Transient – Market Commentary

The month saw a strong rally driven by falling US Treasury yields. The S&P 500 and the Nasdaq rose by +9.1% and +10.8% respectively, pushing global markets higher. While the US represents approximately 70% of the MSCI World, we note that markets such as Belgium, Spain and Switzerland rose by +19.0%, +21.8% and +19.8%, respectively, reflecting not only sensitivity to falling rates but also the degree of negative sentiment prior.

As might be expected Growth outperformed Value +11.2% to +7.4%, and Developed Markets, measured by the MSCI World, outperformed Emerging Markets +9.4% to +8.0%.

Within Emerging Markets, South Africa underperformed mildly at +7.4% in USD terms, we think primarily because the global rally pushed rand hedge shares higher while locally exposed companies lagged.

The various market returns for November are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for November 2023*

	Nov-23	YTD 2023
FTSE/JSE ALSI (ZAR)	8.6%	7.1%
FTSE/JSE ALSI (USD)	7.4%	-3.8%
MSCI World	9.4%	18.0%
MSCI EM	8.0%	5.7%
MSCI Value	7.4%	5.8%
MSCI Growth	11.2%	31.2%
S&P 500	9.1%	20.2%
Nasdaq 100	10.8%	47.0%

*Total return indices, Source: Factset

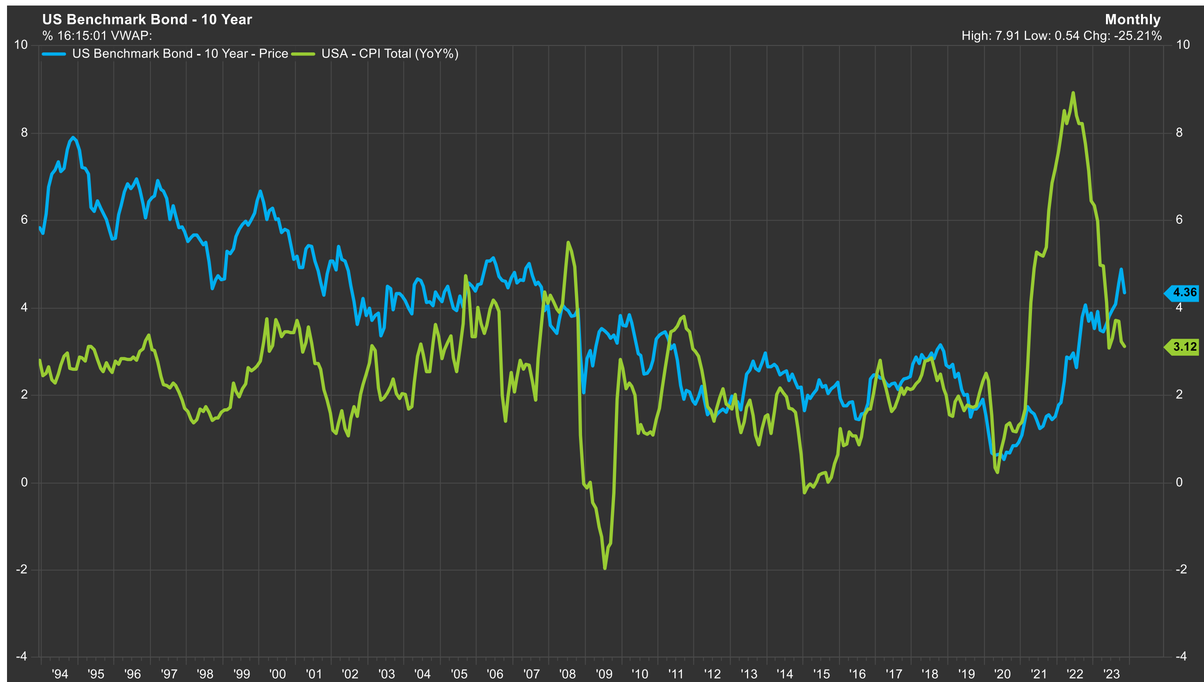
The inflation surge appears transient after all and with it the movement in interest rates to come. Chart 1 below sets out US CPI vs the US 10-year Treasury yield. On current trends the inflation episode would have lasted 3 years from its initial Covid-related surge in 2021 (US monetary policy increased money supply sharply in 2020), peak in 2022, and decline in 2023. US long interest rates have followed, causing a sharp market decline in 2022, and after a short pullback reached nearly 5% by October 2023. We think the chances of these declining in 2024 is high, and have already done so since October. The 10-year yield at the time of writing in December is below 4%.

