Global Markets Daily: Asset Allocation around Peak Hawkishness (Mariotti/Mueller-Glissmann)

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- Inflation has remained elevated across the major DMs, which suggests the current hawkish central bank tightening cycle appears set to continue and the prospects for peak inflation, peak hawkishness as well as a peak in real yields will remain key for markets to stabilise, in our view.
- We think a peak in US 2-year rates will be a key signal for peak hawkishness and provide some relief across assets. Historically, 2-year yields have peaked at a higher level and before the Fed fund rate - in between a month and a month and half before - but we think we are not yet near such a turning point.
- The road to peak hawkishness tends to be challenging for most assets: equities and 60/40 portfolios' performance tends to worsen 3-6 months before the end of the hiking cycle, and cyclical equities generally underperform vs. defensive. The US Dollar can remain strong until the peak in rates is reached.
- We remain relatively defensive in our asset allocation for over the next 3 months (OW cash & N equities) and look for opportunities to add risk over the next 12 months. We continue to like collars on equities to take advantage of the very low skew and remain constructive on real assets for the new cycle. With TIPS yields approaching 1%, inflation-protected bonds will start to turn more attractive, in our view.

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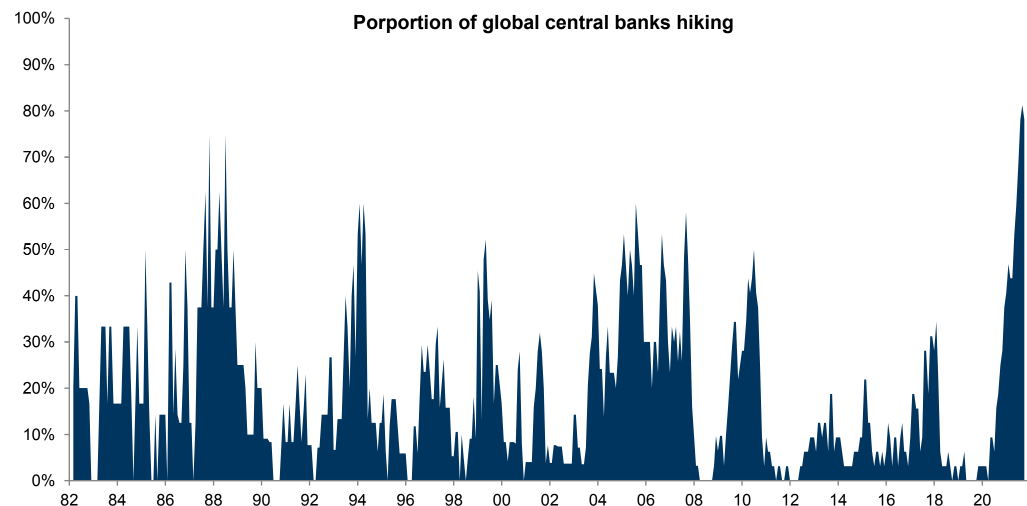
Asset Allocation around Peak Hawkishness

Inflation has remained elevated across the major DMs, which suggests near-term risks for central bank policy are still skewed to the hawkish side. After last week's upside surprise in US inflation, our economists forecast a steeper Fed hiking path - they now expect a 75bp hike in September followed by 50bp hikes in November and December (from 25bp previously). The revised hiking path also raises risks for a continuation of the tightening cycle into 2023. At the same time, they expect further hawkish moves from both the ECB and the BOE into next year.

The scope of the current tightening cycle appears historically large. The share of global central banks that are currently in a hiking cycle is at a record high (and this is true also when considering the DM space only) (Exhibit 1). Therefore, the current hawkish central bank tightening cycle appears set to continue, and rising real yields remain a key headwind for multi-asset portfolio - a simple US 60/40 portfolio is now down 16% YTD (-19% at the June trough), more than during the Covid-19 crisis. The prospects for peak inflation, peak hawkishness as well as a peak in real yields will remain key for markets to stabilise, in our view.

