THE GLOBAL CIO OFFICE

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Who or What to believe?

- **Some US corporate management signals trouble, but the consensus is still complacent**
- **It is weird that the market is expecting fewer rate increases than the Fed seems to be signalling**
- **ECB likely to join other central banks in signalling higher rates – good news for the euro**
- **We continue to expect lower equity markets, higher bond yields**

As economic conditions remain starkly unfavourable, we find ourselves siding with central bankers taking a more hawkish stance on future tightening. Inflation remains worrisome and far from under control. China's nascent recovery looks likely to cause some inflation pressures, although easing supply lines may help ease those pressures somewhat. We see U.S. 10-year yields pushing through the 3% mark and believe eurozone yields could move much higher given the continued inflation shocks. Equity markets have paused and consolidated, but we expect further downward pressure.

As we analyse the current situation, we go back to the global financial crisis of 2007-09 to not only draw some similarities but also some pertinent lessons. The first equity market crash in July 2007 was the warning sign from the market that something was amiss. However, it was only in October 2007 that analysts began downgrading their corporate profit forecasts. Initially, analysts only characterised the issue as a fourth-quarter problem even as their forecasts for 2008 remained extraordinarily high. Indeed, as the crisis assumed monumental proportions and markets tumbled through 2008 as a consequence, analysts slashed their corporate profits forecasts significantly. For analysts, corporate management often acts as the harbinger of 'truth'—to indicate that things are difficult before analysts take the cue and rejig their forecasts. What complicates the problem is that management is usually late in signalling that times are tough. **The evidence is that companies only reluctantly warn that they see a downturn in business. It is natural corporate behaviour for management to not want to be one of the first in their industry to suggest that times are getting tougher.**

Chart 1: Neither corporate sentiment nor corporate profits forecasts are a goo predictor of future market performance

Source: Bloomberg

Note Yellow line S&P500 Index, green line ISM survey of manufacturing confidence, white line S&P500 earnings forecasts

The ISM survey for industrial confidence in the manufacturing sector and a key indicator of the state of the U.S. economy was still above 50 in mid-2008, just a few months before the collapse of Lehman Brothers.

At least some business leaders are breaking from the consensus—and the norm—on this occasion. Last week, Tesla CEO Elon Musk said that he had a "super bad feeling" about the economy and announced a 10% layoff of salaried employees.

JPMorgan CEO James Dimon was more forthcoming in his remarks last week as he warned investors to "brace yourself" because a "hurricane" was about to rock the economy. The comments, as significant as they were, were a stark departure from his May 23rd assessment of the risks to the U.S. economy: "I'm calling it storm clouds. They may dissipate". On the Beaufort weather scale, Jamie took his assessment of the U.S. economy up two notches in just ten days to the highest warning level possible in weather parlance!

We have always had a healthy scepticism for central bankers' forecasts. It's not their fault that they are often put on a (high) pedestal as if they were God-like on their insights and projections. In November 2007, Reuters, reporting on Ben Bernanke's comments to Congress, said, "the U.S. central bank expects the world's largest economy to regain steam by the middle of next year as housing and financial markets stabilise". We all know what followed. I remember once saying in a TV interview that Ben Bernanke was "just another economist". That remains my mantra for dealing with Fed commentary.

Last week CNN challenged former fed chair and current U.S. Treasury Secretary Janet Yellen on her previous forecast that there was a "small risk" of inflation and that it would be "manageable." To her credit, she did admit that she got it wrong. "Well, look, I think I was wrong then about the path that inflation would take". It comes as a surprise then that we find ourselves siding with the Fed over the market.

With the benefit of historical hindsight, it seems strange that the market finds itself discounting fewer rate increases than the Fed is signalling. Last week's Fed minutes were relatively hawkish, suggesting that 50bps incremental increases in rates could be on the agenda for some meetings to come. And yet the market prices a more modest tightening. **If the Fed increased interest rates by 50bps at each meeting through to the end of the year, the fed funds rate would rise to 3.5%. That would be significantly above the 2.75% that the market is currently pricing by the end of the year.** The market argues that the Fed will be happy to move interest rates just to what is assumed as a neutral rate. However, the forecast of a neutral rate doesn't square with a late-cycle U.S. economy, a tight labour market and the highest inflation in decades. If the oil price remains at current levels, it would still be up 70% year-on-year in December.

Given the flow of recent economic news, we are more inclined to side with the Fed's view of the need for significantly higher interest rates than the market is currently pricing. Recent economic data has shown a greater resilience, and inflation remains a significant problem. The market expects U.S. inflation to stay at 8.3% year-on-year this week. Last week's U.S. employment report was stronger than expected, with job gains of 390,000. Granted that global growth is not as resilient with the recent weakness in China hurting Asian growth and recent weaker-than-expected manufacturing data from Korea and Taiwan only further demonstrating the scale of the problem.

The ECB is likely to confirm to the market that even Europe, like the U.S., needs a dose of monetary tightening. Eurozone headline inflation of 8.1% could no longer be explained away, and hence the market now expects the ECB to react by raising interest rates by 25bps per quarter moving forward. The ECB is also likely to end its quantitative easing in July.

As the market has come to discount a more hawkish ECB, the euro has stabilised against the dollar. From a low of 1.038 in mid-May, the euro has recovered to 1.072 but is still a long way short of 1.219 a year ago.

In conclusion, we don't believe the consensus in the financial markets is for modest rate increases and a soft landing. We find ourselves siding with central bankers' increasingly hawkish views. We believe investors should prepare themselves for higher-than-expected short-term interest rates and U.S. 10-year bond yield that comfortably pushes through the 3.0% mark. In the eurozone, the much higher than expected inflation puts upward pressure on long-term interest rates. German 10-year bund yields are at their highest in a year, but at 1.267% they are still woefully below inflation at 7.9%. European credit is likely in for further losses. **Global equity markets have seen some respite last week after two weeks of continual losses. However, the headwind of central bank tightening in the coming weeks will put further downward pressure on the markets.** The re-opening of China is a specific positive for Asian equity and commodity markets. However, they will be concerned that China's comeback only exacerbates the inflation headwinds for developed equity markets.

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