The most recent pullback in rates appears to have caused a strong market rally in November, with US markets rising by approximately +10% with several European markets rising +20% in a month.

Memories are short in markets, or rather, the latest news always dominates and market participants move on quickly. This dynamic is amplified in the age of social media with multiple commentaries from multiple sources.

It seems not long ago, the beginning of 2022 to be precise, when (primarily long-suffering Value) managers were boldly declaring inflation to have apparently irreversibly returned, interest rates about to irreversibly rise, and an age of ever-declining interest rates causing much Value pain over many years to have irreversibly ended causing some pain, in turn, to Growth stocks. This all came true, for a while.

Chart 1. US CPI vs US 10-year Treasury yield



Source: Factset

Where to next?

While wary of making predictions we try to assess where we are to try to make sense of what forces might drive markets in the new year.

So where are we? Inflation has fallen, but not yet within target bands and some risks remain, discussed further below. Short interest rates are still high but likely at a peak, according to the Fed Chair himself, also discussed below. Long interest rates are therefore likely at a peak too.

Equity markets are driven by interest rates and profits. The Fed Chair's comments in early December appeared to explicitly set expectations of rate cuts for 2024 (somewhat walked back by FOMC colleagues the following week, confusing the message). So anticipating the interest rate move appears relatively easy – short rates can be expected to fall. If inflation continues on its current trajectory and/or an economic slowdown becomes apparent, long bond yields can be expected to fall as well, all of which is supportive of equity prices. We saw just how supportive in November, and again in early December, on Chairman Powell's comments.

There appears to be some debate in the market whether the short rate might start to fall in the first or second half of 2024. This is related to the profits and economic slowdown issue discussed next.

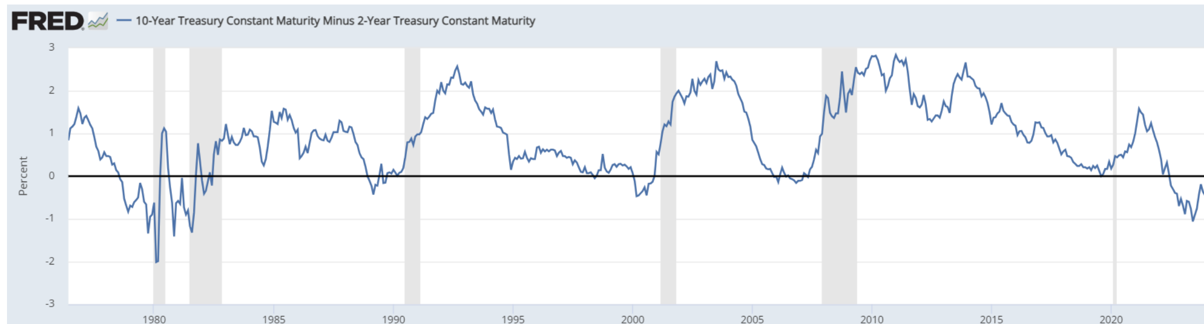
What about profits?

A key factor will be the much-anticipated slowdown. What are the chances of a slowdown?

We think very likely. The persisting yield curve inversion drives many commentators' expectations of recession. We point out that we think this is somewhat circular in that bond yields are a reflection of market views i.e. it makes no sense to say we expect a recession because long rates are lower than short rates. Long rates lower than short rates

represent the market telling us it most likely expects a recession, and the market has a good track record in the US in anticipating recessions, per Chart 2 below.

