High and Dry – Radiohead, 1995

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RATES PEAKING: WHAT IS IN STORE FOR H2?

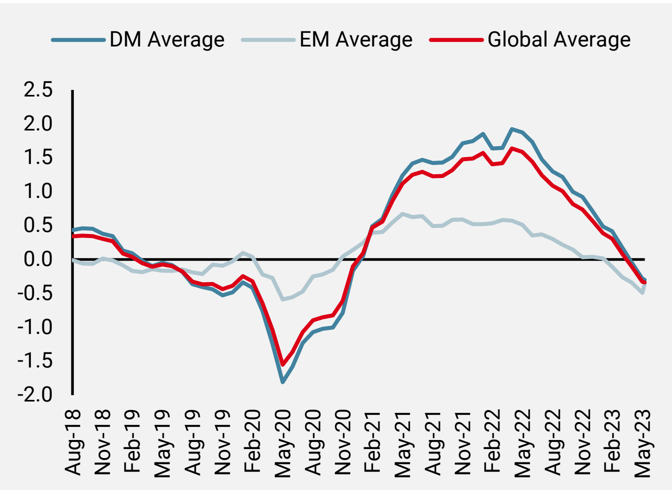
Is optimism warranted as we close the first half of 2023? The performance of equity markets in H1 could suggest so. Stocks have rallied as the macro environment has provided a relatively good mix of rapidly falling inflation with growth holding up and the largest part of rate hikes in this cycle now behind us. The latter effect seems to be driving sentiment, although central bankers have been clear that their inflation job is making progress but is not complete. In the second half of the year, investors will witness economies that are slowing as credit conditions deteriorate and financial stress coming and going on a regular basis. Hopes for a large monetary policy pivot could be disappointed for those using the roadmap that prevailed over the last decade's "low inflation period". We discuss what is the right dose of risk for portfolios and how to position as we navigate these uncertainties in the next six months.

WHAT'S NEXT?

Visible progress on the inflation front

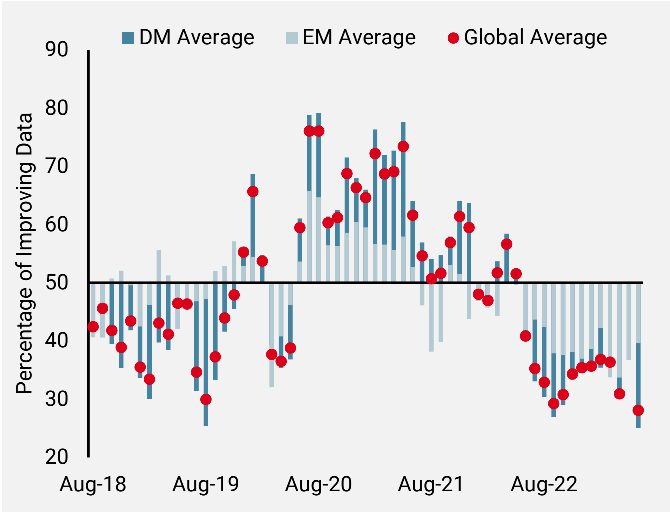
If an investor had to choose a single indicator driving financial markets over the last 12 months, short-term policy rates or inflation would be among the top answers. Indeed, back in May 2022 some developed economies saw inflation shooting up towards double digit levels while policy rates were still not far from historical lows. Fast forward a year later, the world has changed and interest rates have increased from zero to 5% in the US, and from –0.5% to above 3% in the Eurozone. This helped to push down inflation, as US headline CPI dropped to 4.9% in April from above 9% in summer 2022. The progress made on inflation is visible in our Nowcasters where both DM and EM indicators have recently declined below the zero threshold, indicating a very low inflation risk ahead (Figure 1a). The downward momentum in prices is still important, as can be measured by the diffusion index – the percentage of data increasing vs decreasing (Figure 1b).

Figure 1a: Global Inflation Nowcasters – level



Source: Bloomberg, Unigestion. As of 07.06.2023.

Figure 1b: Global Inflation Nowcasters – diffusion index



Source: Bloomberg, Unigestion. As of 07.06.2023.

