LET THE CUTTING BEGIN… BUT NOT YET IN THE US!

This week saw the first interest rate cuts by major country central banks since the pandemic.

First Canada and then the European Central Bank (ECB) lowered their policy rates by 25 basis points, following earlier moves by Switzerland and Sweden. Some hoped that the cuts signaled the arrival of the long-awaiting easing of global monetary policy, with the US soon to follow. Markets initially cheered. But that reaction faded with the Friday news that the US economy is still adding jobs at an unusually rapid rate. Unemployment rose to 4% in May and labor force participation slipped – both potentially worrying signs for growth. But the labor market report also showed an additional 272,000 jobs were created in America last month, above the monthly average for Q1.

By week's end, US equities were up by 1.5%, 10 year yields down 7bps (despite a big jump on Friday) and the dollar was slightly stronger.

The Federal Reserve (Fed) is not only expected to resist cutting rates when it meets next week, it is also expected to postpone later into the fall any projected rate cuts. The world economy is in an unusual position. Instead of leading global monetary policy, the world's major central bank is lagging its peers. Why? And what impact should investors look for?

Divergence among major economies lies behind the timing difference. In theory, as interest rate policy diverges, this will reduce underlying economic differences in inflation and growth, including through the impact on exchange rates.

RockCreek has laid out three themes for investors to watch: inflation, growth, and interest rates. On the first two, the US diverged markedly from its peers in the first months of this year. That has led to the difference in monetary policy. If maintained over time, tighter US policy would tend to strengthen the dollar and weaken the currencies where rates are easing. Such currency moves in theory would reinforce the boost to their economies that central banks in Canada and Europe are seeking with rate cuts. But they are unlikely to let any exchange rate moves go too far, for fear of stalling progress on disinflation.

The US experienced disappointing inflation numbers in Q1 together with unexpectedly strong growth, in jobs and spending. That put interest rate cuts on hold. In Europe, inflation has mostly continued to move closer to the 2% price stability goal. Although April figures were not as subdued as the ECB had hoped, the low number for Germany – where price increases are very nearly 2 % – helped to tip the ECB decision to cut this week.

Dismal growth outcomes have also added to easing pressure in Canada and Europe. The easing may have begun for both. But it will not proceed quickly. BoC Governor Tiff Macklem and ECB President Christine Lagarde signaled that they would move with caution, as inflation was still too high. Investors should expect these central banks to skip further summer cuts and wait until September. By then, the Fed could be ready to lead the way again. But only if the economic data – importantly including next week's consumer price report for May – are consistent with slowing inflation.

Q2 WOBBLES BUT JOBS STILL GROWING: IS MONETARY POLICY REALLY BITING?

As the American consumer kept spending earlier this year and businesses continued to hire at a rapid rate, some observers have wondered if monetary policy is not as restrictive as the central bank thinks. Perhaps, policy rates of more than 5.25%, the highest level since 2007, are still too low to choke off demand and bring down inflation. Former President of the New York Fed, William Dudley, recently suggested as much. On that view, US rates must stay at today's level – or perhaps climb even higher – if inflation is to be brought down sustainably to 2%.

If the US economy is instead slowing, as some recent data suggests, then it could be that restrictive policy has just taken longer than expected to affect the broader economy. Either way, it is now clear that both sides in the early arguments about the 2021/22 inflationary surge were wrong in important ways.

Former Fed Chair Ben Bernanke and renowned economist Olivier Blanchard point out, in a research paper issued at the end of May, inflation subsided rapidly after mid-2022 in large part because energy and food price shocks abated. The fears of many that high unemployment and recession would be needed to avoid a dangerous wage-price spiral turned out to be misplaced. But the hopes of "team transitory" that inflationary shocks would quickly pass were also wrong. The sequence of shocks from the pandemic and post-pandemic period was long. And eventually steady wage inflation, above the rate consistent with 2% price increases, has emerged as a contributor to slowing – if not halting – the disinflation progress.

Looking beyond the short-term, there is reason to expect that it could be difficult to bring inflation back to 2%. The geopolitical world has shifted dramatically since 2018/19. Americans no longer have such easy access to cheap and subsidized goods from China. Immigration restrictions and likely easy fiscal policy will also tend to increase price pressures however the US election is resolved. And real incomes for middle-class US households are still below the aspirations of many.