Chart 2. Yield curve inversions and recessions



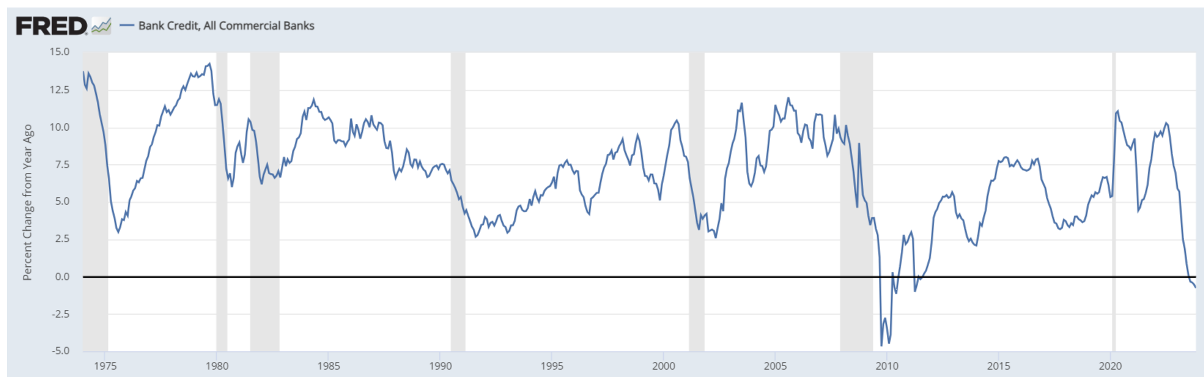
Source: St Louis Fed, FRED

Note the inversion typically ends before the onset of recession.

The single most important indicator, however, and in our view, is the negative bank lending growth currently observed in the US. Up to 90% or more of spending is in the form of credit, therefore a contraction in credit growth is an indicator of a contraction in spending, and a good guide to the likely trajectory of the economy. It appears the Fed has already pivoted (at least in its thinking) and this could likely be the reason.

The contraction in US bank lending is presented in Chart 3 below.

Chart 3. Percentage change in bank credit



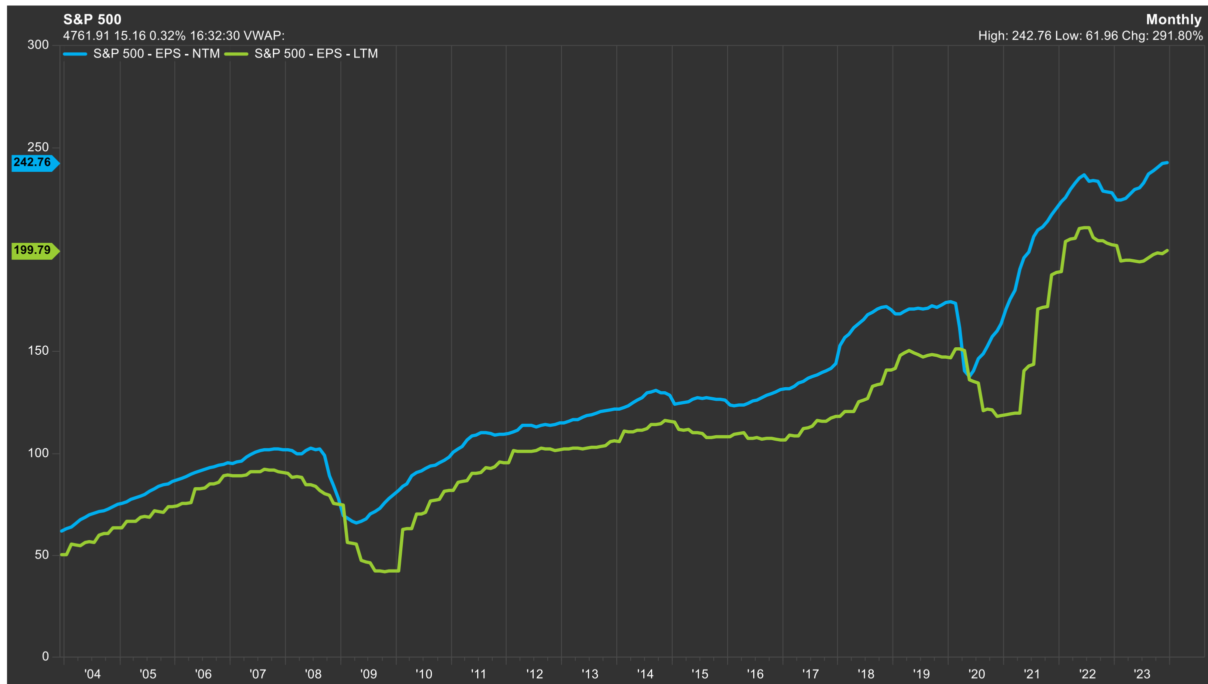
Source: St Louis Fed, FRED

But analysts are expecting profit growth

Chart 4 below sets out 12-month trailing earnings per share ("EPS") for the S&P 500 and 12-month forward EPS estimates. We have presented this chart before. The reason we do so again is to highlight the fact that while EPS have been falling for most of 2023, analysts expect EPS growth in 2024.

