Rothschild & Co
Wealth Management

MARKET PERSPECTIVE | SEPTEMBER 2023

Summertime blues

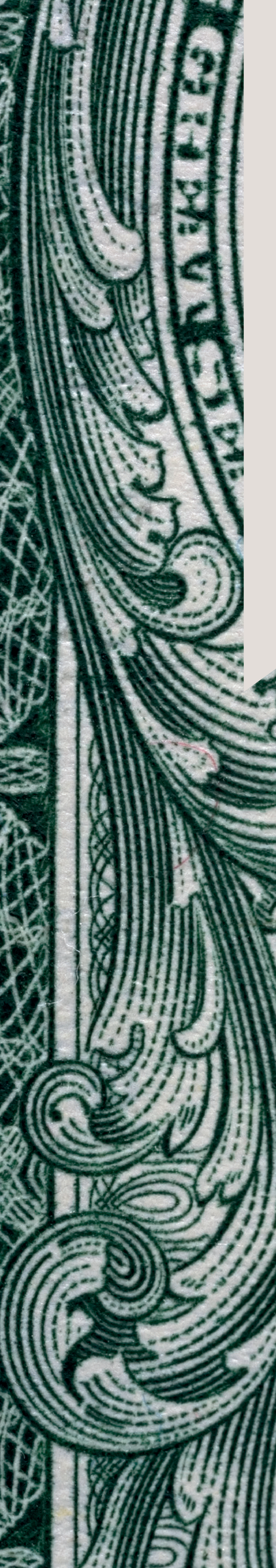

Image sources: US $1 bank note, detail © Getty Images.

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Foreword

CONTENTS

4 Summertime blues
7 Inflation update

Stocks and bonds did not have a happy August. Prices rallied a bit by month-end, but the weather wasn't the only thing that was a washout.

The main driver was a further increase in interest rates, this time at longer maturities: expectations for policy rates were little changed (and may have peaked earlier in the year). Yield curves are still inverted – long rates are lower than short rates – but by a bit less than they were. The prospective interest rate 'plateau' we have had in mind has stretched further into the future: as a colleague puts it, the question is not now 'how high?', but 'how long?'.

We try always to keep an open mind. Received economic wisdom has been hugely one-sided of late, and we mustn't forget there can be upside surprises to growth – and thence to interest rates. Indeed, the last two years may yet turn out to be a dress rehearsal for a main inflationary event that still lies ahead of us. That said, we think today's levels of short- and long-term rates are broadly appropriate – and that stocks will eventually be able to live with them.

Corporate profitability continues to trend at historically healthy levels, as we discuss below. Valuations are not stretched, and while stocks are well above their 2022 lows, we think the cyclical train has not yet left the station.

We also think that government bonds themselves are starting to offer the prospect of real wealth preservation for the first time in recent years – though yields could of course overshoot 'old normal' levels for a while. In our regular inflation update here we reiterate our long-standing view that the main direction of travel for core inflation is still downwards, albeit patchily. But we think stocks have the edge.

Kevin Gardiner / Victor Balfour / Anthony Abrahamian
Global Investment Strategists

Summertime blues

RETURN OF THE 'OLD NORMAL'

Global stocks were down 5% (USD terms) through the first half of August, paring 2023 gains. Bonds also suffered: the 10-year Treasury note returned to pre-GFC levels, pushing year-to-date nominal returns into negative territory for what would be a second consecutive year.

