Who is right: Equities, Bonds or the Fed?

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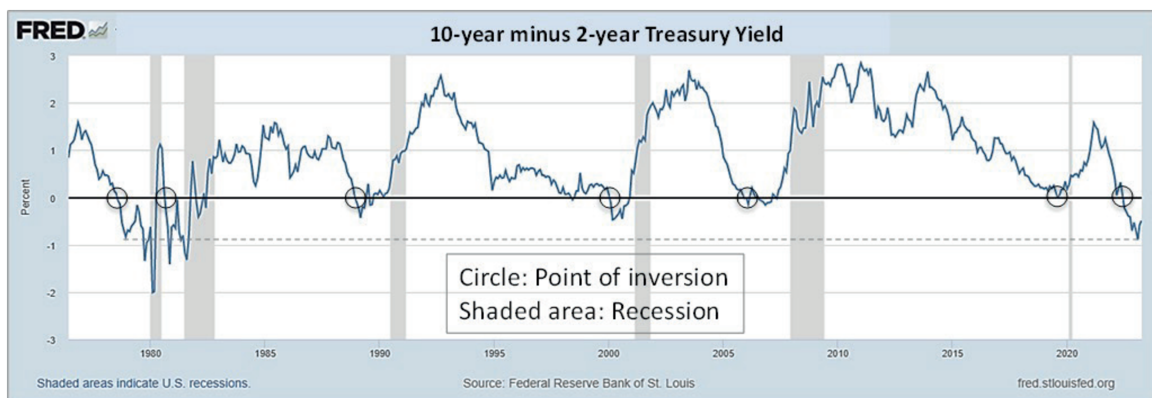
US economic data released in April has given mixed signals about the taming of inflation: there have been many signs of a slowdown in economic activity yet inflation remains far in excess of the target and certain elements of inflation remain sticky and resilient. Central banks now face a complex trade-off between further tightening the policy to control inflation versus pushing the economy into a bad recession. Analysts, investors and even central bank officials seem to be divided on their outlooks. As a result, signals coming from equity markets, bonds and the Fed are quite at odds with each other.

ECONOMIC AND MARKET UPDATE

Equity markets – calm and complacent: Equity markets have been sanguine with the VIX index of volatility touching an abnormally low level of 16.40 during the month, showing a high degree of complacency among equity investors while the S&P 500 companies, at an index level, is trading at above-average valuation of 18.20 forward PE ratio, which signals robust growth in corporate profitability. Equity investors believe that the economy is slowing down and inflation is likely to fall rapidly by the second half of the year, which would help the Fed to pivot and start loosening policy and boosting risk-on sentiments.

