

## Market Report

# Soft, hard, or no landing at all?

31<sup>st</sup> March 2023

How quickly things change. Not long-ago analysts thought the global economy was powering ahead. Now they worry about a deep recession caused by fallout from the banking turmoil. With its trajectories, headwinds, and tailwinds, the language of central banking abounds with aviation metaphors. We have gone from “no landing” to “hard landing” and that a “soft landing” now looks unlikely. In keeping with the analogy, with the airplane in a tailspin (lack of market confidence) and engines about to turn off (bank lending) the market has seen an array of conditions over a few short months.

Over the course of the month just ended, expectations about the economy and Federal Reserve policy swung from one extreme to another. Early on, Fed officials were talking up more and bigger interest-rate increases to slow stubborn inflation. Then, seemingly out of nowhere, came the second-largest bank failure in US history (and the “merger” of UBS and Credit Suisse). Suddenly, we seemed headed into the abyss of recession.

However, federal bank regulators stitched together a new safety net, and by month’s end, the bank runs apparently had slowed to a stroll. Nonetheless, despite a marked absence of evidence of significant economic weakening, fears that banks had lost deposits—or at least might have to start paying up for them—and would clamp down on credit, put everyone on recession watch again.

In financial markets, cognitive dissonance took over. Expectations switched to falling interest rates; the Fed was seen ending its increases by May and reversing course in the year’s second half. Bond prices rallied, with yields falling.

Stocks reacted positively to the prospect of future Fed easing. Technology led the advance, with the Nasdaq Composite ending up 6.7% in March and 16.8% in the quarter, its best showing since 2020’s second three months. The S&P 500 was up 3.5% for the month and 7.0% for the quarter. While those gains followed double-digit losses in 2022, they hardly seem like harbingers of recession.

Central bankers are having to consider several factors all at once. Headline inflation is coming down, but core inflation—consumer prices without energy and food—remains stubbornly sticky. And, while it remains unclear how turmoil in the American and Swiss banking systems will spill over into the main economies, the disruption shows how high interest rates can endanger financial stability.

Meanwhile, central bankers also want to encourage economic growth amid the uncertainty. It has been an interesting quarter to say the least!



### Reasons to be optimistic

While there are still reasons to be optimistic, we might not see their impact until late in 2023 or possibly even 2024.

- **Global growth** - has generally surprised positively during the first quarter of 2023. This stronger growth is perhaps best illustrated by the rebound in the US and European composite purchasing managers' index (PMI) business surveys since the start of the year
- **Energy prices** - lower energy and oil prices have probably played an important role in the improvement in business sentiment, along with the reopening of China
- **Equities** - against this backdrop, developed market stocks returned nearly 8% over the quarter

### Reasons to be cautious

- **Geopolitics** - backdrop remains challenging, with no end in sight to the war in Ukraine and renewed tensions between the US and China
- **Inflation** - headline inflation continued to ease over the quarter on the back of low energy prices, but core inflation generally remained stickier, forcing global central banks to tighten monetary policy further

### So, can we expect more turbulence in the coming months?

Uncertainty surrounding the cumulative and lagged effects of monetary tightening, combined with ongoing geopolitical tensions, suggests that volatility in rates, currency and equity markets is likely to remain elevated in the coming months and quarters.

## USA

### There is reason to believe that the US may achieve the so called “soft” landing

US economic data published since the beginning of the year suggests that the largest economy in the world continued to grow in the first quarter. The labour market remains resilient as February non-farm payrolls grew by a stronger-than-expected 311,000.

The February consumer price index (CPI) report showed that headline inflation fell to 6.0% year on year, an eighth consecutive monthly decline and now well down from its 9.1% peak in June 2022. It is also worth noting that inflation is now dominated by shelter costs, accounting for over 70% of the



increase in prices.

Changes in rents and house prices tend to feed through into shelter inflation with a lag though. So much of the current inflation data is reflecting prior rent gains, whereas more recent data show rent increases have generally slowed and house prices are coming under pressure.

