Investment Views

August 2022

Pivot, pause or persevere?

After almost a year of inflation-busting rhetoric, several Central Bankers have flinched in the face of slumping growth, depressed asset prices and weaker labour markets. Calls to pause or reverse rate hikes are intensifying despite elevated global inflation.

The People's Bank of China was the first to blink, dialling up various forms of liquidity support that have pushed annualised M1 money growth from an all-time low of -2% in January to +6%. This, in turn, has sparked a 15% rebound in A-share equities despite numerous economic challenges, particularly in the real estate market. The debt-laden domestic economy remains fragile, suggesting ongoing support from the authorities as Xi Jinping seeks a third Presidential term.

Elsewhere in Asia, the Bank of Japan (BoJ) has doubled down on its ultra-supportive stance despite inflation running in excess of its 2% target; it continues to defend a 0.25% yield ceiling on the 10-year government bond. Buoyed by this monetary largesse, the Topix index continues to outperform other major markets, ending July unchanged for the year-to-date. That said, the lax BoJ policy has undermined the yen, pushing it 15% lower versus the US dollar.

Turning west, the European Central Bank's (ECB) July meeting delivered the first rate hike in over a decade; a larger-than-expected 0.5% increase. However, President Lagarde also unveiled the "Transmission Protection Instrument" (TPI) in an effort to avoid a rerun of the 2012 Eurozone debt crisis. Whilst the detail is sketchy, this new facility seems to allow the ECB to buy bonds from indebted member states, such as Italy, to cap any rise in their borrowing costs relative to German Bunds. As such, the TPI is a nuanced form of QE and smacks of state financing by the ECB, which is outlawed by Union rules. Some form of challenge in the German courts seems inevitable.

With constrained Russian supplies driving EU gas prices to a crude oil equivalent of US$400/barrel (source: FT), the unfolding energy crisis will sustain higher inflation whilst crippling growth; a deep European recession is on the cards. Despite 'Deutsche distaste', an increasingly interventionist ECB seems unavoidable as it holds together a delicate Union. The likely election of a far-right, Eurosceptic Italian government will only exacerbate the problem.

A couple of Central Banks retain a hawkish bias. The Bank of England has raised the UK base rate several times since December, taking it from 0.1% to 1.75%. In a recent press briefing the Governor cautioned markets to expect further rises to head off double-digit inflation, despite forecasting a recession for much of 2023. A similar dynamic played out across the Atlantic. Faced with the highest inflation for 40 years, July saw the US Federal Reserve deliver its second consecutive 0.75% rate hike, marking its most aggressive tightening cycle since the early 1980s. The target rate range now stands at 2.25-2.5%, with markets pricing in a 3.25% peak later this year.

Given the global role of the US dollar, the next steps from the Fed will set the economic and market tone for the remainder of the year. If Chairman Powell keeps raising rates despite an evident economic slowdown, higher real (inflation-adjusted) yields and a strong US dollar will endure. Such a counter-cyclical policy mix would repeat the dynamics that undermined both bond and equity markets earlier this year.

Conversely, any policy shift (actual or anticipated) that sees rate hikes moderate or pause should help put a floor under asset markets. In this scenario, unless inflation has slumped back towards the 2% target, both real yields and the US dollar should fall, providing a liquidity tailwind for global assets.

So the question is will the Fed keep hiking or find cause to pause? To state the obvious, inflation is key. US CPI rose 1.3% during June, leaving it up 9.1% year-on-year. Shelter and energy costs, 32% and 8% of the CPI basket, rose 0.7% and 7.6% respectively, accounting for c. 60% of the monthly increase.

Shelter inflation will probably remain elevated, as this measure of rental costs tends to lag property prices by up to 18 months; higher mortgage rates have only just started to weigh on the housing market. Energy costs could also prove troublesome. Even though forecourt gasoline prices have fallen 20% from their June peak (source: AAA), rising gasoline futures suggest pump prices could rebound later this month. Offsetting this, other commodities have seen significant declines; lumber and copper prices have fallen 64% and 34%, respectively, whilst the wheat price is back at pre-Ukraine invasion levels. With big-ticket consumer goods (such as autos and household appliances) also seeing sharp corrections, pervasive inflationary pressures are beginning to dissipate. A sense that we have seen peak supply disruption from China's covid lockdowns serves to reinforce this impression.

