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OUT OF THE ORDINARY

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Push On, Pause or Pivot?

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Mountaineers are well aware of the fact that if you want to get to the summit of Everest you have to follow some fairly clear rules if you also intend to return safely to Base Camp. First, you have to start the ascent in the middle of the night. Then you must reach the summit by a certain time if you are to have long enough to descend in daylight. Sensible climbers turn back if they are running late, even at the cost of not achieving their very publicly declared, very

expensive ambition. The more reckless push on, many of whom are still up there, frozen for posterity.

At the risk of getting tangled up in (yet) a(another) tortured metaphor for financial market activity, we return this week to the subject of central bank policy and what it means for investments. Investors have spent a lot of time this year trying to second guess the policy deliberations of central bankers, often betraying a lot of wishful thinking in the process. If only the US Federal Reserve (Fed) would signal a peak of the monetary tightening cycle, which pretty much everyone else would then follow, we could all get back to watching equity markets going up… It has not proven to be so simple.

The biggest rally during this equity bear market started in mid-June and ended in late August. It took the MSCI All-Countries World Index up 13%, with the tech-laden NASDAQ 100 Index leading the charge, up 23%. One of the key drivers was that investors started to bet on the prospect that interest rate increases were going to stop (and possibly reverse) in the second half of 2022 in the face of rapidly weakening economies. The big fly in the ointment turned out to be inflation, especially in service industries, which were seeing strong demand from consumers recently released from Covid confinement. This demand ran into a shortage of workers, with wages soaring.

Even so, it took a very clear message from Jerome Powell, the Fed's chairman, at the Jackson Hole symposium for central bankers, to change the mood. He emphasised the Fed's desire to tame inflation (a sentiment echoed by other central bank chiefs) and the message was followed up in yet starker words at September's Federal Open Market Committee meeting. This is the body that sets US interest rates. The committee raised its projection for rate rises in 2023 and suggested no hint of a cut before 2024. The market took fright and major equity and bond indices hit new lows for the cycle, helped along a bit by the turmoil in the UK Gilts market (which was itself created in part by the relentless rise in interest rates and bond yields).

What next for interest rates?

Having bottomed on 14th October, markets are now back on "pivot watch" thanks to increasing signs of weakness in economies and the corporate sector, even if full-blown recessions have not yet been captured in the data. Two major central banks have already delivered "dovish" surprises to the market by not raising rates as much as had been expected. These are the Reserve Bank of Australia and the Bank of Canada. The European Central Bank has also toned down its guidance about the extent to which it will raise rates. Traders latched onto an article in the Wall Street Journal written by Nick Timiraos (an acknowledged Fed "insider", who has been a conduit for hints of policy changes in the past), which discussed the fact that some Fed members were wondering about how they might begin to discuss the possibility of raising rates at a slower pace (and, yes, that is deliberately vague).

The effect is clear to see in interest rate futures prices. The priced-in peak for the Fed Funds rate was just over 5% on October 20th, and it has now come back to 4.95%. Bond yields have also declined sharply, with the 10-year US Treasury yield falling from 4.25% to 4.06%. Such moves have been mirrored in most other developed markets (with the caveat that the UK has been more volatile than

others owing to its domestic strife). But with the Fed Funds rate currently at 3.25% and expected to be raised to 4% at this week's FOMC meeting, you can see that there is still some ground to cover to reach the top. Time to return to Everest. There is a lot of talk about a potential policy mistake ahead, but, in many respects, the mistake was made a long time ago when the Fed adhered for too long to its "transitory" inflation narrative and kept policy too loose. Rather than starting the climb to the summit in the dark at midnight, it had a lie in, waited for dawn (when sunrise illuminated the inflation problem) and has been trying to catch up ever since.

This is where the timing gets tricky. Having proclaimed itself to be an inflation-bashing institution, what will it take for the Fed either to pause for a break to reassess the situation or to head back down? Or will it just keep on going because that's what it said it would do, turn around quickly citing its great achievement and then go hell-for-leather on the way down having broken the economy and financial markets in the process, praying that it survives? Jerome Powell has been adamant so far that he doesn't want to repeat the mistakes of the 1970s when policy was eased too soon, inflation bounced and necessitated an even tighter regime finally to kill it off.

Dependent on the data

It will require the Fed's members to make decisions about things that they can only infer rather than see clearly now. We know from history that both inflation and unemployment are lagging indicators of the state of the economy, although conditions today are complicated by the pandemic (such as never experienced by modern day policymakers) and its aftermath. The third quarter corporate earnings season is sending conflicting messages. There are signs of an incipient slowdown, and they were most evident in the results of some of the big US tech names. At the same time, many companies are reporting the ability to raise prices, although often at the expense of volume growth. Banks and Energy companies are in rude health thanks to expanding margins and limited signs of impairments or demand destruction.

The central banks will no doubt fall back on data dependency, and so markets will remain slaves to data releases, with anything to do with inflation or employment most keenly watched. We will remain in "cautious not fearful" mode as we have been for some weeks. While we can see the arguments for a pause in the rates cycle (if not a pivot or reversal), we also believe that the full effects of monetary tightening and the squeeze on household incomes have yet to be revealed in the economy and corporate earnings.

I will repeat my opinion that I think this cycle is a combination of 2000/03 (the Tech Bust) and 1989/91 (a more traditional monetary policy tightening cycle to combat inflation), and they took a while to play out. The current bear market is not one that was catalysed by a shock that can be easily reversed by swinging interest rate cuts or more Quantitative Easing. Indeed, one could say it was deliberately engineered to take the steam out of economies. And on the last few occasions that central banks resorted to cutting rates and injecting liquidity, inflation was around or even below their 2% target rate. But we also know it is just a cycle, and that at some point the data will unequivocally support easier policy. Now is not the time to give up.

Economic Commentary

FTSE 100 weekly winners

Melrose Industries PLC	12.0%
Land Securities Group PLC	9.4%
Barratt Developments PLC	8.6%
Rentokil Initial plc	8.4%
Persimmon Plc	7.7%
Just Eat Takeaway.com N.V.	7.4%
Pearson PLC	7.4%

FTSE 100 weekly losers

Hargreaves Lansdown plc	-8.7%
Prudential plc	-10.0%
Standard Chartered PLC	-8.4%
HSBC Holdings Plc	-7.5%
Rio Tinto plc	-6.6%
NatWest Group Plc	-4.3%
Reckitt Benckiser Group plc	-4.3%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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