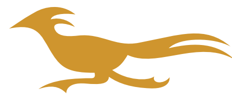
VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

Market Musings 11/23



Roadrunner, Radiohead and Rates

Readers of a certain age will be familiar with the cartoon Roadrunner and in particular the work of Wile E Coyote. Wile E's entire existence was predicated on his need to catch Roadrunner, coming up with ever more elaborate schemes to achieve his goal. He would order some contraption from the ACME company (a forerunner of Amazon noted for the ability to deliver anything, anywhere, within a day) before inevitably failing in his goal as Roadrunner gave him the slip once more.

However, Wile E was also magic. He could defy gravity, temporarily. Having tried to chase Roadrunner over a cliff for the millionth time, he would levitate – briefly – before becoming aware of his situation and plummeting to the ground. To quote Radiohead, 'Gravity always wins.'

Today, I feel like we may be having a Wile E moment with global markets and the economy. A brief but exhilarating moment of weightlessness before gravity wins again. Because, rather like Wile E's experience of gravity, monetary policy works with a lag.

Unlike the era of low rates of the last decade, the economy and markets look like they will have to become more aligned in today's environment. Developed market equities, as measured by the MSCI world index are still only 13% off all-time highs, with the market assuming recession defying earnings growth over the next 2 years. Long dated bonds remain at decade long highs in the UK and Europe despite stagnant economies.

By Rob Scammell
Senior Portfolio Manager

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And whilst growth remains strong in the US, can this continue in the face of aggressive rate rises and tightening financial conditions?

A key question therefore is what is more likely to be correct – equity markets with their relatively sanguine view of the world or history? The latter would suggest that the majority of the effects from rate increases are still to pass through into the real economy.

A look at the facts

The Fed has raised interest rates by 5.25% over 20 months. The Bank of England has increased rates by 5.15% over 22 months. It also generally takes 12-24 months for changes in monetary policy to fully feed through into the economy.

By any measure, the full effect of the policy increases have not yet fed through into the real economy. Looking at US unemployment as an example, there is a clear lag between the peak in interest rates and the peak in unemployment.

Labour markets in both the UK and US remain strong, with real wages now increasing as inflation falls (wage settlements from when inflation was higher are now feeding through). However, it is too soon for us to be celebrating a soft landing.

Longer dated yields in the US have also started to rise in response to much higher than expected issuance of new debt. The so-called bond vigilantes from the early 1990s are back.

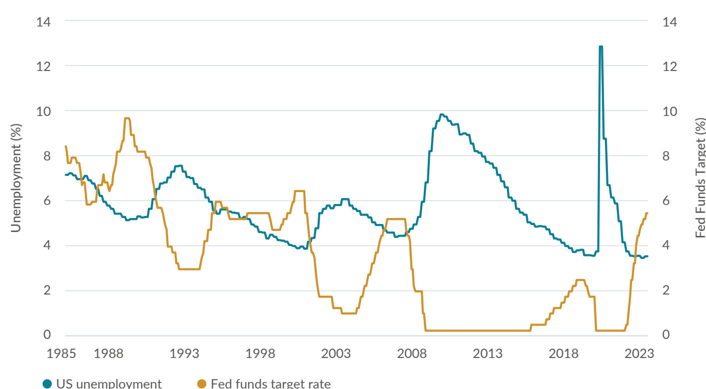
History doesn't repeat but it does rhyme

There have been three distinct rate cycles since the mid 1980s, and we are now halfway through the fourth major cycle (excluding 2015-2020 which was cut short by Covid). On each occasion, unemployment peaked around 3 years after the final interest rate rise.

This hiking cycle has been the most aggressive of all of those since the mid 1980s in terms of both the pace and extent of interest rate rises. This means that the lags will likely be more significant.

As an example, the 2004-2007 cycle saw interest rates move up by 4.25% in 27 months, whilst this cycle has seen rates move 5.25% in 20 months. As noted above, the turning point in unemployment typically does not occur until just after rates have peaked, as such in our view, it is still too early to talk about a soft landing.

