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Insight INVESTMENT

GLOBAL MACRO RESEARCH
ASSET RETURNS POST RATE PEAKS

FEBRUARY 2024

GLOBAL MACRO RESEARCH

BNY MELLON | INVESTMENT MANAGEMENT

MARKETS ARE PRICING IN THE END OF THE RATE CYCLE, AND IF THEY ARE CORRECT THEN ASSET PRICES HAVE HISTORICALLY PERFORMED WELL IN THE PERIOD BETWEEN THE LAST HIKE AND THE FIRST CUT. SO FAR RISK ASSETS HAVE PERFORMED POORLY RELATIVE TO SIMILAR PERIODS IN HISTORY. BUT GROWTH APPEARS TO BE STABILIZING, AND COULD START TO REACCELERATE, AND THIS IS LIKELY TO PROVE POSITIVE FOR RISK ASSETS.

EXECUTIVE SUMMARY

- Rate expectations have changed dramatically and, although markets appear to have got ahead of themselves, inflation is moderating and growth has slowed, which supports the view that the hiking cycle is over. // 3
- A soft landing is still achievable, and economic activity appears to be stabilizing. Our asset allocation framework suggests a regime shift could be underway, and history suggests that the reacceleration in growth could eventually shift us into an environment that could be very favorable for risk assets. // 5
- Looking back at previous rate cycles, if this is a genuine end to the hiking cycle asset returns have so far been poor relative to history. Markets may face bouts of volatility as a more realistic path for central bank policy is priced in, but easier policy has generally led to a positive backdrop for both equity and fixed income markets. // 7

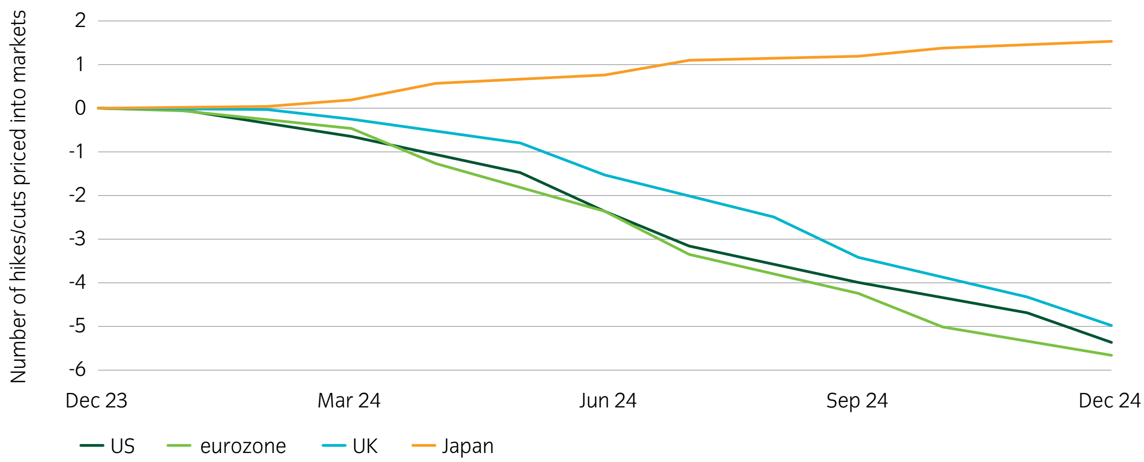
THE TIGHTENING CYCLE
APPEARS TO BE OVER

A FED PIVOT HAS LED TO A RAPID REPRICING OF RATE EXPECTATIONS

A change in rhetoric at the US Federal Reserve at the end of 2023 saw one of the most pronounced reassessments of the path of policy rates in modern times. At the start of 2024 the market was pricing in a nearly 80% chance of a cut in the Fed Funds rate by March and a whopping 150bp of cuts by the end of the year. For reference, the Fed's own forecasts from the Federal Open Market Committees December meeting was for official rates to decline by 75bp in 2024. For the European Central Bank (ECB), market pricing ended 2024 suggesting a 54% chance of a cut by March and over 150bp of cuts by the end of 2023.

