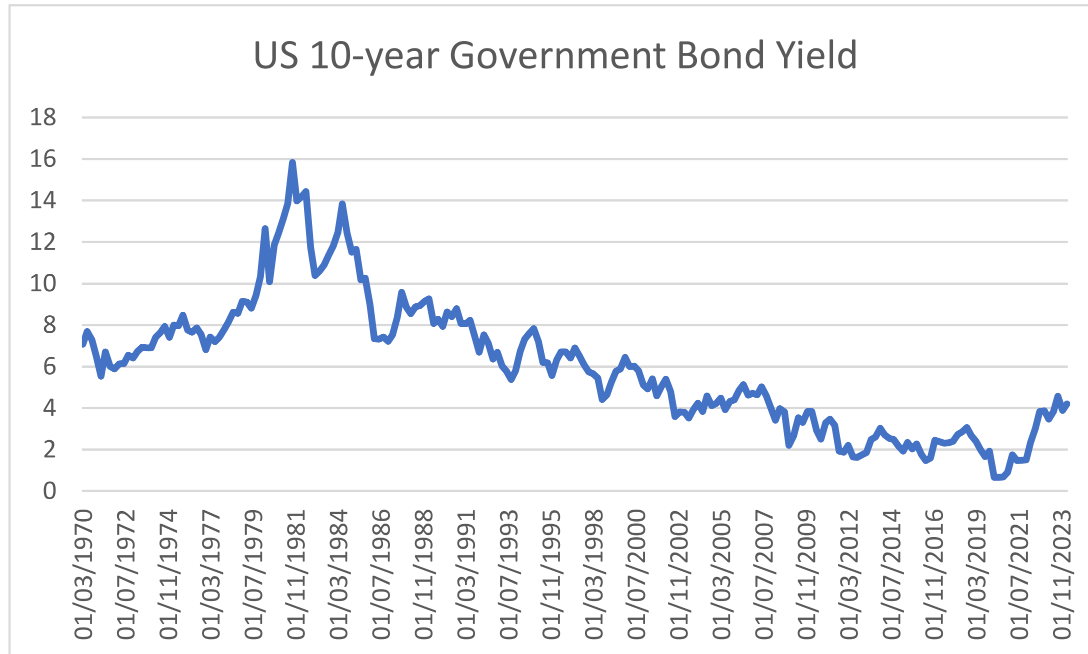
Lotos Asset Management

Quarterly Investment View

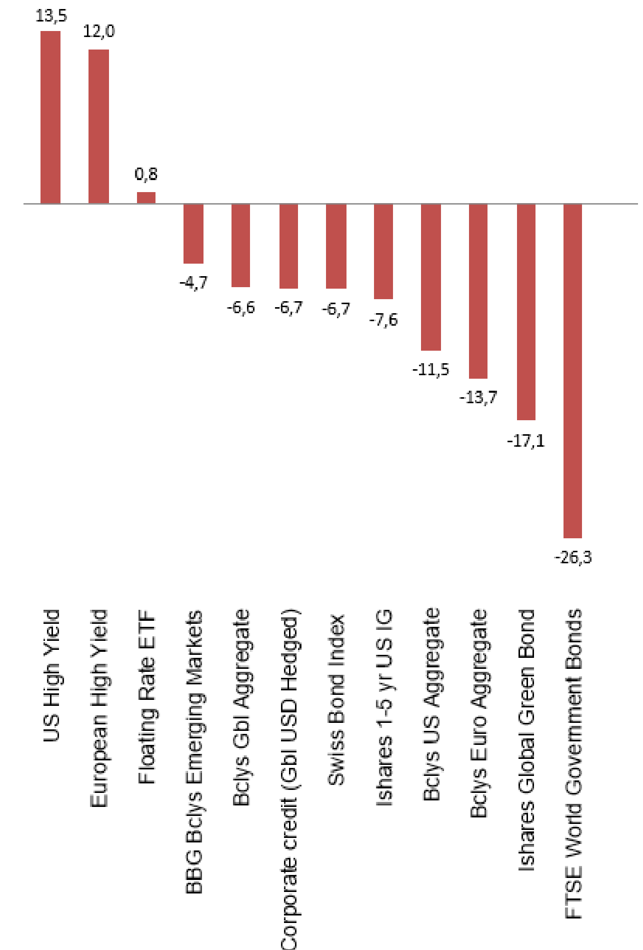
Fixed income: Caught between inflation fears and potential for interest rate cuts

The stock market has been showing an impressive performance for quite some time, while bond markets have been remaining in the shades, particularly since September 2020.

