BARINGS INVESTMENT INSTITUTE

14 January 2022

THE WEEK AHEAD

Hawkish Fed Makes Markets Rethink Pricing

WATCH LIST

Date		Period	Consensus		Previous
U.S.					
Mon 1/17	Markets Closed for MLK Jr. Day		--		--
Tue 1/18	NAHB Housing Market Index	Jan	84	–	84
Wed 1/19	Building Permits	Dec	1712 K	–	1712K
Wed 1/19	Housing Starts	Dec	1655 K	▼	1679 K
Thu 1/20	Existing Home Sales	Dec	6.45 M	▼	6.46 M
Europe					
Tue 1/18	U.K. Jobless Claims Change	Dec			-49.8 K
Tue 1/18	U.K. Unemployment Rate	Nov	4.2%	–	4.2%
Wed 1/19	U.K. Consumer Price Index	Dec	5.4% Y/Y	▲	5.1% Y/Y
Thu 1/20	EA Consumer Price Index (Final Estimate)	Dec	5.0% Y/Y	▲	4.9% Y/Y
Fri 1/21	U.K. Retail Sales ex Auto Fuel	Dec			2.7% Y/Y
Asia Pacific					
Mon 1/17	China Retail Sales	Dec	3.8% Y/Y	▼	3.9% Y/Y
Mon 1/17	China Industrial Production	Dec	3.7% Y/Y	▼	3.8% Y/Y
Mon 1/17	China Fixed Assets ex Rural (YTD)	Dec	4.8% Y/Y	▼	5.2% Y/Y
Mon 1/17	China Property Investment (YTD)	Dec	5.2% Y/Y	▼	6.0% Y/Y
Mon 1/17	China GDP	4Q21	3.6% Y/Y	▼	4.9% Y/Y
Tue 1/18	Bank of Japan Policy Rate	Jan	-0.1%	–	-0.1%
Thu 1/20	PBOC Monetary Policy Meeting	Jan	--		--
Fri 1/21	Japan Consumer Price Index	Dec	0.8% Y/Y	▲	0.6% Y/Y
Fri 1/21	South Korea Exports 20 Days	Jan			20.0% Y/Y

Arrows indicate consensus forecast compared to the previous period. Local dates of release.

U.S.

- **Housing market data** should show continued strength in the sector, supported by impressive demand and limited inventory.
- We will watch **Q4 earnings season** to see how profits faired amid both elevated inflation and consumer demand.

Europe

- **U.K. inflation data** for December may give insight on the impact of the latest COVID wave on the economy.
- The **U.K. unemployment rate** will show if workers are affected by rising COVID cases, and the **earnings release** will indicate whether wages are following inflation growth.

Asia Pacific

- **China activity data** for December could show the impact of regional outbreaks on consumption, while production likely held up. **China 4Q21 GDP** may also continue to moderate.
- The **January BOJ meeting** is unlikely to reveal major policy changes, but focus will be on how the BOJ reacts to steadily rising inflation expectations.

What This Week Means For Markets

Markets boosted and pulled forward rate hike expectations following the hawkish shift in FOMC meeting minutes, with three hikes now priced in for 2022. A declining U.S. unemployment rate and rising CPI supported the shifting Fed reaction function, which led to a risk-off tone, with equities selling off and rising rates in the first week in January. Markets were quieter this week, with some curve flattening as the front-end moved higher amid expectations of hikes. While our baseline outlook sees the Fed tightening this year, we believe it will remain accommodative so growth doesn't slow too much and derail the recovery. The dollar index saw its biggest single-day decline since May, likely due in part to unwinding of overweight positioning and repricing of lower risks from Omicron—leading EM equities to outperform. In Germany, yields rose following the upside surprise in CPI. Please see our Monthly Macro Dashboard.

IN REVIEW

FOMC Delivers a Hawkish Shift as Inflation Rises

The FOMC meeting minutes from December delivered a hawkish surprise to markets, confirming the sooner-and-faster pace of rate hikes. But the real revelation came from the detailed discussion surrounding reducing the size of the Fed's balance sheet—or quantitative tightening (QT). While committee members did not decide on a QT timeframe or path, expect it to begin well before that seen in the prior cycle, and at a faster pace. Markets increased and pulled forward rate hikes in response, now pricing in three rate hikes in 2022.

Elevated inflation, given protracted supply constraints and broadening price pressures, continues to worry committee members; many noted that substantial gains in labor force participation might take longer, and that full employment could be near. This is a key shift, as concerns for a full and equitable labor market recovery kept them more dovish to this point.

