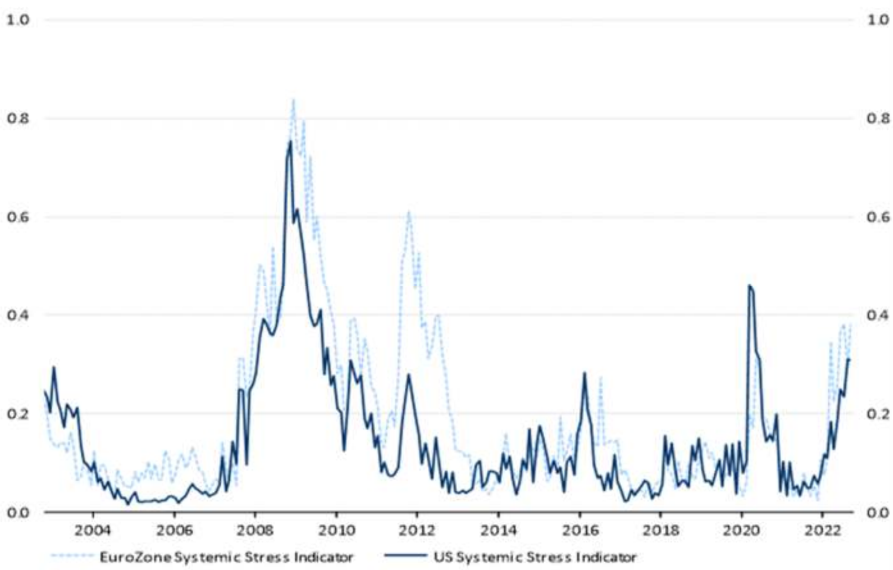
October 2022
Issue No. 25

GLOBAL INSIGHT

Overview

- In our Macro View, we consider the evidence that higher rates are already beginning to cause issues in the wider economy.
- However evidence continues to gather that suggests we are, at least, fast approaching peak levels of US inflation. Where do we see current opportunities?
- In our Investment Outlook, USD strength continues to dominate the narrative, with implications for relative performance across asset classes and geographies.
- Markets remain too optimistic with respect to the earnings outlooks in our view, leaving room for disappointment.
- In our feature piece, Mark Nash of Jupiter Asset Management assesses the impact of Central Bank policy on government bond markets and discusses some of the opportunities this creates for active fixed income investors.
- Indicators of systemic risk produced by the European Central Bank suggest the risks of a more significant issue have been quickly increasing in 2022. This is yet another factor suggesting further caution with respect to portfolio positioning in the near-term.

Systemic Risks are Rising



Inside this issue

Economic Highlights

- Inflation markets are now pricing US headline inflation to average just 2.9% over the coming year. US interest rate futures are anticipating peak interest rates of c.4.5% by March 2023, where they are now expected to remain for the balance of the year.
- Falling valuations in equity markets have been consistent with the overall increase in real yields.
- Short term fixed rates on UK mortgages have risen significantly, precipitating a likely slow down in the housing market.

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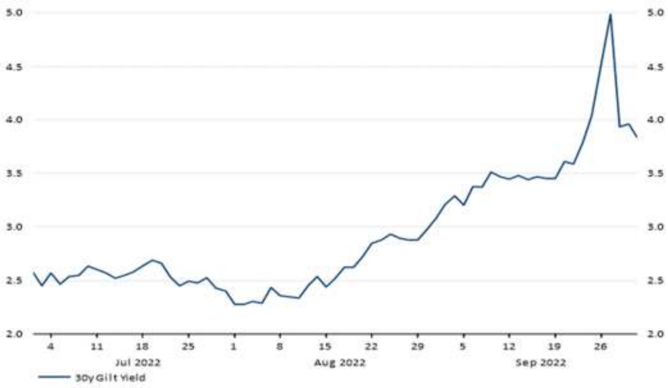
Based upon information available up to and including
14th October 2022

Key Issues in Charts

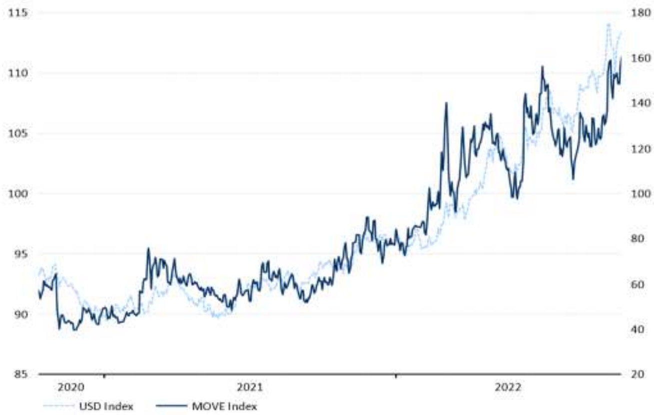
Long-dated UK Government Bond Yields in Q3 2022