Given the cooler inflation data and the turmoil surrounding Silicon Valley Bank, the Federal Open Market Committee voted unanimously to raise the federal funds rate by just 25 basis points (bps) in March to a target range of 4.75%-5.00%.

Despite the hit to bank shares the S&P 500 rose in March, helped by strong returns from growth stocks that were buoyed by falling bond yields. Over the quarter the S&P 500 rose by 7 %. US treasuries returned 3% over the quarter.

## Europe

### ECB expects higher growth and lower inflation

In Europe, despite rapidly rising interest rates and the turmoil in the banking sector in March, economic activity also surprised on the upside throughout the quarter on the back of falling energy prices and the resilience of services activity.

The euro-area composite PMI for March rose to a 10-month high of 54.1, which was well above expectations. This strong momentum was almost entirely driven by the service sector, where the PMI increased from 52.7 in February to 55.6 in March, while the manufacturing sector continued to struggle as shown by the drop in the manufacturing PMI to 47.1 in March.

At a country level, the two main growth engines of the euro-area, Germany and France, both posted strong activity data in the first quarter. In Germany, all sub-components of the IFO index (business climate, business situation and business expectations) improved substantially over the quarter. In France, even though the country has been confronted with several days of national strikes to protest against pension reforms, the composite PMI jumped from 49.1 in January to 54 in March.

Euro-area consumer confidence, though slightly down in March, improved over the quarter.

On the inflation front, although headline CPI continued to decrease throughout the quarter from 9.2% year on year in December to 8.5% in February, core inflation increased from 5.2% to 5.6% over the same period.



With growth more resilient than expected and core inflation stubbornly high, the European Central Bank (ECB) increased its deposit rate by 50bps in March despite the banking turmoil caused by the collapse of Silicon Valley Bank in the US and the subsequent issues for Credit Suisse in Europe.

The ECB also updated its macroeconomic projections and now expects higher growth and lower inflation this year. While the door remains open to future rate hikes, these will be data dependent.

Despite the hit to bank shares in March, European stocks outperformed over the quarter delivering just over 10%. European government bonds returned 2.5%.

## UK

### **OBR figures show that the UK would avoid a recession in 2023**

The UK economy has also fared better than expected so far this year. The preliminary composite PMI for March dropped slightly from 53.1 to 52.2 but remains in expansion territory. Consumer confidence surprised to the upside, increasing from -45 in January to -36 in March.

On the inflation front, the headline CPI and core CPI increased, respectively, to 10.4% and 6.2% year on year in February, which was above expectations in both cases.

The Bank of England increased its policy rate by 25bps in March to 4.25% and left the door open to further tightening if necessary to bring inflation down. As more fixed rate mortgages expire this year though, the BOE may not need to tighten much further.

UK equities underperformed global equities over the quarter but still delivered just over 2%. UK government bonds returned just over 2%.

## Asia

### **Asian economies continue to stand out as a relative safe haven**

China's surprise abandonment of its zero covid policy at the end of last year has led to a strong rebound in its economy since the beginning of the year, while inflation has so far remained surprisingly low, allowing the People's Bank of China (PBOC) to maintain an easy monetary policy.

The non-manufacturing business surveys are showing a strong rebound in the domestic service sectors. The better-than-expected credit growth in January and February undoubtedly contributed to this better economic momentum.



Despite this strong economic momentum and credit growth, China's February CPI print came in below expectations, rising only 1% year on year, while the producer price index stayed in deflation territory, falling 1.4%. Against this backdrop, the PBOC announced a 25bps cut to its reserve requirement ratio for banks in March, which was earlier than expected.

Asian (ex-Japan) stocks returned 4% over the quarter.

### How have the markets performed?

We have selected key indices as a representation of the markets rather than a substitute for the whole market as they are the most recognisable for our clients.

