Daily Note

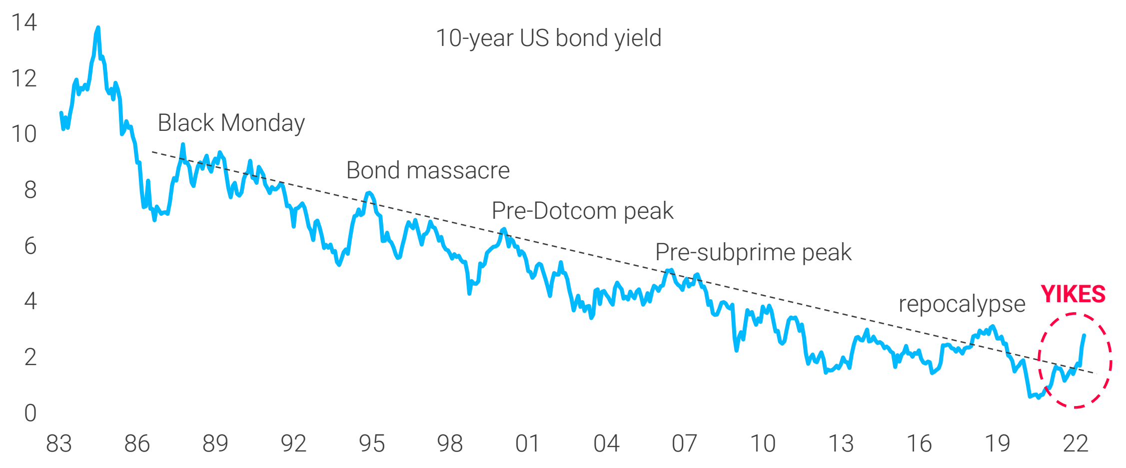
THE MOST BEARISH CHART IN FINANCE

Dario Perkins

- **Everyone now expects central banks to hike rates until "something breaks"**
- **But this seems naïve – or silly even. Why make the same mistake again?**
- **The policy bias is clear, but a global growth scare could change things.**

There is a strong consensus in markets that central banks – especially the Federal Reserve – will continue raising interest rates until something breaks. The idea is so popular it is virtually a cliché among financial pundits. And it is certainly consistent with the historical pattern. Chart 1, which I put on FinanceTwitter as a joke a few months ago, is now the sell-side's favourite piece of technical analysis (aka the "most bearish chart in the world"). The problem with predicting a policy error is that it assumes central banks are incredibly naive, verging on stupid. Why would they make a mistake that everyone else has seen coming? Is it because central banks are packed with PhD economists who do not understand markets (which was certainly the case in 2008)? Or, as Paul McCulley, Zoltan Pozsar and various others point out, is "breaking stuff" (or to use the euphemism, generating a significant tightening in financial conditions) now part of their job? Perhaps the "central bank put" has become a "central bank call".

Chart 1: What will break next with higher rates?



Sources: Bloomberg, TS Lombard.

Let's start with the most popular explanation of Chart 1 – that the trend increase in leverage has made economies more sensitive to interest rates over time, such that smaller hikes in the cost of borrowing become destructive. This hypothesis makes sense, especially as we can tie various market accidents to specific policy events. The subprime bubble, for example, burst when variable-rate mortgages reset, causing acute stress among overleveraged homebuyers. Michael Burry et al. saw the problem coming, whereas Ben Bernanke – who ignored the inverted yield curve – did not. And the Fed's hawkishness clearly triggered various other disasters in markets, such as the 1994 bond rout and, more recently, "volmageddon". It can be hard to predict these events because, as another popular investor cliché puts it, you see who has been swimming naked only when the tide goes out. For sure, there have been some highly speculative activities taking place in finance over the past two years; and while risk assets have absorbed the "hawkish pivot" surprisingly well, things could get dicier going forwards.

Perhaps we can also blame the authorities' post-1980s overtightening habit on an implicit policy bias, whereby they naturally repeat the same mistakes. Faced with the threat of inflation, it is clear central banks tend to suddenly freak out and become overzealous in their policy action. This is largely because they believe their own hype about what causes inflation. Always keen to take the credit for 40 years of low inflation, they are desperate not to repeat the mistakes their predecessors made in the 1970s. Recent remarks by Stefan Ingves, governor of the Riksbank, summarize the prevailing mood: "It is easy to underestimate what a long-term investment it is to convince an entire country that the inflation target is 2 percent. If you start screwing it around, you can easily lose your footing..." For the most part, I think officials put too much weight on their "monetary credibility"; but it is clear these beliefs have a powerful influence on their behaviour. Combine an acute fear of inflation with uncertainty about how monetary policy does, in fact, works and it is easy to see why central banks keep making the same errors. They hike rates and nothing happens ("long and variable lags"), so then they ratchet things up.

Yet, just as central banks are too quick to take credit when things are going well, so the rest of us are too quick to blame the authorities when something goes wrong. I call this the "stuff happens hypothesis" (though I sometimes use a cruder version when engaging with clients I know well…). Stuff happens and central banks are not always in control, even if it can sometimes appear that they are responsible. In fact, the natural path of monetary policy and the business cycle can produce a misleading idea about central banks' contribution, making them appear more powerful than they are. Look again at Chart 1. Policymakers always cut rates quickly, wait until they are absolutely sure the economy is recovering, and then raise rates slowly and carefully. Even if the "bad stuff that happens" is entirely random, the patterns in Chart 1 should come as no surprise. Not only is there are a good chance the Fed will try to tighten policy when something does go wrong; the peak in interest rates will naturally decline over time.

So, what about the current tightening episode? This time, to risk falling into the classic sell-side trap, things do look a little different. Central banks' desire to normalize policy as quickly as possible reflects the fact that this is not a normal business cycle. Governments shut down their economies and reopened them, and rapid monetary tightening is analogous to this stop-start move. Yet, the odds of a policy error are increasing, especially when everyone seems to be over-extrapolating COVID distortions into a new secular inflation narrative and when central banks are channelling the virtues of Paul Volcker (or, in Europe, the '70s Bundesbank). What we need is a "growth scare", one that is sufficient to stop central banks freaking out but not large enough to plunge the world into recession. And with all parts of the world facing near-term problems, this scare is now a distinct possibility. Combine China's property slump (and lockdowns) with a massive squeeze on real incomes in Europe, plus tighter financial conditions in the US, and perhaps the world economy will deteriorate just enough to put the authorities on a more cautious policy path. In fact, this "soft patch" may be our best chance right now of a "soft landing".