The Way We See It

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Fed's pause and eventual rate cuts in 2024: Realistic expectations ?

A brief update report which serves to review the recent market development and to offer our outlook for the rest of the year and beyond.

Review of Developments
- Global Economies

On growth dynamics, recently-released data showed significant growth divergences amongst key economies.

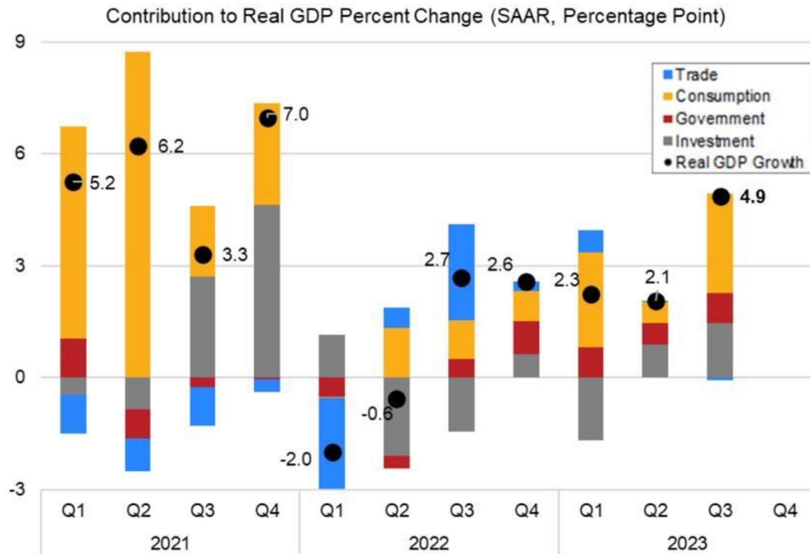
On the strong side, the preliminary Q3 GDP in the U.S. puts all other countries to shame: it grew by a robust annualised 4.9% rate, boosted principally by consumption, as US mortgage holders, in general, are much less affected by the 500bps Fed rate hikes, owing to the ultra-low rates on their fixed-rate 20-year mortgages, which they locked in during the 2020 to H1-2022 period. Government spending and the rebuilding of private inventories also contributed.

On the opposite end of the growth spectrum, the latest Eurozone Q3 GDP data confirmed the past few months' weak partial economic indicators: it shrunk by an annualised 0.4%. Weak global trade and government spending were the key decliners.

China's official Q3 GDP data showed a slightly-better-than-expected annualised rise of 5.2%. The services sector was the strongest contributor, while housing

sector was the strongest contributor, while housing and foreign trade were the weakest.

Q3 2023 U.S. Real GDP Growth



Source: The Conference Board

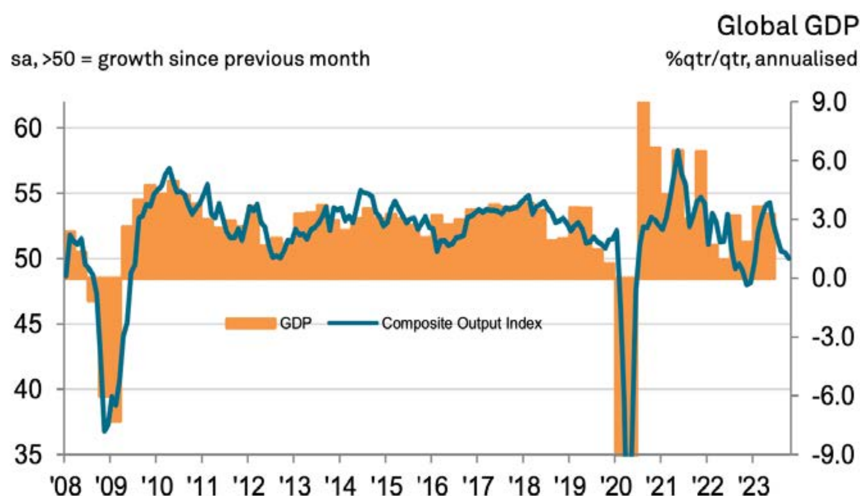
On the inflation front, since August to date, in most developed economies, the favourable headline trend was reversed by the recent bounce in energy prices. Furthermore, core inflation indicators, while decelerating in the last few months (i.e. the 3-month annualised core Personal Consumption Expenditure Deflator in the U.S. has fallen from 6% a year ago to 2% currently), remain elevated. The latter is caused by a number of structural factors including rising wages in low-skilled services, lower net immigration, green energy, manufacturing re-shoring, and so on.

