagnation
Growth slumps. Inflation pressures abate because labor market slack holds back wage growth. Central banks are unsuccessful in reviving growth and inflation. The yield curve flattens, and equities take a hit as earnings slump.

Runaway inflation
Inflation expectations become unanchored in the post-Covid confusion. A messy transition to net zero could exacerbate this. 1970s-style stagflation is back. Yields surge across the curve and risk assets sell off.

Classic risk-off
Asset bubbles form and burst. Trade wars flare up again and hurt global activity. Central banks struggle to respond. Long-term yields fall sharply amid a flight to perceived safety and the term premium turns negative again. Risk assets suffer.

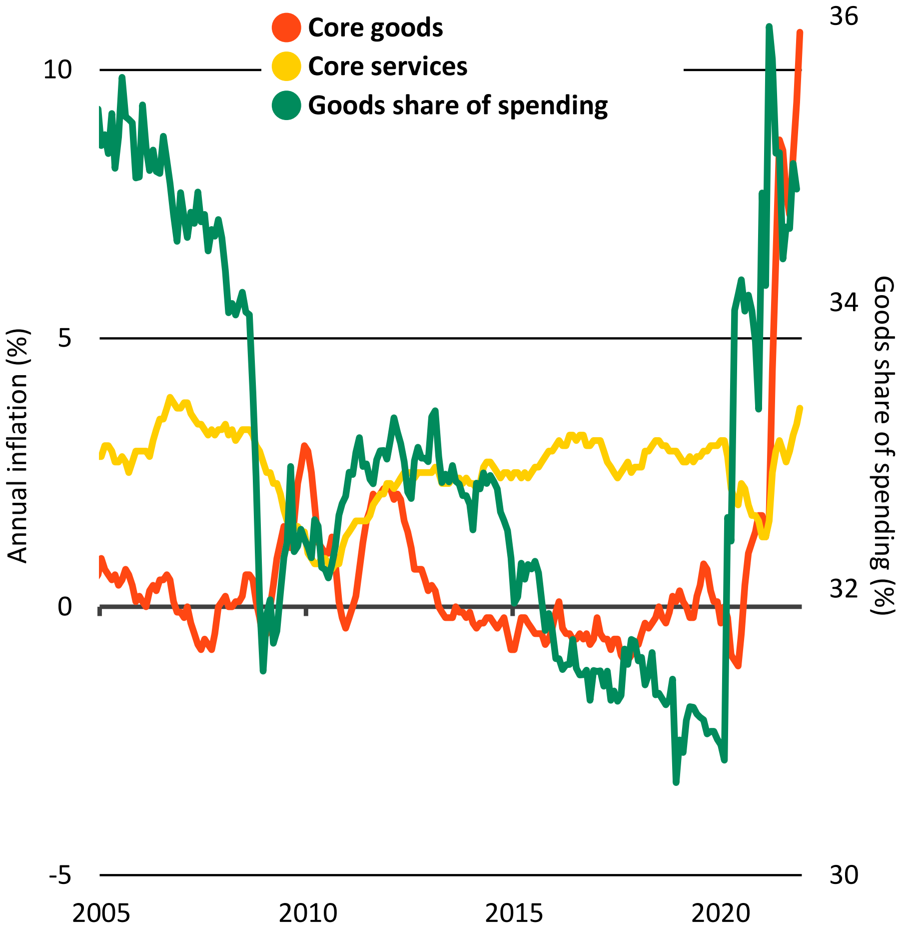
Global bonds

Sources: BlackRock Investment Institute, December 2021. Notes: The schematic shows hypothetical macro and policy outcomes. These are our views on the implications for equities and government bonds as of December 2021. For illustrative purposes only. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any funds, strategy or security in particular.

