At peak rates?

Deepak Mehra
Chief Economist
Treasury, Asset Management and Global Markets

To curb runaway inflation, the US Federal Reserve along with all the major central banks have increased interest rates to historic levels at an aggressive pace while also reducing their balance sheets but the economy, especially in the US, has been surprisingly resilient, underpinned by a strong consumer. It is a sort of a tug of war between the resolute Federal Reserve on one end and the resilient economy on the other. So far in this contest, the economy seems to have an upper hand; however, recent data points to signs of upcoming weaknesses. Investors are trying to evaluate if the Fed will increase rates again and when is it likely to cut them.

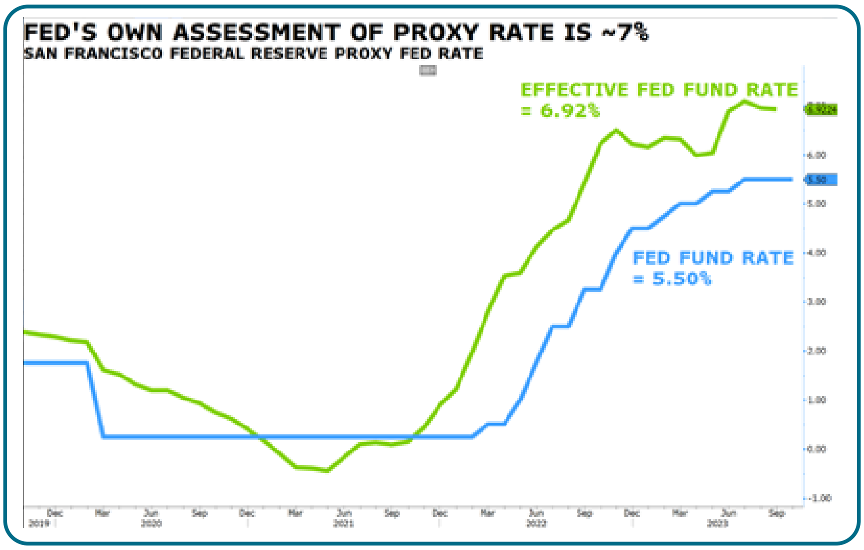
ECONOMIC UPDATE

The resolute Fed: Among the many weapons available in its armory, the Federal Reserve has been firing its three most potent ones to bring inflation down to the target level of 2%. These are:
1) The Fed Fund Rate has been increased at the sharpest pace in the last four decades and at the 5.25% – 5.50% range, it is at a 22-year peak. Higher rates increase the cost of borrowing for individuals and companies and in turn curb spending.
2) The Fed's balance sheet that had grown from levels of $ 4 trillion, pre-pandemic, to the peak of $ 8.95 trillion in the first quarter of 2022 has been reduced by over $ 1 trillion. This operation, referred to as quantitative tightening, helps to reduce liquidity in the system and tighten financial conditions.
3) Forward guidance is the communication from the Fed and its officials on the future path of interest rates. This plays an important role in influencing the financial decisions of households, companies and investors. Forward guidance from the Fed has been extremely hawkish leading analysts to believe that rates will remain 'higher for longer.'

US Fed Fund Rate
22 Year High

When the Fed uses multiple tools to affect financial conditions, the effective interest rate which is experienced by the economy is far more than the Fed Fund Rate. Considering various parameters of the financial conditions prevailing in the economy, the Federal Reserve Bank of San Francisco calculates a proxy rate that can be interpreted as indicating what interest rate would typically be associated with prevailing financial market conditions if these conditions were driven solely by the Fed Fund rate. The current proxy fed fund rate, by the Fed's assessment, is close to 7% (please see graph below). This makes the policy much more restrictive compared to general perception.