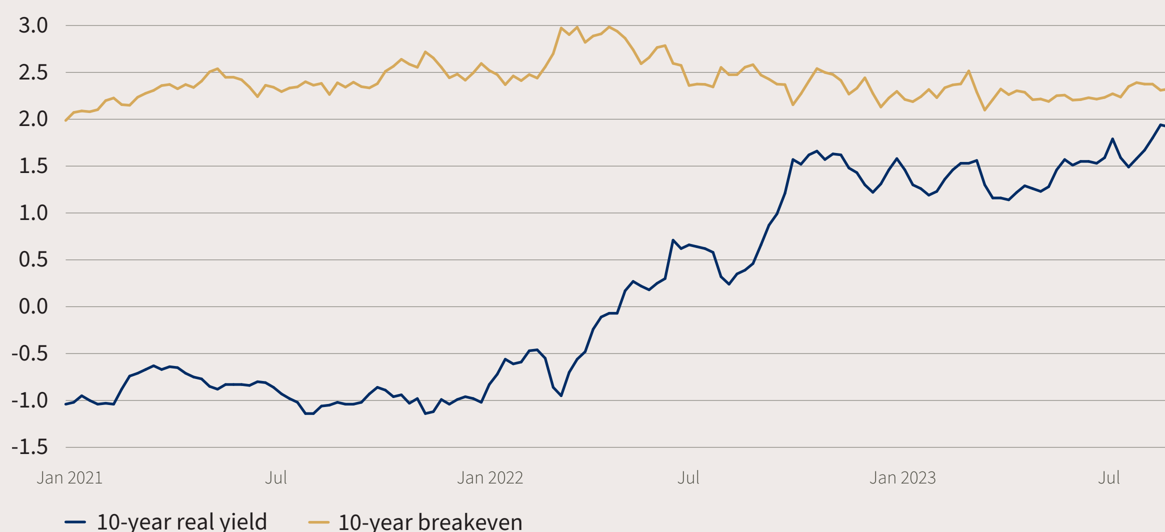
It was real yields, not inflation expectations, which were moving higher – as in 2022. Remarkably, the biggest surge in CPIs in 40 years or so continues to have little sustained impact on the 'break-even' inflation priced into bonds for the coming decade, which is only modestly elevated from end-2020 levels. Instead, there has been a reassessment of the trend real interest rates seen as necessary to contain it.

10-year real yields in the US (figure 1), and in the UK if we adjust for the different (RPI) inflation benchmark, are now almost 2% (from a *negative* 1% at end-2020). This is close to what we think of as the two economies' likely trend rates of GDP growth and has pushed nominal yields further into what we think of as 'old normal' territory (4–5%). Real yields for German and French 10-year government bonds, however, have risen less markedly recently, remaining almost a percentage point or so below the eurozone's likely trend growth, and nominal yields there have not yet convincingly regained 'old normal' levels (3–4%).

The latest moves have coincided with news that economies are (again) not as fragile as feared, notwithstanding ongoing weakness in 'soft' survey data (where poor summer weather in much of Europe may be affecting services in particular).

FIGURE 1: US 10-YEAR BOND DECOMPOSED

Real yield and break-even inflation (%)



Source: Rothschild & Co, Bloomberg

VISIONS AND REVISIONS...

US hard data have led the way. Estimates of current-quarter annualised GDP growth are currently above 5% – not bad for an economy supposedly on the brink of a meaningful recession since early 2022 – driven by consumers whose finances are not especially stretched, whose real wages are growing again, and whose reported confidence may have bottomed out.

UK data have surprised too – not because growth is strong, but because expectations have been so persistently downbeat, and because the official statisticians have acknowledged that they have probably been under-recording output (and this may not be the last word). But even eurozone GDP has been a decimal point or two bigger than expected (and has also seen some modest upward revision – which here too may not be the last word). And in both the UK and eurozone, real wages are likely growing again, as in the US.

However, short-term growth surprises would usually translate into higher expected short-term interest rates, not bigger longer-dated yields. Most economists remain glum about longer-term prospects (for little good reason, as we often note, but that's another matter). Indeed, most pundits faced with short-term good news respond by marking down their longer-term forecasts. And while we are less surprised by recent resilience – we have long argued that a significant economic downturn is neither necessary nor likely – we are surely still not out of the cyclical woods just yet.

MONETARY LAGS: LONG, VARIABLE – AND USELESS?

The lags between changes in policy rates and economic activity are famously 'long and variable'. If the big monetary hit is in reality still ahead of us, as much received wisdom is wont to believe, a more pronounced weakening in US growth in particular – and a few more financial accidents at least – may still lie in store later this year. If so, we'd suggest that in such a case, those lags will be so long and variable as to make the attempted cyclical fine-tuning of interest rates a futile pursuit. Put bluntly, monetary policy may not be fit for purpose, a point to which we will return.

