MPL
WEALTH MANAGEMENT

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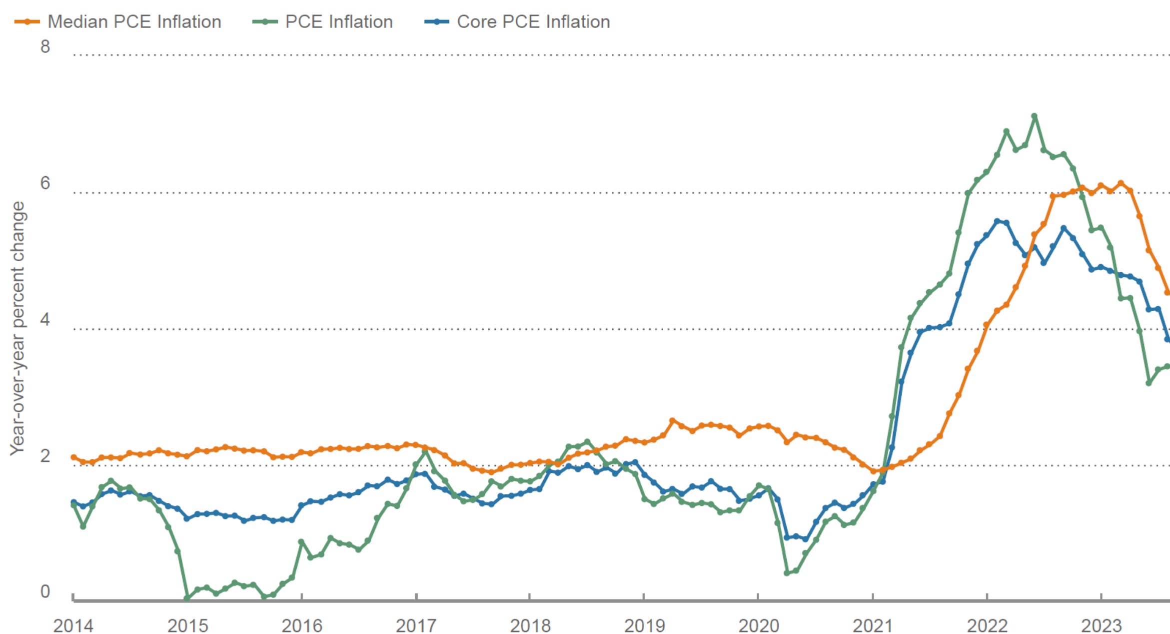
Income Bias

With the frustration of the now twenty-plus month bear market (excluding the seven big US technology companies - Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla) still with us, we are finally beginning to see what we have been waiting for:

Inflation

Inflationary pressures continue to ease from their recent peak.

Median Personal Consumption Expenditures Inflation



Source: Bureau of Economic Analysis, Federal Reserve Bank of Cleveland, Haver Analytics

It is encouraging that the various measures of Personal Consumption Expenditures (PCE) Inflation (which covers a broad range of goods and services and provides a general overview of the prices of things that are purchased directly by, or on behalf of, households) shown above, have fallen from the peaks throughout 2022. The PCE metric is one most closely followed by the US Federal Reserve (the Fed) when considering setting its interest rate policies.

This has encouraged global central banks to pause the interest rate hiking cycle, which has otherwise blighted financial markets, and manifesting in this bear market. Whilst inflationary pressures are clearly easing however, we are not out of the woods yet.

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"Higher for longer"

In the US, inflation is still running above the 2% annual target set by US Federal Reserve, and as indicated above consumer spending remains strong, with a steady and strong labour market, although the rate of jobs job growth is now beginning to moderate.

This is a positive for efforts by the Fed to cool inflation whilst at the same time trying to avoid a recession, but it has stoked fears that the inflation fight could be prolonged, prompting a new mantra of 'higher (interest) rates for longer' by the Fed.

However, strains are starting to appear in US consumer spending at the lower end of the demographic or wealth scale, as saved funds from the Covid pandemic era start to run out, and this could eventually change this higher rates for longer mantra, to one of interest rate cuts going forward.