After the inflation shock in the 1970s, fixed income investors experienced more or less steady positive returns for an astounding long period of 40 years (see chart at the bottom: when yields decline, bond prices gain). Just when inflation was declared non-existing, it revived with the unpleasant consequences of negative fixed income performances. The graph to the right shows that conservative investors who traditionally invest in bonds should have done what they don't like: take on risk. Only non-investment grade vehicles generated double digit returns over the last three and a half years. The other category in positive territory was floating rate, which allows for coupon adjustments. The reference index – Global Aggregates – returned a negative 6.6%. World government bonds slumped over 26% during this period of time.



Source: US Treasury



Source: Bloomberg

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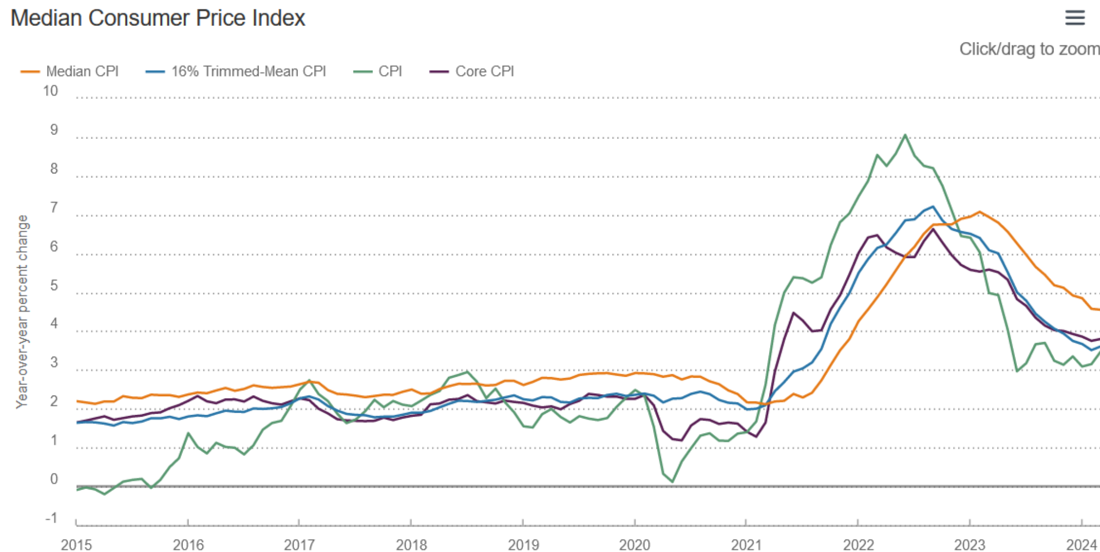
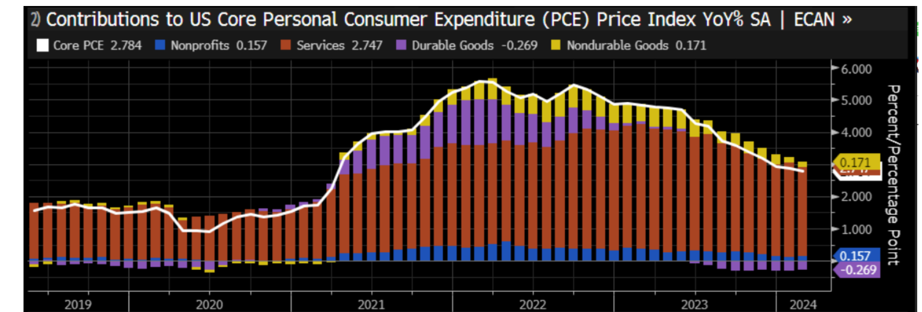
Inflation figures have more or less steadily decreased after peaking in February 2022 at 5.6% (US Core Personal Consumer Expenditure – PCE) to an actual level of 2.8% as shown on the top graph to the right. Market participants therefore assumed that the Federal Reserve could start cutting interest rates comfortably this year. The consensus assumption at the start of the year of 150 basis points of easing was in hindsight too optimistic. After the most recent release of the Consumer Price Index (CPI) investors now expect under two rate cuts in 2024. What explains the drastic change of opinion?