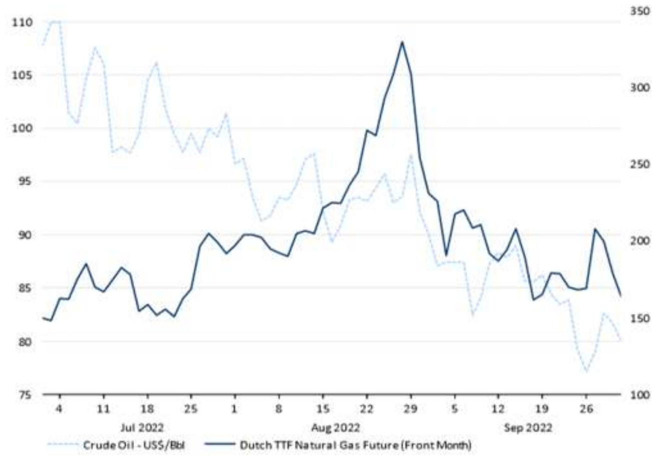
- Long-dated government bond yields behaved erratically over the 3rd Quarter.
- The worst of these moves was initially triggered by the UK governments so-called ‘mini-budget’ which promised to deliver a variety of unfunded tax cuts.
- The sharply negative reaction from bond and currency markets triggered margin calls at a number of large UK pension funds.
- The Bank of England subsequently stepped in to calm markets through the temporary purchase of government bonds.

US Dollar Index continues its ascent

- Higher interest rates and uncertainty in bond markets has helped support a significant rise in the US Dollar, which shows few signs of letting up.
- The MOVE index measures market expectations of future volatility in bond markets and is trading at levels last seen during the Financial Crisis in 2008.
- USD strength presents issues for areas such as Emerging Markets which carry high levels of USD-Denominated debt.



Energy price pressures in Q3 2022



- Oil prices provided some respite to consumers over the quarter as Crude oil fell from $110 per barrel to nearer $80 per barrel.
- Discussions between developed market government and the OPEC producing countries continues around the appropriate balancing of supply and demand.
- European natural gas prices also softened from earlier peaks but still remain highly elevated and problematic relative to historical levels.

Higher Rates Start to Bite

By Adam Jones, Senior Investment Manager

During the third quarter, markets continued to wrestle with Central Banks who have now made crystal clear that their only current objective is to suppress end demand to such an extent that, in addition to ongoing supply constraints, higher energy prices and latent inflationary pressures from the housing market, consumers will be forced to pull back on expenditure to a very significant extent. Interest rate markets earlier this year had been pricing the expectation that the Federal Reserve would have to begin lowering rates around Q3 2023, an expectation that several Fed Governors pushed back on aggressively over the period. This left markets with little choice but to finally take them at their word.

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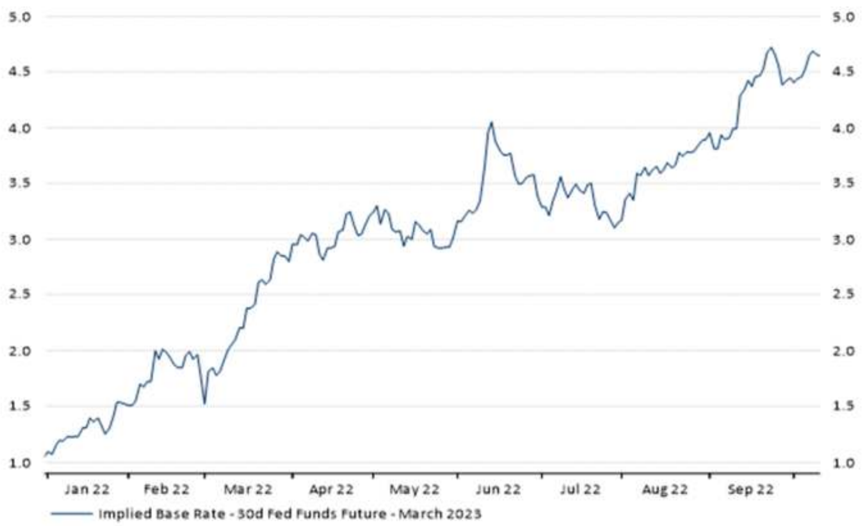
Futures Pricing US Rates in Excess of 4.5% by March



Source: *Hottinger Investment Management / Refinitiv Datastream*

The result has been a painful one for equity markets in particular, whose strength in July & early August was quickly reversed by the end of September. Base rates in the US are now expected to peak at around 4.5% by March 2023 and remain on hold through at least the end of the year. The difficulty we are currently having is in interpreting just how quickly the effects of tighter policy are likely to manifest in the wider economy. Nobel prize winning economist Milton Friedman famously wrote about the 'long and variable lags' involved with the setting of monetary policy and from this perspective we are yet to face the consequences of the significant increases in rates that have already occurred, let alone those that are still to come.