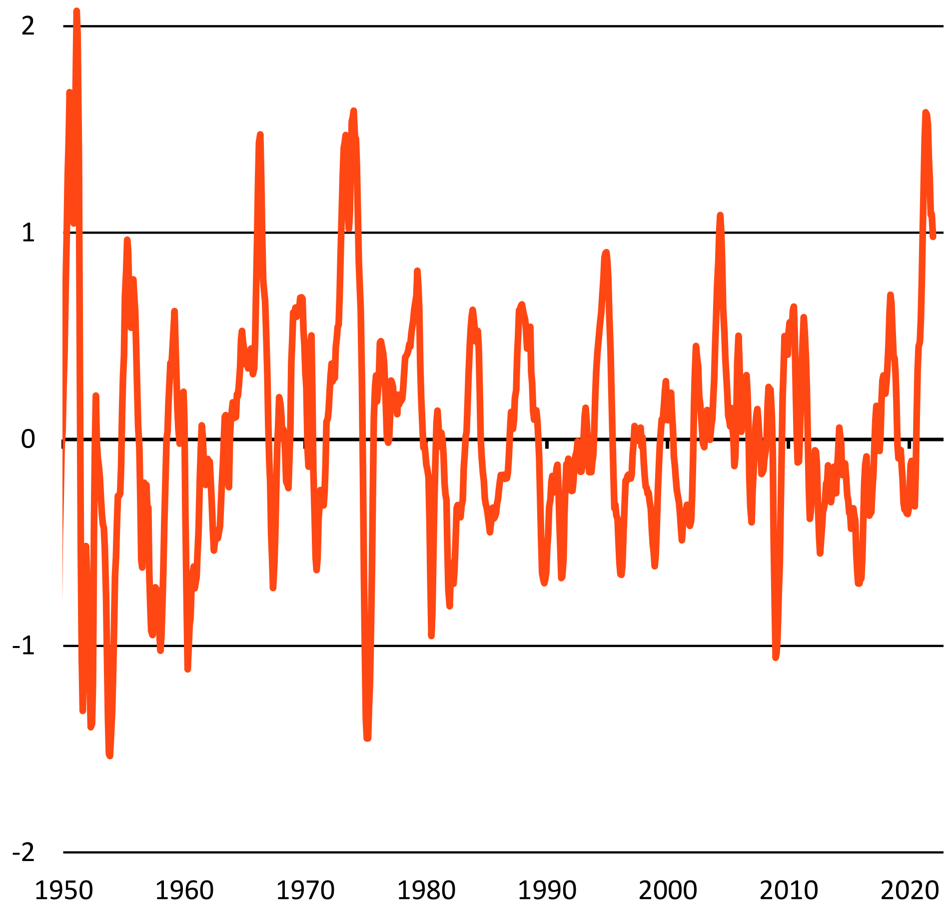
Unusual supply-driven inflation is causing confusion

We are in a new macro landscape where inflation is shaped by supply constraints – a departure from the past few decades. We expect inflation to moderate but settle at higher levels than pre-pandemic.

