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# World Economic and Market Outlook

## – Focus on Interest Rates

Jay Powell, Chair of the US Fed has described high inflation a severe threat to the economy and stated that accommodative policies “were not needed or wanted”. He also emphasised the need for a long expansion and price stability to deliver full employment and increase the labour participation rate. The Fed has now significantly pivoted on interest rates from their thinking in late summer 2021. Goldman Sachs now predicts four rate hikes in 2022, a stance quickly followed by JP Morgan investment bank. Bond markets in the short term were pleased with the Fed’s determination not to allow runaway inflation and the 10 Year Treasury yield fell to 1.74% having touched around 1.80% earlier in the week. This rally in US Treasuries occurred even though there was an expectation of a 7% inflation number later in the week which proved to be accurate.

Gavekal, a global economic consultancy also brought out a piece saying the Fed sees stable prices as necessary for a long cycle. John Authors formally an FT writer, before switching to Bloomberg, noted that since the end of the Volcker era, all Fed hiking cycles had only finished with the Fed fund’s rate was above the inflation rate. This begs the question - what will inflation will be, for example, at end 2023? if there were eight one quarter point hikes, the Fed fund’s rate would still only be 2.00-2.25%. It seems unlikely that inflationary pressures will dissipate quickly as there are now more elements of sticky inflation producing elevating pressure. To date, although the timing of both the first US rate hike, and the number in 2022 has been brought forward, there has been no alteration to the terminal rate or end rate of this economic cycle.

The Federal Reserve now has the tricky task of achieving a ‘soft landing’ for the US economy- a slowdown in growth while raising rates far enough to subdue inflation without causing a recession. This is not always as easy to achieve as the market hopes and many market participants err on the side of optimism in predicting a soft landing during rate hiking cycles.

Investors have become accustomed to relying on what is described as the Fed “put” to bail equity markets out if sustained falls occur by easing monetary policy. However, the inflation background makes the ability to cut interest rates and print money (QE) very difficult, in fact almost impossible. Although there has been very significant style rotation in the US Equity market, overall index levels remain close to all time highs, and a steep fall is unlikely to be seen as too concerning at a time when the economy remains strong. While Powell is well aware of the implications of sustained financial market weakness on the real economy, falls from very high levels may be of less concern to the Fed, especially if credit markets remain stable. Furthermore, one wonders the confidence impact of the Fed bailing out equity markets after the recent Board member trading scandals where there have been three departures, including the high profile Vice Chair Richard Clarida. This internal turmoil at the US Central Bank has led some commentators to question how impartial the Fed members can be when they have high exposure to equities and would clearly leave members open to criticism of serving self interest if it was perceived their measures the Fed engineered were benefitting their own personal wealth. The Federal Reserve may now place quelling inflation as their number one priority and necessary to prevent longer term turbulence in equity markets even if there are some levels of short term pain or volatility.

While market indices trade close to highs, another significant point to note is that 40% of the Nasdaq which is more technology focused, is already down 50% from its highs. This is at the individual stock level. To put this in perspective the Nasdaq Index (overall) in March 2020 fell 60% from its previous peak in the Covid pandemic, while the tech wreck of the early 2000's saw a 50-60% pull back and a 70% decline during the Global Financial Crisis.

The narrowness of the US equity market has attracted renewed attention with a focus on what is being called the "S&P 10", the biggest ten stocks in the Index. Coming to end November the S&P 10 had returned close to 40% whilst the MSCI World Ex the US market had only returned around 8%. There is less awareness of performance of the remainder of the US equity market which could be dubbed the S&P 490. These returned to end November close to 20% for the year so have significantly outperformed other markets. 2021 was a year where US equities substantially outperformed other markets, even excluding the top performing mega caps which delivered such exceptional performance.

Last week in the market saw the Nasdaq sell off to over 1% on the Tuesday night and then enjoy a significant rally bouncing to finish marginally higher. For chart followers, the resistance and bounce off the 200 day moving average which sits around 14,600 would be seen as significant. These intra-day swings have been highlighted as being driven by option trading and positioning and something referred to as Gamma Trading which is far less to do with fundamental investment strategies. Reading short term market moves is currently extremely difficult.

Although Omicron case numbers remain extremely high, there are early indications it burns through relatively quickly and this will have implications for economic activity not too far down the road. If Omicron passes through quickly there could be a further surge in consumer spending, this time more targeted perhaps at services.

While the Fed has undoubtedly pivoted from its previous stance on rates, the foot remains firmly on the accelerator with real rates so negative at a time of 7% inflation. There is now a risk that the sticky components of inflation including the rental element and other service sector inflation means even if manufacturing bottlenecks and supply side pressures ease, inflation will not fall back to pre-pandemic levels quickly. The evidence remains that the US Federal Reserve is behind the curve and therefore there is a risk they will be forced to do more than the market thinks on interest rates. Markets are responding quickly to data and headline news flow and it might prove that good news is in fact bad news for the markets if Omicron proves to be short lived and economic activity rebounds faster than expected, pushing bond yields higher. A US Treasury bond yield of around 1.75% does not seem to offer much long-term value. Monetary tightening is more likely in 2022 than was expected at the start of the year. Looking at consensus forecasts for US rate rises one might have expected the US currency to be strong, but in fact it seems to have decoupled from growth in the short term partly because most investors were long of the US$.

Looking forward there are positive and negative arguments for the US currency. The positive is that with the US hiking rates it will be a high yielding currency with positive carry, while the negative is that as US rates are rising, real rates remain highly negative, and the actions by the Fed are too slow to deal with the inflation problem. If the latter view prevails, US currency weakness would likely occur. The markets have initially rallied on the Powel statement but the big risk remains that a further upward spike in bond yields will hit equities again this year at some point.

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