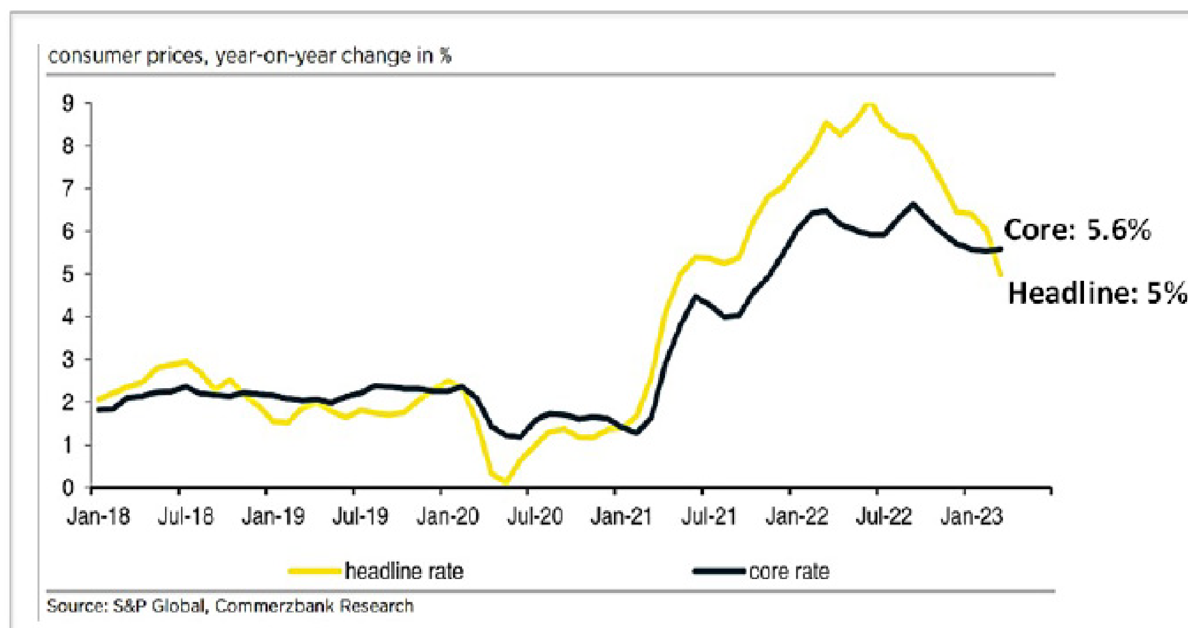
Bond markets – screaming recession: In the bonds market, the 10 years minus 2 years US Treasury yield curve is deeply inverted, signaling an imminent recession in the economy. All nine recessions since 1955 have been preceded by an inverted yield curve. Typically, a recession is seen within 12 months of the inversion and this time around the yield curve has been inverted since July of last year. The level of inversion witnessed last month was the deepest in the past 40 years. Investors looking at the bond market would be cautious and risk-averse at this point in time.



Federal Reserve – still on the job: The Federal Open Market Committee (FOMC), that sets the interest rate, publishes on a quarterly basis a dot-plot chart which maps out policymakers' expectations for where interest rates could be headed in the future. The dot-plot published in March this year shows one more rate hike, taking the terminal rate to the 5%-5.25% range, and a pause for the rest of the year. Interestingly, the FOMC acknowledges a risk of recession this year and despite that, it intends to hold rates for the rest of the year. If investors were to believe the Fed, tight monetary policy is likely to continue for much longer than anticipated and should lead to risk-off sentiments.

US Inflation outlook – Headline US inflation declined sharply from 6% y-o-y in February to 5% y-o-y in March whereas due to the sharp decline in energy prices from the same time last year. However, core inflation, after stripping out volatile energy and food prices, turned out to be more sticky, increasing from 5.5% y-o-y in February to 5.6% y-o-y in March mainly due to stubbornly high cost of housing. The silver-lining perhaps is that on a month-on-month basis, the cost of shelter and rent has started to ease.

US Inflation down to
5%



Source: S&P Global, Commerzbank Research

US economic activity – signs of slowing down: There are widespread signs of slowing economic activity in the US. Q1 2023 GDP growth printed at 1.1% annualized, much slower than market expectations of 1.9% and a significant drop from growth of 2.6% in Q4 2022. The ISM manufacturing index declined in March to 46.3 and marked the fifth month in a row that the index has been in contraction sub-50 territory. Barring the pandemic-period, this is also the weakest reading since 2009, showing weak demand. The ISM services index dropped sharply from 55.1 in February to 51.2 in March, in further evidence that services-driven boom in the economy is fading away. Retail sales data for March also came in below expectations.

US Q1 2023 GDP
1.1%

Economic activity in EU and UK remains resilient: The macroeconomic picture for the EU remains stronger than anticipated as the energy shock of 2022 continues to unwind. The region avoided a recession with Q1 2023 GDP rising by 0.3% after falling by 0.1% in Q4 2022. As for the UK, that marginally avoided recession in Q4 2022, the outlook remains uncertain with consumers under tremendous pressure from high inflation and rising cost of mortgages while businesses suffer from labour shortage, higher wages and unrest. Inflation readings for March in the EU and the UK eased a bit on lower energy prices but still remain at elevated levels of 6.9% and 10.1% respectively, much beyond the levels acceptable to central banks.

