

Someone is (Probably) Wrong

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The equity market is pricing in economic resilience, but the bond market is not. The only way to reconcile this cross-asset pricing is a rapid fall in core inflation, which is highly unlikely.

After the recovery from the October low, the S&P 500 is back trading close to 19x earnings. While this is only slightly above the 30-year average of around 18x, it is certainly not pricing in pronounced economic weakness or the fall in corporate earnings that would accompany it.

In contrast, the US bond market is pricing in a series of interest rate cuts starting this summer. There are three reasons why we might see interest rate cuts later this year. Firstly, the economy goes into recession. Secondly, some sort of financial accident that leads to rates being lowered on financial stability grounds. Lastly, core inflation falls very quickly back to target.

The first two reasons would be bearish for the equity market, whereas the last one would be supportive.

Core inflation should fall over the next six months as lower rental inflation feeds through to the official rent statistics. This is due to the well-known time lag for tenant leases to reset. We have just started to see this come through in the March inflation report.

However, core services ex housing inflation is still tracking around 0.4% month-over-month and goods prices have also continued their modest rebound over recent months. This backdrop is incompatible with the Fed's 2% inflation target. There is also evidence that companies are using lower input prices to rebuild margins, rather than passing on the savings to consumers.

Back in early 2019, the Federal Reserve did pause their rate hiking cycle before cutting rates later that year. This could be a potential scenario supporting the apparent discrepancy between bond and equity pricing. However, the inflation backdrop was very different as headline inflation was below 2%.

The current setup is similar to the start of this year. In January, the equity market was continuing the recovery from the October lows, while the bond market was pricing in interest rate cuts in the second half of this year. After a flurry of strong economic data in January and February the market quickly shifted to price out interest rate cuts. Bonds sold off and the 2-year Treasury touched a 15-year high of 5%.

The equity market was "right" and the bond market was "wrong". Strains in the banking system in March have since revived this disconnect.

It is important to note that the bond does not purely price the expectations for future interest rates. Some buyers of bonds are matching liabilities, hedging or making structural allocations rather than taking views on interest rates. However, if pricing moves too far from the expected path of interest rates then speculative investors will often take positions to exploit these discrepancies.



Furthermore, markets are priced based on a probability weighted average basis, not the most likely single outcome. It is therefore also possible to reconcile cross asset pricing by considering that in an environment where inflation is falling and economic risks are elevated, then interest rates being cut substantially is a higher probability than being raised substantially from here.

Traditional wisdom is that the bond market is “smarter” than the equity market. But as Buffett once quipped: “traditional wisdom is long on tradition and short on wisdom”. The shape of the yield curve has been assigned mythical powers of prediction, as inverted yield curves almost always proceed recessions. However, the bond market largely missed the 2022 inflation surge and only priced in three 25bps rate hikes at the start of last year, when we actually got 425bps.

It is quite possible that bonds and equities are both “wrong”. The expectation of easier monetary policy later this year has helped the equity market, with sectors such as Technology offsetting weakness in other sectors like Financials. If the Fed remains resolute in the fight against inflation and the bond market prices out rate cuts, this would probably put downward pressure on price-earnings ratios. This is what happened in February this year.

It is widely acknowledged that recession risks are elevated. The optimism earlier in the year has been tempered due to the likely tightening in credit conditions after the strains in the banking system. However, lower bond yields have helped support the equity market. The so called “soft landing”, where inflation comes down enough to warrant rate cuts without a recession, is still possible.

One thing the last three years has taught us is to expect surprises, but it is hard to escape the conclusion that financial markets are pricing interest rate cuts without the pain necessary to actually deliver them.

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