The key message from the latest November Fed's FOMC meeting, in which rates remain on hold for a consecutive second month, emphasised the need to keep rates high for longer, as the road to achieving an annual 2% core inflation rate remains uncertain. The Fed's chairman, in a Q&A session, also hinted that the prospects of a cut versus a further rate increase favours the latter. In the month of October, most other OECD central banks remain on hold.

Finally, global geopolitical risks remain high: Russia and Ukraine, Gaza and Israel, plus geopolitical and trade tensions beyond semiconductor chips between the U.S. and its partners, against China.

Q3 GDP in the U.S. (and China) puts all other countries to shame.

J.P.Morgan Global Composite PMI™



Source: J.P.Morgan, S&P Global Market Intelligence

- Global Markets

The weakness in long-dated government bonds and other risk growth assets, observed in the two months of August and September, continued in October. This was mainly caused by the continuing hawkish messaging by the Fed and other G7 central banks, rising long bond yields and the release of mostly in-line U.S. Q3 corporate sales and earnings results, together with relatively guarded outlook statements. Cash, as a result, was, again, the outstanding winner.

Within the global equity universe, all major markets fell. Again, the Chinese and the rest of the Emerging Markets bloc performed relatively more poorly. Investors were disappointed with the continuing poor growth in Chinese exports as well as domestic demand, and the feeble effort by the Chinese government to reflate.

China & EM performed poorly among equity markets.

Unlike the last two months, the dominant seller of stocks in October, appeared to be the Systematic investing group. The latter's action was principally driven by their quant-computed Algos, which signalled to reduce exposure to risk assets as soon as their price fell and the volatility of price moves rose.

High interest rates continued to attract the attention

of fundamentally-driven asset allocators, thus discouraging the latter to buy equities and other growth-dominated assets in the short-term.

Equity & Bond markets both weakened; Cash outperformed.

Near-term performance of various asset classes

as at 31/10/2023

Asset Class	US Equities	Global Equities	GEM Equities
Index	MSCI USA	MSCI World	MSCI EM
1 month	-2.30%	-2.88%	-3.87%
3 months	-8.45%	-9.22%	-12.09%
YTD	10.92%	8.34%	-1.80%
FY 2022	-19.46%	-17.73%	-19.74%

Asset Class	US Corporate	US Treasury	US Aggregate
Index	Bloomberg US Corporate	Bloomberg US Treasury	Bloomberg US Agg
1 month	-1.87%	-1.21%	-1.58%
3 months	-4.57%	-3.42%	-4.15%
YTD	-1.86%	-2.71%	-2.77%
FY 2022	-15.76%	-12.46%	-13.01%

Asset Class	Global Govt Bonds	Global Aggregate	Global Commodities
Index	Bloomberg Global TSY	Bloomberg Global Agg	CBR
1 month	-1.23%	-1.20%	-1.19%
3 months	-5.21%	-4.73%	-0.36%
YTD	-4.82%	-3.38%	1.23%
FY 2022	-17.47%	-16.25%	19.53%

Asset Class	Asia ex Japan Equities	China Offshore	China A
Index	MSCI AC AxJ	MSCI China	MSCI China A Onshore
1 month	-3.86%	-4.26%	-3.00%
3 months	-12.39%	-15.22%	-12.43%
YTD	-3.98%	-11.08%	-11.38%
FY 2022	-19.35%	-21.80%	-27.09%

Source: GOJI, MSCI, Bloomberg

Similar to the trend observed last month, the U.S. and global bond markets continue to trade poorly. Cash outperformed bonds in all periods including the month, quarter and year to date to the end of October. The government bond market's weakness can be explained by the fact that the U.S. economy shows no sign of weakness after 500 bps of rate hikes, compounded by a significantly large amount of new supply of U.S. bonds hitting the market in the last few months, worsened by continuing QT (*please refer to our comprehensive special topic section discussing bonds at the end of last month's report*).

