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Market Pulse

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STICKY INFLATION AND STRONG ECONOMIC DATA: MARKETS ANTICIPATE HIGHER TERMINAL RATES

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In February, falling US fourth quarter earnings and weak guidance helped push equities lower amid more persistent inflation than expected and strong economic data. The market has interpreted this data as likely to usher in higher terminal rates in the US. The potential for further monetary tightening therefore weighed on bond prices as well as equities. The economic data was supportive of the US dollar, which strengthened on higher rate expectations, while commodities (priced in dollars) declined. In Europe, despite falling headline inflation, the European Central Bank (ECB) remained hawkish amid sticky core inflation. Meanwhile, UK-EU relations thawed as an agreement was reached on the Northern Ireland protocol. In Japan, Ueda was picked to be the next Bank of Japan Governor and is viewed as being a dovish choice.

Macro

Global macro data was suggestive of economic strength, with global Purchasing Managers' Indexes (PMIs) showing a strong rebound into expansionary territory in some cases. This bolstered the case for continued restrictive policy from central banks, given still-elevated inflation.

US economic data

January data suggested that the US economy remains strong, ranging from stronger-than-anticipated labour market data to sticky inflation. In terms of the former, non-farm payrolls showed an additional 517,000 jobs added in January against consensus expectations of 185,000. However, it should be noted that some of this rise was due to statistical adjustments, like annual changes in population. Nevertheless, wage data was indicative of a tight labour market – average hourly earnings rose by 4.4%, marginally above the forecast 4.3%. In terms of price pressures, the CPI slowed marginally to 6.4% year-on-year (YoY), in January, from 6.5% in December, but against the 6.2% expected.

The Federal Reserve

The US Federal Reserve (Fed) raised its key rate by 25 basis points (bps) to a range of 4.5-4.75% at its February meeting and stated that it would "need substantially more evidence to be confident that inflation is on a sustained downward path." This, combined with the supportive macro backdrop, led rate markets to price in a higher terminal rate (i.e. the cyclical peak in rates). In addition, Fed speakers generally kept to their hawkish messaging.

Eurozone

Eurozone consumer price inflation continued to decelerate, falling to 8.6% YoY in January from 9.2% in December. However, core inflation remained elevated at 5.3% YoY, the same rate as in December. This is an issue that the ECB remains focused on, and the deposit rate was raised by 50bps to 2.5% at the February meeting. Moreover, Governing Council members appeared keen to communicate that further rate rises are still to come this year.

UK

Meanwhile, in the UK, January CPI rose by less than expected (10.1% YoY, down 1 percentage point from October), while retail sales volumes (up 0.5% from December) were above expectations. However, the latter were likely buoyed by January discounts and were down 5.1% YoY. Falling inflation and lacklustre demand suggest the Bank of England (BoE) may be closer to its peak base rate. However, after the Bank raised its base rate by 50bps to 4.0% at its February meeting, it reiterated that risks to its inflation forecasts "are very clearly and significantly skewed to the upside."

Northern Ireland deal

On the political front, the UK and the EU agreed a deal on post-Brexit arrangements in relation to Northern Ireland. Called the 'Windsor framework', the deal aims to have a 'green lane' for goods travelling between Great Britain and Northern Ireland, and this would have significantly reduced checks. There would also be a 'red lane' for goods going from the Great Britain to Northern Ireland and onto the Republic of Ireland to ensure they adhere to Irish and EU regulations and standards. The initial response from the Democratic Unionist Party (DUP) appeared to be positive, but a key area to be explored will be the implementation of EU law and the role of the European Court of Justice within Northern Ireland.

Japan

The Japanese government announced that Kazuo Ueda was its pick to take over from current Bank of Japan Governor Haruhiko Kuroda when his term expires in April. This move was viewed as a choice supportive of policy continuity and one that may hint at a dovish lean.

MARKET ROUND-UP

Equities

Global stock markets gave back some of their year-to-date gains in February, with the prospect of higher central bank rates weighing on sentiment. World equities fell by -1.9% (-0.5% in euro terms) in February.

In the US, Q4 company earnings were weak. Nearly all companies (98%) in the S&P 500 had reported by the end of February, with earnings down 2% YoY. Indeed, the MSCI USA ended the month down by -2.4% (flat in euro terms).

European equities, despite falling towards the end of the month, gained in February amid support from China's reopening and a weaker euro, both aiding exporters, and natural gas prices falling by nearly -18%. Europe ex-UK equities rose by 1.3%.

Bonds

The prospect of higher terminal rates pushed bond yields higher in February. Government bond yields rose significantly across the curve in the US and the eurozone. US 10-year Treasury yields ended February at 3.92% (compared to 3.51% a month earlier), while the equivalent for German bunds was at 2.65% (against 2.29% at the end of January). The rebound in yields pushed the ICE BofA 5Y+ Euro Government index lower by -3.3% in February.