Chart 1: **US unemployment v Fed funds target rate**



Source: *Bloomberg VLK*

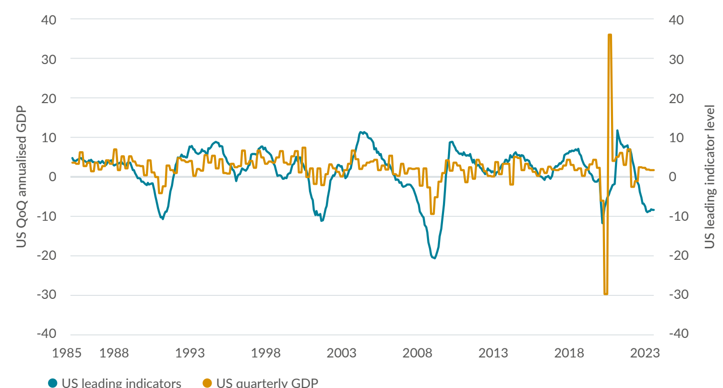
A recession seems more likely than not

Unemployment is particularly interesting when trying to explain lags in monetary policy. But it is not necessarily useful when trying to assess the future path of economic output.

This is because unemployment is a lagging indicator as described earlier; economic output has usually already fallen before unemployment figures start to increase.

Unhelpful? Yes. But there are a variety of indicators that are considered 'leading' indicators.

Chart 2: **US leading indicators and GDP growth**



Source: Bloomberg VLK

And fortunately, some of these are aggregated into one data point as shown in Chart 2. When the leading indicators dip below 0, this typically points to GDP growth turning negative soon after.

On every occasions since the mid 1980's, when the leading indicators index has gone below -1, a recession has always followed shortly afterwards. US leading indicators are currently at -8, and if history repeats itself we should expect a US recession.

Why haven't we seen a recession yet?

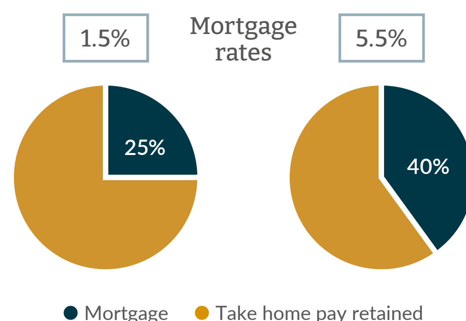
The devil is in the detail.

Firstly, as already discussed above, the speed of tightening has resulted in lags. But this is not the only factor.

Households have also been insulated by the fact that many, at least in the UK and US, have fixed rate mortgages. In the US, this is typically for the lifetime of the loan - those that took out or remortgaged in 2020 when interest rates were at historic lows will be unaffected directly, at least until they want to move.

Likewise, in the UK, those that took 5 year fixed rate deals in 2020 or 2021 are not facing an imminent increase in payments. However, this will not last forever as those fixed rate deals roll off. Meanwhile, new buyers, or those wishing to upsize, will have to pay higher mortgage interest rates immediately.

How take home pay is split



Source: VLK

The difference on a 25 year £250,000 mortgage at 5.5% p.a. compared with 1.5% p.a. is an extra £535 a month. For a couple on the average UK salary, that means that higher mortgage interest costs could eat up 40% of take home pay, compared to 'only' 25% of take home pay before.

This is likely to have an impact on both discretionary spending and house prices. Renters in the UK are not immune, as the housing shortage has meant landlords have been able to pass on their higher mortgage costs as higher rents: rental levels for new lettings in the UK have increased by 12% over the last year.

So costs are up, can savings or earnings cover them?

Consumers also built up large quantities of enforced savings during the pandemic, which they have used as a buffer against the rising cost of living and interest rate increases. However like fixed rate mortgage deals, this will not last forever either. A study by the Federal Reserve bank of San Francisco[1] suggested US consumers have now mostly exhausted these savings.

As such consumers and households are facing a double whammy – their expenses are going up just as their savings have been depleted, with the logical conclusions that, in aggregate, households will have to cut back on discretionary spending.

Corporates to the rescue?

Ignoring the obvious impact on corporates from a decline in consumer spending, let's look at a more fundamental question – how sensitive are they to rising interest rates? Corporations also built up buffers during the pandemic, by issuing long term debt at low interest rates. Recent research by Goldman Sachs suggests much of this debt will not need to be repaid until 2026.

However, this mostly benefits large corporations with access to the deepest funding markets and best interest rates at the time. Smaller companies have suffered much more, illustrated by small caps equities underperforming their large cap counterparts. Smaller, non-public companies, without access to capital markets, may be reliant on floating rate bank loans which will now cost significantly more to service, which will impact hiring and investment decisions.

