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MARKET PERSPECTIVE | NOVEMBER 2023

Disinflation *and* growth

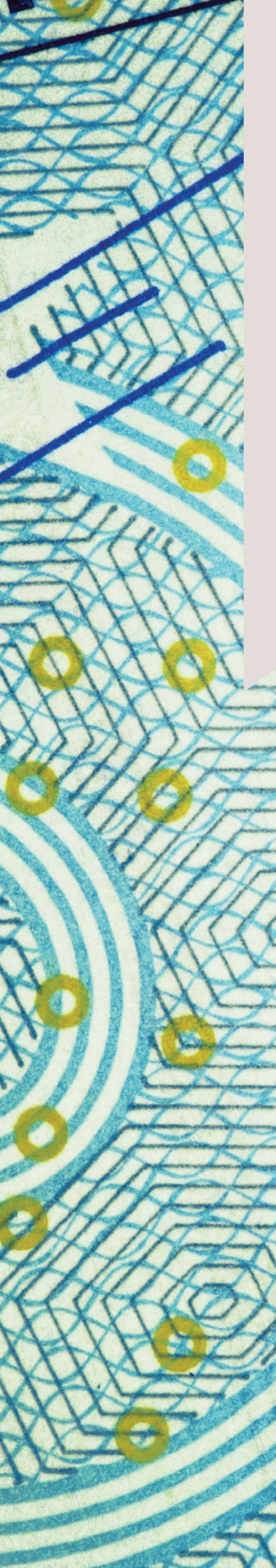

Image sources: €50 bank note, detail © Getty Images.

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Foreword

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Dreadful events can affect global markets, but they may not. The business cycle, in contrast, certainly will.

If the world has suddenly become more dangerous, then safe haven assets are now more attractive. If the supply of oil is about to be disrupted, then we face another supply shock.

But it's not yet clear what, other than human misery, the crisis in the Middle East signifies. The only certainty is that nobody, not even the most learned historian or military strategist, knows. So far, the movements in bonds, gold, flight currencies, option prices – and on the potential downside, stocks – are unremarkable. Indeed, bond prices have actually fallen.

Meanwhile, the business cycle rolls on.

The latest macro data continue to paint a picture of ongoing disinflation alongside economic resilience. We still think a more dramatic downturn is neither necessary nor likely.

This suggests that interest rates may not be rising much further, but also that they are unlikely to start to fall quickly. The 'plateau' profile we have had in mind for interest rates is increasingly reflected in money and bond curves. It also suggests corporate profitability may remain healthy.

We have seen this economic climate as favouring stocks more than bonds, though it's arguably a closer call now than for many years: bonds are no longer expensive. The conflict could change that, but we don't think it has done so yet.

We set out our view of the evolving inflation and interest rate pictures below. Plus, we address the theme of our recent Investment Conference, namely: why is macro received wisdom so biased, and what can investors do about that?

Kevin Gardiner / Victor Balfour / Anthony Abrahamian
Global Investment Strategists

Resilience continues

ECONOMIES HAVE NOT SLUMPED

As we write, it looks as if the two biggest economies in the world grew at an annualised pace of around 5% in the last quarter. This is not unusual for China, though its real estate slump, stop-go virus management and the slow return of trend growth to more earthbound dimensions mean that the risk of disappointment has been rising.

But for the United States, supposedly on the brink of recession since the spring of 2022, it is unusual. The US economy often beats expectations, but not to this extent.

The rest of the world – most notably, Europe – looks less robust. The eurozone, and Germany within it, has likely been in technical recession (consecutive quarters of declining GDP). But the cumulative decline is small compared with the more dramatic pronouncements made for most of the last year and a half.