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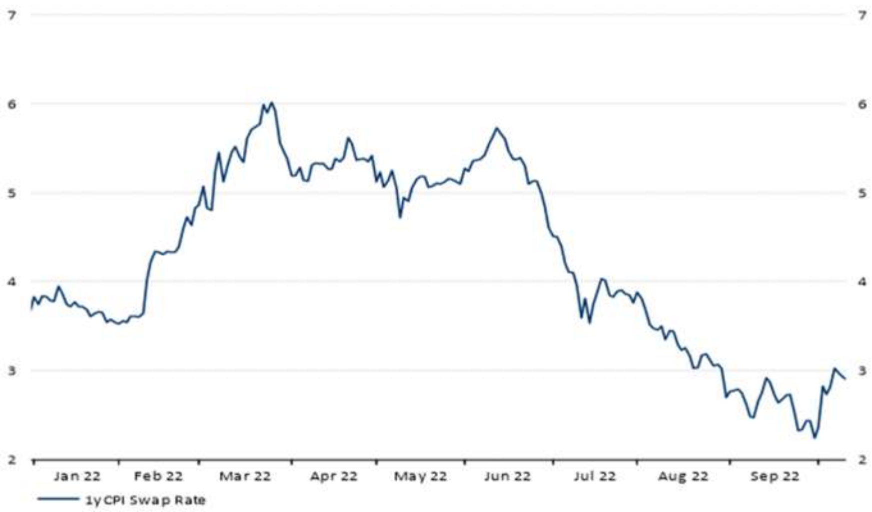
Friedman, M. (1961) The Lag in Effect of Monetary Policy. The Journal of Political Economy, 69, 447-466.

Our belief is that inflation markets should perhaps cast a more useful light on forward-looking market expectations.

With interest rate markets having finally accepted the resulting path of rates our belief is that inflation markets should perhaps cast a more useful light on forward-looking market expectations. Here we note that over the coming year headline US CPI is priced to average just 2.9%. The fact that we are starting from a current level of 8.3% therefore suggests an especially rapid decline in inflation, the likes of which can only really be consistent with the prospect of recession.

Inflation Swaps Pricing a Rapid Decline in Inflation



Source: *Hottinger Investment Management / Refinitiv Datastream*

For us a key variable to monitor in this respect is the labour market, more specifically the JOLTS data and Quits rate.

This decline is, of course, also consistent with the idea that the peak in headline inflation is increasingly likely to be behind us. For us a key variable to monitor in this respect is the labour market, more specifically the JOLTS data (total number of job openings) and Quits rate (total number of people quitting their job – which has historically been a sign of confidence that they can find employment elsewhere).

Labour market data points toward an easing of wage pressures.

Fewer Job-Openings and a Cooling in the Quits Rate Point to an Easing of Wage Pressures

Source: *Hottinger Investment Management / Refinitiv Datastream*

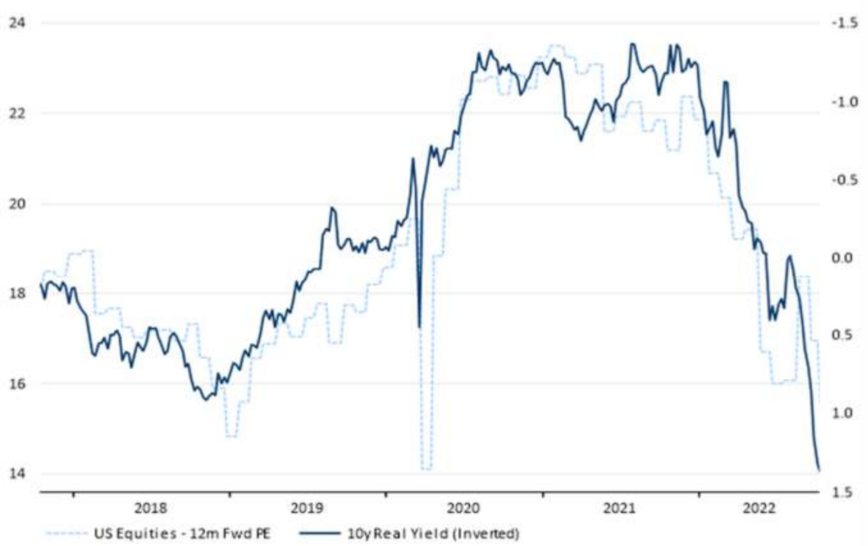
These datasets have tended to provide a useful short-term steer on the direction of travel for employment costs, which constitute a large part of the Fed's concerns around more persistent long-term inflation.

A recent softening in this data also coincided with a significant, albeit short-lived, rally in equity markets, something we believe could well happen again.

A recent softening in this data also coincided with a significant, albeit short-lived, rally in equity markets, something we believe could well happen again should this continue. It is indeed a strange world we live in where fewer jobs provide a catalyst for market strength.

These inflationary prospects, when coupled with the expectation of higher interest rates, point to the idea that 'real' (i.e. after inflation) interest rates should continue to rise. It is this dynamic which has, and will likely continue to exert downward pressure on the valuations assigned to US equities. Our view is that markets could well trade within a range over the coming months as these dynamics play out and we learn more about third quarter earnings over the months of October & November.

