

Global Research

Market implications in a global stagflation scenario

Introduction – central bank response critical for market reaction to a stagflation scenario

In our recent paper *Research Global: 'Stagflation' risks on the rise*, 15 September, we discussed the risk that the **global economy could face a (mild) stagflation scenario where inflation pressures turn out to be more persistent while the global economy continues to slow. This is not our base case – we see about a 30% chance of a stagflation scenario playing out.** A key factor behind this scenario is that supply constraints like labour shortages and supply chain problems persist for longer than expected, reducing potential output and resulting in further rising wage pressures, possibly spilling into higher inflation. While we think central banks will be patient with regard to reacting to the high inflation (especially given the weak underlying economic momentum), we think they will ultimately tighten monetary policy to avoid a de-anchoring of inflation expectations, with the Fed tightening faster from 6M-24M and the ECB taking action in H2 22 if inflation pressures stay elevated in H1 22.

In this paper we discuss the market implications in such a scenario across different product groups, where central banks combat higher inflation with tighter monetary policies (see summary table below). A monetary policy tightening in the US seen in a strong rise in short-end US real rates, in a relatively low growth environment, will in our view provide a substantial hit to global risk sentiment, partly reinforced by a materially stronger USD, sending global equities lower and credit markets spreads wider, especially the high yield segment. While longer rates would initially increase, we think the significant hit to the global growth outlook would reverse the sell-off at the long-end of rates curves, forcing a flattening of yield curves. The verdict by central banks on inflation is likely to be made in early parts of 2022.

While the discussion of the market impact on different product groups below hinges on a tightening of monetary policies, **we discuss at the end of the note the financial market impact if central banks were to keep policies accommodative** despite the substantial rise in inflation expectations. This would lead to broad weakening of USD while commodity currencies would benefit.

Today's key points

- Policy tightening by the Fed and other central banks in response to persistent global inflation pressures will hit global risk sentiment
- The USD will benefit from tighter US monetary policy and risk off while EM FX will be particularly vulnerable
- Global equities will fall on the back of higher yields which will devalue future cash flows
- While yields will initially rise and curves steepen, this will subsequently reverse as global growth outlook falters
- Credit risk spreads, notably on high yield bonds, are set to widen due to deterioration in corporate credit metrics and reduced hunt for yield

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The impact of a 'stagflation' scenario where central banks tighten policies

Market outlook in 6 months in our base-case and stagflation scenario

	S&P 500 1/	EUR/USD	KEY EM FX	US 10 year yield	US Curve (2-10 year) bps	German 10 year yield	Credit spread (HY), bps
Base case	1.2%	1.13	-10%	1.75%	145	-0.2%	+30
Stagflation	-10.0%	1.05	-20%	0.75%	35	-0.6%	+100

Source: Macrobond Financial, Danske Bank

Equity market – the repricing of future cash flows

Equities have for years benefited from expansive monetary policy and low yields. On the one side financing cost have declined and despite increasing debt levels coverage ratios are super high. On the other, the relative valuation has continued to speak in favour of equities as bonds have gotten increasingly expensive and the TINA (*there is no alternative to stocks*) argument persistently supports equities. Equity risk premiums are still high and despite the rally in stocks this year equities have not become cheaper since 1 January and earnings have soared.

A change in monetary policy is probably the one thing that can challenge equity valuations the most. A sharp move higher in yields will devalue the TINA argument and secondly mean that the net present value of future cash flows will drop. Put on top of this a weakening macro momentum that is very often associated with a drop in prices. The duration of the stagflation, or in other words the length of the higher inflation and weakening macro, is of course crucial in order to say anything with justification about the impact on equities. However, stagflation is one of the regimes where equities tend to do worst, measured in real returns.

There is basically nowhere to hide in equities if a stagflation scenario hits. However, sector composition in the equity market is very different from the 1970s and 1980s before and after the big stagflation period. Also, today the duration within equities is very different from sector to sector. Hence, it will not just be a question of which sectors and companies are able to hand increasing input cost over to customers.

In fact the biggest effect will come from changing the discount rate and hence companies and sectors with large expected cash flows way into the future will be the biggest losers. This will also mean that growth stocks will underperform value stocks and the valuation premium for growth stocks will come down sharply.