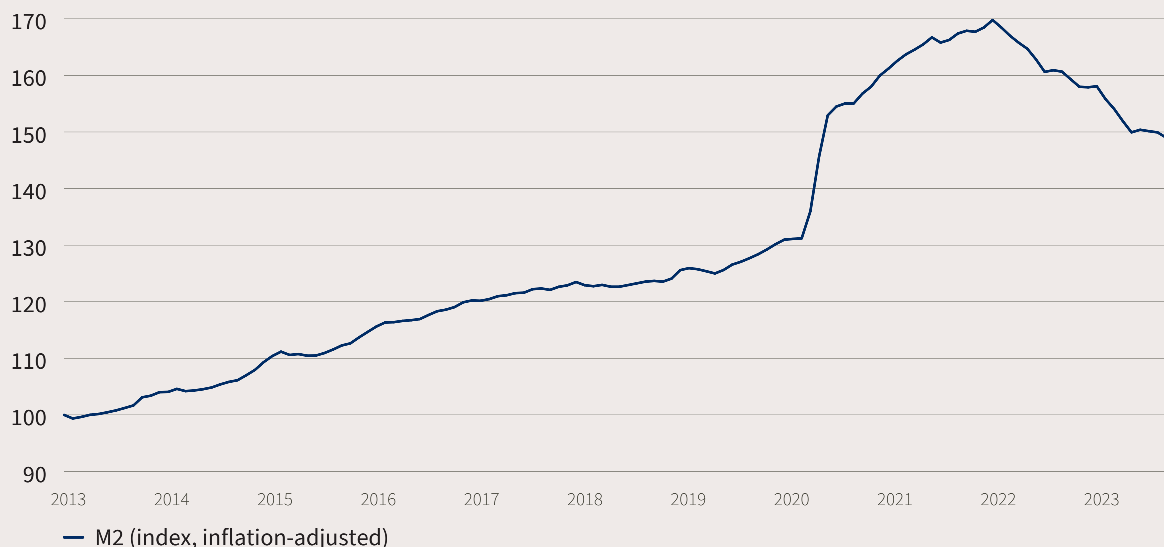
The UK has avoided even a technical recession as yet (with its statisticians revising the starting point favourably – not a surprise to our readers), despite an even louder chorus of economic gloom. Japan seems likely to have fared worse, as it often has in recent years, but after a remarkable 6% annualised surge in the previous quarter.

Having dodged a widely predicted slump for a year and a half, you might think the global economy would win some plaudits for resilience, and perhaps a more balanced prognosis from a chastened consensus. Not a chance.

To be fair, a remarkably strong quarter does often segue into a weaker one. The US economy may now be poised to give something back in the fourth quarter, just as Japan's economy did in the third. And the events in the Middle East pose a clear threat to energy costs, corporate capital spending and portfolio investment.

FIGURE 1: US MONEY SUPPLY STILL MORE THAN ADEQUATE

100 = January 2013



Source: Datastream, Rothschild & Co

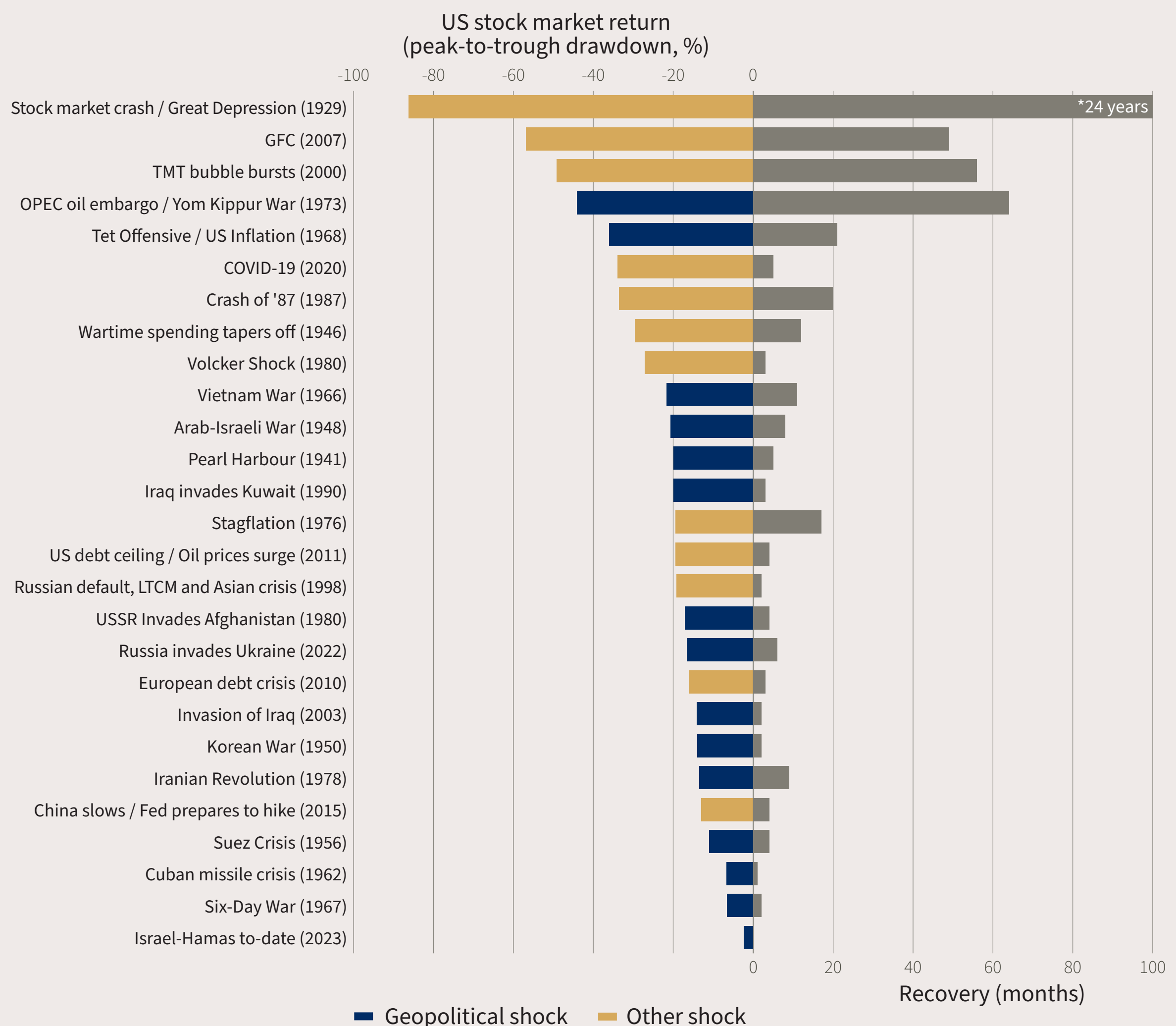
As yet, however, forward-looking indicators such as the widely followed purchasing managers' indices, including the bellwether US manufacturing ISM, continue to point to economic softness, not collapse.