The US Dollar was quiet in October. Market consensus was pricing in a "Fed-on-hold" policy from November onwards.

The Commodities complex fell modestly, caused by profit-taking in energy prices. Gold was the outstanding performer, as it benefited from escalating geopolitical tensions in the Middle East and elsewhere.

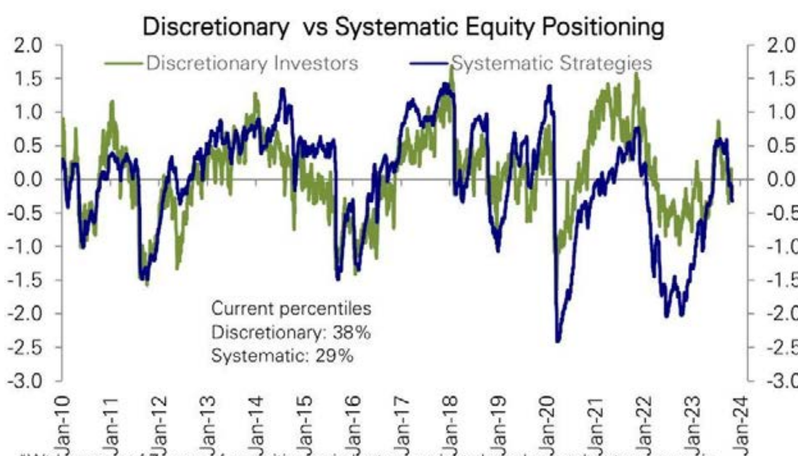
In terms of equities investment flows and positioning, both fundamental and quantitatively-driven funds remained slightly underweight equities, relative to their historical norm. Amongst Systematics, the more flexible and aggressive CTAs were actually reported to be net short in U.S. and global equities (*data as at 1st November*).

Both fundamental and quantitatively-driven funds remained slightly underweight equities.

Consolidated Equity Positioning

Source: Deutsche Bank Asset Allocation

Discretionary vs Systematic Equity Positioning - *Systematics Buying vs Discretionary Selling*



Source: Deutsche Bank Asset Allocation

At the time of writing, there is a growing consensus that we may have seen the worst of the fall in markets in the three months from August to October. Hope is building up for a more bullish seasonal rally leading to Christmas and the new year.

Let us discuss this more hopeful scenario in the section below.

Market Outlook
- Global Economy

While there are both positive and negative factors operating in the U.S. and the world economy, the potential growth positives are likely to continue to favour the U.S. over the rest of the world, as discussed previously.

Europe is likely to be burdened by the lack of growth initiatives and the high interest rate regime. Thanks to its government's moderately easier policies, the Chinese economy may have bottomed, but the strength of its economic recovery is still clouded in uncertainty. The sputtering growth engine of China and the domestic-focused nature of the U.S. economy are unlikely to help the rest of the world.

In brief, the U.S. and world economy are expected to continue to grow, but at a sub-par rate. Having said that, we continue to attach a small probability to a mild U.S. recession, possibly occurring in 2024. We are still somewhat concerned that, after a decade of almost zero interest rates and trillions of QE and fiscal pumping, the abrupt reversal of these super-easy monetary and fiscal policies has and is likely to continue to cause unexpected financial crises and/or recessionary conditions. Net, net, the world economy, in our opinion, remains fragile (*financial accidents have and can continue to happen!*).

The Way We See It
- Global Markets and Investment Thematics

The above economic, monetary, and geopolitically unbalanced backdrop is expected to prevail in the remaining of the year.

Until the U.S. Fed tells us that they are truly convinced that they have tightened sufficiently to tame inflation and cool a red-hot labour market, we continue to think that it would be sensible for long term investors to continue to adopt a neutral-risk strategy.

This translates into a strong focus on quality and lowly-geared assets that can deliver predictable cash flows. In addition, until the U.S. banking and commercial property sectors are functioning healthily, and that the Fed truly pivots from doubly tight (high cash rates and QT) to ease, investors could consider holding a mild overweighting in US-dollar-denominated Treasuries and Investment Grade corporate bonds.

GOJI's view remains - neutral-risk strategy for LT investors; focus on quality assets.

