Monetary policy expectations are likely to remain a key market driver, which can lead both equities and bonds to move in tandem, as has been the case in recent months. (ddp)

Tightening fears increase ahead of Powell's testimony

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Stock markets ended close to flat on Monday. But beneath this uneventful outcome, investors continued to adjust to the prospect of higher interest rates for longer. Fed funds futures moved to price a new cycle high in rates of 5.48% by September, up 3 basis points on the day and from 4.8% at the start of February. That comes ahead of testimony to US lawmakers from Federal Reserve Chair Jerome Powell.

Meanwhile, the yield premium offered by 2-year US Treasuries over 10-year bonds—the yield curve inversion—reached its highest level since 1981 at 94 basis points. This inversion has historically pointed to market concern over the possibility of an approaching recession.

Rates were also a focus for investors in the Eurozone. Markets are now pricing more than 150 basis points of additional tightening from the European Central Bank by the end of 2023—the most hawkish outlook to date.

In our view, uncertainty about the trajectory for inflation, monetary policy, and economic growth is likely to keep markets volatile in the months ahead. Against this backdrop, we advise investors to consider the following investment strategies:

Diverging inflections mean we advocate diversifying beyond the US. We expect emerging market equities and early cyclical equity markets, such as Germany, to perform better than US equities. The US economy's resilience may raise the risk of a later, deeper recession as the Fed presses ahead with its efforts to combat inflation. By contrast, China appears poised for an upswing in growth as economic momentum picks up following the dismantling of COVID restrictions. The official PMIs for February were ahead of expectations, and the policy backdrop remains supportive. Domestic consumption is rebounding, and we expect it to support Chinese GDP growth of around 5% this year, as well as provide a positive catalyst for other emerging markets.

Value stocks, including the energy sector, should be relatively resilient if inflation remains stubborn. Value stocks have historically outperformed growth stocks when inflation is above 3% and in the 12 months following the final Fed rate hike of a cycle. Meanwhile tech, the largest growth sector, is likely to be hampered by a further slowdown in earnings growth due to a weaker enterprise outlook and slowing consumer demand, while valuations are demanding.

Risks to the US economic outlook mean we recommend select defensive exposure. We prefer the global consumer staples sector, where relative earnings momentum is positive and strengthening.

In fixed income, all-in yields remain appealing, particularly relative to opportunities in other asset classes. We like high grade, investment grade, and emerging market bonds, but retain a least preferred view on high yield corporate credit.

Monetary policy expectations are likely to remain a key market driver, which can lead both equities and bonds to move in tandem, as has been the case in recent months. This means that less-correlated hedge fund strategies such as macro, equity market neutral, and multi-strategy funds may continue to play an important role in helping diversify portfolios.

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