Although market pricing backed up slightly at the start of 2024, the story remains one of markets anticipating an easing cycle of historic proportions. Japan is the one outlier, but even if the Bank of Japan does finally take part in the hiking cycle, the level of interest rates will remain well below other major markets.

Figure 1: Rate cuts / hikes – market expectations[1]



IT MAY NOT BE A FALSE DAWN, BUT THE SPEED OF THE EASING CYCLE IS IN QUESTION

Whether inflation falls sufficiently quickly to allow the Fed (or the ECB) to get close to fulfilling market expectations is unclear, but markets have proven overly optimistic many times in the past. Over the last few years there have been at least six other occasions where such pivot hopes have been dashed. In March 2023 (Silicon Valley Bank), late September/early October 2022 (gilt crisis), July 2022 (CPI surprise), May 2022, February/March 2022 (Russia invasion of Ukraine) and November 2021 (Omicron variant), pivot hopes proved to be false and market rallies built on the hope of easier policy relapsed.

What is different from these previous false dawns is that a broad range of inflation metrics are now clearly on a downward path. In the second half of 2024, US Personal Consumption Expenditure inflation has slowed significantly and the same is true for core CPI in the eurozone and the UK. If this trend continues, real interest rates will move higher if central banks do not respond with easier policy rates. It is the speed with which the markets anticipate the policy easing that we believe appears overly aggressive. This leaves open the possibility of periodic bouts of volatility as expectations re-adjust.

[1] Source: Insight and Bloomberg. Data as of December 29, 2023.

Looking at economies more broadly, most are expected to weaken to varying degrees as the cumulative effects of prior policy tightening feed through to activity. The US has been the most resilient major economy, but even here, expectations are for softer times ahead. In Figures 2 and 3 we can show growth expectations for 2023 and 2024 for the US and the global economy. The anticipated slowdown in the US is clear, but Figure 2 also shows how expectations stabilized in the latter part of 2023, consistent with a softish landing or end of a mid-cycle adjustment.

Figure 2: US growth expectations (2023 vs 2024)[2]

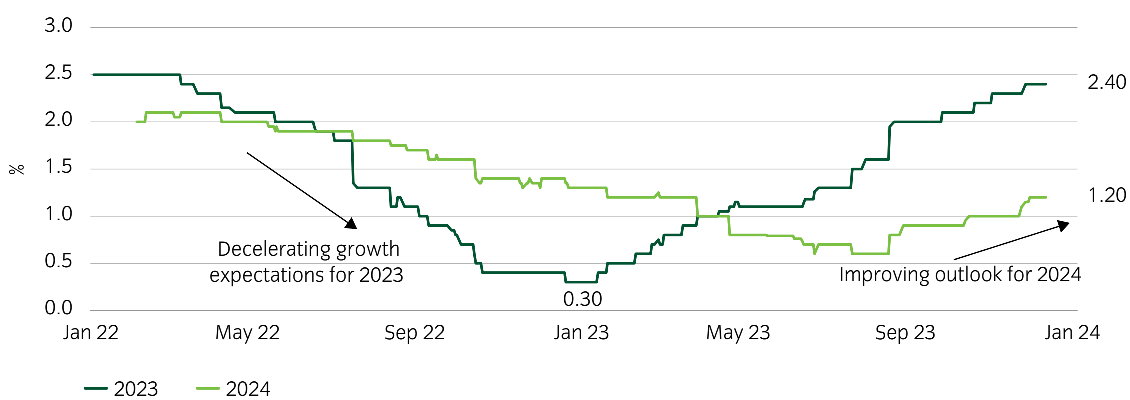
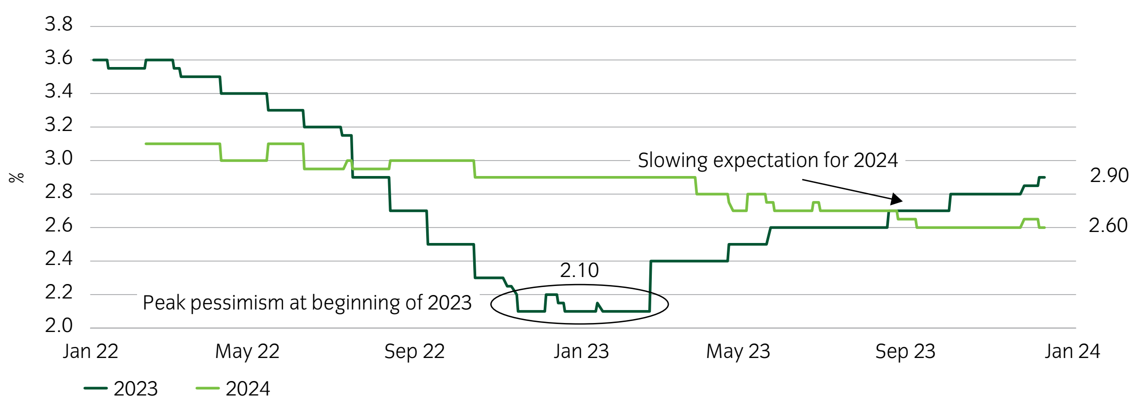