In terms of geographical diversification, it appears that it may pay to be neutral in the US versus other global equities. This is based on the differing growth, liquidity and valuation trends across the globe, which currently favour the rest of the world over the US.

Short-term Technical Analysis

We wish to continue to share a technical chart of the leading risk index in the world, the US-based S&P 500 stocks index. It shows that the index has been rising since October 2022, within a volatile upward-trending range, until the past few months.

S&P 500 Stock Price Index

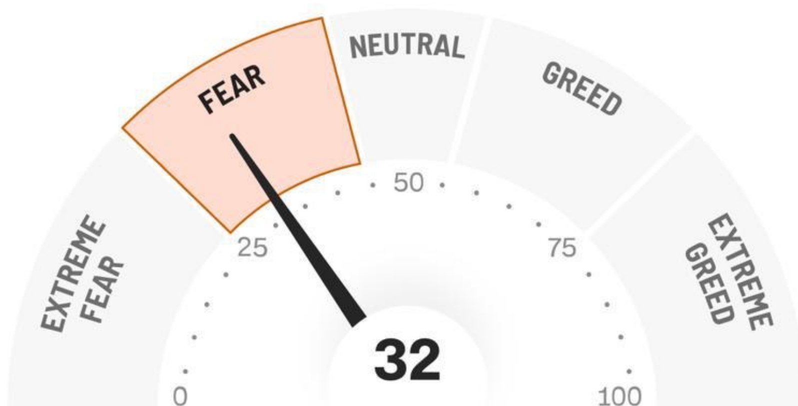
Source: MarketWatch.com

In the August to October period, the S&P 500 Index fell below both the 50- and 200-day moving average lines (but no Dead Cross signal occurred). Recently, it has moved up above the 200 DMA again. This highly volatile trading pattern is likely to continue for some time, as long as trading liquidity is thin, and that day-traders and Systematics control the daily trading flows (which they have doing for the past few years).

As discussed in our last few reports, we remain somewhat skeptical that the equity rally in H1 can be maintained in H2. In other words, while many analysts continued to predict new historical highs for U.S. equities by year end, it has been our view that they appear excessively bullish.

Market consensus appears excessively bullish to predict new historical highs for U.S. equities by y/e.

Fear & Greed Index
- What emotion is driving the market now?

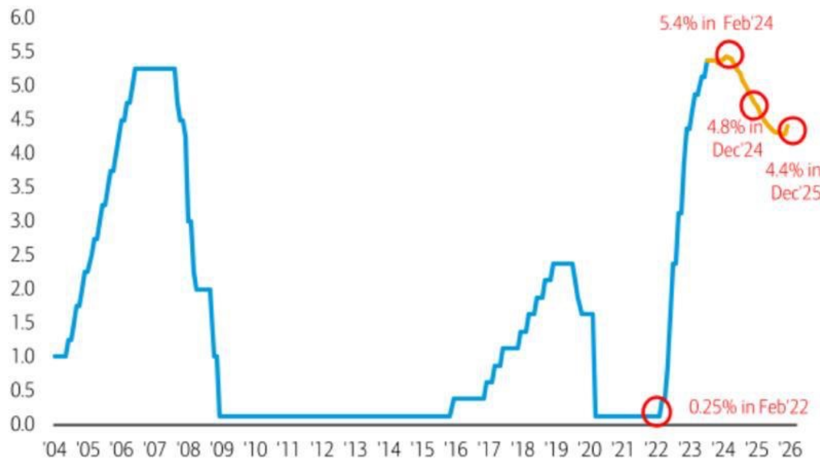


Source: CNN Business

To summarise, it remains our strong belief that a sustainable bull market in equities and corporate bonds will return at some stage, but it would only occur when valuations fall further to reflect the U.S. and global sluggish growth trend, and, more importantly, when the U.S. Fed and other major central banks switch from the current tightening to an easing mode (*please note that, according to Mr Jay Powell's latest thinking, if the Fed had to make another move in its monetary policy in the near future, it would veer towards another hike, NOT a cut!*).

