Drummond Capital Partners

Market Insights – August 2023

Market Update | Navigating Towards A Soft Landing?

Key Points:

- *Market expectations for a recession in the US have shifted materially over the past year. In late 2022 a recession was seen as almost certain and markets had fallen materially, while currently equity markets seem to be fully pricing a soft landing.*
- *Relative to expectations, the path of inflation and economic growth in the US has been better than expected and equity markets have risen as a result.*
- *The key question for the period ahead is whether markets have gone too far in pricing out the risk of recession.*
- *If a soft landing is in the price, market upside is probably limited and if economic growth slows, pointing to a recession, equity markets arguably will need to give a lot of the recent rally back.*

History's most well flagged recession is yet to arrive in the US and markets seem to have given up waiting. In this month's *Market Insight*, we re-assess the probability that the Federal Reserve manages to engineer a soft landing in the US. In our March 2022 *Quarterly*, we highlighted "While we don't believe an economic recession is the most likely outcome over the next 12 months, unless inflation moderates significantly, the risk of a recession in the following year is high." By June 2022, our central case was for there to be a recession in the US as a result of higher interest rates. A recession in the US remains our central case, though the probability of a recession has fallen.

The US Economy Has Decoupled

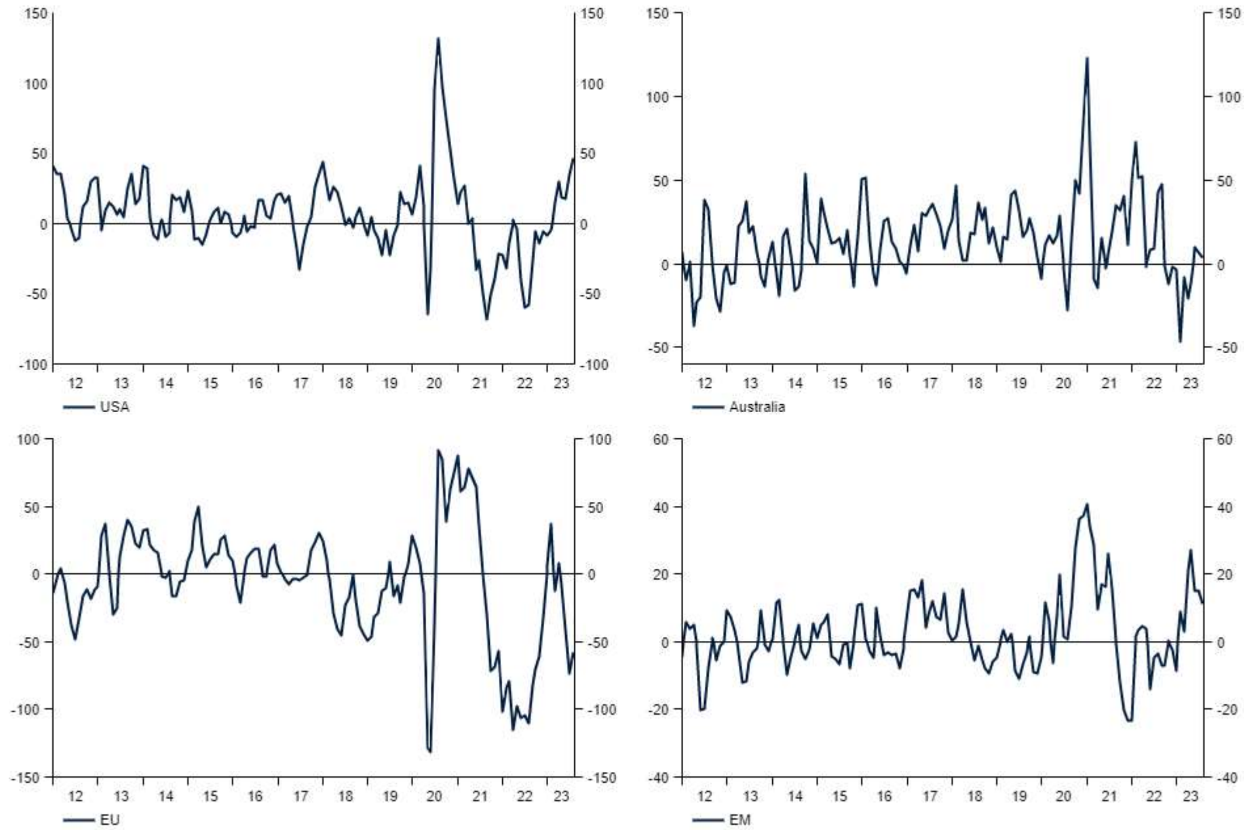
There are three primary reasons the probability of a recession in the US has fallen in the eyes of the market.

