Lotos Asset Management

Quarterly Investment Strategy

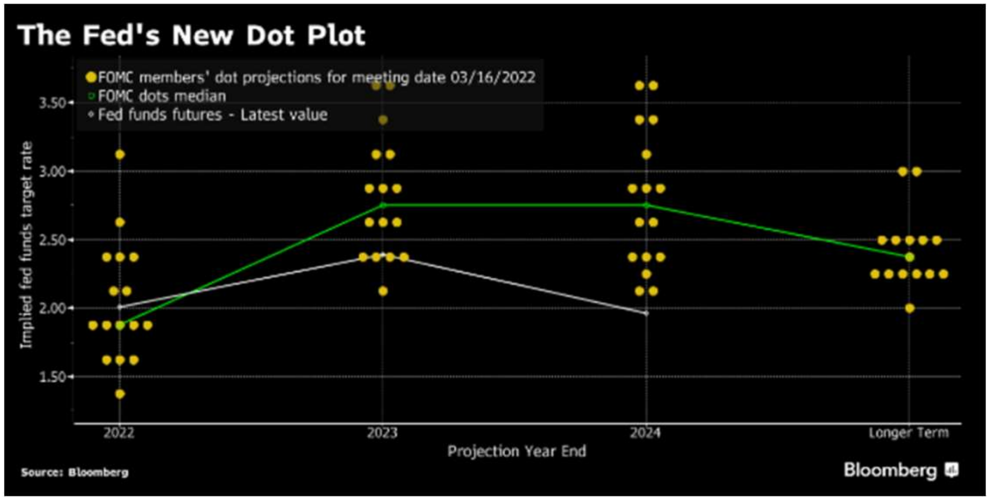
April 2022

How close are we to the peak in interest rates?

2022 was supposed to be a complex and difficult investment year with stubbornly elevated inflation, rising rates, supply bottlenecks, margin uncertainties and differences in handling the Corona crisis leading to volatility. But considerable external shocks and subsequent sanctions reinforced certain worrisome trends even further and increased unpredictability sharply.

In one crucial field, we were offered however more insights: The Federal Reserve (Fed) revealed its plan how to shrink its balance sheet. A total of $ 95 billion a month are foreseen, consisting of $ 60 billion in Treasuries and $ 35 billion in mortgage-backed securities. The last time the Federal Reserve has undertaken the same endeavor from 2017 to 2019 a peak rate of $ 50 billion was reached. On the other hand, quantitative tightening of $ 95 billion a month is notably less than the $ 120 billion that the Fed was buying for most of the last year. The minutes also showed that many officials would have preferred to raise the target rate by 50 basis points instead of the 25 basis points that had been finally applied, but were held back by negative international events. The latter also amplified the risk to inflation. This explains the more aggressive approach in respect to rate hikes and the balance sheet runoff. Factors highlighted in the minutes that could keep inflation elevated include strong aggregate demand, significant increases in energy and commodity prices, and supply-chain disruptions that are likely to require a lengthy period to resolve.

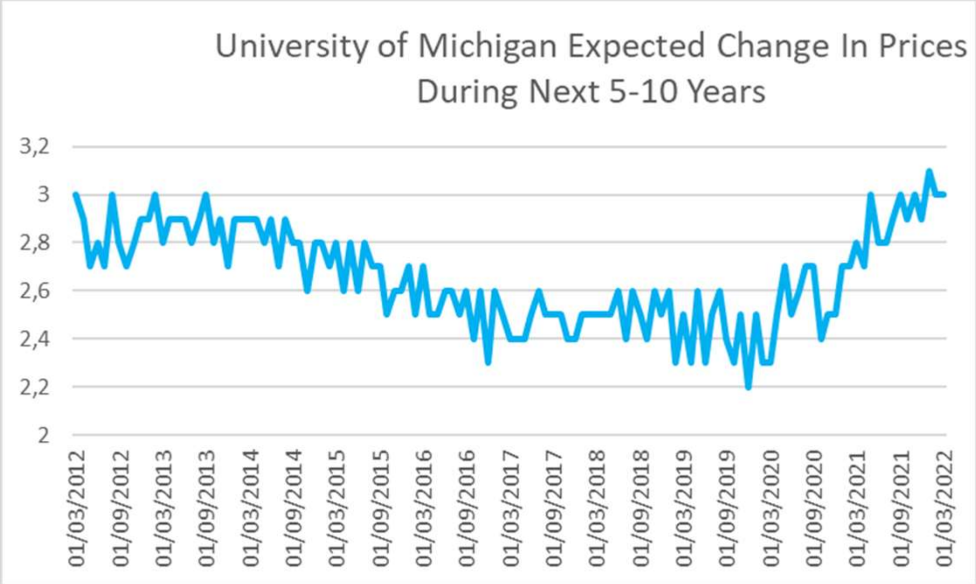
Fed officials in March expected rates to be lifted to 1.9% by the end of 2022 and 2.8% by the end of next year (see picture to the left; green line, representing median). Since then, officials signaled openness to moving faster in interviews and speeches.



