Peak Rates Slower Growth

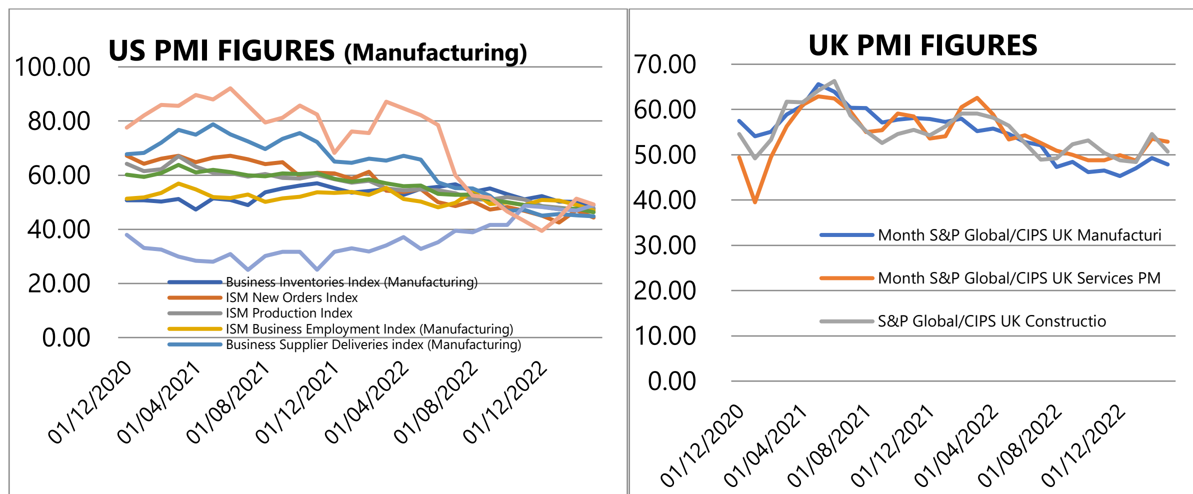
The US Federal Reserve is currently shrugging off recession warnings from internal advisers and continues to signal that another rate hike will be needed in light of both stubbornly high core inflation rates and very tight labour markets (as shown in the March 21-22 Federal Open Market Committee, FOMC, the Fed's rate setting body, minutes.) The Fed has dialled back on expectations as to how high rates will need to be increased due to the recent (localised) banking turmoil brought about the collapse of Silicon Valley Bank in California and Credit Suisse in Switzerland. The minutes of the March meeting also indicate that they may pause or even cease rate rises after May.

Whilst such a pause is by no means guaranteed, the idea of one chimes with expectations in the interest rate futures markets, in that the current US interest rate hike cycle should peak between March and May of this year.

Fed advisers at the meeting anticipated that a mild recession would start in the US later this year, the FOMC minutes said. Previously, advisers had judged a recession was as likely to occur as not.

Charts showing leading economic indicators in the US (below) support the view that after nine increases in the Fed Funds Rate since 17th March 2022 (by nearly five percentage points from an initial range of 0.25% - 0.50% to a current range of 4.75% to 5.00%) economic growth is definitely trending lower. A similar position is seen here in the UK, with Purchasing Managers Indices for Manufacturing, Services, and Construction either showing activity contracting (a read of less than 50) or falling levels of expansion in growth (figures remaining above the 50-dividing line between expansion and contraction but falling from previous levels).

