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INVESTMENT MANAGEMENT

Inflation May Be Peaking in the U.S. What about the Rest of the World?

FIXED INCOME | FIXED INCOME TEAM | MARKET PULSE | SEPTEMBER 2022

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Inflation is inching downward at the headline level, but remains stubbornly high at the core level (excluding food and energy). In fact, inflation data released on Tuesday, September 13, revealed that prices rose slightly in August. Regardless, inflation in the U.S. may be peaking, but it's more of a "rounding top" than a sharp decline from the highs, putting added pressure on the Fed to continue tightening.

The picture is cloudier in Europe and the UK, where inflation is still on the rise primarily due to severe energy shortages throughout the region, in part due to the war in Ukraine. But since the pandemic, the UK and European economic cycles have lagged the U.S. by about 3 months, meaning if U.S. inflation is in fact peaking in 3Q - albeit slowly - then inflation may peak for the UK and Europe in 4Q. Following the Fed's lead, both the European Central Bank and Bank of England have been aggressive with rate hikes to combat inflation.

In the APAC region, economic weakness in China is a drag on the region, especially for Emerging Markets (EM). The central banks in Australia and New Zealand are still tightening but seem to be softening their pace. EM is more idiosyncratic and country specific, but the rate of change for increasing inflation is starting to slow and central bank policy across the region is likely to follow suit.

To date, 2022 has been mostly about rising inflation. Looking ahead, however, we should perhaps incorporate a view of peaking, then falling, inflation in 2023. That said, inflation risks remain. Inflation may in fact peak, then fall, but the question is will it fall enough - to target levels - **and will it then stay there**. Inflation could reverse a downward course based on changes in supply chains or labor shortages, keeping it higher than target levels, and for longer than expected. In this scenario, central banks may need to restart a tightening cycle sometime late in 2023 - and this is a risk scenario that is not currently priced in the markets. Alternatively, if the economy slows more than expected, then inflation will likely be controlled, but for all the wrong reasons.

Given this backdrop I am often asked "is it time to buy bonds?" Well, the short answer is yes **and** no, depending on my four Ws: **Where** geographically, **Which** bonds, **What** maturity, and **When** to buy.

- **Where:** The **U.S**. as inflation has likely peaked and Fed may reach terminal Fed funds of 4% by end of the year. **UK & Europe** as inflation and policy lags the U.S. by three months. **Emerging Markets** may be a little early but idiosyncratic to country risk.

- **What:** Per the "Three Bears": **Long duration is** "**too hot" -** an attractive play for a recession but also riskier. **Short rates are "too cold"** as central banks become aggressive. **3-4 years of duration looks "just right."**

- **Which: Investment Grade/High Quality** offers yield, duration sensitivity and lower default risks but if we have a mild recession, then **High Yield** can offer more potential upside.

- **When:** Timing is everything. U.S. policy rates are likely to peak and hold first. This plus a strong US dollar gives **U.S. assets an edge over other markets**.

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