Exhibit 1: A record share of central banks are in a hiking cycle
Up to 32 Central Banks included



Source: Haver Analytics, Goldman Sachs Global Investment Research

Besides the elevated and persistent inflation, another reason why the Fed is likely to continue tightening is that the macroeconomic backdrop has proved to be resilient, especially as the US labor market has been exceptionally strong. Looking at historical episodes when the Fed stopped hiking with inflation considerably above target as is currently the case, it required an unemployment rate well north of 5% for the Fed to stop tightening (Exhibit 2). Wage growth has also on average been much lower than we are seeing now; the current path for wage growth is well above the 3.5% level our economists believe to be compatible with 2% inflation.

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Exhibit 2: The current macro backdrop suggests the Fed is likely to continue tightening

Levels of macro variables at US Fed fund rates peak and change over the following 3- and 6-months

US Fed Fund rates peak	Level	Cut or pause?	CPI			Wage growth			ISM			Unemployment			Real GDP growth		
			At peak	+3m chg	+12m chg	At peak	+3m chg	+12m chg	At peak	+3m chg	+12m chg	At peak	+3m chg	+12m chg	At peak	+3m chg	+6m chg
Apr-80	17.6	Cut	14.6	-1.4	-4.5	8.0	-0.2	1.0	37	-2.4	14.2	6.9	0.9	0.3	-0.8	-0.9	3.8
Jun-81	19.1	Cut	9.7	1.3	-2.5	8.8	0.1	-3.0	51	-8.2	-12.4	7.5	0.1	2.1	3.1	1.3	-4.2
Aug-84	11.6	Cut	4.3	-0.1	-0.9	3.9	-0.9	-1.0	53	-2.7	-5.3	7.5	-0.3	-0.4	7.0	-1.3	-2.6
Mar-89	9.9	Cut	4.9	0.3	0.3	4.2	-0.5	0.0	52	-4.2	-1.6	5.0	0.3	0.2	4.3	-0.5	-1.4
Feb-95	5.9	Pause	2.9	0.3	-0.1	2.4	0.3	0.6	55	-8.4	-9.2	5.4	0.2	0.1	3.5	-1.0	-0.9
May-00	6.3	Pause	3.1	0.2	0.4	3.8	0.1	0.2	53	-3.3	-11.9	4.0	0.1	0.3	5.3	-1.2	-4.4
Jun-06	5.0	Pause	4.2	-2.2	-1.5	4.0	0.2	0.1	52	0.2	0.6	4.6	-0.1	0.0	2.9	-0.7	-1.2
Dec-18	2.3	Pause	1.9	-0.1	0.3	3.5	0.0	-0.2	54	0.3	-6.5	3.9	-0.1	-0.4	3.1	0.2	-0.6
Average			**5.7**	**-0.2**	**-1.1**	**4.8**	**-0.1**	**-0.3**	**51**	**-3.6**	**-4.0**	**5.6**	**0.1**	**0.3**	**3.5**	**-0.5**	**-1.4**
Current			***8.2***			***6.1***			***53***			***3.7***			***1.7***		

Source: Haver Analytics, Goldman Sachs Global Investment Research

Against this backdrop, US rates have pushed materially higher YTD, and the market is already pricing in a steep Fed hiking cycle for this year, but our rates strategists expect further repricing, especially in the front-end and real component. In particular, they see US 2-year and 10-year rates rising to 4.3% and 4%, respectively, by the end of 2023. After the summer sell-off, US 2-year rates have moved well above their pre-Covid peak and not far off the year-end Fed fund rate forecast from our US economists. Outside the 1980s when the Fed fund rate rose above US 2-year yields, 2-year yields have historically peaked at a higher level than the Fed fund rate - about 80bp above on average (Exhibit 3).