ELECTION SURPRISES: EM FIRST, OTHERS SOON

Three major emerging markets – India, Mexico and South Africa – had important elections this week. In all three, the results surprised pollsters and changed the outlook for their countries, perhaps in important ways.

India, as discussed in more detail below, caught the attention of investors. Prime Minister Narendra Modi failed in his attempt to win an outright majority for a third term. A strong win had been widely expected, and seen as positive by many investors. But a more considered reaction to the setback for Modi is now emerging. A coalition government will restrain the Prime Minister from carrying out constitutional changes to consolidate India as a Hindu state. Such reforms would have deepened divisions in the huge and multi-ethnic country. Moreover, in the past, coalition governments have often been most successful in promoting growth.

More elections are to come, in Europe, the UK and, of course, later this year, in the US. They will all be watched for signs of policy changes that could impact markets and business. Many Wall Street leaders appear to have decided to support former President Trump. Polls suggest that the race remains very close. Americans, as many around the world, are unhappy with economic developments, in particular inflation, and inclined to blame the government in power. Voters also appear willing to embrace radical approaches, including moving away from traditional American policies of free trade and open markets.

Economists, including from the American Enterprise Institute, believe that raising tariffs, as former President Trump has promised, will boost inflation and harm the US economy. Measures to restrict immigration and carry out mass deportations would also curb the growth in labor supply that has helped to achieve recent economic growth.

The US election is still months away. This weekend, Europeans go to the polls to determine their national representatives in the European Parliament. Turnout tends to be low – close to that in US mid-terms. But the results can be important as a signal of the mood of the broad European electorate. They also matter for EU policies and direction; the Parliament must confirm the next European Commission President as well as approve legislative changes. A resurgence of far-right parties is widely expected, and feared, by many. A decline in the strength of Green parties, which have driven climate and sustainability policy in Europe, is also likely. On July 4, the UK is expected to vote in a Labour government, led by Keir Starmer, after 14 years of Conservative power. Unlike in the US, the transition takes place immediately.

Except in Mexico, this week's elections also showed a desire for change. One cause for celebration – democratic outcomes were upheld, even when powerful leaders were disappointed, as in India and, more dramatically, South Africa. It is possible to be cautiously optimistic that in both countries the shock to the leadership – particularly difficult perhaps for the ruling African National Congress (ANC) that led the liberation movement after apartheid – will lead to better policies.

INTEREST RATE AND CURRENCY MARKETS

Election outcomes and central bank decisions were the significant drivers of rates and currency risk in recent weeks. This was true across developed and emerging markets. Perhaps the most interesting market action was in the wake of the ECB decision. Following the bank's decision to cut rates ahead of the Fed, the Euro actually strengthened against the dollar. This was driven by the revision of interest rate cut expectations in 2024 post announcement and press conference. The Canadian Dollar reacted more intuitively, weakening against the USD after the Bank of Canada cut on Wednesday; the move was sharp at first, but eased slightly throughout the session.

In emerging markets, the volatility was driven by largely unexpected election outcomes. This was most prominent in the Mexican peso. Immediately following the Mexican election, the peso fell 4.3% on June 3 – the currency's biggest single day move since June 2020. It continued to weaken throughout the week and ended down 7.3%. Long MXN funded with dollars had been a popular trade for many months leading into the election, given the strong positive carry in that trade. The dramatic move in the peso, especially on the day following the election, was potentially influenced by unwinding of those carry trades. In South Africa, the Rand strengthened on the news of the ANC's underperformance but flagged in subsequent days as the electoral outcome remained uncertain. Finally in India, the Rupee ended the week flat despite significant gyrations as investors celebrated the exit polls, panicked about the actual results, and worked to become comfortable with the coalition.

EQUITIES: ARE ANIMAL SPIRITS ALIVE AND WELL?

