GLOBAL LONG-TERM UNCONSTRAINED

Monthly Market Update

MARTIN CURRIE
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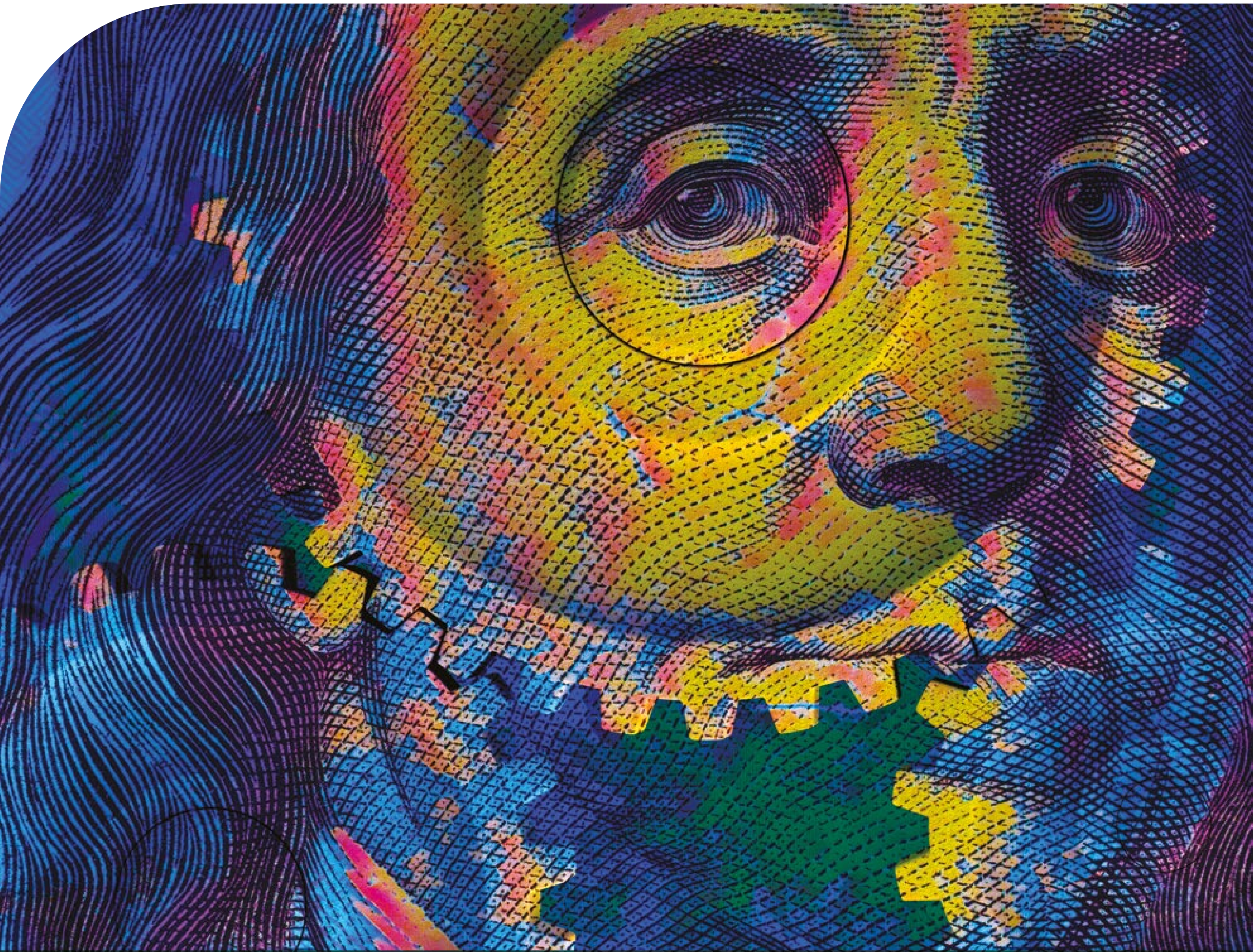
The last of the summer rate hikes

Peak rates nearing, recession fears receding



In this month's market insights, we explore the current interest rate cycle in more detail.