Meanwhile, inflation remained high to close out 2021. December CPI rose 0.5% M/M and 7% Y/Y, in line with expectations and driven by supply chain disruptions, with an acceleration in M/M core goods prices—led by vehicles and apparel—while M/M services prices moderated slightly. The impact from Omicron could still weigh on services in January. As the transition from spending on goods to services unfolds with fading health concerns, we expect to see deflationary pressures from goods, while services pick up.

However, risks to the outlook remain amid COVID waves and continued supply chain disruptions, which could keep goods prices elevated for longer. Our baseline outlook calls for inflation to remain elevated in 1Q22 and ease by year end as inventories rebuild and supply chains heal. Expect the FOMC to remain accommodative and be ready to pivot so too much tightening doesn't destroy demand.

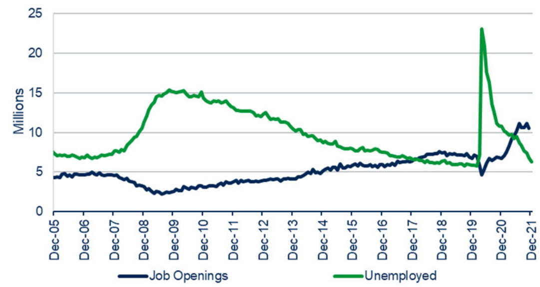
Is Full Employment Near in the U.S.?

The December employment report signaled a tightening labor market despite a below-consensus gain in nonfarm payrolls, (up 199,000; cons. 450,000), with higher revisions to prior months.

Similar to last month, the Household Survey—which is used to calculate the unemployment rate—was much stronger, with a 651,000 gain in employment and the unemployment rate falling to 3.9%, for the right reasons. As demand for labor continues to outpace supply, average hourly earnings surprised to the upside.

Timing meant Omicron had little impact on this report, so next month's release should show signs. While there is still room for labor supply improvement, a delayed return will likely be slowed by Omicron. With the acknowledgment of the weaker labor supply rebound, it is more likely the FOMC will lift off in March.

NUMBER OF OPEN JOBS EXCEEDS UNEMPLOYED



Source: Haver. As of January 13, 2022.

Policy Support in China Shows Early Results

The supportive fiscal stance—including robust government bond issuance—helped stabilize money and credit data, though more stimulative monetary policy action may be implemented to better shore up weak credit demand. Total social financing stock growth rose to 10.3% Y/Y in December, showing further improvements from September's bottom. But, the downward trajectory in loan growth was apparent despite the reserve requirement ratio cut in December, as banks remained cautious.

December CPI moderated to 1.5% Y/Y from 2.3% prior, below expectations, as food and energy prices decreased. Core inflation also remained soft and unchanged at 1.2% Y/Y as inflationary pressures remain manageable, particularly given tepid domestic demand—due in part to the zero-COVID strategy. With Omicron now in China, the economic costs of this approach may only rise, possibly delaying the consumption recovery to H2 and further exacerbating existing supply chain disruptions in the U.S.

Euro Area Recovery is Steady Despite High Inflation

The annual euro area inflation rate rose to a record 5% in December, above market forecast of 4.7%, due mainly to energy costs, as well as prices for food, alcohol, and tobacco. The strong print can also be due to resilient demand indicated by robust, recovering retail sales. Core inflation increased 2.6% Y/Y. Policy makers still see the current spike as temporary. February will be a key test to this view, as base effects and slowing energy inflation should see the headline number finally start to decline.

Retail sales rose by 1% M/M in November, significantly better than market expectations of -0.5%. The Y/Y increase also beat expectations and rose 7.8 % in November, the most since May, signaling the recovery was not derailed by the fourth COVID wave hitting Europe (and supporting our central scenario).

