

A Tale of the Fed and “Goldilocks”

The story for 2024 in capital markets has been one where the Fed has “confused” economists with “noisy” guidance in terms of rate cuts in an economic environment which is neither too hot nor too cold (Goldilocks). Despite this “confusion”, G7 developed market equities continue to challenge all-time highs whilst bond markets remain range bound.

Why is this happening? Are markets too complacent? Should we be worried if the Fed cut rates by less than expected?

In our inaugural piece, we attempt to dissect and discuss the implications of the Fed conundrum and whether “Goldilocks” will persist.

From the CIO Desk.

What has happened?

As mentioned, G7 equity markets continued its bullish trend in 2024 whilst bonds remained range bound as expectations for the Fed to cut rates slowly diminished whilst the economy remained in a “goldilocks”** environment. Part of the bullish signs in equities were driven by technology on the back on optimism on AI trends globally; Interestingly, Malaysian equities out-performed in ASEAN. Bonds was generally flat but flows continued into bonds as clients locked in favorable yield especially in developed markets. Gold also outperformed.

So what's next - the Fed's conundrum

Maintaining high interest rates at current levels when inflation is not accelerating, raises the real rate of interest. To avoid a persistent high real interest rate, the nominal rate needs to fall. Policymakers must weigh these complexities and data to employ a nuanced approach to monetary policy or risk tipping the economy into a downturn.

Markets now expect fewer rate cuts from the US Federal Reserve in 2024 than it did in December 2023. Some expect none. Markets changed their minds for two reasons: the persistence of inflation and labor market strength in the U.S.

The Fed's conundrum is whether to keep interest rates high (in pursuit of its price stability mandate), or lower the policy rate, and in doing so, threaten its other mandate (maximum employment, a proxy for economic growth).

Is inflation beaten?

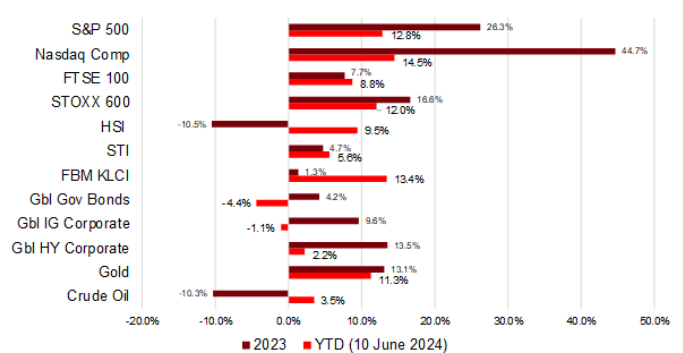
To be sure, inflation has fallen from over 8% to under 3.3% in May, but remains stubbornly above the Fed's 2.0% target (horizontal red line in graph). With a healthy labor market, the economy appears to be able to 'live with' the high policy rates used to battle inflation- although Q1GDP growth was lower than expected (annualized 1.3% QoQ).

Will inflation drop to the target 2.0% level this year? We are doubtful, but should inflation resume its decline, that may be sufficient for the Fed to start rate cut.

Tightening/Easing cycles – in the final straights now

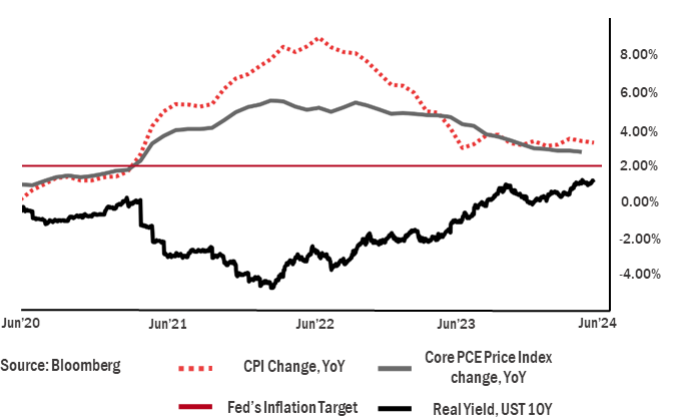
In past cycles, peaks in US policy rates have been associated with sharply falling bond yields. There is no reason to expect the current cycle to be different, especially considering that the recent tightening cycle has been one of the most aggressive in history. We believe that the current cycle's yield decline has begun. Since the peak in October 2023, the 10-year US Treasury yield has fallen by just 71bps; in past cycles, the decline averaged 258bps.

Performance of various markets and asset classes, YTD 2024



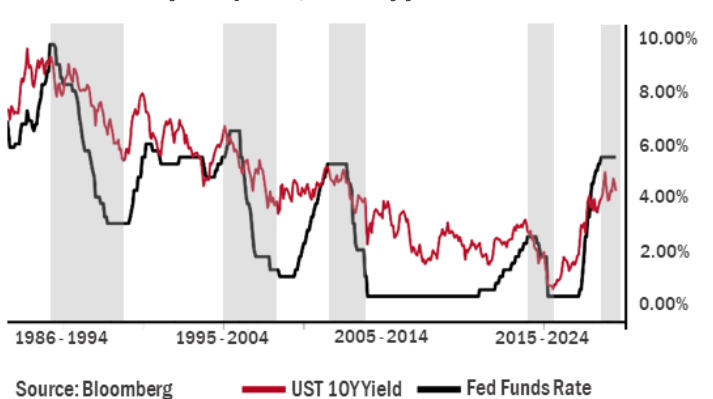
Source: Bloomberg

US CPI and PCE Price index changes, and UST 10Y 'real' yield



Source: Bloomberg

When the Policy rate peaks, Treasury yields fall



Source: Bloomberg

Bottom-line: We believe rates are likely to be cut in late 2024 and into 2025, without which the real yield (or real cost of borrowing) could slow the economy meaningfully. Hence, we advocate an overweight on bonds to lock in yields in anticipation of more capital gains when the rate cut cycle gathers momentum.

