Investors and the Fed – what's in the balance?

September 2024

- The US Federal Reserve looks set to cut interest rates at its meeting on 18 September on the back of lower inflation and a slowing US economy.
- Despite expectations of a soft landing, some investors are increasingly concerned this may be too little too late, increasing the chances of a recession.
- While a soft landing remains Impax's base case, market volatility has picked up and market breadth has improved, benefiting most Impax strategies.

What is the Fed looking at?

At the time of writing, the US Federal Reserve (Fed) is expected to make one 25 basis point cut when it meets on 18 September. Fed funds futures are pricing a further three cuts to follow by the end of the year.[2] The question on investors' minds: is this a soft landing or the start of a recession?

The debate follows several months of inflation trending downwards, with the Consumer Price Index (CPI) reaching 2.5% on 11 September. Falling energy prices account for much of this, and while housing remains a significant contributor, even this is slowing year-on-year.[2] The Fed's preferred measure of inflation, the Personal Consumption Expenditure Price Index, is similarly declining, defying expectations of a slight uptick in July at 2.6%.[3]

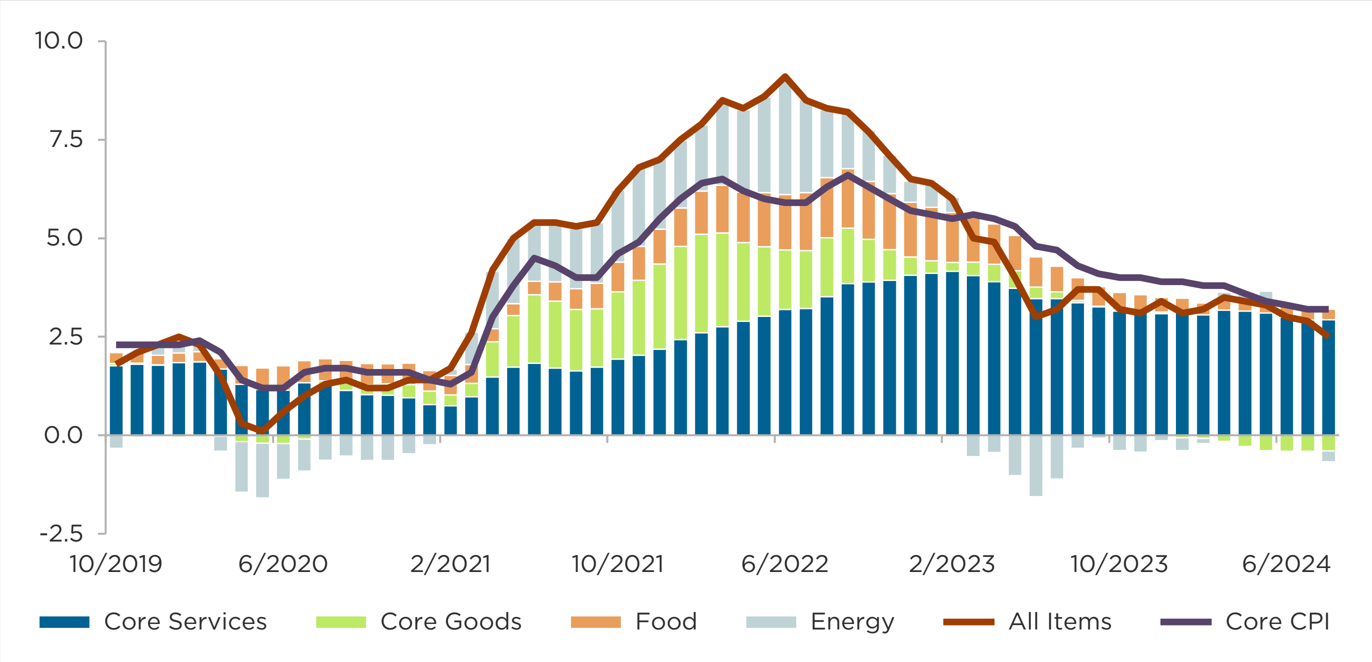
Employment data is also weakening from a strong base. August non-farm payroll data showed the US economy adding 142,000 jobs, below consensus forecasts of 160,000. While these numbers were higher than the downwardly revised 89,000 jobs created in July, 4.2% total unemployment is meaningfully higher than the 3.7% recorded at the start of the year.[4] With job openings normalized to pre-pandemic levels, consumer sentiment, particularly amongst the less affluent, is not as strong as it once was.

However, this picture is complicated by the number of people entering the workforce. The US labour force participation rate for people aged 25 to 54 recently surpassed pre-pandemic levels at 80.9%, just 1% shy of the 30-year high.[5] At the same time, annualised US GDP growth has been revised up to 3.0% in Q2, driven by robust consumer spending. It is this dynamic which prompted Claudia Sahm to doubt the conclusions of her eponymous recession indicator.[6]

1 "Accredited investor" within the meaning of OSC Rule 45-501, Canada.
2 Bloomberg as of 10 September 2024
3 Bloomberg as of September 2024
4 Reuters: Unemployment falls, suggests orderly US labor-market slowdown
5 Bureau of Labor Statistics, August 2024
6 Sahm C., August 2024: My Recession Rule Was Meant To Be Broken, Bloomberg

Contributions to US CPI (% year-on-year)

October 2019 – August 2024



Source: Bloomberg, as of 12 September, 2024.

