The tick chart and views expressed in this note reflect the information and data available up to September 2021.

EXHIBIT 1: MAS ASSET CLASS VIEWS FROM SEPT STRATEGY SUMMIT

ARE MARKETS OVERSTATING THE CASE FOR RATE HIKES IN 2022?

Hot on the heels of the highest year-over-year U.S. consumer price inflation (CPI) print since the 1990s, the UK saw its highest rate of inflation in a decade last week. The path of inflation is certainly dividing the economic community: one side firmly in the “inflation is transitory” camp, while the other side fears a sustained bout of inflation eventually leading to sharply tighter monetary policy.

We lean to the “transitory” camp given base effects, easing of supply chain pressures, and workers returning to the labor force. Nonetheless, we acknowledge that there are risks – notably from rents, increasingly tight labor markets, and the possibility of an upward drift in inflation expectations – which could keep CPI prints elevated for a while.

In either case, we expect central banks to maintain accommodative policy for a good deal longer than markets currently price. True, if inflation turns out to be more persistent than we expect – and especially if it comes with a sharp rise in wages - rate hikes will be warranted. Still, we expect tighter policy to be delayed, even if a later start means a faster pace of hikes once they are underway.
Strong growth, some inflation, limited policy response

Our economic base case anticipates above-trend growth in 2022, with monetary policy tightening taking place very gradually as current inflation risks moderate. Our central view is that the Fed will keep working toward its new average inflation targeting (AIT) framework and will continue to view prevailing inflation pressures as short-lived. Despite more aggressive policy pricing in the money markets, and current elevated levels of inflation, we think the first U.S. rate hike is more likely to come in 2023.

Market pricing moved sharply following recent prints in inflation - U.S. October CPI rose to 6.2% year-over-year (y/y), accelerating from September’s 5.4% print. Inflation has become a political flashpoint, with October’s reading prompting President Joe Biden to comment that reigning in inflation is “a top priority.” In money markets, the pickup in inflation has caused a bear-flattening of the yield curve driven by investors increasingly pricing the start of a U.S. hiking cycle as early as mid-2022.

In our view, this bear flattening puts too little weight on the Fed’s commitment to achieving full employment. In other regions too – notably the UK and New Zealand - investors have priced in an aggressive hiking cycle which seems to imply, simultaneously, no let-up in inflation pressure, and an ultimate hawkish policy error. Exhibit 2 shows pricing of hikes in the U.S., UK, and eurozone in 2022 and 2023, which we believe has gone too far in the U.S. and UK, with now five hikes by 3Q23 priced for each country. In the U.S. and UK markets have priced in an aggressive pace of rate hikes.

Under normal circumstances, a pickup in inflation might be expected to lead to a bear steepening of the curve - where longer dated bonds, whose returns are more sensitive to inflation risks, sell off. But despite the announcement of Fed tapering, and ongoing inflation fears, U.S. 10 year-yields have remained resolutely anchored to current ranges around 1.50%. This likely reflects ongoing demand for duration from non-U.S. central banks as well as bond buying from actors such as liability hedgers and from rebalancing flows, where demand is typically less price sensitive.

As a result, the repricing of rate hikes in the front end of the curve is probably amplified and in combination with the anchoring of long dated yields, lead to bear flattening. This phenomenon is usually more associated with late cycle, rather than the opening rounds of mid cycle, which is what many other economic indicators point to. In the coming months, if inflation readings indeed moderate as we anticipate, then we would expect the bear flattening trend to cease and possibly partially reverse.

That is not to say that central banks will not look to raise policy rates, but more that the market’s interpretation of the Fed’s eagerness to begin hiking is somewhat at odds with the more dovish language of key officials. Longer dated yields, meanwhile, will probably continue to be heavily influenced more by non-price sensitive duration demand than by inflation and so will rise, but slowly. To be sure, yield curves signals are more opaque than they once were. Even so, the recent bear flattening probably overstates central banks’ pace of hiking and understates the underlying growth in the economy.