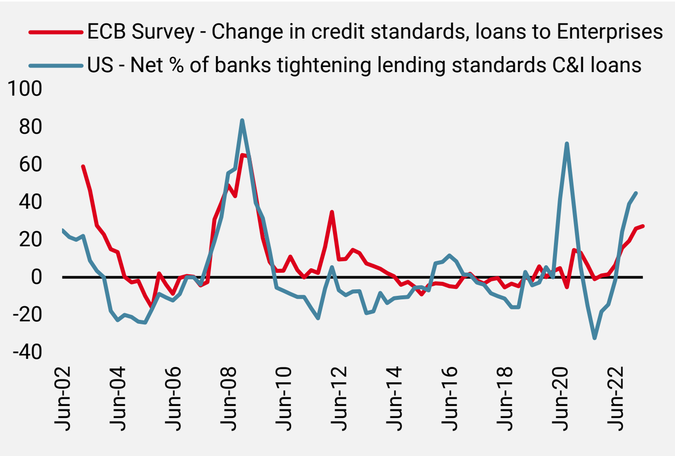
Is this battle over? Probably not. Over the last 12 months, easing supply chains and falling energy prices largely contributed to price declines. Now that supply chains have normalised and goods prices are on a downward path, bringing down services costs and capping rising wages is the hard task remaining for most central banks.

As inflation normalises, economies have been resilient to the steep tightening cycle. The latest employment numbers in the US confirm that while consumers have been hit by rising prices, as of May the labour market continues to add a large quantity of jobs. Other regions are experiencing equally low unemployment rates.

Recession risks have been pushed back but persist…

With inflation falling and growth remaining strong, one could argue that rate hikes have produced what they were meant to achieve. That is without accounting for stress in the banking sector. Credit conditions started to deteriorate at the end of 2022, and banks reported tighter credit standards and weaker demand for loans in Q1, before the emergence of banking worries (Figure 2). The collapse of Silicon Valley Bank and subsequent failure of other regional lenders and the UBS takeover of Credit Suisse in Europe will contribute to making global banks even more cautious and slow the supply of credit.

Figure 2: Credit conditions are tightening

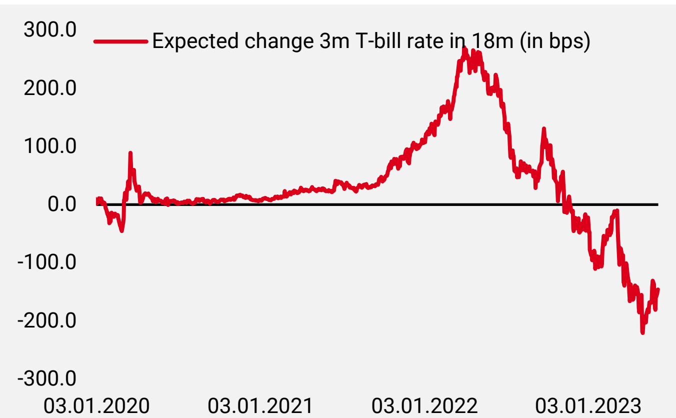


Source: Bloomberg, Unigestion. As of 07.06.2023.

…as economies are too strong to cut

Back in April, markets were discounting not only a pause in the US rate hiking cycle, but also cuts happening as soon as this summer. That has been a main supporting factor for global stocks and risk sentiment this year, and contributed to keeping stocks' volatility low while bond volatility remains high. While some cuts have been de-priced, we assess the prospect of rate cuts as quite optimistic, both in terms of timing and magnitude as close to 150 bps of cuts are still expected in the US over the next 18 months (Figure 3). Indeed, notwithstanding progress on reducing price pressure, G4 central banks will want to see more confirmation before declaring victory on the inflation battle and a sustained downward trend towards 2%. In addition, despite some signs of weakening activity, economic conditions remain good enough and the US job market is still strong by historical standards. In this environment, the space to cut rates for central banks remains quite narrow and they are more likely to adopt a wait and see strategy for the rest of the year. Recent speeches from FOMC members have confirmed that rate cuts are not on the cards yet.