Figure 3: Global growth expectations (2023 vs 2024)[3]



EUROPE AND CHINA ARE A DRAG ON GLOBAL GROWTH

Similar comparisons for mainland Europe and the UK show much weaker growth in 2023 (0.6% and 0.5% respectively) and very little change expected this year. The eurozone appears close to (or already in) a mild recessionary environment. The ECB and the International Monetary Fund (IMF) are more optimistic about growth in 2024 than most private-sector forecasts and even they see growth of just 0.8% and 1.2% respectively. Restrictive monetary and fiscal policy (as restraints suspended during the pandemic are phased back in) are headwinds and the eurozone remains more vulnerable to energy price shocks and geopolitical uncertainty. That said, more recent data points offer some hope of respite and the recent easing in financial conditions could help the stabilization story, should pricing pressures allow.

The UK economy is flatlining and the latest GDP report highlights that both businesses and households remain cautious, with the latter cutting their real expenditure even as inflation has moved lower. Retail activity picked up coming into year-end but with inflation having surprised on the downside for two consecutive months, further good news on prices would give the Bank of England some scope to ease policy in a bid to escape the current period of stagnation.

Of course, global growth dynamics are not helped by China. The cumulative, and still largely unrecognized, losses associated with the property sector crisis weigh heavily on the broader economy and even if monetary and fiscal policy offer support, a quick turn-around seems unlikely.

[2, 3] Source: Insight and Bloomberg. Data as of December 29, 2023. Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialise or vary significantly from the actual results. Accordingly, the projections are only an estimate.

LOOKING FORWARD TO THE NEXT STAGE OF THE CYCLE

CENTRAL BANKS ARE NAVIGATING TOWARDS A SOFT LANDING

In our view, for the current market pricing of monetary policy to be correct, it requires either inflation to continue to fall quickly or for there to be a further deterioration in growth. In the case of the latter, the level of valuations means equity markets are likely to be vulnerable to a resulting fall in earnings expectations.

Should core inflation prove problematic, the recent interest-rate euphoria would likely quickly fade, and a more bearish narrative would again come to the fore. A delay in the easing cycle would increase the risk that the slowdown in economic activity that is already underway could accelerate, with eventual central bank action too late to avoid a sharper and more meaningful economic contraction which would be likely have negative consequences for risk assets.

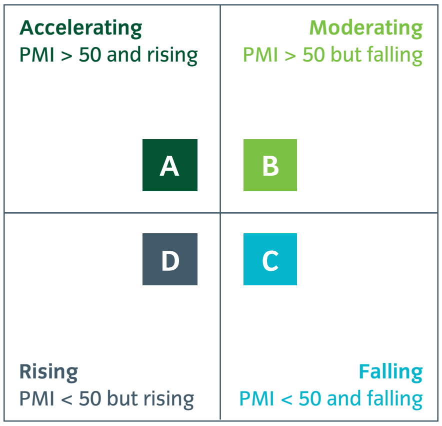
In our view, the optimal path for risk asset performance requires inflation to continue its descent without economies slipping into a meaningful recession. In the eurozone and the UK, the growth backdrop is already consistent with the need for monetary support. For the US, the Fed's balanced growth and inflation mandate offers it the opportunity to ease policy away from a restrictive stance even into an economy that shows resilience. It remains a narrow landing strip but in recent months it has become more plausible that a soft landing can be achieved, and markets have responded positively to that.