KEY FINANCIAL INDICATORS

Rates	Yield	1 W Change	1M Change	3M Change	6M Change	12M Change	YTD Change
Fed Funds	0.25%	0 bps	0 bps	0 bps	0 bps	0 bps	0 bps
U.S. SOFR	0.05%	0 bps	0 bps	0 bps	0 bps	-3 bps	0 bps
3 Month USD Libor	0.24%	1 bps	4 bps	11 bps	11 bps	0 bps	3 bps
3 Month Euribor	-0.56%	1 bps	3 bps	-1 bps	-2 bps	-1 bps	1 bps
3 Month U.S. T-Bill	0.12%	3 bps	7 bps	7 bps	7 bps	4 bps	7 bps
2-Year U.S. Treasury	0.89%	7 bps	23 bps	54 bps	67 bps	75 bps	17 bps
10-Year U.S. Treasury	1.72%	2 bps	24 bps	14 bps	36 bps	58 bps	21 bps
10-Year German Bund	-0.06%	7 bps	29 bps	5 bps	23 bps	41 bps	12 bps
10-Year U.K. Gilt	1.13%	7 bps	40 bps	-2 bps	49 bps	79 bps	17 bps
10-Year JGB	0.13%	5 bps	9 bps	5 bps	11 bps	10 bps	7 bps
Fixed Income	**Yield**	**OAS**	**1W Return**	**1M Return**	**3M Return**	**12M Return**	**YTD Return**
Barclays Capital U.S. Government-Treasury	1.45%	N/A	-0.2%	-1.4%	-1.1%	-2.5%	-1.5%
Barclays Capital U.S. TIPS	1.63%	N/A	-0.4%	-0.9%	-0.2%	4.6%	-2.0%
Barclays Capital U.S. Aggregate	1.98%	37	-0.3%	-1.3%	-1.2%	-1.9%	-1.5%
Barclays Capital Global Aggregate	1.45%	36	0.1%	-1.0%	-0.8%	-4.5%	-0.7%
Barclays Capital U.S. ABS	1.27%	34	-0.1%	-0.3%	-0.8%	-0.6%	-0.3%
Barclays Capital U.S. MBS	2.22%	33	-0.4%	-1.0%	-1.3%	-2.0%	-1.1%
Barclays Capital U.S. Corporate Investment Grade	2.56%	94	-0.4%	-1.6%	-1.2%	-1.2%	-1.9%
BAML Euro Corporate Investment Grade	0.58%	98	-0.3%	-1.1%	-0.6%	-1.3%	-0.4%
Barclays Capital U.S. Corporate High Yield	4.45%	286	-0.2%	0.2%	0.6%	4.6%	-0.6%
BAML European Currency High Yield Non-Financial	3.09%	330	-0.2%	0.1%	0.6%	2.8%	0.0%
CS U.S. Leveraged Loans	5.37%	427	0.2%	0.7%	1.0%	4.8%	0.4%
JPM CEMBI Broad Diversified	4.77%	308	-0.5%	-0.8%	-0.8%	0.7%	-0.8%
JPM EMBI Global Diversified	5.57%	376	-1.2%	-2.0%	-1.7%	-2.0%	-1.9%
JPM GBI-EM Global Diversified	5.86%	N/A	0.7%	0.7%	-2.0%	-7.3%	0.3%
Equities	**Price**	**Div Yield**	**1W Return**	**1M Return**	**3M Return**	**12M Return**	**YTD Return**
S&P 500	4,726.35	1.22%	0.6%	0.4%	9.0%	26.1%	-0.8%
Euro STOXX 600 (Local)	486.20	2.64%	-1.6%	2.2%	6.3%	19.0%	-0.3%
U.K. FTSE 100 (Local)	7,551.72	3.28%	0.5%	3.6%	5.9%	11.8%	2.3%
Japan Nikkei 225 (Local)	28,765.66	1.65%	-1.9%	1.2%	1.9%	2.1%	-0.1%
China Shanghai Composite (Local)	3,597.43	2.00%	0.1%	-1.9%	1.4%	-0.3%	-1.2%
MSCI AC World (Local)	753.61	1.76%	0.5%	0.8%	5.7%	18.3%	-0.3%
MSCI Emerging Markets (Local)	1,267.34	2.34%	3.3%	2.1%	0.8%	-2.5%	2.6%
Commodities/Currencies	**Price**	**1W Change**	**1M Change**	**3M Change**	**6M Change**	**12M Change**	**YTD Change**
S&P GS Commodity Index	595.55	3.5%	9.4%	2.8%	12.0%	37.4%	6.1%
WTI Crude ($/bbl)	82.64	6.2%	15.2%	2.3%	11.4%	55.7%	9.7%
Copper ($/lb)	4.56	3.6%	6.6%	5.4%	5.6%	26.6%	2.4%
Gold ($/oz)	1,821.40	-0.3%	2.3%	3.0%	1.6%	-1.1%	0.9%
U.S. Dollar Index	94.92	-1.3%	-1.2%	0.4%	2.9%	5.4%	-1.1%
Euro (USD/EUR)	1.14	0.7%	1.0%	-1.1%	-3.8%	-6.1%	0.4%
British Pound (USD/GBP)	1.37	0.9%	3.5%	0.6%	-1.5%	0.5%	1.1%
Japanese Yen (Yen/USD)	114.85	-0.8%	1.3%	1.1%	4.1%	10.2%	-0.3%
Chinese Yuan (CNY/USD)	6.36	-0.1%	-0.1%	-1.4%	-1.7%	-1.6%	-0.1%

Source: FactSet and Bloomberg. As of January 12, 2022.

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