For professional investors only

‘Higher for longer’ rates will curb inflation, so quality is the way to go

European equities | October 2023

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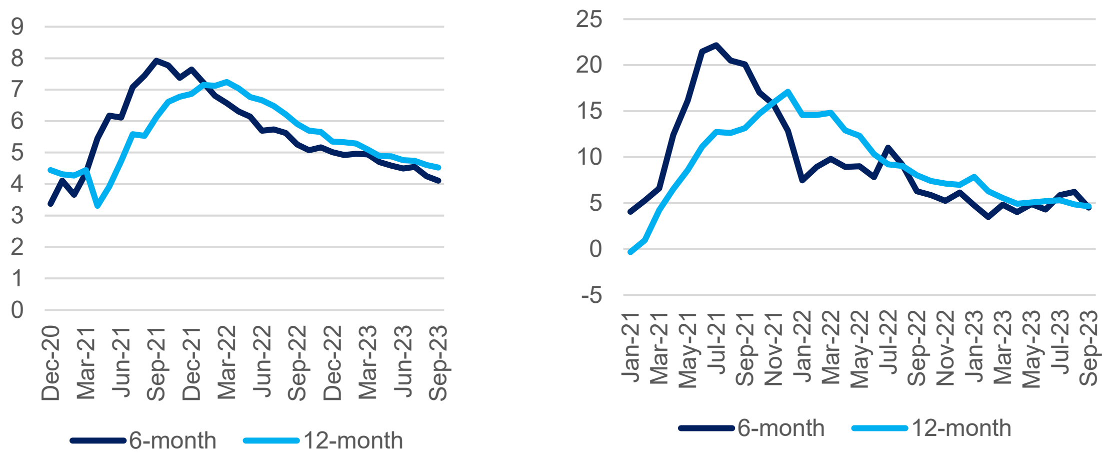
- **Interest rates are at or close to a peak, but will remain higher for longer. Inflation must be killed off for good**
- **Recession in the US remains likely, much more so than in Europe**
- **European equities may once again outperform the US**

The US, Europe, China and the rest of the world are moving in different directions. There have been positive economic surprises from the US, while Europe and China were more muted. Labour demand in the US remains above supply, though it is rebalancing. The ISM Manufacturing Index has contracted for 10 months, while the Services PMI expanded due to strong consumer spending.