Meanwhile, real wages are growing again on both sides of the Atlantic. The earlier spikes in energy bills and other supply-constrained costs have faded. Nominal pay continues to grow at a faster pace than usual, though not sufficiently fast to raise the spectre of 1970s-type wage-price spirals. Indeed, the US labour market has been remarkably passive, even as unemployment has stayed low.

And this cycle – unlike the 2000s – has not been characterised by private sector financial excess. There are no major binges to unwind. The surge in liquidity which fuelled the demand-led component of inflation was led by money creation, not demand for credit. Incidentally, the falling US money supply (M2), which is alarming some monetarists, has to be viewed with that earlier surge in mind (figure 1 on page 4).

As far as geopolitical risk is concerned, we've noted often how even the most troubling regional conflicts can leave global trade, discount rates and stock markets unaffected – figure 2 offers a reminder. Today's worst case is all too easy to imagine, but there are less destructive scenarios to consider too.

FIGURE 2: US STOCK MARKET DECLINES AFTER SELECTED EVENTS



Source: Bloomberg, Rothschild & Co
Note: Stock returns are prices only, in nominal terms.

The full effects of higher interest rates have yet to make themselves felt of course. For this reason alone we would not be out of the cyclical woods just yet, even if we could somehow set geopolitics aside. But it's possible that history and the textbooks are both overstating the likely impact of monetary policy.

Yes, this has been the most dramatic tightening since the 1970s, with US policy rates rising by five percentage points in eighteen months. But the starting point was a very loose one (nominal rates at record lows, nominal M2 having surged by a third), and ex post real rates even now are not high. Meanwhile, the pass-through from policy rates to mortgages and corporate borrowing can be slow and incomplete.

We would not be surprised if the global economy were able to 'muddle through' this episode, as it so often does in other contexts. Economies don't have to go into reverse to bring inflation down, they just need a bigger margin of spare capacity. Such an outcome – disinflation without slump – would not be a bad one for portfolios.

Spare a thought though for our unfortunate central banks. If the lags which characterise the transmission of monetary policy are so 'long and flexible' as to leave the global economy seemingly unfazed after almost two years, can that policy – even when implemented sensibly – be fit for purpose?

Arguably, the hunt for more convincing monetary management should be underway now. But, the answer to today's monetary question is surely not more active fiscal policy.

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Inflation update

Headline inflation rates in the developed world have broadly edged lower since our last *Market Perspective*, and have now more than halved from their peak (figure 3). Meanwhile, core inflation rates, which exclude the more volatile food and energy components, have finally turned lower too.

The latest developments across the four major Consumer Price Index (CPI) categories – food, energy, goods and services – have been mostly promising.

