Rathbones
Look forward

InvestmentView
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More twists and turns ahead?

Financial markets seem steadier now that the banking sector tumult has eased. But the inflation and growth outlook remain uncertain, raising the risk of further turbulence.

If you look at the final numbers for stock and bond performance in March - and for the first quarter overall - the outcome wasn't bad. But the headline numbers don't tell the full story. Financial markets were tossed back and forth as investors grappled with sticky inflation, a sudden crisis of confidence in the banking sector and more interest rate rises.

By the start of March, investors had begun to fear the encouraging inflation picture was starting to reverse as core inflation measures in the US and Europe ticked higher once more. This led to expectations of more central bank rate hikes than many had previously anticipated. The sudden collapse of American lender Silicon Valley Bank and two smaller peers, followed by the forced sale of Swiss banking giant Credit Suisse to its even bigger rival UBS, then dwarfed concerns about reaccelerating inflation. Many investors feared a system-wide financial crisis had begun and central banks might begin cutting rates quickly to keep the banking sector stable. As we explained in our recent Investment*Update* on banking stress, we didn't view the panic triggered by the bank collapses as a nasty warning of a looming systemic financial crisis. But it's hard to believe it won't lead to banks getting still more cautious about lending to households and businesses. We were already seeing lending slowing down and lending standards tightening before the panic set in. Further belt tightening raises the already high probability of a mild US and global recession.

The path ahead looks far from smooth. We still believe it makes sense to stay invested in equities, and assets like corporate bonds which have some 'equity-like' risk, though with a defensive bias - keeping our seatbelts securely fastened as we expect more turbulence ahead.

Is the end to rising interest rates and high inflation getting closer?

The world's big central banks stuck to their guns on rate increases amid the banking sector tumult. The US Federal Reserve (Fed) and Bank of England both hiked rates by a quarter of a percentage point, while the European Central Bank (ECB) was more hawkish by comparison and hiked rates by half a percentage point. But beyond their immediate policy moves, most central banks acknowledged that the outlook had grown more uncertain.

Estimates over the past 18 months or so about when rates will peak have been dead wrong many times as inflation - and economic growth - have stayed higher for longer than most people expected. Most investors expect the Fed to hike rates in May by quarter of a percentage point to 5.25% and then call it quits. And many seem confident that the Fed will start cutting rates by the end of the year. We still think it's hard to see the Fed in particular cutting rates significantly this year with inflation still running much higher than its 2% target.

The figures for US inflation in March showed the headline consumer price inflation rate falling a bit more than expected, but core inflation (which strips out volatile energy and food prices) was still stubbornly high. And UK consumer price inflation dropped by a mere 0.3 percentage points to 10.1% year-on-year in March. The BoE had expected the rate to be 9.2% by this point, so it was a big upside surprise.

Inflation in supply-constrained goods, whose prices surged in 2021, has been close to zero for a few months. Meanwhile, energy inflation actually subtracted from headline inflation last month for the first time since late 2020.

But inflation in the services sector of the economy is proving stubbornly resistant to the impact of higher rates. Much of the stickiness in services sector inflation is down to high wage inflation. Labour costs account for a much

bigger part of the prices we pay for services than they do for those of goods. Yes, wage growth is already falling a bit. And indicators that lead wage growth tell us that wage growth will probably slow further. But it may well stay relatively high until the end of this year and that could stop core inflation rates from getting back to policymakers' targets.

Economic data in many countries has been dipping lately as the effects of higher rates filter through. It's important to remember that the full effects of central bank rate hikes aren't truly felt until roughly a year or so after they are implemented. Even the shortest estimate among recent academic studies that look at how long it takes for rate hikes to hit the real economy would suggest that we've only just passed the stage where most of the impact of the Fed's first quarter-point hike back in March last year, for example, is being felt. And there's another 4.5% of Fed rate hikes still to be felt after that… and counting.

As the delayed effects of higher interest rates and less bank lending filter through the economy., conditions will likely worsen ahead. We're not expecting a deep or prolonged downturn. But we do think current equity market pricing is at odds with the probability we place on a global recession (as well as sticky inflation).

Navigating further turbulence

Navigating mild recessions is a normal part of investing. They rarely hold back equity returns for long, which is why we're staying invested. Quality and defensiveness are the two factors we're favouring within our equity portfolios. Measures of quality we look for are sector-beating returns on investment, high and stable profit margins and easily manageable levels of debt and interest payments. Indeed, the ability of companies to cover their interest payments with their profits suddenly became a top-performing factor in March. In terms of defensiveness, we look for low volatility in share prices relative to the overall market and companies whose earnings are less sensitive to the ups and downs of business cycles.

Corporate bonds are also looking attractive. For the first time since before the Global Financial Crisis, the yield on higher-quality investment grade corporate bonds is meaningfully higher than the equivalent equity yield (annualised returns divided by price). Corporate bonds often outperform equities after the Fed raises rates for the last time in a tightening cycle, regardless of how the economy is holding up. Equities need an improving growth outlook to outperform – in 2001 and 2007 the beneficial impact of the first rate cut was overwhelmed by deteriorating growth. For sure, bond yields are sensitive to the business cycle too, but they are two-thirds less sensitive than equity valuations.

US corporate bonds look expensive (their yields are too low), but the yield gap between European corporate bonds and safer government debt is wide relative to history and looks more attractive.

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