- Core inflation has moderated faster than originally thought, meaning it appears as though the Federal Reserve will need to do less damage to the economy than otherwise would have been the case to normalise inflation.
- Household and corporate balance sheets have remained very strong, despite higher interest rates. Corporates in particular have been in large part cushioned from rate rises by high cash balances and fixed rate borrowing.
- The industrial production cycle may be turning upwards, driven by fiscal stimulus, lower energy prices and the US decoupling with China.

All of these factors are very US specific. China, Europe, the UK, Canada, Australia and New Zealand are all facing a relatively worse mix of inflation and growth than the US (see below), and their equity markets have responded accordingly. The US equity market is up around 26% from the October 2022 low, while the rest of the world is up around 18% and Australian equities are up around 12%.

Economic and Inflation Surprise

Higher is positive

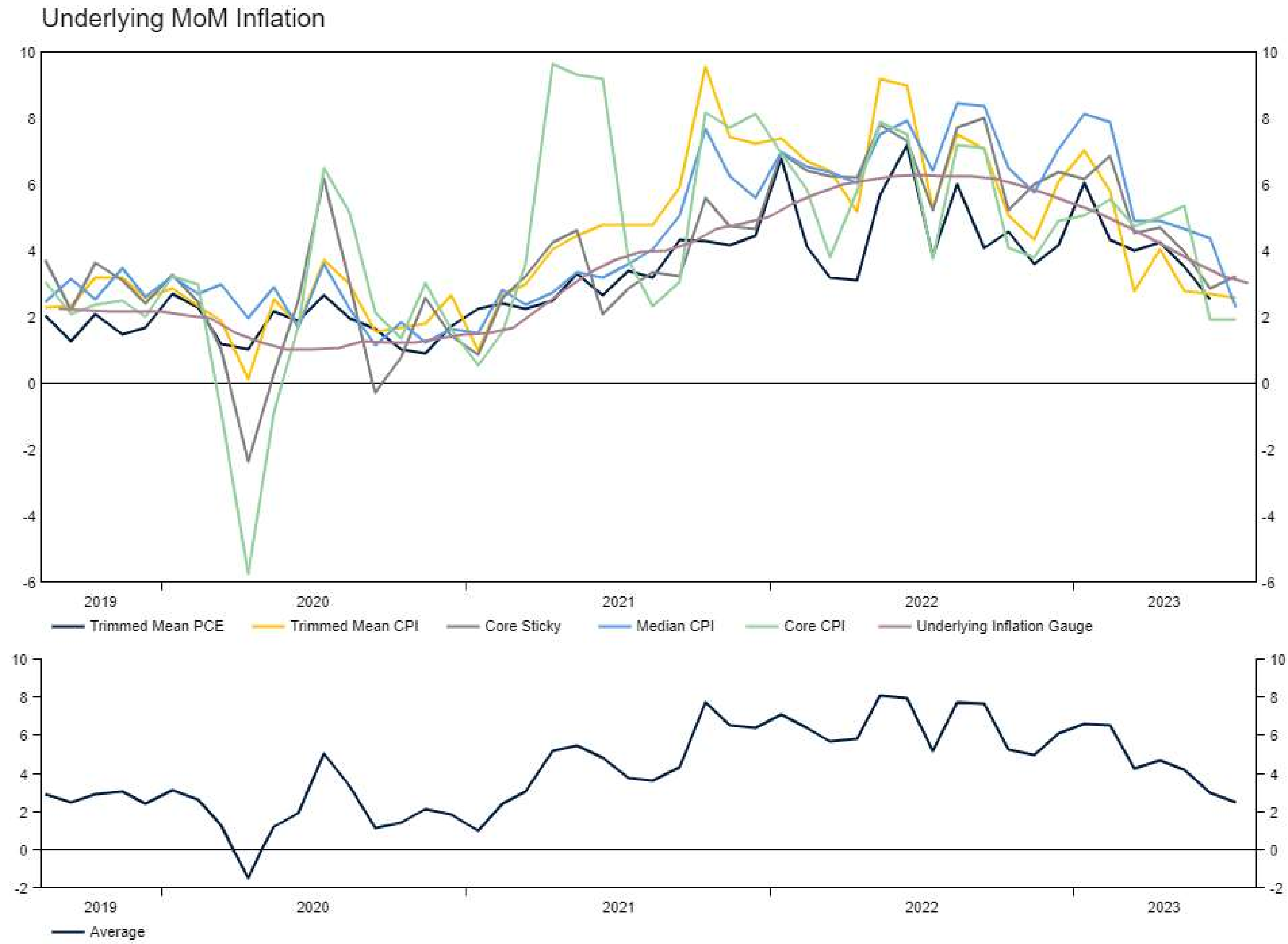


Source: Refinitiv Datastream, Drummond Capital Partners

This is mirrored by hard economic data as well. After a brief respite, China's housing market again looks to be imploding. The economies of Germany, Netherlands and New Zealand have shrunk in two of the last four quarters. The UK economy has barely grown over the past year. Real retail sales in Australia have declined more than they did in the Financial Crisis. Indeed, in many major economies outside the US, real retail sales have been going backwards.

Why Have Markets Priced a Soft Landing?

Turning back to the US, the first reason why sentiment has improved so much around the soft-landing narrative is that inflation has moderated substantially. This moderation has also been relatively broad-based outside of housing. The chart below shows a plethora of core inflation measures for the US and the trend lower in the last four months has been significant. That is not to say that the inflation demon is slayed. The US labour market remains very tight and wages growth is not consistent with inflation being at target. Some of the components dragging inflation lower seem transitory (airfares for example) and commodity prices are again rising. These factors risk a re-acceleration. However, from a headline perspective, the news on the inflation front is promising. Lower inflation and still rising wages have seen real household income growth turn positive, after broadly falling in the year to mid-2022, supporting household consumption expenditure.