We also present Chart 4 to highlight that in times of recession, analysts equally seem surprised by the onset of recession and rapidly downgrade their EPS estimates. Admittedly the sample size is not large, but at the same time there is no reason to believe that the same will not repeat should it reoccur.

Chart 4. Trailing 12-month EPS vs 12-month forward EPS

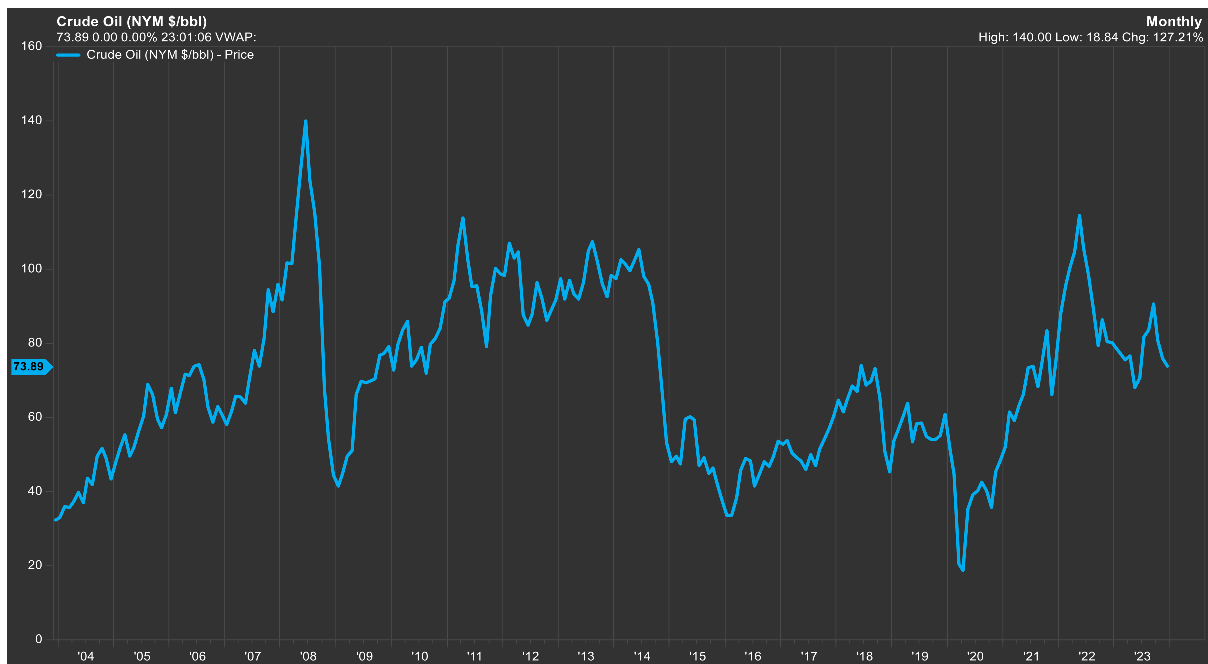


Source: Factset

Are there any risks to the inflation view?

We think the oil price is the key variable. An oil price increase would put the inflation numbers under pressure. The oil price, however, also appears to be pointing to a downturn, currently at USD74 from a high of USD115 in 2022. This is presented in Chart 5 below.

Chart 5. Oil price



Source: Factset

M1 CAPITAL
INVESTMENT MANAGEMENT

Summary

In summary it is possible the Fed is already pivoting in response to US economic data. Should there be a downturn we can expect a rapid decline in profits and probably equally rapid cuts to interest rates. While the interest rate cuts will be supportive the profit side of the equation means equity prices will likely be under pressure. We expect 2024 to be volatile.