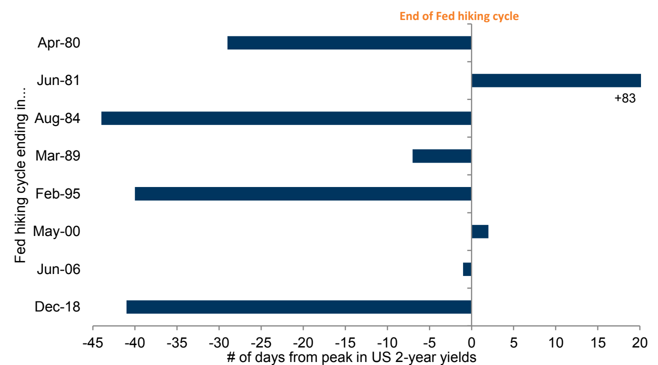
More interestingly, 2-year rates have generally peaked either before the Fed fund rate - in between a month and a month and half before - or nearly simultaneously (Exhibit 4). The 1981 cycle represents the only major exception to this trend, but in that period, the Fed was oscillating between hiking and cutting, fighting a double-digit inflationary shock, which resulted in rates remaining elevated for longer.

Exhibit 3: US 2-year yields are well above their pre-Covid peak and not far from our US Economists' year-end Fed fund rate forecast

Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 4: On average, 2-year yields peak about a month to a month and a half before the end of a Fed hiking cycle

Days from peak in US 2-year yield to end of Fed hiking cycles



Source: Bloomberg, Goldman Sachs Global Investment Research

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We think a peak in US 2-year rates will be a key signal for peak hawkishness and provide some relief across assets. Although we think we are not yet near such a turning point, an analysis of past episodes can provide a useful template to better understand the type of cross-asset pattern investors can expect in the last leg of a Fed hiking cycle, i.e. approaching peak hawkishness. As always, there can be significant differences across episodes: as we wrote before, Fed hiking cycles have on average been relatively good for risky assets - especially commodities - but towards the end of the cycle, markets were often scared somewhat by the risk of the Fed tightening policy 'too aggressively', ultimately triggering a vicious cycle between tighter financial conditions and weaker growth. This can be the case especially in periods of high and sticky inflation.

We find that equities' performance tends to worsen 3-6 months before the end of the hiking cycle (Exhibit 5), and the same is true for a standard 60/40 portfolio (Exhibit 6). Looking below the equity surface, Exhibit 7 shows that the last leg of the hiking cycle is indeed generally characterized by a more pessimistic repricing of growth, with cyclical equities starting to underperform vs. defensive - the narrow range of outcomes around the average as the peak in the US 2-year is reached provides evidence of consistency in the pattern.

On the flipside, the peak in US 2-year rates generally provided significant relief for both US equities and a standard 60/40 portfolio, as more accomodative monetary policy is typically supportive of a valuation re-rating in equities and the peak in front-end rates has coincided with a peak in 10-year rates (Exhibit 8). Peak hawkishness has also generally also brought a volatility reset in both the equity and rates markets.

Cyclicals meanwhile do not rebound as clearly past peak hawkishness. We think that is because typically the Fed started cutting amid a less rosy growth backdrop. Actually, in the last four hiking cycles (1995, 2000, 2006 and 2008), the Fed held rates high, which has favored a faster rebound in cyclicals, rather than moving seamlessly into a cutting cycle. That was possible as the macro backdrop at the end of the last few hiking cycles was characterized by a relatively favorable growth/inflation mix (Exhibit 2), which could be the case again this time around.