U.S. goods vs services inflation and spending



U.S. indicator of supply constraints

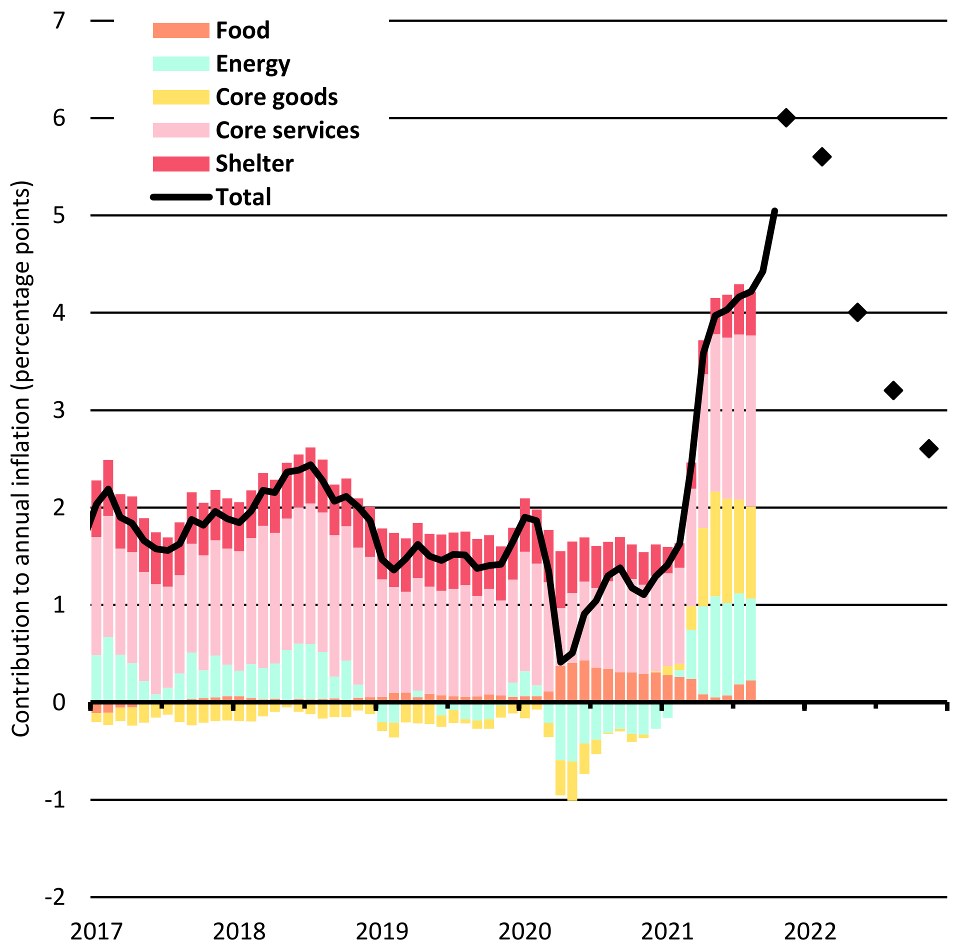


Sources: BlackRock Investment Institute, Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, Institute for Supply Management, with data from Haver Analytics, January 2022. Note: the orange and yellow lines on the chart on the left show core goods and core services CPI inflation respectively, measured by the year-on-year percent change in prices. The green line shows the share of nominal goods spending in total U.S. personal consumer spending. The chart on the right shows the index of manufacturing supply chain constraints. The index is based on ISM survey indicators: supplier delivery times, backlog of orders, prices paid and inventories.

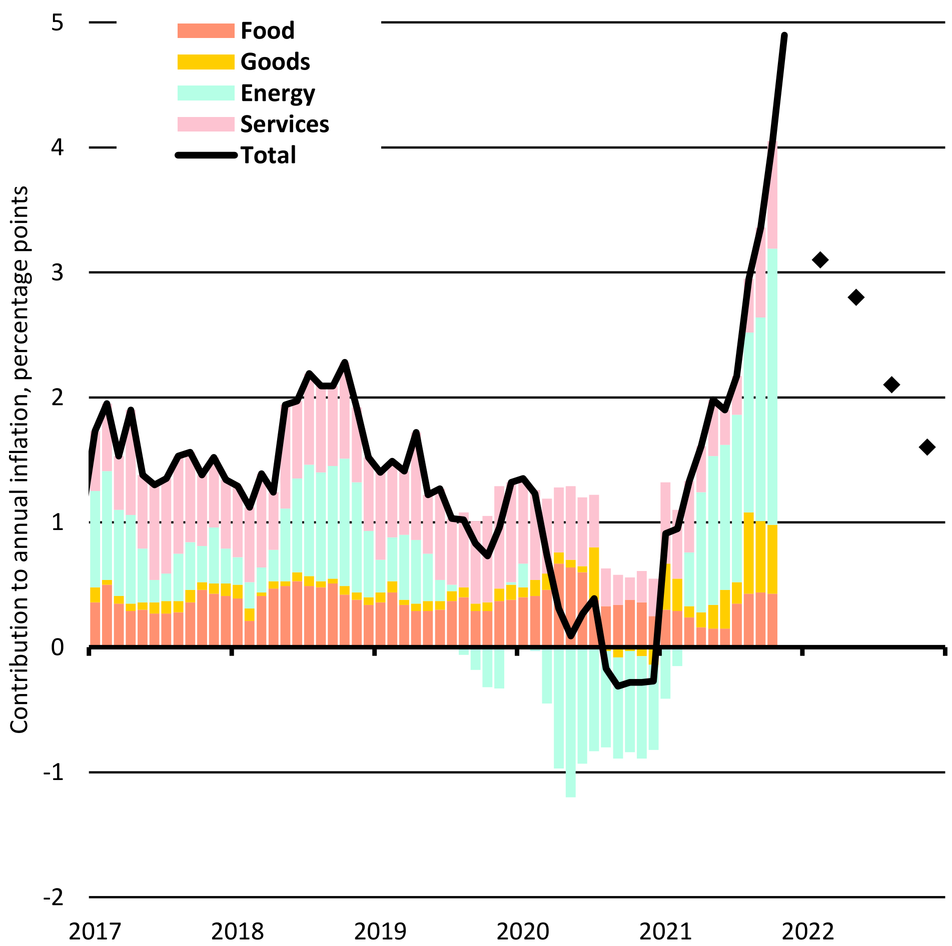
Inflationary pressures have broadened out