Lower Equity Multiples are Consistent with the Change in Real Yield Expectations



Source: *Hottinger Investment Management / Refinitiv Datastream*

Our view is that markets could well trade within a range over the coming months as these dynamics play out and we learn more about third quarter earnings.

Closer to home we have also seen the emergence of stress in certain market segments as a result of the pace and veracity of increases in rates. The UK bond market faced significant challenges in recent weeks given the emergence of liquidity issues in the enormous (and apparently highly leveraged) Liability Driven Investment sector, which consists primarily of defined benefit pension schemes. The move was triggered by the UK's new government announcing a variety of unfunded fiscal measures, which stand in direct contrast to the current intentions of the Bank of England who are seeking to tighten monetary policy. Bond markets were quick to revolt, an issue that was quickly addressed, albeit poorly, by the Bank of England who stepped in to purchase Gilts on an ongoing basis.

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Our bigger concern is that this might be the first of many liquidity and/or leverage events that could surface as a consequence of economies having spent many years in a zero rate environment with very little surrounding volatility.

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Without wishing to sound too gloomy the more worrying issue in our view lies with UK housing. The UK mortgage market has a very different structure to that of the US, where mortgages typically carry a fixed rate of interest for the entirety of the loan's term (usually 30y). Here in the UK we tend to borrow far more so in 2yr & 5yr fixed instruments, which move to a variable rate following the initial period. According to the Bank of England's most recent data, some 80% of outstanding UK mortgages carry an initial fixed rate term of below 5 years which leaves our property market more exposed to higher rates than most. Recent changes also do not paint an especially encouraging picture for the average future value of UK property.

Change in UK Short Term Fixed Mortgage Rates Suggests Lower Property values in the Year Ahead

Source: *Hottinger Investment Management / Refinitiv Datastream*

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Given the regulatory environment for UK banks over the past decade (and their resulting balance sheet strength) we do not believe a decline in property values would lead to any kind of broader contagion or financial crisis. However, the basic implication is that UK consumers will now have to add falling property values to an already long list of growth headwinds (higher energy costs, higher mortgage & debt payments, sterling weakness to name just a few).

As mentioned above we consider ourselves to still be in the relatively early stages of higher interest rates (whose effects we know to come through on a lagged basis) and we are already seeing casualties emerge. The likelihood of policymakers taking rates too high, too fast drives us to position ourselves especially cautiously as we look out toward the end of the year. The corollary, of course, is that we still see a number of exciting opportunities in individual equities whose investment prospects look brighter than ever.

One area of particular interest is Technology, where for many businesses we would argue the structural outlook has become far more positive in the context of increased focus on areas such as cyber-security, business efficiency and the benefit of low relative total labour costs. We can today find many examples of world-class companies whose share price has fallen by 60-80% from their highs, which we believe has largely been a function of the move in interest rates and resulting impact on Net Present Values as opposed to any sustained deterioration in the underlying business model.

The higher rate environment may well be here to stay, at least for now, but being able to acquire these sorts of high growth, high margin lowly-indebted businesses at levels significantly below average valuations (in both relative and absolute terms) feels, at least in some cases, like too good an opportunity to miss.

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"…to buy when others are despondently selling and sell when others are greedily buying requires the greatest fortitude and pays the greatest reward…"

Sir John Templeton

Whilst we are humble enough to acknowledge that we may not have seen the immediate peak in inflation (owing to volatility within its component parts) we do think the outlook for the next 1-2 years is clearly lower, which gives us more confidence when looking at potential new additions to client portfolios.

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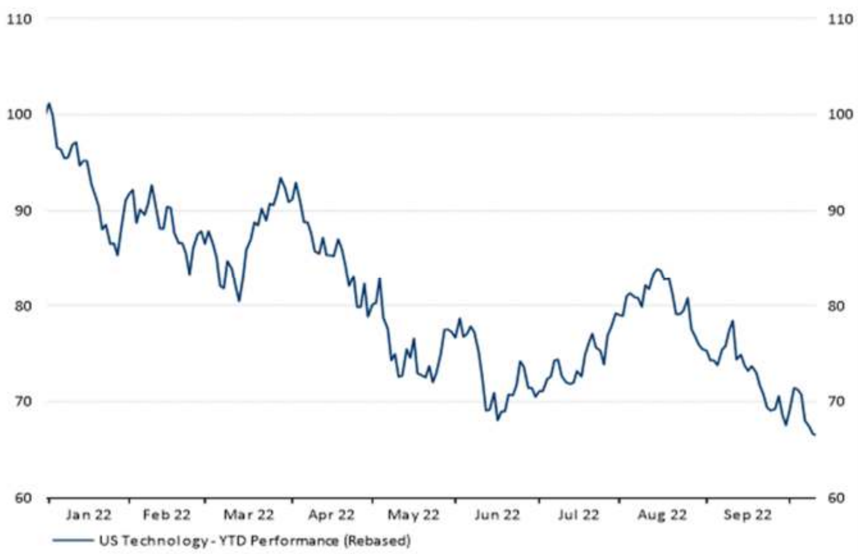
US Technology Sector



Source: *Hottinger Investment Management / Refinitiv Datastream*

Investment Outlook

The determination of central banks to quell rising levels of inflation through a series of significant interest rate rises soon had investors taking stock of the valuations of all asset classes.