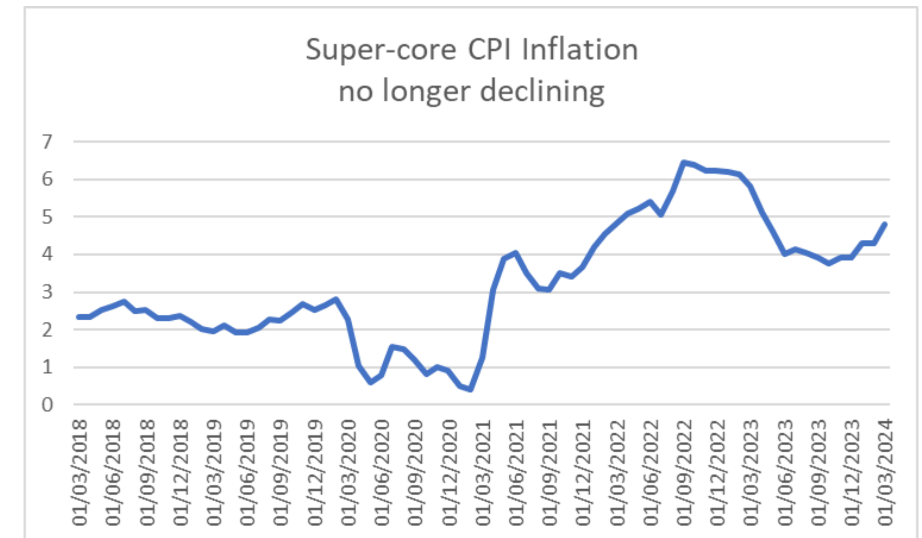
In the CPI, housing carries a significant weight. It accounts for approximately one-third of the overall index. It includes both rental prices and owner-occupied housing costs. While rents dropped, shelter prices failed to decline. In order to better assess inflation in the services sector, the Fed has been closely pursuing inflation in services excluding housing, the so-called "super-core inflation index". The recent upward trend alarmed markets as it reflects a surprisingly strong services inflation (see bottom graph to the right). Also using the trimmed mean (in which outliers in both directions are excluded and an average taken of the rest) shows (see blue line below) a tiny increase.



Source: Bureau of Labor Statistics, Federal Reserve Bank of Cleveland, Haver Analytics



