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GLOBAL

Macro Outlook Summary

April / May 2023

After the dramas of March, markets were calm in April. Central banks were also silent as investors awaited the widely expected rate hikes of May, all of which duly happened with 25bps hikes across the board.

Progress on inflation is however a different story. US CPI dropped again to 4.9% while the EU rate edged up from 6.9% to 7%. Without question EU inflation is easing but within the block the ranking of inflation in member states brings a few surprises. Austria and Sweden at 9-10%, well over the average, while Portugal, Greece and Spain have dropped to 3-4% is somewhat counter-intuitive. German inflation is running at 6.1%. Given today's widespread Central Bank warning that monetary tightening has a lagged effect on the economy, which almost everyone surely already knew, it seems all the more surprising that the ECB and BoE were so slow to begin their hiking cycles. How things change.

The UK is quickly moving to the bottom of the class as CPI came in at 8.7% in May which is a mere 2% lower than its peak six months earlier. Again surely almost everyone knows the long track record in the UK of being an inflation prone economy yet inaction prevailed for far too long. This is very poor progress and given the quote from Governor Bailey in January at Davos that their models projected inflation to be significantly lower in the Spring it looks as if time has finally run out on that call.

Adding salt to the central bankers wounds, economic growth has surprised many to the upside. In the UK, the majority of the UK MPC noted 'repeated surprises' in the resilience of the economy and their new growth projections erased the recession previously forecast. With inflation remaining so high, the economy remaining resilient and the BoE talking about easing their rate hikes there seems to be some sort of wilful mismanagement going on here, or a deep seated fear of being held responsible for tipping the economy into a recession. The German economy, usually the engine room of EU growth, is struggling with 1Q23 GDP reported at negative -0.5%. Again the dispersion of growth rates across Europe is surprising with EU growth at +1.3% and those countries recording low inflation like Spain and Portugal reporting +4% and +2.5% growth respectively. On the face of it the correlation between high growth and high inflation doesn't look reliable, but then it never has been.

1Q23 growth in the US on the other hand was +1.6%, driven by stronger consumer spending in goods and services. Second quarter growth is expected around +1.1% so different economies have progressed very differently on driving down inflation without killing off the economy. Soft landings still look possible.

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The obvious cloud hanging over markets during May has been the US debt ceiling which hopefully passes through the Senate today or tomorrow (2-Jun) so markets will be looking for the next topic to focus their attention.

There is a trader's rule of thumb that a strong USD forewarns of a risk-off market meaning equities go down. In 2022 this rule worked well as the DXY Dollar Index strengthened from 96.0 to 114.5 by 30Sep22 which also marked the equity market low. From there the index fell back to 100, the first time on 1Feb23 and again mid-April. The point is that in the past two weeks DXY has rallied past 104 and convincingly broken out of its bearish downtrend channel. The bearish forces on the USD from US debt ceiling tensions in May, the ongoing US regional banking crisis and the longer term weaponization of the dollar are clearly being more than countered by mysterious other forces driving the USD upwards. With short term interest rates at 5.25% this may be one driver but it doesn't easily fit with the fact that the Fed is nearer to the end of its hiking cycle than the ECB or BoE so the relative interest rate differential should narrow. Investor sentiment that a global recession is looming may be the driver, so a traditional risk-off move but the data remains mixed. An alternative explanation but which contradicts this rule of thumb is that investors could be focusing on the brighter outlook for near-term US economic growth and corporate profits.

Most commentators place us on the verge of the most anticipated recession in history but the real debate is focused on the likely severity of the recession and the resulting impact on corporate profits. Here the picture is mixed. Advertising, manufacturing and freight have been in a recession for a year. But the consumer is strong and with a tight labour market so we're back to the old story of a rolling recession passing through sectors and geographies across the US. The bull case is that the US has made more progress than any other G10 country in bringing down inflation, the economy is firmly underpinned by solvent consumers, corporate earnings may be stronger than analysts predict and allocators are perhaps moving back to the dollar to invest in that economy betting that it will post more growth in the next 12 months than elsewhere. We think this is the DXY message at this juncture so while we heed the note of caution from the rule of thumb we are inclined to the bull scenario for the next few quarters.

Returning to the point about how well prepared investors have become for 'the recession', sentiment has become markedly negative according to the Bank of America Global Fund Manager survey. This is reporting more bearish readings than at any point in the past 20 years and growth expectations at all time lows with a mere 20% expecting a stronger economy in 12 months time. Investment factors are also flagging a change. In Feb'20 we saw a factor rotation from growth to value. Now in May the value factor has rotated to momentum. If this indicator is right then a market sell-off is not on the cards unless there's a shock to the system. Central bank rhetoric is mainly hawkish with Powell expressing his personal view that inflation wont go down as easily as markets think and that rate cuts are not really in Fed thinking. The BoE and ECB are signalling the inflation fight is not over and while the BoE is fairly non-committal about what to do next there are particularly hawkish tones now emanating, somewhat belatedly, from Lagarde.

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But as any student of previous inflation cycles should know it is the monetary aggregates which matter the most. Remarkably there have been zero column inches on this topic to date, as if no one remembers the lessons learnt from the 1980's. Since the outbreak of Covid in Feb'20 the M2 monetary aggregate has increased sharply in every economy. The US aggregate increased by 45% to the end of 2021 but has been on a steady path lower ever since. The EU aggregate grew by 25% over the same period but has only come off its peak since Sep'22. Within that data German remains at its peak. And then the UK where M2 increased 30% and similarly remains close to its peak. If this gauge of liquidity in the system is to be regarded as relevant then inflation is likely to remain persistent and more liquidity draining is needed in the latter economies. But what we don't think is that central banks have any agenda to return the M2 aggregate back towards pre-covid levels. We therefore think they are prepared to be tolerant towards somewhat persistent but lower inflation as long as they can talk about 'progress being made'. So, bottom line, a substantial injection of liquidity will remain in the system for the foreseeable future.

Interestingly this brings us to several key investment points. If further but more gradual interest rate hikes are applied in small part by the US and more substantially in the EU and UK, then government bonds at the short end will be forced to adjust upwards in yield, albeit slowly. Money market returns will become genuinely attractive in the short term. More complex is how each yield curve will evolve to price up future inflation expectations, but what we feel confident in is that short dated government bonds yields will be higher in 3Q23.

Equity markets appear to understand this and may be trying to look well beyond peak rates in late 2023. In the past few weeks growth names in mid and small caps have started to perform, led by the megacap US tech names in 1Q23. If that broadens the currently narrow leadership that seems to fit with the facts that economies are still awash with liquidity, a US soft landing remains a distinct possibility and the USD is rising as investor capital flows back into a tech led economy. Ultra bearish positioning by institutional investors will add momentum to this trend if they are forced to rethink positioning and maybe that is being flagged by factor investors who see momentum as the new dominant regime for equity markets. There are always black clouds to think about and there's plenty in global pricing that seems unsustainable but now doesn't feel to us as quite the right time to be bearish and batten down the hatches.

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