STICKING A SOFT LANDING

When the Federal Reserve kicked off monetary easing with a big 50-point cut last week, few expected another bonus for markets to be announced by China's central bank a week later. Even more surprisingly, China's Politburo followed up on Thursday with strong support for the People's Bank of China (PBoC) package of monetary measures and a hint that fiscal policy could finally be used to reinforce growth. Some cash handouts to the poor were ordered as a matter of urgency, to help spending in the upcoming national holiday.

Markets loved the moves in China. But the Fed's action matters more. That is in part because of the dominant global role of the US economy, and in part because doubts remain about China's ability to sustain the domestic-led growth needed to exert a positive impact on the world economy. Among emerging markets, a lot of money is still on India.

By the end of the week, US equities were up 0.6% while bond markets were flat. Global equities as a whole were up 1.5%. Emerging markets were the standout performer, rising more than 6.0% - about half of which was attributable to China.

WIDENING WAR?

It is almost a year since the October 7 brutal terrorist attack on Israel by Hamas. Hopes of an agreement to end the ensuing deadly and destructive conflict in Gaza and allow release of all the hostages taken by Hamas have been repeatedly dashed. The US Administration's entreaties to end the conflict have failed but, until now, the fear that the war would spill over beyond Gaza had not been realized. No longer. Israel has now stepped up attacks deep into Lebanon, including bombing parts of the capital Beirut.

At the UN General Assembly in New York this week, President Biden called for a ceasefire and warned of the danger of a broader regional war. So far, Prime Minister Netanyahu has insisted that Hezbollah must be destroyed, as an Iran proxy.

After months of tit-for-tat rocket attacks begun by the Iran-backed Hezbollah in Lebanon in "solidarity" with Hamas in Gaza. Israel's escalation began with extraordinary simultaneous explosions of pagers and radios used by Hezbollah to communicate. There is wide domestic support in Israel for the government's action, given the disruption to the lives of the 70,000 Israelis in the border region who have been forced to evacuate their homes by Hezbollah rockets.

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Much of the world is watching for the outcome of the US election, in little more than a month, to see how the world's greatest military power will approach this conflict, and other global challenges. Uncertainty about US foreign policy is at a high point, given the policy gulf between the two candidates and the closeness of the election. This is also casting a shadow over the war in Europe where Ukraine has pushed into a sliver of Russian territory but is faced with Russian advances elsewhere and renewed bombing of energy facilities and other civilian areas.

THE FED LANDS THE PLANE

Continued evidence of strong US growth through the second quarter, still low unemployment and declining inflation demonstrate that the soft landing once seen as elusive is likely underway.

If so, then hats off to the Fed. Critics of the slow reaction to the pandemic wave of inflation of 2021/22 may have been surprised by the forceful action since. This, together with the inflation-fighting credibility that had been built up earlier, combined to bring down inflation while avoiding recession and costly job losses. Most observers a year ago ruled out such a benign outcome.

Friday's news that August inflation dropped to 0.1% MoM on the Fed's preferred PCE measure reinforced expectations of further rate cuts in November and December, as signaled by the Fed's policy making committee in the Summary of Economic Projections (SEP) released on September 18. Lower rates in the US are helping to ease strains in emerging markets as well (see below).

The Fed has another six weeks to decide whether to revert to 25 basis point rate cuts at its next meeting in early November or to cut by another 50 basis points. Next week's labor market reports will be a useful guide, with news on job openings, unemployment and payrolls in September. The central bank will have another month's labor market data– for October– before the November meeting, as well as the September consumer price inflation report.

Fed officials' comments since the September 18 rate cut have shown a broad consensus that the economy remains solid but the time is right to move rates back to neutral lest monetary tightness tips the economy into recession. The one dissenter in the meeting, Governor Michelle Bowman, supported a cut, but a smaller one. She cautioned that inflation was still a concern. The Paris-based OECD experts would not agree. Their latest forecasts, released on September 25, project US inflation of 1.8% next year – below the 2% price stability goal.

A bigger question for policymakers – and investors – than the size of the November move is just how to calibrate a neutral stance in today's economy. If the economy continues its recent strong performance, interest rates that balance the Fed's dual mandate are likely to be higher than in the pre-pandemic period. But guiding the economy to that point will require as much skill – and luck – as achieving a soft landing.

TOO SOFT IN EUROPE

Americans are still mostly unhappy about economic developments here since the pandemic. But in Europe, the picture is worse. In Germany, the Ifo Institute has just moved to project a slight decline in GDP this year rather than the slight increase forecast six months ago. In France, where a government has only just been formed after elections this summer, concerns about debt and deficits has now pushed spreads on government bonds to 80 basis points over German bunds, higher than in Spain for the first time since 2007.