Figure 1: Wage growth is slowing

Private industries | Leisure and hospitality

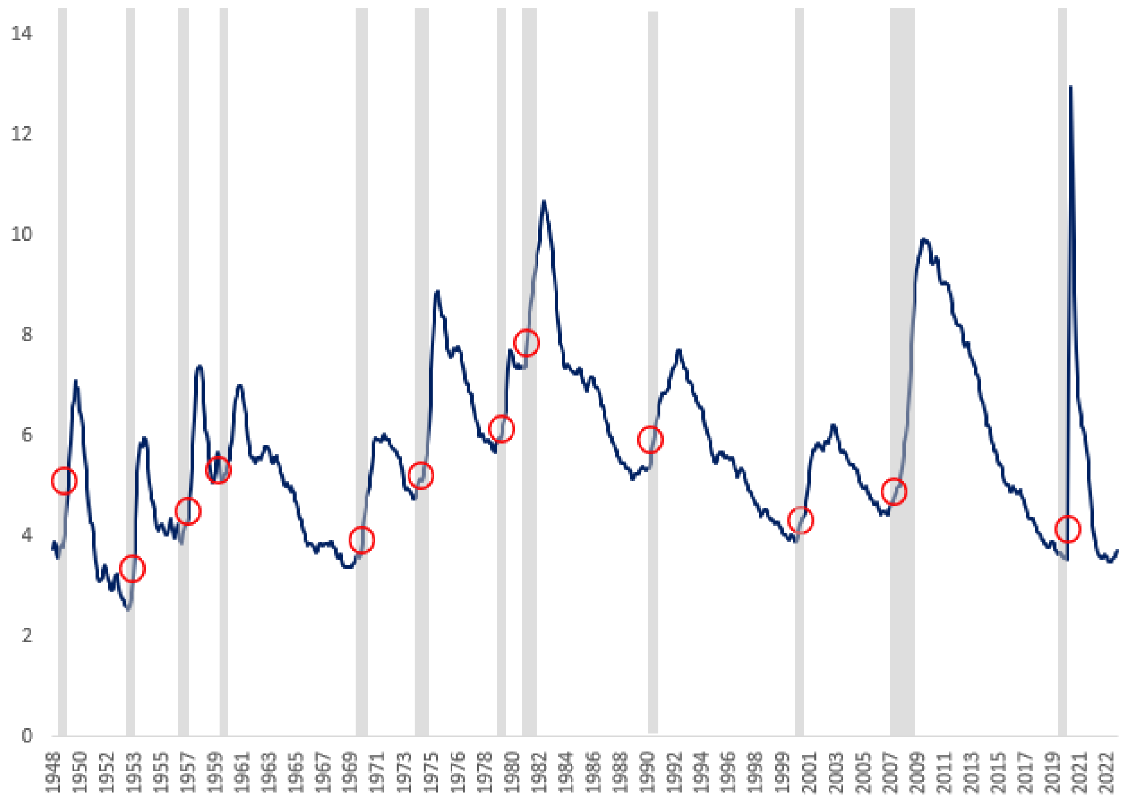


Source: BCA Research, 2023. Average hourly earnings’ percentage change

Recent jobs data will fuel inflation, so interest rates need to stay at their neutral level, which is hard to ascertain. However, US inflation is likely to fall. The Federal Reserve splits inflation into three: goods, shelter, and services ex-shelter. Goods inflation is above trend but falling; asking rents, now flat to falling, are a forward indicator for shelter inflation, which lags; while services are a function of wages, and wage growth peaked at 7% in 2022, and is now 4.5% (Figure 1). Job openings and quits rates have softened.

For a soft landing, central banks need to get monetary policy exactly right. The Fed forecasts a 4.1% peak in unemployment and a half-point rise in the unemployment rate.[1] Yet its own rule book says such a rise causes a recession. Previous cycles have lifted the unemployment rate by 280 bps on average, not 50 bps. It would be unprecedented for a 500bps hike *not* to prompt recession (Figure 2).

Figure 2: US unemployment rate (3-month average)



Source: BCA Research, 2023. Shaded areas denote NBER-designated recessions; circles denote times when three-month average of unemployment rate increased by more than a third of a percentage point from prior lows. There has never been a case in the post-war era where the average of the unemployment rate has risen by more than a third of a percentage point without a recession taking place

Fears of “higher for longer” interest rates are depressing bonds: the US Treasury 10-year yield recently touched 4.9% in mid-October. Global equities, meanwhile, have fallen 10% from July’s high. If you strip out the top seven technology stocks in the US and equal-weight the S&P500 the index peaked in February and is flat year-to-date.

[1] US Federal Reserve, Economic projections, 20 September 2023

US 10-year yields rose in Q3 as central banks stuck to high interest rates. Tighter monetary policy is working: yields on corporate and household loans are the highest in 15 years. Even if the Fed does not hike again, policy will tighten further as inflation falls and real rates rise. The Fed's forecasts show real short-term policy rates rising from 1.3% to 2.5% by the end of 2024. This hurts risk assets. At current yields, the equity risk premium is the lowest since the early 1970s, except during the TMT (technology, media and telecom) bubble of the 1990s. The rise in real yields is impacting equity valuations.

Only two of the last nine hiking cycles did not prompt recession. On these two occasions, the Fed hiked by 300bps, not 550 bps, and started when inflation was low, unlike in 2022. US growth remains robust, at least in services, but manufacturing in Europe and China has been weak. Services PMIs in Europe are falling and China is worse.