Source:Bureau of Economic Analysis



Source:Bloomberg

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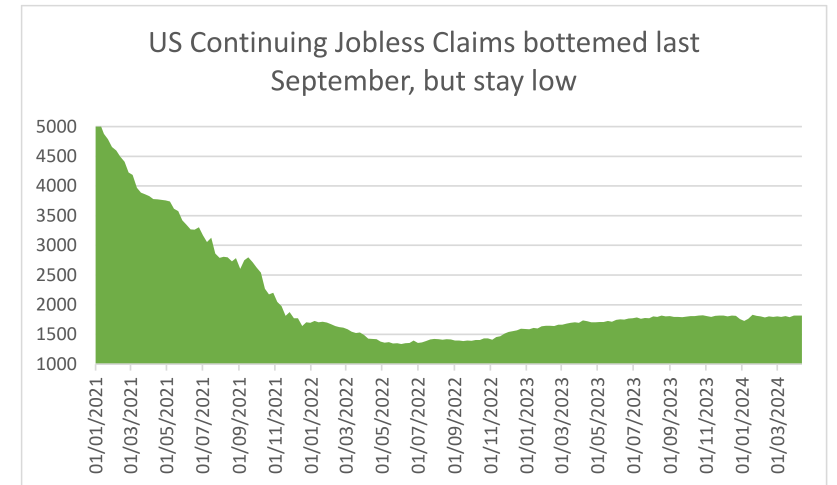
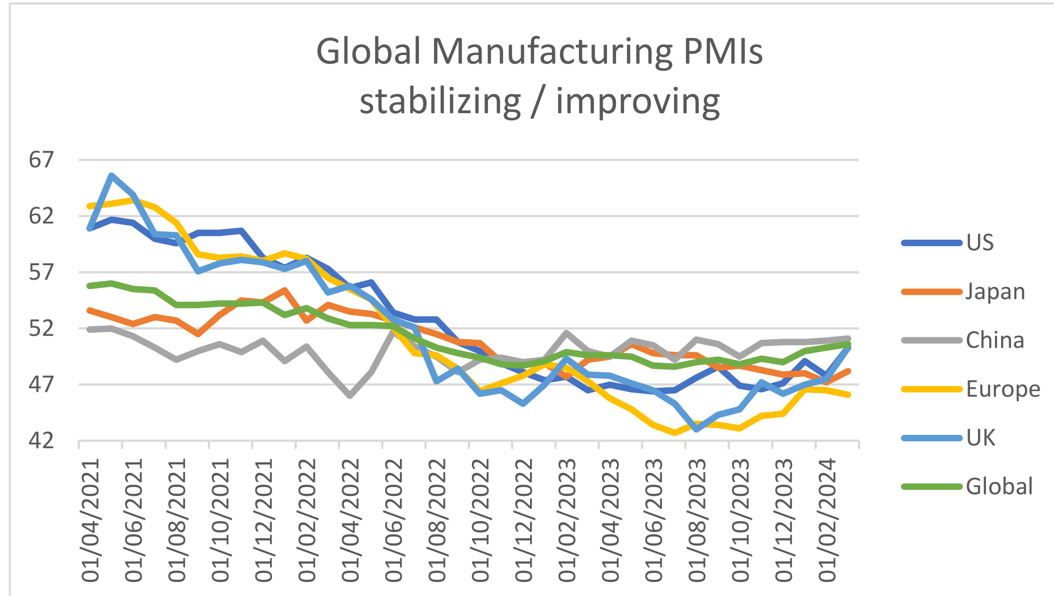
Also, economic data surprised to the upside. Retail sales were much higher than expected across the board with the previous month also being revised up, probably due to a healthy labor market. Initial jobless claims remained low (see graph to the top right), new jobs increased faster than expected, vacancies stopped declining but were still above pre-pandemic highs, wages grew at a solid pace and workforce participation rose. Leading indicators might soon end the consolidation phase (see graph to the bottom right). Supply managers' surveys also seem to have exited negative territory, even on a global level with the exception of Europe (see graph below).

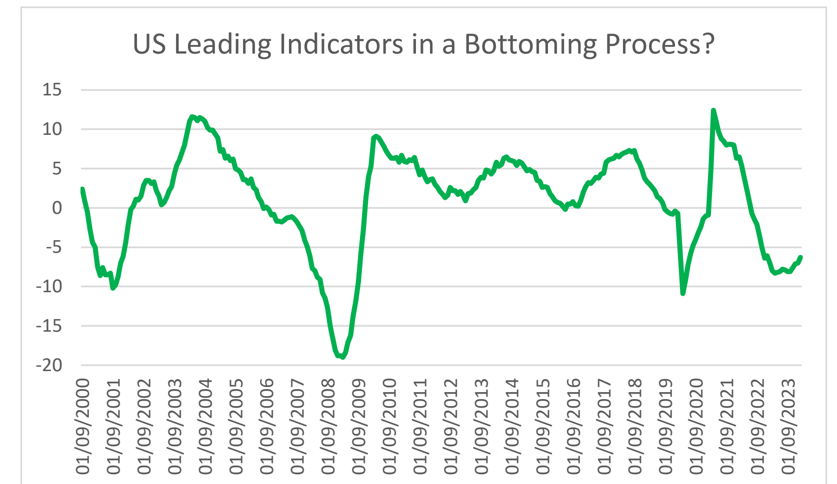
Despite the rather positive economic developments, financial conditions remain still quite easy given the Fed's prospect of interest rate cut late last year. Since then, the 10-year US Treasury yield plunged from over 5% last October to 3.80 % in December. This rapid decline has now been partially reversed. This dynamic has also been reflected in mortgage interest rates, which climbed again over 6% for fixed 30-year papers and might tighten financial conditions for homeowners.