Equities- bullish trend continues?

To understand the momentum in US equities, we attempt to analyze trends in operating profit margins (OPM) of S&P500 companies. Since mid-2020, OPM trends have been rising and now exceeds pre-pandemic levels. This reflects:

1. US companies' ability to pass on higher prices in an inflationary environment
2. Cost control (including via headcount cuts) in many industries, including financials and technology.

The discipline of cost control and capital allocation becomes more acute with elevated borrowing costs and risk-free rates.

Market Breadth improving over time

S&P500 earnings are projected to grow by 9.0% in 2024 and (an optimistic) 13% in 2025. At the current 20.8x PER this year, the market does not appear attractive at the index level, but once technology sector is excluded, the valuation drops by 2 PER multiples.

Market breadth has improved from 6 months ago, with all sectors (but real estate) registering a positive return. This is markedly different from 2023 whereby 3 sectors (utilities, consumer staples and energy) registered negative returns.

Bottom line: OPM trends remain on an uptrend and unless this is derailed, market momentum on US equities should continue. However, the risk-reward suggests a neutral view at this juncture given how well the US market has done.

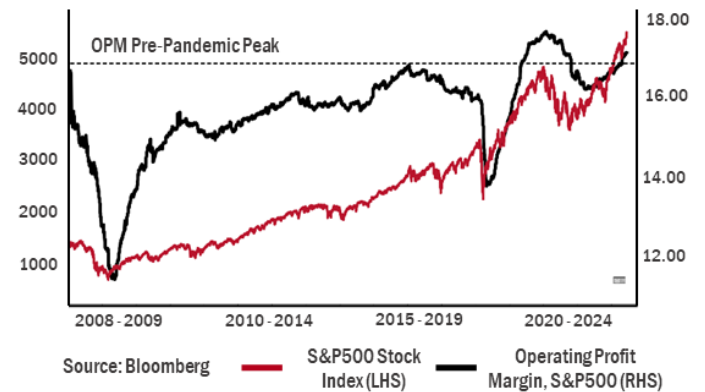
How does this affect Asia?

Should the Fed delay its rate cuts into 2025, the US dollar will stay high. Dollar strength will be further helped by other developed market central banks cutting before the Fed. The Swiss National Bank, Canada's central bank and the ECB have stared down that road; the Bank of England is likely to follow.

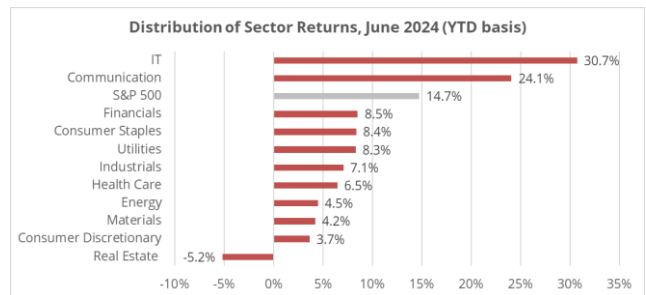
Although Asian economies have stronger growth prospects than developed countries, rates are not expected to be cut in Asia, and the resulting strong dollar could prove to be a headwind for Asian equities. (There is a clear inverse relationship between the MSCI Emerging Markets Asia index and the DXY (the dollar index).

Bottom-line: However, we don't think the USD can stay high for that long given a delayed expectations of rate cuts. This could be a tailwind for investors to think about a tactical view on Asia especially in markets like China and ASEAN (including Malaysia)

S&P500 Operating Profit Margins – above pre-pandemic level

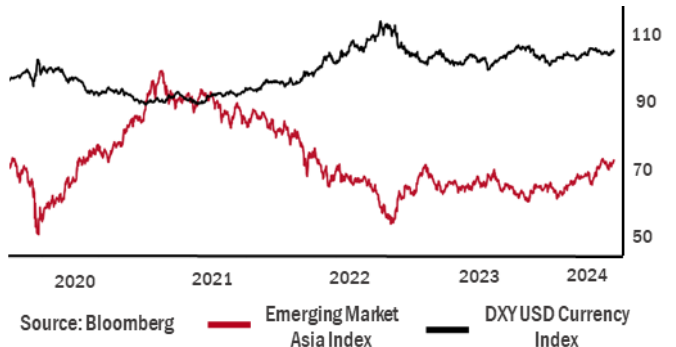


US equity market 'broadens' out beyond technology



Source: Bloomberg

Asian Emerging markets inversely correlated to the US Dollar



Conclusion: The big picture is this- it is not a question of whether of the Fed will cut rates this year but rather when and by how much. A delayed policy action in 2024 can only lead to more rate cuts in 2025 to "play catch up" in terms of being more accommodative in an environment which is starting to shows signs of softening.

The consequence of "goldilocks" is a favourable backdrop for developed market bonds whilst global equities continue to "melt up" to dizzy heights. It remains to be seen if this AI tech rally in the US can defy gravity for that long.

Happy investing!

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