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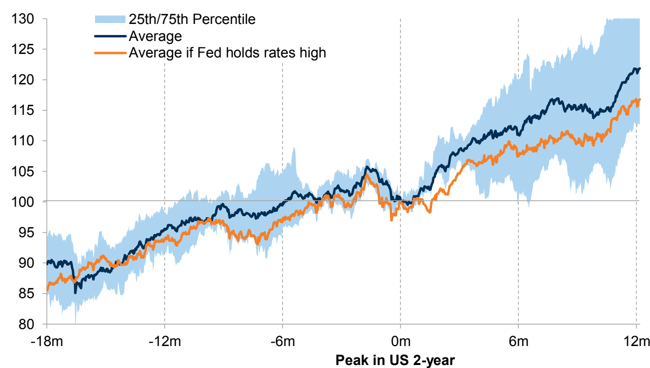
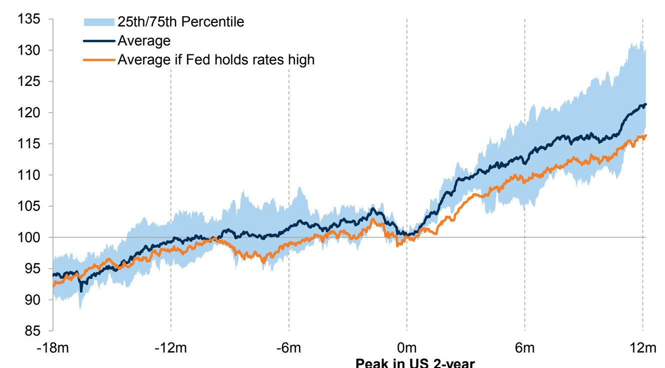
Exhibit 5: Equities tend to suffer approaching the peak in US 2-year yields, but rebound afterwards...
S&P 500, data since 1980



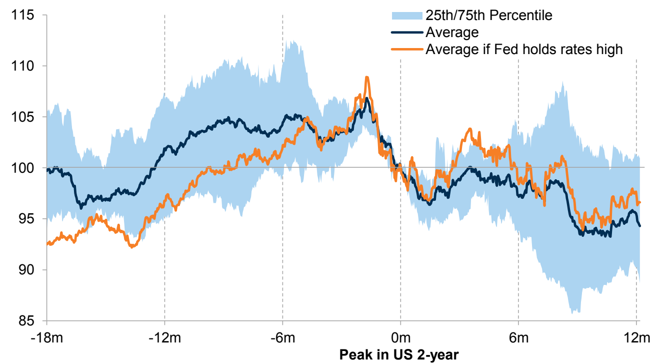
Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 6: ...similar to a 60/40 portfolio
60/40 portfolio, data since 1980



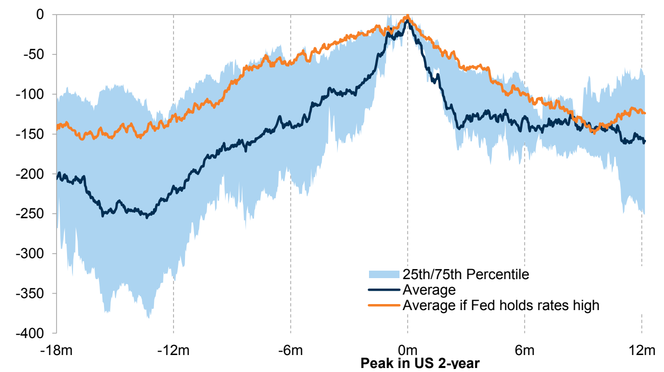
Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 7: Cyclicals underperform vs. defensives before the US 2-year peak and struggle to rebound after
Cycl. vs. Def., data since 1980



Source: Datastream, Goldman Sachs Global Investment Research

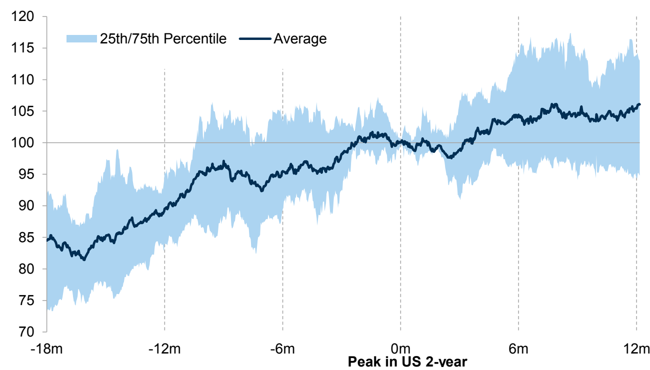
Exhibit 8: Typically, the peak in 2-year yields coincides with the peak in the 10-year
US 10-year yields, data since 1980