Bond markets have taken note with the 10-year Treasury yield falling back towards 2.7% from a mid-June peak of 3.5%. Market derived inflation expectations have also retreated with average US CPI between 2027 and 2032 now forecast at 2.2% p.a. Policymakers have historically placed greater weight on market-based estimates than consumer surveys and backward-looking CPI prints.

The material falls in expected CPI may help to explain why Powell sounded slightly less hawkish at his July press conference. He conceded that economic growth is cooling and warned of the lagged impact of prior rate hikes. Although far from an explicit pivot, it was less one-sided than recent speeches. The Fed also pledged that policy would become more "data-dependent", a notable sea change from prior guidance for inevitable further rate hikes.

If we focus in on the data, the US economy is clearly struggling with the US now technically in a recession. Defined as two consecutive quarters of negative GDP growth, Q2's -0.9% contraction followed -1.6% in Q1. The Biden administration was quick to dismiss the validity of this definition and argued that the downturn was due to volatile one-off factors like the inventory cycle; a less partial take would highlight an increasingly challenged consumer, rising jobless claims and a precipitous decline in housing activity.

This sharp loss of momentum is ably illustrated by the US Manufacturing ISM. Having peaked in March 2021 at 64, this monthly survey of manufacturing activity touched 53 in July. Many forward-looking indicators, including new orders and warehouse inventories, suggest it could soon fall to the low 40s. Since the 1970s, the Fed has stopped hiking rates every time this indicator has fallen below 50.

So where does that leave us? With stubbornly high headline CPI, US rate cuts are unlikely. If history is any guide, a pause in future rate rises and/or a postponement of the quantitative tightening program are likely first steps; the September Fed meeting could well see the final rate rise of this cycle, as recession fears trump inflation.

Regardless, a Fed pivot will likely occur before inflation has fallen back to the 2% policy target, leaving real rates (yields minus inflation) in negative territory for the foreseeable future. Whilst timing is hard to judge, this is our central expectation, with a sustained period of negative real yields supporting both our gold bullion and index-linked bond positions.

Under this scenario, headline equity indices would not necessarily be out of the woods, especially if a nasty recession arrives before the dovish tilt. Whilst falling discount rates would provide a degree of support to equity valuations, corporate earnings growth would likely follow GDP lower, undermining stock prices. Although any initial weakness could impact all equities, we would expect the more cyclical sectors (like banks and consumer discretionary) to under-perform. Conversely, less economically sensitive sectors could offer 'safe harbour'. Our healthcare and climate change exposures fall into the latter category.

Policy Matrix Summary

The matrix below is a summary of our current 12-24 month outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high-level guide on where we stand at this time.

12-24 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives	Gold Miners China A Shares UK Small Companies Japan ESG & Impact funds FinTech & Blockchain	Inflation-linked US Treasuries	Gold, Volatility Strategies
–		European US	UK European Japanese	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	31st Jul 22	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.2171	-0.1%	-3.2%	-12.5%
CHF	1.0499	0.3%	2.2%	-4.9%
AUD	0.6985	1.2%	-1.1%	-4.9%
JPY	133.2700	1.8%	-2.6%	-17.7%
EUR	1.0220	-2.5%	-3.1%	-13.9%
BOND YIELDS (10 yr)				
UK	1.86	-0.37	-0.04	1.30
US	2.65	-0.37	-0.29	1.43
Germany	0.81	-0.52	-0.12	1.28
Australia	3.06	-0.60	-0.07	1.88
Japan	0.18	-0.05	-0.04	0.16
				EQUITIES
US. S&P 500 (USD)	4,130.29	9.1%	0.0%	-6.0%
UK. FTSE 100 (GBP)	7,423.43	3.5%	-1.6%	5.6%
MSCI Eur ex UK (Local)	1,500.43	6.9%	-3.9%	-9.6%
Japan. Topix (JPY)	1,940.31	3.7%	2.1%	2.1%
China. Shangai Comp (RMB)	3,253.24	-4.3%	6.8%	-4.2%
HK. Hang Seng (HKD)	20,156.51	-7.8%	-4.4%	-22.4%
Australia. All Ords (AUD)	7,173.75	6.3%	-7.1%	-6.4%
MSCI Pac ex Jap (USD)	1,317.67	3.8%	-5.9%	-13.7%
MSCI World (USD)	2,746.37	7.9%	-1.8%	-10.5%
MSCI World (GBP)	2,256.85	7.9%	1.5%	2.2%
				COMMODITIES
Oil (WTI)	98.62	-4.3%	-0.1%	49.1%
Gold	1765.94	-2.3%	-6.9%	-2.7%

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