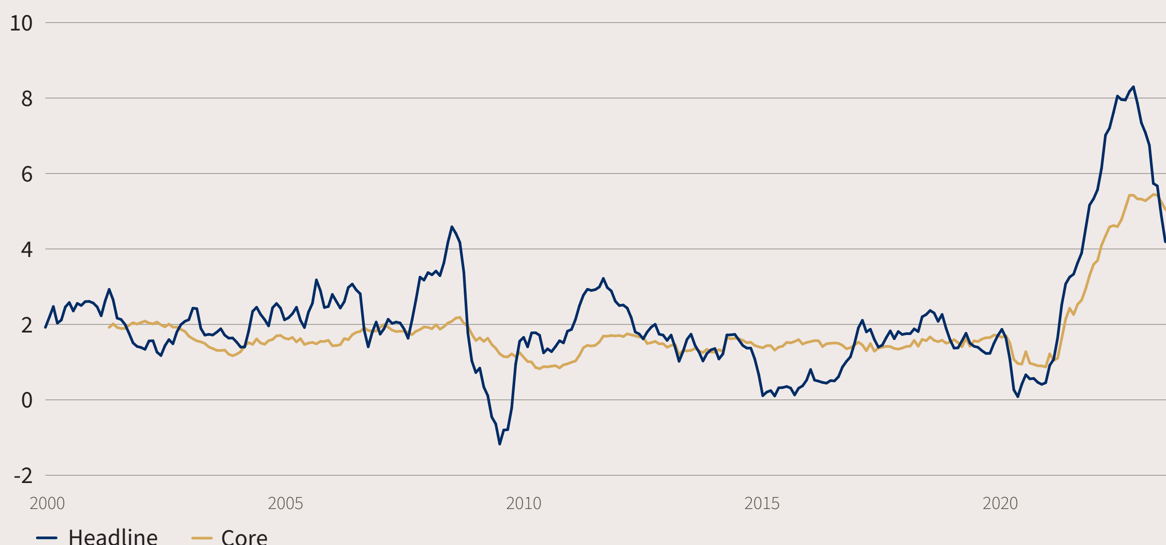
FOOD AND ENERGY CPI

To start with, both food and energy-related CPI inflation have fallen meaningfully over the course of this year, with the latter in *deflation* territory – prices not just slowing but falling – across the US and Europe.

Energy prices, however, have rebounded in recent months. Oil prices have increased by roughly a quarter from this year's low, while European wholesale natural gas prices have more than doubled since June. Events in the Middle East have been nudging prices a little higher, but they have not yet reached – or approached – new cycle highs. Instead, oil prices currently are 30% below last year's peak and natural gas prices are 85% below their high (figure 4). Importantly, government-imposed energy price caps in Europe – which shape the prices paid by many consumers – should fall during winter.

FIGURE 3: DEVELOPED MARKET INFLATION RATES

Year-on-year (%)



Source: Rothschild & Co, Bloomberg
Note: Developed market series is a GDP-weighted average of US, Canada, Eurozone, UK, Switzerland, Denmark, Norway, Australia, Japan, New Zealand and Singapore data.

Meanwhile, food prices at the wholesale level have continued to fall with the UN Food and Agriculture Organisation's World Food Price Index now roughly a quarter below March 2022's high. There tends to be a strong, albeit lagged, correlation between changes in wholesale food prices and the prices on supermarket shelves – with processing, transportation and other costs also affecting the latter. But food price inflation has been fading for a while in the US and has also definitively peaked in Europe (figure 5). This downward trend should continue over the rest of this year, given the trajectory for wholesale food prices.

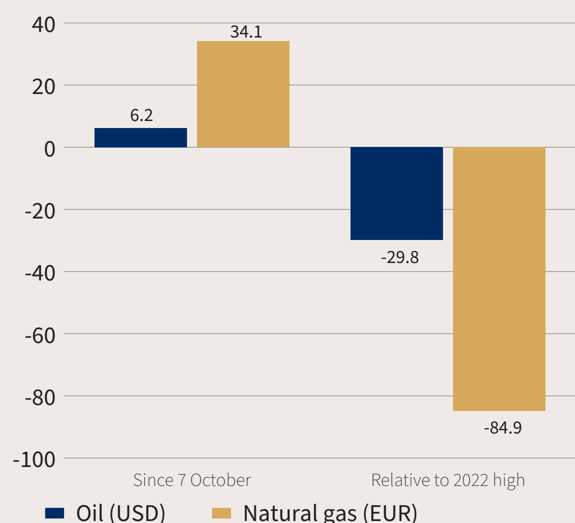
GOODS CPI

Goods-related CPI inflation has also cooled on both sides of the Atlantic, with supply chain conditions loosening considerably following China's relaxation of COVID restrictions at the end of last year. Of course, further disruptions to global supply chains are possible, particularly with a tense geopolitical backdrop. But the impact is unlikely to be *that* large, so long as the conflict remains largely regional, and provided China – the central node in the global manufacturing network – stays open for business and US–China trade tensions remain in abeyance.