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After a hawkish pause in June, it remains unclear whether the US Federal Reserve's (Fed) 25bps interest rate rise in July is the last rate hike of the current cycle. However, we believe the Fed is highly likely to be getting closer to the end. With the European Central Bank (ECB) also raising rates by 25bps in July, it is relevant to tackle the debate on when interest rates will peak.

In our view, the current interest cycle will have likely peaked by the end of 2023. The market is now anticipating rapid rate cuts from both the Fed and the ECB in H1 2024. This is an outlook we do not share, due to the persistent inflation and the likelihood of avoiding a recession. Either way, we believe that we have seen the last of the summer hikes from both central banks, as far as the current hiking cycle is concerned, and therefore predict a more supportive environment for quality growth stocks, going forward.

The last of the summer rate hikes – getting close to peak interest rate cycle

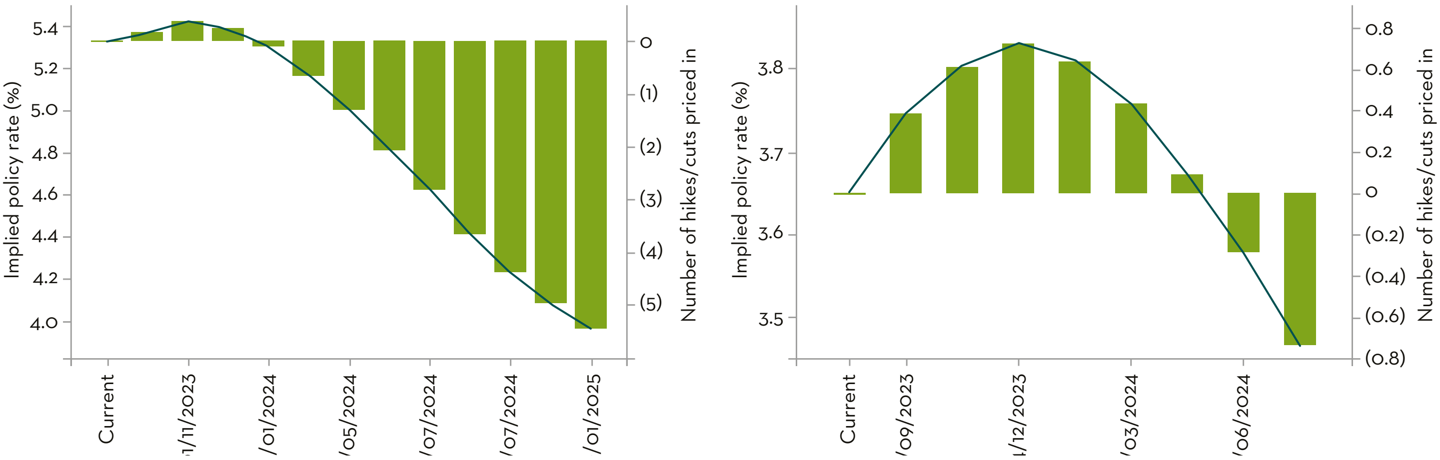
We wrote in our mid-year outlook update last month that the Fed rates are close to peaking, and predicted at the time 1-2 more hikes for the Fed, and 1-3 for the ECB before year-end. With both central banks raising rates in July by 25bps, we believe that we might now only have one to two more rate hikes coming from the Fed, and zero to two from the ECB before the year-end. All of this will of course be data dependent – specifically inflation data.

The market is now anticipating one more rate hike by the Fed before year end, followed by rapid rate cuts in H1 2024, with an implied Fed rate of 4.6% expected by July 2024 (from 5.25-5.5% currently), as can be seen in the chart below. For the ECB, the market is now anticipating rates to peak at 3.83% by end of 2023, from a current rate of 3.75%, i.e. implying less than one more 25bps hike, before a reversal in rate direction from the summer of 2024 onwards.

Central bank policy rates versus rate hikes/cuts

US Federal Reserve

European Central Bank



Source: Bloomberg, August 2023.