The buoyant mood of investors at the beginning of the quarter stemmed from the belief that by the middle of 2023 central banks will be reversing policy in the face of weakening growth and the term “pivot” was introduced by financial commentators to explain this phenomenon. As the summer heatwave continued the determination of central banks to quell rising levels of inflation through a series of significant interest rate rises soon had investors taking stock of the valuations of all asset classes.

The rise of inflation as more than just a short-term phenomenon has meant that markets continue to be largely driven by macro-economic outcomes.

Since the Global Financial Crisis markets have been supported by central bank policy so when quantitative easing policies began to be reversed many started looking for markets to start operating efficiently once more under their own direction. However, the rise of inflation as more than just a short-term phenomenon has meant that markets continue to be largely driven by macro-economic outcomes that are currently unfavourable for traditional asset classes adjusting to the prospect of a period of recession and limited investment choices. This has provided a productive environment for the alternative fund universe, especially macro-driven hedge fund strategies, illustrated by the HFRX Hedge Fund Index which was up 10.7% over the quarter to 16.9% year-to-date.

Energy and industrial metal prices have fallen significantly over the course of the quarter reflecting the increased likelihood of global recession. Oil has retreated 23.4% over the course of the quarter despite supply disruptions. Commodities more generally fell 7.5% over the quarter but remain up 10.4% year-to-date. In particular energy prices have fallen the best part of 30% since June alleviating some of the supply side pressures that were prevalent during the first half of the year. Gold continued to prove itself a poor safe haven losing 8.1% over the quarter to trade near lows of $1650/oz prompted by continued dollar strength and higher real yields.

In times of trauma traditional asset classes become more positively correlated so it has been a miserable year for financial markets.

In times of trauma traditional asset classes become more positively correlated so it has been a miserable year for financial markets. Global equities are down 26% and global government bonds 21% year-to-date in dollar terms[i]. Within equity markets there are two observations we would make. Historically, the defensive qualities of US equity indices have been notable when markets are under pressure due to their liquidity and depth of the market’s diversification but it would seem not this time. Secondly, large cap UK equities have held up relatively well being down only 6.6% this year despite the poor underlying environment for the UK economy.

US equities have fallen in line with both other developed and emerging market indices as the enlarged technology sector has re-rated after years of outperformance.

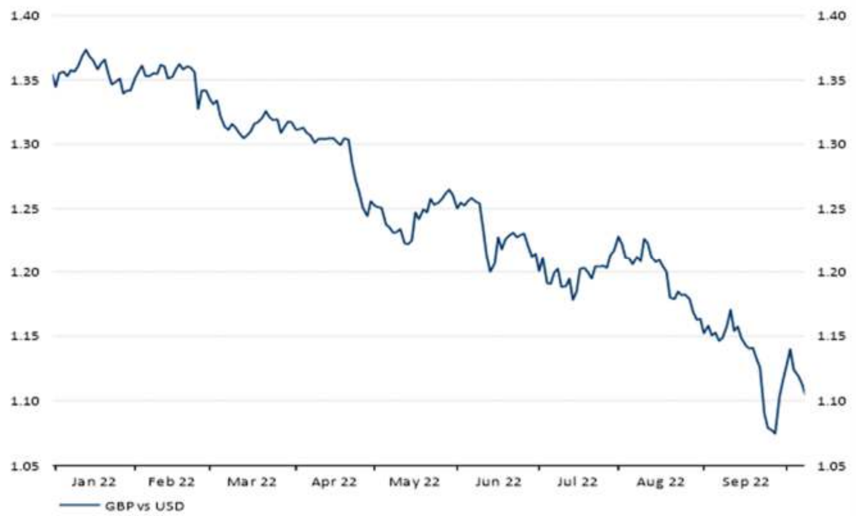
Possibly due to the size of mega-technology companies, such as Microsoft and Apple, as a percentage of US equity indices, US equities have fallen in line with both other developed and emerging market indices as the enlarged technology sector has re-rated after years of outperformance. This is further illustrated by the S&P growth and value indices which also exhibit different defensive return profiles down 30.9% and 17.9% year-to-date respectively. To emphasise the point further using the ARK Innovation ETF as a proxy for disruptive technology outside of the "mega-caps", the fund has lost 60% of its value so far this year as the sector has re-rated. Over the course of the quarter, however, US growth has outperformed value by 4.1% versus 6.4% with most of that outperformance happening during July when markets were reacting favourably to the possibility of an early "pivot" by the Fed. Looking forward, we would argue that the US has a better outlook than Europe due to fewer energy problems and, therefore, closer to peak inflation as well as our expectations that the US dollar will remain strong. This would favour US assets when the underlying macro picture becomes more favourable which is why growth sectors jump at the prospect of any light at the end of the tunnel although we believe that currently equity earnings expectations are overly optimistic so any sustainable rally will occur from a lower starting point.