Equities have performed well this year, relieved that recession has not yet arrived. However, the disconnect between them and underlying economic momentum suggests share prices may fall or economic activity must rebound.

We had thought a robust economy sustained by excess pandemic savings might cause a second round of inflation. High oil prices and a less exciting post-lockdown bounce in China have tempered growth. This makes that second round less likely. Currently, continued tight labour markets are prompting unrealistic wage demands; US auto workers wanted 40% over four years. Strikes are at their highest in recent memory. But soon, slower growth and higher unemployment will bring down price and wage increases.

Slowing demand has not led to slower output growth, but rather lower inflation, as the US has full employment. Official interest rates have gone up by 550bps but mortgage payments are lower than in 2019 because of cheap pandemic-era refinancing; in addition, most households have 30-year mortgages. Rates will catch up, and the Chicago Fed says the lagged effect of hikes will slow the economy by 300bps.

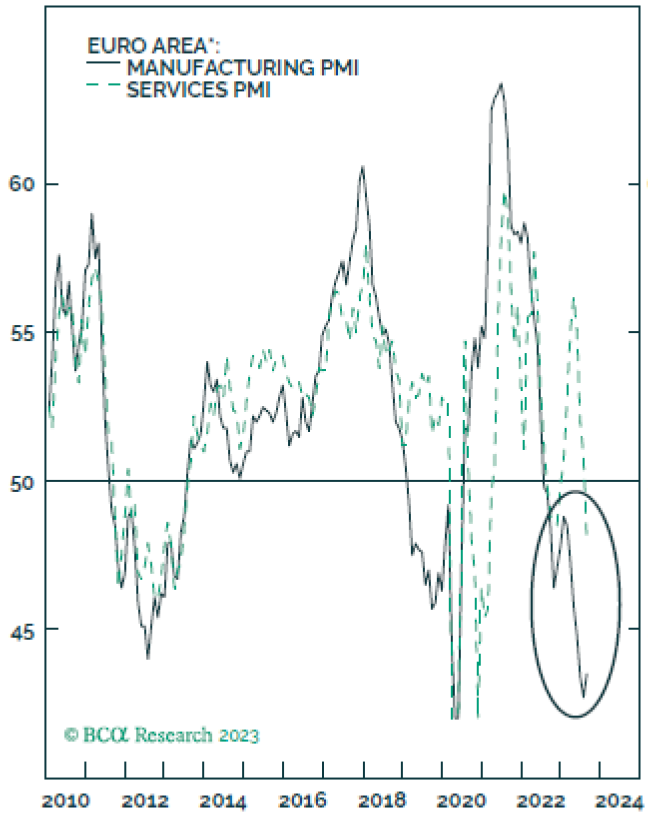
The lagged effect of rents in CPI means core inflation is only 1.5%; if you put in current rents, it is closer to 0.5%. This means the underlying Fed funds rate is almost 5%, as it was during Paul Volcker's early 1980s quest to kill inflation. This is because the delayed effects of fiscal and monetary stimulus are feeding their way into the system. It will be some time before they fall back to the Fed's target of 2%.

Europe

European growth remains weak due to a slowing Asia and restrictive monetary policy: the manufacturing and services PMIs remain below 50 (Figure 3). Headline and core inflation remain high at 4.3% and 4.5% respectively, but the producer price index (PPI) and selling price indicators predict falls. European Central Bank (ECB) rates have probably peaked at 4%. The ECB says hiking is over, though rates will stay high.[2] These aggressive hikes are unprecedented, and real rates will turn positive as inflation falls. Credit standards are now tight in Europe and private demand for credit has fallen. Money supply is contracting at its fastest rate since the euro was founded. The same is true of credit flows which are falling. Construction is also contracting and new building permits have collapsed as this sector is most sensitive to interest rates.