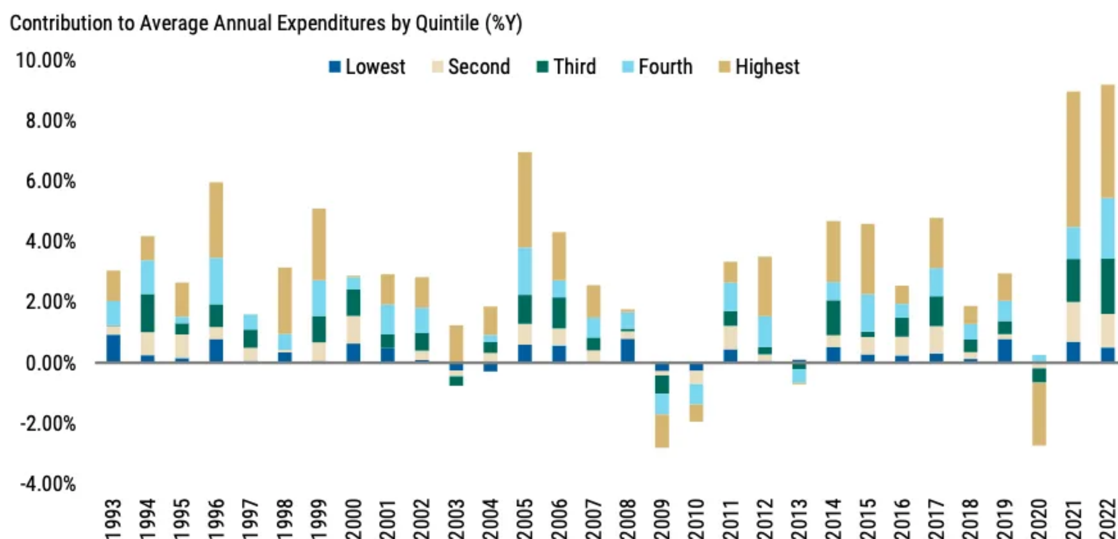
In a recent interview with CNBC, Citigroup CEO Jane Fraser said "cracks" in consumer spending are most notable among those on the lower rungs of the ladder. Fraser said that while Citi's data shows consumer spending is still "good" and is in positive figures, growth has begun to "come off". She acknowledged that lower-end consumers are beginning to show signs of distress, with "cracks" in their behaviour beginning to appear.

"Savings are down," Fraser continued. "They're very low at the moment" and she thinks some of the excess savings from the Covid years are close to depletion. American households actually had far less in their bank accounts than previously estimated, with the Bureau of Economic Analysis finding that between 2017 and 2022 families saved $1.1 trillion less than previously thought.

The key factor here, however, is the top quintile of earners – or households in the top 20% of income in the US.

A report from economists at investment bank Morgan Stanley published late last month, showed that the top quintile of earners accounted for 45% of all consumer spending between 2020 and 2022. Since 2004, this group has typically accounted for closer to 39% of all spending.

Exhibit 1: Contribution to average annual expenditures by income quintile



Source: BLS, Morgan Stanley Research

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Spending by this top quintile, who are benefiting from a higher interest rate in the form of increased interest payments on their bank deposits and bond investments, remains resilient. Spending will slow in this segment if there are broad-based white-collar layoffs and any significant loss of wealth, particularly in housing. However, odds are low at this stage that this will materialise, meaning that this resilience, plus the current situation regarding commodity prices (explored below), could lead to further interest rate hikes if the US economy continues to expand too swiftly.

"Commodity prices"

Production cuts by Saudi Arabia and its allies, but particularly Russia, in the summer caused the oil price to rise by more than 25% from a level of around US$75 per barrel in mid-June to over US$95 in late September. Whilst the price of Brent Crude has retreated to around US$84 per barrel at the time of writing, some worry that the current Israel-Gaza conflict could further exacerbate matters here.

Notwithstanding the ongoing oil supply disruptions caused by the Russia-Ukraine war, according to the World Bank's quarterly Commodity Markets Outlook report, if the conflict between Israel and the militant group Hamas intensifies, under the worst-case scenario global oil supply could fall by 6 to 8 million barrels per day, against current global oil consumption which stands at roughly 102 million barrels per day. This could lead to oil prices rising to an estimated all-time high of US$157 per barrel, which would certainly be damaging for the global economy.

An increase in commodity prices could also intensify existing food price inflation concern, as surging oil and gas prices would inevitably have a ripple effect: for example expenses would increase in the shipping and fertilizer sectors, which in turn would translate into higher prices globally for agricultural commodities.