Central banks will start to raise rates but remain more tolerant of inflation. Fighting such inflation aggressively with monetary policy will dent growth while doing little to address the underlying cause.

U.S. PCE inflation breakdown, 2017-2021



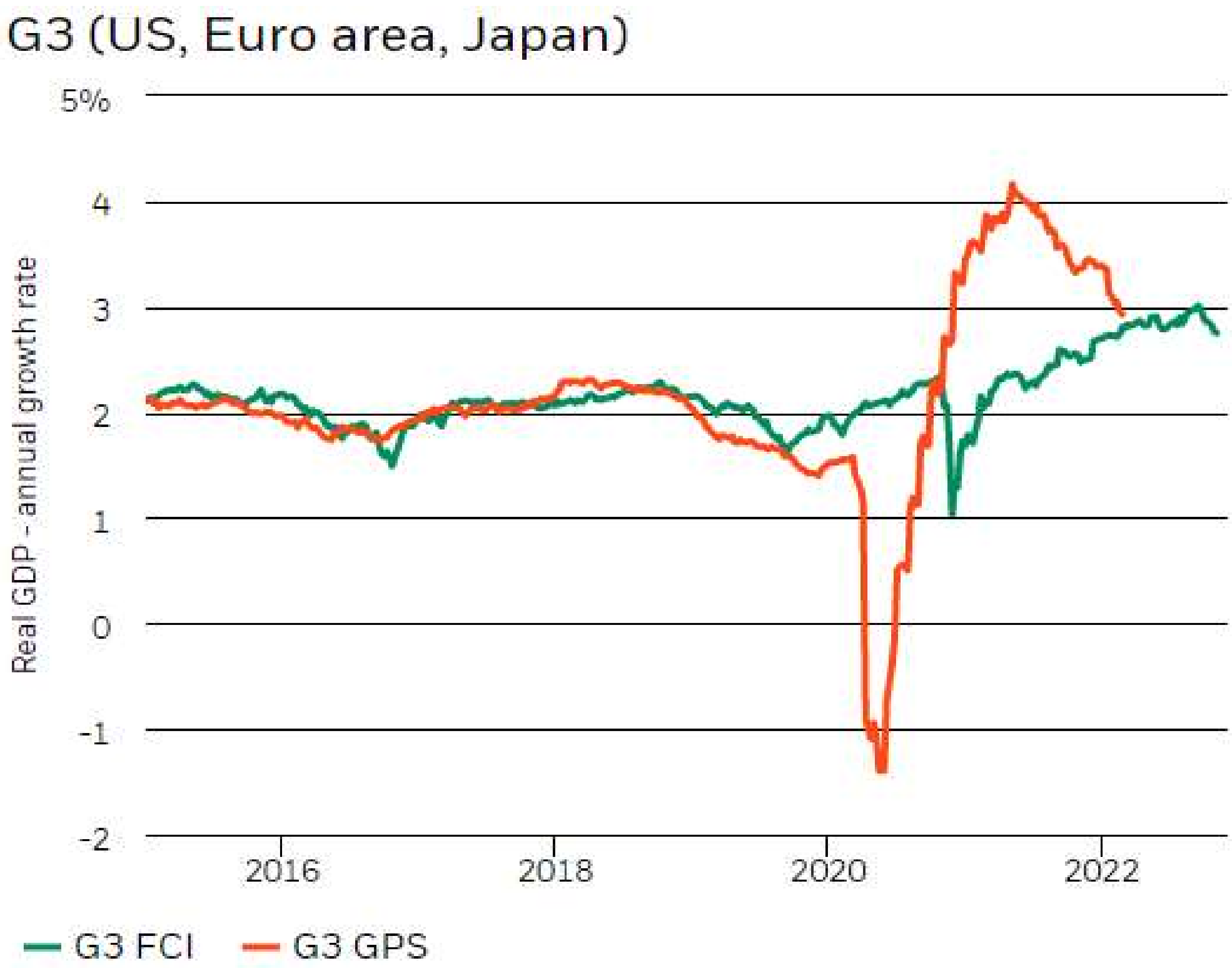
Euro area HICP breakdown, 2017-2021



Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, Eurostat, Reuters News with data from Haver Analytics, December 2021. Notes: the charts show the breakdown of U.S. headline PCE inflation and Euro area headline HICP inflation into the percentage point contribution of different components. The markers show consensus projections of headline inflation rates – or the total shown in the charts above. There are no consensus projections for individual component contributions. "Goods" in the euro area refer to industrial non-energy products. There is no Shelter sub-component in the euro area.