Given the extent to which all central banks misjudged the scale of the post-pandemic inflationary pulse, the idea that we could see an immaculate disinflationary period (where inflation came down without any material rise in the unemployment rate) always seemed somewhat far-fetched. However, at least in the US, it looks as though this may prove possible. The growth outturns in Europe have been more negative, but the energy-driven inflation pulse was far greater and the geopolitical repercussions of Russia's invasion of Ukraine were felt more keenly. Arguably, even the current outturn in Europe is better than many had hoped for.

REVISITING OUR GROWTH REGIME

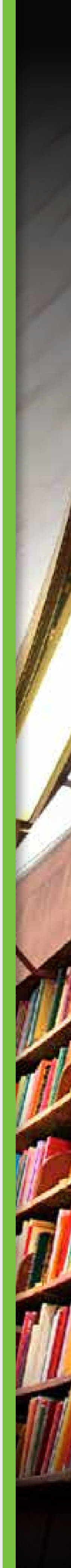
Regular readers may be aware of our regime-based asset-allocation framework, which helps us assess likely asset-class behaviors in different growth, inflation and real rate environments. From a growth perspective we look at a range of data points to guide our current thinking, but our long-term analysis uses PMIs given the timeliness of the releases of comparable data across a wide range of countries (see Figure 4).

Figure 4: A stylised view of PMI growth regimes[4]



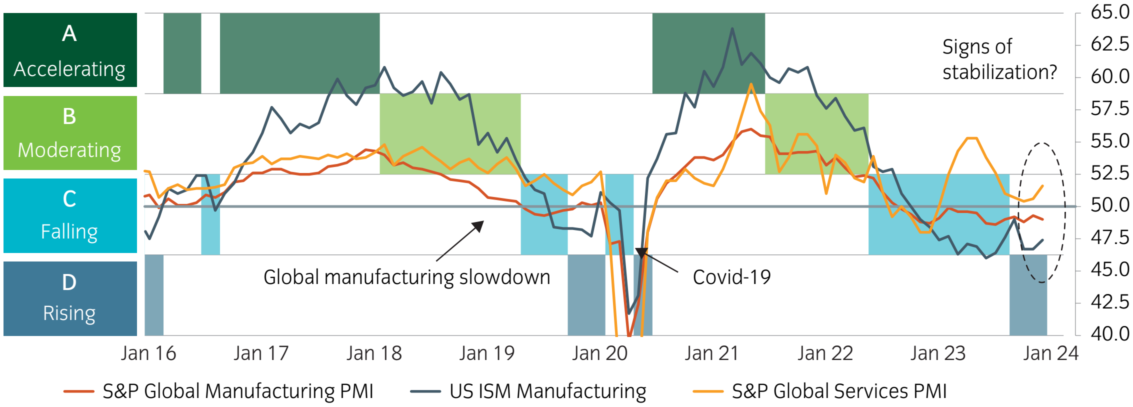
A basic guide to Purchasing Managers Indices (PMI)

- Each month, a carefully selected group of private sector companies are surveyed on the state of conditions within their industry
- This provides a valuable insight into the underlying trends that companies are experiencing, from the level of new orders to the ease, or difficulty, of finding new employees
- The data is aggregated into an overall score, which can be used to judge the health of the broader economy and whether growth is accelerating or decelerating
- A score above 50 indicates that activity is improving, with a score below 50 indicating contraction



The latest data set is inconclusive but towards the end of last year we saw enough evidence when looking at growth dynamics on a broader basis to suggest that activity may be stabilizing (see Figure 5).

Figure 5: Our growth regime framework is starting to show signs of stabilization[5]

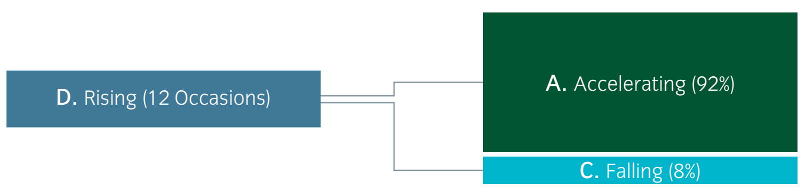


To be clear, this remains an environment where growth is still in contractionary territory (in PMI terms these are below 50, and in the case of the US Institute for Supply Management (ISM) Index that has remained so for 14 consecutive months now), but the rate of change is starting to improve. Should that growth improvement continue, we would enter a more positive 'accelerating' regime where growth is once again expanding.