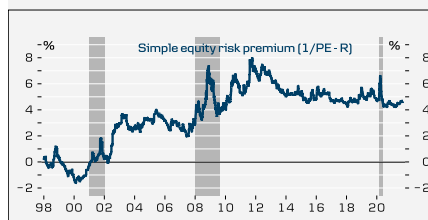
FX – long USD, short EM

Although EUR/USD is not directly affected by e.g. considerations of dollar debt, the market would be very likely also to reprice spot lower. The channels one could consider in this would in part be 1) rising global uncertainty, 2) a strong rise in short-end US real rates, 3) historical evidence, where dollar shocks have often been substantial and abrupt once they get going – e.g. in 2014/2015 where EUR/USD dropped from nearly 1.40 to 1.05 (almost 30%) in less than a year. In the base case where the Fed fully recognises the inflationary trends and equally responds to this, we see EUR/USD around 1.13 in a few quarters. **If an even more stagflationary outlook is present, requiring more Fed action and adding a further gloomy market environment in e.g. equities and EM, we would expect EUR/USD to drop towards 1.05 or similar.**

Monetary policy tightening in the US is one of the most acute risks for emerging markets, alongside protracted local epidemics and a fragile global recovery. In 2013, several EM currencies plummeted as a result of Ben Bernanke's speech that came to signal an abrupt end to ultra-loose monetary policy in the US. This time around, the markets could be better prepared, but the risks are real, and some EM countries are more vulnerable than others.

In our base case scenario, a Fed tapering announcement would push US yields higher, strengthen the dollar and unwind the positive terms of trade shock from rising commodities to exporters of natural resources. As a result, servicing USD denominated debt would become more difficult across the EM. Countries with high debt and large

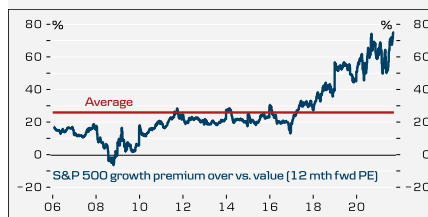
Initial higher yields will challenge equity valuation



Note: Past performance is not a reliable indicator of current or future results.

Source: Bloomberg, Macrobond Financial, Danske Bank

Growth stocks will suffer the most if yields are rising



Note: Past performance is not a reliable indicator of current or future results.

Source: Bloomberg, Macrobond Financial, Danske Bank

deficits would be the most exposed, since they have large refinancing needs. Furthermore, many EM countries have exploited the low rate environment by issuing more short-term debt during the pandemic to cover for the pandemic-induced rise in budget deficits, which means they will face refinancing needs sooner rather than later. Some indebted countries are, however, more resilient than others, as they have higher foreign reserves or a current account surplus.

Overall, in the base case, countries like Turkey and Hungary with low FX reserves and a high share of foreign debt could be more vulnerable to a currency depreciation than countries like China and Russia that have improved their trade position while also having better reserves coverage. The most vulnerable region remains Latin America (Argentina, Colombia and Chile in particular), where high absolute levels of debt, large external financing needs and a large commodity exporting industry could create trouble.

Rates – initially steeper curves

EUR rates/yields

Trading in bond markets in a stagflation scenario will become increasingly difficult for several reasons, but will ultimately depend on the timing of the policy responses from the Fed and the ECB, though these two should not be viewed too much in the same light, particularly as the ECB has a narrow inflation mandate compared to the Fed. Furthermore, the timing of market moves will not be ‘event-driven’ as in a political election, but rather an emerging narrative. Hence the exact starting points to put on tactical ‘stagflation’ trades are challenging.

Assuming a stagflation scenario is evolving now, we expect that 2s10s German curve will steepen around 15bp to the 50-55bp range, driven by the longer end (Bunds approaching -0.1%). Critically, the directional BTPs-Bund spread is expected to widen at least 20bp on such move to above 120bp due to renewed concerns about growth outlook and credit risks emerging. Finally, we expect the Bund ASW spread to revisit the 30bp range (around 8bp tighter). European linker bonds would also perform in this scenario. These moves are all considered on a 3m horizon. Looking ahead, the slowing growth outlook would ultimately be supportive of fixed income products and result in lower yields. We could see Bunds revisiting -0.6% in 6-12m, in this case.

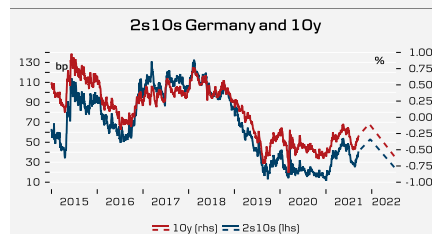
UST yields: initial upward pressure, then curve flattening

Even with the lower growth in our stagflation scenario the rising inflation pressure would force the Fed to hike Fed funds a lot faster than assumed by the market on a 6-24 month horizon. We still assume that that tapering will be concluded next summer.

Initially, we believe that the combination of higher inflation, tapering, forthcoming rate hikes, higher break-even rates and higher real rates will lead to a significant move higher in US nominal yields and a steeper curve 2s10s. We would not be surprised to see 10Y yields hitting 1.75-2.0% on a three to six month horizon.