How close are we to the peak in interest rates?

The hazard first step by just raising rates by 25 basis points leaves the impression that the Fed is behind the curve. This is potentially very dangerous as inflation expectations are as important as reported figures. Once the credibility of the interest rate setting committee is lost, inflation expectations will no longer be anchored. Such a situation will be difficult to bring under control again. For the time being, longer-term inflation expectations still seem under control, but credibility is more easily lost than gained.

Source: The Federal Reserve Bank of St. Louis



Source: University of Michigan

The sharp rise in 10-year Treasury yields (seen on the previous page, right chart) implies market confidence about growth. The Fed seems to have persuaded the market that it will catch up. Investors anticipate that the Fed is hiking aggressively in the short term. But how far will they go? And importantly, what is already priced into the market? In an environment of solid economic growth, a strongly improving labor market and excessive inflation it seems imperative that they at least target neutrality. The so-called neutral rate is the theoretical federal funds rate at which the stance of Federal Reserve monetary policy is neither accommodative nor restrictive. It is the short-term real interest rate consistent with the economy maintaining full employment with associated price stability. In the March minutes even a move to a tighter policy stance was not excluded, but this will depend on economic and financial developments.

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To define at what level monetary policy is neutral depends on many factors. The Chicago Federal Reserve President Charles Evans sees neutral policy in the 2.25-2.5% range. He favors reaching that level by March 2023 but would also agree to accelerate hikes in order to attain this level already in December. As a consequence, some 50 basis point rate increases have to occur.

In respect to reducing the size of the Federal Reserve's balance sheet, the process could start as early as May. We consider it important to mention that the Fed will not primarily sell Treasuries, but allow securities to mature. That said, there is not each and every month enough maturing paper. We expect the Fed to be more specific in May how they are planning to handle this situation. It will also be interesting to know if the runoff could be handled in a curve-neutral manner.

