



HOUSE VIEW

FIXED INCOME AND THE INFLUENCE OF THE MOON

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From the earliest of times, humankind has sought to find answers looking towards the Moon.

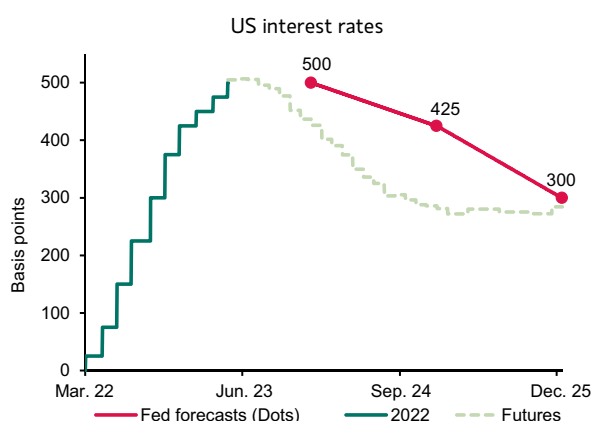
The Moon is a fascinating regnant of our night sky. It influences our lives in unexpected ways. The Moon has effects on human behaviour, on the environment, on the tides of the sea, and on our farmers' harvests. It is best to sow crops that grow tall under a crescent moon, which encourages the sap to rise from the roots to the crown of the plant. Under a waning moon, however, you should take the chance to remove dead flower heads and move plants around your plot.

Last week, as it happens, just as the Federal Reserve held its monthly meeting, the sky was graced with a total lunar eclipse, or "blood moon". For several hours, the Moon took on a deep red colour. This phenomenon occurs when the Moon travels across the shadow cast by our own planet, the Earth, and for that short time accepts the mantle of an eclipse that we, our world, have cast upon it. And, meanwhile, in the markets, we sit and wait for what we believe will be the latest hike in interest rates within our current economic cycle. The Fed, having driven up the price of money to 5% and even 5.25% – higher than anything we had seen since 2007 – then shifted in its rhetoric.

Its announcement was not especially clear one way or another. The Fed continued to say that in future decisions they will move "meeting by meeting, driven by the data." However, they omitted from their communiqué the so far traditional caveat that they "might" have to undertake "some" additional tightening. This leads us to suspect that they are now feeling the hangover of an interest hike of 500 basis points over just 18 months – the swiftest tightening since the 1980s. From now on, we all need to watch when and where the economy will be hurt by such a hawkish monetary policy. We shall have to look at how quickly inflation slows down in the service sector.

We could even wonder whether a "Blood Moon" is some sort of sign among the mass of economic data. Well, is it, or is it not? Whether or not the Moon has anything to do with it, we believe the signs are clear. If you just look at the estimates published by the Fed, the US economy will very soon have to struggle with the effects of real interest rates of 2%. If we subtract the Fed's own expectation of 3.3% inflation over 12 months, that 2% figure is the result, and we haven't seen anything as high as that since 2006. Moreover, regional US banks have been doing quite badly, which means credit terms will become tighter.

1. THE CURVE IS PRICING IN DEEPER CUTS THAN THE FED ITSELF



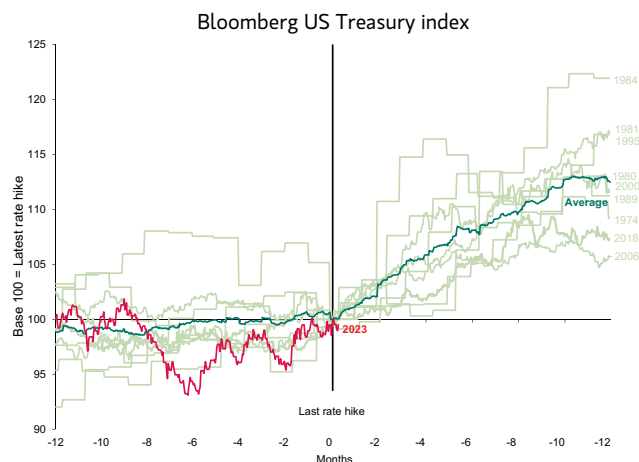
It seems obvious that, as and when the economy weakens, rates will have to be lowered to stimulate activity. So one can only be surprised by the fact that expectations in the United States are shooting off in quite different directions: The Federal Reserve insists it will keep rates at the present level, at least until the end of this year; the market, however, is expecting a lowering of rates that will be both sharp and early. Everyone is assuming a first cut in September and, by January, a cumulative reduction of more than 100 basis points.