Looking forward, we would argue that the US has a better outlook than Europe due to fewer energy problems and, therefore, closer to peak inflation as well as our expectations that the US dollar will remain strong.

With regards to the second observation, 80% of the earnings of the large global companies listed in the UK are derived from overseas[ii] which clearly supports equity valuations at times of turmoil. The strength of the US dollar versus sterling benefits dollar earners who pay their dividends in sterling so that even if a company does not increase revenues, it can still maintain its dividend in sterling terms. Small and mid-cap stocks that rely on the domestic economy struggle, falling 10.5% this year, given the deteriorating UK economic environment, while overseas earnings and the number of global oil companies and miners listed in the UK has supported large-cap UK equity. Conversely, it could be argued that the UK economic difficulties since Brexit have kept UK assets at already relatively cheap valuations that may help explain the interest shown in UK corporate assets by overseas competitors. Although the state of currency markets can be mainly attributed to US dollar strength this year, the weakness of sterling due to the poor and deteriorating political and economic back drop in the UK will challenge the robustness of UK equities going forward. The pound is down 8.6% this quarter and 17.8% year-to-date versus the dollar and 11.1% weaker against its major trading partners[iii].

Overseas earnings and the number of global oil companies and miners listed in the UK has supported large-cap UK equity.

GBP vs USD



Source: *Hottinger Investment Management / Refinitiv Datastream*

We cannot help but feel that markets are still too overly optimistic against a backdrop of deteriorating global growth.

Analyst downgrades have only just begun when OECD Global consumer confidence has already turned extremely weak.

This leaves plenty of room for disappointment when price-to–earnings multiples are still priced close to historical averages which poses downside risks to equities.

Developed Government bond markets have reacted to the aggressive tightening stances of their central banks and yield curves have significantly inverted.

We expect energy inflation will keep bearish pressure on European government bonds and the EUR throughout the coming quarter.

The fourth quarter starts with the reporting season for earnings, and we cannot help but feel that markets are still too overly optimistic against a backdrop of deteriorating global growth. Mid-September the price of Fedex fell 20% following a warning on the outlook for global shipping volumes, and Ford indicated that third quarter earnings would be below consensus estimates due to input costs[iv]. Absolute Strategy Research (ASR) contend that US earnings momentum has only recently turned negative and analyst downgrades have only just begun when OECD Global consumer confidence has already turned extremely weak. Barclays report that consensus forecast for S&P full year 2022 earnings-per-share stands at $227, a rise of 1.5% year-to-date, which they believe is over-estimating earnings by 3-5% and 2023 by 10%[v]. UK and European consensus are equally reflecting healthy EPS growth in 2022 and 2023. This leaves plenty of room for disappointment when price-to–earnings multiples are still priced close to historical averages which poses downside risks to equities.

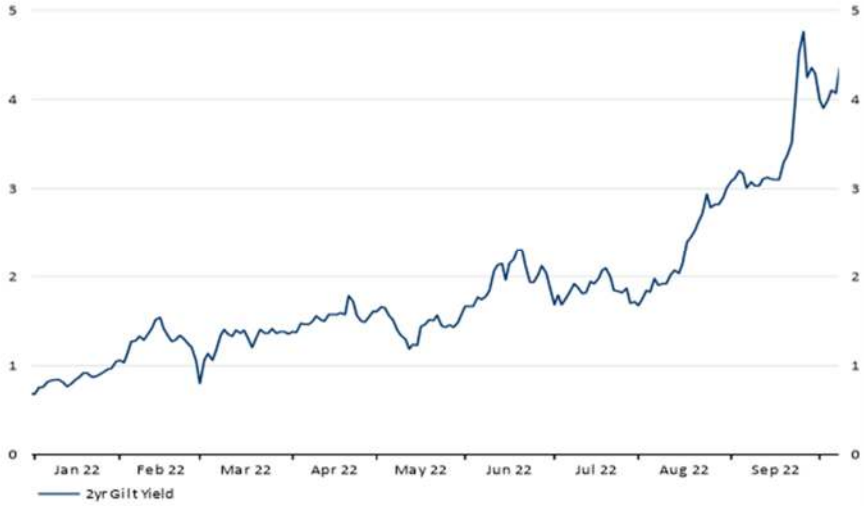
The increased likelihood of recession putting increased pressure on earnings could be further affected by a drop in share buybacks. Corporate buyback programmes have significantly bolstered the performance of equities over the last decade and a reduction in cashflow may make certain buyback programmes unsustainable. In fact, ASR calculate that recent buyback funding ratios suggest that a high proportion of recent buybacks are less than 50% funded by cashflow and the size of remaining programmes in operation leaves the effect highly concentrated[vi]. Weaker profits will clearly affect the repurchase flows in 2023 and could further undermine equity market performance.