A 'RISING' REGIME ALMOST ALWAYS EVOLVES INTO AN 'ACCELERATING' REGIME

Historical data since the early 1970s suggest once an economy enters a rising regime the likelihood of it then moving into an accelerating regime is very high (92% probability, see Figure 6). When we analyze the same historical data, an accelerating growth regime is generally the sweet spot for risk assets and during these times the correct asset-allocation strategy has been to skew towards pro-cyclical exposures such as equities.

Figure 6: The evolution of growth regimes in our asset allocation framework (1972 to 2023)[6]



When looking at our combined, growth, inflation and real rate regimes it is worth noting that the current combination (where growth is gaining momentum, inflation is above central-bank targets but moving downwards, and real rates have been rising) is rare – only five occasions in the sample period (1972 to 2023). For these periods the cyclical backdrop has always been improving (i.e., moving from rising to accelerating).

INFLATION REMAINS A RISK

Should this time be different, the most likely culprit would be a re-emergence of inflation. For a while now, hopes of any meaningful improvement in the growth environment have been faced with an uncomfortable question – could we see a new mini-cycle taking hold until central banks declare victory over inflation? Now the question is morphing into whether central banks are about to declare victory over inflation.

While any historical perspective of inflation-fighting requires going back decades, an uncomfortable observation has been relapses in inflation have been more common than one might think. Historically, if inflation is above target and falling the likelihood of it rising again before it hits target has been higher (68%) than the number of observations when it swiftly returned to below target levels (32%). This perhaps guides us as to where the risks to the happy middle ground may lie.

[5] Source: Insight and Bloomberg. Data as of December 29, 2023.
[6] Source: For illustrative purposes only. Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialise or vary significantly from the actual results. Accordingly, the projections are only an estimate.

CHECKING THE OUTLOOK THROUGH THE RATE-CYCLE LENS

For asset markets to enjoy a positive outcome, this must be a genuine end to the interest-rate cycle. It is critical to distinguish between genuine 'ends' and other times when the Fed looked to be at the end of the hiking cycle but ultimately had to re-engage to further tighten monetary policy. Examples of these 'premature pauses' (defined as when the Fed cuts only to subsequently tighten again) occurred in 1973, 1979, 1980 and 1987.

From a market perspective, at the risk of stating the obvious, premature ends have been challenging experiences for equities and government bonds, both from an excess return and 'hit rate' perspective (i.e., the percentage of time we have seen positive returns). A genuine peak in the rate cycle has tended to usher in a better environment for both asset classes.

Our analysis also looked at asset-class performances after a rate cycle ended with an extended pause. Going back to the early 1970s, the median time between the last rate hike and the first cut has been 60 days. The mean is 110 days – and by the end of 2023 a period of 158 days had already passed.

In Figure 7 we outline the 10 largest extended pauses or plateaus in US official interest rates going back to the early 1970s. Such episodes are rare and all but one pre-date the global financial crisis. The period between the last hike and the first cut has generally been a rewarding one (with the exception of equity investors in the wake of the tech boom busting at the start of the millennium). The table also shows the starting point in terms of real yields, equity market valuations and whether a recession came to pass either during the pause period or within 12 months of the first easing at end of the tightening cycle.

