



It's Shaping Up to be a Volatile Year with the Triple Challenge of Inflation, Rate Hikes and War

By Ali Marshad

US Treasury yields have surged by an average of 150 basis points so far this year with market participants pricing in 7 more rate hikes before year end taking the total up to 10 in 2022 as opposed to the original expectation of only 3 hikes at the start of the year. The high interest rate environment is driven by the fear of rising inflation that looks much more permanent and persistent than previously expected, and it is being further exacerbated because of the war in Ukraine.

Central Banks around the world have been struggling to cope with stubbornly high inflation buoyed by the aftermath of the COVID pandemic which led to global supply chain disruptions and industry bottlenecks thereby pushing inflation to its highest level in 40 years. Soaring commodity prices and price shocks caused by the Russia-Ukraine conflict added further uncertainty to inflation and global growth expectations with investors now pricing in the Fed fund rate to reach 2.78% by the end of the year. As a result, the Fed was forced to raise its interest rates for the first time since December 2018, as inflation continues to run hot at 8.4% and the unemployment rate continues to fall (from 3.8% to 3.6%) with several Fed voting members remaining open to an aggressive hiking trajectory going forward.

Overall, we think that headline and core inflation have peaked in the May print and will only gradually start to drop as base effects kick in (from the price surge in June – September 2021). Inflation is however expected to remain above 8% in the coming weeks due to high food and energy prices as well as European inflation which has surprisingly been on the upside. Higher commodity prices are also filtering into higher transportation costs and higher costs for the service industry for food and restaurants. That said, we acknowledge that 2022 inflation risks appear to be on the upside on balance, given uncertainty from the Russia-Ukraine conflict and the ensuing risk of a further delay in the resolution of supply chain bottlenecks caused by the lockdown in China. That is why the median market consensus for headline inflation remains very high at 7.2%. Nevertheless, markets have now adjusted to high inflation rates and are now looking beyond the inflation horizon.

Currently, however, we think that market dynamics are reflecting fears of a global recession. Massive lockdowns in China this year along with signs of weakening economic activity in some countries, particularly in Europe; as well as downward revisions to company guidance in quarterly earnings results and aggressive monetary tightening are now fostering downward GDP growth revisions in many countries. As a result, we are seeing a shift from inflation to recession concerns with the probability of a US recession having risen to 30% as of June. The World Bank has also cut its global growth estimates to 2.9% for 2022 and even lower in 2023.

Notwithstanding that the upcoming rate hikes do not push growth over a cliff, this type of growth deceleration coupled with strong commodity prices, may be best described as a “not too hot, not too cold ” global backdrop, which should be supportive for GCC credit returns. The market negativity since the beginning of the year has translated into more constructive technicals especially as investors hold elevated cash positions while new debt supply has remained subdued.

The challenging backdrop of high inflation, tighter global financial conditions and rising core yields has weighed on the performance of EM fixed income since the start of 2022. In the GCC for instance, Saudi and Qatar were amongst the worst performing fixed income markets, both down by 10.7%, followed by the UAE; down 9.4%. On the other hand, the smaller, more oil dependent nations such as Oman and Bahrain outperformed as they dropped by only 3.6% and 2.7% respectively.

However, the recent stabilization in core yields has driven the asset class to perform better since mid-May but spreads remain above average for most names. We think this more constructive price action could extend on subdued positioning, hiking cycles well advanced/priced in, and attractive EM rates valuations both in absolute terms and relative to DM rates which should support GCC bonds going forward supported by high oil prices. We acknowledge, however, that the continued tightening by central banks, high inflation and recession remain real risks. Hence, we become more constructive on duration and see select opportunities in low GCC cash bonds and in corporates that have lagged the recent rally, particularly in oil-related names although a meaningful turnaround is unlikely unless we see more liquidity enter the markets.

Even before the Russia-Ukraine war began, we experienced volatility in the first quarter of the year with inflation consistently ticking upwards in every major geography. Central banks turned hawkish towards the end of 2021 and kept leaning aggressively into that message from the start of 2022. With that in mind, we have been maintaining a low duration stance in all our fixed income portfolios which has helped us outperform so far this year (-3.5% on average vs -8.6% on the Bloomberg GCC bond index whilst on the Shariah Compliant mandates -2.5% on average vs -5.0% on the Bloomberg GCC Sukuk Index). Additionally, we have held an overweight to high yield on commodity exporters as well as real estate as they tend to be the natural beneficiaries of higher inflation and commodity prices.

Turning our attention to the Fed, we now look for two 50 bps hikes in June and July followed by three 25 bps hikes in each of the last three months of the year. The SICO Capital Money Market Portfolio offers one of the best ways to capture the higher interest rates with most of the underlying securities and deposits linked to SOFR and equivalent short-term rates. The 3-month Bahraini Interbank Rate for example rose from 1.60% to 2.80% this year, mimicking the expected rate hikes by the US Federal Reserve earlier until June and is likely to increase by another 1.75 percentage points to 4.1% should the Fed raise interest rates by a total of 10 times this year as predicted by Fed fund futures.

Other GCC short term interest rates are likely to follow suit given their pegged rates and hence our money market solutions can help our investors to preserve capital and offer attractive yields. Investors will also be given the opportunity to rotate into higher yielding fixed income securities at the end of the rate hike cycle particularly into the GCC with the stronger backdrop of regional markets, supported by healthy oil prices and a positive ratings outlook.