

## **Did Inflation Crash the Market in 2022 and Where Next for Real Yields – Market Commentary**

November saw significant US strength. The MSCI World returned +4.6%, however this was underpinned by a +5.8% US return. The MSCI ex-US Index, in contrast, returned +0.2%, while the MSCI Emerging Markets Index was down -3.6%.

Within the US Growth outperformed Value +5.3% to +3.9%, however Financials, not considered a Growth sector, were second-best performing at +8.0%.

South Africa performed in line with Emerging Markets, slightly outperforming at -3.0% in USD terms.

For the year-to-date the US remains the best-performing market at +27.6%. Growth outperformed Value +25.4% vs +18.4%. Emerging Markets are far behind at +7.7% but South Africa performed twice as well at +15.2% in USD terms, with the outperformance achieved entirely since the formation of the GNU in June.

We summarise these global market returns in Table 1 below.

**Table 1. South African and global equity returns (USD) for November 2024\***

	<b>Nov-24</b>	<b>YTD 2024</b>
FTSE/JSE ALSI (ZAR)	-0.9%	13.8%
FTSE/JSE ALSI (USD)	-3.0%	15.2%
MSCI World	4.6%	21.8%
MSCI EM	-3.6%	7.7%
MSCI Value	3.9%	18.2%
MSCI Growth	5.3%	25.4%
S&P 500	5.8%	27.6%
Nasdaq 100	5.3%	25.3%

\*Total return indices, Source: Factset

2022 was an unsettling year in equity and bond markets. The MSCI World returned -18.1%, the Nasdaq was down -32.4%, and the Bloomberg Barclays Global Aggregate Index, a bond benchmark, was down -14.1%. It seems long forgotten now and perhaps difficult to believe, but Nvidia was down -50.3%. A 60/40 equity/bond portfolio, a configuration apparently trusted in the US to deliver positive returns through different market environments produced negative returns, while the self-reinforcing sentiment in that year led to commentary such as "a -90% stock is a -80% stock down a further -50%", a correct, but ultimately unrealised conclusion for a large part of the market.

### **What happened?**

As is widely known US Treasury yields rose and this led to the market declines. A standard outcome since rising interest rates imply declining asset prices. The US 10-year Treasury yield, presented in Chart 1 below rose from a low of 0.54% in July 2020 to a high of 4.90% reached in October 2023. US long interest rates rose in anticipation and response to surging US inflation. Since higher rates lead to higher interest costs and lower discounted present values, asset prices decline, equities more so than bonds on account of the longer duration of their anticipated cash flows. So, little surprise, in fact, that a 60/40 portfolio produced negative returns since both equities and bonds are sensitive to rising rates.

## Was inflation the cause?

It is commonly understood that rates rose in anticipation, and response, to the onset of inflation. This is the popular and easily presented explanation, and the subject of this commentary. We suggest instead, upon examination of bond yields that the market was never really particularly worried about sustained inflation. Instead interest rates rose because the market's worries dissipated. If this reasoning which we present is correct, then the conclusion is that inflation did cause rates to rise but only because the market concluded it would not be a long term concern.