Inflation: Still leaning to transitory camp

Recent inflation prints have had a “sticker shock” quality to them which has reinforced the debate between the “transitory” and “persistent” camps. Some factors driving inflation higher relate to supply chain disruptions that we expect to resolve in coming months. We also expect other issues such as shelter – measured from owners’ equivalent rent (OER) - to remain elevated for a while. However, with workforce participation set to improve in months to come as cautious workers come back to the labor force, we do not expect to see a prolonged wage-price spiral.

We already see some alleviation of supply chain pressure in items such as semiconductor chips. This should in turn lead to knock on effects to ease goods inflation over the first half of 2022. For
another crucial item - energy - a belated supply response (including release of reserves) should begin to address tightness in energy markets next year. Finally, the base effects leading to high inflation will start to operate in the opposite direction by the middle of 2022. Together these factors imply an easing of inflation pressure over the coming quarters.

Ultimately, to see persistently higher inflation we would need to see much higher long-term inflation expectations and a strong boost in wage inflation. Certainly surveys of inflation expectations have moved up lately, but the biggest moves are in the shorter forecast horizons. University of Michigan 5-10 year inflation expectations have also risen, but much less dramatically. Wages have also recently strengthened, but while wage settlements are currently pushing up labor costs, the long-term disinflationary pressures from factors such as automation and globalization have not gone away. In sum, we see good reasons to expect inflation higher in this cycle than the last, but equally good reasons why the recent mid-single digits range for CPI is unlikely to last for long.

**What is the path of rates for central banks?**

In our recently published 2022 Long-Term Capital Markets Assumptions, we categorized central banks into three blocs: fast to normalize rates (Canada, Norway, UK, etc.), more measured (U.S., Australia) and slow (eurozone, Switzerland, Japan).

The UK is likely to lift off early, but while the five hikes priced in by the end of 2022 probably well reflect the inflation risks that the UK faces, they fail to account for the fragility of the post-Brexit UK economy. Supply disruptions will likely keep UK inflation readings higher for longer than in comparable regions, but the UK’s worsening relationship with Europe threatens trade and sentiment in the UK, which likely means fewer hikes than markets have priced for 2022.

U.S. investors are pricing two hikes in 2022. While that outcome seems plausible, we think lift-off will more likely occur in 2023. By mid-2022, when tapering is due to end, base effects and improving supply chains will probably have combined to pull inflation down significantly. While OER may still be elevated – in turn leading some to fear more “sticky” core inflation – we continue to expect that a dovishly minded Fed will prefer to delay hiking for some time after tapering has concluded.

The eurozone is the one area where markets may have understated the prospect of rate hikes, not in the short term but over the long run. Certainly, we don’t expect the European Central Bank to raise rates in the next year or two, but further out we think a more dynamic eurozone economy may eventually justify higher policy rates. In contrast to the U.S. and the UK, the full path of rates for the eurozone may currently be under-priced.

**ASSET ALLOCATION IMPLICATIONS**

In our view, the likelihood of sustained buoyant nominal growth strengthens the case for a continued pro-risk stance. We prefer to tilt portfolios towards cyclical markets and those still to benefit from re-opening. The latest earnings season, characterized by upside surprises, provided further evidence that cost pressures did not squeeze profit margins to any significant extent. Moreover, while negative real rates are a good reason to avoid bonds, they are ultimately supportive for stocks.

We expect yields in aggregate to rise gradually, but in the very short end of curves in the UK and the U.S. we see scope for some of the aggressive schedule of hikes to be priced back out of curves. This would translate to some mild curve steepening, justifying a continued, modest underweight to duration. In EUR markets, the pricing of hikes in the belly of the curve may be underestimated. As a result, blending in underweights in EUR core curves may also have merit.

Overall, we would push back against those who assume either that inflation will be persistent, or that yield curves cleanly signal a hawkish policy error and subsequent growth shock. We believe inflation will moderate and will ultimately settle to a range that allows the Fed to maintain a dovish attitude. On the growth front, we believe structural non-price sensitive demand for duration continues to cloud the signal that might come from yield curves. Looking through these issues allows us to focus on the backdrop of above-trend growth and easy rates which, in our view, ultimately supports a pro-risk allocation.
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As of June 30, 2021.

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