Figure 3: Futures pricing of Fed funds rate 18 months ahead



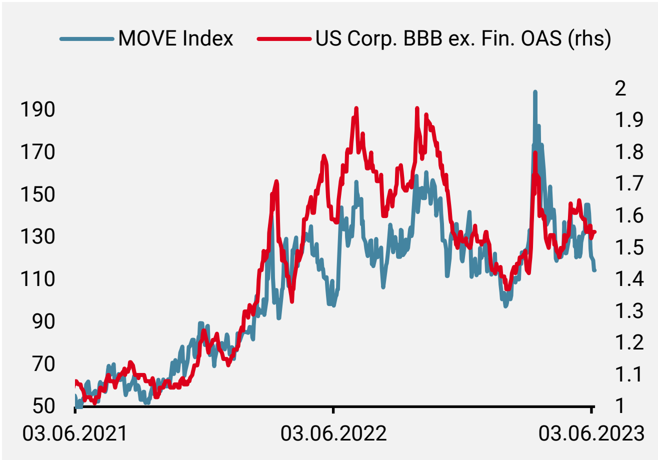
Source: Bloomberg, Unigestion. As of 06.06.2023.

Watch for credit risk as growth slows further

Even though the probability of a recession has diminished in 2023, it remains high according to our systematic growth Nowcaster indicator. With the above-mentioned banking worries persisting and market stress that could re-appear soon, we believe that risky assets will trade in a range-bound fashion in coming months and we retain a defensive tilt in portfolios. Now that the threat of a US default has been averted, macro trends and inflation dynamics will dictate the medium-term direction of market sentiment.

Figure 4: Credit spreads vs bond volatility

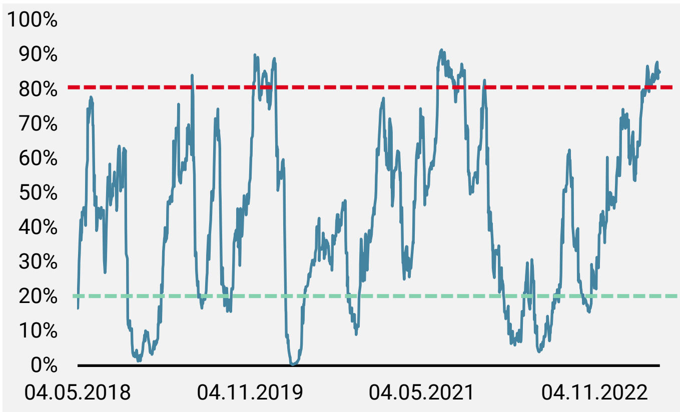
In credit, the impact of the March banking turmoil on spreads was short-lived (Figure 4) but tension could remerge as more signs of economic slowdown become visible.



Source: Bloomberg, Unigestion. As of 07.06.2023

In addition, risky assets have been supported as equity markets seems to focus on the positive news of inflation normalisation and companies that reported better than expected Q1 earnings. Complacency levels are now either at, or close to, extreme optimism. (Figure 5). Investors will have to incorporate this before adding risks in portfolios later this year given the uncertainties surrounding macro developments.