	1 January 2022	31 March 2022	30 June 2022	30 September 2022	31 December 2022	31 March 2023	Change since January 2023 (%)
<b>S&amp;P 500</b>	4,797	4,530	3,785	3,585	3,839	4,109	<b>7.0%</b>
<b>Dow Jones</b>	36,585	34,678	30,775	28,726	33,147	33,274	<b>+0.4%</b>
<b>Nasdaq</b>	15,833	14,442	11,029	10,576	10,466	12,222	<b>+16.8%</b>
<b>FTSE 100</b>	7,505	7,516	7,169	6,894	7,452	7,632	<b>+2.4%</b>
<b>Global Bonds</b>	243	230	211	196	206	212	<b>+3.0%</b>
<b>UK Bonds</b>	255	235	213	182	185	191	<b>+3.2%</b>
<b>Energy Index</b>	31	46	49	46	41	33	<b>-20.0%</b>

NB: Figures rounded up to the nearest whole number.



Stock markets surrendered a large part of their January gains in February and early-March, before rebounding strongly in the last 2 weeks of the quarter. “Defensive growth” stocks, and the big tech sector in particular, have benefitted from improved growth expectations and lower yields.

European markets have returned the strongest performances after benefitting from mild weather that has defused the energy crisis, resilient business activity surveys and stronger than expected corporate earnings.

Bond markets have performed positively as yields have fallen across the curve in the US and Europe in response to lower rate hike expectations in the US and the financial sector turmoil.

### Interest Rates in 2023

All the major central banks now have a mandate to ensure that interest rates rise and fall within what are considered stable inflationary limits. In most instances this is 2% per annum, the 'goldilocks' scenario where the underlying economy is neither 'too hot nor too cold'.

	1 Jan 2022	31 Mar 2022	30 Jun 2022	30 Sept 2022	31 Dec 2022	31 Mar 2023	Highest prediction 2023
<b>US (Fed)</b>	0.20%	0.50%	1.75%	3.25%	4.50%	5.00%	<b>5.75%</b>
<b>UK (BoE)</b>	0.25%	0.75%	1.25%	2.25%	3.50%	4.25%	<b>5.0%</b>
<b>Europe (ECB)</b>	0.00%	0.00%	0.00%	1.25%	2.00%	3.50%	<b>4.75%</b>
<b>Japan (BoJ)</b>	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	<b>0.0%</b>

NB: The figures in the final column are an amalgam from several different sources, so are more akin to a trend rather than a prediction. They are for the full cycle rather than a fixed period.

The US figure of the highest prediction looks at odds with our analysis. The “markets” have priced one more hike of 0.25%, the Fed has announced one more hike on 22<sup>nd</sup> March (we suspect 0.25% again), and we agree with one more hike to 5.25% as well. However, the highest forecast is based on various forecasts for the year, as compiled by Bloomberg. In this instance, one investment bank still thinks the Fed will hike 3 more times, so hence the number in the final column.



At the quarter-end, Fed fund futures markets imply one more rate hike, but also 2 rate cuts before the end of the year, as opposed to the FOMC's "dot plot", which shows that policymakers expect to maintain rates between 5.0% and 5.25% until 2024. This discrepancy is expected to lead to further volatility in the coming months and quarters.

Indeed, the disinflationary effect of the ongoing normalisation of supply chains, wages, and housing rental markets still has a long way to go and policymakers want to give themselves time to assess the cumulative and lagged effects of rate hikes, especially in the context of recent stress in the US regional banking sector.

### **Which asset classes should we consider?**

As we enter the second quarter, we expect China's economy to continue to be supported by its Covid reopening, but we see more downside risks in developed economies.

The recent events in the banking sector are likely to lead to a further tightening of bank lending standards, which could further slow growth in developed economies, possibly leading to a moderate recession over the course of the year. However, with little evidence of extreme excess in the real economy and with better capitalised banks, we see a repeat of 2008 as unlikely.

If the commercial banks tighten lending standards, the Federal Reserve, and other central banks, will need to do less to bring about the desired slowdown in activity and reduction in inflation.

As our "Year of Inflections" continues to evolve, events over the past month have shown how quickly the outlook can shift. There are still considerable uncertainties, in both directions. With confidence in the banking sector still fragile and question marks about the economic and central bank outlook, markets are likely to remain volatile. Against this backdrop, it is sensible to focus on strategies to build resilience, mitigate risks, position for opportunities created by regional divergences, and diversify portfolios.

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