Whilst the market might have a healthy bull-bear debate before year end, centered around number of hikes still to come, for us, as long-term investors, the more relevant aspect to focus on is that we are now close to peak rates. And, we might have now seen the last of the summer hikes for both the Fed and the ECB, as far as the current rate hiking cycle is concerned.

Being close to peak interest rates in itself should be supportive to the Quality Growth style within equity markets in our view, as the market starts to anticipate a reversal in the rate cycle towards cuts. It is worth flagging that we do not share the market view of rapid rate cuts in H1 2024. This is based on our view that 1) inflation will remain sticky, and 2) the economy will avoid a recession – both variables together should keep the Fed away from reversing rates for some time in 2024, after reaching peak rates at the back end of 2023.

A pivot in rates remains premature for this year, and is unlikely until sometime in 2024

In addition to the Fed, we continue to believe that a pivot by other western central banks is unlikely to take place until sometime in 2024. This is based on our assumption that inflation will remain stickier - therefore more elevated and longer lasting than what the market is expecting.

That said, we do anticipate an easing in the inflationary pressures in the second half of this year, in large part as a result of the elevated base effect of last year. However, we also believe that deglobalisation trends, ongoing localised bottlenecks in supply chains, and wage inflation could risk keeping the inflationary pressures higher.

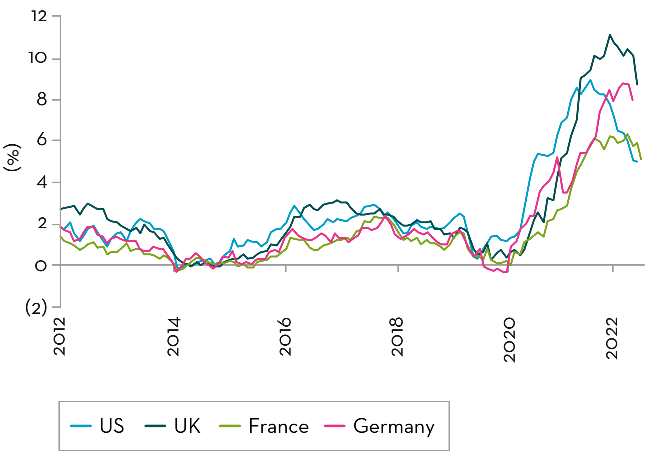
We believe that neither the Fed nor the ECB will be successful in hitting their c.2% inflation target by 2024, even though they are likely to have made good progress towards that target by then. As such, with both central banks stating clearly that they will remain data dependent, stickier inflation will likely keep them away from reversing the hiking cycle for the time being.

Wage inflation remains key to watch for signs of further inflationary pressures

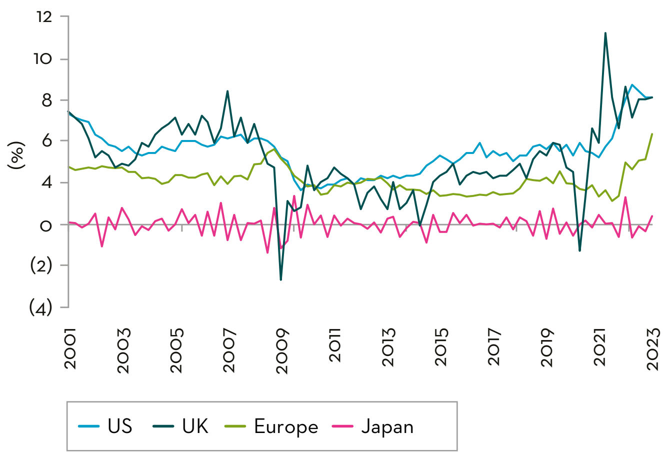
As we wrote in more detail last year (October 2022), all eyes need to remain on wage inflation, for signs of inflationary pressures becoming more persistent. Wage inflation is by far the largest contributor to medium-term inflation, hence its importance.