SERVICES CPI

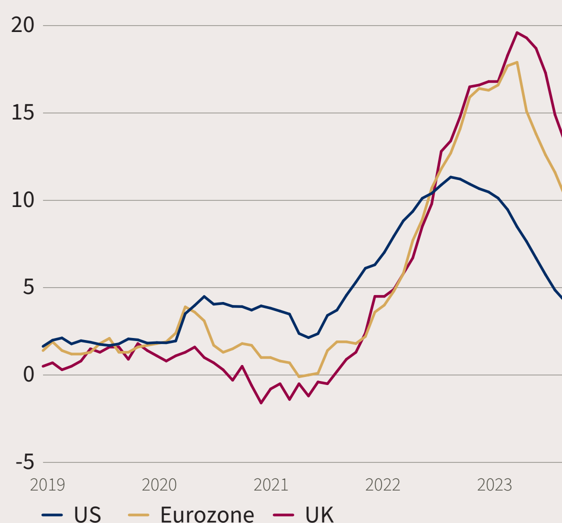
Services CPI inflation has been the stickiest component of the inflation equation, and is arguably the most important, given its bigger weight. It has only tentatively peaked across the US and Europe, against a backdrop of elevated nominal wage growth. Recently, real (inflation-adjusted) wage growth rates have subsequently turned positive, with wage growth now outpacing headline inflation. But we doubt that these gains will push unit wage costs – pay adjusted for productivity – into more inflationary territory, and still feel that the likelihood of a more troubling 1970s-style wage-price spiral remains low.

FIGURE 4: ENERGY PRICES
Price change (%)



Source: Rothschild & Co, Bloomberg

FIGURE 5: FOOD CPI INFLATION RATES
Year-on-year (%)



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

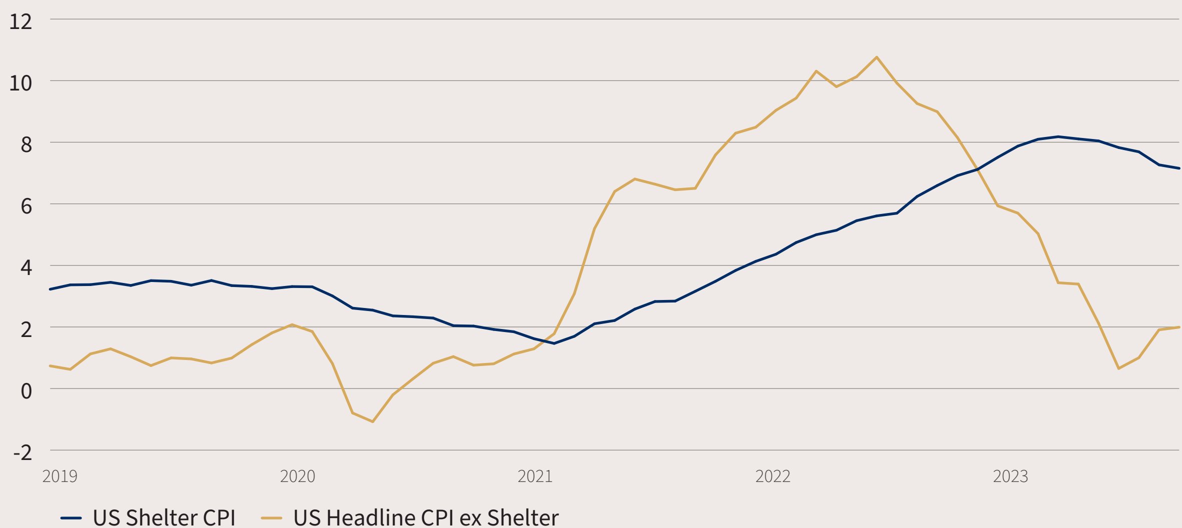
Within services, it's worth noting that US shelter inflation, a gauge for housing and rental costs, is the largest contributor to the overall US inflation rate. Excluding shelter, US inflation has already returned to its 2% target (figure 6). The shelter component accounts for more than one-third of the entire CPI basket, and is still elevated as weaker house prices have yet to feed through to the CPI metric (there tends to be a one-year lag). Given that house price and rental cost growth have slowed over the past eighteen months, we should also see US shelter inflation cool more meaningfully in the coming months.

CONCLUSION

Core inflation rates should decelerate further over the rest of this year and into 2024, though there may be some renewed pressure on headline rates given the partial rebound in energy prices. We still think core and headline inflation, in both the US and Europe, will settle in an above-target 2–4% range in the medium term, amid elevated (but not escalating) wage growth.

Core inflation rates should decelerate further over the rest of this year and into 2024, though there may be some renewed pressure on headline rates given the partial rebound in energy prices.

FIGURE 6: US SHELTER INFLATION DYNAMICS
Year-on-year (%)



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

How recency bias affects interest rate expectations

We all have intellectual and behavioural biases[1] that subconsciously help us rationalise and explain things. We may rely most on information which supports our own prior beliefs, or we might distil a confluence of unrelated and complex events into a neatly plausible – but mistaken – narrative.

[1] 'Uncovering behavioural biases when investing', Rothschild and Co Wealth Management, 11 October 2023

Such biases shape our economic perceptions too – and potentially, our investment decision-making. As analysts, we have to guard against them and remain objective.