### Chart 1. US 10-year Treasury Yield



Source: Factset

### How is it that the market was never really worried about inflation?

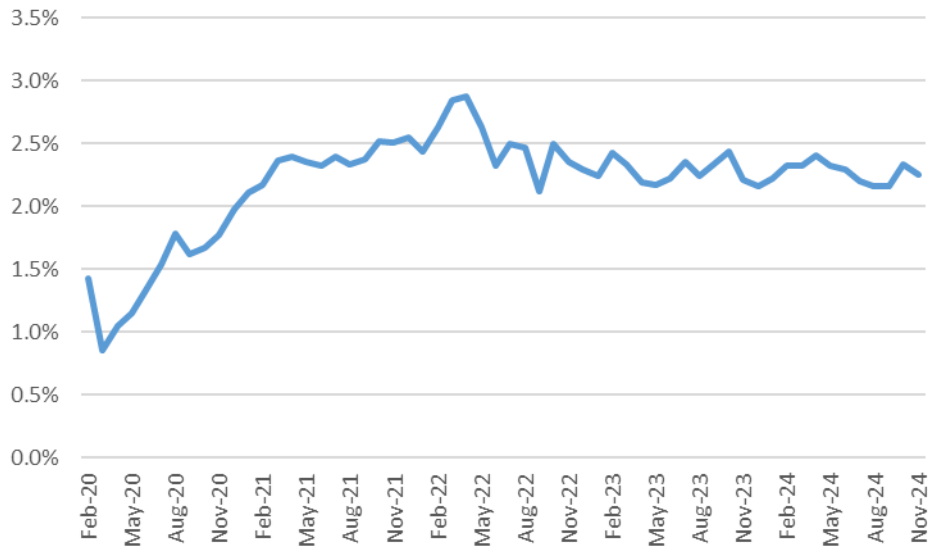
The difference between the 10-year Treasury yield and the 10-year Treasury Inflation-Protected Security yield is the breakeven inflation rate, or the inflation rate the market expects over the 10-year period plus an uncertainty or risk premium.

We present this 10-year breakeven inflation rate in Chart 2 below.

Per Chart 2 below, 10-year inflation expectations did indeed rise mildly at the beginning of 2022, reaching a maximum 2.9%. For the full period since May 2021, expected inflation and the associated risk premium have fluctuated in a tight band between 2.0-2.5% p.a. During this period Treasury yields rose sharply.

While we are discussing breakeven inflation it is also worth fast forwarding briefly and noting that in the current environment (again but this time mildly) rising rates following Fed rate cuts are causing much consternation. Breakeven inflation however has again not deviated materially from the 2.0-2.5% band. At the end of November it was 2.25%. Assuming 0.25% is a risk premium, the market continues to expect 10-year inflation of 2.0% p.a.

**Chart 2. US 10-year breakeven inflation rate**



Source: M1 Capital

**What caused rates to rise if it wasn't inflation?**

We present in Chart 3 below, the yield on US 10-year Treasury Inflation-Protected Securities (TIPS), or the 10-year real yield.

**Chart 3. 10-year real yield on US TIPS**



Source: Factset

For completeness we also present the same real yield together with US M2 money supply growth in Chart 4 below.

**Chart 4. 10-year real yield on US TIPS and M2 Money Supply growth**



Source: Factset

Note in Chart 4 above, how the real yield became negative in early 2020 with the onset of Covid and the explosive growth in US money supply (for anyone doubting that the money supply growth caused the inflation, or that the market wasn't worried about the same money supply growth).