[2] Reuters, ECB hiking campaign is over but no easing until at least July, 20 October 2023

Figure 3: Europe's manufacturing and services PMIs remain below 50



Source: BCA Research, 2023. *source: HCOB, S&P Global PMI. Note: series truncated at 42 for presentation purposes

Restrictive monetary policy is hitting the economy just as growth is weak. Manufacturing is contracting due to falling exports and services are slowing too. The labour market is tight but loosening; slower jobs growth means slower wage growth. The employment component of the EU Manufacturing and Services surveys show cooling wage costs and rising unemployment. Inflation should return to target in 2024, but this will not result in rate cuts. EU households have €1.5 trillion of excess savings from the pandemic.[3]

Falling inflation will bring real income growth. This means that despite rising unemployment, households will feel better off, boosting consumption. This will likely come as China stabilises, bolstering exports. Global inventories are low, Chinese deflation is moderating and the renminbi has fallen, which boosts global industrial activity and benefits Europe. European yields will remain higher than the past 10 years. Hours worked are at a record high and the UN expects Europe's 2030 working age population to be 12.4 million lower than the 2011 peak. Despite immigration, workers will become scarce.

[3] FT.com, Excess savings are back, maybe, 2 October 2023

Figure 4: Euro area total hours worked

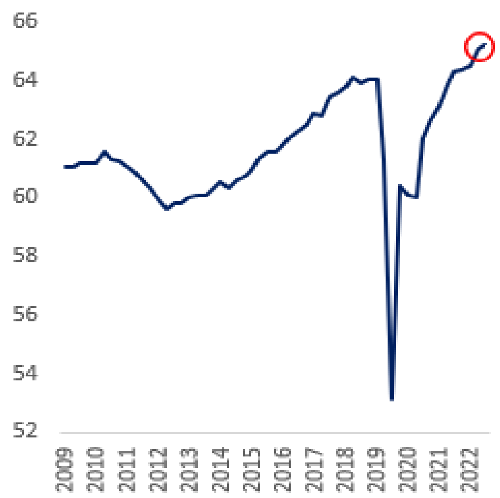


Figure 5: Hours per employee in total economy

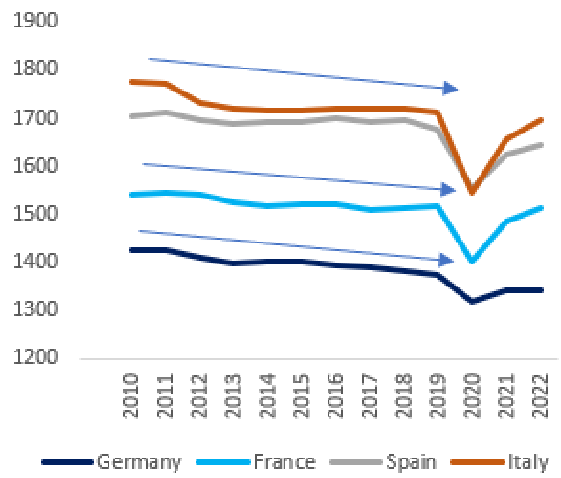
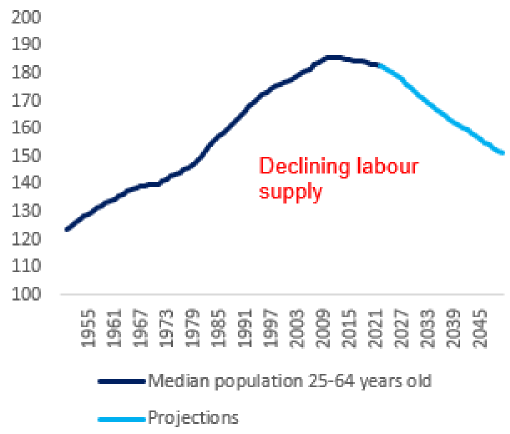


Figure 6: Euro area median population (millions)



Sources: All figures BCA Research, 2023. Figure 4 data source: European Central Bank, July 2023. Figure 5 data source: OECD, 2023. Figure 6 data source: United Nations, data taken from 20 euro area countries