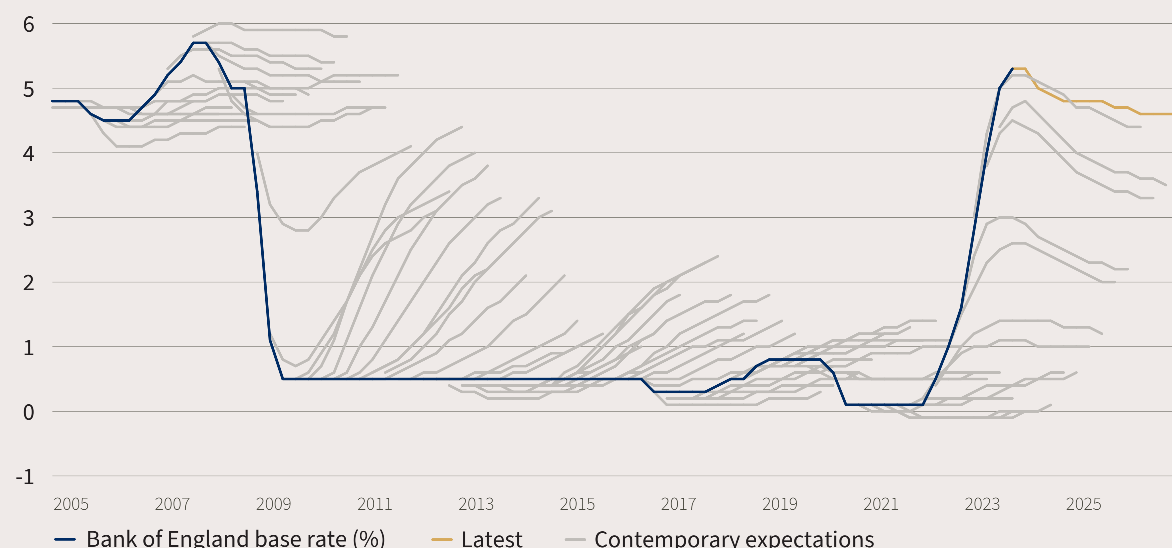
A particularly topical bias concerns how we might perceive inflation and interest rates. Recent experience can be a powerful driver of future expectations. This 'recency bias' results in us simply assuming that future events will resemble recent history. In 2021, for example, it might have led us to believe that an inflation rate exactly at or below target is typical. We might have said the same about near-zero – or even negative – interest rates.

Policymakers may not have been immune to such bias. In many of their speeches and articles they seem to have been extrapolating a relatively recent past and projecting it into the future.

Recency bias can be seen clearly in the evolution of expectations embedded with the interest rate curve (figure 7). The 'porcupine' chart shows how such expectations were steadily reluctant to stray far from then-current levels – initially downwards, and then, for several years, they were slow to recognise more significant upside risk.

FIGURE 7: INTEREST RATE EXPECTATIONS – A CASE OF RECENCY BIAS?

UK base rate and market implied policy rates (3-month OIS)



Source: Rothschild & Co, Bloomberg, Bank of England

Today, policymakers and money markets seem to have finally caught up with what we consider to be reality (although we could ourselves be mistaken, of course). An interest rate plateau – the 'higher for longer' outlook – has moved into focus, with bond markets also starting to digest this change in regime (as longer dated yields edge higher). This is happening with rates and yields now close to what we have seen as 'fair value' all along.

There is a big subjective component to inflation itself. Actual inflation depends, in part, on what we expect it to be, because those expectations can shape our wage bargaining and price-taking behaviour. The painful 1970s 'stagflationary' decade serves as a potent reminder of what happens when inflation expectations become self-fulfilling. The economic pain then was acute and indiscriminate – and equally miserable for investors.

There are unsettling echoes today – war, unstable oil prices and industrial action. But the reality is that a longer period (three decades) of relatively benign inflation – mostly in the 1–3% range – has served to keep the 'breakeven' inflation expectations priced into inflation-linked bond markets well contained. Even when some inflation rates reached double digits, local bond markets only expected a relatively subdued 4% average inflation rate over the next 10 years. Today, developed world breakeven rates have faded back to 2%.

This contrasts with those expected money rates, where more recent trends seem to have anchored expectations, ultimately mistakenly. We doubt that US and European inflation will return fully and quickly to 2% targets, but when the cyclical dust settles, we think it will turn out to be interest rates which have travelled furthest from their low trends, not inflation. For us, the big surprise was that interest rates were so low for so long.

Central banks have now acted vigorously to contain the inflationary surge (and, we think, largely validate those stable bond market breakeven expectations). But for a while at least, it seemed as if policymakers were deliberately fostering higher inflation. Supposedly dispassionate central bankers were likely exhibiting their own cognitive biases – and not just recency bias. Even the smartest people are not immune from groupthink and herding.