CHINA BOOST –BUT WILL IT BE ENOUGH?

China's leadership demonstrated this week that it understands the need for a shift in economic policy to boost flagging growth. The latest data show GDP falling short of the official 5% growth target. PBoC steps to boost credit, support the property market and shore up the stock market caused a wave of buying early this week. Monetary measures alone cannot address China's underlying weakness in domestic demand. So a further unexpected announcement later in the week from the Politburo suggested that fiscal policy would also be used was important in fueling market enthusiasm.

It is now clear that President Xi and colleagues urgently want to improve consumer confidence and shore up the property market that is at the heart of the weakness in the economy. But serious doubts remain about whether they will be able and willing to take measures on the scale needed to boost sustainable domestic-led growth. Measures to boost credit will only help if demand for credit and housing rises. So far, China's economic growth still depends on exports to the rest of the world – exports, often heavily subsidized, that other countries are becoming less happy about accepting.

EQUITIES

Equity markets shifted squarely into risk-on mode in the days leading up to the Fed's rate cut. Momentum, growth, and large-cap account for the leading market factors so far this month with AI and technology continuing to retrace some of their July losses. However, other areas of the market have participated much more fully in recent days. Cyclical sectors, in particular consumer discretionary, materials, and industrials, have helped lead the way.

While nobody wants to let a good rally go to waste and a meaningful correction looks less likely in the face of a resilient economy and loosening monetary conditions, investors must be mindful of where they deploy incremental risk. The S&P 500 at 21.4x forward consensus earnings remains above its 5-year average of 19.5x and 10-year average of 18.0x. Much of this premium can be traced to excitement over AI and technology's high representation in the S&P 500 – nearly a third of it now. While the sector remains promising, the margin of safety is not nearly as wide as it was a year or more ago.

Cyclicals, which have been sitting under a recession cloud, may be a more interesting place to look for value. Housing, for instance, has been hampered by mortgage rates, which have been high but are now heading down. The 30-year has fallen from its peak of 7.5% and is now approaching 6%. It will take a while before mortgage rates come down enough to convince homeowners sitting on 3% or lower mortgages to give them up and move, but improved forecasts will lead related stocks to re-rate sooner.

The standout story in equity markets (and other assets; more below) the past few days has been China. The onslaught of monetary and fiscal policy efforts detailed above have sent MSCI China up over 15% this week, its best weekly gain since 2011. MSCI China is now up roughly 20% YTD, bringing it inline with US equities and ahead of many global markets. The sustainability of the rally is undoubtedly in question – we have seen several strong moves higher in recent years – that are unable to sustain gains in the absence of foreign interest. To that end, it is worth acknowledging how lean the positioning was heading into this rally. According to prime brokerage data from Goldman Sachs, mutual funds globally in aggregate have 5.1% allocation in Chinese equities as of end-August, which represents 1st percentile over the past decade; on asset-weighted basis, active mutual fund mandates remain underweight Chinese equities by more than three percentage points vs. benchmark. Hedge funds allocated less than 7.0% in Chinese equities before the recent rally, which is around five-year low.

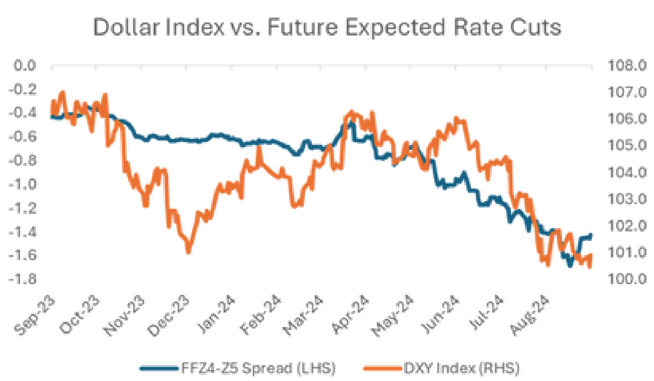
FIXED INCOME

We wrote in our last letter how fixed income assets had performed in descending order of quality, with the exception of triple-C rated bonds. Since the Fed meeting last week that has reversed with lower quality names outperforming in the US – triple-C's still lead the pack. That risk on move and weakening dollar (discussed in further detail below) have conspired to boost local-currency EM debt. Those bonds are +1.5% over the past eight days, bringing their MTD return to +3.5%. While Asia is the top contributing region, the performance is broader based than just a boost from Chinese bonds driven by falling rates: Thailand, Malaysia, and Indonesia all performed better than China for the month.