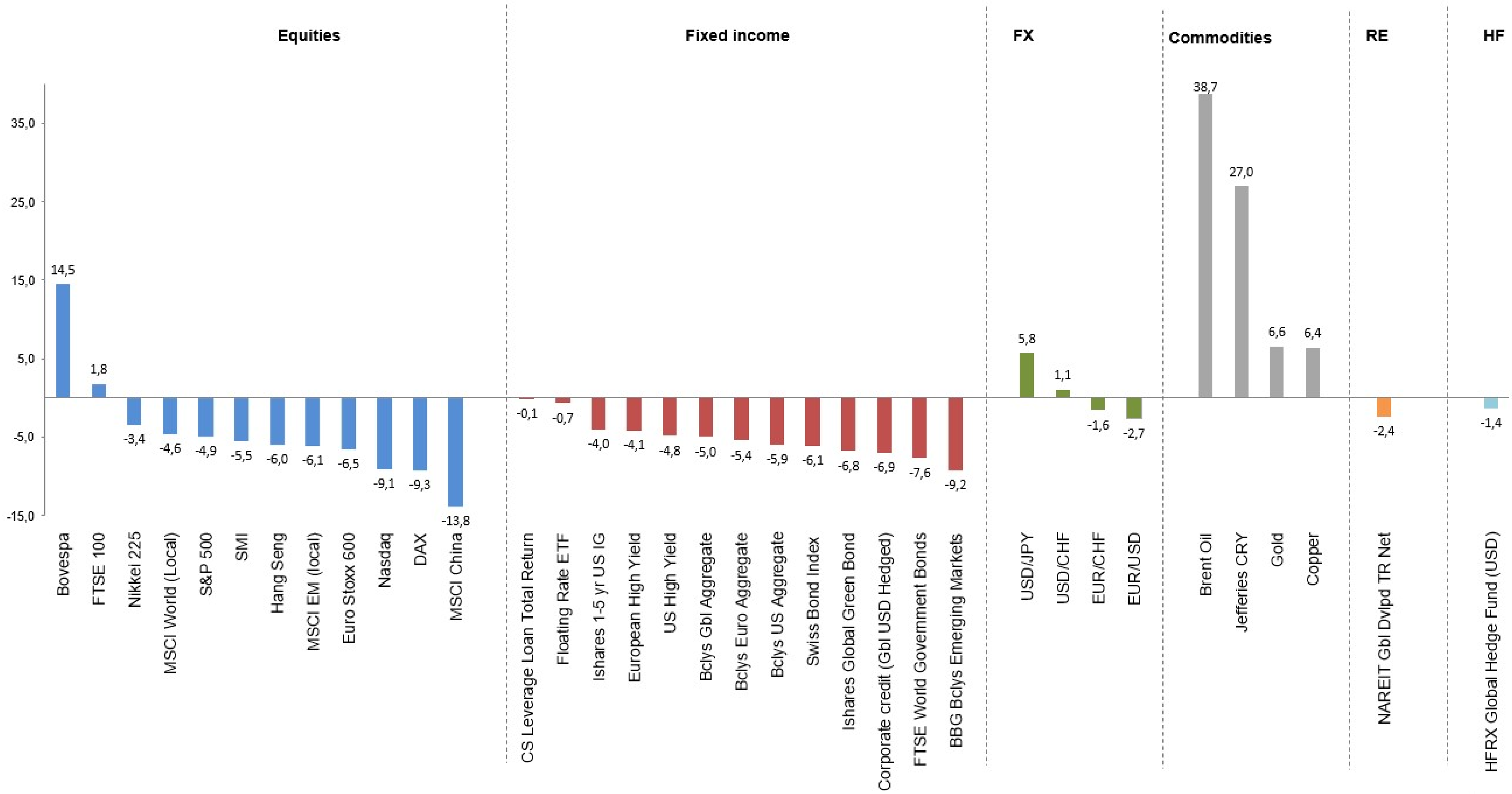
Market participants were quick to anticipate a considerable cooling of economic growth or even a recession. We therefore would like to highlight the following assurance of the Fed: "Participants agreed that lessons learned from the previous balance sheet reduction episode should inform the Committee's current approach to reaching ample reserve levels and that close monitoring of money market conditions and indicators of near-ample reserves should help inform adjustments to the pace of runoff." This statement suggests readiness to slow down or even halt Quantitative Tightening if conditions deteriorated enough.

What is already reflected in the market? Swap traders are pricing in more than 220 basis points of rate increases for the rest of the year. The market seems hence close to anticipate a neutral stance.

Conclusion:
Nobody can of course know where the peak in interest rates will be, particularly not in an environment of extremely low visibility. But we would argue that the normalization of interest rates has progressed a lot. The market seems to have incorporated a somewhat neutral stance. Financial conditions had already started to tighten strictly by communication means over recent months. The Fed is now determined to tackle inflation. The Government has released an impressive amount of strategic oil reserves. There are studies showing that Quantitative Tightening might necessitate less interest rate hikes. Finally, it has to be expected that a less abundant monetary policy will eventually lead to a slowdown in economic growth.

It is too early to call a peak in interest rates. But we are watching very closely all the factors and will be ready to change our for now very short-duration stance in our portfolios.

Performance Major Asset Classes in 1Q 2022 in Local Currencies



Source: Bloomberg

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