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All Ahead Full: Private Credit Outlook 2022 (Fifth of a Series)

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Inflation and interest rates are linked, but not always in straightforward ways. Fear of higher prices can drive rates up, while markets may ignore actual inflation having anticipated it.

This year we devoted a special series to inflation (link) and, with expert help from our favorite economists, have written extensively about rate expectations. Recent data has certainly created alarming headlines. A cursory look at the facts behind the fever is educational.

Last Friday's CPI report showed November's consumer prices up 6.8% versus last year. Not since 1982 (when Joe Montana's 49ers beat the Bengals in Super Bowl XVI) has that metric been as lofty. As one analyst put it, "It was a very high inflation print, but it was a high inflation print that was already expected and should have been priced into the market."

Two other factors have come into play: Omicron's emergence, and the Fed's modified hawkish stance. Both the variant's impact on future growth and the central bank's willingness to taper faster for a potentially earlier rate hike have raised the possibility of a future slowdown. Welcome to the land of mixed signals!

Today's supply chain issues may lead to tomorrow's gluts. Both product and service shortages are resulting in increased production as raw materials and labor come on-line. Even if some demand is sustained, that ramp could create excess inventories, and prices tumble. Lumber was a recent example of this phenomenon.

All of which presents a confusing picture for investors. While "transitory" may have been discarded from the Fed's lexicon, that hasn't clarified the inflation outlook. Our own Brian Nick (and others) remains confident the surge of higher prices will ease by the middle of next year as supply chains normalize and pent-up demand runs out.

In the meantime, long-term Treasury rates flattened in response to more virus and faster hikes. The short-end of the curve seems convinced that "faster" doesn't mean anytime soon.

As our *Chart of the Week* depicts, higher inflation has driven real US Treasury yields to their lowest levels on record. Given that dynamic, investors seeking to hedge against eroding buying power will find insurance expensive.

The good news is investors can access assets less negatively correlated to higher interest rates or rapid economic growth. Direct lending provides a natural hedge as a floating rate product, but also a current yield at a premium to risk-free rates and more public credit instruments.

And even with three quarter-point rate hikes in 2022, that puts Fed funds at 1%. Hard to pin a slowdown on that.

?? From the Editor: The Lead Left will be on break until January 3th. To all of our readers, best wishes for a safe, healthy and restful holiday season.