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Market Update – The Battle with Inflation Continues, but What of Market Prospects?

Getting Ahead of the Curve

Over the past two years central bankers have faced criticism for misreading the economic climate, particularly their lack of action in 2021 when they mistakenly dismissed rising inflation as a transitory factor which would fade of its own accord, meaning that interest rates were kept too low. Even once the extent of the inflationary problem became accepted, the Bank of England in particular faced questions over the slow pace of the hikes they delivered. Eventually though, sufficient action was taken to convince markets that monetary policy setters were now serious about stabilising prices. While it took a while, the correct decisions were ultimately taken, with high inflation calling for high interest rates.

A Balance to be Struck

Unfortunately, the next steps to take are less clear. Inflation, and particularly core inflation, remains above target, yet with there being a lag of around two years for an interest rate hike to broadly impact the economy, judging when to cut interest rates is a difficult decision. Cut too soon in an effort to protect the economy and inflation could reaccelerate, cut too late and risk driving the economy into recession.

Higher for Longer?

While it is still possible that central banks bring through one more interest rate hike, this seems less likely than it previously did. Over recent weeks and months, market expectations have moved away from the potential of further hikes, with short term bond yields falling. Confidence has particularly built around this idea since central banks in early November delivered encouraging words alongside their latest decisions to hold interest rates steady. This was then added to with lower than expected inflation readings released in mid-November. This suggests that the sum of interest hikes so far are now having the desired effect, but how long will interest rates have to stay high?

Progress, Yet Not Complete

UK CPI is now at 4.6%, down from it's its October 2022 peak of 11.1%. The US is also well down from its 2022 peak, at 3.2%, and Eurozone inflation is now down to 2.4%. A lot of progress has therefore been made, but with each central bank targeting inflation at 2%, there is still work to be done and expectations are that getting down to target, and staying there, will be difficult.

Managing the Politics

Labour markets are still tight and wage growth is still at a level which is not conducive to lower inflation. This means that central banks can not yet relax and with elections coming into view in the US and UK, politics may yet add more challenge. While Jeremy Hunt did not turn on the spending taps in his recent Autumn Statement, it is likely that more stimulus will come with the Spring Budget as he and Rishi Sunak look to stimulate the economy in the hope of improving their popularity in the lead up to the looming general election. Meanwhile, in the US, with Joe Biden seeking re-election, fiscal loosening there would also be unsurprising. Against this, central banks may be forced to take tighter monetary policy decisions than would otherwise be the case, if they fear fiscal giveaways would stoke inflation.

When, Not If

The economic backdrop can therefore be characterised as being uncertain over when interest rates will be cut (although early to mid-2024 seems most likely), yet in Future Money's opinion more confidence can be held that the next move by central banks will be a cut, rather than a hike.

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Bonds
So, what does this mean for the prospect of investment markets? High quality bonds are in favour with the Future Money team. Within bonds the additional premium received by lower quality, 'high yield' bonds, seems too low given vulnerabilities which are likely to develop in response to higher borrowing costs. Yet high quality bonds, which face lower default risks, appear good value. Yields are the most attractive they have been since before the Global Financial Crisis and the potential for higher capital returns, should interest rates fall make the argument more compelling. Bonds experienced heavy losses in 2022 as yields had been dangerously low leading into this, but now they appear at levels which Future Money expect to help deliver on their typical 'defensive' categorisation.

Equities
With some exceptions equity markets overall appear reasonable value and Future Money continue to favour this asset class. While values would likely fall should overly high interest rates drive the economy into a sharp recession, this does not look likely currently and even if it did, interest rates would be expected to fall sharply, which would then provide the opportunity for recovery. In the absence of a sharp economic downturn, should we experience a situation where a gradually slowing economy allows inflation to fade, then interest rates will be lowered, spurring a likely rally in equities. In essence, either scenario is likely to lead to equity gains over the medium term, but it just highlights that volatility must be tolerated in order to access the higher growth potential.

Cash
Finally, cash deposits are gaining attention currently, with interest rates seemingly more attractive than they have been since 2008, particularly as other asset classes haven't been performing any better over recent years, yet, at Future Money, we would argue it is worth considering this more closely.

Assess the Conditions
If inflation continues to fall over the coming months and years as it is expected to, then interest rates would likely fall as well, which is important for two reasons. First, the return banks pay on cash deposits will be reduced, and second, as inflation and interest rates come down, Future Money expects both equity and bond markets to rally. This means there is the potential for significant reinvestment risk – should markets strengthen over the next few years, investors who moved to cash and subsequently wish to return to the markets would be forced to buy in at higher levels. Of course, the opposite is also true if markets fall from here, and there are no guarantees on improved market conditions. Yet, given where valuations currently are (as discussed above), should sentiment improve (as inflation recedes), higher returns in market-based investments than in cash deposits would appear likely.

Risk and Reward
Cash investments are used in the Future Money portfolios, and there is the ability to have large allocations here, but currently the team are not making full use of this allowance, with only small amounts held in cash. Allocations are instead focused in equity and bond markets, which they expect to outperform over the medium term, albeit with higher levels of volatility than will be available with a purely cash based strategy.

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