Today, policymakers and money markets seem to have finally caught up with what we consider to be reality (although we could ourselves be mistaken, of course).

Macro groupthink – and what to do about

Recency bias and anchoring issues are two specific sources of bias in expectations. We think there is a more general, pervasive distortion to the macro debate, and have written often about a 'wall of worry'. This wider, overly pessimistic view is particularly visible in the UK, where this last year it has felt as if the public economic mood has been one of barely suppressed hysteria.

THE ECHO CHAMBER

That wall of worry is not foisted on a hapless population by a single manipulative agent, but is created by the reverberating voices of three key actors – the media, establishment groupthink, and ourselves. Problems are amplified and distorted out of all proportion in the resultant echo chamber.

The **media** makes news like manufacturers make widgets. It is ruthlessly efficient at selling advertising space, and to do this it relies on sensationalism and an avoidance of perspective. If nothing happens today, tomorrow's papers will still be full (and unaccountable). Social media has added another degree of urgency.

There is widespread **groupthink:** an established wisdom shared across the political piste by central banks, Treasuries, international NGOs, economics faculties and City economists. This established view is overwhelmingly Keynesian, Malthusian and declinist. It sees balance sheets as having only liabilities. It confuses demography with dependency, and inequality with poverty. It believes that productivity growth is finished, but also that Artificial Intelligence (AI) will destroy jobs. Here in the UK it sees Brexit as a disaster rather than a manageable mistake. This sort of groupthink may have been with us for some time.

Nothing is as quotable as a prediction of imminent doom, yet this received wisdom's long-term track record has been poor. While we have been reading about the global economy lurching from one crisis to another, collective living standards have trended higher. The average human has never been better off in material terms.

"On what principle is it that with nothing but improvement behind us, we are to expect nothing but deterioration before us?"
– Macauley, 1830

Collectively, we are also contributors to the noise. The **human condition** is such as to make us receptive to sensation. Perhaps because the probability distribution of outcomes for each of us is skewed to the left, we tend to worry more about losses than we relish gains, and we talk of the 'diminishing marginal utility' of wealth.

In other words, we get the media and intelligentsia we deserve.

A YEAR OF LIVING DANGEROUSLY

The echo chamber has been especially resonant since early 2022, particularly here in the UK (where there is a tendency towards almost Dickensian breast-beating over the economy). There have been good reasons for global concern: Russia's invasion of Ukraine, the energy squeeze and cost of living crisis, rising interest rates. But the noise has been out of proportion to the macroeconomic damage done, at least so far.

For example, the surge in energy costs hit poorer households and small businesses hard, but even as governments were costing their support measures, and predictions of recession became commonplace, oil prices had fallen back to unremarkable levels and natural gas prices were collapsing.

Here in the UK, the Truss administration's bizarre and politically tin-eared 'mini-Budget' provoked a significant sell off in gilts and the pound. It was said by many to have 'crashed the economy'. The gilt market was quickly stabilised, the pound quickly reversed its decline (the rally of course went largely unreported). If the economy was 'crashed' – the phrase is still used widely – the wreckage is not easily visible in figure 8.

FIGURE 8: THE UK ECONOMY: REAL GDP (INDEX)

Source: Datastream, Rothschild & Co

WHAT TO DO ABOUT IT?

We see our job as investment advisers as that of trying to filter out these echoes and reverberations, and identifying (in the narrow realm of economics and finance) what really needs to be listened to. It is not easy, but we find the following guidelines useful:

- Perhaps the most important step in seeking more objectivity is an **awareness** of the echo chamber and wall of worry, and of the need to keep as open a mind as possible.
- **Common sense** has a role to play. Macro groupthink contains all sorts of logical fallacies and inconsistencies, most visible perhaps in the discussion of debt, and in the funding of our collective pensions.
- A sense of **perspective** can help. Recent inflation and industrial unrest can often seem unprecedented, even though it's anything but.
- **Patience** is also important. Perceived crises are not always as urgent as they seem, and resolution may be a less useful idea than accommodation and adaptation. When something is in the headlines, it's often also in the price, and precipitate action can be a mistake.
- An element of **process** can help distance us from emotion. Committees, though flawed (and prone to groupthink), are preferable to maverick decisions. Generally, numbers are less emotional than words.

Our 'truth' is surely not the only one. But the echo chamber has been a poor guide to the prospects for hiring and investing these last few decades.

Perhaps the most important step in seeking more objectivity is an awareness of the echo chamber and wall of worry, and of the need to keep as open a mind as possible.