Source: Datastream, Goldman Sachs Global Investment Research

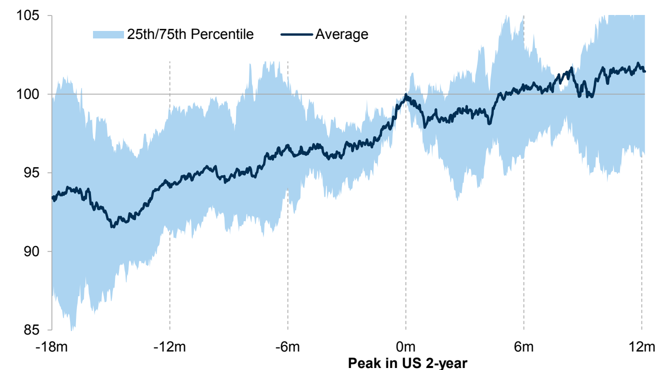
The same analysis for commodities and the Dollar reveals a more mixed picture. After posting a very strong performance on average in the initial phase of the hiking cycle, S&P GSCI returns tend to flatten going into peak hawkishness (Exhibit 9) and weaken post the US 2-year peak. However, it is worth highlighting how the range of outcomes is particularly wide in this case and our commodities team remains constructive at the moment due to supply/demand imbalances. The Dollar tends to be on a strong footing until the peak in US 2-year yields is reached, consistent with our FX strategists' expectations for more Dollar strength ahead, but it has generally weakened and been more volatile afterwards (Exhibit 10).

Exhibit 9: Commodities' performance tends to flatten going into peak hawkishness
S&P GSCI, data since 1980



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 10: The Dollar can remain strong until the peak in US 2-year is reached
DXY, data since 1980



Source: Datastream, Goldman Sachs Global Investment Research

Given our expectations for a prolonged hawkish period, we remain relatively defensive in our 3-month asset allocation (OW cash & N equities) and look for opportunities to add risk for the 12-month horizon. As we discussed in our Balanced Bear Research, standard 60/40 portfolios have become riskier in the face of a challenging growth/inflation mix and still elevated valuations vs. long-run history. Additionally, there remain risks around our central forecast of a soft landing: a more hawkish Fed and severe economic downturn would imply larger downside for both equities and bonds, in our view. We continue to

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like collars on equities to take advantage of the low skew and with markets likely to trade in a more ‘fat and flat’ range.

We remain constructive on real assets for the new cycle; however, many real assets have struggled more recently due to rising real yields – higher TIPS yields make other real assets, such as real estate, infrastructure or gold, less attractive on a relative basis and valuations need to de-rate. Also, several real assets have some element of cyclicality, especially real estate which often has embedded leverage. We think the ongoing valuation re-set will create attractive entry points in real assets for long-term investors, as we expect higher inflation and inflation volatility structurally. TIPS as ‘pure’ inflation hedge are also starting to become more attractive - our rates team expect real yields to increase further into year-end but nearing their peak.

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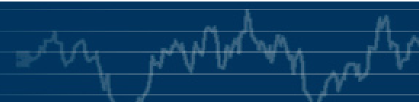
TRADE IDEAS



Best Trade Ideas Across Assets

For pricing, charts, and a list of previous recommendations, please visit our Trade Ideas page.