Developed Government bond markets have reacted to the aggressive tightening stances of their central banks and yield curves have significantly inverted meaning yield of 10-yr bonds are lower than 2-yr bonds as investors believe that a recession is around the corner. 2-yr yields have reflected the aggressive tightening of central banks led by the US Fed with three 75bps hikes to counter strong inflation growth while 10-yr yields reflect the decay to future coupon payments due to persistent inflation. The dollar index was up 7.1% over quarter, 17.2% year-to-date, leaving the EUR, Pound and Yen under pressure as the ECB, BOE and the BOJ struggle to counteract Fed policy. US Treasury prices backed up 4.4% over the quarter while UK gilts struggled with the market's extreme reaction to the new governments inflationary mini budget backing up 13.9% over the quarter to be 26.6% lower year-to-date.

We expect energy inflation will keep bearish pressure on European government bonds and the EUR throughout the coming quarter although the EU is working hard on a cross-country scheme to split the pricing of electricity and gas allowing a cap on non-gas generated electricity. Germany's unilateral stabilisation fund seems to have undermined the creation of a unified EU response to the energy crisis and provoked criticism from smaller, more indebted nations. We believe the situation is likely to worsen, and the EU is no nearer solving the problem merely redistributing the cost to safeguard the private sector, undermining the ECB's ability to tackle inflation.

Over the course of the quarter High yield credit has outperformed investment grade credit in the US but the opposite seems to be true in Europe potentially

2 year Gilt Yield



Source: *Hottinger Investment Management / Refinitiv Datastream*

UK gilts struggled with the market's extreme reaction to the new governments inflationary mini budget .

further highlighting the pressure within the energy sector. As interest rates move higher, many companies could face higher refinancing costs and credit spreads are yet to reach the levels normally associated with recessions, 200-210bps in investment grade and 850-900bps in high yield[v]. Therefore, we remain cautious on corporate bond markets and with the dollar expected to remain strong see little respite in Emerging market debt markets either .

As interest rates move higher, many companies could face higher refinancing costs and credit spreads are yet to reach the levels normally associated with recessions.

In summary, inflation data points to further interest rate tightening and financial markets will probably remain macro-led. Slowing growth should continue to erode pricing power and margins leading to weaker equity prices in coming quarters. We would continue to favour defensive and quality stocks with strong cash flow and robust balance sheets over growth and cyclical sectors. Government bond curves remain significantly inverted reflecting fears of a deep recession in 2023 in many economies. This leaves investors not properly compensated for duration risk but in fear of aggressive moves in the short end until such time as a central bank pivot returns to the forefront. Overall, the weakness in equities still leaves bond markets looking more attractive in relative terms although there are many stresses within credit which may well see rising default rates.

In summary, inflation data points to further interest rate tightening and financial markets will probably remain macro-led. Slowing growth should continue to erode pricing power and margins leading to weaker equity prices in coming quarters.

[i] Statistics sourced from Refinitiv Workstation

[ii] https://www.ftadviser.com/investments/2022/09/09/ftse-can-do-well-despite-the-economic-outlook/

[iii] Statistics sourced from the Bloomberg Terminal

[iv] Absolute Strategy Research – Earnings season: How Bad Will It Be?

[v] Barclays – Investment Outlook: The US, and then the rest...

[vi] Absolute Strategy Research – Investment Committee Briefing – October 2022

Governments Put Their Bond Markets in the Firing Line

By Mark Nash, *Fund Manager, at* ***Jupiter Strategic Absolute Return Bond Fund***

The fluid macro environment over 2022 has been an excellent playing field for macro investors.

The fluid macro environment over 2022 has been an excellent playing field for macro investors as the shifts in sovereign fundamentals have not been this aggressive since before the financial crisis. Amidst all the volatility, there has been defined macro regimes producing market trends that flexible portfolios can capture. However, to be successful, portfolio constructs have had to change and adapt as the market's views on growth and inflation have not remained static.

The pressure facing developed market economies has come from both external and internal sources.

The pressure facing developed market economies in 2022 has come from both external and internal sources. The sanctions that followed Russia's invasion of Ukraine has excluded the largest fuel producer from the global economy and has heralded a new era of expensive and inelastic global energy markets. It marks a very big shift towards the end of globalisation as cheap and easily accessible energy is not available anymore. Expensive energy hitting strong economies drove inflation higher and trade balances lower for those without adequate domestic energy resources. Looking more broadly, expensive global resources appear permanent, as a lack of investment in recent decades in resource extraction and energy infrastructure and the green transition compound problems.

In conjunction with expensive energy the wage / price spiral risks are real.

A shortage of labour in the West has made the situation worse. Labour is suffering from weakened post Covid health services, tighter immigration policies and, for demographic reasons, more retirees. In conjunction with expensive energy the wage / price spiral risks are real. As goods prices have eased back in recent months on the back of improving supply chains, services prices have boomed as economies reopen. This classic macro imbalance drove a singular response from central banks: to crush demand.

The weaker growth this produced combined with deteriorating trade balances for developed market commodity importers and the 'cost crisis' meant currency markets took the strain, as expensive imports damaged private sector balance sheets. Whilst the move in currency markets favoured the resource rich economies, the sell-off in the bond market was not on firm ground.

