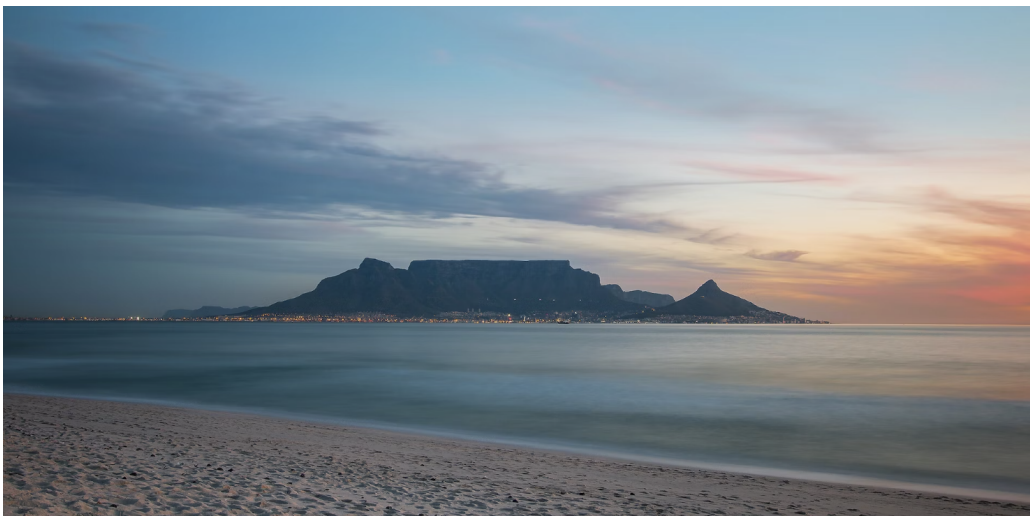


September 22, 2023

BILBoard September 2023: Peak rates in sight



While central banks could still make some final tweaks, most market participants now believe that we are at (or inches away from) the top when it comes to US and European rates. What is most important for investors now, is the *shape* of the peak we are arriving at. Central banks have made it clear that we can set aside any imagery of a Toblerone-style jagged peak, steep on both sides. The summit is more likely to resemble South Africa's Table Mountain: a steep incline in rates, only for them to remain steady at high altitudes until policymakers are certain that inflation risks have abated. A protracted period of higher rates will weigh on growth but, at the same time, promises new income opportunities in portfolios.

Europe

As Dutch ECB Governor Klaas Knot put it, the ECB has reached the "finessing" phase of the hiking cycle. Since summer 2022, the central bank has raised rates 10 times, bringing the deposit rate to an all-time high of 4%. Any further hikes will be a hard-sell (absent an unforeseen shock), given the deteriorating macro picture. Going by PMI data, the European services sector has now joined manufacturing in contraction, and the economy is skirting recession. Germany, the bloc's traditional growth engine, is facing a cyclical downturn, while

being confronted by long-running structural issues that had bubbled under the surface until the war in Ukraine. Despite the ailing growth outlook, euro zone inflation and wage growth are still too high, and the labour market has remained exceedingly strong. While no uptick in unemployment seems like a welcome development at first glance, labour hoarding is weighing on productivity (the ECB expects the latter to decline by 0.2% in 2023), and could reinforce a wage-price spiral. At the same time, production cuts and renewed demand from China, have pushed crude prices north of USD 90 per barrel. These factors amplify the stagflation risk that already clouded the euro zone outlook and galvanise the case for postponing rate cuts. As Governor Villeroy has said, "keeping borrowing costs high for a sufficiently long period is now more important than raising rates significantly again," while Bundesbank President Nagel opined that "it would be wrong to speculate that an interest-rate peak will soon be followed by cuts."

US

In the US, the Fed's sequence of 11 hikes appears to have blown out the inflationary fire. However, certain embers are still glowing hot (especially in the services sector, where PMI data shows that companies have been raising prices at a faster pace amid still-firm demand).

