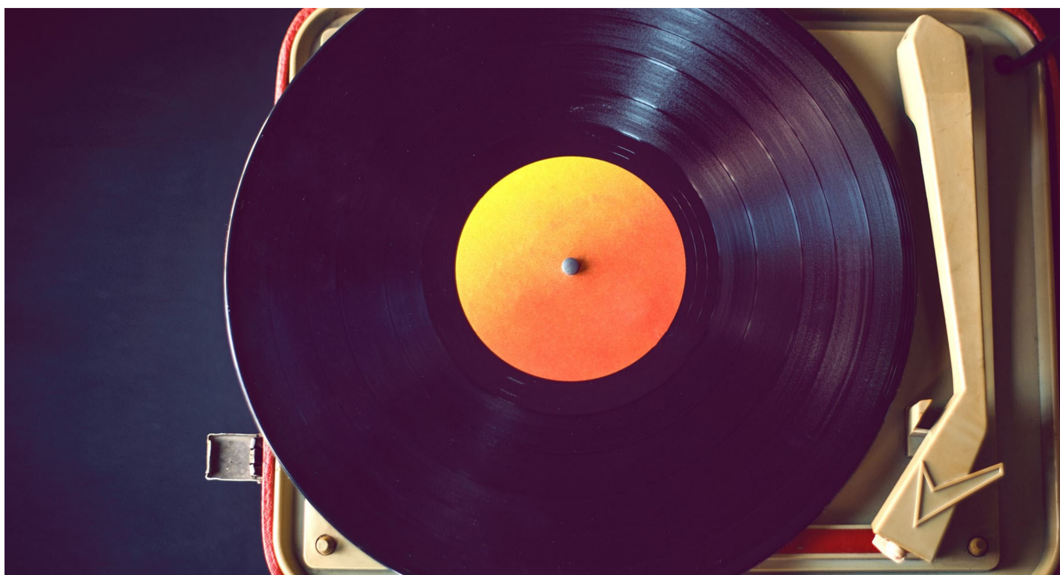
Investec

OUT OF THE ORDINARY

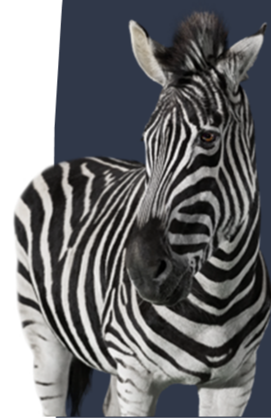
WEEKLY DIGEST | 21 February 2023

A Stuck Record



John Wyn-Evans
Head of Investment Strategy

One good thing about the renaissance of vinyl records is that people under a certain age might finally understand the idiom of something being like a scratched record. At the moment, we're stuck in the groove that repeats endlessly the need to triangulate US economic data against the Federal Reserve's (Fed) stated intentions for monetary policy and the market's expectations of what they will really do.



What did we see in the last week?

The most notable market shift last week was again in US rates expectations. We have been observing for a while that there was a big disconnect between the Fed's stated intention for interest rates (as expressed in the Dot Plot) and the market's attitude, and we described it as a massive game of "chicken". This would have to be resolved either through the market capitulating in the face of stronger data or the Fed capitulating in the face of a weak economy or (in the perfect scenario) an "immaculate disinflation". It was the market that chickened out.

US Overnight Index Swap Rates continued to reflect the strong January employment data that landed on 3 February, hawkish commentary from several Fed speakers and the latest Consumer Price (CPI) data which were published on St. Valentine's Day, cementing the "higher for longer" rate narrative. Peak Fed Funds have now been priced up to 5.28% in June, the highest of this cycle so far, and the December rate is now above 5%. As recently as the beginning of February, traders were thinking that the Fed would be cutting rates aggressively in the second half of this year, and futures were pricing in 4.17%. Just three weeks later that number is up to 4.92%, and so exactly three quarter-point cuts have been priced out.

