Beneath the Surface

February 2023

SIGNET

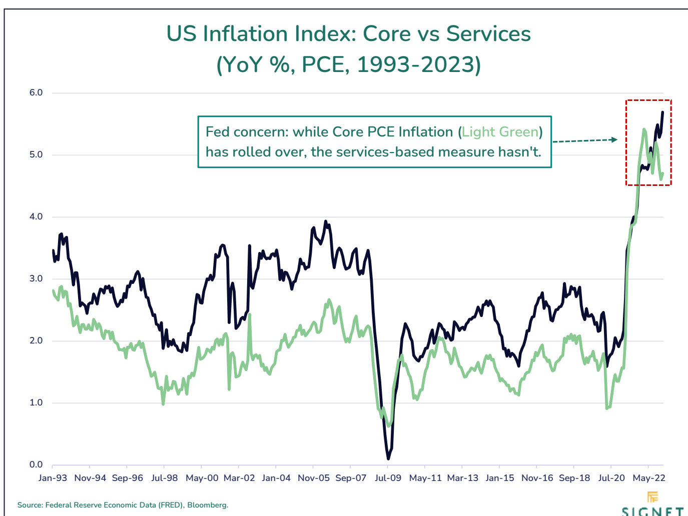
The Trouble with Inflation Expectations

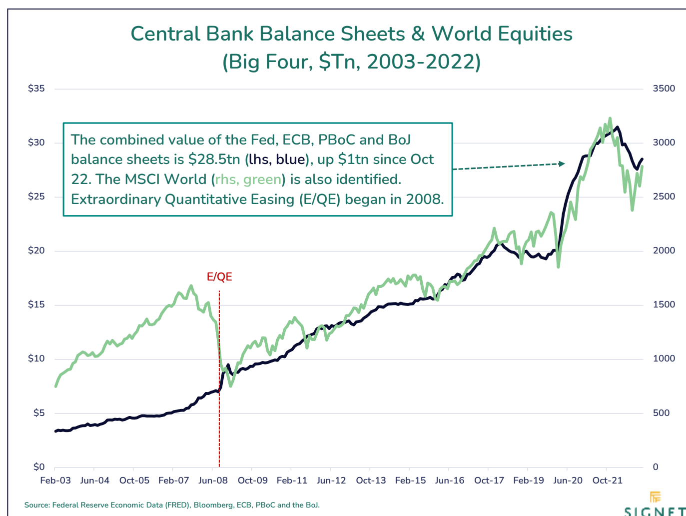
- In January, we highlighted the aggressive nature of current monetary policy, relative to the more measured approaches we have experienced in recent decades. In the US, the Effective Federal Funds Rate has been hiked at 4.2% per annum, a speed that has only been exceeded once, during the early 1980s under Paul Volcker, and that was between recessions. The central bankers' objective has been to stop inflation expectations spiraling out of control. Central bank behaviour, and their communications, influence inflation expectations and ultimately, therefore, the macroeconomic outcome. Inflation expectations are an important determinant of realised inflation, so the ongoing expectations must be rigorously steered towards the "transitory" narrative and away from the unanchored wage-price "spiral" narrative.

- The Fed's role has been hampered recently by services-based inflation data which, unlike the headline metrics, has not rolled over and continues to plough higher. Even without the volatile housing component, the services-based inflation data remains uncomfortably elevated and sticky. The chart on the left highlights this dilemma, reflecting the disruption to the relationship between these two metrics. Consequently, both the Fed's narrative and actions have appeared increasingly hawkish in the last two months, and this is now being priced into the markets. Further, broad money aggregates, such as M2 or the commercial banks' 'Other Deposit Liabilities' (ODL), are now contracting on a year-on-year basis, which is extremely unusual. The last time the US economy experienced contracting money supply, along with rate hikes, was in 1931.

- The aggressive nature of current policy may prove to be the foundation of the second major policy error since Q1 2020, as investors are whipsawed by overreactive policy makers. The stance of monetary policy has lagged implications for the stability of the financial system of course; empirical evidence suggests that a loose monetary policy stance over an extended period leads to increased financial fragility with a time lag. Market fragility is often preceded by the search for yield (greed), the rapid expansion of unproductive credit, the interconnectedness of markets and the exuberance of shadow banking. The source of this fragility is therefore closely connected to financial repression – a constant in the years 2008 to 2022 – and the distortion of market incentives and signals. Stability breeds instability, as Hyman Minsky suggested, and it may not take much of a spark to trigger a fire.

- Lastly, we must consider the central bank asset management programmes. In March, the ECB will join the Fed in quantitative tightening; neither bank has extensive experience of this process. A cursory check of central bank balance sheets, mapped against a world equity index (chart right), suggests that caution is warranted for now.





- **Therefore:** We remain cautious so remain defensively invested. Fixed Income: there are opportunities to target quality and liquidity. Equities: target quality but there's no rush. Commodities: target precious metals.

Research Report Disclaimer: This communication and all the information provided is marketing material. The views and opinions contained herein may not necessarily represent views expressed or reflected in other communications and/or strategies of Signet Capital Management Ltd. (the "Company"). Therefore, this material is intended to be for information purposes only and is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Please read our Marketing Communication Disclaimer for further assistance.

Marketing Communication Disclaimer: The content of this material is a marketing communication and does not constitute any form of independent investment advice and/or recommendation and/or research. The material is for general information purposes only (whether or not it states any opinions). Nothing in this material is (or should be considered to be) legal, financial, investment and/or other form of advice and/or recommendation on which reliance should be placed. No opinion given in the material constitutes a recommendation by Signet Capital Management Ltd. (the "Company") or the author that any particular investment, security, transaction or investment strategy is suitable for any specific person. Although the information set out in this marketing communication is obtained from sources believed to be reliable, the Company makes no guarantee as to its accuracy or completeness. All information is indicative and subject to change without notice and may be out of date at any given time. Neither the Company or the author of this material shall be responsible for any loss that you may incur, either directly or indirectly, arising from any investment based on any information contained herein. This material may include charts displaying financial instruments' past performance as well as estimates and forecasts. Any information relating to past performance of an investment does not necessarily guarantee future performance. Please seek independent advice.