Figure 5: Nasdaq complacency indicator



Source: Bloomberg, Unigestion. As of 29.05.2023

What we are monitoring

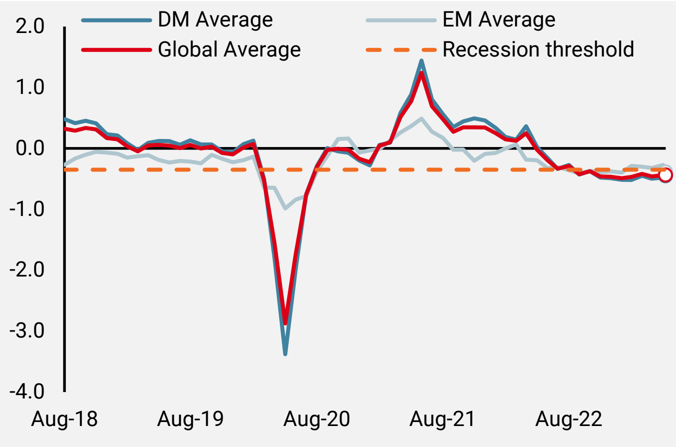
In summary, progress on reducing inflation pressures over the last few months has been a net positive for markets and risk taking – defying investors' cautious positioning. While the rate hiking cycle is getting closer to its peak, holding US rates at 5% for longer could exacerbate the negative growth impact expected in H2 and, in turn, delay a larger risk rally in markets after the very weak performance of last year for bonds and stocks. The low volatility in markets at present is likely underestimating risks in H2, and with that in mind we would stay on the mild-cautious side, while we take advantage of the yield available in short-term high-rated credit.

What are the main factors that would make us change our view in H2? First, a steep drop of core services inflation could validate the rate cuts expectations and confirm that a monetary pivot is indeed coming sooner. This is however unlikely to happen without a sharp deterioration in activity – and would be a catalyst to buy duration. Lower earnings would suggest exposure to quality stocks rather than cyclicals.

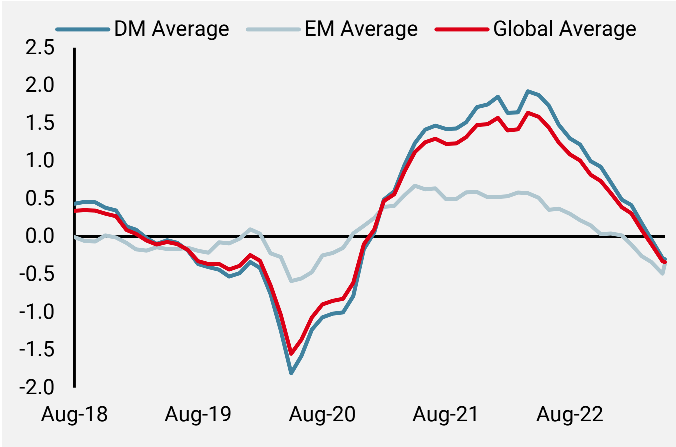
Second, signs of systemic risk in financial markets becoming more pronounced than the short-lived banking stress of March. We would expect central banks to act in this environment, but so far these episodes of stress have been too shallow to change the monetary course. A more severe market stress could mark the start of a rate cutting cycle. Without these developments, the "high" for longer mantra driven by inflation will continue and seizing opportunities will require agility in this complex macro landscape.

UNIGESTION NOWCASTING

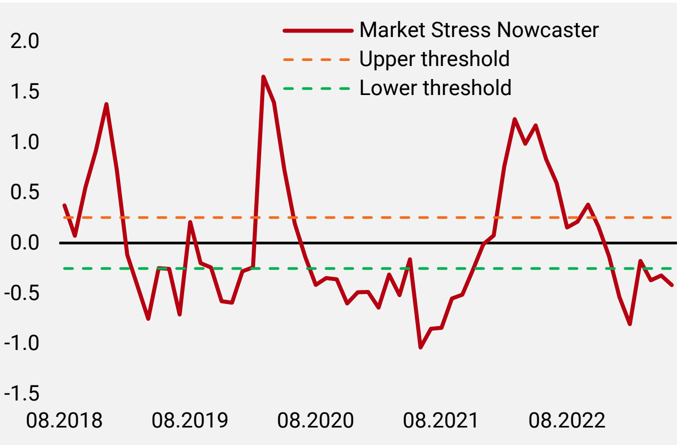
World Growth Nowcaster



World Inflation Nowcaster



Market Stress Nowcaster



Nowcasters update

- Our Growth Nowcaster continues to point at a high risk of recession, although the slide in growth has stabilized in Q1-23.
- Our World Inflation Nowcaster as still on a strong downward trend in both EM and DM.
- Our Market Stress Nowcaster remains volatile on a week-by-week basis, driven by increases in the spread component.

Source: Unigestion, Bloomberg, as of 07.06.2023.

IMPORTANT INFORMATION