US AND UK PURCHASING MANAGERS INDICIES 2020 TO PRESENT

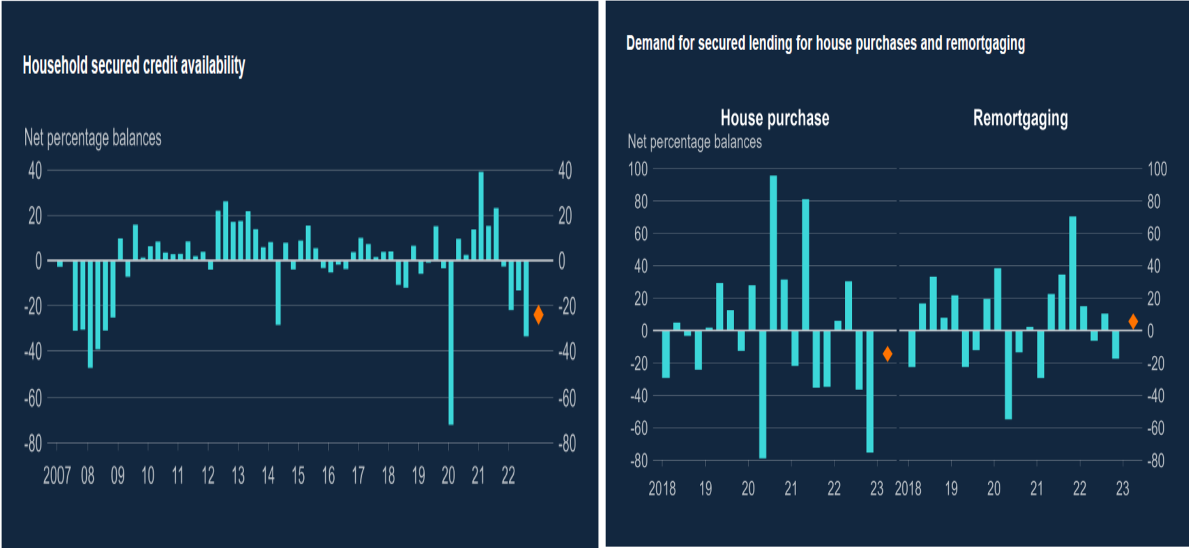


Source: Bloomberg/MPL

The Bank of England Credit Conditions Survey published in January and covering the period from 21st November to 9th December 2022, also supports the trend of slowing economic growth. On the supply side, lenders reported that the supply of secured credit to households decreased in the three months to end-November 2022. The availability of unsecured credit to households also decreased in Q4 2022 and is expected to have decreased further in Q1 2023. On the demand side, secured lending for house purchase decreased in Q4, and was expected

to decrease further in Q1 2023. Corporate lending to small and medium sized businesses also decreased in Q4 2022.

<u>BANK OF ENGLAND SECURED CREDIT AVAILABILITY AND DEMAND FOR SECURED LENDING FOR HOUSE PURCHASES AND REMORTGAGING – Q4 2022</u>