There was an upward re-pricing of the terminal rate in the US and the eurozone, with ECB Governing Council members deemed to be very hawkish in February speeches. At the end of the month, rate markets were expecting a peak federal funds rate of 5.4% by July, up from 4.9% at the end of January and compared to the current 4.5-4.75% range. For the ECB, markets project a terminal rate of 3.9% to be reached in December, compared to 3.4% a month ago and the current 2.5%.

Currencies and commodities

The US dollar rallied in February as economic data releases outperformed those of the likes of Europe. The euro against the dollar ended February at 1.0606, down from 1.0865 at the end of January, with the Dollar index (DXY) rising by 2.7% over the period. For commodity prices, tighter monetary policy and a stronger US dollar were headwinds, contrasting with tailwinds such as China's reopening. For the month, commodities were down by -3.8% (-1.5% in euro terms), with Brent crude oil down by -0.7% and copper down by -3.0%.

CHARTS OF THE MONTH

Global Equities

Source: ILIM, Bloomberg. Data is accurate as at 28 February 2023.

Bonds – German 10-year yield

Source: ILIM, Bloomberg. Data is accurate as at 28 February 2023.

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	MTD Return (%)	YTD Return (%)	2022 Return (%)
MSCI Ireland	4.3	16.0	-21.1
MSCI United Kingdom	2.7	7.5	1.4
MSCI Europe ex UK	1.5	9.1	-11.9
MSCI North America	-0.1	4.7	-13.8
MSCI Japan	-1.5	2.8	-10.8
MSCI EM (Emerging Markets)	-4.2	1.6	-14.5
MSCI AC World	-0.5	4.8	-12.6
10-Year Yields	**Yield Last Month (%)**	**2022 Yield (%)**	**2021 Yield (%)**
US	3.92	3.87	1.51
Germany	2.65	2.57	-0.18
UK	3.83	3.67	0.97
Japan	0.51	0.42	0.07
Ireland	3.13	3.13	0.24
Italy	4.47	4.70	1.17
Greece	4.44	4.62	1.34
Portugal	3.51	3.59	0.47
Spain	3.60	3.66	0.57
FX Rates	**End last month**	**2022 Rates**	**2021 Rates**
U.S. Dollar per Euro	1.06	1.07	1.14
British Pounds per Euro	0.88	0.89	0.84
U.S. Dollar per British Pounds	1.21	1.21	1.35
Commodities (USD)	**MTD Return (%)**	**YTD Return (%)**	**2022 Return (%)**
Oil (Brent)	-0.7	-4.0	6.7
Gold (Oz)	-5.2	0.3	-0.3
S&P Goldman Sachs Commodity Index	-3.8	-3.9	26.0

Source: ILIM, Bloomberg. Data is accurate as at 1 March 2023.

THE ILIM VIEW – LOOKING AHEAD

The direction of growth, inflation and monetary policy are set to remain key for global equities. January's euphoria gave way to a more sombre February. Now, global stock markets appear to be at a crossroads: they could either climb a wall of worry or fall to reflect a less favourable outlook.

Although the outcomes are unlikely to be so binary, in our view, there is certainly room for equity markets to price in a downside economic scenario. Indeed, negative company guidance and continued price pressures, from input costs to wage growth, speak to the potential for further margin compression and could easily tip into a more severe economic slowdown or recession. However, market performance has thus far been in line with that of a 'soft landing' (i.e. slowdown, but no recession). There have also been some powerful supports, including China's reopening.

At the same time, economic data, including February PMIs, have shown strength, but the implication here is that central banks are further away from peak rates than previously assumed. Should animal spirits be revived amid still high inflation, then it is likely that central banks will have to double down on their hawkishness. Indeed, this partly drove some of the market moves in February as central banks' terminal rates were repriced upwards. Communication from the likes of the Fed and the ECB has remained hawkish, with the latter seemingly more hawkish than late 2022. If central banks do tighten more aggressively than was assumed, equity markets are vulnerable to further downside from here.

Current valuations in the US do not look particularly attractive in this context: the 12-month forward P/E for the S&P 500 is 17.7x against a long-term average of 16.5x. Global equities trade at a multiple of 15.3x against a long-term average of 16.0x, offering better value. On balance, we believe there could be a better entry point for equities later this year.

THE MONTH AHEAD

MARCH

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
			9 China Inflation Rate YoY	10 BoJ Interest Rate Decision GB GDP MoM US Non-Farm Payrolls US Unemployment Rate
	14 US Inflation Rate YoY GB Unemployment Rate	15 US PPI MoM US Retail Sales MoM	16 ECB Interest Rate Decision	
		22 Fed Interest Rate Decision GB Inflation Rate YoY	23 BoE Interest Rate Decision	
				31 EA Inflation Rate YoY Flash EA Unemployment Rate

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Figures referenced herein have been sourced from ILIM and Bloomberg. Forecast figures have been prepared by ILIM based on reasonable assumptions, internal data and data sourced from Bloomberg.

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