BlackRock Financial Conditions Indicator

Our financial conditions indicators (FCI) give a forward view of where our Growth GPS may head and are expressed in GDP terms.



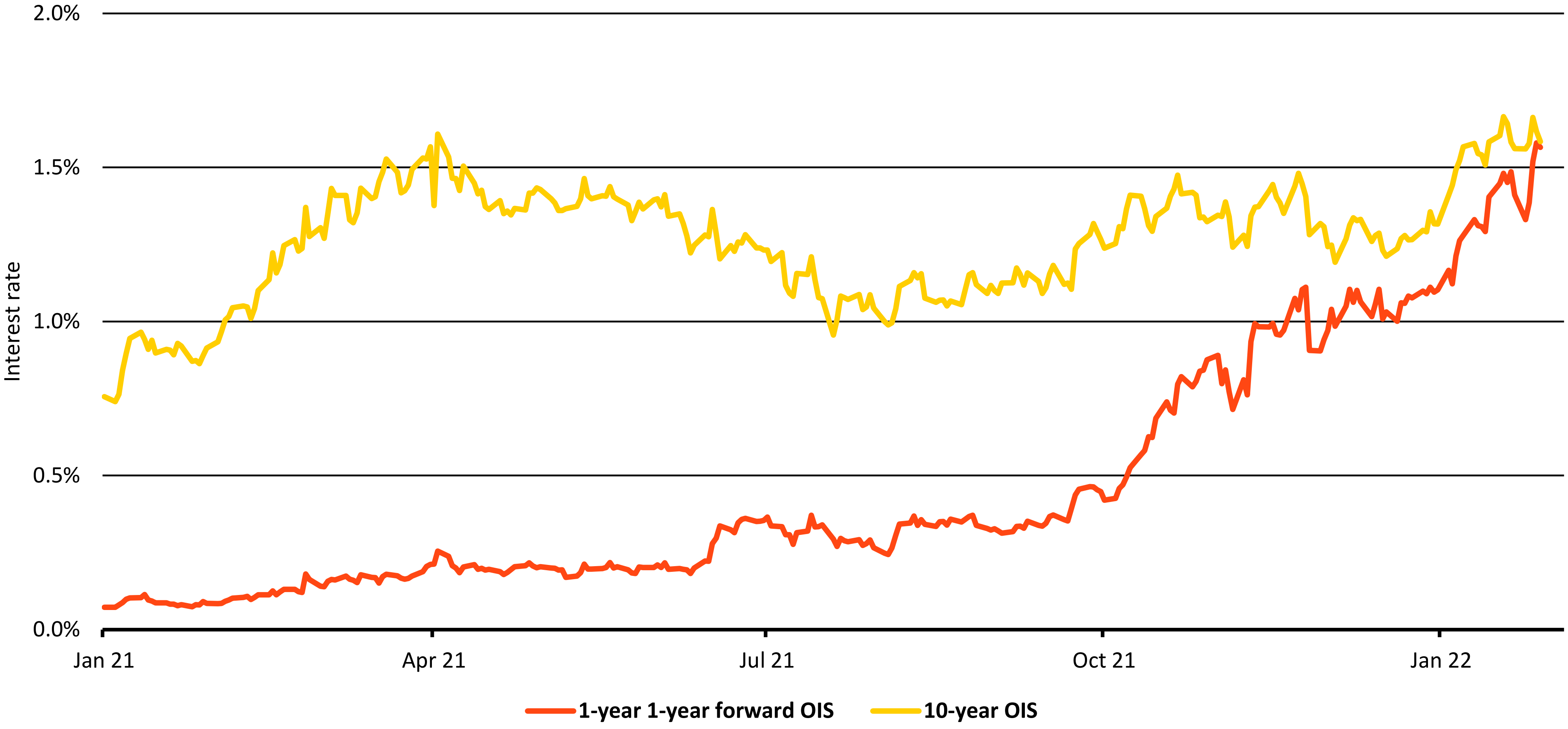
- The BlackRock G3 Growth GPS shows where the 12-month forward consensus GDP forecast for the US, euro area and Japan may stand in three months' time.
- The FCI shows the rate of G3 GDP growth based on its historical relationship with our Growth GPS. The FCI **inputs include policy rates, government bond yields, corporate bond spreads, equity market valuations and exchange rates. The FCI has historically led changes in the Growth GPS.**
- Financial asset prices can both drive and be driven by the growth outlook. Our FCIs keep only the portion of financial asset prices such as real term premia that drive, rather than are driven, by growth news.