Figure 7: Characteristics of historical Fed cycles with extended "pauses"[7]

		Real yields		Treasuries	12m trailing P/E		Equity		Recession	
Peak	Length (d)	Start	End	Total return	Start	End	Total return	Drawdown	During	Recession after
1971	125	0.36	1.80	0%	18.2	19.3	3%	0%	No	No
1975	123	-2.50	0.79	-2%	10.1	10.7	-8%	-10%	No	No
1983	124	5.93	8.95	-2%	12.5	13.1	0%	-3%	No	No
1985	119	6.14	4.81	9%	11.4	13.3	14%	-3%	No	No
1995	155	4.73	3.18	12%	17.2	16.1	16%	0%	No	No
1997/98	553	4.22	3.66	25%	19.4	22.9	33%	-7%	No	No
2000/01	232	4.20	3.60	14%	26.8	23.0	-12%	-13%	No	Yes
2006/07	446	2.67	2.12	12%	15.6	15.8	19%	-1%	No	Yes
2018/19	224	1.00	0.28	8%	15.9	18.5	18%	-8%	No	Yes
2023	**132**	**1.50**	**1.97**	**-1%**	**20.5**	**19.6**	**0%**	**-10%**	**No**	**?**
Average	223	2.97	3.24	6%	16.4	17.0	9%	-5%		
Hit rate				75%			67%	11%		

If the Fed's July 2023 rate hake was the last in this cycle, then the asset class returns in the intervening period have been poor by historic standards (see Figure 8 and 9), although the end of 2023 saw a significant upswing. The pace of rate cuts currently priced into markets leaves open the possibility of periodic bouts of volatility as rate expectations re-adjust to a more realistic path, but history does suggest that equity and fixed income markets may continue to make gains into 2024. At some stage, we expect the equity/bond relationship will become less correlated, thereby providing more of a source of diversification in cross-asset portfolios, but this may take time to reassert itself.

[7] Source: Insight and Bloomberg. Data as of December 29, 2023.

Figure 8: Historical performance of US equities after interest rates peak[8]

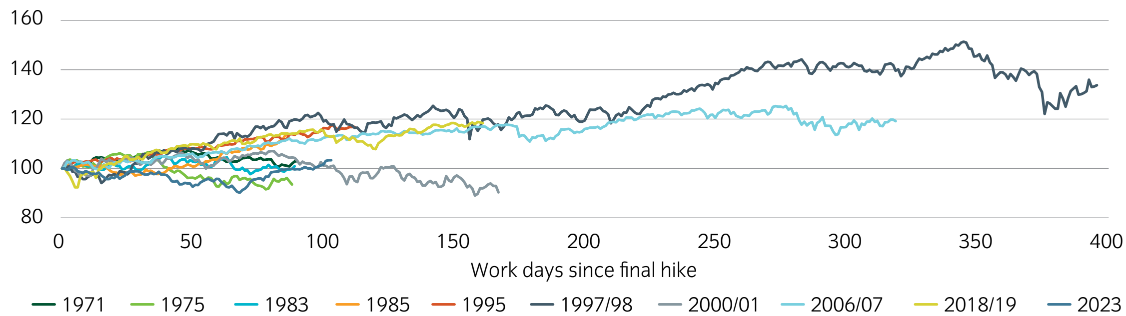
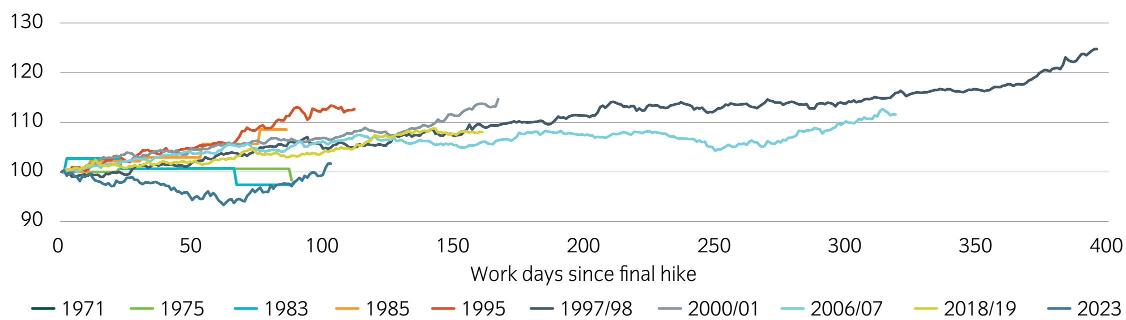


Figure 9: Historical performance of US Treasuries after interest rates peak[9]



[8,9] Source: Insight and Bloomberg. Data as of December 29, 2023. US equities is the S&P 500 Index, US Treasuries is the 10-year Treasury. Past performance is not indicative of future results.

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