Insights
Global Cash Outlook

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Positioning Your Balance Sheet — 2022 Opportunities

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With inflation rising and labour markets tightening across the US and Europe, central banks are taking divergent approaches to monetary policy. Starting from historically accommodative policy, in December the US and UK moved more aggressively than expected while Europe maintained its dovish approach. In the coming year — as the post-vaccine recovery continues and labour, supply chain, and inflation issues unfold — monetary policy may be less predictable than usual. The potential for wage inflation will be a major factor. Broadly speaking, amid higher inflation we foresee central banks remaining somewhat less accommodative than during the pre-vaccine era, but they will move cautiously. We expect rising interest rates and strong credit conditions, which will be favourable for cash investing.

The Fed Seeks to Thread a Thin Needle

Conceding that inflation appears somewhat less “transitory” than it had previously believed, the Federal Open Markets Committee (FOMC) pivoted at its December meeting to a hawkish outlook and policy stance. On COVID-era quantitative easing (QE), as anticipated it doubled the pace of tapering, ending QE in March rather than June. But it surprised many by raising core PCE inflation estimates for 2021 from 3.7% to 4.4%, and for 2022 from 2.3% to 2.7%, and by signaling that it is prepared to hike interest rates three times in 2022. This marks a sharp shift from its previous meeting, at which no members of the FOMC foresaw three rate hikes in 2022. If the policy is implemented as forecast, the federal funds target range will rise from 0-25 basis points (bps) at present to 75–100 bps by the end of 2022. This would support higher returns for cash investors.

Meanwhile, credit markets should remain stable and sound. We expect credit-rating upgrades to continue outpacing downgrades as the economic recovery from pre-vaccine days continues. Banks are well positioned to lend, and have robust, liquid balance sheets. They continue to provide a solid foundation in the money markets.

The Fed sees a clear need to rein in inflation. Coming after 2021’s unexpectedly high pandemic-rebound growth and inflation, the Fed would be tightening monetary policy into growth that is strong but softening. State Street Global Advisors foresees US economic growth slowing from 5.6% in 2021 to 4.4% in 2022 — i.e., still vigorous compared to the past decade. Our growth forecast exceeds the Bloomberg consensus (3.9%) and the Fed’s own 2022 projection (4.0%)[1] at the time of writing. Three rate hikes in a year may appear hawkish, but they could also be seen as more of a return to normal given extraordinarily accommodative pandemic-era policy.

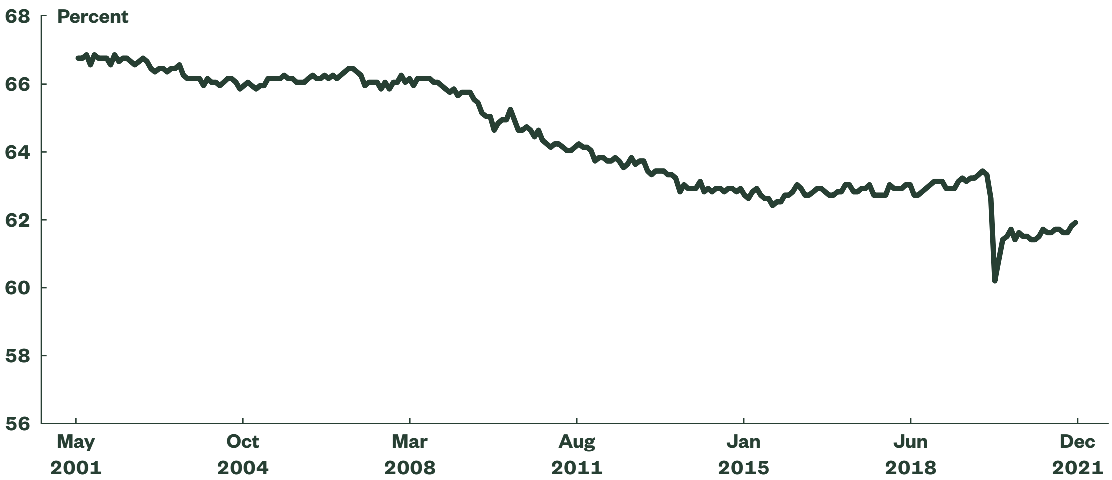
State Street Global Advisors’ inflation estimates significantly exceed the Fed’s 2.7% projection for 2022. We believe consumer price inflation will fall from 4.7% in 2021 to 4.4% in 2022.[2] We do not believe the US is entering a 1970s-style inflation cycle. The structure of the economy is entirely different. Supply challenges will eventually dissipate as life normalises, bottlenecks are cleared, and consumer demand moderates. After all, people won’t buy a new couch or exercise bike every year!

