Capital Markets Strategy

Essential inCights for the C-Suite

Chart of the Day

This afternoon, the Fed is widely expected to raise rates by 50 bps for the first time in 22 years. Even with 10 year inflation break-evens above 2.8%, UST 10 year rates briefly breached 3% for the first time in 4 years (nearly doubling YTD from 1.51% on Dec 31) on expectations of accelerated Fed tightening . According to the St. Louis Fed, 10 year UST yields have generally been higher than inflation for most of the last 20 years prior to March 2020.

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As the Fed drains liquidity, asset prices that have been fueled most by Fed-induced liquidity are the most vulnerable. For risk assets, a rising rate environment poses challenges, especially as **bond yields and sovereign debt** offer more competitive returns. Higher rates also exert downward pressure on P/E multiple expansion for growth stocks in particular. YTD, the NASDAQ is down nearly 20% and the S&P 500 has declined 12%. Tech-heavy regional stock markets (Taiwan) globally have also come under pressure. High growth businesses and low profit or loss-making start-ups are particularly vulnerable.

The TINA (there is no alternative) trade is under pressure. Commodity currencies, companies and stocks are benefitting.

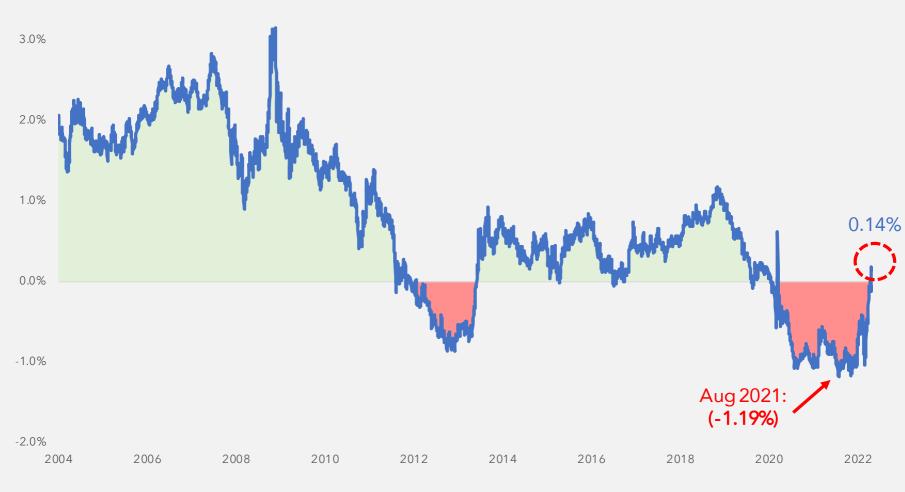
Returns on IG & HY bonds have been more deeply negative YTD than any year since the 1970s, as rising rates and spreads, as well as increased volatility, increase corporate borrowing costs. Mortgage rates on new housing purchases are now above 5% for the first time since 2011. Accelerated Fed tightening (and the unexpected war in Ukraine) has also precipitated more US Dollar strength in 2022 YTD (+8%) than most had anticipated, which in turn puts pressure on both DM (Yen at 20 year lows, Euro also down sharply) and EM currency pairs (Hungary, Malaysia), multi-national corporate earnings, and the USD liabilities of non-US multi-nationals.

In our view, it will be much easier for the Fed to reduce inflation from 8-9% to 4-5% with its demand side tools directly impacting interest rate sensitive sectors (durable goods, auto, housing), than it will be to reduce inflation from 4-5% down to 2-3% without precipitating a "hard landing," given the concurrent supply side sources of inflation (COVID impact on supply chains, Ukraine on energy and food).

After reaching a low of (-1.19%) in August, UST 10 year "real" yields have returned positive for the first time since March 2020, as they have been for much of the last 20 years

UST 10 year real yield

4.0%



Source: (1) Bloomberg. Data as of May 4, 2022. WSJ. Barron's. FT. Freddie Mac. MUFG Rates Strategist (Goncalves).

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