Source: US Department of Labor



Source: S&P Global



Source: Conference Board

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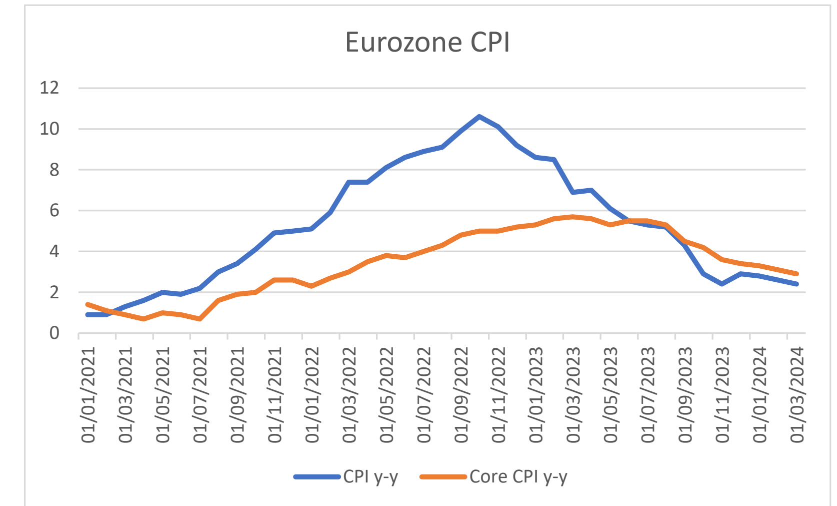
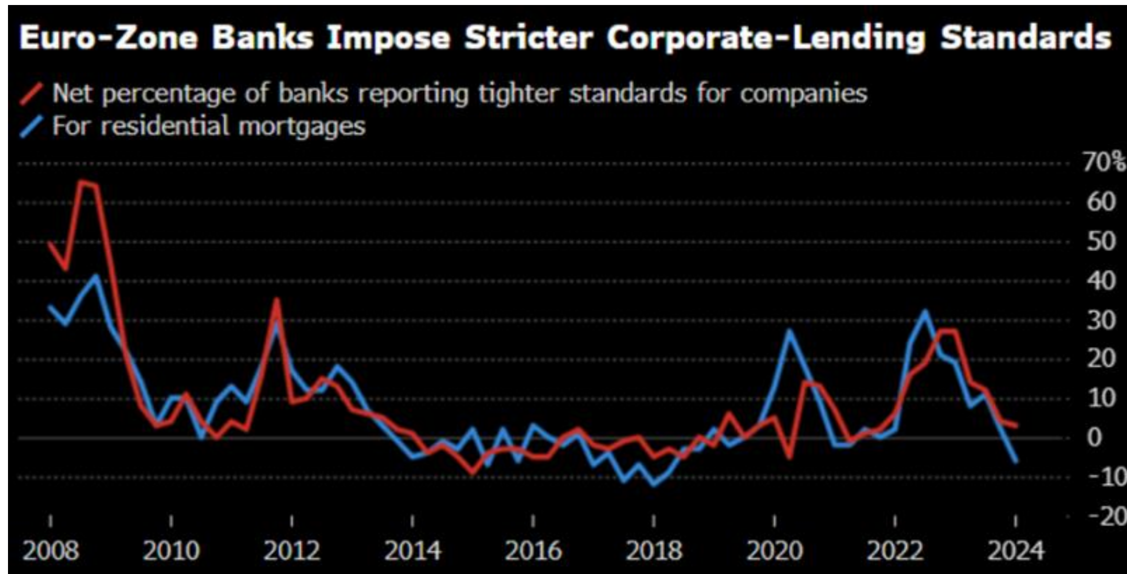
Sticky inflation combined with solid economic data in the US, have complicated the task of other central banks. They had originally expected the Fed to be the first to cut rates and thereby to preserve their currencies' value. Yet, the SNB surprised markets with a rate cut, supported by low inflation figures and subdued inflation expectations. As Switzerland is an export-oriented economy, the ensuing weaker currency was quite welcome. Some other central banks, such as the ECB and the BoC, are now also bracing to cut interest rates ahead of the US.

