SWINGS AND ROUNDABOUTS

Markets have had an unsettling spring. First, bad news last month on US inflation for Q1 dashed hopes of an early interest rate cut. Equities and bonds dropped as the data came in. April's 4% decline in the S&P 500 brought a five-month streak of gains to an end. News in early May on the real economy then rallied spirits again. By the end of this week, US equity markets were up by 4%, and bonds were up 1% for May.

Next week's consumer price report will be a critical early signal of whether inflation is still stuck well above the Federal Reserve's 2% goal. If the report shows little change in inflation from Q1, markets will likely decline again. Analysts will have to rethink the story of a gradual easing of US monetary policy that will support a benign soft landing. Conversely, any evidence that price increases are slowing again towards the Fed's price stability goal should be reason for investors to cheer.

DIVERGENCE ACROSS THREE THEMES

RockCreek has laid out three themes for investors to watch this quarter: inflation, growth, and the implications of the first two for interest rates. This year has seen a divergence between the US and other major developed markets on both inflation and growth. That is now leading to a divergence in interest rate expectations.

Strong US growth – and inflation apparently stuck between 3% and 4 % – have made a September cut in interest rates the most optimistic timing for the Fed.

Elsewhere, summer rate cuts are more of a certainty. Indeed, two European central banks – Switzerland and Sweden – have already begun easing. The Bank of England held its policy rate unchanged this week at 5.25%. But with two members favoring an immediate cut in rates and others signaling that they thought the time was almost ripe, a June reduction in UK interest rates is very likely. The same is true for the European Central Bank (ECB) and the Bank of Canada.

The Fed is thus in the unusual position of lagging rather than leading the monetary policy cycle. To the extent this reflects greater US or economic dynamism, as the latest forecast from the International Monetary Fund (IMF) suggests, the US market will remain attractive.

THE US STORY

The causes of May's mini-rally are both good and not so good.

Strong US corporate earnings, especially in the big tech companies (as detailed below) that have fueled the run-up in stocks, helped to validate current high valuations. That's the good part. At the same time, evidence that some of the heat may finally be coming out of the US labor market put rate cuts back on the agenda for the fall. That is good news for markets and less good news for Americans looking for a job. This week's report that unemployment insurance claims rose at the beginning of May added to signs that the US jobs market may be softening, albeit gently.

So far, the labor market may be easing, but it remains clear of recession territory. After taking account of the slowdown in job growth and decline in vacancies reported for April, job gains averaged a healthy 242,000 a month in the past three months. Moreover, unemployment, although it ticked up last month, is still below 4% for the 27th month. Just two years ago, it was widely viewed as impossible to cool inflation without a lot of Americans losing their jobs, and a plunge in profitability.

The May pickup in US market sentiment was helped by soothing words from Fed Chair Jerome Powell and colleagues, who met on May 1. The Chair has emphasized that he views the current rate environment as restrictive, effectively ruling out the need to consider rate hikes, even if inflation remains sticky.

Since the peak of the inflationary surge passed in the second half of 2022, the Fed, mindful of its dual objectives, has been focused on finding a balance between achieving the price stability goal without crushing the economy. The question looking ahead is whether today's policy mix is tight enough to exert downward price pressure while not too tight to allow growth to continue.

POLITICS, GEOPOLITICS, AND MARKETS

Some wonder whether US central bankers will avoid cutting rates ahead of the Presidential election, even if the data would warrant action in September. At RockCreek, we believe Chair Powell and colleagues will follow the data, even if it leads to uncomfortable timing. The Fed has stressed that it remains data-dependent. In today's economy, when key macro outcomes have confounded forecasters, this is a wise approach. But dependence on unpredictable data means policy itself can add to volatility and uncertainty.

Most people do not like uncertainty. Neither do financial markets. Post-pandemic uncertainty about economic relationships and the long-term outlook for growth and interest rates comes against a backdrop of considerable geopolitical and political turmoil. Wars in Europe and the Middle East continue. China's relations with the US and Europe remain strained. But perhaps the biggest uncertainty troubling investors now concerns the US Presidential election in November.

The outcome of the election – for Congress and a third of the Senate as well as for the Presidency – is likely to remain highly uncertain throughout the next six months. Polling suggests that all three of the executive branches could go to either one of the two main parties. Divided government – with one party controlling the Presidency and the other controlling one or both chambers of Congress – may seem to promise the most continuity. If that is the outcome, it could trigger a relief rally. But some of the changes promised by former President Trump could be done without Congress. That includes some actions with important economic and financial ramifications, such as sharply increased import tariffs and restrictions on immigration. Both would tend to be inflationary. President Biden is also considering further raising tariffs on China, in particular to dampen demand for Chinese electric vehicles, but former President Trump favors significantly broader trade barriers.

WILL THE GOVERNMENT AND CONSUMERS CONTINUE TO HOLD UP THE ECONOMY – AND WHAT ABOUT RISING US DEBT?

An enormous fiscal boost helped the US to weather the pandemic shock to the economy with little of what economists call scarring. The downside was that this added to the demand pressures that, when met with lockdown supply constraints, contributed to an inflationary surge. Inflation took off globally while post-pandemic growth has been stronger in the US than in most other advanced economies.

Americans are more aware of and concerned about inflation than they are pleased by the growth and employment performance. But consumers have not as yet been put off spending by high price tags. In part, consumption has been supported by drawing down savings made during the pandemic. Those savings have lasted longer than many expected. But they are now exhausted, according to a new study by Hamza Abdelrahman and Luiz Edgard Oliveira of the San Francisco Fed.