Sources: BlackRock Investment Institute and Bloomberg, February 25, 2022. Notes: The green line shows the rate of GDP growth implied by our financial conditions indicator (FCI), based on its historical relationship with our Growth GPS. The BlackRock Growth GPS (orange line) shows where the 12-month forward consensus GDP forecast may stand in three months' time. The FCI inputs include policy rates, bond yields, corporate bond spreads, equity market valuations and exchange rates. Forward-looking estimates may not come to pass

U.S. Federal Reserve rate expectations re-timed, not resized

The sharpest repricing has been in the path of short-rates over the next two years. Long-run rate expectations have remained relatively stable at historically low levels – key for risk asset valuations.

U.S. interest rate expectations, 2021-2022

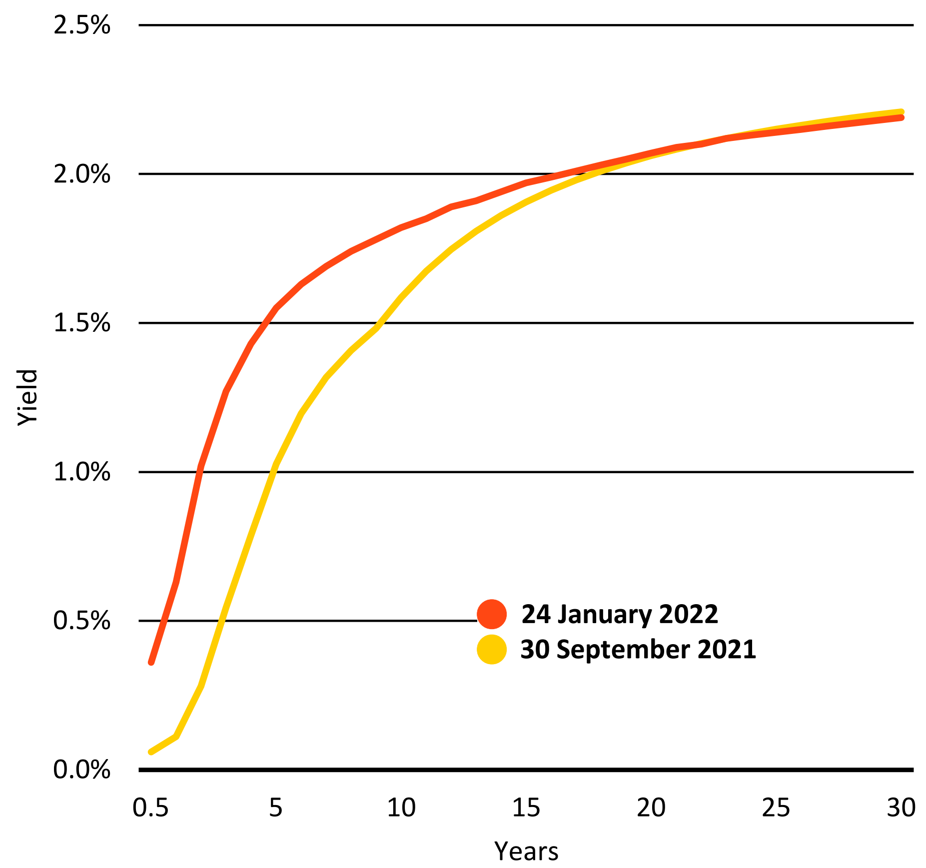


Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, February 2022. Notes: The chart compares near-term market pricing of Fed rate expectations to the end of 2023 (orange line) with market pricing 10-years out based on overnight interest rate swaps (OIS). An OIS is an interest rate swap in which daily payments of a reference rate, such as the effective
federal funds rate are exchanged for a fixed rate over the contract period. This captures the expected path of the reference rate over the contract term.

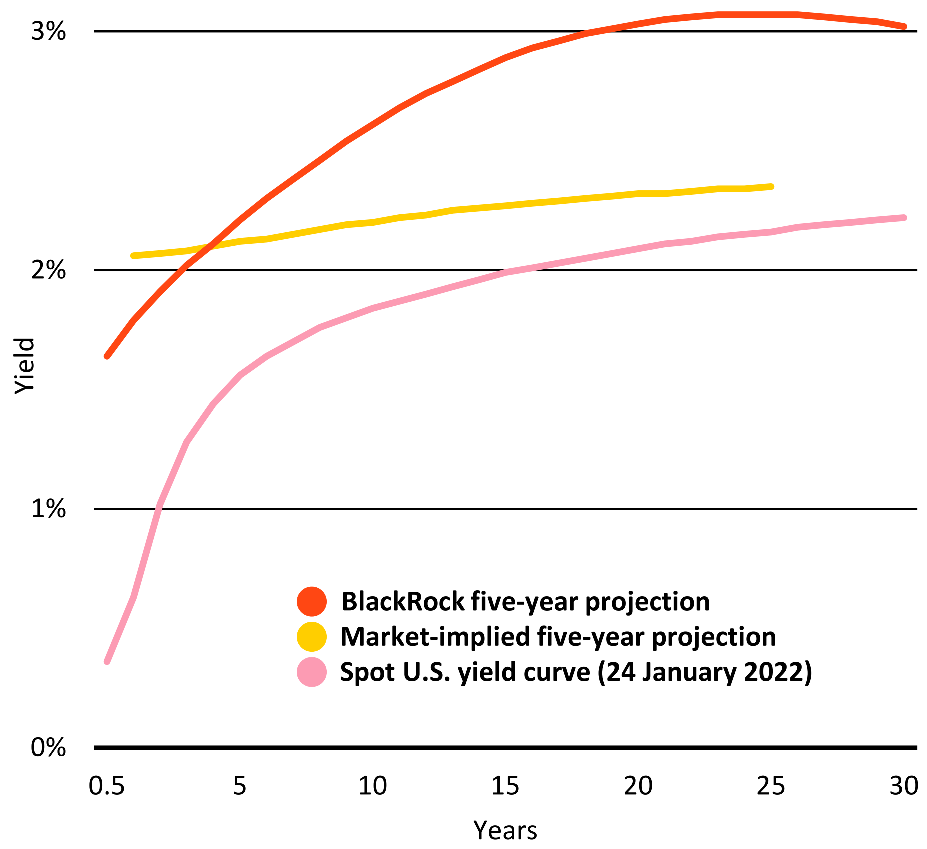
We still expect steeper yield curves driven by term premium

Markets have swiftly repriced a steeper near-term path of front-end interest rates in the U.S. Yet we see markets underappreciating higher term premium in bond markets in the long-run.