Despite slowing US growth and choppy international currency markets, the S&P 500 and Nasdaq Composite reached record highs on Wednesday, June 4 before slipping; as of the end of the week, they are up 13% and 15%, respectively, year-to-date. We've also witnessed a mini-meme stock craze take hold with Keith Gill's (a.k.a. Roaring Kitty) recent return to Reddit and YouTube with the disclosure of an eye-popping stake in GameStop held mostly through options. The retail company's shares have surged as much as 180%

this year, and it's not the only questionable stock getting attention. In May, seven of the top 10 most traded stocks, measured by number of shares traded, were penny stocks valued at less than $1, and not one of those companies is profitable. Despite all that, the overall market has not been nearly as strong as it might appear on the surface. It's been a very narrow and distorted market. Most notably, Nvidia has accounted for approximately 34% of the S&P 500's gain so far this year on its way to passing Apple as the second largest public company in the US. The S&P 500 on an equal-weighted basis has been on a downward trend since May 15th and is up only 5% this year. The same is true for the Russell 2000, which is flat so far in 2024. Stubborn inflation and a weakening economy could make it difficult for small-cap and other left-behind market segments to narrow the performance gap in the near-term. That the latest AAII Sentiment Survey measured a rise in pessimism among individual investors also doesn't help.

Japan has shown the most obvious signs of investors looking to take a pause even though the country's corporate sector continues to hum along. After sprinting out to a 20% gain in the first quarter, the Nikkei 225 has pulled back by 4%, leaving it up 16% YTD (in local currency). European stocks were also beginning to fade after a strong run this year but were listed this week by the ECB's decision to cut interest rates. The STOXX 600 recovered to near its May 15th all-time high and is up 7% thus far in 2024. Recent performance has been driven by the ECB's telegraphing and decision to cut interest rates. Corporate profit margins have also been surprisingly resilient. Sixty percent of companies in the Stoxx Europe 600 beat first quarter consensus estimates, led by the banking sector. Europe has also benefited from a low bar as the market has been priced at a material discount to the US for a long time.

FIXED INCOME

Prior to the release of payroll data on June 7th, the Bloomberg Global Agg was up 1% MTD. Performance has been led by mortgages (up 2%), Treasuries (up 1%), and investment grade credit (also up a little over 1%). The mood of the relative performance seems in line with the pockets of slowing momentum in the economy and equities as detailed above.

Going forward, the shape of the yield curve continues to pose a headwind to adding duration at longer-dated tenors. In the event issuance fears come to fruition, a bear steepening would drive losses in those maturities. Should the economy enter recession, that has historically led to a bull steepening of the curve, in which the front-end rallies more than the back-end.

Recessions have also historically led to credit spread widening, but depending on the severity of the economic downturn, that risk may be worth bearing for additional yield in the highest quality credits. A potentially more interesting option to pick up yield while playing a bit more defense is to buy agency mortgages, which yield more than treasuries but are much more highly correlated to risk-free government bonds than investment grade credit.

PRIVATE CREDIT

Private credit markets have undergone tremendous growth. A nascent asset class at the end of the Global Financial Crisis, it is now roughly $2 trillion in size. This growth has been supported by strong demand from borrowers as traditional sources of debt financing have retrenched amid increased regulation. Simultaneously, investors have been willing suppliers of capital as they seek stable and uncorrelated returns, and are perhaps not as concerned as one should be about the risks associated with a lack of regulation and use of leverage in the asset class.

While investors continue to tout the merits of private credit, one must proceed with caution. The IMF recently published a counter-narrative highlighting how private credit is less regulated and more opaque compared to bank lending or the broadly syndicated loan market. Skeptics argue that as private debt becomes a larger, more interconnected component of global capital markets, the greater the probability it triggers a systemic shock.

Like all investments, pursuing the right strategies and opportunities within those makes all the difference. Investors can look beyond the $2 trillion corporate direct lending market that is most often cited and includes the multi-trillion-dollar asset based finance market, select cash-flowing real asset strategies, as well as other esoteric strategies. Some areas of interest have been on the most underfinanced segments of the market – where a lack of capital inflow keeps spreads and yields elevated and lending standards high. This helps to avoid many of the risks associated with exuberant growth.

Preferred investment themes have remained consistent over the past 12 months. In terms of corporate-based strategies, there is a preference for lower middle market, non-sponsored universe of investment opportunities vs. the more commoditized upper middle market sponsor-backed lending. Although asset based finance has seen a surge of interest more recently, there are still down-market opportunities – under the radar of the new entrants – structured through bankruptcy-remote facilities that support strong controls and oversight. Moreover, some asset-based lending opportunities have emerged in response to the IRA and CHIPS Act in less-trafficked market segments.