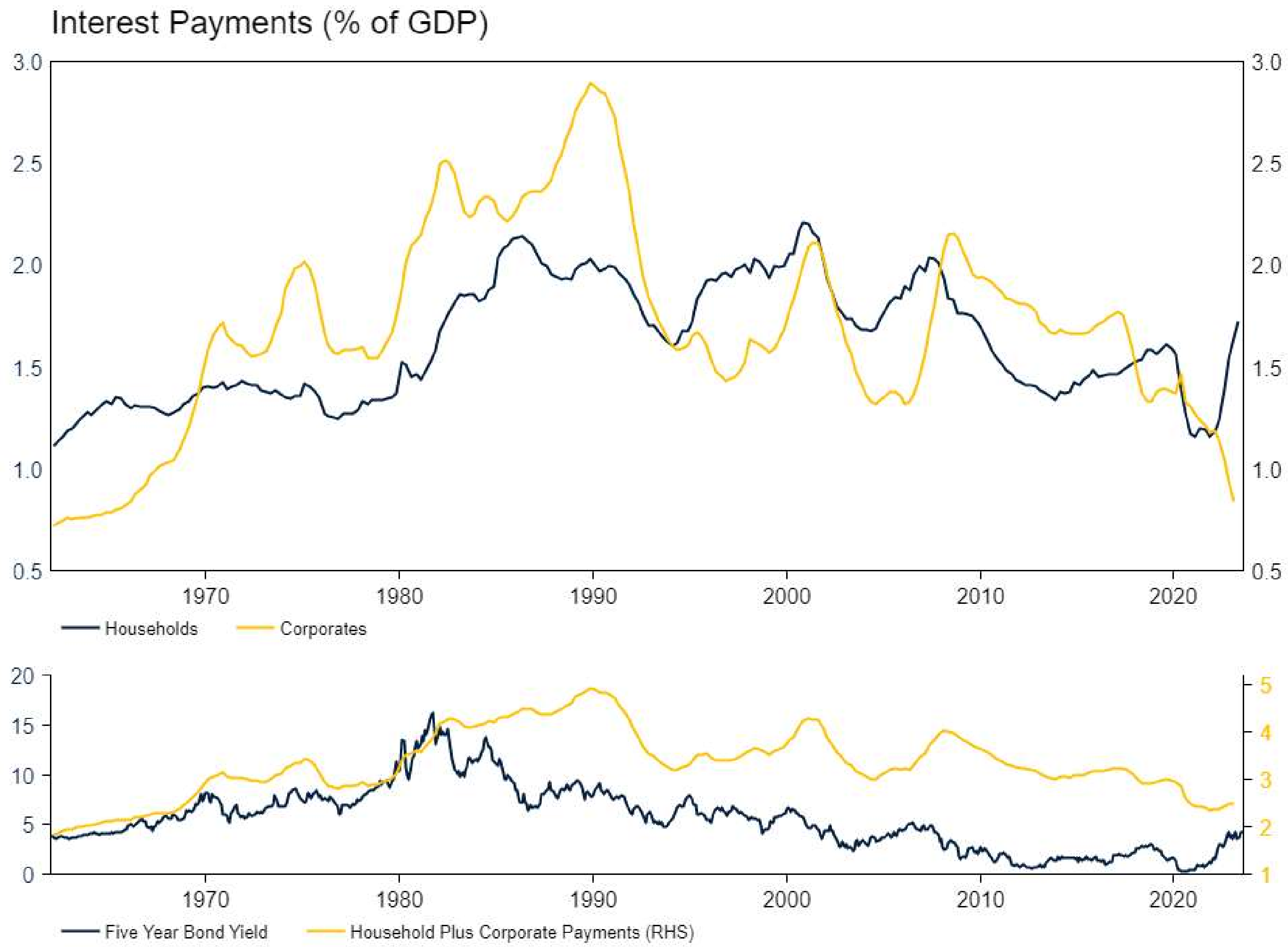


Source: Refinitiv Datastream, Drummond Capital Partners

The second reason the market is discounting a higher probability of a soft-landing is the limited impact higher interest rates have had on the US household and corporate sectors so far. The vast majority of US households, unlike most other major economies, have benefited from 30-year fixed term mortgages. This means the interest rate increase to date faced by the sector has taken interest payments as a share of the economy only slightly higher than where they were pre-Covid and much lower than the prevailing average between 1980 and 2010. While the structure of US mortgages is common knowledge, the drag on household finances as still been less than expected.

Perhaps more importantly (and contrary to the way things are supposed to work), the burden of higher interest rates has been completely avoided in the US corporate sector. Despite higher interest rates, net corporate interest payments have actually fallen (see figure below). In previous monetary policy tightening cycles, net interest payments have increased, seeing corporates pull back on hiring and capex. The reason for this outcome is not obvious, but may reflect US corporate interest rate hedging behaviour (issuing fixed term debt when interest rates were very low in 2020) and substantial interest earning cash on the balance sheet of mega-cap technology companies.

Over time the impact of higher interest rates will be felt on households (as they move residence and refinance at higher rates) and corporates (as fixed rate maturities expire), but for now the net impact of higher rates on the two sectors appears to be roughly neutral (bottom panel of figure below).



