Multi Asset
Navigator
WEEKLY STRATEGY

UNIGESTION

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LET'S TWIST AGAIN Chubby Checker, 1961

Last week, despite global equities rallying 3.5%, sovereign bond yields continued to decline. Several factors explain this trend, including a "flight to quality" on the back of rising trade war tensions, lower inflation premiums generated by a declining oil price and the European authorities placing Italian debt under review. However, the most important driver remains the U-turn in the stance of central banks within just six months. For example, the RBA cut its main rates last week, following on from a cut by the New Zealand central bank in May. Importantly, both the Fed and the ECB have confirmed that the next move could be a cut and not a hike, as expected six months ago. Once again, central banks are the price makers. Should we be prepared to dance and twist again?

WHAT'S NEXT?

Managing tweets and speeches

Traditionally, portfolio managers have to track macro data, inflation expectations, the earnings outlook and the geopolitical equilibrium to allocate risk within their respective investment universes. Macro risk, market sentiment and valuation have historically been the main risk factors that drive asset returns over the short and medium term. However, since the financial crisis and the implementation of unconventional monetary policy, central bank press conferences have become key to assessing to what extent liquidity injections and lower short-term rates would continue to support risk premia. Following Trump's election, there is now a new element that needs to be considered – the US President's tweets. His messages affect both market sentiment and macro risks because any change in global trade will determine the global economic outlook.

As for policy mix, where monetary and fiscal policy aims to find a balance in the cyclicality of implemented measures, there is now a new challenge for investors – interpreting the ping-pong between Trump's tweets and Powell's speeches. The most recent Trump announcements have nearly all been negative for equity markets because they focused on higher tariffs and rising protectionism measures, while Powell's interventions have been markedly supportive for both bonds and equities.

We have analysed the speeches, press conferences and testimonies that the Fed president has given since 2018. The turn is clear. Average daily performance of the S&P 500 index on the day of the communication was negative (-0.23%) in 2018 when the Fed was focused on inflation pressures and normalisation. In 2019, when its tone shifted toward easier financial conditions to avoid policy mistakes, the average daily performance has been positive (+0.16%) on communication days. The change is similar for US 2-year interest rates. In 2018, the average change in yield was up 1bp following the communication, while in 2019 this has reversed to a fall of 3bps.

From patience to action?

The message delivered last week by Fed members has highlighted how much things have changed. While core inflation is currently well below the Fed target and uncertainty about trade war consequences are rising, the potential for a rate cut has been alluded to by different Fed members. As a result, the 2-year bond yield reached a new low at 1.84%, having stood at 3% one year ago. This fall reflects aggressive market expectations of two US rate cuts this year, in September and December, and at least two more next year.

Following this dovish communication, most of the US bond yield curve (versus 3-month Treasury bill rates) is now inversed. This means that all bond yields for maturity up to 15 years are below the 3-month Treasury bill rate. Therefore, the real 3-month Treasury bill yield is now above real long-term rates (+0.7% vs +0.5% when we use the core PCE to deflate rates). This situation rarely occurs rarely and has historically been a clear signal of upcoming recession.

However, with the Fed dot communication in March still pointing to interest rate hikes, is the current pricing too aggressive? Although the divergence is large, the trend is narrowing and the Fed is converging toward market pricing, in terms of both dot changes and communication. After communicating about patience, is time for action gone? We believe that the odds of a pre-emptive cut have risen. However, the market is currently pricing in an easing cycle, which is very different from a pre-emptive cut. Such an easing cycle only happens during recessions. While our proprietary US Nowcasters for both inflation and growth do not point to any recession risk for the time being, we think that expecting a cycle of easing soon is too optimistic. We believe that Fed could repeat the 1995 episode when it had temporarily lowered its main rates before pursuing the 1994 initiated cycle of tightening with a hike in 1997.

Beta party one more time?

Although monetary policy expectations are already high, we tend to be less cautious than previously about growth-oriented assets. Macro elements with low but stable growth and without inflation risk are still supportive. And while market sentiment is mixed, it could reverse soon if there is no escalation in trade war talk. Moreover, high risk aversion is currently offset by a lighter positioning toward equities and lower earnings expectations than historically for most equity indices. Valuation is neutral while most growth-oriented assets have already rallied.

Our main argument remains the 1995 example. Then, 2-year interest rates had declined sharply, from 7.7% to 5.5%, ahead of the Fed cut in June. And, as with today, developed equities had posted large returns in the first five months of the year. Also similar to today, emerging assets and commodities were lagging. The one difference was the trend of the trade-weighted US dollar, which was much weaker than today.

So, what happened when the Fed did cut? Developed market equities and credit spreads resumed their rally. Equities returned 15% within six months, while long-term bond yields declined further and commodities rallied. One more time, let's twist again?

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IMPORTANT INFORMATION