But if it's not yet longer-term growth prospects which are driving longer-term real yields higher, what might it be? Maybe central banks, having worked hard to regain some credibility, have somehow stumbled on the 'right' level of long-term rates, and in pushing short-term rates up to those levels, have crept a little 'ahead of the curve', which is now catching up with them?

REAL YIELDS AND THE GRAVITATIONAL PULL OF CORPORATE PROFITABILITY

Most likely, perhaps, we are simply in the middle of an ongoing reappraisal of value in a bond market which has been so distorted (most visibly by central bank purchases, now being unwound) for so long. The arguments for a permanently lower 'equilibrium' interest rate (often termed 'r-star') have always looked dubious, and as the distortions are removed, economic gravity may be reasserting itself.

Higher trend economic growth would be one possible source of such gravitational attraction, but as noted, the jury is still out on that. Another gravitational pull, however, may come from a source which is already well-established in today's data – namely, corporate profitability.

There are no completely convincing theories of why interest rates are where they are, why the supply and demand of loanable funds should be what it is. But in some loose, underlying sense, the return on productive capital may have something to do with it.

In this model, the productivity of business assets shapes a so-called 'production frontier' which traces how today's worth can be transformed into tomorrow's – the rate of 'value added'. A tangency between that convex frontier and our collective 'time preference' – the rate at which we subconsciously discount an uncertain future – is where interest rates are determined.

Put bluntly, if business assets deliver sustainably high real returns, shouldn't loanable funds do the same? Some adjustment for risk would be needed, but arguably they ought to be travelling in the same direction over time.

Figure 2 shows US return on equity (RoE) – corporate earnings as a proportion of the book value of shareholders' funds – alongside 10-year bond yields, both net of contemporary year-on-year CPI inflation. For three decades now, profitability as measured by this real RoE has trended around double-digit levels (11%, to be precise) while this measure of real bond yields has drifted steadily lower. Of course, not all of that decline can be attributed to central bank purchases; but there have been other non-economic flows at work for much of the time, including liability-driven investing, China's current account surplus and some slowing in perceived trend growth.

The gap is now narrowing. For some, this could be troubling: if that corporate profitability was only robust *because* those real yields were falling, then it may now falter. But if profitability is driven independently, by such things as the ever-evolving product cycle (with increasingly intangible output requiring similarly intangible balance sheets), innovation and (far-fetched though it may sound) active corporate management, then it needn't.

A generation of pundits has got US corporate profitability wrong, expecting it to 'mean revert' for the last three business cycles at least. What if it remains healthy, and instead exerts a gravitational pull upwards on those low yields? What if this is the mean to which it has reverted after the value-destroying 1970s?

INVESTMENT CONCLUSION

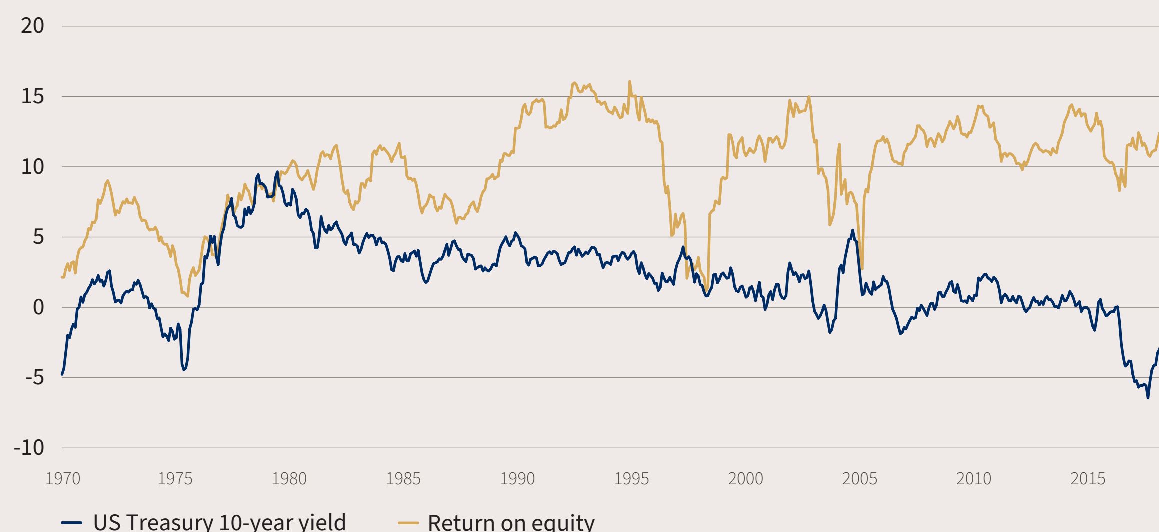
Whatever their drivers, today's bond yields are still unremarkable in historic terms: it would be foolish to draw any 'lines in the sand' just yet. Having undershot any measure of fair value in recent years, yields could easily now overshoot for a while. But value is returning, and more bonds are offering plausibly positive real yields.