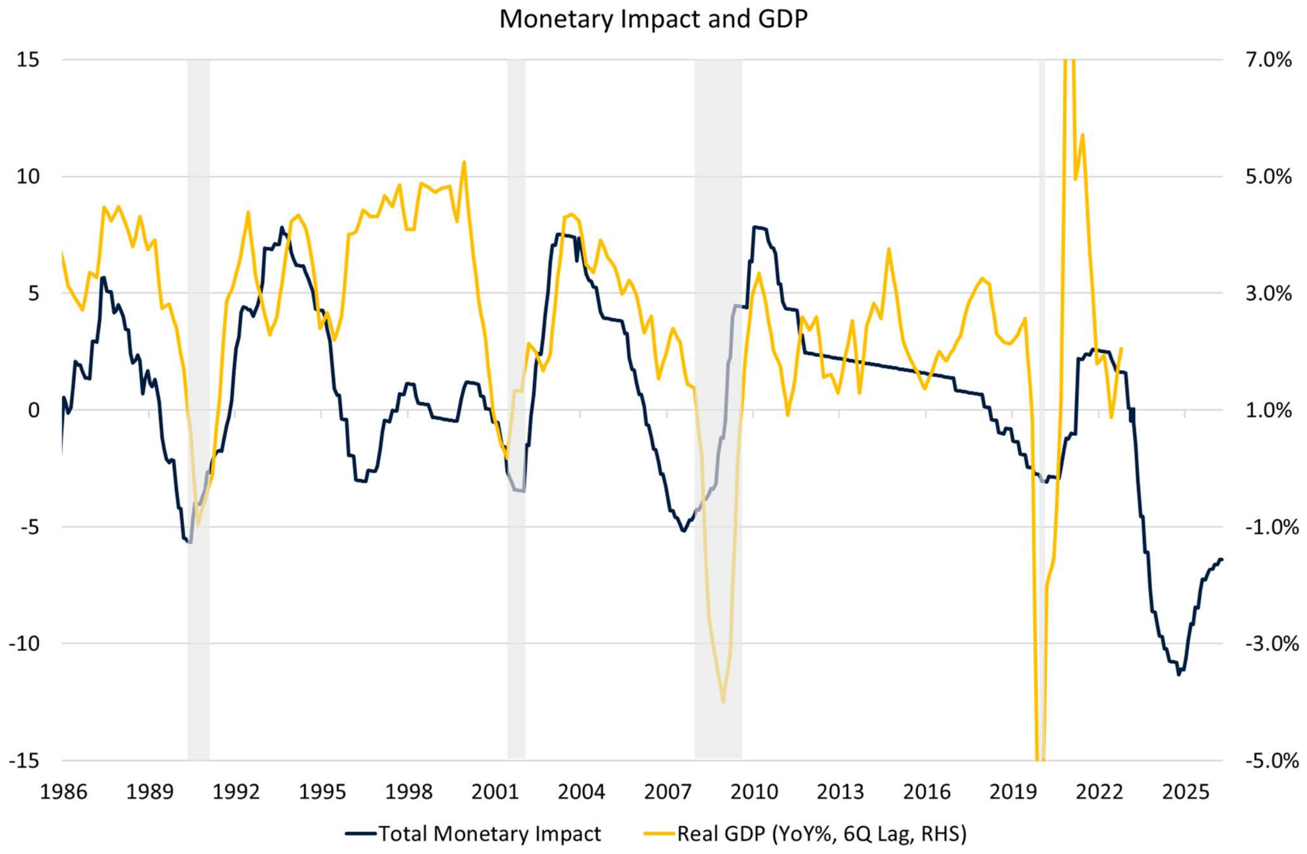
Source: Refinitiv Datastream, Drummond Capital Partners

The third source of hope specific to the US economy is a potential turning point in the industrial production cycle. Some lead indicators (new orders within manufacturing surveys, CEO sentiment) imply that the ISM (the premier US survey of manufacturing activity) has bottomed and could again to move higher. Lower energy prices, with West Texas Crude falling from a high of US$122 per barrel in mid-2022 to a low of around $US65 a year later, have also helped.

Favourable fiscal policy is also boosting manufacturing. The Inflation Reduction and CHIPs Acts are encouraging private business investment into higher tech manufacturing and green energy. The effect of this is being compounded by a desire for US businesses to decouple from China. Indeed, inbound foreign direct investment into China fell to a record low in the June quarter. Defence spending is also getting a boost via the shipment of arms to Ukraine. Though these measures in aggregate pale in comparison to the stimulus seen by the US Government during Covid, they are positive relative to the previous expectation that fiscal spending would be a drag on growth this year.