As can be seen in the chart below, wage inflation has been picking up in the US, EU, and the UK, which might lead to a more elevated and more prolonged inflation in the medium-term. It also carries the risk of turning inflation from being frictional, to becoming more structural. This would certainly keep central banks focused on the inflation side of the inflation/growth balance.

Headline CPI inflation on a monthly basis (%)



Wage inflation nominal (%)



Source: FactSet. For CPI data is shown as at 30 April 2023; for France as at 31 May. Wage inflation data shown to 31 March 2023. US: Atlanta Fed wage tracker, Europe: Eurozone negotiated wages, Japan; cash earnings, UK: total pay.

Continue to focus on Quality Growth companies with pricing power

Interest rates peaking should gradually lead to less downside pressure on long duration stocks, which quality growth stocks typically are. We define quality growth stocks as companies with solid balance sheets, high returns on invested capital, and exposed to structural growth. All of these characteristics are relevant at this point in the economic cycle, given the downside risk to economic growth from higher interest rates. Quality growth stocks, as we have highlighted before, should be able to fare relatively better, should we be heading into a recession (which is not our central scenario).

We continue to favour companies with four important characteristics:

(i) resilient earnings profiles, given ongoing risk of earnings downgrades;

(ii) pricing power, which helps protect margins, given risk of stickier inflation;

(iii) solid balance sheets, which will provide financial resilience, should we be heading into a recession; and

(iv) structural growth prospects, given the lower growth environment at this stage in the economic cycle.

What sectors and styles work post interest rates peaking

As we approach the peak in interest rates, we take a look at market performance post the last Fed hike over the previous 60 years, for our readers who might be particularly interested in this aspect.

The table below lists the performance of the S&P 500 over one, three, six and 12 months, post the last Fed hike, from 1966 to now. Overall, the market has fared well over three, six and 12 months post the last interest rate hike. As can be seen, with an average performance of +3% over three months, +7% over six months, and +13% over 12 months.

Change in S&P after last rates hikes (blue denotes market falls)

	1 month	3 months	6 months	12 months
September 1966	(1%)	5%	14%	21%
June 1969	(8%)	(4%)	(6%)	(24%)
July 1974	(9%)	(8%)	(5%)	13%
March 1980	4%	14%	24%	33%
December 1980	(5%)	0%	(3%)	(10%)
May 1981	0%	(7%)	(6%)	(13%)
February 1982	(1%)	0%	4%	31%
August 1984	0%	(2%)	8%	12%
May 1989	(1%)	9%	8%	11%
February 1995	3%	9%	19%	32%
March 1997	(2%)	11%	20%	39%
May 2000	1%	2%	(7%)	(15%)
May 2006	1%	5%	12%	18%
December 2018	7%	13%	17%	29%
Average	**(1%)**	**3%**	**7%**	**13%**
Typical performance	**1%**	**2%**	**5%**	**10%**

Past performance is not a guide to future returns.

Source: Credit Suisse estimates, Refinitiv Datastream. December 2022. Performance shows S&P 500 index.