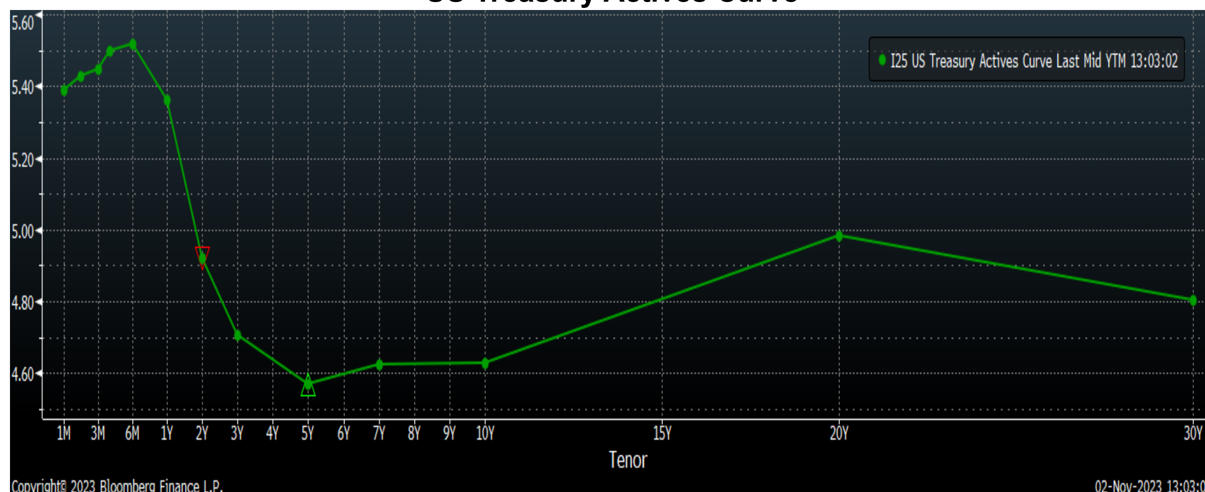
These factors would add pressure to headline inflation, which is the total inflation figure in an economy. This figure includes inflation in a basket of goods that includes commodities like food and energy. 'Core' inflation on the other hand, excludes food and energy in its calculation. Thus inflation expectations would have to be revised higher, with central bankers responding accordingly, potentially raising rates further still and hampering investment markets in the process.

Bond Yields

This change to the 'higher for longer' mantra by the Fed set the tone for a sell-off in US Treasuries. Yields on 2, 5, and 10-year US Government Bonds rose to their highest levels in more than a decade, with global equity indices equally suffering a brutal period throughout October.

Indeed, recent events have now led to an 'inverted' US Treasury yield curve, where bonds maturing in a year or two yield more than those for five and 10-year maturities – this is a reversal of the normal pattern where longer-dated treasuries carry higher interest rates to compensate for the additional time and inflation risk of investing in them.

US Treasury Actives Curve



Source: Bloomberg

An inverted yield curve is usually an ominous sign, that historically has rarely been wrong in predicting a looming recession. Bringing all these matters together, our view is that putting the events of 2022 and the current year behind us, we have to view our forward asset allocation with a new lens:

Global investors in the main are worried about the following scenarios:

1. Will there be a soft or hard economic landing in the US? - If there is a soft landing and we return to the Fed's 2% target, interest rates will gradually fall.

   In this scenario, and depending on the sensitivities to interest rates and grades of the bonds within investment portfolios, we will be well compensated in building a greater allocation towards income, within the total return (income plus capital gain) expectations for client portfolios. By holding bonds, we will be paid attractive income levels while we wait for capital appreciation to come about as interest rates fall across the US yield curve in the event of a soft landing - where economic growth remains positive but weak and company earnings stagnate, but at the same time the labour market remains resilient within the US economy.

   Bond holdings will be married with cash deposits. Cash – as highlighted by our relaunched Cash Management Service – is an attractive asset class once more. With gross one-year yields in excess of 5% per annum, this is now the starting point for returns expectations.

   In the equity space and after the brutal month of October, equity valuations are more attractive following that month's sharp falls, but we remain cautious nevertheless. Until we see a corporate earnings recession and coupled with benign inflation, it may be some time before we see a new bull market in equities. However, exposure to high quality income-producing companies or funds with good growth prospects in this period, will be a positive complement to fixed interest and cash in this environment.

   Our overweight in the Technology sector and the Artificial Intelligence boom have provided some positives so far this year, and we will be looking to gain more exposure to the sector through another vehicle here.