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

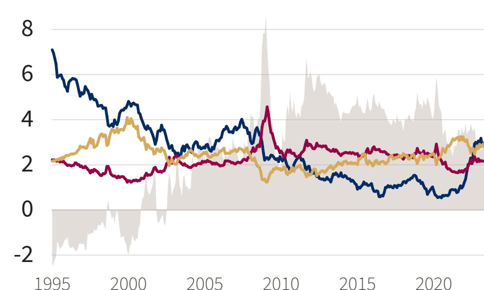
Year-on-year, %

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	4.8	-2.8	-21.5
10-yr UK Gilt	4.5	-2.9	-22.7
10-yr German bund	2.8	-3.9	-21.2
10-yr Swiss Govt. bond	1.1	0.5	-10.0
10-yr Japanese Govt. bond	0.9	-3.2	-4.7
Global credit: investment grade (USD)	4.3	1.4	-11.4
Global credit: high yield (USD)	9.9	8.8	0.6
Emerging (USD)	8.4	6.6	-13.9

Source: Bloomberg, Rothschild & Co

SELECTED STOCK MARKETS

Dividend yields, recent local currency returns (MSCI indices)

	YIELD (%)	1YR (%)	3YR (%)
World: all countries	2.3	9.3	21.4
Developed	2.2	9.3	25.6
Emerging	3.0	9.2	-5.1
US	1.7	9.3	22.9
Eurozone	3.5	10.2	29.9
UK	4.2	7.0	46.6
Switzerland	3.3	-2.1	7.1
Japan	2.2	20.7	49.6

Source: Bloomberg, Rothschild & Co

SELECTED EXCHANGE RATES

Trade-weighted indices, nominal (2000 = 100)

	LEVEL	1YR (%)	3YR (%)
US Dollar (USD)	119	-1.3	9.7
Euro (EUR)	134	5.9	1.8
Yen (JPY)	73	-2.9	-24.4
Pound Sterling (GBP)	82	2.8	5.4
Swiss Franc (CHF)	190	6.2	12.2
Chinese Yuan (CNY)	140	-2.2	5.0

Source: Bloomberg, Rothschild & Co

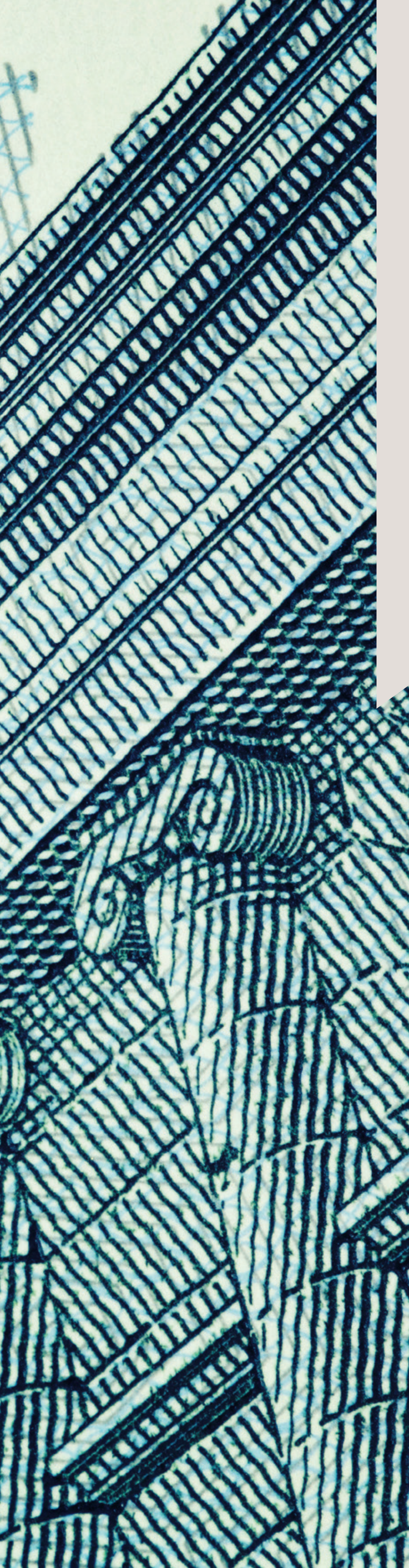
COMMODITIES AND VOLATILITY

	LEVEL	1YR (%)	3YR (%)
CRB spot index (1994 = 100)	285	3.0	89.2
Brent crude oil ($/b)	90	-6.7	119.6
Gold ($/oz.)	2,006	20.6	5.2
Industrial metals (1991 = 100)	314	-2.3	21.4
Implied stock volatility: VIX (%)	21	-22.3	-36.2
Implied bond volatility: MOVE (bps)	129	-9.5	123.2

Source: Bloomberg, Rothschild & Co

Data correct as at 27 October 2023.

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



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