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CIO Viewpoint

Markets abandon their fight against the Fed

Investment Solutions

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Economic data is challenging market narratives. Expectations of a US slowdown have been foiled by signs of still-robust activity, while inflation is not falling as fast as investors had hoped. We believe a volatile path to lower inflation is inevitable, and recessionary episodes still look likely. This calls for patience and balanced portfolios, poised to buy risk assets on market weakness.

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Markets rose over the first six weeks of 2023 in the belief that the Federal Reserve (Fed) could slow its rate hikes as the US economy weakens. But recent data shows the economy is proving resilient. More than half a million new jobs were created in January (see chart 1). Retail sales saw the biggest rise in two decades; surveys of company managers showed sentiment improving from pessimistic levels. At the same time, inflation remains stubbornly elevated. Excluding food and energy, US consumer inflation rose 0.4% in January compared with December, reversing three consecutive monthly declines. The Fed's preferred gauge of inflation – the personal-consumption expenditures price index – also rose in January on the previous month. Investors are now contemplating a scenario of continuing growth and above-trend inflation, and have priced in higher interest rates. Fed fund futures now imply rates peaking around 5.5% and being sustained for longer, more in line with the Fed's own guidance, and our long-standing view that rate cuts are largely a story for 2024.

Is the disinflationary narrative over in the US? We do not think so. Market-based measures of rents are now falling, and we expect services inflation to follow suit in coming months, taking over from goods inflation (which has now normalised) as the main disinflationary driver. However, addressing tight labour markets and high wage growth will take more work by the Fed. Its monetary tools are less effective in areas where the supply of labour and competition for workers is a key factor. We expect it to keep raising interest rates in March, May, and perhaps even June, to a peak of around 5.5% and maintain them in restrictive territory this year, leading inflation down to around 3% by year-end. A potential resurgence in commodity prices – perhaps linked to the Ukraine war, or a Chinese demand surge – is another outside risk to the inflationary outlook.

Key takeaways

- Markets' interest rate expectations have risen following strong US economic data
- We think the disinflationary narrative continues. US interest rates should peak around 5.5% and stay there for a prolonged period, leading inflation down to around 3% by end-2023. We still expect the US economy to experience recessionary episodes this year
- Labour market dynamics and corporate earnings will be key trends to watch. While expectations of the latter have fallen, it is hard to see the S&P500 rising much from here
- In this environment, we favour a neutral exposure to equities, and would use market weakness to gradually build exposure to risk assets.

Enough already?

Will US growth remain robust in 2023, despite tighter financial conditions? One possible explanation for recent strong data is that the widely-anticipated slowdown is already behind us, after two consecutive quarters of a mildly contracting economy. The equity sectors that performed best at the start of 2023 are those that ordinarily outperform during an economic recovery phase, such as consumer discretionary, materials, or communication services.

"You don't want to bet against American consumers," Ed Yardeni of Yardeni Research told Bloomberg last week. "When they're happy they spend money and when they're depressed they spend even more money."

However, we do not subscribe to this explanation. Mild winter weather is likely to have helped data from earlier this year, as people were not deterred from shopping, or working outdoors. At some point, excess savings consumers accumulated during the pandemic must run out. US banks have lifted their loan requirements and tightened credit standards. Rate-sensitive areas of the economy such as housing starts, mortgage applications, business loans and investment have already weakened markedly. We still expect recessionary episodes this year, as private investment contracts and jobs growth slows.