1. Stay long SGD vs. short TWD, opened on October 29, 2020, at 20.95 (indexed at 100), with a revised total return target of 125 and a revised stop of 119, currently trading at 122.07.
2. Stay long MSCI EM vs. short EMBIG-Div, opened on November 9, 2021, at 100, and revised on 8 December to include duration (from hedged previously) together with a revised total return target of 120 and a revised stop of 86, currently trading at 91.59.
3. Buy 6m20y JPY A/A+ 25 payer spread, opened on April 29, 2022, at 0bp, with a total return target of 15bp and a stop of -7bp, currently trading at 6bp.
4. Buy 10y30y straddles vs. sell 3y30y straddles (3:1 vega risk), opened on May 20, 2022, at 30abp, with a target of 35abp and a stop of 27abp, currently trading at 34abp.
5. Buy 6m USD/JPY digital puts, opened on May 20, 2022, at 128, with a target of 115, currently trading at 143.04.
6. Stay long 5y5y HICP inflation swaps, opened on July 15, 2022, at 2.06%, with a target of 2.35% and a stop of 1.85%, currently trading at 2.25%.
7. Sell EDH3 96.25 Call, opened on July 15, 2022, at 51bp, with a revised 5bp trailing stop, currently trading at 9bp.
8. Short BAZ2, opened on July 22, 2022, at 3.88%, with a revised 10bp trailing stop, currently trading at 4.51%.
9. Sell 3m 5s10s USD curve straddles, opened on July 22, 2022, at 0.19, with a target of 0.09 and a stop of 0.25, currently trading at 0.22.
10. Stay long CMBX 14 BBB- index vs. CMBX 10 BBB- index, opened on July 29, 2022, at a 1 to 1.4x notional ratio, with a target of 3% and a stop of -3%, currently trading at 0.49%.
11. Sell 10y BTPs vs. Bonos, opened on August 5, 2022, at 100bp, with a target of 125bp and a stop of 90bp, currently trading at 112bp.
12. Stay short EUR/MXN, opened on August 11, 2022, at 100, with a total return target of 108 and a revised stop of 103.5, currently trading at 104.11.
13. Stay long THB vs. MYR, opened on August 17, 2022, at 7.95, with a target of 7.30 and a stop of 8.30, currently trading at 8.11.
14. Stay long IDR vs. PHP, opened on August 24, 2022, at 100, with a target of 108 and a stop of 96, currently trading at 101.46.
15. Pay THB 5y OIS, opened on August 30, 2022, at 2.18%, with a revised target of 3.00% and a revised stop of 2.35%, currently trading at 2.64%.

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16. Stay long INR 5y bonds vs pay ND-OIS, opened on August 28, 2022, at 60bp, with a target of 0bp and a stop of 100bp, currently trading at 58bp.
17. Receive BRL DI Jan25s, opened on August 31, 2022, at 12.02%, with a target of 10.5% and a stop of 13%, currently trading at 12.03%.
18. Receive KRW 2Y ND-IRS vs. pay HKD 2Y IRS, opened on August 31, 2022, at 20bp, with a revised target of -60bp and a revised stop of 0bp, currently trading at -22bp.
19. Stay long SFRH3/Z3 steepeners versus BAH3/Z3 flatteners, opened on September 2, 2022, at -25bp, with a target of 0bp and a stop of -40bp, currently trading at -7bp.
20. Stay short Chile's 5y CDS vs. buy Peru's 5y CDS, opened on September 5, 2022, at 24bp, with a target of -5bp and a revised stop of 20bp, currently trading at 10bp.
21. Stay short EUR/CHF, opened on September 8, 2022, at 0.97, with a target of 0.955 and a stop of 0.985, currently trading at 0.966.
22. Stay short 5y Bunds, opened on September 9, 2022, at 1.55%, with a target of 1.80% and a stop of 1.40%, currently trading at 1.64%.
23. Stay short 30y Gilts vs. Bunds, opened on September 9, 2022, at 1.67%, with a target of 2.0% and a stop of 1.55%, currently trading at 1.69%.
24. Sell 1y1y TIPS, opened on September 9, 2022, at 56bp, with a revised 15bp trailing stop, currently trading at 92bp.
25. Stay short NZD vs. CAD, opened on September 9, 2022, at 0.797, with a target of 0.780 and a stop of 0.820, currently trading at 0.794.

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Reg AC

We, Cecilia Mariotti, Christian Mueller-Glissmann, CFA and Andrea Ferrario, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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