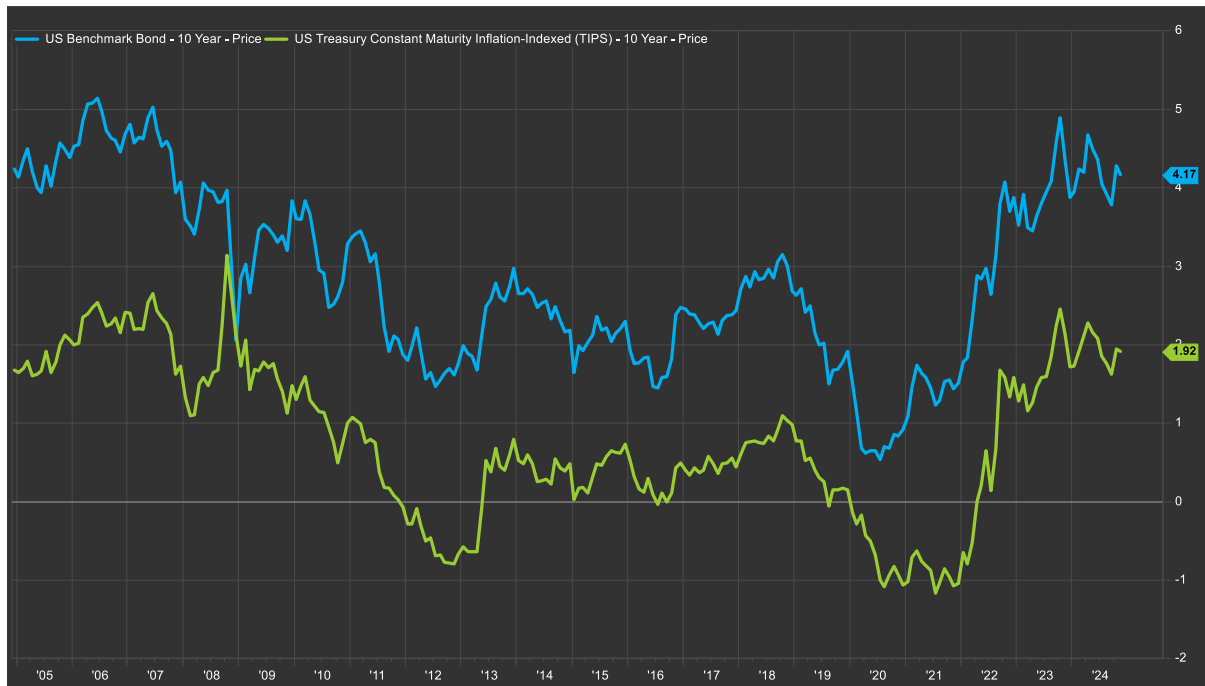
But our interest is 2022, and also 2025.

Note also the sharp rise in real yield in early 2022 from -1.0% to +1.5% and then to +2.5%, just when the equity and bond markets were declining.

We also present in Chart 5 below, the US 10-year Treasury yield vs the 10-year TIPS or real yield. Per Chart 5, the 10-year Treasury (nominal) yield is mostly consistent with the real yield.

So fear of inflation drove the negative real yield in 2020 when investors were prepared to realise a -1.0% p.a. real return in exchange for protection from uncertain future inflation. In 2022 the fear dissipated and real yields normalised i.e. became positive again as TIPS sold off. Incidentally we have written about negative real yields before as they were prevailing, suggesting shorting US TIPS would be a profitable trade when real yields normalise.

**Chart 5. US 10-year Treasury yield vs the US 10-year TIPS yield**



Source: Factset

### **Why did real yields normalise?**

Rising real yields indicate dissipating inflation fears. But rising real yields also coincided with a tightening phase by the Fed, which likely explains the dissipating inflation fears. In general monetary policy is regarded as a significant driver of real yields.

### **What is the conclusion?**

The simple initial conclusion from all of the above is that the real rate is the rate to watch, and what happens to the real yield determines nominal yields and the direction of asset prices.

### **Where to next for real yields?**

To gauge where real yields go next we might be inclined to say there isn't enough history, and/or that the real rate should be more or less constant. The question then, on available data, is is the long term real rate 2.0%, as it was prior to the Financial Crisis and again since 2022, or closer to 0.0% to 0.5%? There is no clear answer on available historical data except one might be inclined to suggest that capitalism is likely to require a real long term rate closer to 2.0%.

On this reasoning nominal yields are therefore likely to stay where they are.

An alternative point of view is that monetary policy is a significant driver of real yields. And that over time real yields are not constant and will follow the Fed rate.

We present a final Chart 6 below of the Fed Funds rate and the 10-year real yield.

Chart 6 appears to confirm the Fed funds rate as a driver of real returns, at least over the last 15 years.

**Chart 6. The 10-year real yield and the Fed funds rate**



Source: Factset

If we assume Fed policy drives real rates, we would expect these (and therefore nominal yields) to decline as the Fed rate declines. This would be supportive of asset prices.

### Summary

Real rates are important to watch as they drove the market down in 2022. They will also likely follow the Fed rate down in the next 12-24 months. While supportive of prices, declining rates do not guarantee a rising market. Earnings growth is the other driver of equity prices and the prospects for recession have not been conclusively resolved yet.