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While equities should remain a key component of long-term portfolios, CIO expects global stocks to deliver limited returns and exhibit high volatility over the remainder of the year. (ddp)

Focus shifts back to inflation

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Swift action by policymakers has stemmed fears of a wider systemic crisis in the US and Eurozone banking systems.

Amid ongoing concerns over profitability, the US KBW bank index remains 22% below the levels prior to the collapse of Silicon Valley Bank (SVB) but has stabilized, while the broader market has fully recovered—the S&P 500 is 1.5% above its pre-SVB level. On Thursday, the Federal Reserve's weekly balance sheet data also showed signs of stabilization. Discount window borrowing declined to USD 80bn from USD 110bn the previous week, and borrowing under the Bank Term Funding Program increased to USD 64bn from USD 54bn.

Markets moved quickly to price in central bank rate cuts in the wake of SVB's collapse. But more stable conditions in the financial system will allow central banks to refocus on the macroeconomic fundamentals, where inflation remains too high to allow an imminent shift to monetary easing:

Fighting inflation remains the Fed's priority. Speaking on Thursday, Minneapolis Fed President Neel Kashkari said that "the services part of the economy has not yet slowed down and… wage growth is still growing faster than what is consistent with our 2% inflation target." Richmond Fed President Tom Barkin highlighted that the FOMC was discussing a 50-basis-point hike just a few weeks ago, and said that "if inflation persists, we can react by raising rates further."

Core PCE inflation data is unlikely to change the Fed's mindset. Later today, the core PCE inflation data, the Fed's preferred measure of inflation, will be released. On a month-over-month basis, core PCE is expected to moderate in February to 0.4% from 0.6% in the prior month, based on the Bloomberg consensus, but the year-over-year rate is expected to remain unchanged at 4.7%.

Core Eurozone inflation remains stubbornly high. On the back of lower energy prices, Eurozone headline inflation dropped to 6.9% year-over-year in March from 8.5% in February, the largest decline over a month since 1991 when Eurostat started collecting data. But core CPI increased to 7.5% y/ y in March from 7.4% in February. The data is likely to keep pressure on the European Central Bank to continue raising rates. Ahead of the Eurozone data, market pricing for the

terminal ECB rate (based on overnight index swaps) increased by 11 basis points on Thursday to 3.44% after stronger-than-expected German inflation data.

ECB President Christine Lagarde said this month that officials "will be looking to see a sustained downward turn in underlying inflation measures to be confident that the inflation path will converge to our target in the medium term."

Overall, central banks remain concerned about stopping rate hikes given still-elevated inflation, but they also need to consider how to balance their battle with inflation with risks to growth and financial stability. Against this backdrop, we prefer high-quality fixed income relative to equities.

While equities should remain a key component of long-term portfolios, we expect global stocks to deliver limited returns and exhibit high volatility over the remainder of the year. Tactically, while it may be too soon to expect rate cuts, we see a higher probability that central bank hiking cycles will end sooner. We therefore think it's time to increase exposure to bonds, which we recently upgraded to most preferred. We see high-quality fixed income as attractive given decent yields and the potential for capital gains in the event of a deeper economic slowdown. Investors holding excess cash should consider opportunities to lock in today's yields within the asset class.

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