Government direct spending has been the other major support for the US economy. The tail end of the pandemic-related fiscal spending impulse helped to fuel the US economy last year. This year, the government will continue to run a large fiscal deficit, adding to the debt load that is now reaching 100% of GDP. But budget spending will not increase so as to provide an impulse to the overall economy this year. Indeed, it is likely that the net effect of fiscal policy – spending and taxation together – will be slightly contractionary.

That does not stop many from worrying about the increasing debt load – with higher interest payments adding to spending. Some bond market experts believe that the prospect of higher deficits and debt for years to come will keep interest rates high and bond prices depressed into the medium-term. They envisage a regime shift from the post Global Financial Crisis (GFC) period of low rates globally and perhaps even a sudden collapse in bond prices. Others are more optimistic. RockCreek's advisory board has experts on both sides – as this discussion from our recent macroeconomic discussion shows.

DEVELOPED MARKET EQUITIES

The past two weeks have been busy with more than 80% of S&P 500 companies reporting results. Overall, first quarter earnings have been supportive of equity markets with EPS growth tracking at a 5% growth rate versus 3% previously forecasted. Healthy earnings were a major factor limiting the S&P 500's recent dip to a shallow 6%, lasting from March 28th through April 19th.

Big Tech had lofty expectations to meet on the back of tremendous AI demand – and largely exceeded them. Microsoft beat on both the top and bottom line while posting 17% year-on-year revenue growth for the second consecutive quarter, driven by 31% growth in Azure. Alphabet easily beat numbers as cloud and search revenue growth accelerated. Amazon and Meta also registered double beats although the scale of Meta's increased AI investments spooked investors.

Interestingly, more companies appear to be following on the heels of Big Tech's playbook last year of taking major steps to reel in costs and improve efficiency. Net profit margin growth for S&P 500 companies is on pace to grow almost 12% for Q1, which is slightly above the five-year historical average. Outside of Big Tech, this has been driven predominantly by cost-cutting measures as opposed to surging revenues.

Market mood remains positive right now, although it always is before the party comes to an unexpected halt. We may indeed see the market continue higher if the economy remains strong and inflation eases. From a valuation standpoint, it is difficult to envision an extended bull cycle from here though. The Shiller P/E has not been a great indicator of future market performance, but it's worrying when it's in the top percentile. Similarly, the Buffett Indicator, which expresses the value of the US stock market in terms of the size of the US economy, is at a two standard deviation level, indicating a strongly overvalued market.

FIXED INCOME

So far this month fixed income markets have been driven by two events: the FOMC decision on May 1 and the Employment Report for April (both of which are discussed above). At the end of April, markets were expecting the Fed to cut just once by the end of this year after a succession of hot inflation prints in Q1. Markets are now expecting one additional cut for 2024. Despite this change in expected policy easing, the yield curve remains notably inverted. The 3m10yr point is inverted by 95bps – 23bps more than at the end of April. Similarly, 2s10s remain 36bps inverted, flat over the same period. Uncertainty around the evolution of inflation and thus the path of monetary policy has kept implied volatility high. The ICE BofA Move Index continues to trend around the 100 level, more than twice that of its post-pandemic nadir.

The shape of the curve, elevated volatility, and higher-for-longer outlook have created strong opportunities in active management for fixed income both in long only and hedge fund format. Staying shorter duration and collecting yield has proven a successful strategy as longer duration positions have been whipsawed YTD as rates shot higher after a strong rally in Q4'23. Interestingly, despite this higher-for-longer outlook credit spreads are quite tight, suggesting little implied pricing of a credit event for the whole market. While this may prove true, particularly in the event of a successfully orchestrated soft landing, security selection will play a crucial role for credit given the relatively limited risk premia in the asset class. Capital structure arbitrage and related strategies have benefitted significantly YTD with the current high interest rate environment.

FX

Divergent monetary policy has been a main driver of FX moves so far this year. The dollar, as measured by DXY, has strengthened by approximately 4% this year. What is most notable about the move is how disparate the strength has been. For example, the developed market central banks running relatively easy monetary policy – Japan, Switzerland, and now Sweden – have seen their currencies depreciate by roughly 7-10% vs. the greenback this year. Those likely to ease more aggressively, Eurozone and UK, for example, have seen modest weakening of 2% or so.

Perhaps most surprising has been the resilience of certain emerging market (EM) currencies. The MSCI Emerging Markets Currency Index is flat on the year, supported by the Indian Rupee. Another notable performer is the Mexican peso, which has strengthened against the dollar in 2024, driven by responsible central bank policy, increased FDI, and increased remittances to the country. Commodity exporter's currencies – particularly large copper exporters – have performed well this year. The Peruvian Nuevo Sol is slightly stronger against the dollar. The Chilean Peso is weaker, but it has strengthened meaningfully since the copper rally started in February.

EMERGING MARKETS EQUITIES

Better-than-expected performance of EM currencies is not the only surprising statistic out of this group of countries. For years EM equities have underperformed the US, so much so that many investors have thrown in the towel on the asset class altogether. Taking such a wide view obscures the dynamic nature of, and opportunities present in, the individual countries that make up the index. Over five, and even ten years, markets exposed to secular tailwinds of growth (India) and tech and innovation (Taiwan) have kept pace with, and even outperformed in some instances, US equities. Mexico has also been a strong performer in the past five years as an obvious beneficiary of North American "friendshoring."