All Eyes on Unemployment

In addition to growth and inflation, several factors are complicating the Fed's job. Of course, the ongoing pandemic remains a potential wildcard, as Omicron has reminded us. At press time uncertainty was high, but it appeared that Omicron infections would be widespread but less severe, and would not lead to widespread shutdowns. A more likely scenario for the US is that COVID will continue its transition from pandemic to endemic. With vaccinations widely available and treatments advancing, people will adapt. The virus's impact on the economy will be less pronounced — despite the ongoing tragedy of high daily mortality rates.

Health crisis aside, the pandemic has changed the economic picture in ways that could have medium- to long-term impacts. For interest rates, the most notable — and perhaps unpredictable — change is in employment. Currently, many workers remain on the sidelines. While labour force participation is recovering slowly from its April 2020 low, the rate remains at a level not seen since the 1970s.[3] There are a variety of reasons for this. Some late-career workers are retiring early, prompted by COVID and a rising equities market that is swelling retirement-account balances. Others are vaccine skeptics, or are too concerned about the virus to return to front-line jobs. Some have saved enough pandemic-era government assistance to take a break or hold out for better opportunities; household excess savings is at record highs.[4]

Figure 1
US Labour Participation Rate

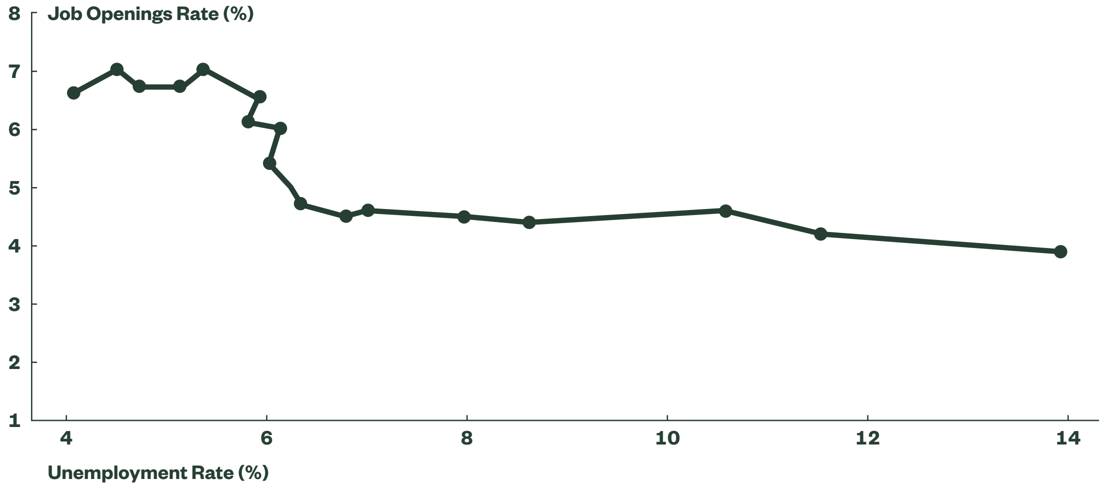


Source: US Bureau of Labour Statistics.