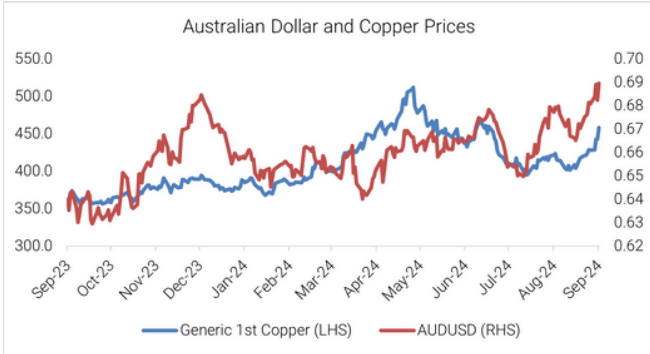
In rates, it is worth briefly discussing the moves in the US yield curve post Fed meeting. Following the cut, front-end rates, particularly in the very front-end (less than two years) have fallen, as one might expect. Rates from the five-year point out have backed up approximately 10-20 basis points. A lot of investors are wondering why the curve has reacted this way and what the bond market is indicating as a result. We plan to explore this in more detail in our upcoming quarterly letter, but in general it would seem that the bond market is recalibrating the risk of a recession (soft landing more likely, on the margin) following strong performance from duration thus far in the quarter.

CURRENCIES

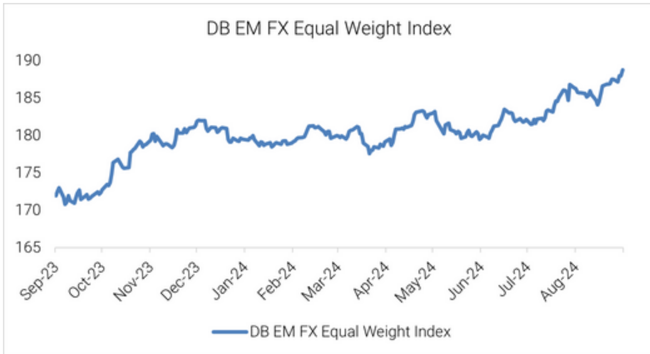
Since the weak US payrolls data on August 2nd, the dollar has continued its sell off versus other major currencies, particularly against cyclical currencies such as the euro, Australian dollar, and Norwegian Krone. One possible driver is the rapid increase in market expectations of Fed rate cuts, as seen in the chart below. This spread has narrowed in recent days while the dollar has been choppy, potentially indicating a temporary bottom in the US currency.



Another reason the Australian dollar has continued to strengthen against the greenback is Australia's exposure to China – especially as an exporter of key commodities. Optimism over Chinese stimulus has also had a meaningful impact on the Aussie. emerging currencies are also getting a boost from stimulus optimism. The asset class was initially supported solely by high real rate differentials with the US. In addition, countries like Chile, Brazil and South Africa export industrial commodities.

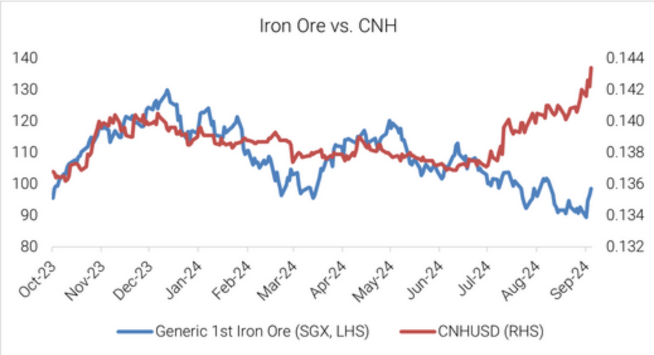


One market in which the dollar has started to gain its footing again is Japan. The dollar has reversed much of its recently lost ground against the Japanese yen, recovering to 143 from its local lows below 140. Much of this may be attributed to a lack of policy direction from the Bank of Japan following its surprising second rate-hike in late July, along with a sell off in longer-term US Treasuries and a steepening in the curve.



COMMODITIES

In recent weeks commodity markets have been dominated by two trends. First, in industrial metals, prices have risen significantly following the PBoC's stimulus measures detailed throughout the letter. The hope that this latest round will finally spur long-term demand for new construction and continued growth in EV production has most notably buoyed copper and iron ore prices.



While industrial commodities have surged in recent days, oil prices have been considerably more choppy owing to an array of conflicting factors. Potential Asian growth acceleration and rising tensions in the Middle East have at times worked to keep prices elevated. However, Saudi Arabia's willingness to unwind recent production cuts in order to regain market share weighed heavily on prices. By the end of the week Brent prices were 4% lower, bringing month-to-date losses to minus 7%.