THE GLOBAL CIO OFFICE

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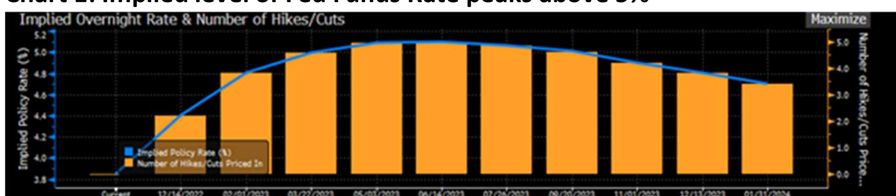
Central Bankers Diverge, as Investors Go Bottom Fishing

- **Central bank policy starts to diverge as they get beyond knee jerk rate rises**
- **Thus far the rise in yields explains the fall in equity markets**
- **US equities are particularly vulnerable to future downgrades to profit forecast**
- **European equities have already suffered a deep derating**
- **Rumours of a re-opening of the Chinese economy encourages bottom fishing for an oversold asset**

When it comes to global central banks, there's no one-size-fits-all approach that does wonders. As the banks attempt to cure the ills of the global economy, they employ measures that are often widely different. That will likely be the reality going forward, too, as central banks appear set to unveil policies over the next several months that will widely diverge. Which central bank gets it most right is still open to investor debate.

The Federal Reserve last week only confirmed the market's long-held suspicion that the central bank would have to target higher policy rates for longer to tame the inflationary pressures. Although the FOMC said it was sensitive to any substantial economic slowdown, the data flow indicates that growth, although marginally lower, will still be good, aided further by rising employment.
Equity buyers were conspicuous by their noticeably thin presence on the ground ahead of the Fed decision. As Chairman Powell's press conference ended, equities edged lower again. The US Treasury market, meanwhile, moved to price in a higher-than-expected peak in rates and the persistence of those rates through much of 2023. The market is currently pricing a peaking of rates comfortably above 5%, with policy rates not expected to fall below that level until the end of 2023. Also, an end-2023 4.75% policy rate would imply the US 10-year government bond yield in sync with that level, too.

Chart 1: Implied level of Fed Funds Rate peaks above 5%

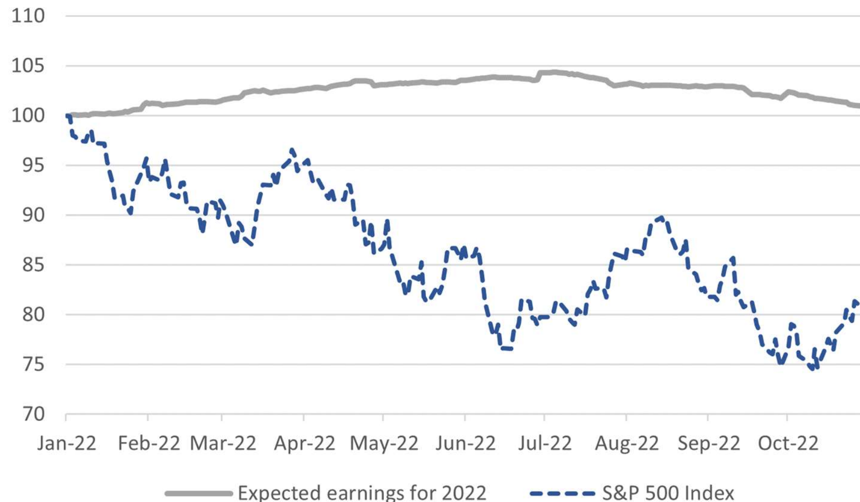


Source: Bloomberg

Higher US policy rates and a potential anchoring of the 10-year bond yield at 4.5% or higher could pose problems for the US equity markets. However, as Chart 2 shows, the fall in the US equity market over the past few months has been substantially about higher interest rates and less about any fall in corporate profit forecasts. US corporate

profit forecasts have held steady for much of the year but that cannot continue. Quite frankly, the Fed needs to see a setback in the economy to squeeze inflation out of the system, which, by consequence, must also mean corporate profits have to fall in 2023.

Chart 2: US corporate profit forecasts hold up but the market falls due to higher interest rates
Expected 2022 corporate profits for the S&P500 and the S&P Index rebased to Jan 1st 2022 =100



Source: Bloomberg

The Bank of England kept to the script with its 75bps rate increase; however, the split 7-2 vote surprised investors that it was not unanimous. In the statement released after the meeting, the BoE's Monetary Policy Committee appeared to indicate that further rate increases would be more modest. The committee suggested that the 'new' government was committed to a far stricter fiscal policy than had previously been the case, and the UK is already indicating there's some pain ahead. To an extent, the market doesn't quite believe in actions of the MPC. Although the market already factors in the probability that future rate increases will be in increments of just 50bps, the peak in interest rates that it currently prices is about 50bps below the Fed's, even though the UK has a bigger near-term inflation headache with a headline rate of 10.1%. Indeed, the peak in rates that the market currently prices is somewhat below where it was before the meeting. By being hesitant on rate increases, the BoE didn't do itself any favours. Sterling slid 2% against the dollar as the MPC's split vote was announced, before recouping 50% of the losses.

The ECB met the previous week, but it topped up its messaging to the market with a series of relatively hawkish speeches from its board members through the past week. Irrespective of whether the ECB pushes on a little faster in raising the rates, we believe the consensus forecast peak in policy rates is still only 3% at the end of next year.

It's worth giving a shout-out for the performance of the Eurostoxx index, which has recently rallied 12% from its October low. The near 35% de-rating of the market has attracted investors, irrespective of the challenges of the war in Ukraine. As of mid-October, the de-rating was some 45%. There is a dark winter ahead with the scale of the energy crisis yet unknown. But maybe, just maybe, the European markets have seen their darkest relative day.

Chart 3: Eurozone corporate profits up strongly aided firmly by a weak euro

Expected 2022 corporate profits for the eurostoxx50 and the eurostoxx50 Index rebased to Jan 1st 2022 =100

Source: Bloomberg

China stocks rally, room for optimism? It may have just been a somewhat wishful thinking, but Chinese equity markets rallied strongly last week as reports circulated that authorities were considering easing the stringent COVID restrictions. Eventually, though, those hopes may be dashed again, at least in the immediate term. But that also leaves us hopeful of a potential upside for the equity markets as and when there is a 'real' re-opening. Similar to what happened in Europe, the MSCI China and the Hong Kong equity markets are beginning to find the limits to their downside. Chinese equity market indices are back at levels seen during the global financial crisis, with valuations lowest in decades (Hang Seng P/E 9.4). Buyers will naturally look to bottom-fish.

Chart 4: Intraday rally in the Hang Seng Index amidst hopes of a reopening of the economy

Source: Bloomberg

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