The transmission mechanism may have been somewhat blunted for both households and corporates, but it is still working.

So what do markets think?

In both the UK and the US, the real economy is still growing, though growth in the UK remains close to zero. Financial markets which are, in theory, more forward looking have started to take some notice of the implications of higher interest rates.

Unlike the era of low rates of the last decade, the economy and markets look like they will have to become more aligned in today's environment. Developed market equities, as measured by the MSCI world index, are still only 11% off all-time highs.

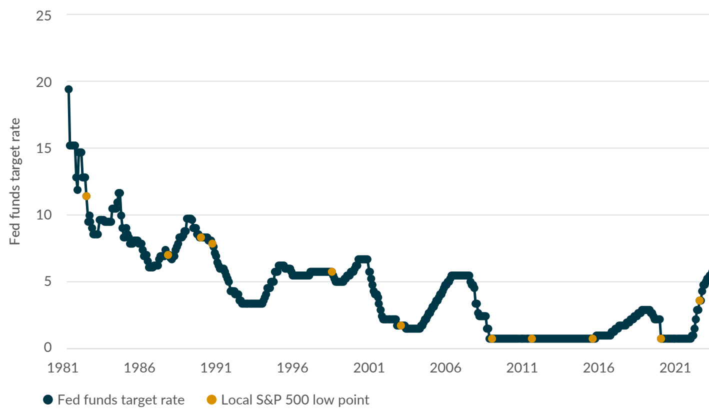
Rather like unemployment, equity markets typically reach their low point after the final interest rate rise.

Interestingly, as shown on Chart 3, US equity markets reached their low point (so far) in this cycle in October 2022, when the Fed Funds target rate was still only 3.25%; since then policy rates have moved up by a further 2.25 percentage points and, more relevant to equity market valuations, long dated yields have moved up by 0.7 percentage points.

Much of this rally in equities has been sparked by optimism around AI technologies and the hoped for productivity benefits this will unlock. The tech heavy NASDAQ index has risen by 30% since September 2022. Stripping out the impact of the big tech firms, the story is less optimistic, since the October 2022 lows, the equally weighted S&P 500 is up 11% compared to the market cap weighted increase of 23% and the FTSE 100 which contains almost no technology companies is up 8%.

[1] https://www.frbsf.org/our-district/about/sf-fed-blog/excess-no-more-dwindling-pandemic-savings/

Chart 3: **Local equity bottom and Fed funds rate**



Source: Bloomberg VLK

Markets are therefore relying a great deal on new technology to improve future corporate earnings. Valuations in equities do not compare favourably with those in bonds.

The earnings yield on the S&P 500 is hovering around the same level as the 10 year US treasury bond. And the equity risk premia, though inherently unobservable, is believed by many commentators to be at a multi-year low. Historically this does not bode well for equity market returns over the medium term.

What would a 'soft landing mean'?

The picture presented so far doesn't seem a great one for investors who are not paying attention and adjusting their asset allocation.

They may however be reliant on something else – a so called 'soft landing' – where everything just works itself out, and markets can continue on with their respective bull runs in both equities and credit, with inflation as an issue vanishing into the ether.

What does history tell us? As with most things in financial markets, this is not the first time that interest rates have moved upwards over a sustained period.

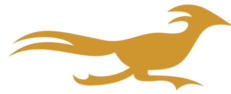
Between 2004 and 2007 the Federal Reserve moved the target rate from (a then all-time low of) 1% to 5.25%. In 2007 many commentators were also looking at decelerating inflation, low unemployment and high equity valuations and similarly suggesting there was going to be a soft landing.

February 15, 2007
Fed chairman projects 'soft landing' for U.S. economy – Business – International Herald Tribune

August 6, 2007
IMF Survey: Soft Landing Ahead for U.S. Economy

None of this is to say that we will definitively enter a recession in the UK, US or globally in the near future. But there are headwinds that we believe are not currently priced into financial markets. The prospect of a soft landing cannot be adequately assessed until the lags from the large and swift increase in developed world interest rates has properly fed through to the real economy.

Conclusion



We do not believe that the current climate will lead to a 2008-2009 style financial crisis. We may yet complete the cycle with no surprises.

But we do believe that one of the more predictable elements of financial markets is that participants repeatedly tend to make the same kind of errors of judgment. And today, markets and history are pointing to quite different outcomes.

...we may yet complete the cycle with no alarms and no surprises...

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