Is A Soft Landing Likely?

So, if the above explains the increased probability of a soft landing, why do we still think there will be a recession in the US? Put simply, there has never been an increase in interest rates of this magnitude without one and monetary policy operates with long and variable lags. The figure below shows a proxy measure of monetary policy impact (measuring the change in interest rates and the level versus recent averages) and economic growth in the US. Though the relationship is a little loose, typically, it takes around 18 months for the full effect of monetary policy to be felt. In the late 1980s it was a little earlier. In the Financial Crisis, it was a little later, but the key point is that eventually the pain is felt. Based on this 18-month lag, the impact of monetary tightening over the past year should be felt through 2024. Importantly, because this tightening cycle has been so aggressive the predicted impact on economic growth is very large.

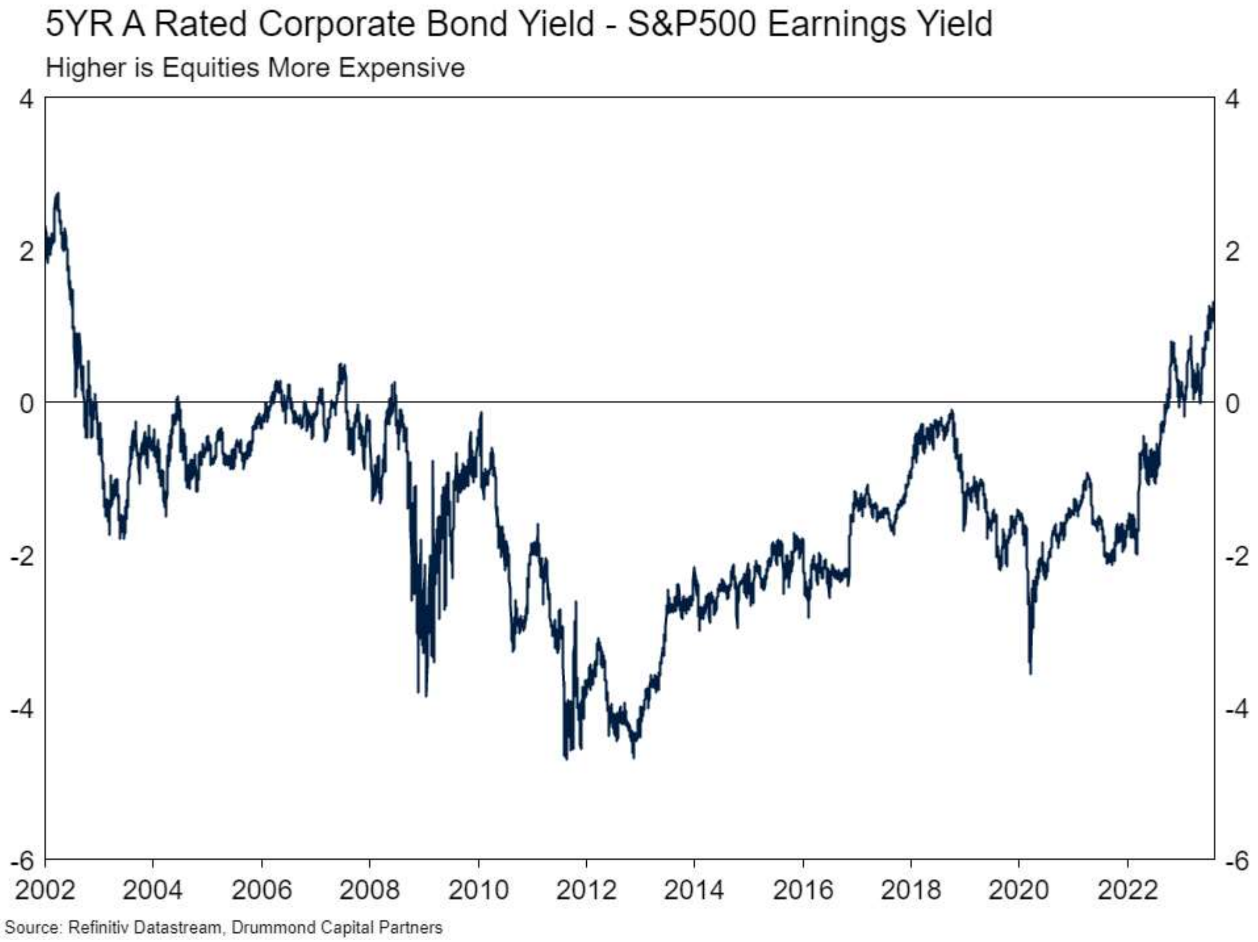


Some of the factors which supported the soft-landing narrative should also fade in the year ahead. Commodity prices look to have bottomed. Ongoing conflict in Ukraine and potentially West Africa following the Niger Coup could drive food and energy prices higher. This will again drag on real household incomes. The boost from fiscal stimulus will slowly wane. Though both the CHIPs Act and IRA are quite long lived, a Republican Congress in an election year may put pressure on fiscal spending. Most importantly, as fixed rate debt expires, households and corporates will slowly feel the pain of higher interest rates, which will also drag on growth.

Another important factor in the recession is likely column is the substantial tightening of bank lending standards and lending demand seen across the US economy over the past year. This reflects higher interest rates and also the slow-moving banking crisis, which is forcing smaller banks to tighten access to credit to shore up their balance sheets in the face of continued falling deposits.

Portfolio Positioning

While the probability of a soft landing has increased so far this year, equity markets now seem to be close to fully pricing in that eventuality. Global equities are less than 10% away from their all-time highs, a discount which can more than be explained by higher interest rates. Relative to high grade bonds, the US equity market is the most expensive it has been since 2002.



That is not to say that we expect a capitulation in the US equity market because of excessive valuations. Rather, the upside from here is probably capped because a soft landing is fully priced in (and it is pretty hard for an economy to beat a goldilocks scenario) and the risk adjusted return available from safer assets (including cash) appears much higher. We still think there is a greater than 50% chance of a recession in the US, other major developed markets are stagnating and China is reaping the cost of decades of fiscal largess into unproductive investment.

