12th September 2022

Waiting

- **The markets appear to be in the mood to put a positive spin on current data**
- **However central bankers remain hawkish pushing on with substantial rate rises ahead**
- **Fiscal policy in Europe is starting to take the edge off some of the worst predictions of recession.**
- **Both the UK and eurozone governments look likely to cap energy prices with an implicit significant fiscal boost to their economies**
- **Thank you ma'am….**

Recent economic data or indeed the broader market action have done little to give us an emphatic signal of what the future holds for the economy or the markets in general. Opinions remain divided over the future course of the global economy and whether it will be a full-blown recession or a technical one. Nevertheless, we await greater clarity from the upcoming flow of economic data releases and corporate results to understand where we are headed.

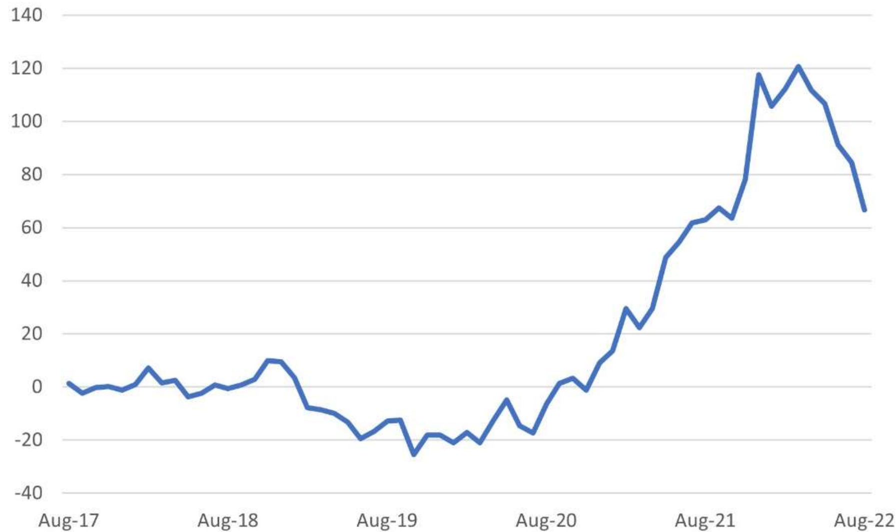
To be fair it appears the markets appear to be in the mood to take a more positive view of life for the immediate future, based on a marginal improvement in growth and inflation.

Central bankers, to be sure, remain hawkish. Last week the ECB and the Reserve Bank of Canada raised policy rates by 75bps each, thus keeping to the oft-repeated script that significant rate increases are required to contain the runaway inflation. The Federal Reserve and the Bank of England are expected to follow suit during the course of the month. Meanwhile, irrespective of the outcome of this week's US inflation report, we expect the Fed to align with the views of the FOMC's voting members that inflation is running hot and the Fed should raise rates early and substantially. We still believe that the US central bank and the Bank of England will increase interest rates by 75bps at their next meeting.

While negative inflation surprises were overwhelming through the second quarter – and even as they continue to beat expectations – they have since calmed and are not as bad as they were during the second quarter (Chart 1).

Beyond September – and the frenzy of rate increases – it will be interesting to see how the markets' views of the future pace of policy rate increases develop. Much will depend on the need to balance inflation risks and growth worries. Equally important is the direction that fiscal policy takes.

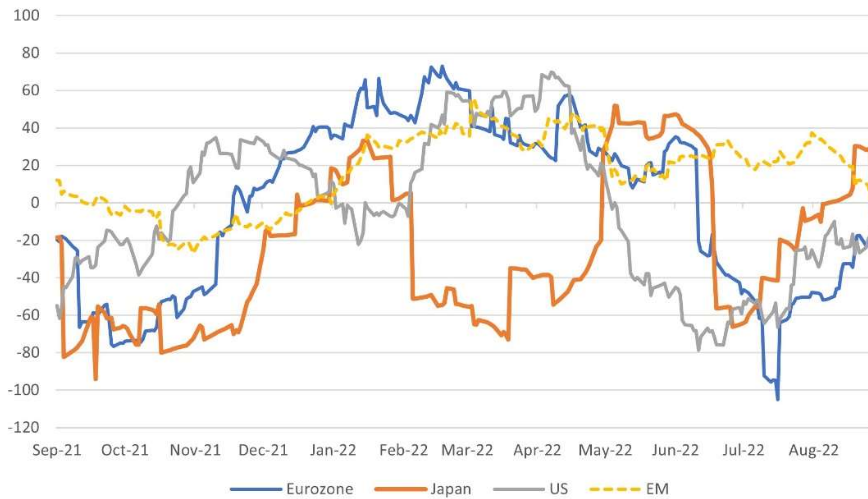
Chart 1: Inflation surprises for the G4



Source: Bloomberg

End-July onwards, economic data referencing growth has improved, almost getting back to the zero line where downgrades to economists' growth forecasts typically begin to abate.

