

# Portfolio Manager Perspectives

## Mark Dowding's Global Macro Update

February 9, 2024

### Running hot

And that's not just global temperatures!

#### Key points

- As the US economy continues to exhibit strength, hopes for an early rate cut dwindle.
- In our judgement, the Eurozone growth backdrop is weak and progress on reducing inflation may be slowing.
- We see strong underlying demand for high grade credit, and this means we'll likely continue to see tight spreads.
- Looking ahead, the focus is on next week's US CPI report, which has the scope to set the tone for the remainder of the month.



Global yields largely tracked sideways over the past week, following a marked increase in Treasury yields in the wake of the FOMC playing down hopes for a March rate cut and strong payrolls data. This reaffirmed the robust momentum that continues to be exhibited by the US economy.

In many respects, data has shown further strength since the December Fed meeting, which triggered a material easing in financial conditions. A slowing in activity remains likely as we progress through 2024, though for now, there is little to cause us to move from a long-held view that rate cuts are only likely to commence in the second half of this year.

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Up to this point, the narrative of moderating inflation has not been challenged, and in this light, next week's CPI report carries some risk, were data to disappoint to the upside. An uptick in wages and prices paid surveys suggests that policymakers can't afford to become too complacent with respect to price pressures.

Although it seems wrong to be sounding any alarm bells, we have previously noted that the last mile in bringing inflation back towards target is likely to be protracted and it may be a number of months before core CPI drops below 3%, a level at which we feel the Fed will be more comfortable in reducing rates.

Moreover, we continue to challenge a narrative that monetary policy travels up the stairs but down the elevator. This much is true if data softens abruptly (a.k.a. a hard landing), or if there is a material adverse financial market event. Yet a soft landing is widely discounted in the valuation of risk assets, with the S&P topping 5,000 for the first time this week. In such a scenario, once a rate cutting cycle begins, we think it may proceed at a measured pace.

Moreover, we would highlight parallels to the two easing cycles in the US in the 1990s, during which rates declined by 100bps or less, before they turned higher again. In this respect, markets probably discount too much monetary easing, unless we ultimately move towards a recession. In this regard, a desire to return to valuation norms seen in the 2010s, prior to the pandemic, may well prove to be misguided.

In the past week, European policymakers have also played down prospects of early rate cuts. The ECB's Schnabel was notably more hawkish in her recent comments, relative to a more dovish stance in December. In her interview, Schnabel noted that progress on reducing inflation was slowing, whilst also highlighting an uptick in some sentiment surveys suggesting a slightly improved economic outlook.

Nevertheless, we still see the Eurozone growth backdrop as pretty weak. Southern Europe is doing relatively well and labour markets are relatively robust. Yet, away from this, GDP in the region is bumping around zero and policymakers are ever more fearful of building downside risks. Many of these seem increasingly linked to a fear of a Trump victory and a more insular United States. Questions such as 'will Ukraine prevail in a Trump second term?' come to the fore, and certainly it seems attitudes will need to change in countries like Germany, yet the country is hamstrung by weak leadership and an ongoing obsession with past history, making decisive action difficult.

Arguably, it is at times like this when the UK's departure from the EU is most missed, and one hopes that Berlin does not sit on its hands too long and live to regret its lack of action.

There has been little new data in the UK over the past week. Underperformance of long-dated gilts suggests that fiscal fears are not too far from the surface, at a moment when the Conservatives are gearing up for March tax cuts, and increasing scrutiny on Labour's fiscal plans is also creating medium-term cause for concern.

Meanwhile it has also been a quiet week in Japan, notwithstanding a speech from Deputy Governor Uchida laying out a somewhat cautious scenario on the potential path of rates this year. However, renewed vigour in the US economy probably makes it more likely than not that the BoJ policy action will be forthcoming in March.

Elsewhere, weakness in US regional banks has been a notable market concern, notwithstanding broad market gains led by the megacap stocks. The falling stock price of New York Bancorp has triggered concerns of a repeat of SVB in March last year.

That said, the reason for the price movements is very different, and we are much less concerned that pressure on the sector will lead to a renewed liquidity event, given measures put in place. Even so, US regional banks remain a weak spot and have been exposed to higher yields and falling property values. We continue to expect some softness in commercial real estate prices, though in many respects, we think that the worst of the price action is now behind us.

Elsewhere we continue to see strong underlying demand for high grade credit, and we think this can continue to lead spreads somewhat tighter in the next few months. We see most value in euro financials and note that we are much more sanguine with respect to the earnings and profitability outlook for the major European banks, a view largely endorsed in our conversations with policymakers.

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In FX, strong data has helped to support the dollar over the past couple of weeks. However, the inflated valuation of the greenback is an impasse to material dollar strength at this stage.

Moreover, we think the more interesting development could be in certain EM currencies, which may be set to weaken as rates fall much more quickly than is the case in developed markets. This is a fact making us quite bullish on a number of local interest rate markets, though in FX, those currencies which are over positioned carry plays could be among the most vulnerable.

## Looking ahead

All eyes will be on next week's US CPI report. This certainly has the scope to set the tone for price action across the remainder of the month. In this context, an in-line number might just see volatility subside and markets catch their breath for a moment, before we head into the next round of data and central bank meetings in March.

When commentators come to review price action in this period in a year or two from now, it will be interesting if the market's current obsession with rate cuts may seem to have been a bit strange at a time when evidence seems to suggest that the economy is speeding up more than it is slowing down. Although the narrative that the next policy move could be a hike is deeply unfashionable, it is worth noting this is certainly not a zero per cent probability event at this juncture.

Climate data show that global temperatures are predictably hotting up and have now breached the +1.5 degree threshold. It seems that for the moment at least, the US economic temperature is also running pretty hot, continuing to confound many forecasters fast asleep to the broader trends. Pity the poor macro economists – it seems like projecting the climate these days is a much easier ask, even if the outcomes are far more depressing.



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