A low bar for corporate earnings

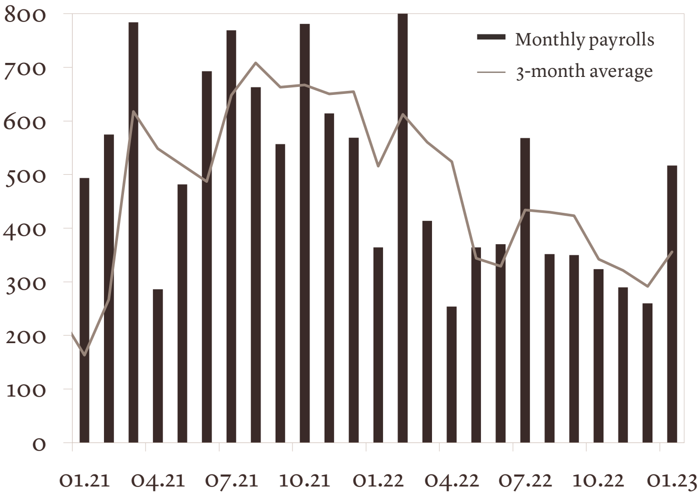
The corporate earnings picture also reflects weakening demand. 2022's fourth-quarter earnings were poor, but the gradual cut in earnings estimates has brought expectations more in line with our base case scenario (see chart 2). Most analysts now expect profits for companies in the S&P500 to be broadly flat in 2023. This is still benign for even a mild recession, but much closer to our own estimates, and a potentially low bar to clear if the situation improves from here. Another risk lies on valuations, where higher than expected interest rates could cap the earnings multiple on which companies' shares trade. Labour market dynamics remain key in this regard. For the Fed, wage growth remains key to the inflation outlook, while for companies, higher wages – and for some, ongoing hiring – suggests they could experience a squeeze on margins in 2023, as lower revenues collide with increased labour costs.

In a best-case outcome, where the worst of the growth slowdown is behind us and companies can grow revenues at around 5% this year, keep margins near record highs and price-to-earnings ratios at current levels, we think the S&P500 index could rise as high as 4,500 in 2023. However, in an adverse scenario where inflation fails to fall to around 3% by year end, and the Fed is forced to raise rates to 6% or above, we could see the S&P500 fall to around 3,200. More likely, we think, is that volatile macroeconomic data will see it fluctuate through the year to finish around current levels of 3,900, in response to slowing growth and lower demand.

In light of this, we favour a balanced investment approach, with equity allocations at a neutral level versus our strategic benchmark. We suggest using market weakness to gradually build exposure to risk assets. We continue to look for relative value within asset classes, favouring areas that may prove more insulated from negative surprises, enjoy better growth

1. Still adding jobs, unemployment at historic low

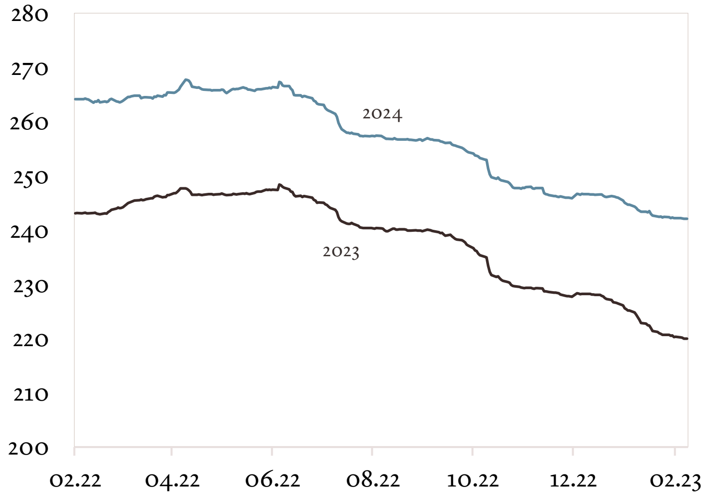
US new jobs created, monthly, and 3-month average (in thousands)



Sources: Bloomberg, Lombard Odier

2. S&P500 earnings estimates have fallen

Evolution of analysts' consensus earnings per share (EPS) estimates



Sources: Bloomberg, Lombard Odier

prospects, or a cushion from lower valuations. In equities, we favour the rest of the world over the US, with a particular focus on Chinese and emerging market stocks that should benefit from China's reopening. In fixed income, we favour quality assets such as US Treasuries and investment grade bonds. While we believe the dollar's weakening trend could temporarily pause, we still think stronger growth outside the US should outweigh the benefit to the dollar from higher domestic interest rates, and expect more dollar weakness in 2023. Inflation – and the spectre of higher rates – remains the biggest risk hanging over markets. We hence expect a volatile path to normality, requiring active asset management, as the economy recovers from a sequence of shocks.

Sources: Bloomberg, Lombard Odier

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