Effective Fed Fund Rate
~7%



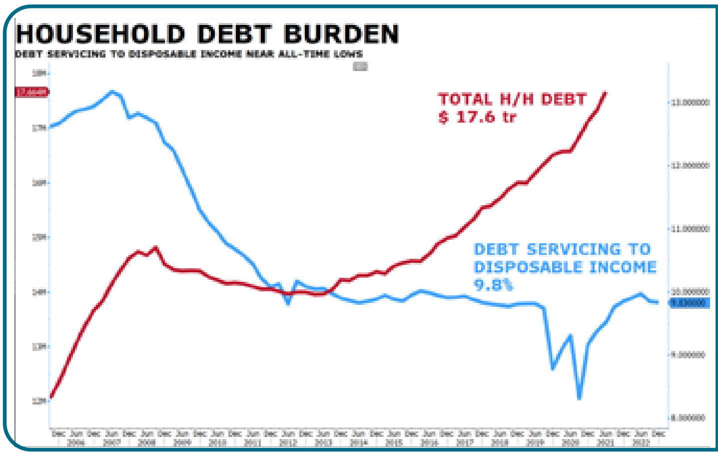
The resilient economy: Despite the resolute Fed aggressively tightening the monetary policy, the US economy has held on surprisingly well. The strong growth in the number of jobs in September and surprisingly high print of the GDP growth for Q3 are some of the recent data that show that the economy has held on quite well against the Fed's onslaught. There are a number of reasons for that:

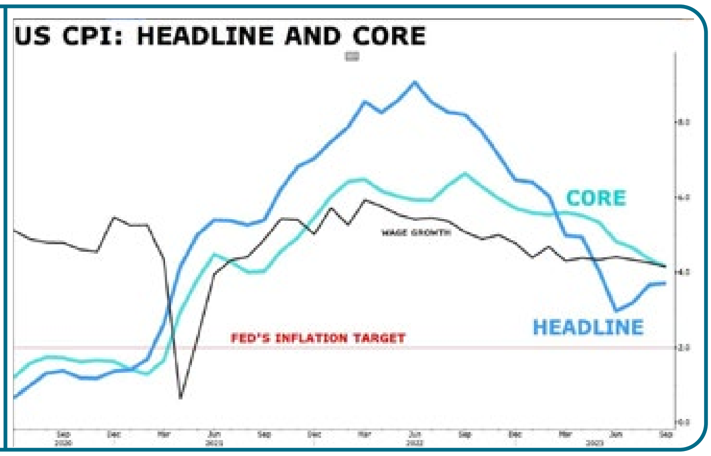
1) Interest rate sensitivity: Consumers and companies have been able to lock in lower rates for the long term when interest rates were close to zero for over a decade. As a result, higher interest rate on mortgages and commercial loans has not impacted the borrowers. Debt servicing as a percentage of disposable income for individuals and as a percentage of net profit for corporates is at multi-decade lows, leaving more disposable income for spending (please see graph below).

2) Labor market imbalance: The number of available jobs for every job seeker still stays at a level of 1.5, which is better than the peak ratio of 2.0 last year but is still higher than the long term average of 1.20. This imbalance comes from a lot of people above the age of 55 dropping off the labor market. When workers feel confident of getting another job, they are likely to increase their overall spending levels, contributing to higher inflation.

3) Wages: A large part of the improvement in inflation is due to the easing of food and energy prices – which is evident in the headline Consumer Price Index (CPI). However, wages have been slower to come down (due to labor market imbalance), leading to a slower easing of Core CPI, which is heavily tilted towards services. Please see the below graph plotting CPI and wages growth. Higher level of wage growth has helped to keep consumer spending intact.

No. of jobs
for every
unemployed
1.50





Signs of upcoming economic weakness: The effects of monetary policy take some time to work through the system. Higher rates and tighter monetary policy have been in place for a while, but the first signs of upcoming weakness are now visible when we parse the economic data carefully.