This means capital expenditure will rise, and fiscal policy loosen. Defence spending, the green transition and onshoring to renew old capital stock should lead to a European investment boom. The falling labour supply and strong investment will mean unemployment cannot rise much and will bring real wage growth. This will be inflationary, keeping rates and yields higher, so the ECB cannot relax monetary policy. Investment, budget deficits and lower savings because of an ageing population will drive the neutral rate of interest higher, as is the case in the US. Labour is 60% of corporate costs so wage growth will squeeze margins, as capital expenditure and onshoring will squeeze cash flows. Europe could have some respite as inventories bottom out and China stabilises, but a higher neutral rate of interest means lower equity valuations.

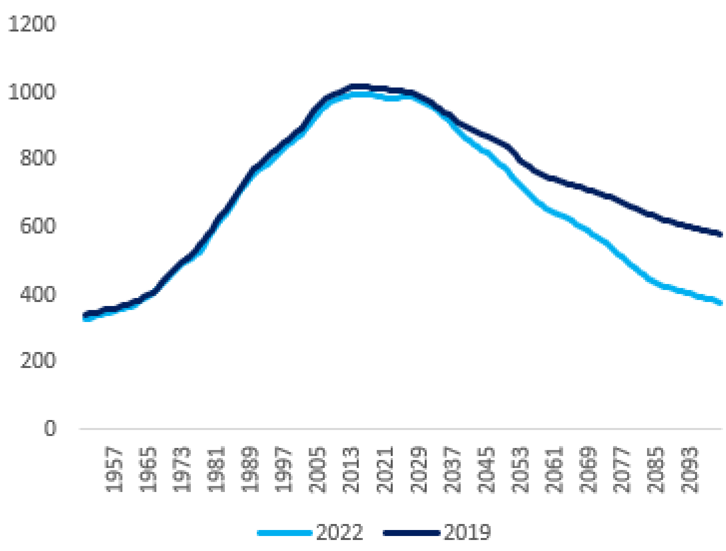
China

Chinese growth did not continue after the post-Covid rebound. The economy is slowing – M1 (money supply) growth has slowed to 3% and GDP growth to 3.2%, meaning the 5% target for 2023 may be missed. The renminbi slid 6% this year to its lowest since 2009, with no recovery in exports. Credit growth is soggy and total social financing the slowest since 2002. Official Chinese PMIs paint an optimistic picture; the Yicai Economic Activity Index, meanwhile, suggests a weaker outcome due to the indebted property market, and tepid monetary and fiscal support. Growth in total social financing and government spending are at their lowest for decades.

The housing sector is problematic and producer prices are falling. Without a government response, this deflation will drag down other emerging markets. The limited stimulus and a recovery in inventories should help, but China faces structural problems: geopolitics; onshoring to the US, Japan and Europe for high-end manufactured goods; and US near-shoring to Mexico will all depress exports of low-end goods.

Foreign direct investment has dropped. Housing is overvalued and oversupplied, with property developers more leveraged than in Japan in the late 1980s/early 1990s. Demographics are a concern: the UN says the working population will shrink by 60% before the end of the century (Figure 7). If the government were to prop up spending, as in Japan, this would be sustainable. But local governments have done most of the spending, relying on land sales which have dried up. It needs the central government to turn this around, and it shows no sign of action.

Figure 7: China working-age population projections (millions)



Source: BCA Research, 2023, based on UN population figures

Conclusion

Bond yields are breaking out for the wrong reasons: not because of strong growth but because of a rising term premium, excess bond supply and fewer buyers as global savings fall. Yields are breaking out, but leadership is not cyclical. Bond yields should fall as labour markets moderate and pricing pressures ease – yet they are not.