U.S. yield curve, Jan 2022 vs Sept 2021



U.S yield curves, spot vs estimates, Feb 2022

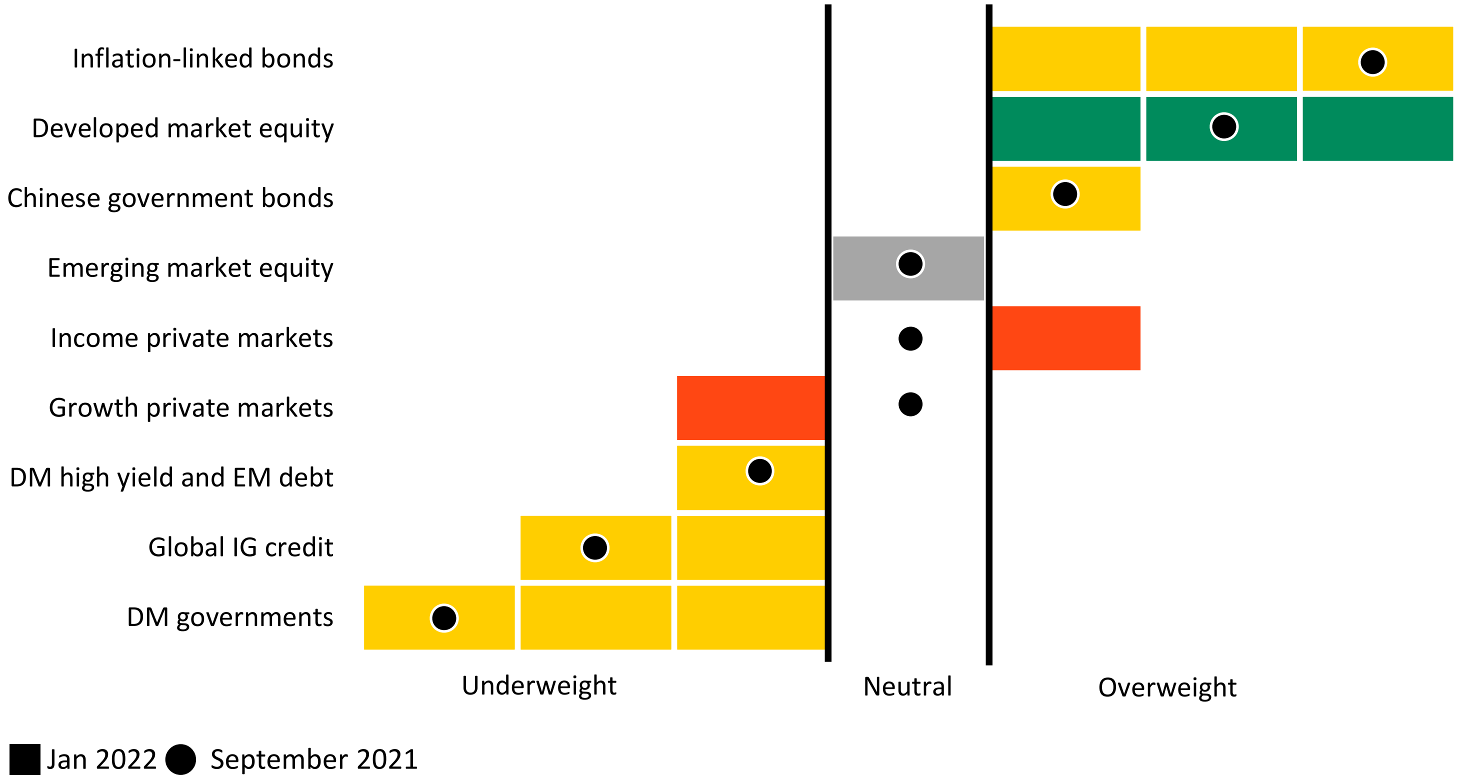


Past performance is no guarantee of future results. Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, February 2022. Notes: The left chart shows the shift in the U.S. yield curve between 30 September 2021 and 24 January 2022. The chart on the right shows the current spot U.S. yield curve (pink), a market-implied projection of the yield curve five years from now based on overnight index swap pricing (yellow line) and our estimate (orange line) of where U.S. yields will be in five years' time.

We prefer equities over credit, government bonds

The sharp repricing of interest rate expectations has hit risk assets. We see a strategic opportunity to upgrade our developed market equity view while retaining our underweight on government bonds.

Hypothetical U.S. dollar 10-year strategic views vs equilibrium, January 2022



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IMAP Specialist series: Implications of Interest Rate rises

Session 2 : Implications on Investments

Amy Xie Patrick, Pendal Group
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Moderated by David Cohen, Evergreen Consultants

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