Market pricing in 66% probability we've seen last Fed hike

Market pricing for Federal Funds rate (%)



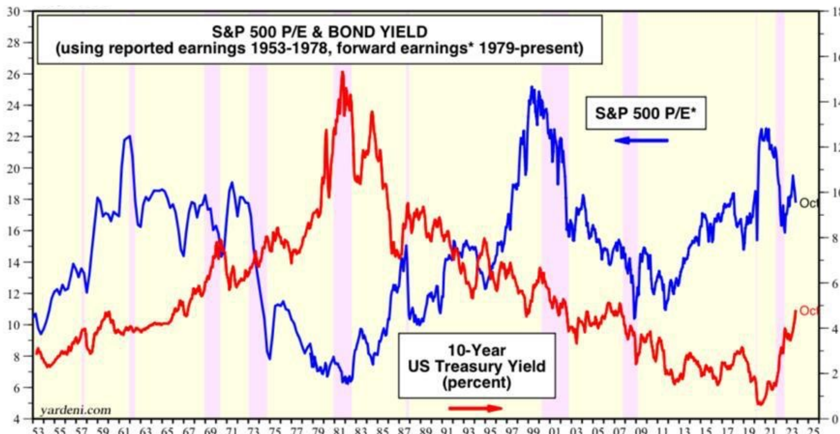
Source: BofA Global Research

In the meantime, due to continuing high interest rates, prevailing global macroeconomic uncertainties compounded by troubling geopolitical factors, markets are likely to remain volatile. Consequently, in our opinion, a neutral-risk and quality-focused investment strategy should remain the foundation of risk-averse investors.

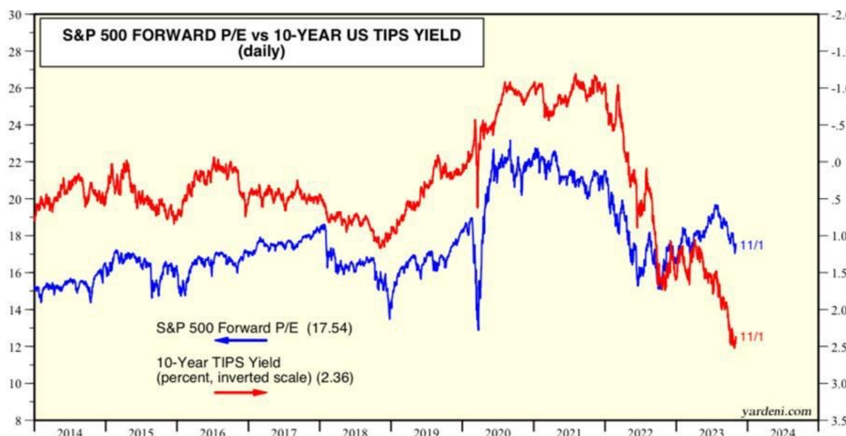
Market pricing in 2/3 chance of no more Fed hike.

Post-Script

What is a fair P/E for the S&P 500 Index, given the return of 4.5% 10-year bond rate ?



* Four-quarter trailing sum of reported earnings through 1978, then time-weighted average of analysts' consensus estimates for S&P 500 operating earnings per share for current year and next year. Monthly from January 1979.
Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Yellow areas are bull markets
Source: I/B/E/S data by Refinitiv, Standard & Poor's, and Federal Reserve Board.



Source: Federal Reserve Board, I/B/E/S data by Refinitiv and Standard & Poor's.

Source: Yardeni Research, Inc.

U.S. equities appear 20-25% overvalued vs long bond yields of 4.50%+ p.a.

The above two charts, borrowed from Ed Yardeni's excellent data base and his detailed analytical research, clearly shows that the leading global equities market, symbolised by the S&P 500 Index (SPX), appears expensive vs long-dated bonds. In addition, the spread between the 10-year bond and dividend yield of the SPX (not shown here) is one of the largest over the past 20-year period. This again points to the relative expensiveness of equities vs bonds.

While estimating and predicting the level of the SPX vs current bond yields is an art rather than a simple exercise based on a systematic formulae, our view is

that, currently, the SPX appears to be some 20-25% overvalued.

In brief, assuming no big change in the market's aggregate EPS trend in the coming 12 months, if the 10-year bond yield were to remain above 4.50% p.a. over the next 6-12 months, then the SPX is likely to fall. Alternatively, if long bond rates were fall by over 100 bps towards 3.50% p.a., then the SPX is likely to remain at current level or rise a little.

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