Chart 2: Growth data surprises for major developed and emerging countries



Source: Bloomberg

Fiscal policy has the power to help growth but makes central bankers worry. The UK is a case in point. The new cabinet led by Liz Truss stares at a formidable challenge as it looks to prop-up growth by capping energy prices as part of a massive fiscal boost. While capping energy prices is positive for inflation, it will boost households' spending power, which may, in turn, lead to stronger growth—and higher inflation. It would not be a pretty picture if the government's actions to boost growth only result in more rate increases from the Bank of England. As laid out in the plans, the new UK government could increase government spending by GBP150bn, equivalent to what was spent during the pandemic. Unlike during the pandemic, the Bank of England is likely to raise rates to ward off added inflation risks. This week, we, like the market, expect the Bank of England to raise interest rates by 75bps.

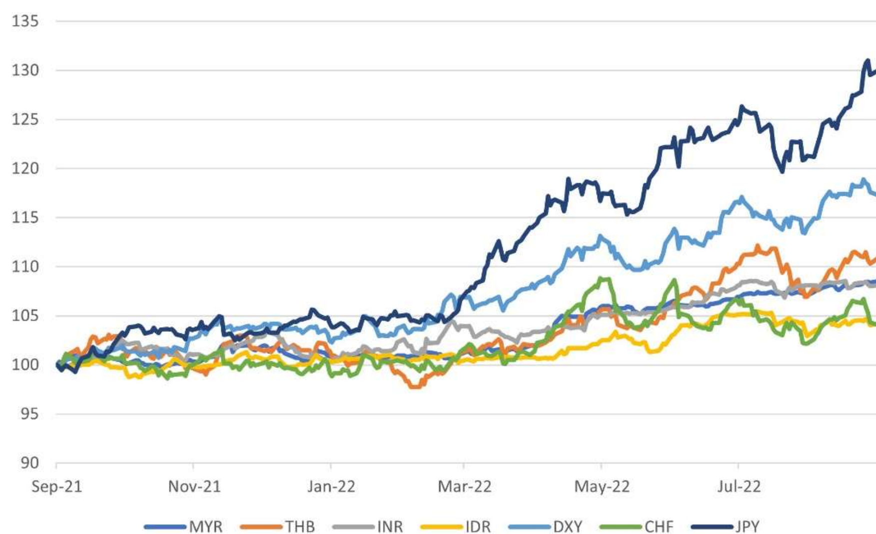
The eurozone also look likely to implement a scheme to cap energy prices and by implication add a significant fiscal boost to the eurozone economy.

Could the trade-weighted dollar be finally peaking?
The news that a new UK cabinet are set to provide a material fiscal boost to the UK economy helped stabilise sterling against the dollar. Indeed, across the currency markets the dollar peaked and settled lower on a trade-weighted basis. The key to the dollar peaking after its recent remarkable run, is the belief that growth outside of the US is finding more support and that interest rates could push higher outside relative to the US. The eurozone, like the UK, looks set to commit to action that will cap gas prices with a significant fiscal stimulus. Hence the euro managed to climb above the 1.00 level against the dollar. Even the yen managed a small gain against the dollar. Recent economic data, while not really encouraging, has shown an underlying resilience. Despite higher COVID-19 cases consumer sending has remained robust. On the other hand, industrial confidence has improved despite higher input costs from a weaker yen.

In our view, what stands out about the dollar's recent surge is that the ascent has been principally against the developed market currencies. Market commentators often misrepresent the dollar's rise as creating an emerging market crisis. No doubt there are countries such as Sri Lanka that are struggling, however the scale of the dollar's rise is much more modest against emerging markets currencies than it is against the developed market currencies. Chart 3 shows the Malaysian Ringgit, the Indian Rupee, the Indonesian Rupiah, and the Thai Bhat have all performed better than the major currencies over the past 12 months. Indeed, the relative strength of many emerging market currencies has allowed their respective central banks to be quite measured in their policy rate responses.

The relative stability of emerging market currencies has allowed emerging market debt to perform well of late. The emerging market bond index with a yield-to-worse of 7.1% remain attractive to income seeking investors. The spread is down to 360bps, 80 bps tighter than the recent July peak. For those investors wanting to be more price sensitive we would suggesting holding off purchases and wait for another spate of market weakness.

Chart 3: Emerging market currencies hold their own



Source: Bloomberg

Queen Elizabeth II - A heartfelt thanks to a remarkable woman
While it is easy to lose sight of important events in the back and forth of the financial markets, these past few days – and through the coming week – the focus of the United Kingdom has been and will be the death of Queen Elizabeth II. Many, including yours truly, are immensely thankful for the 70-year reign of an extraordinary woman. With her passing, it truly feels like the end of an era that can be characterised in both positive and negative ways. However, the Queen managed to transcend all with her exemplary sense of duty, decency, and service to her nation. We can only hope that the qualities she exemplified will not be lost with her demise.

Gary Dugan
Johan Jooste (Consultant)
Bill O'Neill (Consultant)