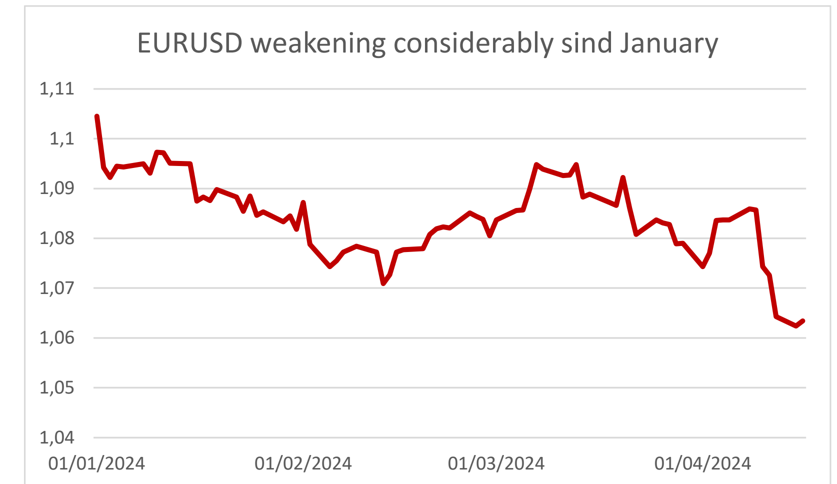
Contrary to the US, the restrictive effect of higher interest rates seems to affect economic output. The path of inflation, particularly in the Eurozone (see graph to the top right), would support policy easing. The prospect of lower European benchmark rates has already weakened the EUR (see graph to the bottom right). One of the negative consequences of a weaker currency is that imported goods, notably oil and other commodities could become more expensive. In view of the armed conflicts this would reinforce an already existing trend. What are our conclusions?



