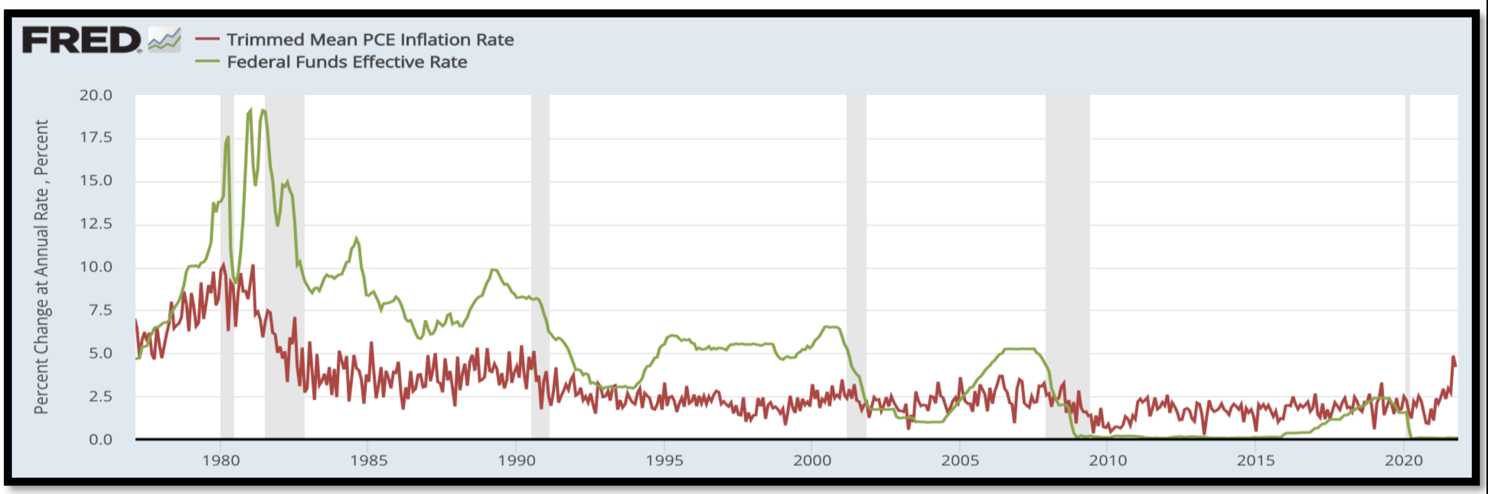
A Different Credit Risk

December 31, 2021

Economists and professional institutional investors are paid to think about the potential risks to investment portfolios, and they've been doing a lot of thinking lately, about the Omicron variant, supply chain issues, crypto volatility, a possible recession, and a recent resurgence in inflation. So, what is their number one concern going into 2022?

According to a survey of 106 professionals in the investment world, the biggest concern is central banks, in the U.S. and abroad, overreacting to inflation and tightening credit. One market strategist spoke for the group when he said that it will be challenging for the U.S. and the world economy to tolerate excessive interest rate hikes, especially coming from the U.S. Federal Reserve Bank. Not only would higher interest rates make it more costly for companies to borrow to invest in their operations; they would also entice some investors away from the stock market, which some see as increasingly risky as valuations continue to rise.



Of course, with inflation running at 5%, and short-term bond rates at 0%, the so-called 'natural' interest rates are much higher than they are currently—which is another way of saying that anyone investing in bonds today is losing money when measured in purchasing power. As you can see from the graph, where the Fed funds rate is in green and a version of the inflation rate is in red, there has recently been a pretty broad divergence between the two, and those seem, historically, not to last long. Bringing bond rates up to the inflation rate might trigger the recession and market pullback that institutional investors and economists worry about.

But of course, just because this is a worry doesn't mean that the central banks will proceed recklessly, or that if they do, it is not a given that the markets and global economy will respond as predicted. The poll found that a significant number of the respondents thought there was still room for positive growth surprises, and that the global economy might prove more resilient than current consensus expectations. One analyst noted that the strong labor market recovery supports a positive outlook for consumption. Others thought that 'inflation proving transitory' would be the most consequential positive surprise.

If you were looking for investment advice from this poll, you might be disappointed. The survey respondents tended to favor the regions they're based in: European economists and institutional investors were overwhelmingly overweight in European equities, while U.S.-based respondents were more confident about American stocks. Those who were based in Asia were more optimistic about China than their counterparts elsewhere. This proves once again that even the experts disagree about what and where we could find higher returns.

Sources:

https://www.advisorperspectives.com/articles/2021/12/15/central-bankers-are-the-biggest-risk-to-stocks-in-2022-survey-finds

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