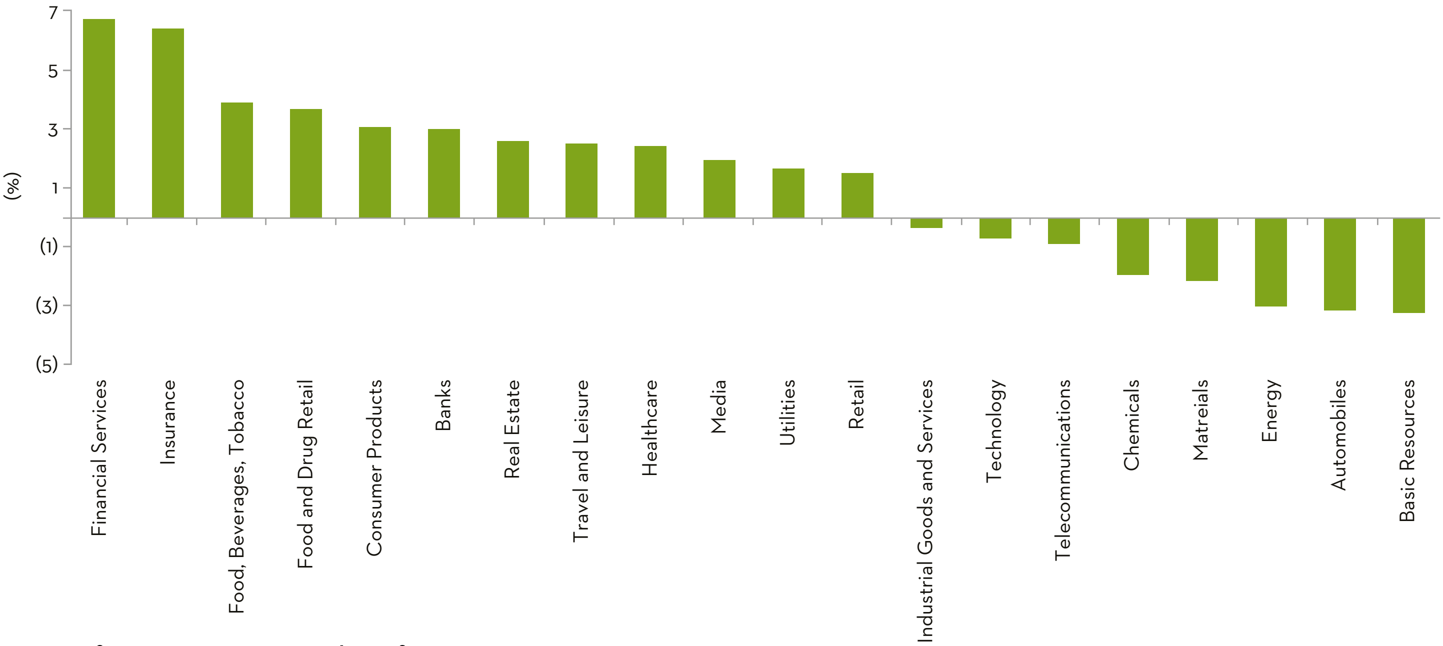
The average result however masks the various aspects that can drive share price performances in equity markets, not least starting valuation levels at the time of the last rate hike, but also some of the more fundamental drivers of market sentiment. Notably ISM* data plus other leading indicators, and the expectation of the pace of rate cuts post the last hike, so the reader should be careful about not taking these results too "mechanically".

*Institute for Supply Management. Also known as ISM Manufacturing Purchasing Managers Index (ISM PMI), is a monthly gauge of the level of economic activity in the manufacturing sector in the United States versus the previous month.

Looking at which sectors have typically performed post the last Fed rate hike, focusing on six months performance, there is a mixed array of sector performance, as can be seen in the chart below. We note that some of the sectors with typical quality growth characteristics, such as Consumer Staples, Consumer Discretionary and Healthcare have typically performed well. Whilst some of the Value sectors (Telecoms, Materials, Energy, Basic Resources) have tended to underperform.

On aggregate, Technology and Industrial goods have had a broadly neutral performance over that period.

Average performance relative market 6 months after last rate hike



Past performance is not a guide to future returns.

Source: Credit Suisse estimates, Refinitiv Datastream, December 2022.

Once again, it is worth emphasising that this average performance masks the nuances listed above that investors need to take into account (valuation levels, economic momentum post Fed rate hike, and interest rate expectations).

Therefore we do not propose that the facts highlighted above are a good guide of future performance. Instead as we get closer to peak rate, these illustrate a few features of historic performance following final Fed hikes, for investors interested in shorter term market and sector moves.

Recession fears might be like waiting for Godot, and might not materialise

In our recent mid-year outlook update (accessible on our ***website***), we reiterated our view that a recession could be averted, and we have stuck with our view that a sharp slowdown is our central scenario, both for the US and wider global economies. We reiterate once again that, as long-term investors, we prefer to focus on the fundamentals of companies we invest in. We believe that long term compounding characteristics of these companies should lead to share price appreciation through a longer term economic cycle.

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