It's a wonder, then, that risk assets have fared reasonably well through this shift in expectations. The MSCI World Equity Index is effectively unchanged this month and High Yield Credit spreads are only marginally higher. There are a few reasons behind this. One is that equity earnings have remained resilient. Yes, there have been further downgrades to current year expectations, but "bottom up" forecasts have hung in very well relative to some of the more bearish "top down" projections.

What is the current outlook for liquidity?

Second, and evidence of another scratch in the grooves of my market narrative record, is liquidity, another theme we have returned to often recently. One of the better analysts of liquidity factors is Matt King, Global Markets Strategist at Citigroup. But even he acknowledges that sometimes the moves are only apparent in hindsight, and he made that clear in a note published last week. As we have written about previously, there has been a huge wave of liquidity from the combination of the rundown of the US Treasury General Account (TGA), Bank of Japan (BoJ) asset purchases and Chinese injections into the banking sector. For good measure, Matt also threw in around €300bn of EU liquidity creation since August 2022 as governments ran down their deposits at the European Central Bank (ECB) – much of which was associated with the EU Recovery Fund to combat the effects of the pandemic, and a lot of which remained unspent long after being raised in bond markets. All of this adds up to around $1.4 trillion of liquidity.

Matt calculates that every trillion-dollar shift in liquidity has the effect of moving equity markets by +/- 10%, Investment Grade spreads by 50bps and High Yield spreads by 200bps. This seems uncannily close to what has happened in the last few months. He gained some headlines last week by claiming that this was a one-off surge that was probably done now. Looking at the various sources again: the TGA resource is finite; the BoJ's potential ending of Yield Curve Control has lost its shock factor; the People's Bank of China is only trying to stabilise the Real Estate sector, not to facilitate a new property boom; neither will it want too much cash leaving the country with outbound tourists; and the ECB's excess deposits are returning to normal, and Quantitative Tightening (QT) will soon accelerate. For him, the Fed remains the biggest imponderable, and much will hang on the pace of the economy and the path of inflation. US interest rate policy, then, remains highly "data dependent", which means the potential for sharp moves around economic data prints.

How do we create an investment strategy?

So how do we turn all of this into a cogent investment strategy? There are plenty of different views around the market. Just on Monday morning I could

see five varying approaches. BCA's US Strategist thinks that the S&P 500 can crack on to the mid-4000s (from 4079 now) by mid-year on the back of economic and corporate earnings resilience before retesting last year's lows (3600) sometime in the second half as still tight monetary conditions finally push the economy towards a recession in 2024. Goldman Sachs is more sanguine, seeing a flatter market overall, with the index ending the year at 4000 as earnings come in unchanged on 2022 and there is no meaningful valuation shift. Bank of America thinks the US market could top out imminently and revisit the 3800 level as soon as early March if Fed chair Jerome Powell delivers a more hawkish message in his next scheduled speech on 7 March. Morgan Stanley is also cautious, seeing an earnings recession ahead and describing the most recent market action as a "speculative frenzy based on a Fed pause/pivot that is not coming".

Finally, JP Morgan sees several liquidity warning lights flashing. These include: yield curve inversion; the facts that US M1 Money Supply is negative year-on-year for the first time since 2006 and that EU money supply growth is decelerating sharply; bank lending standards are tightening; we've never seen equities put in the lows before the Fed stops tightening; the lagged effect of rate rises that have already occurred; the fact that QT will remain a factor even once the Fed does reach its pause.

To my mind, there seem to be four plausible outcomes, and the focus remains squarely on the US as the key driver of global monetary conditions and risk appetite. The perfect scenario would be one of "Immaculate Disinflation", where inflation naturally declines, and growth is resilient. Sovereign bonds might not rerate dramatically but would provide decent carry; equities would benefit from earnings growth and some reduction in the risk premium; credit spreads would tighten.

The opposite outcome I call "Tightening 2.0", which would constitute something of a replay of the first nine months of 2022. The Fed becomes much more hawkish as inflation remains sticky and aggressively pushes the US economy into recession. Although bonds would do better in the end, initially they would fall as inflation persisted and in anticipation of even higher interest rates. Equities would derate again and suffer from weaker earnings. This scenario would call for a much bigger Alternatives weighting again, and this time cash would provide a better return, too, given the big increase in base rates in the past twelve months.