The drop in labour participation has exacerbated workforce imbalances that had emerged before the pandemic. Currently, job vacancies are high, likely sufficient to support full employment in the coming quarters. Consistent with this, the Fed predicts 3.5% unemployment for 2022–2024. The Beveridge Curve, a measure of labour-force efficiency, shows low unemployment amid high job openings. This scenario is a catalyst for higher wages. A moderate rise would support economic growth, but higher levels could fuel inflation and therefore monetary tightening. High labour pressure could also slow the supply chain recovery.

Figure 2
Beveridge Curve

May 2000 to Nov 2021



Source: US Bureau of Labour Statistics.

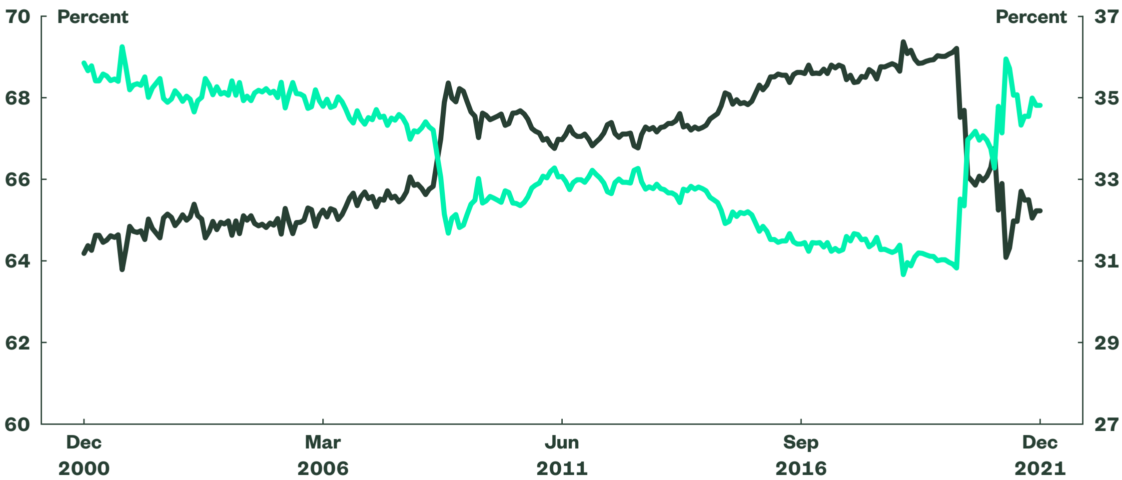
The Beveridge Curve will be a key indicator in the quarters ahead, particularly if workers continue to avoid the job market and borders are closed. Another factor will be the speed at which people retrain to fill the skills gap, particularly in areas where demand far exceeds supply, such as technology and healthcare. It's unclear whether this imbalance will lead to labour shortages that could take years to resolve, or whether workers who left during the pandemic will return in significant numbers to ease the imbalance.

The Post-Pandemic Consumer

A final risk that is boosting uncertainty is the possibility that US consumer habits have changed. During the depths of the pandemic, people started spending less on services and more on goods. By the beginning of 2022 this trend had only partially moderated. In addition to the pandemic, demographics could be a factor. Millennials are now acquiring homes in peak numbers.[5] As they settle into suburban life, will demand for housing and household goods remain high, supporting a long-term rebalancing between goods and services? We believe that, as concerns over the pandemic wane and households deplete the cash they have saved, the balance between goods and services is likely to approximate pre-pandemic norms, and spending will rise on hard-hit services, such as leisure, hospitality, and travel.

Figure 3
US PCE as a Percent of Current Dollars SAAR

US Services (LHS)
US Goods (RHS)



Source: BLS, Bloomberg as of January 18, 2022.