Contribution of consumer spending in GDP

70%

The first indication comes from the US Non-Farm Payroll data that on the surface looked very strong with 336,000 jobs added in September, however, further details reveal that the quit rate, which measures the percentage of workforce quitting their jobs every month, has dropped down to pre-pandemic levels. This indicates the loss of confidence, among workers, of finding another job that has better terms. This in turn reduces their bargaining power and wage growth potential. The same data also showed wage growth has further slowed down compared to the previous month. Another indication comes from rising delinquencies in auto loans and credit cards, and the rising balances of credit card debt. These probably suggest that people in the lower income groups have run out of their accumulated savings and will not be able to sustain consumption at the same rate. Furthermore, careful examination of the surprisingly strong Q3 GDP data which showed that the US economy grew at an annualized rate of 4.9% reveals that 1.3% of that was due to inventory buildup which is difficult to repeat in the coming quarter. Apart from these factors, the drop in savings rates and the re-introduction of students loan repayments (which were suspended after Covid) should further slowdown spending.

These are early signs that suggest that consumer spending that contributes to 70% of the US GDP has most likely peaked and going forward will probably be coming off gradually.

What's happening in the UK and Europe? UK rates are at 5.25% and inflation rate has eased from a high of 11.10% last year to 6.7%; still very high compared to other developed economies. In Europe, interest rates are at a lifetime high of 4% while inflation has eased significantly from a peak of 10.6 last year to 2.9% in September, inching quickly to European Central Bank (ECB) target of 2%. Households in the UK and Europe are creaking under the burden of high food, energy, mortgage and rental costs and it seems that both the Bank of England and ECB will find it difficult to raise rates any further and will hope that the sharp monetary policy tightening so far works through the economy over the next few quarters.

Inflation in the UK

6.7%

MARKET UPDATE AND OUTLOOK

A good level to enter US equities: US stocks have entered correction territory, down about 10% from their peak in late July, primarily reacting to the rise in long-term Treasury yields and fears of recession at some stage next year. Even after this correction, the S&P 500 index is up 10% for the year but is trading at the same level as April 2021. Technically, the index is now oversold with the Relative Strength Index, that is a function of momentum of recent price changes, signaling buying levels. As far as a recession is concerned, we believe this one, if at all, is an engineered one and hence quite different from the previous recessions where the economy stalled due to financial crises. The impact of such a mild recession is likely to be minimal on corporate profitability. In fact, a mild recession will help to loosen the sticky inflationary pressures in the economy and allow the Fed to cut rates, which in turn would be good for equities and bonds.

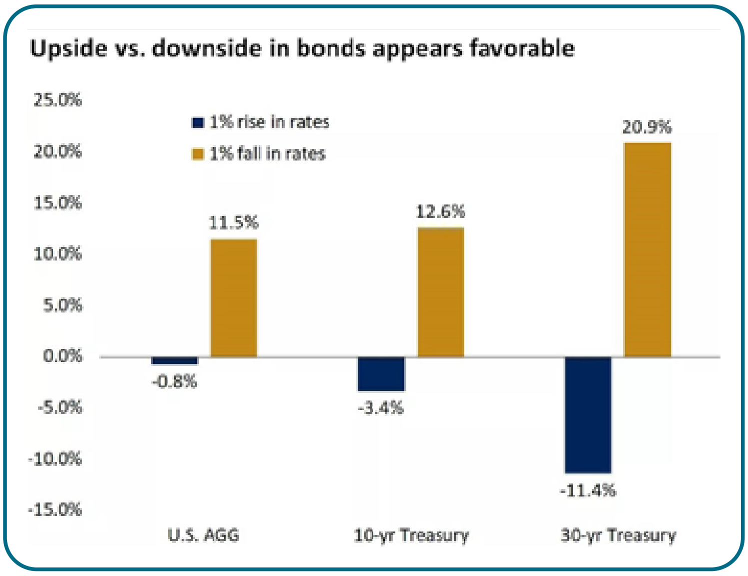
S&P 500 YTD 2023

+10%

In an encouraging sign, the Q3 earnings season for the S&P 500 is at the mid-point and positive earnings surprises are above their 10-year averages. After three consecutive negative quarters, corporate profits are on track to return to growth in the third quarter and are expected to improve further through 2024. Companies are benefiting from solid demand which is driving growth in revenue, while the easing of raw material and input costs is likely to increase profitability.

