



# GLOBAL MARKETS UPDATE

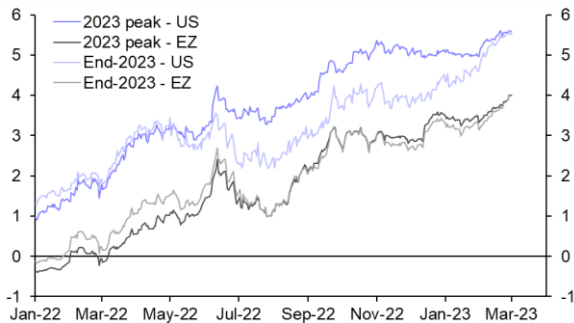
## Two points on “higher for longer” and asset markets

- **With much of the global economy holding up surprisingly well and inflation not coming down as quickly as expected, investors are weighing up the risk that policy rates remain elevated for much longer than previously thought. This *Update* discusses what that could mean for global asset markets.**
- **A slew of recent evidence has suggested that the global economy is running much hotter than had been widely expected.** And that’s playing out in much higher inflation prints. [Data released earlier this week](#) showed the euro-zone core inflation continued to rise in February. And last month, US data suggested that core price pressures there weren’t fading as quickly as economists and investors seemed to have expected.
- Some of this may reflect unusually warm weather in much of the northern hemisphere, and statistical agencies may be struggling to estimate seasonal factors due to COVID affecting previous years’ data. But it’s clear that the inflationary backdrop is not quite as favourable as investors had [anticipated](#).
- **In response to all this, investors have raised their policy rate expectations significantly.** OIS pricing suggests that they’ve revised up their expectations for policy rate peaks, and no longer expect rate cuts this year in either the US or the euro-zone. (See Chart 1.)
- That, in turn, has resulted in renewed sell-offs in bond and equity markets. The former leaves sovereign yields some way from our end-year forecasts, which reflected a view that bond yields would continue to drop back. And while we *had* warned about renewed falls in equity prices, we’d thought they would happen because growth disappointed rather than renewed valuations pressure from higher risk-free rates.
- **It’s too early to throw in the towel on those forecasts just yet. But we think there are two key points to consider on how “higher for longer” might continue to play out in markets, should evidence of a resilient global economy – and stronger-than-expected inflationary pressures – continue to pile up.**
- **First, we suspect yields might continue to rise more quickly at the short end of the curve than at the long end.** Short-term yields have generally risen by more than those at the long end over the past month; the 10-year US Treasury yield, for example, is up by ~60bp from its trough of around a month ago, compared with a ~80bp rise in the 2-year yield over the same period. It’s a similar story in the euro-zone.
- But it’s arguably surprising that yield curves haven’t inverted more. The relative rise in the 10-year and 2-year Treasury yields implies the 8-year/2-year forward rate – i.e., the 10-year yield excluding yields over the next two years – rose by just ~3bp less than the 10-year did. In other words, arguably the bigger story over the past month is not the further inversion of the yield curve but the fact that the whole curve has shifted up. That could reflect higher term premia, perhaps due to higher perceived inflation risk. But it may also be that investors aren’t just revising up their expectations for near-term rate hikes, but also for the nominal “neutral” rate policy will settle at in the long run.
- **It would make some sense if investors had raised their estimates of neutral rates, given how little economies seem to have slowed in response to the rapid tightening undertaken so far. But market-implied neutral rates now seem, at least according to some estimates, quite high.** 5-year/5-year forward “risk neutral” yield estimates, which ought to reflect neutral rates if policy is expected to return to neutral in 5 years, are around 4% in the US. (See Chart 2.) That all but unwinds their falls over the past two decades, and is well above our own figure of ~3% and that of the median FOMC participant of 2.5%.
- We wouldn’t completely rule out a still-higher neutral rate. But it seems unlikely to us that investors will continue to revise up their estimates of it quite as quickly as they seem to have lately. That suggests that there’s less scope for big rises in long-term yields, even if those at the short end of the curve climb further.
- What’s more, it suggests that neutral rate estimates could fall a long way – bringing long-term yields with them – if major economies *do* eventually slow more decisively and inflationary pressures fade.
- **Second, we doubt equities would continue to hold up as well as they have lately.** While the S&P 500, for example, has fallen over the past month, it’s down less than 5% from its February peak. And the EURO STOXX is within 0.5% of its own recent peak. That’s probably in part because the rise in *real* yields – which arguably matter more for equity discount rates – has been smaller than the rise in nominal yields in most economies. But investors may also be banking on a healthier-than-expected economy – and thus stronger corporate earnings – partly offsetting the effect of a higher discount rate.

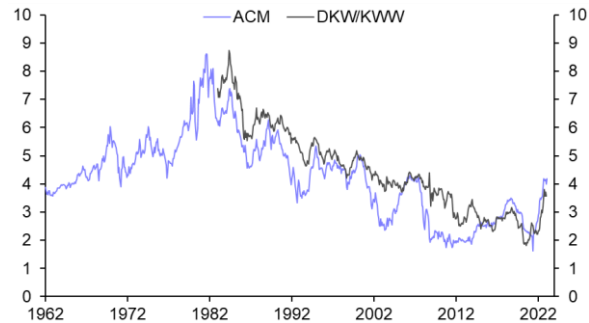


- We suspect that’s too optimistic. If economies are holding up well now it just delays, in our view, the slowdowns that are probably necessary if inflation is to return to target. So any boost to corporate earnings will probably be small, and offset by slower growth in future.
- What’s more, appetite for risk may diminish as rates continue to rise. There’s a lot of uncertainty about neutral rates and the lags with which monetary policy operates, meaning that still-higher interest rates arguably increase the risk of central banks “overtightening”, thereby triggering more significant downturns than we currently forecast.
- Such a scenario may also increase the chance of disorderly market conditions, as market participants struggle to adapt to big swings in asset prices. The dysfunction in the UK Gilt market late last year is a concrete – if extreme – a example of such an episode (even if it was primarily triggered by ill-judged fiscal policy rather than monetary tightening). More generally, bond market volatility in both the US and Europe was unusually high for large parts of last year. The risk of a more persistent breakdown in core asset markets could prove a further headwind for risky asset prices.

**Chart 1: OIS-Implied Policy Rate Expectations (%)**



**Chart 2: 5-year/5-year Forward Est. US Treasury Risk Neutral Yield Estimates (%)**



Sources: [ACM](#), [DKW/KWW](#), Refinitiv, Capital Economics



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