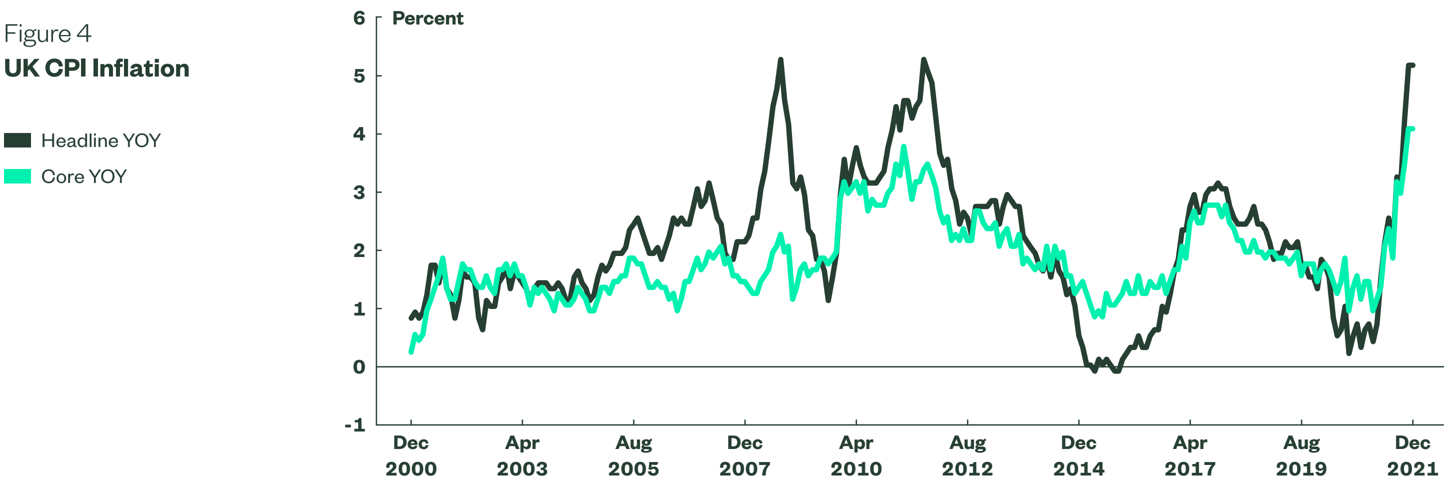
BoE Hikes Sooner Than the Fed, But Not Without Hesitation

At its December meeting, the Bank of England (BoE) delivered a surprise rate hike after inflation came in at 5.1% — above the bank's November forecast and the biggest jump since 2011.[6] The rate hike, the first since COVID's onset, set the BoE rate at 25 bps. The move was supported by eight of nine policymakers, and increased the rate from a historic low of 10 bps.

While the BoE had clearly been poised to raise rates, many investors had assumed the hikes would begin in Q1 2022. Still, a 15-bps increase will have a minimal impact, and can be considered more of a reduction in extraordinary accommodation than a hike. Economists differ over when and how often the BoE could hike rates in 2022 and 2023; the market reflects greater certainty, pricing in four hikes for 2022 alone. We foresee the BoE raising rates at least one more time in 2022.

As expected, the Monetary Policy Committee also unanimously voted to maintain the balance of its COVID-era Asset Purchase Facility (APF). Balance-sheet expansion ended in mid-December, with the bank holding £895 billion in bonds, including £20 billion in investment-grade non-financial bonds and, more importantly, £875 billion in Gilts.[7] The BoE's Gilt holdings account for a large portion of outstanding Gilts — upward of 40%. Gilt yields — about 75 bps at press time — suggest that investors expect that slow post-Brexit growth will be the predominant challenge, although inflation is a concern. As a result, if the BoE heeds market expectations it does not have much room to tighten policy. While the UK's labour market is strong, elevated energy prices and a proposed Scottish referendum in 2022 could further complicate monetary policy and weigh on economic growth already constrained by Brexit.