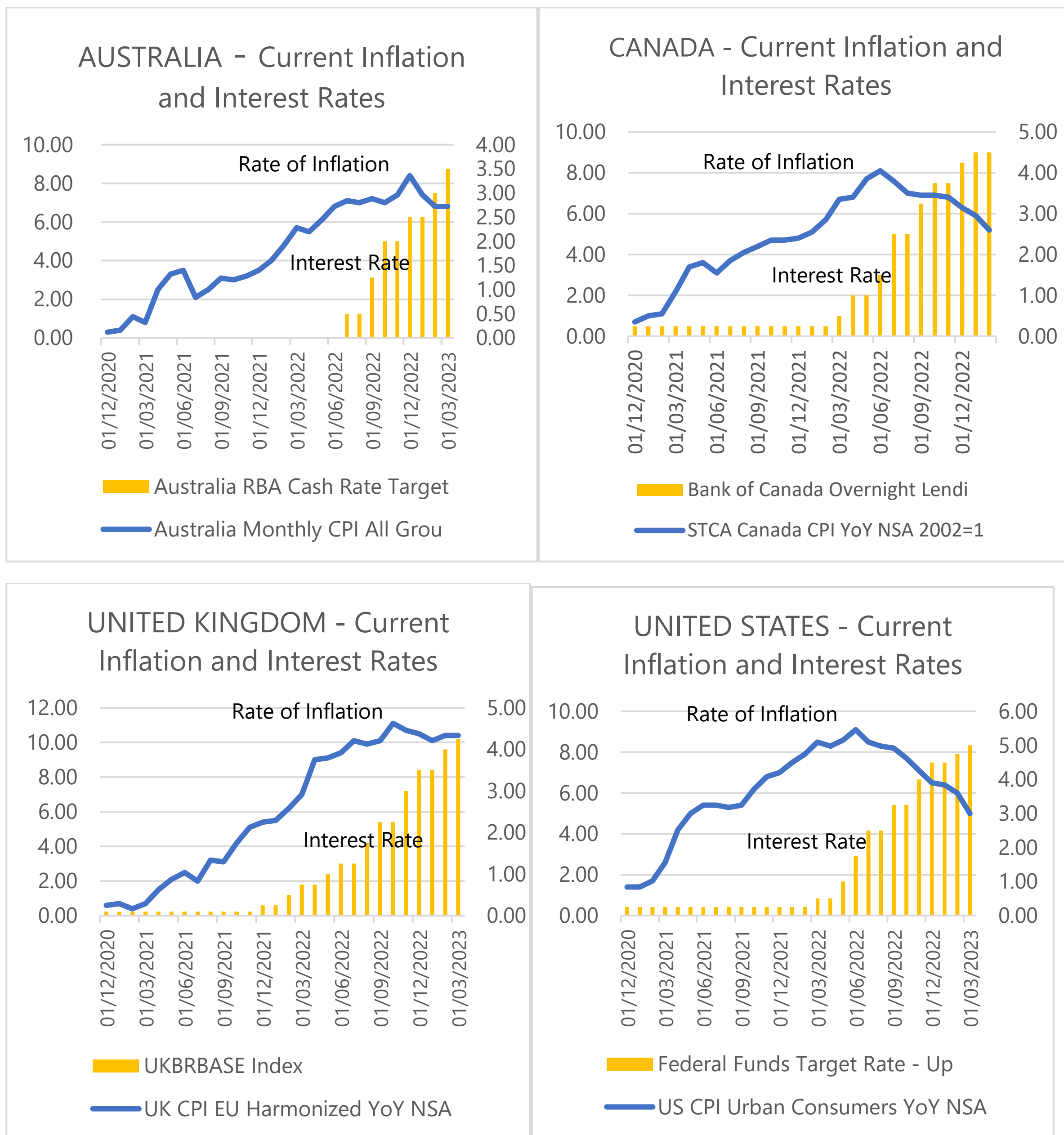


Source: Bank of England

The conditions detailed above lead us to believe that we are near to the peak of the current interest rate cycle in the US, the UK, and indeed in many other economies across the globe.

Several of the central banks overseeing the 10 most traded currencies since the start of the interest rate tightening cycle in September 2021, have already instituted pauses in the rate tightening cycle, for example, the Reserve Bank of Australia paused rates on 4th April, citing that hikes since May 2022 would potentially extinguish excess demand in the Australian economy, which in turn would send inflation on a downward trajectory.

The Central Bank of Canada meanwhile has telegraphed its intention to hold interest rates at their current 4.50%, where they have been since January. Canada's inflation rate peaked at more than 8% in June 2022, but as of March 2023 had cooled to 5.37%. The Bank has stated that it needs to assess whether current rates are already sufficiently restrictive to bring inflation back to target, and needs to understand the cumulative effect of the rate rises to date.



Source: Bloomberg/MPL

Most global central banks that have been on a rate-hiking mission to combat above-target inflation, may be either close to a peak or already done with interest-rate hikes, auguring a hiatus before possible monetary loosening then comes into view.

With the first clear signs of dents in economic growth expectations now visible, and with the fallout from recent financial-market tensions triggered by the tightening rates still lingering, any pause by the Federal Reserve after at least one more rate increase expected on 3 May could cement a turn or 'pivot' in what has been the most aggressively rapid interest rate-hiking scenario the world has seen in decades.

As stock markets are themselves forward-pricing mechanisms which will benefit from any pause or pivot in the current rate cycle trajectory, the MPL investment team have begun the process of tactically reallocating some of the cash held in client portfolios for the past year, back into financial markets.

Portfolio Changes

AXA Framlington Global Technology (Overweight): Global Technology, an area which has been negatively impacted due to the downward effect of higher interest rates upon the terminal valuations of growth companies in the sector, remains in our view to be super-cyclical, meaning that despite recent setbacks it remains on a longer-term growth trajectory. Perversely, it is the perfect area of market shelter in the current peak rate environment, many companies in the sector have exceedingly elevated levels of cash flow generation, continued earnings growth prospects, strong balance sheets (often with low debt) and in the interim have had their valuations mauled by the markets. Hence, while many of these companies are initially still in a recovery mode, this will be enhanced when interest rates eventually start falling.

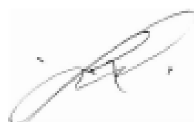
Cash (Neutral): Following the recent increase in the UK base rate to 4.25%, a portion of the cash available in client portfolios has been rolled into a one-month certificate of deposit with Barclays Bank at a gross interest rate of 4.15% per annum. If the Bank of England were to increase interest rates from current levels, we would expect the rates offered to MPL clients to reflect any such rise.

iShares Core FTSE 100 ETF (Overweight): Using the recent banking tumult to our advantage, the sharp pullback in the FTSE-100 Index that it occasioned was used to initiate a tactical overweight position in this Index. As evidenced by the rates available within our Cash Management Service, the banking sector will continue to thrive, in the short term at least, within this higher interest rate environment, where lending margins are vastly improved from recent years.

Even with an economic slowdown now evident in the UK, many quality companies within the FTSE-100 such as Diageo, the global drinks brand, are currently displaying not only highly defensive qualities such as strong balance sheets, high cash flow and free cash flow levels, sufficient to allow them to remain untroubled in a slow growth environment, but they also have strong earnings growth prospects over the next several years. All this while they are paying dividend yields in excess of 2%, which investors can garner whilst they wait for financial markets to reward the company for this growth over the coming years.

UK Commercial Property Trust PLC (Overweight): Commercial property is very much an interest rate-sensitive asset class, and where peak or near-peak interest rates in the UK have recently reduced the price of this Investment Trust to under 50 pence, which represents a discount of over 35% to the Net Asset Value of the properties held within the Trust. That also translates into the Trust offering investors a 6.78% yield, levels only seen three times in the past 15 years . We have thus taken the holdings in this vehicle to an overweight position.

With Kind Regards



Mark Kitson
INVESTMENT DIRECTOR

Simon Weighell
SENIOR INVESTMENT MANAGER

Richard Dawes
INVESTMENT MANAGER