We believe the US equity market is placed well for strong medium to long term returns due to a combination of factors: headwinds from Fed rates and Treasury yields are likely to ease; corporate profits are likely to grow after three quarters of fall, the market is technically in an oversold position and recession, if any, is likely to be short and shallow.

Generational buying opportunity in bonds: Bond markets have suffered due to a sharp rise in interest rates. The wider universe of investment grade bonds has now lost money for the third consecutive year, which is unprecedented. The recent selloff in bonds has made their yields even more attractive. Considering that the central banks are at or near peak rates, this presents a good entry point for long term investors. High investment grade bonds now offer yields close to 6% per annum for 7 to 10 year maturity. Given the higher income component currently available, that can better offset price declines, a 1% decline in rates would potentially lead to a much larger upside in prices than the downside from an equivalent 1% rise in rates. The chart below shows that a 1% fall in rates can lead to 11.5% gains in the general investment grade bonds represented by the US Aggregate Index that has an average duration of 6.1 years while it can lead to gains of 12.6% gains for 10-year Treasury bonds or other bonds with a similar duration. Given the high level of coupons available, the downside risk of 1% increase in rates is significantly smaller. Clearly, the upside in high quality bonds is more than the downside risk.



Source: FactSet, Edward Jones.

MARKET DATA

Global Equities	Last price	YTD 2023
MSCI World	2768.62	6.38%
Dow Jones Ind.	33052.87	-0.28%
S&P 500	4193.8	9.23%
NASDAQ COMP	12851.24	22.78%
EUROSTOXX 600	433.66	2.06%
FTSE 100	7321.72	-1.74%
India Nifty50	19079.6	5.38%
Nikkei 225	31451.29	20.53%
Shanghai Comp	3018.771	-2.28%

Regional Equities	Last price	YTD 2023
Dubai DFM	3877.08	16.22%
Abu Dhabi ADX	9343.88	-8.49%
Saudi Tadawul	10,690.09	2.02%

Market Data As of 31 Oct 2023

Currencies	Last price	YTD 2023
Dollar Index	106.713	3.08%
Euro	1.0575	-1.21%
GBP	1.2137	0.45%
JPY	151.3	-13.34%
CHF	0.9101	1.58%
AUD	0.6327	-7.13%
CNH	7.336	-5.64%
INR	83.255	-0.62%
SGD	1.37	-2.23%

Commodities	Last	YTD 2023
WTI Crude	81.46	1.50%
Brent Crude	85.56	-0.41%
Nat Gas	3.601	-19.53%
Gold	1980.16	8.56%
Silver	22.7286	-5.12%
Copper	365.2	-4.16%
Corn	478.5	-28.64%

CBD INVESTMENT SOLUTIONS

CBD offers a range of solutions that can help you manage wealth for short-term or long-term objectives:

ASSET CLASS	SOLUTIONS
FIXED INCOME	• A large range of regional and international bonds, perpetuals and sukuks • Top-rated global and regional mutual funds investing in bonds and sukuks and distributing regular income • Both Sharia-compliant and conventional fixed income solutions are available
EQUITIES	• International equity and ETF trading on CBD's award-winning mobile app CBD Investr • Trading in UAE equities with CBD Financial Services mobile app or with brokers
MULTI-ASSET	• Income distributing mutual funds, from leading fund managers in the world, investing in equities and fixed income
SYSTEMATIC INVESTMENT PLAN	• Invest regularly in globally diversified and actively managed portfolios on CBD’s award-winning mobile app CBD Investr
ALTERNATIVES	• Mutual funds investing in US senior secured loans delivering regular income

Visit us on www.cbd.ae and www.cbd.ae/cbdinvestr for more information on investment solutions

CONTACT US

As always, your dedicated Relationship Manager remains available by phone or email for any enquiries or support you may require. Alternatively, you can write to us on cbd.investmentsolutions@cbd.ae

بنك دبي التجاري
Commercial Bank of Dubai