

Consensus is rarely optimal

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Last year, a late surge in the S&P 500 left market consensus expectations for annual returns of 5% in the dust. The index finished up over 25%. History has shown that some forecasts are more error-prone than others, and predicting annual market returns is one with a particularly inconsistent track record. As John Galbraith, a renowned economist, once said, “there are two kinds of forecasters: those who don’t know, and those who don’t know they don’t know.”

The market defied gloomy predictions for 2023 as it bounced back from a terrible 2022. The much-anticipated US recession, that Bloomberg consensus had predicted with absolute certainty, did not happen despite the tightening in financial conditions. One notable surprise of this economic cycle has been that both consumers and businesses have proven to be less sensitive to interest rates than in the past, particularly when compared to the financial crisis of 2008. The failures in the US regional banking system in March of last year have so far proven to be little more than a bump in the road.

Based on recent communications from the Federal Reserve, Bank of England and European Central Bank, interest rates are expected to be cut through 2024. The consensus is now entertaining the idea of a ‘soft landing’ - a successful slowing of the economy without causing significant collateral damage. One wonders though, if central banks are on track for a soft landing, why the market is pricing in so many rate cuts. Even if these cuts are fully realised, investors should remember that monetary policy works with long and variable lags, so the impact may not be immediate. Investors should perhaps be considering what could go wrong.

The US economy has continued to show steady above-trend economic growth and rapidly falling inflation. While in some sense this portrays a picture of an ideal economy, it also poses challenges for monetary policymakers who must decide how to respond to conflicting signals between activity data and prices. This scenario of robust growth and painless disinflation may go wrong in one of two ways: either the US economy falls into a recession or inflation proves more persistent than expected.

On the one hand, easier financial conditions, rising home prices, rebounding consumer sentiment, and a stabilisation in manufacturing activity have all amalgamated for near-term US growth prospects. However, the economy has continued to enjoy significant policy stimulus which largely explains the contrast between its strength and the weakness of other economies such as Europe, Britain, China and Japan. Any shift in policy may put this strength to a test. On the other hand, an unsustainably low savings rate is a key risk to the US economic outlook as consumers continue to draw down on their pandemic savings. This sets the stage for a new economic regime that may see inflation targets becoming more of a floor than a ceiling, and fiscal policy impacting inflation and interest rates.

Inflation has been trending towards target levels both in the US and the Eurozone. Thus far, inflation has fallen without higher interest rates crashing economies. However, the finishing line has not been reached and victory cannot be declared yet. The last mile is usually the hardest and there is plenty of scope for surprises. Although the 2% inflation target has almost been achieved in the US Personal Consumption Expenditure (PCE), the Consumer Price Index (CPI) is still running at 3-3.5% annualized over the past one, three and six months. There still remains an upside risk to inflation due to higher healthcare costs, rising container shipping costs, a rebound



in goods prices, and real wages. As a result, PCE inflation may converge up to CPI in the near term, instead of CPI converging down to PCE.

The latest data releases are forcing greater attention on important inflation dynamics, particularly on the stickiness of services inflation. Its deceleration is needed before some of the goods deflation runs out of steam. Policymakers want to see services ex-housing inflation moderating rapidly. This is what is called 'super core' inflation. It represents the stickiest component of the inflation basket which should move down for policy makers to declare victory. Apparently, this component of inflation re-accelerated from 3% late last year to 5.5% on a 6-month annualised basis last month.

The possibilities of an economic slowdown or an inflation relapse are creating dilemmas for central banks, making their actions even more difficult to predict. Keeping rates too high for too long can have long lasting effects on economic growth. Keeping rates steady while inflation is coming down implies rising real rates. Maintaining positive real rates for too long, especially at a time when most developed countries are facing growing levels of debt and surging interest rate payments, is unsustainable. Central bankers in the US, Europe and UK have already been pushing back on market expectations of interest rate cuts beginning sooner rather than later. The path to a painless soft landing remains challenging, with geopolitical tensions, regional conflicts and global trade disruptions becoming additional headwinds for policymakers.

One key takeaway from 2023 was that remaining fully invested for the long-term is paramount for investors. Time in the market outweighs trying to time the market, especially based on consensus views. As a final thought, with the increasingly unpredictable nature of market returns, forecasting the outlook is tougher than ever. The best approach in such an environment is a relentless focus on quality and well-thought through diversification across a broad range of asset classes and sectors. High-quality businesses will earn high returns, benefit from competitive moats, and have balance sheets that will sustain them in any economic conditions. Aligning quality with sensible diversification will help investors to succeed regardless of consensus views.

Sources: Bloomberg Economics

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