In between those are two more "muddle through scenarios", which might well favour a traditional 60:40-type equity/bond allocation. One is "Resilient Growth", in which earnings remain supportive for equities and inflation is slow to fall but at least heads in the right direction. Bond yields would probably head a bit higher, but equity earnings strength could potentially equalise any associated derating. The other is "Mild Recession", which would be good for government bonds. While equities would come under some downward pressure from lower earnings, those lower bond yields would provide some valuation support. And if the recession did its work in bringing inflation down sufficiently, investors would not take long to anticipate the next growth cycle.

Our task is to weigh those outcomes and construct a robust portfolio. Our current stance puts us in the "Mild Recession" camp, and we recommend being slightly underweight in equities and commensurately overweight in Fixed Income, with a decent allocation still to our favoured Alternatives that can provide returns uncorrelated to other asset classes. While investing must of course also reflect personal needs and risk appetite, it's still not an environment for taking a big swing of the bat, although we continue to believe that an opportunity to become much more constructive on riskier assets will present itself sometime this year. And if you've heard all that before, well I can only say that you will probably hear it all again in the weeks ahead.

Economic Commentary

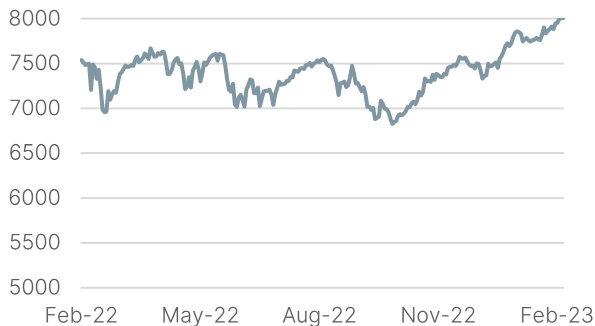
FTSE 100 weekly winners

Flutter Entertainment Plc	10.9%
Polymetal International Plc	10.8%
Coca-Cola HBC AG	10.5%
Burberry Group plc	7.3%
Entain PLC	6.5%
BAE Systems plc	5.2%
Standard Chartered PLC	4.9%

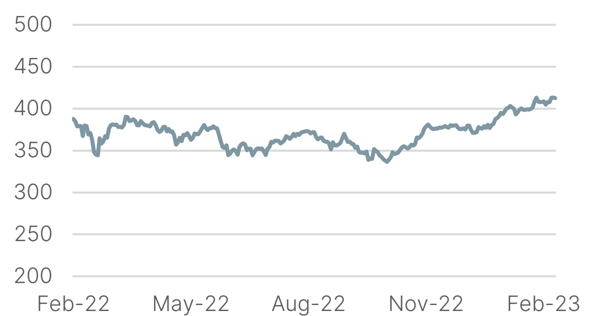
FTSE 100 weekly losers

Hargreaves Lansdown plc	-7.0%
Barclays PLC	-6.6%
NatWest Group Plc	-6.5%
Lloyds Banking Group plc	-4.5%
Persimmon Plc	-3.7%
International Distributions Services plc	-2.5%
Berkeley Group Holdings plc	-2.4%

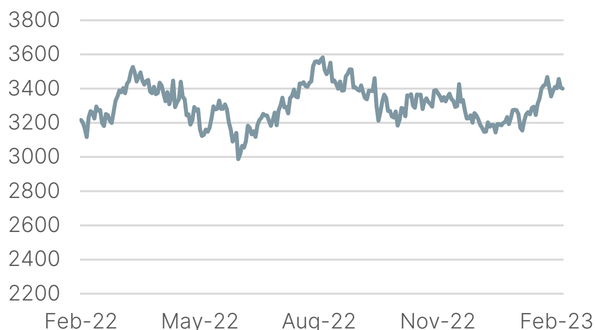
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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