Ultimately, our best guess is that core inflation will continue heading in the right direction: credit conditions are tight, pent-up savings will be depleted this quarter according to San Francisco Fed estimates, the labour market is gradually weakening, and student loan repayments are set to re-start in October for millions of Americans (expected to create a 0.6pp drag on monthly PCE spending). These factors suggest demand will start to soften, ultimately aiding the economic "cooling" process (Fed models suggest the bulk of inflation is now demand-driven rather than supply-driven).

However, US households' propensity to consume has already surprised economists this year and it is difficult to estimate exactly how long their stamina will persist (especially with Thanksgiving, Black Friday and Christmas in the pipeline). Ongoing economic resilience has led the Fed to keep one more precautionary 25bp hike for this year on its dot plot*. Thereafter, policy rates are expected to remain at "restrictive levels" for a prolonged period. Indeed, the projections for 2026 showed the median dot at 2.9%. That's above what the Fed considers the "neutral" rate (considered to be 2.5%) that is neither stimulative nor restrictive for growth.

Investment strategy

A protracted period of higher rates will take a toll on growth, and we maintain a cautious approach to portfolio construction and an underweight stance on risk assets.

August's lacklustre market performance implies that the 2023 equity rally is beginning to falter as markets, previously starry-eyed about the future of AI, shift their gaze back to underlying economic fundamentals. Even positive earnings surprises did little to push up prices, while the mildest of disappointments were punished.

In this context, the hedge we put in place in August (covering 1/3 of our US equity exposure and 1/3 of our European equity exposure) has proved beneficial. We are keeping it in place for now, as we seek a degree of protection, believing that there could be more downside risk ahead. Regionally, our largest underweight is to Europe. We are slightly underweight on US equities, and neutral on Japan, Emerging Markets and China. Style-wise, we emphasise quality and a neutral stance on growth versus value.

Consumption has been the driving force behind surprising economic strength, and consumer-related sectors contributed the most to global earnings surprises during the Q2 reporting season. On a tactical basis, we had two preferred sectors through the summer, both focusing on this theme: consumer staples and consumer discretionary. Should we start to see signs of waning demand, we will adjust accordingly.

With the bulk of the climb in rates now behind us, the view up here is an attractive one for fixed income investors, with yields at quite handsome levels. This month, we continued our mission to capture income opportunities by further reducing gold (a non-yielding asset) and total return, and using the proceeds to top up on investment grade credit, this time in the form of floating-rate notes which provide a slightly higher yield than money market funds.

We are constructive on Govies over the longer term (as they should deliver protection in an economic downturn), and monitor attractive entry points to build up our positioning.

We remain underweight on high yield. While the segment has performed quite well recently, we do believe that tighter monetary policy will ultimately lead to higher spreads and that downside risks outweigh upside potential. Up here at (or close to) peak rates, credit (the corporate world's oxygen) is less abundant. Lower quality companies are likely to be the first to succumb to altitude pressure.

*A chart updated quarterly that records each Fed official's projection for the federal funds rate at the end of each calendar year

High-Level Matrix

30/08/2023								
	DEFENSIVE		LOW		MEDIUM		HIGH	
	Stance	Change	Stance	Change	Stance	Change	Stance	Change
Global Allocation								
Equities	●	→	●	→	●	→	●	→
Fixed Income	●	→	●	↑	●	↑	●	↑
Cash & cash equivalents	●	→	●	→	●	→	●	→
Alternatives	●	→	●	↓	●	↓	●	↓
Equities								
USA			●	→	●	→	●	→
Europe			●	→	●	→	●	→
Japan			●	→	●	→	●	→
China			●	→	●	→	●	→
Emerging Markets Ex-China			●	→	●	→	●	→
Fixed Income								
Government Bonds - Developed	●	→	●	→	●	→	●	→
Emerging Market Debt	●	→	●	→	●	↑	●	↑
Corporate - Investment Grade	●	→	●	↑	●	↑	●	↑
Corporate - High Yield	●	→	●	→	●	→	●	→
Alternatives								
Gold			●	↓	●	↓	●	↓
Total Return			●	↓	●	↓	●	→

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