2. If the US consumer cracks (that is where the top three top quintiles of the population stop spending) – the Fed may have to cut rates more aggressively to avoid a hard landing, which would be a recession essentially - where economic growth is negative and company earnings stagnate or decline, alongside a poor labour market. In this circumstance, capital appreciation in bonds would probably occur aggressively at the short end (out to 2 years) of the curve, as the US yield curve is inverted – see chart.

3. In the event of an intensification of the conflict between Israel and Hamas, with consequent added inflation and a global slowdown, short-dated paper (Bonds) and cash would still offer protection in this scenario.

At this stage, our plan involves a key scenario going forward.

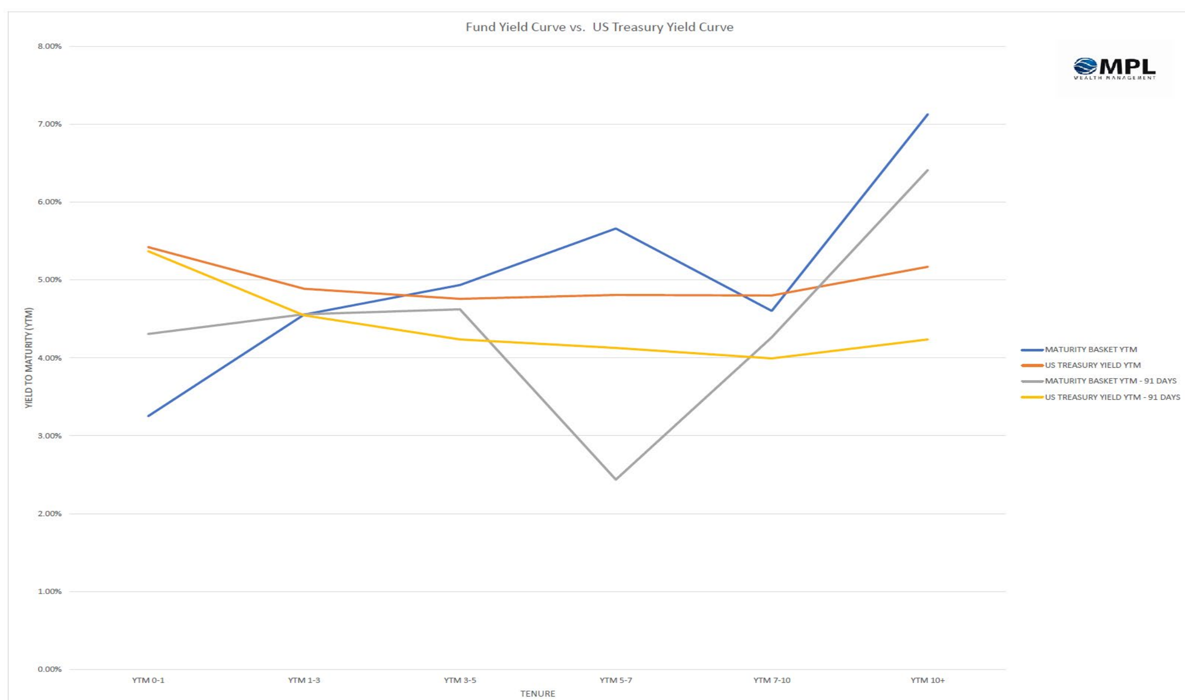
Portfolio Changes

As briefly mentioned in our last letter, we will now be adding the following Strategic Bond Funds into client portfolios.

Jupiter Global Macro Bond Fund

The Jupiter Global Macro Strategic Bond Fund seeks to achieve income and capital growth by delivering a return net of fees, greater than the Bloomberg Barclays Global Aggregate Index (GB Sterling Hedged) over rolling 3-year periods. The fund primarily invests (at least 70%) in a diversified portfolio of global fixed, variable, and zero rate debt securities, including government and corporate bonds. The fund will vary the currencies in which it invests to enable it to achieve its objective.

The managers feel that with currently robust labour markets, the chances of a significant economic downturn are limited, and we are increasingly at risk of a cyclical rebound in manufacturing at some point.



Source: Bloomberg, MPL Wealth Management

The fund has benefitted from a shorter duration position with a significant steepening position, in which yields on the longer-term bonds held rise more than those on the shorter dated bonds, which has led to capital gain.