Stocks are not expensive, and (we think) can live with a US note yield of 4–5%. Just as bond yields can overshoot, stock price-to-earnings (PE) ratios can easily undershoot, and as the longer-duration asset stocks will usually be most volatile. And those higher bond yields increasingly offer stiffer competition as investments.

Nonetheless, that potential equity volatility cuts both ways – and that healthy trend in RoE suggests that not all of the last thirty years' valuation uplift has been attributable to lower interest rates. We don't think the cyclical, risk-on train has yet left the station, and we want to be firmly on board when it does leave. Looking through the summertime blues, we think a mix of contained inflation, economic resilience and sustained corporate profitability will eventually favour stocks most.

FIGURE 2: THE GRAVITATIONAL PULL OF CORPORATE PROFITABILITY?

US RoE and 10-year bond yield: inflation-adjusted (%)



Source: Rothschild & Co, MSCI, Bloomberg

Inflation update

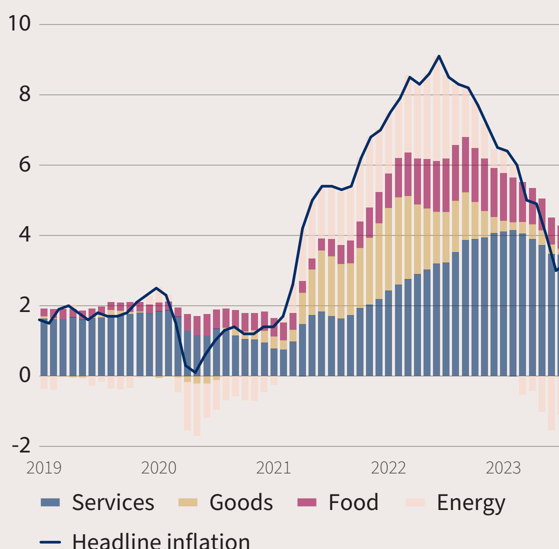
Headline inflation rates have fallen meaningfully over the course of this year, though core inflation – which excludes food and energy – has proven to be more stubborn, particularly in Europe.

US

The US inflation backdrop has arguably looked the most encouraging. Headline inflation declined to 3.2% in year-on-year terms in July, while core inflation has been falling since September last year, currently at 4.7%. In fact, three of the four major headline CPI categories – food, energy and goods – registered a net contribution of just below zero in July (figure 3). Energy deflation may reverse later this year, with favourable base effects abating – oil prices started their sharp decline in June 2022 – but it is unlikely to turn into a significant upside risk, as oil remains well below last year's highs.