As our probability of a soft landing has increased over the past few months we have added to global equities moving from large to moderate underweight and within defensive assets increasing exposure to investment grade corporate debt improving overall portfolio yield. Our largest tilt remains overweight cash where yields are substantially more attractive than recent history and thus retaining an overall defensive bias across portfolios. That said, assuming we are correct that there will be a recession, there is still a large window of uncertainty as to when that recession will eventuate given the lag times between policy tightening and the impact on growth are not stable. As such, we are monitoring higher frequency indicators to determine whether the economy is moving towards a recession or soft-landing and will adjust the portfolios in response through time. If the Federal Reserve declares mission accomplished on inflation and begins to ease monetary policy pre-emptively, a higher allocation to equities in the portfolio will be warranted.

Prepared by Drummond Capital Partners (Drummond) ABN 15 622 660 182, AFSL 534213. It is exclusively for use for Drummond clients and should not be relied on for any other person. Any advice or information contained in this report is limited to General Advice for Wholesale clients only.

The information, opinions, estimates and forecasts contained are current at the time of this document and are subject to change without prior notification. This information is not considered a recommendation to purchase, sell or hold any financial product. The information in this document does not take account of your objectives, financial situation or needs. Before acting on this information recipients should consider whether it is appropriate to their situation. We recommend obtaining personal financial, legal and taxation advice before making any financial investment decision. To the extent permitted by law, Drummond does not accept responsibility for errors or misstatements of any nature, irrespective of how these may arise, nor will it be liable for any loss or damage suffered as a result of any reliance on the information included in this document. Past performance is not a reliable indicator of future performance.

This report is based on information obtained from sources believed to be reliable, we do not make any representation or warranty that it is accurate, complete or up to date. Any opinions contained herein are reasonably held at the time of completion and are subject to change without notice.