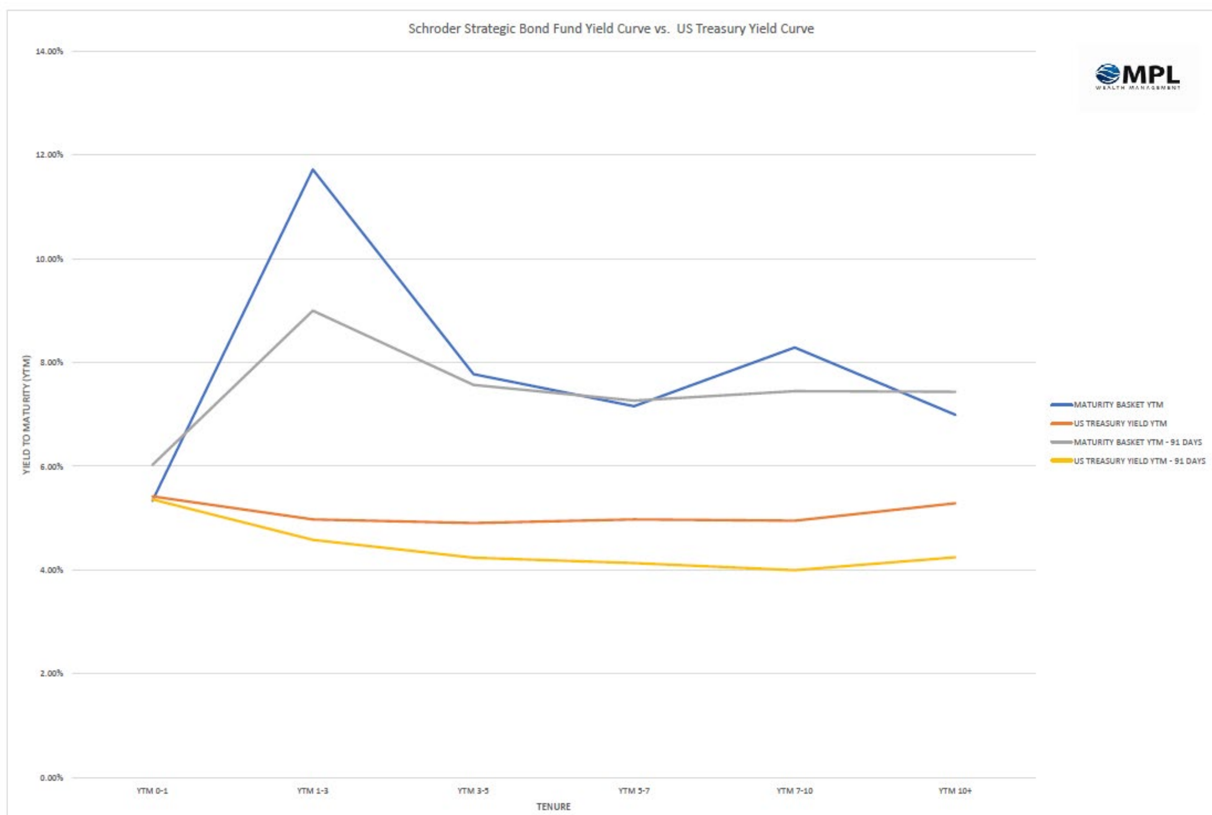
If a soft landing does occur in the US, we can expect this portfolio to appreciate by over 4% for every 1% that interest rates are cut going forward, whilst being paid a yield of 3.7% per annum whilst we wait for this to occur.

Schroder Strategic Bond Fund

The Schroder Strategic Bond Income Fund aims to provide income and capital growth of between 2.5% and 4.5% per annum (after fees have been deducted) over a three-to-five-year period, by investing in fixed and floating rate securities denominated in Sterling.

Investment Grade Credit – whilst the team are neutral on investment grade credit generally, they are positive on European Investment Grade Credit, thus retaining a preference for European investment grade bonds. They expect these to benefit from the European Central Bank (ECB) nearing the end of its rate hiking cycle.

High Yield Bonds (non-Investment Grade) – The fund managers have upgraded their score to positive on this sector. Yields are attractive and they do not expect any pick-up in defaults in the sector, as corporate and household balance sheets remain strong, leaving them in good stead to digest tightening financial conditions and any moderation in growth rates.



Source: MPL, Bloomberg

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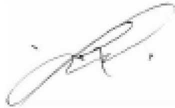
In the event of a fall in interest rates, we expect capital performance to be driven by the 3-to-5-year duration stocks within the bond portfolio, these comprising nearly 30% of this fund's overall weighting. In the meantime clients are being paid a 5.86% income yield in this fund whilst we wait for this to occur.

With Kind Regards

Mark Kitson
INVESTMENT DIRECTOR



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