Historically, after the "pause", the first cuts usually occur about five months later. This is certainly consistent with the market expectation of a rate cut in September. However, we think that rate cuts of this sort are the prelude of recession. Historically, economic contraction arrives 2 to 14 months afterwards. We are therefore cautious about equities, given the macroeconomic uncertainty and the limited potential for earnings growth: the S&P 500 is expected to fall by -0.3% by year-end 2023.

However, just as we have learned that the phases of the Moon affect our harvests, it likewise seems a fact that, after a Fed pause, Treasury bills always bring a positive return. History has shown that it is precisely when official interest rates reach their peak the right idea is to lengthen the tenor of your portfolio and cut down on the risk of reinvesting the proceeds of maturing bonds, which you would only be able to do at a lower rate – especially government and low-risk debt, which is what you use to navigate uncertain periods like this one.

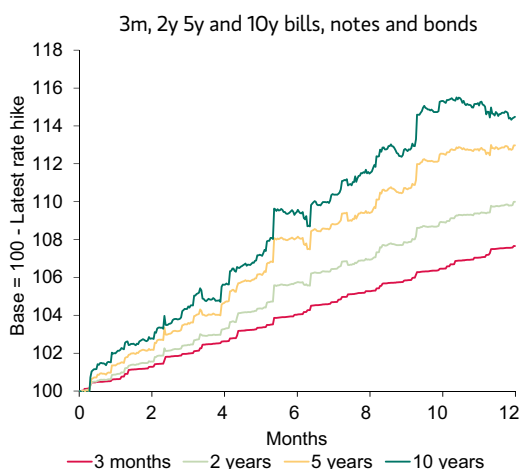
2. PERFORMANCE OF T-BILLS AFTER FED PAUSE

Sources: Bloomberg US Treasury index

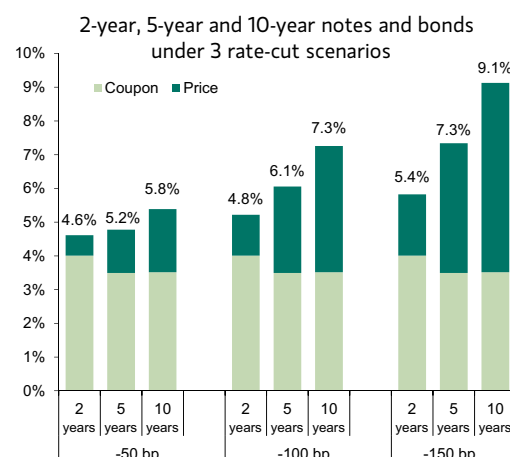


At first glance, since the fixed income curve has inverted, the idea is unappetising. The market is offering higher coupons on short-term debt than longer term bonds. For instance, the two-year IRR is 3.9%, versus 3.5% offered by the 10-year Treasury note. However, as shown in Figure 3, the “tenor effect” will eventually feed through, driving up the attractiveness of longer-term debt. Over the following months, rates will come down. Longer-term debt will therefore go up in value and gain weight through the coupon effect across total investments. See Figure 4.

3. HISTORICAL AVERAGE RETURN ON US TREASURY BONDS



4. SENSITIVITY TO POTENTIAL RATE CUTS



By way of contrast to the US government debt picture, in Europe there is still time to lengthen tenor. The ECB has made clear that official interest rates will continue to rise. In our view, there are still two hikes to come until we reach the terminal deposit rate of 3.75%. This situation will not come about until July/September.

Last week's Fed meeting implies that fixed income is now in a crescent moon. This is the period when farmers improve their soil and sow the field in hopes of a good harvest. And it is now that asset managers need to lengthen the tenor of their portfolios. From now on, developments may not be as linear as we have seen in the past. However, lengthening tenor at an uncertain moment, like the present, has paid off in every cycle over the past 50 years. Patience pays off. And here is the adage: in the words of Rousseau, patience is bitter, but its fruit is sweet.

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