Source: US Department of Labor



Source: ECB Bank Lending Survey, Bloomberg



Source: Conference Board

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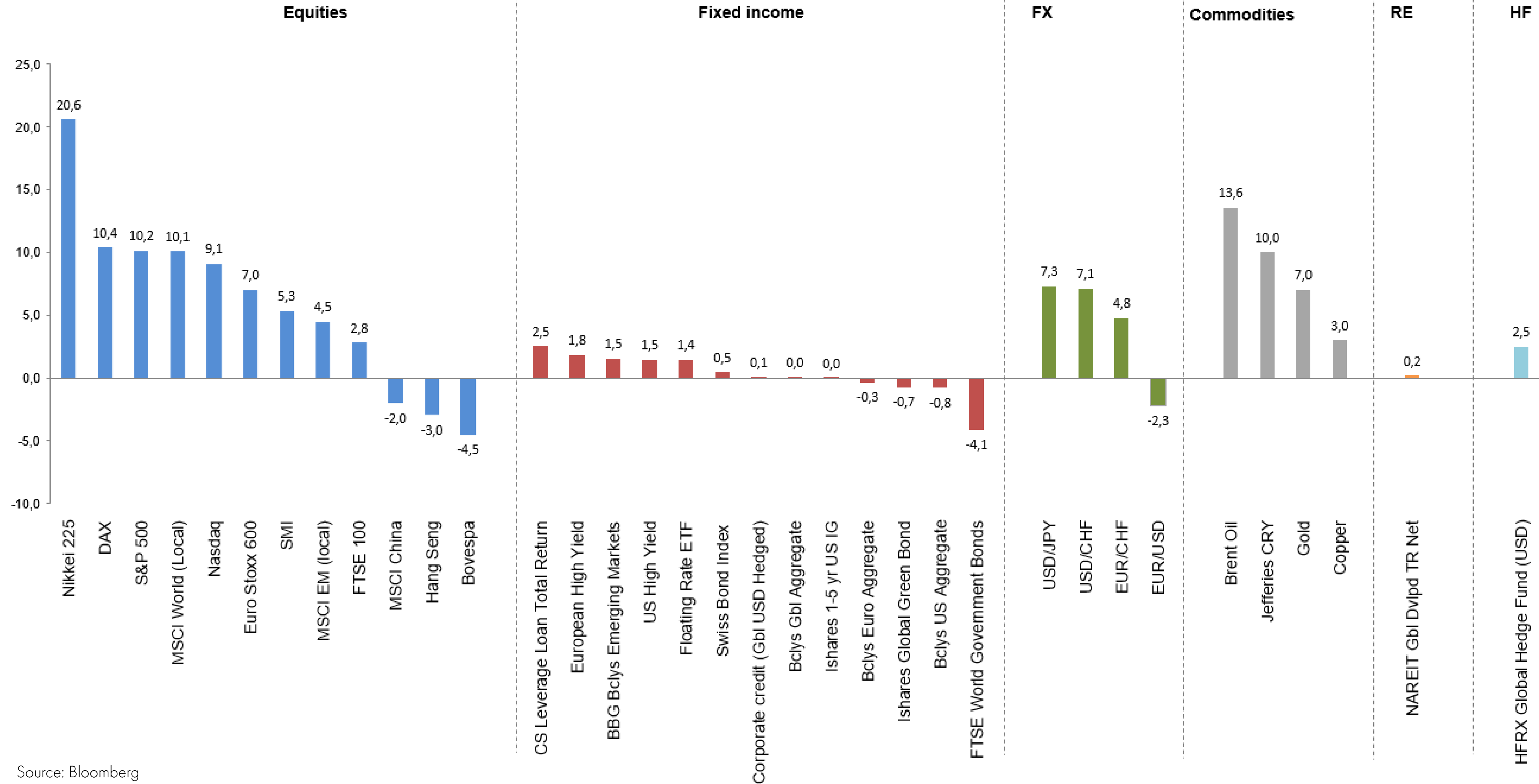
Conclusion

- Interest rate cuts will be delayed in the US. This seems now to a high degree be reflected in the market.
- Given stubborn US inflation, caution should be exercised with long durations.
- Higher-for-longer rates entails the risk of refinancing needs. In view of the record bond issuance at low levels of interest rates this will probably concern markets only two years from now.
- As such, high-yield bonds could still be included in a portfolio.
- While interest rate cuts in the European markets would be favorable for fixed income, the ensuing currency risk has to be accounted for. Hedging costs weigh on performance.
- We remain overweight stocks. The US is still our preferred investment geography.
- The earnings and margin trends in the US seem solid with less risk than in other geographies. Solid economic trends support this notion.
- While expensive stocks are more vulnerable in the context of higher rates, the need for rapid implementation of Artificial Intelligence is urgent. We hence stick to investments benefiting from this trend.
- Infrastructure spending, military expenditures and investment needs due to de-globalization are not dependent on interest rates.
- Geopolitics and Elections in many parts of the world will increase volatility.
- China continues to be challenged on many fronts. The unpredictability and opacity of governance and data will continue to discourage investors from getting involved.
- Europe is confronted with its significant exposure to China and the end of the peace dividend. Leading indicators point to economic weakness. We remain underweight.

Performance major asset classes 2024 (March 31) in local currencies



Source: Bloomberg

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