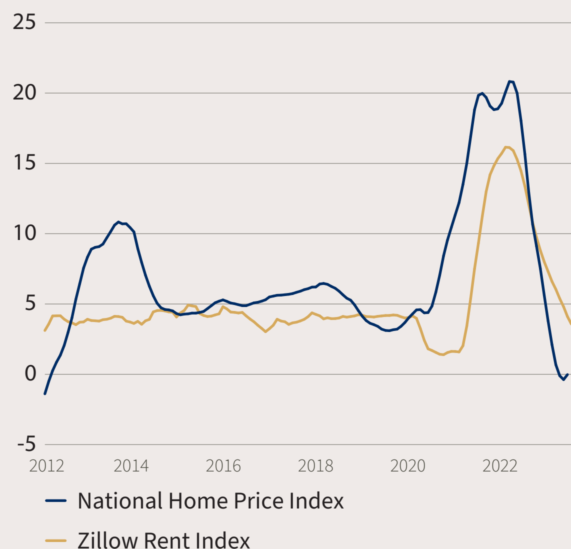
Instead, the services category has been the main driver of headline (and core) inflation in recent months. Services inflation accounts for almost 60% of the entire CPI basket, with shelter – a gauge of housing and rental costs – accounting for the majority of that. Shelter inflation has only rolled over modestly so far, but it tends to lag house price and rental cost developments due to measurement differences: the CPI metric captures average costs across the housing stock over the past twelve months, rather than the cost of the latest month's transactions alone. US house price growth has turned negative, while rental cost growth has returned to pre-pandemic rates (figure 4), and so shelter – and services – inflation should continue to abate over the rest of this year.

FIGURE 3: US HEADLINE INFLATION RATE DECOMPOSED
Year-on-year contributions (%)



Source: Rothschild & Co, Bloomberg, US Bureau of Labor Statistics

FIGURE 4: US PROPERTY AND RENTAL PRICE GROWTH
Year-on-year (%)



Source: Rothschild & Co, Bloomberg, S&P/Case-Shiller, Zillow Inc

EUROPE

Europe's inflation dynamics appear stickier, with core inflation yet to definitively peak in the eurozone and UK (figure 5).

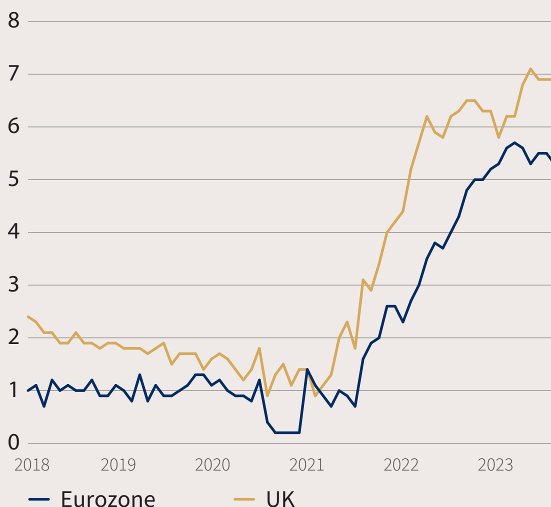
Promisingly, headline inflation rates have fallen sharply, halving to 5.3% in the eurozone and declining to 6.8% in the UK. This has mostly been driven by energy deflation: government energy price caps have continued to move lower amid the collapse in wholesale natural gas prices. Food inflation – the other distinct headline component – has also started to turn lower and should continue to move in that direction over the rest of this year. Wholesale global food prices are more than 20% below last year's high, according to the UN Food and Agriculture Organization.

That said, both goods and services CPI rates remain stickier. The former has moved slightly lower, though more definitively in the eurozone than the UK, amid falling production costs for manufacturers and easing global supply chain stress. More concerningly, services inflation is yet to peak in both the UK and eurozone, likely due to above-trend nominal wage growth.

UK wage dynamics continue to look the most troubling: regular pay growth is still rising in nominal terms, and real (inflation-adjusted) wage growth should turn positive this year (figure 6). But a more dangerous 1970s-style wage-price spiral still seems unlikely to us: labour markets have structurally changed since then – unionisation rates are far lower today, for instance – and most of the ongoing boost to pay growth may reflect timing (wage settlements may have taken a while to be implemented).