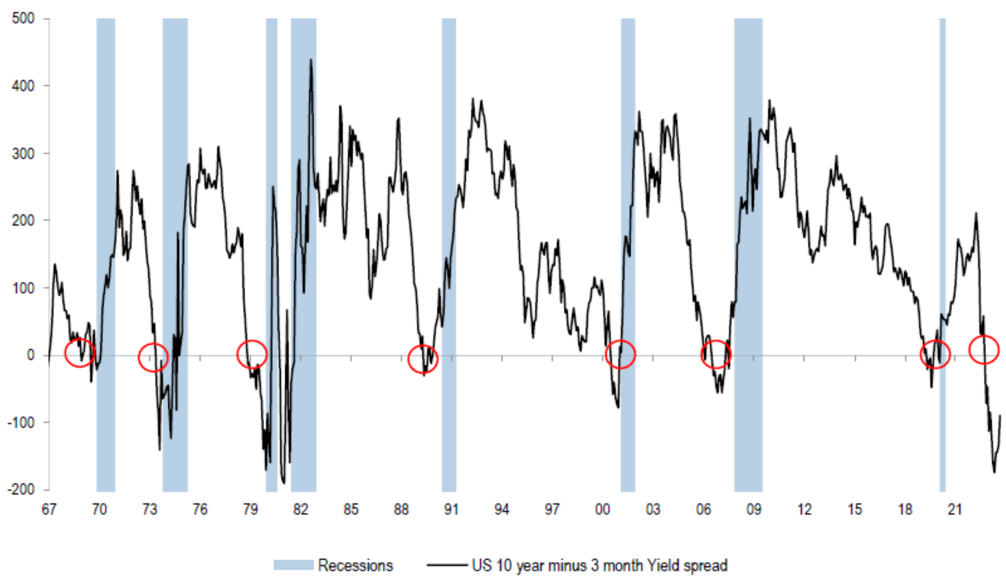
Q3 earnings statements are important, and we need to focus on forward-looking statements. 2024 forecasts are for earnings growth of 12% in the US and 8% in Europe. There has been little 2023 earnings growth, yet there are hopes of a rebound. The market is not priced for disappointment.

With real yields where they are, US equity price/earnings should be five points lower than the current level of 18-19. There is little valuation cushion. Conflict in the Middle East will boost the oil price and stop inflation falling. US monetary policy is “higher for longer”. The market is pricing in cuts of 80bps ahead of the election, but the only way the Fed can cut is if the economy is weak.

The US unemployment rate is at historic low levels, and it is hard to imagine the start of a cycle without a reset. The consensus was bearish in January when the economy was robust, explaining the year-to-date gain. Cyclicals and value stocks have already performed well. We are not yet seeing a riot in credit: spreads are well behaved. Corporate sector interest payments are falling because a few behemoths are cash-generative, but this is the not the case for the whole market. US banks’ held-to-maturity bond losses have gone from $500 billion in March to $800 billion in October. Lending standards are tightening and we sit in a transition period. In the last eight Fed tightening cycles, bond yields fell. Now is a good time to lock in higher yields.

Q4 is seasonally strong for equities. In markets, energy has already performed well, and other commodity sectors should now do better, as should defensives. Consumer sectors – autos, airlines, retail and leisure – will be mixed. Europe performed strongly up to May but has lost half the gains made. M1, the leading indicator for Europe, still looks weak.

Figure 8: US 10-year/3-month yield curve and recessions



Source: Datastream, June 2023

Typically, it takes 12-18 months from the point of yield curve inversion for the US to enter recession. The 10-year/2-year curve inverted in July 2022 and the 10-year/3-month curve inverted in October 2022 (Figure 8). The global PPI and global earnings are strongly correlated.

The PMI and earnings revisions are usually correlated, but a gap has opened up. Either the eurozone PMI is going to bounce back, or earnings need to be downgraded.

Given the difference in outlook for inflation, interest rates and growth between the US and Europe, European equity markets may again outperform the US.

Note: all data contained within the article is sourced from Bloomberg unless stated otherwise, October 2023.