Figure 4
UK CPI Inflation



Source: Bloomberg as of December 31 2021.

Despite the headwinds, the BoE has effectively handcuffed itself to quantitative tightening when it does raise the policy rate. Last July, it provided forward guidance stating that it would no longer reinvest maturing assets in its QE portfolio when the policy rate reaches 50 bps, and would begin selling assets when the rate reaches 100 bps — if economic circumstances allow. The risk to such guidance is that it restricts flexibility. The bank will be forced to tread carefully if the economy weakens notably. Balance-sheet contraction effectively amounts to monetary tightening, at a rate of slightly less than 1 bp per £1 billion of contraction, according to a rule of thumb suggested by former Governor Mark Carney. For instance, shrinking the BoE's balance sheet by the roughly £37 billion in assets maturing in 2022 would increase rates by an estimated 31 bps.[8] The Fed experienced such de facto tightening when it shrank its portfolio in 2018–2019; it ultimately elected to cease asset sales. Attempting to shrink portfolios is a fundamental challenge for central banks in the age of QE. They could hold asset levels steady for an indefinite period, but the expectation has always been that they would unwind these extraordinary measures. Yet the question remains: Is it possible to unwind them?

In UK money markets, typical year-end supply issues occurred again in 2021, prompting deeply negative repo rates and excess market liquidity. Supply of 1- to 3-month assets was very light, complicating quarter-end investing. Banks were less interested in issuing short-dated debt in Q4, having pre-funded much earlier than normal. The BoE could adjust T-bill issuance, although it seems unlikely that they will be able to do anything about negative rates. We don't foresee the BoE establishing a reverse repurchase programme. Policymakers do not want to be seen as bailing out the money fund industry. Market pricing is favourable in the 9- to 12-month part of the yield curve, given the current market predictions for rate hikes.

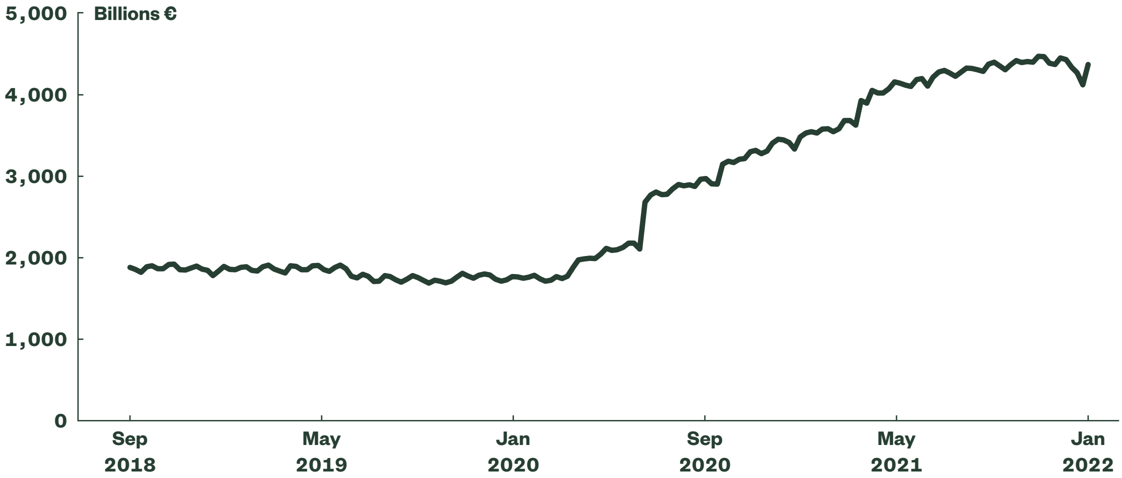
ECB Remains Highly Accommodative Amid Weak Longer-Term Growth Expectations

