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The Ghost of Arthur Burns

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As we head into what is another important week for central bank meetings, it feels as though markets are trying to decide what to do next. The run up from last October's lows in equity markets has been a strong one and a period of consolidation might not be a bad thing if it prevents the buildup of excessively speculative positions which might end being unwound in a disorderly manner.

The MSCI All-Countries World Index is up 22% since 26 October. We have often in the past drawn attention to the fact that when markets turn for the better, they tend to do so aggressively and that it is very difficult to make up lost performance if you are underinvested. That has been the case once again. And for all the calls we heard to hold more cash last autumn, that index move is equivalent to around four years' worth of interest.

But while a near-quarter increase in the index over such a short period looks mighty generous, the picture looks different if one steps back a little. It has only just broken above its previous peak made on 16 November 2021, and so had previously spent two-and-a-bit years going nowhere (by way of a 27% peak-to-trough drawdown, to be fair). Although there is always a risk of a "double top" developing, markets that make new highs tend to maintain that trend.

It was the central banks who spoiled the party last time by raising interest rates aggressively to counter the rising threat of inflation. As it turned out, they were too late and too slow in their response, although even now the jury remains out on the extent to which they could have prevented the increase in inflation given that factors including supply chain disruptions, shifting consumer preferences, fiscal stimulus and, latterly, Russia's invasion of Ukraine were beyond their control.

More recently, the central banks have been accused of being too slow to start cutting rates, especially in the UK and Europe, which are in various states of recession and stagnation. There were calls for faster US rate cuts last year too, but the fact that the economy has so far avoided a widely expected recession paints the Federal Reserve (Fed) in a better light for being patient.

One chart I have referred to a lot in the last couple of years plots the current course of US inflation over the same series from the 1960s and 1970s. They track each other very well until around 1976, which is where today's data ends. It's what happened in 1977 that continues to haunt Fed chair Jerome Powell. Inflation took off again after the Fed's then chair Arthur Burns prematurely declared it beaten. Powell is on record as saying that he does not want to be remembered as another Arthur Burns. He casts himself, instead, in the role of Paul Volcker, who followed Burns and had to squeeze the economy with double-digit interest rates to tame inflation. Obviously, Powell hopes not to have to go the whole hog with the rate increase nor to inflict a nasty recession upon the economy, but he has set his stall out as being in no hurry to cut rates until the evidence is more in his favour. Most other central bank leaders have followed the same line.

Recent hints of "sticky" inflation in the United States have brought interest rate policy decisions back to the front of investors' minds. At the start of the year, this week's policy meetings at the Fed and the Bank of England were supposed to be when we were getting the first rate cuts of the cycle, but they have already been pushed back to June or even July, in terms of what is priced into futures markets. At least the good news is that not having cut rates prematurely, there is a limited probability of them having to be reversed. There is also the fact that part of the reason for higher-than-expected inflation (in the US at least) is because the economy has been much stronger than expected.

I wrote at the start of the year that the market's apparent expectation of lower interest rates, a "soft landing" (at worst), falling inflation, rising equity markets and a weaker dollar didn't make sense and that at least one of those would have to be repriced. Interest rate expectations have been the main victim. Not only has the date of the first cut been pushed back, but the expected year-end level has also risen. At the start of the year, the market was pricing in a December 2024 policy rate of 4% in the US, 4.15% in the UK and 2.6% in Europe. Now the pricing is 4.6%, 4.6% and 3% respectively. We have also seen bond yields back up, with the US 10-year Treasury yield rising from 3.88% to 4.31% and the 10-year UK Gilt yield rising from 3.53% to 4.07%.

Of course, that still implies interest rate cuts to come, but there is increasing concern that they will not be enough to release the pressure from the debt-laden corporations (especially real estate companies) that face refinancing their maturing loans at much higher interest rates than they are currently paying. The same goes for mortgage holders in the UK, where fixed rate deals are expiring at a pace of around 100,000 every month.

On balance, it would not be an enormous surprise if we started to see greater disparity between the market's expectations for interest rate moves in the US and elsewhere. This shift might be further influenced by the approaching US Presidential election. There is a school of thought developing that if the Fed does not cut rates in June, it will be stuck until November because it would not want to be seen influencing the election in any way. Of course, should the economy weaken sharply or be faced with a deflationary exogenous event, it would probably still act.

Economic Commentary

FTSE 100 weekly winners

Company	Change
Antofagasta plc	10.1%
Smurfit Kappa Group PLC	6.3%
Admiral Group plc	6.3%
Glencore plc	6.1%
Weir Group PLC	4.8%
Scottish Mortgage Investment Trust Plc	4.8%
Associated British Foods plc	4.5%

FTSE 100 weekly losers

Company	Change
Reckitt Benckiser Group plc	-13.1%
International Distributions Services plc	-10.4%
St. James's Place Plc	-9.6%
Abrdn plc	-8.4%
Hargreaves Lansdown plc	-5.5%
Persimmon Plc	-5.0%
SEGRO plc	-4.8%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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