How are markets responding?

Equity markets evolving

Since July, equity markets have struck a markedly different tone from preceding months. Market breadth has improved, with cheaper, more defensive stocks such as Real Estate and Utilities as the biggest winners to date this quarter. IT stocks have fallen, as have the more economically sensitive Consumer Discretionary and Energy sectors. Volatility has also risen, as measured by the VIX Index, which in August reached its highest level since March 2020.[7]

Some of this reflects uncertainty around the US economy. Expectations of a rate cut initially drove a sharp rotation into mid and small-cap stocks (which typically benefit from a lower cost of debt), before fears of a recession set them back to already heavily discounted levels. Indeed, the extent of possible rate cuts is now seen by some investors as confirming the recession diagnosis.

However, mega-cap technology companies had also powered markets upward for over 18 months. The Magnificent Seven accounted for approximately half of all equity returns in 2023.[8,9] Elevated expectations and forward multiples meant that even 120% annual revenue growth from Nvidia – AI's poster child – was not enough to stop a pullback. With the prospect of lower rates and a weaker economy, investors are now turning to stocks with stable earnings growth, on lower valuations.

Fixed income markets resilient

Credit markets are very well priced and have remained remarkably resilient despite increased interest rate volatility and modestly higher spreads. The US Treasury Yield Curve has recently disinverted and bull steepened. The policy-sensitive 2-year note has risen 29 basis points during the first half of September to 3.64%, which suggests that investors are pricing in approximately 100 basis points of cuts in the near term.[10]

Meanwhile, companies have continued to take advantage of market access to address looming 'walls' of debt maturing in a more supportive interest rate environment. Investors have easily absorbed this new supply with oversubscribed books resulting in tightening new issue concessions. As a result, idiosyncratic issues aside, high-yield default risks have fallen.

7 Pound, J., August 2024: Wall Street's 'fear gauge' the VIX rises to highest since 2020
8 The Magnificent Seven is a common name for a group of companies in the US stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA and Tesla.
9 Bloomberg, 31 December 2023
10 Bloomberg, 11 September 2024

Although we believe that most investment grade and high yield sectors seem to be at or approaching the peak of the credit cycle, fixed income markets as a whole are not pricing in a hard landing scenario. Sectors to watch are those that are consumer dependent and discretionary in nature as they are flashing early recessionary warning signs.

Bonds from high-yield rated retail companies have been supported by a still-employed US consumer that is willing to spend. However, recent results and management commentary have skewed negative with the pullback on discretionary spending. In this environment, larger, well-capitalized high yield consumer credits that are perceived as value plays are also expected to fare better. Investment grade consumer products companies, despite facing stagnant EBITDA margins and free cash flow generation, continue to be supported by fundamentals that remain fair or stable.[11]

From a credit rating perspective, higher quality investment grade companies have fared better quarter-to-date, suggesting investors are positioning for imminent Fed cuts and a slowdown in the US economy. On the other end of the spectrum, high yield companies rated CCC and below have benefitted from falling interest rates and have outperformed with tightening spreads, suggesting high yield investors are still comfortable taking on credit risk.

Implications for investors

Markets are looking for evidence that rate cuts will imply a soft landing, rather than a harsh recession. Gradual rate cuts and a weaker – but not contracting – economy remain Impax's base case. Even so, variable macro data, equity market concentration and political uncertainty mean financial markets may have a bumpy ride on the way.

An economic slowdown is already weighing on the shares of more cyclical stocks, as well as mid- and small-cap stocks, and these factors have presented headwinds in 2023 and this year to date. Within Impax portfolios therefore, we have been focusing our attention on higher quality names where valuations sufficiently account for such an outcome.

By contrast, falling rates could boost growth stocks and stable, predictable 'bond proxies' like infrastructure stocks. Impax has exposure to both, and our focus on the transition to a more sustainable economy means performance in some names was challenged not only by higher rates, but also by post-pandemic normalisation. For example, the typically defensive growth areas of natural ingredients and life sciences tools faced lengthy destocking cycles. With these issues behind them, the stocks are delivering robust earnings growth and share price gains, even before rates are cut.

Equities

We believe a continued improvement in market breadth would further benefit Impax equity portfolios. Healthcare's recent rally for example, has reversed a tailwind for several strategies while the shift to more defensive utilities stocks has boosted funds with a focus on renewables and independent power producers. Even so, valuations remain attractive, particularly in areas like alternative energy where a possible second term for Donald Trump is more than offsetting long-term structural demand growth. Amidst further potential volatility, we remain attuned to long-term opportunities in quality businesses that trade on reasonable valuations.

Fixed income

Within our fixed income strategies, security selection remains key at this point in the market cycle, and our portfolios are positioned with an up in quality bias. Notwithstanding the recent spread widening, spreads remain very tight relative to history, leaving little cushion to absorb idiosyncratic credit events. Higher quality issuers are still providing sufficient yield without the need to dip further down the credit curve.

In the event of a more material slowdown than forecast, the flight to quality will benefit those issuers as well. We have trimmed and, in many cases, exited credits further down the ratings spectrum, particularly CCCs that are facing near-term maturities, and more challenged single B rated names where the opportunity does not outweigh the risks.

11 EBITDA is an abbreviation for earnings before interest, taxes and depreciation.

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