EU Q1 2023 GDP

0.3%

INVESTMENT OUTLOOK

US interest rates: The market now ascribes a 90% probability of US Federal Reserve increasing the interest rate by another 0.25% on 3 May, 2023. This decision seems to be a given now. The more important event on 3 May will be J. Powell's press conference post the rate decision. That would give an indication of what the FOMC members feel about the outlook for inflation, economic growth and rates. More specifically, investors would parse the press conference to figure out if the May rate hike is the last one in this cycle and if the Fed will pause for the rest of the year or pivot at some stage.

US int. rate hike probability

90%

There are a number of factors that support both a pause for the rest of the year and a pivot sometime in the year:

Factors supporting a long pause – tight policy for the rest of 2023:

1. Core inflation ticked up in March and remains sticky
2. Easing too early can lead to a second round of inflation which would then need more aggressive action
3. J. Powell has referred to the difficulty faced in the late 1970s and early 1980s to control inflation and hence carries a burden of history in decision making
4. Fed was late in recognizing the problem and hence faced issues of credibility. It would not like to make another mistake by stepping off the brake paddle too early

Factors supporting an early pivot – first rate cut before the end of 2023:

1. There are clear signs of a rapid slowdown of economy which may rollover into a recession if tight policy continues
2. The inverted yield curve is already signaling an impending recession
3. Banks are doing the Fed's job of slamming the brakes on the economy by tightening credit conditions to levels typically seen before a recession
4. Aggressive monetary policy will play out in the economy with some lag and hence the Fed probably has already done enough. Anything more may cause structural damage to the economy

We believe the Fed is likely to raise the interest rate by 0.25% on the 3rd of May and then pause for a while to gauge the cumulative impact of policy tightening.

Equities: Banks and mega-cap tech stocks have so far come out with impressive Q1 results, giving further confidence to the equity markets. However, markets are likely to continue to react to every piece of data till more clarity emerges on the future course of interest rates and growth prospects of the economy. During these periods of volatility, equity investors should get back to basics by consistently accumulating diversified portfolios of high quality stocks, either directly or through mutual funds or exchange traded funds during these periods of volatility. This is provided they have the risk appetite and a long-term time horizon.

Fixed income: The Fed seems to be near peak interest rates which makes a strong case for investors to lock-in these high returns for medium to long term in high quality bonds. Due to high level of interest from investors, investment grade bonds have performed well over the last couple of months. Bonds like HSBC 6.161% rated A-, maturing in March 2029, Government of Sharjah 6.5% rated BBB-, maturing in November 2032 are some of the names that have shown strong price appreciations. However, investors remain wary of Additional Tier 1 / CoCos of international banks but continue to invest in the perpetual papers issued by banks in the GCC region.

MARKET DATA

Global Equities	Last price	YTD 2023
MSCI World	2835.93	8.96%
Dow Jones Ind.	34098.16	2.87%
S&P 500	4169.48	8.59%
NASDAQ COMP	12226.58	21.08%
EUROSTOXX 600	466.64	9.83%
FTSE 100	7670.57	5.62%
India Nifty50	18065	-0.22%
Nikkei 225	29123.18	11.64%
Shanghai Comp	3323.28	7.58%

Currencies	Last price	2023 Chng
Dollar Index	101.83	-1.67%
Euro	1.1019	2.83%
GBP	1.2567	3.90%
JPY	136.08	-4.23%
CHF	0.8923	3.36%
AUD	0.6617	-2.52%
CNH	6.9235	-0.28%
INR	81.73	1.10%
SGD	1.3336	0.39%

Regional Equities	Last price	2023 Chng
Dubai DFM	3544	6.26%
Abu Dhabi ADX	9789	-4.13%
Saudi Tadawul	11,271.00	7.57%

Commodities	Last	2023 Chng
WTI Crude	79.59	-5.08%
Brent Crude	80.33	-7.10%
Nat Gas	2.35	-47.24%
Gold	1991.56	8.67%
Silver	25.1	5.22%
Copper	387	2.67%
Corn	633.5	-6.63%

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ALTERNATIVES	• Mutual funds investing in US senior secured loans delivering regular income

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