However, as it becomes clear that the Fed is actually tightening in a stagflation scenario we would expect the curve to flatten significantly – 10Y UST yields could drop below 1% and the curve 2s10s would flatten quite a bit, even as the market will have a hard time pricing in more than the next ‘pre-announced’ rate hike. The market will disagree with the Fed even as it signals tighter monetary policy to quell inflation.

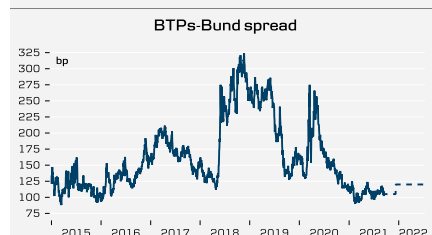
German yields in stagflation scenario



Note: Past performance is not a reliable indicator of current or future results.

Source: Danske Bank

BTPs-Bund spread set to widen 20bp in 3m on stagflation scenario



Note: Past performance is not a reliable indicator of current or future results.

Source: Danske Bank

Credit market

Apart from the direct negative effect of lower technical support from ECB purchases, we mainly see three channels through which a stagflationary environment could affect credit: 1) deterioration in corporate credit profiles 2) broad risk asset sell-off (3) unwinding of the hunt for yield effect. Credit metrics would likely deteriorate as lower growth would hurt corporate income and higher interest rates would imply higher financing costs. According to our (rough) estimates, it would take a significant shock to both income and interest expenses to affect credit metrics significantly, as credit is generally less sensitive to growth changes than e.g. equities. Factoring in harsh impacts on cash generation and financing costs we reach an average c.2 notch downgrade potential in EUR HY based on the most impacted metrics and much lower for the less impacted ratios. Using historical inter-rating spread differences, we estimate this could translate into a 100bp overall spread impact. A broad and deep sell-off in risk assets seems unlikely to us as those are usually caused by event-driven risks (e.g. COVID) or structural imbalances unwinding (e.g. GFC), neither of which, in our view, resembles a stagflationary scenario. Finally, an unwinding of the hunt for yield effect is, in our view, unlikely, as it would probably require a substantial rise in risk-free yields.

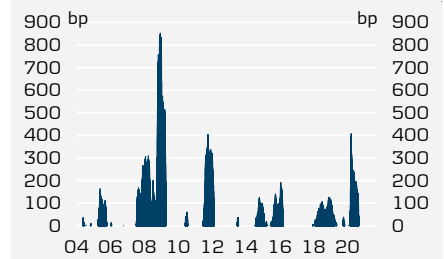
Seeing the rating-induced potential spread impact as an upper bound, internalising the effect of lower technical support from central banks and with HY spreads rarely widening more than 100bp outside 'crisis' scenarios, we would see 100bp widening as a realistic effect.

What if central banks do not tighten monetary policy – a replay of the stagflation of the 1970s?

In our analysis above we assumed that the Fed and other central banks tighten monetary policy to stave off persistent inflation pressures. However, **we cannot preclude a situation in which the central banks do not tighten monetary policy, similar to the response to the supply side shocks in the 1970s.** This could arise either if the central banks either do not want to tighten, fearing the negative impact on economic activity, or if they fail to acknowledge that the economy's potential has been reduced by the fall in labour supply and persistent supply chain issues. In such a scenario, where the economy is operating close to the vertical part of the supply curve, further stimulus would mainly result in (substantially) higher inflation while the increase in economic activity would be very limited.

In this case, where the Fed does not respond to an inflation shock (possibly inadvertently) and may even amplify it by ambiguous communicating, **markets will likely start to speculate on the profit impulse (from elevated and rising commodity prices) only getting larger, benefitting all kinds of commodity exporters and across assets.** In currencies, this would probably be dollar negative and thus beneficial for Russia, Latin America, Norway and Australia, though in some places, concerns related to the erosion of consumer's purchasing power may be a drag. **In equities, we would suspect to see a shift towards commodity producers, and these have actually seen a small pullback recently so there would also be scope for a turnaround in sentiment.** Broad equity markets will likely struggle while the value sectors may be relative winners. However, the flipside to this scenario is that at a certain stage the Fed and other central banks will have to tighten monetary policy even more at a later stage, which would entail a bigger economic setback and hit to risky assets.

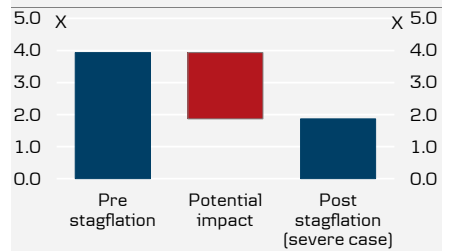
GM spread widening: spreads rarely widen more than 100bp outside of 'crises'



Note: (no bar indicates spreads are tighter than 6m ago)

Source: Bloomberg, Danske Bank

Pre and post FFO coverage ratio for EUR HY



Source: Bloomberg, Danske Bank

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