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The high inflation levels reached over the summer morphed into intense recession risks as high prices destroyed both consumer and business confidence. Commodity markets also succumbed to weaker growth providing some welcome relief. However, as the Ukrainian conflict intensified, and energy became weaponised, global energy prices fractured with European natural gas prices surging as oil fell. As recession concerns grew, global bond markets staged an impressive recovery over the summer months. Whilst central banks secretly enjoyed this demand destruction, governments were not pleased. The recent fiscal spending announcements to support economies changed the market calculus dramatically. As governments took the problem onto their balance sheets stimulating the private sector, inflation once again became front and centre.

This shifted the strain from foreign exchange to the bond markets, resulting in a dramatic bond sell off in recent weeks. Bond investors need higher returns to fund governments and support this new policy mix at a time demand needs to fall, not rise. Central banks need to counter this by getting policy rates higher. In the UK, the fiscal injection was untargeted and stimulatory at a time inflation hovered above 10%. With the central bank reticent to hike, sovereign risk rose as the gilt market, led by the long end, came under serious pressure. The UK might have the highest external funding needs but it's also a window into what is impacting all energy importing economies. Poorly constructed fiscal policy working against central bank actions is clearly not a good mix for the sovereign bond markets.

Poorly constructed fiscal policy working against central bank actions is clearly not a good mix for the sovereign bond markets.

This opens a new chapter for markets in 2022, one in which financial risks are now a problem, alongside the existing inflationary supply and demand imbalance. European governments are now writing blank cheques to cover energy costs dragging their own fiscal balances into the firing line. Sensible government policy has never been so vital. Whereas higher energy had a weakening impact on private sector demand previously, it does not have the same effect now, as governments absorb the cost. If energy prices move higher still, to keep the confidence of the markets tighter central bank policy and government austerity measures will be needed. If this doesn't happen, inflation will not come under control and reliance on external funding sources will intensify. This will prove very difficult for some policymakers given the hardship this imposes on the wider population. Markets will force borrowing costs higher to make sure central banks and governments respond adequately.

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Markets will force borrowing costs higher to make sure central banks and governments respond adequately.

This is also where the US could get dragged down by European problems. As often is the case in a financial crisis, the globally connected financial system transmits problems across the globe. A deterioration of European sovereign risk will likely see a scramble for US dollars everywhere to pay for expensive energy and in some cases intervention in domestic currencies. Either scenario will lead to a selling of US Treasury bonds and an uncontrolled tightening in US financial conditions. That's a feature markets have seen time and time again (the most extreme example being the Covid lockdown volatility in 2020) as US funding its massive current account gets dragged into the mire due to intense global dollar demand. The new Federal Reserve US Dollar lending facilities (Federal Reserve US dollar swap lines and Standing Repo facility) will unlikely be able to prevent it. The steep decline in global sovereign reserves held at the Federal Reserve ominously show this is already happening alongside a deterioration in US Treasury liquidity. The unprecedented global condemnation of UK policies in recent weeks is a recognition of these stresses.

European governments have unleashed the new financial risk fault line with untargeted stimulatory policies.

This all adds another dimension to a very complex policy backdrop. The central banks continue to try to push down growth to combat inflation with very limited success so far. This is being countered by Russia continuing to fan the flames to boost energy prices (Nord Stream pipeline explosion) to keep up the pressure for winter 2023. Western sanctions on Russia only work to boost energy prices further. In direct geopolitical conflict with the US, OPEC cutting production to boost oil prices is an alarming new development supporting the Russian agenda. Finally, European governments have unleashed the new financial risk fault line with untargeted stimulatory policies.

Tight energy and labour markets will continue to dominate with government debt the loser until global growth is crushed, unemployment rises, and energy prices decline across the board.

Tight energy and labour markets will continue to dominate with government debt the loser until global growth is crushed, unemployment rises, and energy prices decline across the board. Rates have moved higher dramatically in 2022 but still none of these factors have been fulfilled. Unless something on the geopolitical stage changes, high bond yields are required to achieve these outcomes making a persistent bond rally unlikely. Western media focus on Russian battlefield losses ignores the financial weaknesses being exploited by Russia against the West. The silver lining of course is Putin is unlikely to escalate into tactical nuclear weapons given that his leverage is improving, not declining, as most think.

A dividing line between sovereign bond markets with natural resources and those without is being drawn, blurring the previous 'developed' and 'emerging' market classifications.

A dividing line between sovereign bond markets with natural resources and those without is being drawn, blurring the previous 'developed' and 'emerging' market classifications. Less inflation and reduced fiscal stress for resource independent countries support their bond market valuations but for the others, higher yields are needed. As the western bond market bubble bursts, both default stress and housing market pain will be accentuated, impacting growth outcomes. Whilst the broad-based and front-loaded bond sell off might soon reach its climax, macro-economic divergence in economies is only increasing and how central banks and politicians react to their own unique circumstances will determine yield levels, curve shape and foreign exchange prices.

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