Current Positioning February 2024

The past month summed up

Equity gains tapered and bond yields rose as inflation came in higher than expected in the US. We don't expect the emergence from the elevated inflation/higher interest-rate environment to be straightforward — whether the economic landing proves soft or hard, the approach will have a fair amount of turbulence.

Current positioning

We are comfortable with our balanced positioning across both our equity and bond portfolios given an environment which looks stable but where sufficient uncertainty exists to argue against being too aggressive. Things can change rapidly and we are continually refreshing our research for investment opportunities set to benefit in the unfolding environment. That uncertainty means that we maintain our investments in diversified assets – such as gold – to protect our portfolios in the event conditions deteriorate.

The rationale

Our core positioning is unchanged from last month, although there has been a slight pivot in the underlying trends that we are monitoring, particularly around inflation, and this means we remain vigilant to the threats to the current benign economic environment.

Let's be clear – the US economy continues to appear in fine fettle but there are two key questions that hover in the background after the rapid rate increases of recent times. First is whether rate increases will ultimately bite on economies hard enough to knock them into recession. There is no sign of this in the US – the world's biggest economy posted growth of an annual 3.3% in the fourth quarter, well beyond the expectations of analysts. All well and good.

But maybe not. The second key question is whether inflation has been put firmly back in the box and for that the evidence has become more balanced. US Treasury Secretary Janet Yellen said in response to the GDP numbers that she didn't think they prompted any more concerns about inflation. The numbers themselves have died down from 2022 when they stood at more than 9% annually.

But policymakers are targeting an annual rate of 2% in order to achieve economic stability and we are not there yet. In fact, the US 12-month inflation figure came in at 3.1% in January. While that was down from the 3.4% in December it was higher than the 2.9% that economists had forecast, according to Bloomberg. Adding weight to inflationary concerns, the US added 353,000 jobs in January, more than double what analysts had predicted, augmenting fears that the tight labour market may push up wages and keep prices rising faster than policymakers want.

Expectations of rate cuts, not surprisingly, declined markedly, with the chance of a Fed pullback in March disappearing almost entirely while even the expectation of a May cut slid to below 50%. Larry Summers, the former US Treasury Secretary, even mooted the chance that further rate increases might be on the table. Against this background the US 10-year yield has climbed from 3.9% at the start of the year to 4.3%. On the day of the inflation announcement, the S&P 500 index slipped 1.4% – it gained just 1.6% in January after a much bigger rise of 4.4% in December.

What might be the cause of this ongoing inflationary pressure? Analysts at BCA Research believe that the decline in inflation will slow – thus far it has almost entirely come from improving supply rather than curtailing demand. With the benefits from increased supply coming to an end, bringing inflation down to 2% won't be so easy, they argue.

This then seems to point to the increased likelihood of two of the four scenarios that we identified last month. First, the consensus still seems to revolve around the Goldilocks soft-landing, where inflation is contained without any significant economic damage. The most recent Bank of America Global Fund Manager survey showed that 79% of respondents expected there would be a soft landing.

However, recent data has raised the prospects of a scenario where the economy remains strong but inflation proves more difficult to tackle. It is unclear whether this would be good news for equities – the positive economic environment for corporate earnings might be eclipsed by the fear of ongoing monetary tightening as experienced in 2022. On the bond side, it's likely to keep yields higher to keep up with those higher-for-longer interest rates.

More cracks in the banks?

Banks are important to the economy – they store our wealth, lend us money and provide an exchange between buyers and sellers. They are also viewed as a key bellwether of the economy. With the banking crisis of 2008 and last year's failure of Silicon Valley Bank still fresh in the memory, signs of stress in the banking sector might prove a portent of trouble on the horizon.

One lender in the news at the moment is New York Community Bancorp. It revealed earlier this month it had taken a hit of $185 million on two commercial property loans and had set aside $500 million to cover other potential losses. Not surprisingly its share price more than halved, while its bonds were downgraded to junk by Moody's. It's not the only bank that fears problems in the US real estate market according to the FT – Aozora Bank and Deutsche Bank have both warned about risks to their US property holdings.

Fears of a systemic problem in commercial real estate have stalked markets ever since the US regional banking scares of March last year. Commercial property in the US has suffered considerably from the after-effects of lockdown, with more people working from home than beforehand, leaving offices in the hustle and bustle of the city underutilised. Combine that with higher interest rates and it makes it more difficult for anyone who's borrowed money to invest in commercial real estate to pay back their borrowings.

It's worth repeating that you can't turn the global economy upside down for a year and a half and not expect there to be after-shocks well into the future. There remain credible risks to the current Goldilocks narrative.

Conclusion

It comes as no surprise, given the periodic ebb and flow of sentiment, that there is now more caution in markets on the back of persistent inflation, following the exuberance at the end of 2023. Central bankers are keen to remind us that the battle is not over and they will hold rates at higher levels for as long as those inflationary pressures remain.

The longer rates remain elevated, the greater the risk that something breaks in the economy, and the consequent tension is stirring markets to react excitedly to each new data point. We are looking for indications of longer-term trends, holding off for the moment on any strong directional movement, and instead retaining a sensible balance between growth and resilience.