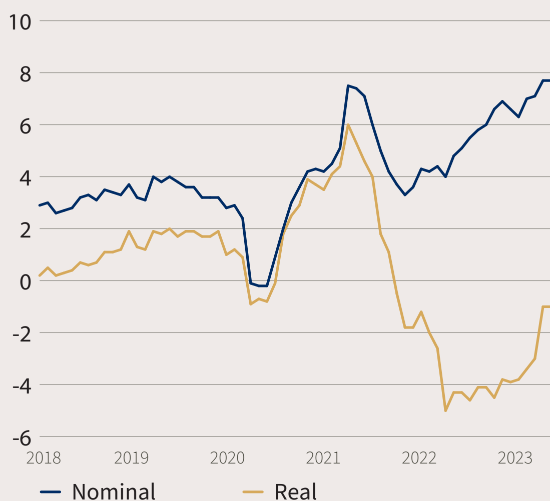
Promisingly, headline inflation rates have fallen sharply, halving to 5.3% in the eurozone and declining to 6.8% in the UK

FIGURE 5: EUROPEAN CORE INFLATION RATES
Year-on-year (%)



Source: Rothschild & Co, Bloomberg, Eurostat, UK Office for National Statistics

FIGURE 6: UK REGULAR PAY GROWTH
Year-on-year (%)



Source: Rothschild & Co, Bloomberg, UK Office for National Statistics
Note: Real wage growth is nominal wage growth minus headline inflation rate.

EMERGING MARKETS

China's inflation backdrop has also been in focus, after the headline rate unusually dipped into deflation territory in July, to -0.3% in year-on-year terms (figure 7). Even so, deflation does not mean a collapse in domestic demand – instead, the culprit was a sharp decline in food prices. Core inflation actually rose in July, while the producer price index (PPI) rate has also tentatively bottomed out.

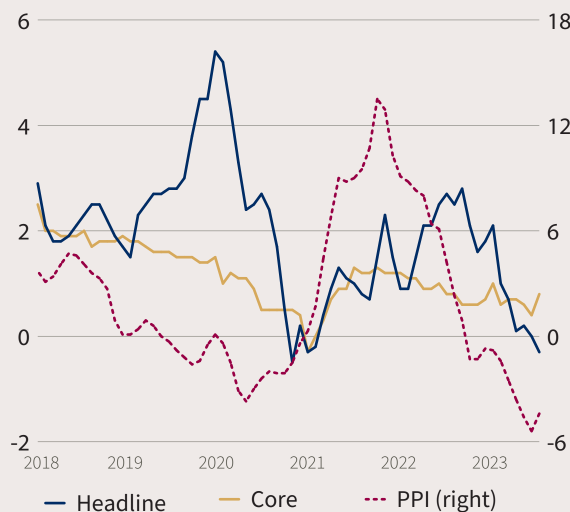
In the broader emerging markets space, headline inflation rates have been much higher: our GDP-weighted aggregate[1] rose above 7% in July (although it was still 3.5 percentage points below last year's high). Yet inflation cycles have varied widely across regions, which can partly be explained by differing staple diets – developing countries' inflation rates tend to be highly sensitive to food prices – with relatively muted inflation figures in countries that primarily eat rice, compared to more elevated readings in those that mostly consume wheat. Thai rice prices have sharply risen this year, however, and so there may be renewed price pressures in some of the emerging Asia nations (figure 8).

[1] Our EM headline inflation rate combines data from China, India, Indonesia, Korea, Malaysia, Philippines, Taiwan, Thailand, Vietnam, Czech Republic, Egypt, Greece, Hungary, Poland, Russia, South Africa, Turkey, Argentina, Brazil, Chile, Colombia and Mexico.

CONCLUSION

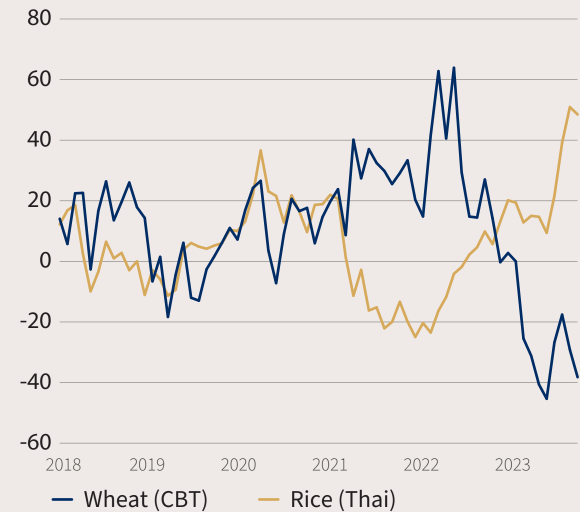
We continue to think inflation will move lower over the next twelve months, eventually settling in the above-trend 2–4% range. Core inflation will probably abate more gradually, amid strong wage growth dynamics. As a result, central banks may need to retain their 'higher for longer' stance beyond what is being discounted by money markets.