The ECB remains the most accommodative of the three major central banks covered by our cash team, largely due to slower growth in the region. In December, the ECB announced that in March 2022 it would end the balance sheet expansion it has been carrying out under Pandemic Emergency Purchase Program (PEPP). It pledged to reinstate net asset purchases under PEPP if needed "to counter negative shocks related to the pandemic." It will continue reinvesting maturing PEPP assets at least through 2024, and said it would remain flexible across jurisdictions in the event of "renewed market fragmentation related to the pandemic" — singling out that Greek assets may be favoured.[9] It will maintain net asset purchases under its pre-COVID Asset Purchase Program (APP) at €40 billion/month in Q2, €30 billion in Q3, and €20 billion "for as long as necessary."

The bank left its policy rates unchanged — with the deposit facility rate at -0.5% — and signaled that it did not foresee any hikes in 2022. Even typically hawkish policymakers do not see a need to raise rates. The ECB attributed its dovish policy to a variety of factors, including moderate inflation and weak longer-term growth. The bank remains concerned about high energy prices, virus-related restrictions, and material and labour shortages that have constrained the economy and may not subside as quickly as expected. On the other hand, the jobless rate is at historic lows and the ECB believes that rising labour costs could eventually fuel inflation. It indicated that it was closely monitoring wage negotiations. The bank expects relatively strong eurozone economic growth in 2022 at 4.2%, easing to 2.9% in 2023 and 1.6% in 2024.

Given the flatness of the yield curve, State Street Global Advisors' portfolio managers tend to prefer shorter-duration assets. The money markets have been experiencing significant supply challenges. Short-term bank and corporate debt continue to be in short supply, and therefore more expensive than short-term French and German government debt. The ECB has created an extraordinary amount of liquidity, reaching €4.5 trillion in 2021, up from €3.3 trillion in the previous year (Figure 5). The Targeted Longer-term Refinancing Operations (TLTRO), an ECB initiative to stimulate bank lending, continues to provide funding for banks at very attractive rates. Overall, the large quantity of cash in the system is pinning down yields, and this appears likely to last. Potential debt issuers, and banks in particular, have more than enough cash, and have termed-out their liabilities. If TLTRO is phased out, dealers will need to find funding elsewhere, adding to the supply of 1-, 2-, and 3-year debt.

Figure 5
ECB Eurozone Excess Liquidity



Source: ECB, Bloomberg, as of January 10, 2022.

At the end of 2021, balance sheet constraints and excessive quantities of cash led to dysfunctional markets. Demand for short-term cash was so low that repo rates reached and even exceeded -5.0% — that's correct, investors were being asked to pay 5% or more to get other institutions to accept their cash. This dysfunction has obviously been detrimental to money market returns, but the situation should improve in 2022.

Despite the challenging conditions, assets under management in EU money funds have remained relatively stable, and we expect this to continue. Investors have long been accustomed to a negative-rate environment. They have optimised their positions and hold the quantity of euro cash that their operations require.

Endnotes

1 https://federalreserve.gov/monetarypolicy/files/fomcprojtabl20211215.pdf.

2 State Street Global Advisors, "Weekly Economic Perspective, Quarterly Edition (December 10, 2021)".

3 https://fred.stlouisfed.org/series/CIVPART.

4 SSGA Weekly Economic Perspective Quarterly Edition (December 10, 2021).pdf.

5 https://apartmentlist.com/research/millennial-homeownership-2021.

6 https://wsj.com/articles/bank-of-england-raises-interest-rates-11639656570.

7 https://bankofengland.co.uk/monetary-policy-summary-and-minutes/2021/december-2021.

8 https://bloomberg.com/news/articles/2021-10-18/boe-rate-bets-imply-one-of-fastest-tightening-waves-this-century.

9 https://ecb.europa.eu/press/pr/date/2021/html/ecb.mp211216~1b6d3a1fd8.en.html.

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- Build from breadth
- Invest as stewards
- Invent the future

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of December 31, 2021 and includes approximately $61.43 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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