FIGURE 7: CHINA INFLATION RATES
Year-on-year (%)



Source: Rothschild & Co, Bloomberg, National Bureau of Statistics of China

FIGURE 8: RICE AND WHEAT PRICE GROWTH
Year-on-year (%)



Source: Rothschild & Co, Bloomberg, Chicago Board of Trade, Thailand Rice Exporters Association

Economy and markets: background

GROWTH: MAJOR ECONOMIES

Business optimism: standard deviations from trend

Source: Bloomberg, Rothschild & Co
Composite of the forward-looking components of manufacturing surveys from China, Germany, Japan, UK and US loosely weighted by GDP

G7 INFLATION

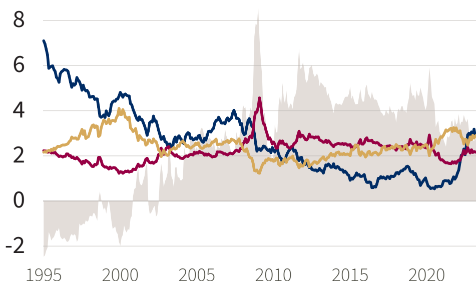
Year-on-year, %

Source: OECD, Bloomberg, Rothschild & Co

STOCKS/BONDS — RELATIVE RETURN INDEX (%)

Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

STOCKS/BONDS — RELATIVE VALUATIONS



- Government bonds: redemption yield (%)
- Developed stocks: price/book ratio
- Developed stocks: dividend yield (%)
- Developed stocks: earnings yield – bond yield

Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

SELECTED BONDS

Current yields, recent local currency returns

	YIELD (%)	1YR (%)	3YR (%)
10-yr US Treasury	4.3	-3.7	-19.2
10-yr UK Gilt	4.5	-7.0	-23.2
10-yr German bund	2.7	-6.1	-19.8
10-yr Swiss Govt. bond	1.0	0.0	-9.1
10-yr Japanese Govt. bond	0.7	-1.9	-3.0
Global credit: investment grade (USD)	4.1	0.4	-9.7
Global credit: high yield (USD)	9.2	8.4	1.8
Emerging (USD)	7.8	4.1	-12.2

Source: Bloomberg, Rothschild & Co

SELECTED STOCK MARKETS

Dividend yields, recent local currency returns (MSCI indices)

	YIELD (%)	1YR (%)	3YR (%)
World: all countries	2.1	14.2	30.0
Developed	2.0	15.3	34.1
Emerging	2.8	5.3	2.9
US	1.5	15.6	32.8
Eurozone	3.3	19.2	33.8
UK	4.2	5.0	46.2
Switzerland	3.1	2.3	11.3
Japan	2.2	26.7	58.1

Source: Bloomberg, Rothschild & Co

SELECTED EXCHANGE RATES

Trade-weighted indices, nominal (2000 = 100)

	LEVEL	1YR (%)	3YR (%)
US Dollar (USD)	118	-0.7	7.2
Euro (EUR)	134	8.9	2.3
Yen (JPY)	73	-2.2	-23.4
Pound Sterling (GBP)	84	6.1	6.0
Swiss Franc (CHF)	190	6.3	13.2
Chinese Yuan (CNY)	138	-5.5	5.1

Source: Bloomberg, Rothschild & Co

COMMODITIES AND VOLATILITY

	LEVEL	1YR (%)	3YR (%)
CRB spot index (1994 = 100)	285	0.7	90.2
Brent crude oil ($/b)	91	-2.4	112.4
Gold ($/oz.)	1,920	12.8	-0.7
Industrial metals (1991 = 100)	322	0.7	26.8
Implied stock volatility: VIX (%)	14	-46.3	-53.0
Implied bond volatility: MOVE (bps)	111	-16.6	136.6

Source: Bloomberg, Rothschild & Co

Data correct as of 31 August 2023.

Past performance should not be taken as a guide to future performance.

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